



seventh edition

Global Business Today

Charles W. L. Hill

University of Washington

 **McGraw-Hill
Irwin**



GLOBAL BUSINESS TODAY

Published by McGraw-Hill/Irwin, a business unit of The McGraw-Hill Companies, Inc., 1221 Avenue of the Americas, New York, NY, 10020. Copyright © 2011, 2009, 2008, 2006, 2004, 2001, 1998 by The McGraw-Hill Companies, Inc. All rights reserved. No part of this publication may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written consent of The McGraw-Hill Companies, Inc., including, but not limited to, in any network or other electronic storage or transmission, or broadcast for distance learning.

Some ancillaries, including electronic and print components, may not be available to customers outside the United States.

This book is printed on acid-free paper.

1 2 3 4 5 6 7 8 9 0 DOW/DOW 1 0 9 8 7 6 5 4 3 2 1 0

ISBN 978-0-07-813721-1

MHID 0-07-813721-7

Vice president and editor-in-chief: *Brent Gordon*

Publisher: *Paul Ducham*

Executive editor: *John Weimeister*

Director of development: *Ann Torbert*

Development editor: *Megan Richter*

Vice president and director of marketing: *Robin J. Zwettler*

Executive marketing manager: *Donielle Xu*

Marketing specialist: *Annie Ferro*

Vice president of editing, design, and production: *Sesha Bolisetty*

Senior project manager: *Bruce Gin*

Buyer II: *Debra R. Sylvester*

Designer: *Matt Diamond*

Senior photo research coordinator: *Jeremy Cheshareck*

Photo researcher: *Robin Sand*

Media project manager: *Jennifer Lohn*

Media project manager: *Joyce J. Chappetto*

Cover design: *Matt Diamond*

Interior design: *Matt Diamond*

Typeface: *10/12 Janson Text Roman*

Compositor: *Aptara®, Inc.*

Printer: *R. R. Donnelley*

Library of Congress Cataloging-in-Publication Data

Hill, Charles W. L.

Global business today / Charles W. L. Hill. — 7th ed.

p. cm.

Includes bibliographical references and index.

ISBN-13: 978-0-07-813721-1 (alk. paper)

ISBN-10: 0-07-813721-7 (alk. paper)

1. International business enterprises—Management. 2. International trade.

3. Investments, Foreign. 4. Capital market. I. Title.

HD62.4.H548 2011

658'.049—dc22

2010017957



For June and Mike Hill, my parents



about the author

Charles W. L. Hill is the Hughes M. Blake Professor of International Business at the School of Business, University of Washington. Professor Hill received his Ph.D. in industrial organization economics in 1983 from the University of Manchester's Institute of Science and Technology (UMIST) in Great Britain. In addition to his position at the University of Washington, he has served on the faculties of UMIST, Texas A&M University, and Michigan State University.

Professor Hill has published some 50 articles in peer-reviewed academic journals. He has also published four college textbooks, one on strategic management, one on principles of management, and the other two on international business (one of which you are now holding). He serves on the editorial boards of several academic journals and previously served as consulting editor at the *Academy of Management Review*.

Professor Hill teaches in the MBA and executive MBA programs at the University of Washington and has received awards for teaching excellence in both programs. He has also taught on several customized executive programs. He lives in Seattle with his wife, Lane, and his children.



brief contents

PREFACE xiii

PART ONE **Introduction and Overview 2**

Chapter One Globalization 2

PART TWO **Country Differences 42**

Chapter Two National Differences in Political Economy 42

Chapter Three Differences in Culture 90

Chapter Four Ethics in International Business 128

PART THREE **Cross-Border Trade and Investment 160**

Chapter Five International Trade Theory 160

Chapter Six The Political Economy of International Trade 202

Chapter Seven Foreign Director Investment 240

Chapter Eight Regional Economic Integration 274

PART FOUR **Global Money System 310**

Chapter Nine The Foreign Exchange Market 310

Chapter Ten The International Monetary System 342

PART FIVE **Competing in a Global Marketplace 378**

Chapter Eleven The Strategy of International Business 378

Chapter Twelve Entering Foreign Markets 416

Chapter Thirteen Exporting, Importing, and Countertrade 442

Chapter Fourteen Global Production, Outsourcing, and Logistics 466

Chapter Fifteen Global Marketing and R&D 492

Chapter Sixteen Global Human Resource Management 526

GLOSSARY 554

ENDNOTES 564

INDEX 593

WORLD MAP 626

ACRONYMS 628

COUNTRIES AND THEIR CAPITALS 629



contents

PREFACE xiii

PART ONE

Introduction and Overview 2

Chapter One

Globalization 2

Opening Case: The Globalization of Starbucks 3

Introduction 5

What Is Globalization 7

The Globalization of Markets 7

The Globalization of Production 8

The Emergence of Global Institutions 10

Drivers of Globalization 11

Declining Trade and Investment Barriers 12

The Role of Technological Change 14

The Changing Demographics of the Global Economy 17

The Changing World Output and World Trade Picture 18

The Changing Foreign Direct Investment Picture 19

The Changing Nature of the Multinational Enterprise 22

The Changing World Order 24

The Global Economy of the Twenty-First Century 25

The Globalization Debate 26

Antiglobalization Protests 27

Globalization, Jobs, and Income 29

Globalization, Labor Policies, and the Environment 31

Globalization and National Sovereignty 33

Globalization and the World's Poor 34

Managing in the Global Marketplace 36

Key Terms 38

Summary 38

Critical Thinking and Discussion Questions 39

Research Task 40

Closing Case: The Globalization of Health Care 40

PART TWO

Country Differences 42

Chapter Two

National Differences in

Political Economy 42

Opening Case: The Polish Surprise 43

Introduction 44

Political Systems 45

Collectivism and Individualism 45

Democracy and Totalitarianism 48

Economic Systems 51

Market Economy 51

Command Economy 52

Mixed Economy 52

Legal Systems 53

Different Legal Systems 53

Differences in Contract Law 55

Property Rights and Corruption 55

The Protection of Intellectual Property 59

Product Safety and Product Liability 60

The Determinants of Economic Development 61

Differences in Economic Development 61

Broader Conceptions of Development:

Amartya Sen 65

Political Economy and Economic

Progress 68

Geography, Education, and Economic Development 71

States in Transition 72

The Spread of Democracy 72

The New World Order and Global

Terrorism 74

The Spread of Market-Based Systems 76

The Nature of Economic Transformation 78

Deregulation 78

Privatization 78

Legal Systems 79

Implications of Changing Political Economy 80

Focus on Managerial Implications 81
 Key Terms 85
 Summary 85
 Critical Thinking and Discussion Questions 86
 Research Task 87
 Closing Case: Egypt, The Troubled Giant 87

Chapter Three Differences in Culture 90
 Opening Case: Business Culture in China 91
 Introduction 93
 What Is Culture? 94
 Values and Norms 94
 Culture, Society, and the Nation-State 95
 The Determinants of Culture 96
 Social Structure 97
 Individuals and Groups 97
 Social Stratification 99
 Religious and Ethical Systems 103
 Christianity 103
 Islam 105
 Hinduism 109
 Buddhism 110
 Confucianism 111
 Language 113
 Spoken Language 113
 Unspoken Language 114
 Education 114
 Culture and the Workplace 115
 Cultural Change 118
 Focus on Managerial Implications 120
 Key Terms 123
 Summary 124
 Critical Thinking and Discussion Questions 124
 Research Task 125
 Closing Case: Panasonic and Japan's Changing Culture 125

Chapter Four Ethics in International Business 128
 Opening Case: Working Conditions in a Chinese Factory 129
 Introduction 130
 Ethical Issues in International Business 131
 Employment Practices 131
 Human Rights 133
 Environmental Pollution 134

Corruption 136
Moral Obligations 138
 Ethical Dilemmas 140
 The Roots of Unethical Behavior 141
 Personal Ethics 141
 Decision-Making Processes 142
 Organizational Culture 142
 Unrealistic Performance Expectations 143
 Leadership 143
 Philosophical Approaches to Ethics 143
 Straw Men 144
 Utilitarian and Kantian Ethics 146
 Rights Theories 148
 Justice Theories 149
 Focus on Managerial Implications 150
 Key Terms 156
 Summary 156
 Critical Thinking and Discussion Questions 157
 Research Task 158
 Closing Case: Siemens Bribery Scandal 158

PART THREE **Cross-Border Trade and Investment 160**

Chapter Five International Trade Theory 160
 Opening Case: Bangladesh's Textile Trade 161
 Introduction 162
 An Overview of Trade Theory 163
 The Benefits of Trade 163
 The Pattern of International Trade 164
 Trade Theory and Government Policy 165
 Mercantilism 165
 Absolute Advantage 167
 Comparative Advantage 169
 The Gains from Trade 170
 Qualifications and Assumptions 172
 Extensions of the Ricardian Model 173
 Heckscher-Olin Theory 177
 The Leontief Paradox 178
 The Product Life-Cycle Theory 179
 Evaluating the Product Life-Cycle Theory 180
 New Trade Theory 182
 Increasing Product Variety and Reducing Costs 182

<i>Economics of Scale, First-Mover Advantages, and the Pattern of Trade</i>	183
<i>Implications of New Trade Theory</i>	183
National Competitive Advantage: Porter's Diamond	185
<i>Factor Endowments</i>	187
<i>Demand Conditions</i>	187
<i>Related and Supporting Industries</i>	187
<i>Firm Strategy, Structure, and Rivalry</i>	189
<i>Evaluating Porter's Theory</i>	189
Focus on Managerial Implications	190
Key Terms	192
Summary	193
Critical Thinking and Discussion Questions	194
Research Task	194
Closing Case: Logitech	195
Appendix A International Trade and the Balance of Payments	197
Chapter Six	The Political Economy of International Trade 202
Opening Case: The Global Financial Crisis and Protectionism	203
Introduction	204
Instruments of Trade Policy	205
<i>Tariffs</i>	206
<i>Subsidies</i>	207
<i>Import Quotas and Voluntary Export Restraints</i>	208
<i>Local Content Requirements</i>	210
<i>Administration Policies</i>	210
<i>Antidumping Policies</i>	211
The Case for Government Intervention	212
<i>Political Arguments for Intervention</i>	213
<i>Economic Arguments for Intervention</i>	219
The Revised Case for Free Trade	221
<i>Retaliation and Trade War</i>	221
<i>Domestic Politics</i>	221
Development of the World Trading System	222
<i>From Smith to the Great Depression</i>	222
<i>1947–1979: GATT, Trade Liberalization, and Economic Growth</i>	223
<i>1980–1993: Protectionist Trends</i>	223
<i>The Uruguay Round and the World Trade Organization</i>	224
<i>The Future of the WTO: Unresolved Issues and the Doha Round</i>	228

Focus on Managerial Implications	234
Key Terms	236
Summary	237
Critical Thinking and Discussion Questions	238
Research Task	238
Closing Case: Why Did Global Food Prices Rise?	238
Chapter Seven	Foreign Direct Investment 240
Opening Case: Walmart in Japan	241
Introduction	242
Foreign Direct Investment in the World Economy	243
<i>Trends in FDI</i>	243
<i>The Direction of FDI</i>	245
<i>The Source of FDI</i>	248
<i>The Form of FDI: Acquisitions versus Greenfield Investments</i>	249
Theories of Foreign Direct Investment	249
<i>Why Foreign Direct Investment?</i>	250
<i>The Pattern of Foreign Direct Investment</i>	253
<i>The Eclectic Paradigm</i>	254
Political Ideology and Foreign Direct Investment	256
<i>The Radical View</i>	256
<i>The Free Market View</i>	257
<i>Pragmatic Nationalism</i>	257
<i>Shifting Ideology</i>	258
Benefits and Costs of FDI	259
<i>Host-Country Benefits</i>	259
<i>Host-Country Costs</i>	262
<i>Home-Country Benefits</i>	263
<i>Home-Country Costs</i>	264
<i>International Trade Theory and FDI</i>	265
Government Policy Instruments and FDI	265
<i>Home-Country Policies</i>	265
<i>Host-Country Policies</i>	266
<i>International Institutions and the Liberalization of FDI</i>	267
Focus on Managerial Implications	268
Key Terms	270
Summary	271

Critical Thinking and Discussion
Questions 271

Research Task 272

Closing Case: Spain's Telefonica 272

Chapter Eight Regional Economic Integration 274

Opening Case: NAFTA and Mexican
Trucking 275

Introduction 276

Levels of Economic Integration 278

The Case for Regional Integration 280

The Economic Case for Integration 280

The Political Case for Integration 281

Impediments to Integration 281

The Case Against Regional Integration 282

Regional Economic Integration in
Europe 282

Evolution of the European Union 282

*Political Structure of the European
Union* 283

The Single European Act 286

The Establishment of the Euro 289

Enlargement of the European Union 292

Regional Economic Integration in the
Americas 293

*The North American Free Trade
Agreement* 293

The Andean Community 297

Mercosur 298

*Central American Common Market, CAFTA,
and CARICOM* 299

Free Trade Area of the Americas 299

Regional Economic Integration
Elsewhere 300

*Association of Southeast Asian
Nations* 300

Asia-Pacific Economic Cooperation 302

Regional Trade Blocs in Africa 303

Focus on Managerial Implications 303

Key Terms 305

Summary 306

Critical Thinking and Discussion
Questions 307

Research Task 307

Closing Case: The European Energy
Market 308

PART FOUR

Global Money System 310

Chapter Nine

The Foreign Exchange
Market 310

Opening Case: Billabong 311

Introduction 312

The Functions of the Foreign Exchange
Market 313

Currency Conversion 314

*Insuring against Foreign Exchange
Risk* 315

The Nature of the Foreign Exchange
Market 319

Economic Theories of Exchange Rate
Determination 320

Prices and Exchange Rates 321

Interest Rates and Exchange Rates 327

*Investor Psychology and Bandwagon
Effects* 328

Summary of Exchange Rate Theories 330

Exchange Rate Forecasting 330

The Efficient Market School 330

The Inefficient Market School 331

Approaches to Forecasting 331

Currency Convertibility 332

Focus on Managerial Implications 334

Key Terms 338

Summary 338

Critical Thinking and Discussion Questions 339

Research Task 340

Closing Case: Caterpillar Tractor 340

Chapter Ten

The International Monetary
System 342

Opening Case: Economic Turmoil in Latvia 343

Introduction 344

The Gold Standard 346

Mechanics of the Gold Standard 346

Strength of the Gold Standard 347

*The Period between the Wars,
1918–1939* 347

The Bretton Woods System 348

The Role of the IMF 349

The Role of the World Bank 350

The Collapse of the Fixed Exchange Rate
System 350

The Floating Exchange Rate Regime	352
<i>The Jamaica Agreement</i>	352
<i>Exchange Rates since 1973</i>	352
Fixed versus Floating Exchange Rates	356
<i>The Case for Floating Exchange Rates</i>	356
<i>The Case for Fixed Exchange Rates</i>	357
<i>Who Is Right?</i>	358
Exchange Rate Regimes in Practice	358
<i>Pegged Exchange Rates</i>	359
<i>Currency Boards</i>	360
Crisis Management by the IMF	360
<i>Financial Crises in the Post-Bretton Woods Era</i>	361
<i>Mexican Currency Crisis of 1995</i>	362
<i>The Asian Crisis</i>	363
<i>Evaluating the IMF's Policy Prescriptions</i>	367
Focus on Managerial Implications	371
Key Terms	374
Summary	374
Critical Thinking and Discussion Questions	375
Research Task	376
Closing Case: Argentina's Monetary Crisis	376

PART FIVE **Competing in a Global Marketplace 378**

Chapter Eleven The Strategy of International Business 378

Opening Case: Avon Products	379
Introduction	381
Strategy and the Firm	381
<i>Value Creation</i>	382
<i>Strategic Positioning</i>	384
<i>Operations: The Firm as a Value Chain</i>	385
<i>Organization: The Implementation of Strategy</i>	387
<i>In Sum: Strategic Fit</i>	389
Global Expansion, Profitability, and Profit Growth	390
<i>Expanding the Market: Leveraging Products</i>	390
<i>Location Economies</i>	391
<i>Experience Effects</i>	393
<i>Leveraging Subsidiary Skills</i>	396
<i>Profitability and Profit Growth</i>	
Summary	397

Cost Pressures and Pressures for Local Responsiveness	397
<i>Pressures for Cost Reductions</i>	398
<i>Pressures for Local Responsiveness</i>	398
Choosing a Strategy	401
<i>Global Standardization Strategy</i>	402
<i>Localization Strategy</i>	403
<i>Transnational Strategy</i>	404
<i>International Strategy</i>	405
<i>The Evolution of Strategy</i>	406
Strategic Alliances	407
<i>The Advantages of Strategic Alliances</i>	408
<i>The Disadvantages of Strategic Alliances</i>	408
<i>Making Alliances Work</i>	409
Key Terms	412
Summary	412
Critical Thinking and Discussion Questions	413
Research Task	414
Closing Case: The Evolving Strategy of IBM	414

Chapter Twelve Entering Foreign Markets 416

Opening Case: General Motors in China	417
Introduction	418
Basic Entry Decisions	419
<i>Which Foreign Markets?</i>	419
<i>Timing of Entry</i>	420
<i>Scale of Entry and Strategic Commitments</i>	422
<i>Market Entry Summary</i>	423
Entry Modes	425
<i>Exporting</i>	425
<i>Turnkey Projects</i>	426
<i>Licensing</i>	427
<i>Franchising</i>	428
<i>Joint Ventures</i>	429
<i>Wholly Owned Subsidiaries</i>	431
Selecting an Entry Mode	432
<i>Core Competencies and Entry Mode</i>	433
<i>Pressures for Cost Reductions and Entry Mode</i>	433
Greenfield Venture or Acquisition?	434
<i>Pros and Cons of Acquisition</i>	434
<i>Pros and Cons of Greenfield Ventures</i>	437
<i>Making a Choice</i>	437

Key Terms	438		
Summary	438		
Critical Thinking and Discussion Questions	439		
Research Task	440		
Closing Case: General Electric's Joint Ventures	440		
Chapter Thirteen	Exporting, Importing, and Countertrade	442	
Opening Case: Vellus Products	443		
Introduction	444		
The Promise and Pitfalls of Exporting	445		
Improving Export Performance	447		
<i>An International Comparison</i>	447		
<i>Information Sources</i>	447		
<i>Utilizing Export Management Companies</i>	450		
<i>Export Strategy</i>	450		
Export and Import Financing	452		
<i>Lack of Trust</i>	453		
<i>Letter of Credit</i>	454		
<i>Draft</i>	455		
<i>Bill of Lading</i>	456		
<i>A Typical International Trade Transaction</i>	456		
Export Assistance	457		
<i>Export-Import Bank</i>	458		
<i>Export Credit Insurance</i>	458		
Countertrade	459		
<i>The Incidence of Countertrade</i>	459		
<i>Types of Countertrade</i>	460		
<i>The Pros and Cons of Countertrade</i>	461		
Key Terms	462		
Summary	462		
Critical Thinking and Discussion Questions	463		
Research Task	464		
Closing Case: MD International	464		
Chapter Fourteen	Global Production, Outsourcing, and Logistics	466	
Opening Case: The Rise of the Indian Automobile Industry	467		
Introduction	469		
Strategy, Production, and Logistics	469		
Where to Produce	472		
<i>Country Factors</i>	472		
<i>Technological Factors</i>	474		
<i>Product Factors</i>	477		
<i>Locating Production Facilities</i>	478		
The Strategic Role of Foreign Factories	479		
Outsourcing Production: Make-or-Buy Decisions	481		
<i>The Advantages of Make</i>	482		
<i>The Advantages of Buy</i>	484		
<i>Trade-offs</i>	485		
<i>Strategic Alliances with Suppliers</i>	485		
Managing a Global Supply Chain	486		
<i>The Role of Just-in-Time Inventory</i>	486		
<i>The Role of Information Technology and the Internet</i>	487		
Key Terms	488		
Summary	488		
Critical Thinking and Discussion Questions	489		
Research Task	490		
Closing Case: Building the Boeing	490		
Chapter Fifteen	Global Marketing and R&D	492	
Opening Case: Ford's Marketing Goes Global	493		
Introduction	494		
The Globalization of Markets and Brands	495		
Market Segmentation	497		
Product Attributes	499		
<i>Cultural Differences</i>	499		
<i>Economic Development</i>	500		
<i>Product and Technical Standards</i>	500		
Distribution Strategy	501		
<i>Differences between Countries</i>	501		
<i>Choosing a Distribution Strategy</i>	504		
Communication Strategy	505		
<i>Barriers to International Communication</i>	505		
<i>Push versus Pull Strategies</i>	507		
<i>Global Advertising</i>	509		
Pricing Strategy	512		
<i>Price Discrimination</i>	512		
<i>Strategic Pricing</i>	513		
<i>Regulatory Influences on Prices</i>	514		
Configuring the Marketing Mix	515		

New-Product Development	517
<i>The Location of R&D</i>	518
<i>Integrating R&D, Marketing, and Production</i>	519
<i>Cross-Functional Teams</i>	520
<i>Building Global R&D Capabilities</i>	521
Key Terms	522
Summary	522
Critical Thinking and Discussion Questions	523
Research Task	524
Closing Case: Microsoft in India	524
Chapter Sixteen	Global Human Resource Management 526
Opening Case: AstraZeneca International	527
Introduction	528
The Strategic Role of International HRM	529
Staffing Policy	531
<i>Types of Staffing Policy</i>	531
<i>Expatriate Managers</i>	535
<i>The Global Mind-set</i>	538
Training and Management Development	539
<i>Training for Expatriate Managers</i>	540
<i>Repatriation of Expatriates</i>	541
<i>Management Development and Strategy</i>	541
Performance Appraisal	543
<i>Performance Appraisal Problems</i>	543
<i>Guidelines for Performance Appraisal</i>	543

Compensation	544
<i>National Differences in Compensation</i>	544
<i>Expatriate Pay</i>	545
International Labor Relations	547
<i>The Concerns of Organized Labor</i>	548
<i>The Strategy of Organized Labor</i>	548
<i>Approaches to Labor Relations</i>	549
Key Terms	550
Summary	550
Critical Thinking and Discussion Questions	551
Research Task	552
Closing Case: Lenovo	552

GLOSSARY 554

ENDNOTES 564

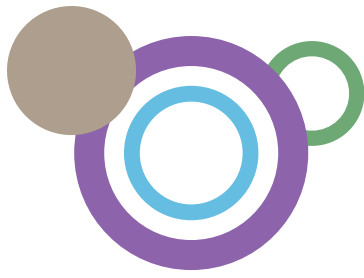
PHOTO CREDITS 591

INDEX 593

WORLD MAP 626

ACRONYMS 628

COUNTRIES AND THEIR CAPITALS 629



preface

Global Business Today is intended for the first international business course at either the undergraduate or MBA level. My goal in writing this book has been to set a new standard for international business textbooks. I have attempted to write a book that

1. Is comprehensive and up-to-date.
2. Goes beyond an uncritical presentation and shallow explanation of the body of knowledge.
3. Maintains a tight, integrated flow between chapters.
4. Focuses on managerial implications.
5. Makes important theories accessible and interesting to students.
6. Incorporates ancillary resources that enliven the text and make it easier to teach.

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

Comprehensive and Up-to-Date

To be comprehensive, an international business textbook must

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

I have always endeavored to do all of these things. Too many other texts have paid insufficient attention to the strategies and structures of international businesses and to the implications of international business for firms' various functions. This omission has been a serious deficiency. Many of the students in these international business courses will soon be working in international businesses, and they will be expected to

understand the implications of international business for their organization's strategy, structure, and functions. This book pays close attention to these issues.

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

- The new trade theory and strategic trade policy.
- The work of Nobel Prize-winning economist Amartya Sen on economic development.
- The work of Hernando de Soto on the link between property rights and economic development.
- Samuel Huntington's influential thesis on the "clash of civilizations."
- The new growth theory of economic development championed by Paul Romer and Gene Grossman.
- Empirical work by Jeffrey Sachs and others on the relationship between international trade and economic growth.
- Michael Porter's theory of the competitive advantage of nations.
- Robert Reich's work on national competitive advantage.
- The work of Nobel Prize-winner Douglas North and others on national institutional structures and the protection of property rights.
- The market imperfections approach to foreign direct investment that has grown out of Ronald Coase and Oliver Williamson's work on transaction cost economics.
- Bartlett and Ghoshal's research on the transnational corporation.
- The writings of C. K. Prahalad and Gary Hamel on core competencies, global competition, and global strategic alliances.
- Insights for international business strategy that can be derived from the resource-based view of the firm.
- Paul Samuelson's critique of free trade theory

In addition to including leading-edge theory, in light of the fast-changing nature of the international business environment, I have made every effort to ensure that the book was as up-to-date as possible when it went to press. A significant amount has happened in the world since I first began work on this book. The Uruguay Round of GATT negotiations were successfully concluded and the World Trade Organization was established. In 2001, the WTO embarked upon another major round of talks aimed to reduce barriers to trade, the Doha Round. The European Union moved forward with its post-1992 agenda to achieve a closer economic and monetary union, including the establishment of a common currency in January 1999. The North American Free Trade Agreement passed into law, and Chile indicated its desire to become the next member of the free trade area. The Asia-Pacific Economic Cooperation forum emerged as the kernel of a possible future Asia Pacific free trade area. The former Communist states of Eastern Europe and Asia continued on the road to economic and political reform. As they did, the euphoric mood that followed the collapse of communism in 1989 was slowly replaced with a growing sense of realism about the hard path ahead for many of these countries. The global money market continued its meteoric growth. By 2007, more than \$3 trillion per day was flowing across national borders. The size of such flows fueled concern about the ability of short-term speculative shifts in global capital markets to destabilize the world economy. The World Wide Web emerged from nowhere to become the backbone of an emerging global network for electronic commerce. The world continued to become more global. Several Asian Pacific economies, most notably China, continued to grow their economies at a rapid rate. Outsourcing of service functions to places such as China and India emerged as a

major issue in developed Western nations. New multinationals continued to emerge from developing nations in addition to the world's established industrial powers. Increasingly, the globalization of the world economy affected a wide range of firms of all sizes, from the very large to the very small. And unfortunately, in the wake of the terrorist attacks on the United States that took place September 11, 2001, global terrorism and the attendant geopolitical risks emerged as a threat to global economic integration and activity.

New in the Seventh Edition

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

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

As part of the overall revision process, *changes have been made to every chapter in the book*. All material and statistics are as up-to-date as possible as of 2009 or early 2010. I have added discussion of current events wherever appropriate. Most notably for this edition, ***detailed discussion of the global financial crisis that occurred in 2008 and 2009, and its implications for international business, has been added to many chapters***. For example, Chapter 6 opens with a case that discusses the impact of the global financial crisis on attitudes toward protectionism in many countries. Similarly, Chapter 10 opens with a case that profiles how the global financial crisis triggered economic turmoil and a currency crisis in Latvia.

Elsewhere, Chapter 6 has been updated to discuss progress on the current round of talks sponsored by the WTO aimed at reducing barriers to trade, particularly in agriculture (the Doha Round). Chapter 7 now discusses the rebound in slumping foreign direct investment flows that occurred in 2008 and 2009, and explains how the global financial crisis of 2008 contributed to this. Chapter 9 discusses the weakness in the U.S. dollar between 2004 and 2008, and its paradoxical rebound in late 2008 in the midst of a severe financial crisis in United States and elsewhere.


Beyond Uncritical Presentation and Shallow Explanation

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

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

To help students go a step further in expanding their understanding of international business, each chapter incorporates two **globalEDGE research tasks** designed and written by Tunga Kiyak and the team at Michigan State University's globalEDGE.msu.edu site to dovetail with the content just covered.

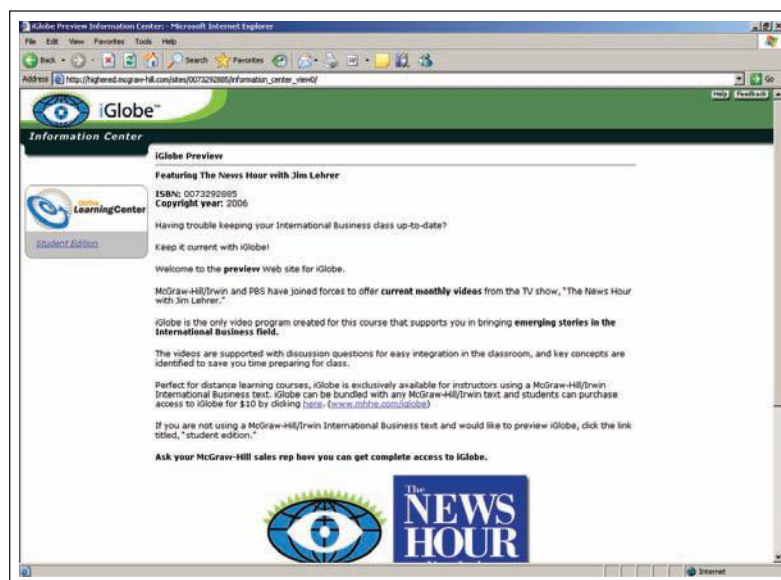
globalEDGE Research Task

http://globalEDGE.msu.edu  Research Task	
<p>Use the globalEDGE Resource Desk (http://globalEDGE.msu.edu/resourcedesk/) to complete the following exercises:</p>	
<p>1. You have been assigned to negotiate a business deal with the representatives of a potential distributor in South Africa. Since having <i>intercultural skills</i> is critical for a successful international experience, you consider collecting information regarding the local culture before your departure. Prepare a</p>	<p>characteristics involved in communicating with the local people that may affect business interactions in this country.</p> <p>2. Asian cultures exhibit significant differences in <i>business etiquette</i> when compared to Western cultures. For example, in China, large hand movements are usually distracting, and it is considered offensive to point while speaking. Find five similar tips regarding the business etiquette of the United Arab Emirates.</p>

iGlobe is McGraw-Hill/Irwin's revolutionary Web-based video archive that incorporates international business news clips from PBS's "NewsHour." Two new clips are added every month, and teaching notes are available for you to integrate the segments with your course. Students can also subscribe for individual access (www.mhhe.com/iglobepreview).

iGLOBE

iGLOBE is McGraw-Hill/Irwin's revolutionary new Web-based video archive, incorporating international business news clips from PBS's *The NewsHour*. New clips are added every month, and teaching notes are available for you to use in integrating the segments with your classroom. Students can also subscribe for individual access. (www.mhhe.com/iglobepreview)



Integrated Progression of Topics

A weakness of many texts is that they lack a tight, integrated flow of topics from chapter to chapter. In Chapter 1 of this book, students will learn how the book's topics are related to each other. I've achieved integration by organizing the material so that each chapter builds on the material of the previous ones in a logical fashion.

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

PART TWO Chapters 2 and 3 focus on national differences in political economy and culture, and Chapter 4 examines ethical issues in international business. Most international business textbooks place this material at a later point, but I believe it is vital to discuss national differences first. After all, many of the central issues in international trade and investment, the global monetary system, international business strategy and structure, and international business operations arise out of national differences in political economy and culture. To fully understand these issues, students must first appreciate the differences in countries and cultures. Ethical issues are dealt with at this juncture primarily because many ethical dilemmas flow out of national differences in political systems, economic systems, and culture.

PART THREE Chapters 5 through 8 investigate the political economy of international trade and investment. The purpose of this part is to describe and explain the trade and investment environment in which international business occurs.

PART FOUR Chapters 9 and 10 describe and explain the global monetary system, laying out in detail the monetary framework in which international business transactions are conducted.

PART FIVE In Chapters 11 through 16, attention shifts from the environment to the firm. Here the book examines the strategies that firms adopt to compete effectively in the international business environment and explains how firms can perform key functions—production, marketing, R&D, human resource management, accounting, and finance—to compete and succeed in the international business environment.

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

Focus on Managerial Implications

I have always believed that it is important to show students how the material covered in the text is relevant to the actual practice of international business. This is explicit in the later chapters of the book, which focus on the practice of international business, but it is not always obvious in the first half of the book, which considered many macro-economic and political issues, from international trade theory and foreign direct investment flows to the IMF and the influence of inflation rates on foreign exchange quotations. Accordingly, at the end of each chapter in Parts Two, Three, and Four—where the focus is on the environment of international business, as opposed to particular firms—there is a section titled “Focus on Managerial Implications.” In this section, the managerial implications of the material discussed in the chapter are clearly explained.

Focus of Managerial Implications

For example, Chapter 5, “International Trade Theory,” ends with a detailed discussion of the various trade theories’ implications for international business management. See page 190 for the rest of this feature.

Focus on Managerial Implications

LEARNING OBJECTIVE 5
Understand the important implications that international trade theory holds for business practice.


Why does all this matter for business? There are at least three main implications for international businesses of the material discussed in this chapter: location implications, first-mover implications, and policy implications.

Location
Underlying most of the theories we have discussed is the notion that different countries have particular advantages in different productive activities. Thus, from a profit perspective, it makes sense for a firm to disperse its productive activities to those

In addition, each chapter begins with an **Opening Case** that sets the stage for the chapter content and familiarizes students with how real international companies conduct business.

Opening Case

For example, in Chapter 3, “Business Culture in China” discusses the concept of *guanxi* in the business culture in China. See page 91 for the rest of this feature.



chapter **3**

Differences in Culture

Business Culture in China

→ Opening Case

The first McDonald's restaurant to open in China was located on the corner of Wangfujing Street and the Avenue of Eternal Peace, just two blocks from Tiananmen Square, the very heart of China's capital, Beijing. The choice of location seemed auspicious, and within two years, sales at the restaurant were surpassing all expectations. Then the Beijing city government dropped a bombshell; officials abruptly informed McDonald's that it would have to vacate the location to make way for a commercial, residential, and office complex planned by Hong Kong developer Li Ka-shing. At the time, McDonald's still had 18 years to run on its 20-year lease. A stunned McDonald's did what any good Western company would do—it took the Beijing city government to court to try to enforce the lease. The court refused and McDonald's had to move. Chinese observers had a simple explanation for the outcome. McDonald's, they said, lacked the *guanxi* of Li Ka-shing. Given this, the company could not expect to prevail. Company executives should have accepted the decision in good grace and moved on, but instead, McDonald's filed a lawsuit—a move that would only serve to reduce what *guanxi* McDonald's might have had with the city government!


This example illustrates a basic difference between doing business in the West and doing business in China. In the advanced economies of the West, business transactions are conducted and regulated by the centuries-old framework of contract law, which specifies the rights and obligations of parties to a business contract and provides mechanisms for seeking to redress grievances should one party in the exchange fail to live up to the legal agreement. In the West, McDonald's could have relied on the courts to enforce its legal contract with the city government. In China, this approach didn't work. China does not have the same legal infrastructure. Personal power and relationships or connections, rather than the rule of law, have always been the key to getting things done in China. The key to understanding this process is the concept of *guanxi*.

Guanxi literally means relationships, although in business settings it can be better understood as “connections.” McDonald's lost its lease in central Beijing because it lacked the *guanxi* enjoyed by the powerful Li Ka-shing. The concept of *guanxi* is deeply rooted in Chinese culture, particularly the Confucian philosophy of valuing social hierarchy and reciprocal obligations. Confucian ideology has a 2,000-year-old history in China, and 60 years of Communist rule has done little to dent its influence on everyday life in China. Confucianism stresses the importance

There is also a **Closing Case** to each chapter. These cases are also designed to illustrate the relevance of chapter material for the practice of international business as well as to provide continued insight into how real companies handle those issues.

Closing Case

For example, in Chapter 3, “Panasonic and Japan's Changing Culture” discusses how business culture has changed over the years in Japan. See page 125 for the rest of this feature.




closing case

Panasonic and Japan's Changing Culture

Established in 1920, the consumer electronics giant Panasonic was at the forefront of the rise of Japan to the status of major economic power during the 1970s and 1980s (before 2009 Panasonic was known as Matsushita). Like many other long-standing Japanese businesses, Panasonic was regarded as a bastion of traditional Japanese values based on strong group identification, reciprocal obligations, and

to the existence of Confucian values in the workplace. At Panasonic, employees were taken care of by the company from “cradle to the grave.” Panasonic provided them with a wide range of benefits including cheap housing, guaranteed lifetime employment, seniority-based pay systems, and generous retirement bonuses. In return, Panasonic expected, and got, loyalty and hard work from its employees.

Another tool that I have used to focus on managerial implications are **Management Focus** boxes. There is at least one Management Focus in most chapters. Like the opening cases, the purpose of these boxes is to illustrate the relevance of chapter material for the practice of international business.



Management FOCUS

DMG-Shanghai

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

In a society that lacks a strong rule-based legal tradition, and thus legal ways of redressing wrongs such as violations of business agreements, *guanxi* is an important mechanism for building long-term business relationships and getting business done in China. There is a tacit acknowledgment that if you have the right *guanxi*, legal rules can be broken, or at least bent.

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

large part by leveraging the contacts of Wu and Xiao, and by backing up their connections with what the Chinese call *Shi li*, the ability to do good work.

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


Sources: J. Bryan, "The Mintz Dynasty," *Fast Company*, April 2006, pp. 56–62; and M. Graser, "Featured Player," *Variety*, October 18, 2004, p. 6.

Management Focus

The Management Focus in Chapter 3, for example, looks at how Dan Mintz, founder of DMG in China, used *guanxi* to create a successful business. See page 112 for the rest of this focus.

Accessible and Interesting

The international business arena is fascinating and exciting, and I have tried to communicate my enthusiasm for it to the student. Learning is easier and better if the subject matter is communicated in an interesting, informative, and accessible manner. One technique I have used to achieve this is weaving interesting anecdotes into the narrative of the text, that is, stories that illustrate theory. The use of **Another Perspective** boxes also serves to provide additional context for the chapter topics.



Another Perspective

Doing Business Overseas

Going overseas for business? Be aware of cultural differences. For example, not all cultures regard time as Americans do. In Germany or Switzerland, meetings start promptly, but not in Saudi Arabia or Mexico, where meetings often begin with lengthy socializing to establish rapport. Be careful how you say things: Americans and Europeans tend to speak plainly and in a straightforward manner, but the Chinese, Japanese, Koreans, and some Latin Americans are indirect and rely on body language and context to make their point. And be careful *what* you say. Americans describe business in financial terms; Swedes are more likely to speak in terms of number of employees. A good rule of thumb: Pay attention to cues and don't assume that your customs are observed everywhere. ("Cultural Differences," Iowa State University Web site, <http://www.celt.iastate.edu>, accessed March 25, 2010; and Bill Decker, "Important Questions to Ask While Conducting Business," *Portfolio.com*, March 11, 2010, <http://www.portfolio.com>)

Another Perspective

For example, this Another Perspective box in Chapter 3 gives a helpful tip for doing business overseas. See page 95 for the rest of the picture.

In addition to the Management Focus feature, most chapters also have a **Country Focus** box that provides background on the political, economic, social, or cultural aspects of countries grappling with an international business issue.

Country Focus

Chapter 2, for example, discusses emerging property rights in China. See page 70 for more details.



Country FOCUS

Emerging Property Rights in China

A new property law took effect in China on October 1, 2007. The law, the accumulation of 14 years of effort, granted rural and urban landholders far more secure property rights. The law was a much-needed response to how much China's economy has changed over the past 30 years as it transitions from a centrally planned system to a dynamic market-based economy where two-thirds of economic activity is in the hands of private enterprises.

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

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

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

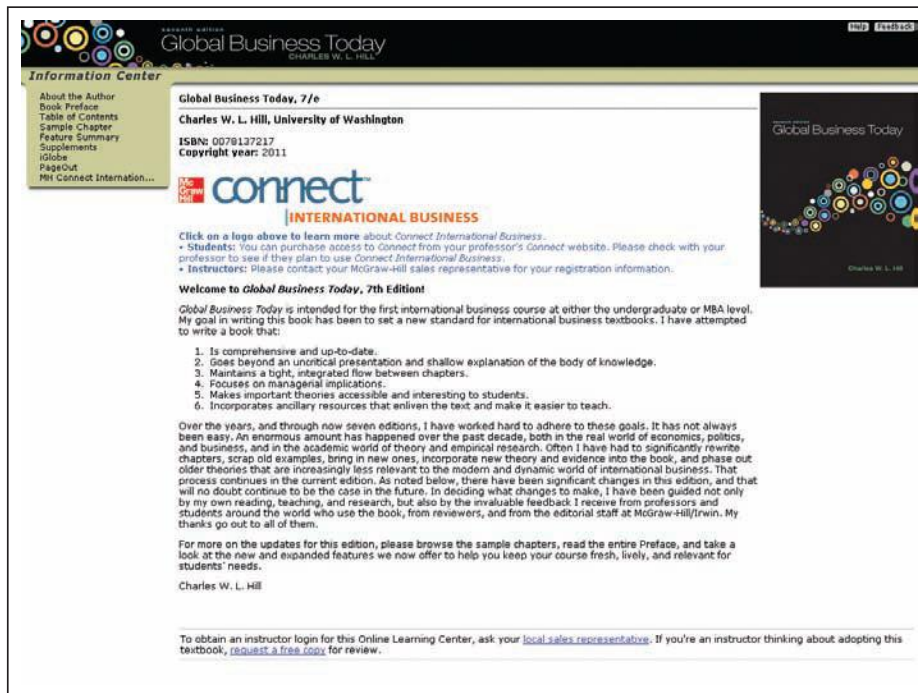
Sources: “China's Next Revolution—Property Rights in China,” *The Economist*, March 10, 2007, p. 11; “Caught between the Right and Left,” *The Economist*, March 10, 2007, pp. 25–27; and Z. Kelang and L. Ping, “Rural Land Rights under the PRC Property Law,” *China Law and Practice*, November 2007, pp. 10–15.

Ancillary Resources That Enliven the Text and Make It Easier to Teach

For instructors, this text offers a number of materials to help keep students active and engaged in the learning process. In addition to the International Business DVD, and iGlobe resources, the **Online Learning Center** (www.mhhe.com/hill) is a one-stop place for several key instructor aids. A password-protected portion of the book's Web site will be available to adopters of *Global Business Today*, and instructors can also view student resources to make more effective supplementary assignments. The OLC includes:

- **Instructor's Manual.** The Instructor's Manual, prepared by Veronica Horton, contains course outlines; chapter teaching resources, including chapter overviews and outlines, teaching suggestions, chapter objectives, teaching suggestions for opening cases, lecture outlines, answers to critical discussion questions, teaching suggestions for the Closing Case, and two student activities (some with Internet components); and expanded Video Notes with discussion questions for each video. The answers to globalEDGE research tasks will also be included here.
- **Test Bank.** The test bank contains approximately 100 true-false, multiple-choice, and essay questions per chapter. The test bank questions are also categorized by Bloom's taxonomy levels of learning and how they meet various AACSB objectives.
- **EZ Test.** A computerized version of the test bank is available, allowing the instructor to generate random tests and to add his or her own questions.

- **PowerPoint®.** Re-created for this edition by Veronica Horton, the PowerPoint program consists of one set of slides for every chapter, featuring original materials not found in the text in addition to reproductions and illuminations of key text figures, tables, and maps. Quiz questions to keep students on their toes during classroom presentations are also included, along with instructor notes.



This book also provides rich, interactive resources to help students learn how to practice international business.

The Online Learning Center for students includes chapter quizzes, student PowerPoints, and a Global Business Plan project. Students can also access interactive modules, including the following:

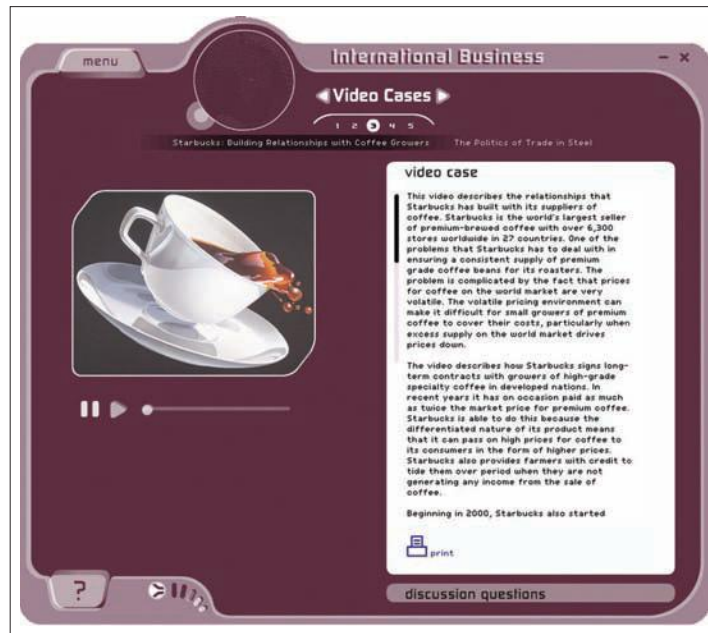
Concept Exercises



Concept Exercises help students learn how to solve realistic problems by exploring Flash modules, linked to the appropriate chapter, of the Hofstede study, absolute and comparative advantage, foreign direct investment, balance of payments, purchasing power parity and inflation, historical exchange rates, and export and import financing.

Concept Videos

The eight Concept Videos, complemented by cases and discussion questions written by Charles Hill, are also exclusive to these online activities. Students can watch and learn more when they access this activity for the appropriate chapter.



Global Business Plan

The Global Business Plan helps students take it one step further into applications, allowing them to build their own business plan one section at a time to prepare for entering a foreign market.



Acknowledgments

Numerous people deserve to be thanked for their assistance in preparing this book. First, I want to thank all the people at McGraw-Hill/Irwin who have worked with me on this project:

Paul Ducham, Publisher
John Weimeister, Executive Editor
Megan Richter, Developmental Editor

Donielle Xu, Marketing Manager
Ann Ferro, Marketing Coordinator
Bruce Gin, Project Manager
Matt Baldwin, Designer
Jennifer Lohn, Media Project Manager
Michael McCormick, Production Supervisor
Jeremy Cheshareck, Photo Research

Second, my thanks go to the reviewers, who provided good feedback that helped shape this edition of the book:

Ron Abernathy, *University of North Carolina–Greensboro*
John Anderson, *University of Tennessee*
David Bartlett, *University of Minnesota*
Lawrence A. Beer, *Arizona State University*
Frances DePaul, Ph.D., *Westmoreland County Community College*
Dr. Dharma DeSilva, *Wichita State University*
David J. Hrovat, *Northern Kentucky University*
Samira Hussein, *Johnson County Community College*
J. Leslie Jankovich, *San Jose State University*
Louis Nzegwu, *University of Wisconsin–Platteville*
Eydis Olsen, *Drexel University*
Andrew R. Thomas, *University of Akron*
Ronald S. Thomas, *Northeastern University*
William A. Walker, *University of Houston*
Allison D. Watts, *Shippensburg University*
David Wernick, *Florida International University*
Ross A. Wirth, *Franklin University*

McGraw-Hill *Connect International Business*

LESS MANAGING. MORE TEACHING. GREATER LEARNING.

McGraw-Hill *Connect International Business* is an online assignment and assessment solution that connects students with the tools and resources they'll need to achieve success.



McGraw-Hill *Connect International Business* helps prepare students for their future by enabling faster learning, more efficient studying, and higher retention of knowledge.

McGraw-Hill **CONNECT INTERNATIONAL BUSINESS** FEATURES

Connect International Business offers a number of powerful tools and features to make managing assignments easier, so faculty can spend more time teaching. With *Connect International Business*, students can engage with their coursework anytime and anywhere, making the learning process more accessible and efficient. *Connect International Business* offers you the features described on the next pages.

Interactive Applications Interactive Applications are engaging tools that teach students to apply key concepts in practice. These applications provide them with immersive, experiential learning opportunities. Students will engage in a variety of interactive scenarios to deepen critical knowledge of key course topics. They receive immediate feedback at intermediate steps throughout each exercise, as well as comprehensive feedback at the end of the assignment. All Interactive Applications are automatically scored and entered into the instructor gradebook.

Student Progress Tracking *Connect International Business* keeps instructors informed about how each student, section, and class is performing, allowing for more productive use of lecture and office hours. The progress-tracking function enables you to:

- View scored work immediately and track individual or group performance with assignment and grade reports.
- Access an instant view of student or class performance relative to learning objectives.
- Collect data and generate reports required by many accreditation organizations, such as AACSB.

Smart Grading When it comes to studying, time is precious. *Connect International Business* helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. When it comes to teaching, your time also is precious. The grading function enables you to:

- Have assignments scored automatically, giving students immediate feedback on their work and side-by-side comparisons with correct answers.
- Access and review each response; manually change grades or leave comments for students to review.
- Reinforce classroom concepts with practice tests and instant quizzes.

Simple Assignment Management With *Connect International Business*, creating assignments is easier than ever, so you can spend more time teaching and less time managing. The assignment management function enables you to:

- Create and deliver assignments easily with selectable end-of-chapter questions and test bank items.
- Streamline lesson planning, student progress reporting, and assignment grading to make classroom management more efficient than ever.
- Go paperless with the eBook and online submission and grading of student assignments.

Instructor Library The *Connect International Business* Instructor Library is your repository for additional resources to improve student engagement in and out of class. You can select and use any asset that enhances your lecture. The *Connect International Business* Instructor Library includes:

- E-book
- Instructor's Manual
- PowerPoint files
- Answers to the end-of-chapter globalEDGE Research Tasks
- Videos and Instructional Notes
- iGlobe
- International Business Newsletter archives
- Access to interactive study tools like Business Around the World, Drag-and-drop maps, and the Global Business Plan

Student Study Center The *Connect International Business* Student Study Center is the place for students to access additional resources. The Student Study Center:

- Offers students quick access to lectures, practice materials, e-books, and more.
- Provides instant practice material and study questions, easily accessible on the go.
- Gives students access to Premium OLC Assets: iGlobe, interactive maps, and Business Around the World.

Lecture Capture Increase the attention paid to lecture discussion by decreasing the attention paid to note taking. For an additional charge Lecture Capture offers new ways for students to focus on the in-class discussion, knowing they can revisit important topics later. Lecture Capture enables you to:

- Record and distribute your lecture with a click of button.
- Record and index PowerPoint presentations and anything shown on your computer so it is easily searchable, frame by frame.
- Offer access to lectures anytime and anywhere by computer, iPod, or mobile device.
- Increase intent listening and class participation by easing students' concerns about note-taking. Lecture Capture will make it more likely you will see students' faces, not the tops of their heads.

McGraw-Hill Connect Plus International Business McGraw-Hill reinvents the textbook learning experience for the modern student with *Connect Plus International Business*. A seamless integration of an e-book and *Connect International Business*, *Connect Plus International Business* provides all of the *Connect International Business* features plus the following:

- An integrated e-book, allowing for anytime, anywhere access to the textbook.
- Dynamic links between the problems or questions you assign to your students and the location in the e-book where that problem or question is covered.
- A powerful search function to pinpoint and connect key concepts in a snap.

In short, *Connect International Business* offers you and your students powerful tools and features that optimize your time and energies, enabling you to focus on course content, teaching, and student learning. *Connect International Business* also offers a wealth of content resources for both instructors and students. This state-of-the-art, thoroughly tested system supports you in preparing students for the world that awaits.

For more information about Connect, go to www.mcgrawhillconnect.com, or contact your local McGraw-Hill sales representative.

Tegrity Campus: Lectures 24/7



Tegrity Campus is a service that makes class time available 24/7 by automatically capturing every lecture in a searchable format for students to review when they study and complete assignments. With a simple one-click start-and-stop process, you capture all computer screens and corresponding audio. Students can replay any part of any class with easy-to-use browser-based viewing on a PC or Mac.

Educators know that the more students can see, hear, and experience class resources, the better they learn. In fact, studies prove it. With Tegrity Campus, students

quickly recall key moments by using Tegrity Campus's unique search feature. This search helps students efficiently find what they need, when they need it, across an entire semester of class recordings. Help turn all your students' study time into learning moments immediately supported by your lecture.

To learn more about Tegrity watch a 2-minute Flash demo at <http://tegritycampus.mhhe.com>.

Assurance of Learning Ready

Many educational institutions today are focused on the notion of *assurance of learning*, an important element of some accreditation standards. *Global Business Today* is designed specifically to support your assurance of learning initiatives with a simple, yet powerful solution.

Each test bank question for *Global Business Today* maps to a specific chapter learning outcome/objective listed in the text. You can use our test bank software, EZ Test and EZ Test Online, or in *Connect International Business* to easily query for learning outcomes/objectives that directly relate to the learning objectives for your course. You can then use the reporting features of EZ Test to aggregate student results in similar fashion, making the collection and presentation of assurance of learning data simple and easy.

AACSB Statement

The McGraw-Hill Companies is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *Global Business Today*, 7th edition, recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the test bank to the six general knowledge and skill guidelines in the AACSB standards.

The statements contained in *Global Business Today*, 7th edition, are provided only as a guide for the users of this textbook. The AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the faculty. While *Global Business Today*, 7th edition, and the teaching package make no claim of any specific AACSB qualification or evaluation, we have within *Global Business Today*, 7th edition, labeled selected questions according to the six general knowledge and skills areas.

McGraw-Hill Customer Care Contact Information

At McGraw-Hill, we understand that getting the most from new technology can be challenging. That's why our services don't stop after you purchase our products. You can e-mail our Product Specialists 24 hours a day to get product-training online. Or you can search our knowledge bank of Frequently Asked Questions on our support Web site. For Customer Support, call **800-331-5094**, e-mail **hmsupport@mcgraw-hill.com**, or visit **www.mhhe.com/support**. One of our Technical Support Analysts will be able to assist you in a timely fashion.



Global Business Today



part 1

Introduction and Overview

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Understand what is meant by the term *globalization*.
- 2 Recognize the main drivers of globalization.
- 3 Describe the changing nature of the global economy.
- 4 Explain the main arguments in the debate over the impact of globalization.
- 5 Understand how the process of globalization is creating opportunities and challenges for business managers.

Globalization

The Globalization of Starbucks

opening case

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

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

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

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

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

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

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

Sources: Starbucks 10K, various years; C. McLean, "Starbucks Set to Invade Coffee-Loving Continent," *Seattle Times*, October 4, 2000, p. E1; J. Ordonez, "Starbucks to Start Major Expansion in Overseas Market," *The Wall Street Journal*, October 27, 2000, p. B10; S. Homes and D. Bennett, "Planet Starbucks," *BusinessWeek*, September 9, 2002, pp. 99–110; "Starbucks Outlines International Growth Strategy," *Business Wire*, October 14, 2004; A. Yeh, "Starbucks Aims for New Tier in China," *Financial Times*, February 14, 2006, p. 17; and C. Matlack, "Will Global Growth Help Starbucks?" *BusinessWeek*, July 2, 2008.



Introduction

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

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

This is the world in which we live. It is a world where the volume of goods, services, and investment crossing national borders has expanded faster than world output for more than half a century. It is a world where more than \$4 trillion in foreign exchange transactions are made every day, where \$12 trillion of goods and \$3.3 trillion of services were sold across national borders in 2009.¹ It is a world in which international institutions such as the World Trade Organization and gatherings of leaders from the world's most powerful economies have repeatedly called for even lower barriers to cross-border trade and investment. It is a world where the symbols of material and popular culture are increasingly global: from Coca-Cola and Starbucks to Sony PlayStations, Nokia cell phones, MTV shows, Disney films, IKEA stores, and Apple iPods and iPhones. It is a world in which products are made from inputs that come from all over the world. It is a world in which a financial crisis in America can trigger a global economic recession, which is exactly what occurred in 2008 and 2009. It is also a world in which vigorous and vocal groups protest against globalization, which they blame for a list of ills, from unemployment in developed nations to environmental degradation



Another Perspective

The United States in Perspective

The United States has the highest level of output in the world, with a GDP valued at over \$14.4 trillion in 2009. The U.S. GDP per capita is \$46,900. With about 4.5 percent of the world's population, the United States produces about 25 percent of the global GDP. (U.S. Central Intelligence Agency, *World Factbook*, www.cia.gov, accessed April 27, 2010)

and the Americanization of popular culture. And yes, these protests have on occasion turned violent.

For businesses, this process has produced many opportunities. Firms can expand their revenues by selling around the world and/or reduce their costs by producing in nations where key inputs, including labor, are cheap. The global expansion of enterprises has been facilitated by favorable political and economic trends. Since the collapse of communism at the end of the 1980s, the pendulum of public policy in nation after nation has swung

toward the free market end of the economic spectrum. Regulatory and administrative barriers to doing business in foreign nations have come down, while those nations have often transformed their economies, privatizing state-owned enterprises, deregulating markets, increasing competition, and welcoming investment by foreign businesses. This has allowed businesses both large and small, from both advanced nations and developing nations, to expand internationally.

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

At the same time as it creates opportunities, globalization has also created new threats for businesses accustomed to dominating their domestic markets. Foreign companies have entered many formerly protected industries in developing nations, increasing competition and driving down prices. For three decades, U.S. automobile companies have been battling foreign enterprises, as Japanese, European, and now Korean companies have taken business from them. General Motors has seen its U.S. market share decline from more than 50 percent to less than 20 percent, while Japan's Toyota has surpassed first Ford and now GM to become the largest automobile company in the world.

As globalization unfolds, it is transforming industries and creating anxiety among those who believed their jobs were protected from foreign competition. Historically, while many workers in manufacturing industries worried about the impact foreign competition might have on their jobs, workers in service industries felt more secure. Now this too is changing. Advances in technology, lower transportation costs, and the rise of skilled workers in developing countries imply that many services no longer need to be performed where they are delivered. For example, accounting work is being outsourced from America to India. Today many individual tax returns are compiled in India. Indian accountants, trained in U.S. tax rules, perform work for U.S. accounting firms.² They access individual tax returns stored on computers in the United States, perform routine calculations, and save their work so that it can be inspected by a U.S. accountant, who then bills clients. As the best-selling author Thomas Friedman has argued, the world is becoming flat.³ People living in developed nations no longer have the playing field tilted in their favor. Increasingly, enterprising individuals based in India, China, or Brazil have the same opportunities to better themselves as those living in Western Europe, the United States, or Canada.

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

What Is Globalization?

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

THE GLOBALIZATION OF MARKETS The **globalization of markets** refers to the merging of historically distinct and separate national markets into one huge global marketplace. Falling barriers to cross-border trade have made it easier to sell internationally. It has been argued for some time that the tastes and preferences of consumers in different nations are beginning to converge on some global norm, thereby helping to create a global market.⁴ Consumer products such as Citigroup credit cards, Coca-Cola soft drinks, Sony PlayStation video games, McDonald's hamburgers, Starbucks coffee, and IKEA furniture are frequently held up as prototypical examples of this trend. Firms such as those just cited are more than just benefactors of this trend; they are also facilitators of it. By offering the same basic product worldwide, they help to create a global market.

A company does not have to be the size of these multinational giants to facilitate, and benefit from, the globalization of markets. In the United States, for example, nearly 90 percent of firms that export are small businesses employing less than 100 people, and their share of total U.S. exports has grown steadily over the past decade to now exceed 20 percent.⁵ Firms with less than 500 employees accounted for 97 percent of all U.S. exporters and almost 30 percent of all exports by value.⁶ Typical of these is Hytech, a New York-based manufacturer of solar panels that generates 40 percent of its \$3 million in annual sales from exports to five countries, or B&S Aircraft Alloys, another New York company whose exports account for 40 percent of its \$8 million annual revenues.⁷ The situation is similar in several other nations. In Germany, for example, a staggering 98 percent of small and mid-sized companies have exposure to international markets, either via exports or international production.⁸

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

The most global markets currently are not markets for consumer products—where national differences in tastes and preferences are still often important enough to act as

LEARNING OBJECTIVE 1

Understand what is meant by the term *globalization*.

Globalization

Trend away from distinct national economic units and toward one huge global market.

Globalization of Markets

Moving away from an economic system in which national markets are distinct entities, isolated by trade barriers and barriers of distance, time, and culture, and toward a system in which national markets are merging into one global market.

a brake on globalization—but markets for industrial goods and materials that serve a universal need the world over. These include the markets for commodities such as aluminum, oil, and wheat; for industrial products such as microprocessors, DRAMs (computer memory chips), and commercial jet aircraft; for computer software; and for financial assets from U.S. Treasury bills to eurobonds and futures on the Nikkei index or the Mexican peso.

In many global markets, the same firms frequently confront each other as competitors in nation after nation. Coca-Cola's rivalry with PepsiCo is a global one, as are the rivalries between Ford and Toyota, Boeing and Airbus, Caterpillar and Komatsu in earthmoving equipment, General Electric and Rolls-Royce in aero engines, and Sony, Nintendo, and Microsoft in video games. If a firm moves into a nation not currently served by its rivals, many of those rivals are sure to follow to prevent their competitor from gaining an advantage.⁹ As firms follow each other around the world, they bring with them many of the assets that served them well in other national markets—including their products, operating strategies, marketing strategies, and brand names—creating some homogeneity across markets. Thus, greater uniformity replaces diversity. In an increasing number of industries, it is no longer meaningful to talk about “the German market,” “the American market,” “the Brazilian market,” or “the Japanese market”; for many firms there is only the global market.

Globalization of Production

Trend by individual firms to disperse parts of the productive processes to different locations around the globe to take advantage of national differences in the cost and quality of factors of production.

Factors of Production

Inputs into the productive process of a firm, including labor, management, land, capital, and technological know-how.

THE GLOBALIZATION OF PRODUCTION The globalization of production refers to the sourcing of goods and services from locations around the globe to take advantage of national differences in the cost and quality of **factors of production** (such as labor, energy, land, and capital). By doing this, companies hope to lower their overall cost structure or improve the quality or functionality of their product offering, thereby allowing them to compete more effectively. Consider the Boeing 777, a commercial jet airliner. Eight Japanese suppliers make parts for the fuselage, doors, and wings; a supplier in Singapore makes the doors for the nose landing gear; three suppliers in Italy manufacture wing flaps; and so on.¹⁰ In total, some 30 percent of the 777, by value, is built by foreign companies. For its most recent jet airliner, the 787, Boeing has pushed this trend even further, with some 65 percent of the total value of the aircraft scheduled to be outsourced to foreign companies, 35 percent of which will go to three major Japanese companies.¹¹

Part of Boeing's rationale for outsourcing so much production to foreign suppliers is that these suppliers are the best in the world at their particular activity. A global web of suppliers yields a better final product, which enhances the chances of Boeing winning a greater share of total orders for aircraft than its global rival Airbus. Boeing also outsources some production to foreign countries to increase the chance that it will win significant orders from airlines based in that country. For another example of a global web of activities, consider the example of Vizio profiled in the accompanying Management Focus.

Early outsourcing efforts were primarily confined to manufacturing activities, such as those undertaken by Boeing and Vizio; increasingly, however, companies are taking advantage of modern communications technology, particularly the Internet, to outsource service activities to low-cost producers in other nations. The Internet has allowed hospitals to outsource some radiology work to India, where images from MRI scans and the like are read at night while U.S. physicians sleep and the results are ready for them in the morning. Many software companies, including IBM, now use Indian engineers to perform maintenance functions on software designed in the United States. The time difference allows Indian engineers to run debugging tests on software written in the United States when U.S. engineers sleep, transmitting the corrected code back to the United States over secure Internet connections so it is



Vizio and the Market for Flat-Panel TVs

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

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

As production for flat-panel displays migrates its way around the globe to low-cost locations, there are clear winners and losers. U.S. consumers have benefited from the falling prices of flat-panel TVs and are snapping them up. Efficient manufacturers have taken advantage of globally dispersed supply chains to make and sell low-cost, high-quality flat-panel TVs. Foremost among these has been the California-based company Vizio, founded by a Taiwanese immigrant. In just six years, sales of Vizio

flat-panel TVs ballooned from nothing to more than \$2 billion in 2008, and in early 2009, the company was the largest provider to the U.S. market with a 21.7 percent share. Vizio has less than 100 employees, who focus on final product design, sales, and customer service. Vizio outsources most of its engineering work, all of its manufacturing, and much of its logistics. For each of its models, Vizio assembles a team of supplier partners strung across the globe. Its 42-inch model, for example, contains a panel from South Korea, electronic components from China, and processors from the United States, and it is assembled in Mexico. Vizio's managers scour the globe for the cheapest manufacturers of displays and electronic components. They sell most of their TVs to large discount retailers such as Costco and Sam's Club. Good order visibility from retailers, coupled with tight management of global logistics, allows Vizio to turn over its inventory every three weeks, twice as fast as many of its competitors, which is a major source of cost saving in a business where prices are falling continually.

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

Sources: D. J. Lynch. "Flat Panel TVs Display Effects of Globalization," *USA Today*, May 8, 2007, pp. 1B, 2B; P. Engardio and E. Woyke. "Flat Panels, Thin Margins," *BusinessWeek*, February 26, 2007, p. 50; B. Womack, "Flat TV Seller Vizio Hits \$600 million in Sales, Growing," *Orange County Business Journal*, September 4, 2007, pp. 1, 64; and E. Taub. "Vizio's Flat Panel Display Sales Are Anything but Flat," *The New York Times Online*, May 12, 2009.

ready for U.S. engineers to work on the following day. Dispersing value-creation activities in this way can compress the time and lower the costs required to develop new software programs. Other companies, from computer makers to banks, are outsourcing customer service functions, such as customer call centers, to developing nations where labor is cheaper. In another example from health care, in 2008 some 34,000 Filipinos were transcribing American medical files (such as audio files from doctors seeking approval from insurance companies for performing a procedure). More generally, some estimates suggest the outsourcing of many administrative procedures in health care, such as customer service and claims processing, could reduce health care costs in America by as much as \$70 billion.¹²

Robert Reich, who served as secretary of labor in the Clinton administration, has argued that as a consequence of the trend exemplified by companies such as Boeing, IBM, and Vizio, in many cases it is becoming irrelevant to talk about American products,

Japanese products, German products, or Korean products. Increasingly, according to Reich, the outsourcing of productive activities to different suppliers results in the creation of products that are global in nature, that is, “global products.”¹³ But as with the globalization of markets, companies must be careful not to push the globalization of production too far. As we will see in later chapters, substantial impediments still make it difficult for firms to achieve the optimal dispersion of their productive activities to locations around the globe. These impediments include formal and informal barriers to trade between countries, barriers to foreign direct investment, transportation costs, and issues associated with economic and political risk. For example, government regulations ultimately limit the ability of hospitals to outsource the process of interpreting MRI scans to developing nations where radiologists are cheaper.

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

The Emergence of Global Institutions

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

The **World Trade Organization** (like the GATT before it) is primarily responsible for policing the world trading system and making sure nation-states adhere to the rules laid down in trade treaties signed by WTO members. As of 2010, 154 nations that collectively accounted for 97 percent of world trade were WTO members, thereby giving the organization enormous scope and influence. The WTO is also responsible for facilitating the establishment of additional multinational agreements between WTO member states. Over its entire history, and that of the GATT before it, the WTO has promoted the lowering of barriers to cross-border trade and investment. In doing so, the WTO has been the instrument of its member states, which have sought to create a more open global business system unencumbered by barriers to trade and investment between countries. Without an institution such as the WTO, the globalization of markets and production is unlikely to have proceeded as far as it has. However, as we shall see in this chapter and in Chapter 6 when we look closely at the WTO, critics charge that the organization is usurping the national sovereignty of individual nation-states.

The **International Monetary Fund** and the **World Bank** were both created in 1944 by 44 nations that met at Bretton Woods, New Hampshire. The IMF was established to maintain order in the international monetary system; the World Bank was set up to promote economic development. In the 65 years since their creation, both institutions have emerged as significant players in the global economy. The World Bank is the less controversial of the two sister institutions. It has focused on making low-interest loans to cash-strapped governments in poor nations that wish to undertake significant infrastructure investments (such as building dams or roads).

The IMF is often seen as the lender of last resort to nation-states whose economies are in turmoil and currencies are losing value against those of other nations. During the past

General Agreement on Tariffs and Trade (GATT)

International treaty that committed signatories to lowering barriers to the free flow of goods across national borders and led to the WTO.

World Trade Organization (WTO)

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.

International Monetary Fund (IMF)

International institution set up to maintain order in the international monetary system.

World Bank

International institution set up to promote general economic development in the world's poorer nations.

two decades, for example, the IMF has lent money to the governments of troubled states, including Argentina, Indonesia, Mexico, Russia, South Korea, Thailand, and Turkey. More recently, the IMF has taken a very proactive role in helping countries to cope with some of the effects of the 2008–2009 global financial crisis. IMF loans come with strings attached, however; in return for loans, the IMF requires nation-states to adopt specific economic policies aimed at returning their troubled economies to stability and growth. These requirements have sparked controversy. Some critics charge that the IMF's policy recommendations are often inappropriate; others maintain that by telling national governments what economic policies they must adopt, the IMF, like the WTO, is usurping the sovereignty of nation-states. We shall look at the debate over the role of the IMF in Chapter 10.

The **United Nations** was established October 24, 1945, by 51 countries committed to preserving peace through international cooperation and collective security. Today nearly every nation in the world belongs to the United Nations; membership now totals 191 countries. When states become members of the United Nations, they agree to accept the obligations of the UN Charter, an international treaty that establishes basic principles of international relations. According to the charter, the UN has four purposes: to maintain international peace and security, to develop friendly relations among nations, to cooperate in solving international problems and in promoting respect for human rights, and to be a center for harmonizing the actions of nations. Although the UN is perhaps best known for its peacekeeping role, one of the organization's central mandates is the promotion of higher standards of living, full employment, and conditions of economic and social progress and development—all issues that are central to the creation of a vibrant global economy. As much as 70 percent of the work of the UN system is devoted to accomplishing this mandate. To do so, the UN works closely with other international institutions such as the World Bank. Guiding the work is the belief that eradicating poverty and improving the well-being of people everywhere are necessary steps in creating conditions for lasting world peace.¹⁴

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

Drivers of Globalization

Two macro factors underlie the trend toward greater globalization.¹⁵ The first is the decline in barriers to the free flow of goods, services, and capital that has occurred since the end of World War II. The second factor is technological change, particularly the dramatic developments in recent years in communication, information processing, and transportation technologies.



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

United Nations

An international organization made up of 191 countries and headquartered in New York City, formed in 1945 to promote peace, security, and cooperation.

LEARNING OBJECTIVE 2

Recognize the main drivers of globalization.

International Trade

Occurs when a firm exports goods or services to consumers in another country.

Foreign Direct Investment (FDI)

Direct investment in business operations in a foreign country.

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

Having learned from this experience, the advanced industrial nations of the West committed themselves after World War II to removing barriers to the free flow of goods, services, and capital between nations.¹⁶ This goal was enshrined in the General Agreement on Tariffs and Trade. Under the umbrella of GATT, eight rounds of negotiations among member states (now numbering 153) have worked to lower barriers to the free flow of goods and services. The most recent round of negotiations to be completed, known as the Uruguay Round, were finalized in December 1993. The Uruguay Round further reduced trade barriers; extended GATT to cover services as well as manufactured goods; provided enhanced protection for patents, trademarks, and copyrights; and established the World Trade Organization to police the international trading system.¹⁷ Table 1.1 summarizes the impact of GATT agreements on average tariff rates for manufactured goods. As can be seen, average tariff rates have fallen significantly since 1950 and now stand at about 4 percent.

In late 2001, the WTO launched a new round of talks aimed at further liberalizing the global trade and investment framework. For this meeting, it picked the remote location of Doha in the Persian Gulf state of Qatar. At Doha, the member states of the WTO staked out an agenda. The talks were scheduled to last three years, although as of 2010 the talks are effectively stalled due to opposition from several key nations. The Doha agenda includes cutting tariffs on industrial goods, services, and agricultural products; phasing out subsidies to agricultural producers; reducing barriers to cross-border investment; and limiting the use of antidumping laws. If the Doha talks are ever completed, the biggest gain may come from discussion on agricultural products; average agricultural tariff rates are still about 40 percent, and rich nations spend some \$300 billion a year in subsidies to support their farm sectors. The world's poorer nations have the most to gain from any reduction in agricultural tariffs and subsidies; such reforms would give them access to the markets of the developed world.¹⁸

table 1.1

Average Tariff Rates on Manufactured Products as Percent of Value

Source: 1913–90 data are from “Who Wants to Be a Giant?” *The Economist: A Survey of the Multinationals*, June 24, 1995, pp. 3–4. Copyright © The Economist Books, Ltd. The 2008 data are from World Trade Organization, *2009 World Trade Report* (Geneva: WTO, 2009).

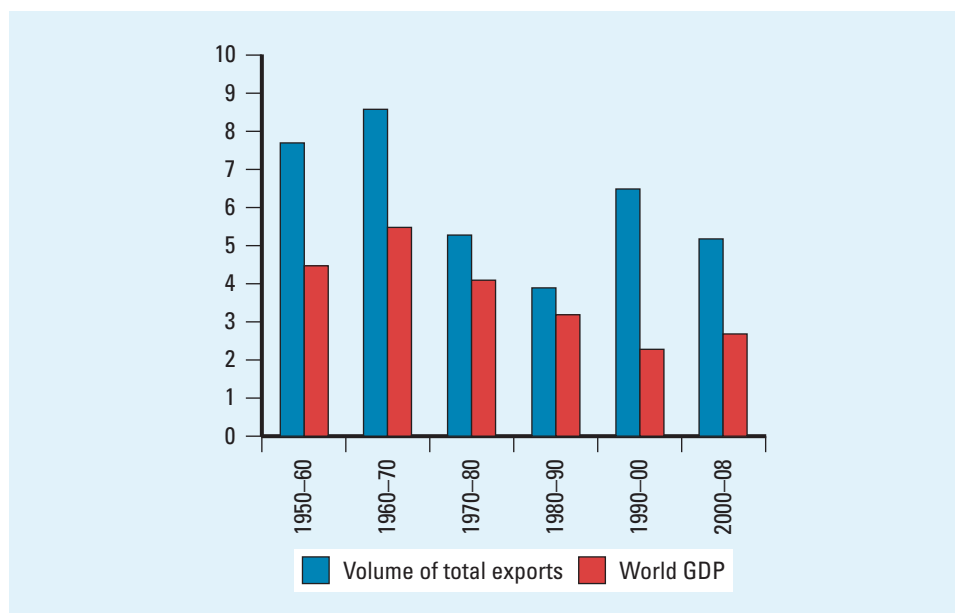
	1913	1950	1990	2008
France	21%	18%	5.9%	3.9%
Germany	20	26	5.9	3.9
Great Britain	—	23	5.9	3.9
Holland	5	11	5.9	3.9
Italy	18	25	5.9	3.9
Japan	30	—	5.3	2.3
Sweden	20	9	4.4	3.9
United States	44	14	4.8	3.2

In addition to reducing trade barriers, many countries have also been progressively removing restrictions to foreign direct investment. According to the United Nations, some 90 percent of the 2,600 changes made worldwide between 1992 and 2008 in the laws governing foreign direct investment created a more favorable environment for FDI.¹⁹

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

According to WTO data, the volume of world merchandise trade has grown faster than the world economy since 1950 (see Figure 1.1).²⁰ From 1970 to 2008, the volume of world merchandise trade expanded more than 30-fold, outstripping the expansion of world production, which grew close to 10 times in real terms. (World merchandise trade includes trade in manufactured goods, agricultural goods, and mining products, but *not* services). But Figure 1.1 does not show that since the mid-1980s the value of international trade in services has also grown robustly. Trade in services now accounts for about 20 percent of the value of all international trade. Increasingly, international trade in services has been driven by advances in communications, which allow corporations to outsource service activities to different locations around the globe. Thus, as noted earlier, many corporations in the developed world outsource customer service functions, from software maintenance activities to customer call centers, to developing nations where labor costs are lower.

Figure 1.1 also does not show the steep drop in world trade that occurred in 2009. In 2009 the global economy contracted by 2.3 percent as the global financial crisis that began with problems in the U.S. subprime mortgage lending market reverberated around the world. The volume of merchandised trade dropped by 12.2 percent, the largest such decline since World War II. The main reason seems to have been a drop in global consumer demand, although an inability to finance international trade due to tight credit



1.1 figure
Average Annual Percentage Growth in Volume of Exports and World GDP, 1950–2008
 Source: Constructed by the author from World Trade Organization, *International Trade Trends and Statistics, 2009* (Geneva: WTO, 2009).

conditions may have also played a role. However, trade seemed set to rebound in 2010, with the WTO forecasting a 9.5 percent growth in volume. It would seem, therefore, that what occurred in 2009 will have no impact on the long-term trend.²¹

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

Evidence also suggests that foreign direct investment is playing an increasing role in the global economy as firms increase their cross-border investments. The average yearly outflow of FDI increased from \$25 billion in 1975 to a record \$1.8 trillion in 2007 (see Figure 7.1). However, FDI outflows did contract to \$1.2 trillion in 2009 during the global financial crisis, although they are forecasted to recover in 2011.²² In general, over the past 30 years the flow of FDI has accelerated faster than the growth in world trade and world output. For example, between 1992 and 2008, the total flow of FDI from all countries increased more than eightfold while world trade by value grew by some 150 percent and world output by around 45 percent.²³ As a result of the strong FDI flow, by 2009 the global stock of FDI was about \$15 trillion. At least 82,000 parent companies had 810,000 affiliates in foreign markets that collectively employed more than 77 million people abroad and generated value accounting for about 11 percent of global GDP. The foreign affiliates of multinationals had over \$30 trillion in global sales, higher than the value of global exports of goods and services, which stood at close to \$19.9 trillion.²⁴

The globalization of markets and production and the resulting growth of world trade, foreign direct investment, and imports all imply that firms are finding their home markets under attack from foreign competitors. This is true in Japan, where U.S. companies such as Kodak and Procter & Gamble are expanding their presence. It is true in the United States, where Japanese automobile firms have taken market share away from General Motors and Ford. And it is true in Europe, where the once-dominant Dutch company Philips has seen its market share in the consumer electronics industry taken by Japan's JVC, Matsushita, and Sony, and by South Korea's Samsung and LG. The growing integration of the world economy into a single, huge marketplace is increasing the intensity of competition in a range of manufacturing and service industries.

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

THE ROLE OF TECHNOLOGICAL CHANGE The lowering of trade barriers made globalization of markets and production a theoretical possibility. Technological change has made it a tangible reality. Since the end of World War II, the world has seen major advances in communication, information processing, and transportation technology, including the explosive emergence of the Internet and World Wide

Web. Telecommunications is creating a global audience. Transportation is creating a global village. From Buenos Aires to Boston, and from Birmingham to Beijing, ordinary people are watching MTV, they're wearing blue jeans, and they're listening to iPods as they commute to work.

Microprocessors and Telecommunications Perhaps the single most important innovation has been development of the microprocessor, which enabled the explosive growth of high-power, low-cost computing, vastly increasing the amount of information that can be processed by individuals and firms. The microprocessor also underlies many recent advances in telecommunications technology. Over the past 30 years, global communications have been revolutionized by developments in satellite, optical fiber, and wireless technologies, and now the Internet and the World Wide Web. These technologies rely on the microprocessor to encode, transmit, and decode the vast amount of information that flows along these electronic highways. The cost of microprocessors continues to fall, while their power increases (a phenomenon known as **Moore's law**, which predicts that the power of microprocessor technology doubles and its cost of production falls in half every 18 months).²⁵ As this happens, the cost of global communications plummets, which lowers the costs of coordinating and controlling a global organization. Thus, between 1930 and 1990, the cost of a three-minute phone call between New York and London fell from \$244.65 to \$3.32.²⁶ By 1998, it had plunged to just 36 cents for consumers, and much lower rates were available for businesses.²⁷ Indeed, by using the Internet, the cost of an international phone call is rapidly plummeting toward just a few cents per minute.

Moore's Law

The power of microprocessor technology doubles and its cost of production falls in half every 18 months.

The Internet and World Wide Web The rapid growth of the World Wide Web is the latest expression of this development. In 1990, fewer than 1 million users were connected to the Internet. By 1995, the figure had risen to 50 million. By May 2009 the Internet had 1.6 billion users.²⁸ The WWW has developed into the information backbone of the global economy. In the U.S. alone, e-commerce retail sales reached \$133 billion in 2008, up from almost nothing in 1998.²⁹ Viewed globally, the Web is emerging as an equalizer. It rolls back some of the constraints of location, scale, and time zones.³⁰ The Web makes it much easier for buyers and sellers to find each other, wherever they may be located and whatever their size. It allows businesses, both small and large, to expand their global presence at a lower cost than ever before.

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

Containerization has revolutionized the transportation business, significantly lowering the costs of shipping goods over long distances. Before the advent of containerization, moving goods from one mode of transport to another was very labor intensive, lengthy, and costly. It could take days and several hundred longshoremen to unload a ship and reload goods onto trucks and trains. With the advent of widespread containerization in the 1970s and 1980s, the whole process can now be executed by a handful of longshoremen in a couple of days. Since 1980, the world's containership fleet has more than quadrupled, reflecting in part the growing volume of international trade and in part the switch to this mode of transportation. As a result of the efficiency gains associated with



Before the advent of containerization, it could take several days and several hundred longshoremen to unload a ship and reload goods onto trucks and trains.

containerization, transportation costs have plummeted, making it much more economical to ship goods around the globe, thereby helping to drive the globalization of markets and production. Between 1920 and 1990, the average ocean freight and port charges per ton of U.S. export and import cargo fell from \$95 to \$29 (in 1990 dollars).³¹ The cost of shipping freight per ton-mile on railroads in the United States fell from 3.04 cents in 1985 to 2.3 cents in 2000, largely as a result of efficiency gains from the widespread use of containers.³² An increased share of cargo now goes by air. Between 1955 and 1999, average air transportation revenue per ton-kilometer fell by more than 80 percent.³³ Reflecting the falling cost of airfreight, by the early 2000s air shipments accounted for 28 percent of the value of U.S. trade, up from 7 percent in 1965.³⁴

Implications for the Globalization of Production As transportation costs associated with the globalization of production declined, dispersal of production to geographically separate locations became more economical. As a result of the technological innovations discussed above, the real costs of information processing and communication have fallen dramatically in the past two decades. These developments make it possible for a firm to create and then manage a globally dispersed production system, further facilitating the globalization of production. A worldwide communications network has become essential for many international businesses. For example, Dell uses the Internet to coordinate and control a globally dispersed production system to such an extent that it holds only three days' worth of inventory at its assembly locations. Dell's Internet-based system records orders for computer equipment as they are submitted by customers via the company's Web site, then immediately transmits the resulting orders for components to various suppliers around the world, which have a real-time look at Dell's order flow and can adjust their production schedules accordingly. Given the low cost of airfreight, Dell can use air transportation to speed up the delivery of critical components to meet unanticipated demand shifts

without delaying the shipment of final product to consumers. Dell also has used modern communications technology to outsource its customer service operations to India. When U.S. customers call Dell with a service inquiry, they are routed to Bangalore in India, where English-speaking service personnel handle the call.

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

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

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

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

The Changing Demographics of the Global Economy

Hand in hand with the trend toward globalization has been a fairly dramatic change in the demographics of the global economy over the past 30 years. As late as the 1960s, four stylized facts described the demographics of the global economy. The first was

LEARNING OBJECTIVE 3

Describe the changing nature of the global economy.

U.S. dominance in the world economy and world trade picture. The second was U.S. dominance in world foreign direct investment. Related to this, the third fact was the dominance of large, multinational U.S. firms on the international business scene. The fourth was that roughly half the globe—the centrally planned economies of the Communist world—were off-limits to Western international businesses. As will be explained below, all four of these qualities either have changed or are now changing rapidly.

THE CHANGING WORLD OUTPUT AND WORLD TRADE PICTURE

In the early 1960s, the United States was still by far the world's dominant industrial power. In 1963 the United States accounted for 40.3 percent of world economic activity, measured by gross domestic product (GDP). By 2008, the United States accounted for 20.7 percent of world GDP, still the world's largest industrial power but down significantly in relative size since the 1960s (see Table 1.2). Nor was the United States the only developed nation to see its relative standing slip. The same occurred to Germany, France, and the United Kingdom, all nations that were among the first to industrialize. This change in the U.S. position was not an absolute decline, since the U.S. economy grew at a robust average annual rate of more than 3 percent from 1963 to 2008 (the economies of Germany, France, and the United Kingdom also grew during this time). Rather, it was a relative decline, reflecting the faster economic growth of several other economies, particularly in Asia. For example, as can be seen from Table 1.2, from 1963 to 2008, China's share of world GDP increased from a trivial amount to 11.4 percent. Other countries that markedly increased their share of world output included Japan, Thailand, Malaysia, Taiwan, and South Korea (note that GDP data in Table 1.2 are based on purchasing power parity figures, which adjust the value of GDP to reflect the cost of living in various economies).

By the end of the 1980s, the U.S. position as the world's leading exporter was threatened. Over the past 30 years, U.S. dominance in export markets has waned as Japan, Germany, and a number of newly industrialized countries such as South Korea and China have taken a larger share of world exports. During the 1960s, the United States routinely accounted for 20 percent of world exports of manufactured goods. But as Table 1.2 shows, the U.S. share of world exports of goods and services had slipped to 8.5 percent by 2009, behind China and Germany.

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

table 1.2

The Changing Demographics of World GDP and Trade

Sources: IMF, *World Economic Outlook*, October 2009. Data for 1963 are from N. Hood and J. Young, *The Economics of the Multinational Enterprise* (New York: Longman, 1973). The GDP data are based on purchasing power parity figures, which adjust the value of GDP to reflect the cost of living in various economies. Export data from WTO press release, "Trade to Expand by 9.5% in 2010," March 26, 2010.

Country	Share of World Output, 1963	Share of World GDP, 2008	Share of World Exports, 2009
United States	40.3%	20.7%	8.5%
Germany	9.7	4.2	9.0
France	6.3	3.1	3.8
Italy	3.4	2.6	3.2
United Kingdom	6.5	3.2	2.8
Canada	3.0	1.9	2.5
Japan	5.5	6.4	4.7
China	NA	11.4	9.6

development and industrialization of the world economy, as opposed to any absolute decline in the health of the U.S. economy, which by many measures is stronger than ever.

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



Another Perspective

The Changing Face of OPEC

For decades, Saudi Arabia, as the world's leading oil producer, has been able to call the shots at the Organization of Petroleum Exporting Countries, more commonly known as OPEC. But recently Iraq put the Saudis—and the rest of OPEC—on notice. As Iraq becomes more politically stable, it is resuming oil exploration and plans to ramp up production. The government's own projections suggest that within seven years, output will rise from its current 2.5 million barrels a day to rival Saudi Arabia's daily 10 million to 12 million. Having serious competition in the oil market would change the picture for Saudi Arabia—as well as for OPEC. (Stephen Glain, "How Iraqi Oil Is Changing the World," *Foreign Policy*, March 17, 2010, www.foreignpolicy.com)

THE CHANGING FOREIGN DIRECT INVESTMENT PICTURE

Reflecting the dominance of the United States in the global economy, U.S. firms accounted for 66.3 percent of worldwide foreign direct investment flows in the 1960s. British firms were second, accounting for 10.5 percent, while Japanese firms were a distant eighth, with only 2 percent. The dominance of U.S. firms was so great that books were written about the economic threat posed to Europe by U.S. corporations.³⁵ Several European governments, most notably France, talked of limiting inward investment by U.S. firms.

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



Country FOCUS

India's Software Sector

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

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

Indian labor and the Internet, software enterprises can create global software development factories that are working 24 hours a day.

Initially Indian software enterprises focused on the low end of the software industry, supplying basic software development and testing services to Western firms. But as the industry has grown in size and sophistication, Indian firms have moved up-market. Today the leading Indian companies compete directly with the likes of IBM and EDS for large software development projects, business process outsourcing contracts, and information technology consulting services. These markets are booming. Estimates suggest that global spending on information technology outsourcing will rise from \$193 billion in 2004 to more than \$250 billion by 2010, with Indian enterprises capturing a larger slice of the pie. One response of Western firms to this emerging competitive threat has been to invest in India to garner the same kind of economic advantages that Indian firms enjoy. IBM, for example, has invested \$2 billion in its Indian operations and now has 53,000 employees located there, more than in any other country except America. In 2007 it announced plans to invest another \$6 billion over the next few years in India. Microsoft too has made major investments in India, including an R&D center in Hyderabad that employs 900 people and was located there specifically to tap into talented Indian engineers who did not want to move to the United States.

Sources: "America's Pain, India's Gain: Outsourcing," *The Economist*, January 11, 2003, p. 59; "The World Is Our Oyster," *The Economist*, October 7, 2006, pp. 9–10; and "IBM and Globalization: Hungry Tiger, Dancing Elephant," *The Economist*, April 7, 2007, pp. 67–69.

Stock of Foreign Direct Investment

The total cumulative value of foreign-owned assets at a given time.

growing political pressures in the United States and Europe to restrict Japanese automobile exports into those markets.

One consequence of these developments is illustrated in Figure 1.2, which shows how the stock of foreign direct investment by the world's six most important national sources—the United States, the United Kingdom, Germany, the Netherlands, France, and Japan—changed between 1980 and 2008. (The **stock of foreign direct investment** refers to the total cumulative value of foreign investments.) Figure 1.2 also shows the stock accounted for by firms from developing economies. The share of the total stock accounted for by U.S. firms declined from about 38 percent in 1980 to 19.5 percent in 2008. Meanwhile, the shares accounted for by France and the world's developing nations increased markedly. The rise in the share of FDI stock accounted for by developing nations reflects a growing trend for firms from these countries to invest outside their borders. In 2008, firms based in developing nations accounted for 14.5 percent of the stock of foreign direct investment, up from only 1.1 percent in 1980. Firms based in Hong Kong, South Korea, Singapore, Taiwan, India, and mainland China accounted for much of this investment.

1.2 figure

Percentage Share of Total FDI Stock, 1980–2008

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

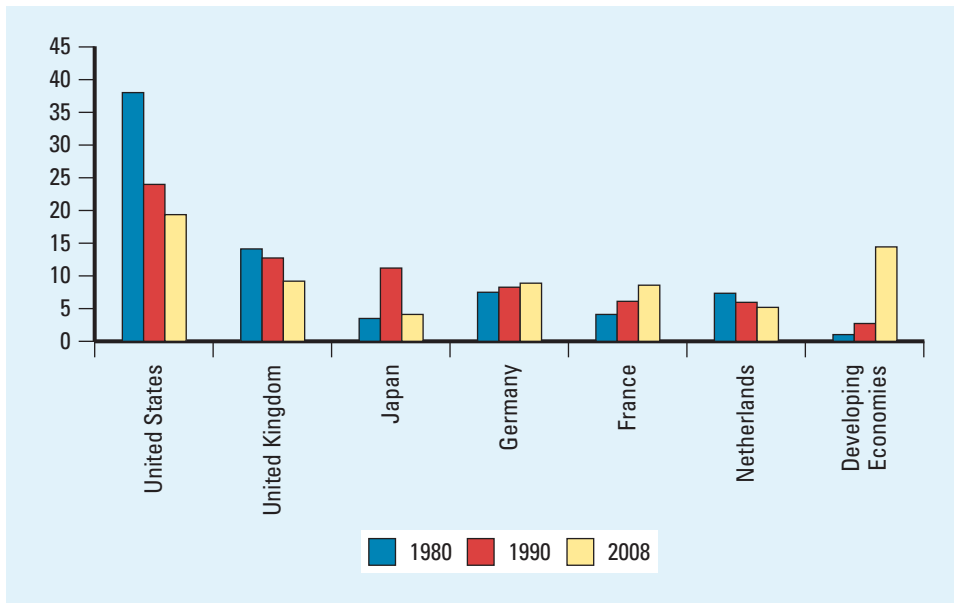
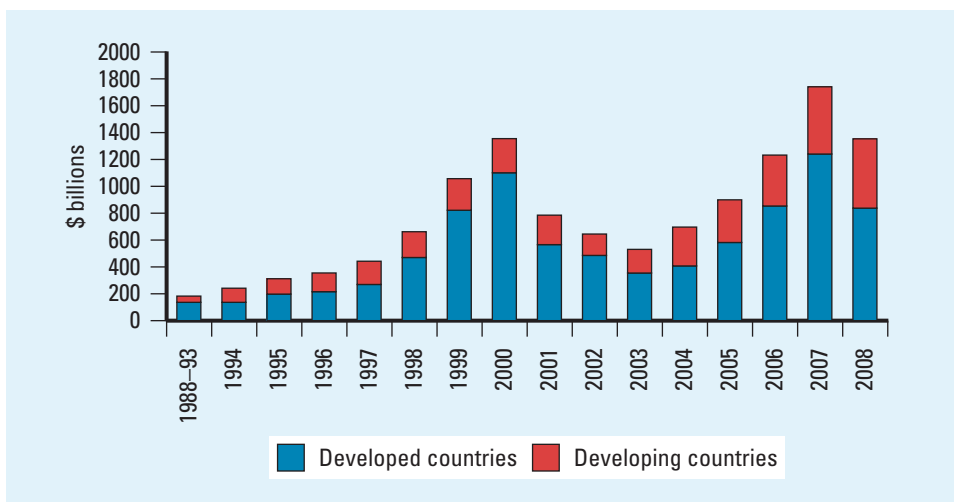


Figure 1.3 illustrates two other important trends—the sustained growth in cross-border flows of foreign direct investment that occurred during the 1990s and the importance of developing nations as the destination of foreign direct investment. Throughout the 1990s, the amount of investment directed at both developed and developing nations increased dramatically, a trend that reflects the increasing internationalization of business corporations. A surge in foreign direct investment from 1998 to 2000 was followed by a slump from 2001 to 2003 associated with a slow-down in global economic activity after the collapse of the financial bubble of the late 1990s and 2000. However, the growth of foreign direct investment resumed in 2004 and continued through 2007, when it hit record levels, only to slow again in 2008 as the global financial crisis took hold (preliminary figures suggest it contracted again in 2009 to \$1.2 billion). Among developing nations, the largest recipient of foreign

1.3 figure

FDI Inflows, 1988–2008

Sources: UNCTAD, *World Investment Report, 2008* (Geneva: United Nations, 2008); and “Global Foreign Investment Now in Decline,” UNCTAD press release, January 19, 2009.



direct investment has been China, which in 2004–2009 received \$60 billion to \$100 billion a year in inflows. As we shall see later in this book, the sustained flow of foreign investment into developing nations is an important stimulus for economic growth in those countries, which bodes well for the future of countries such as China, Mexico, and Brazil, all leading beneficiaries of this trend.

THE CHANGING NATURE OF THE MULTINATIONAL ENTERPRISE

Multinational Enterprise (MNE)
A firm that owns business operations in more than one country.

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

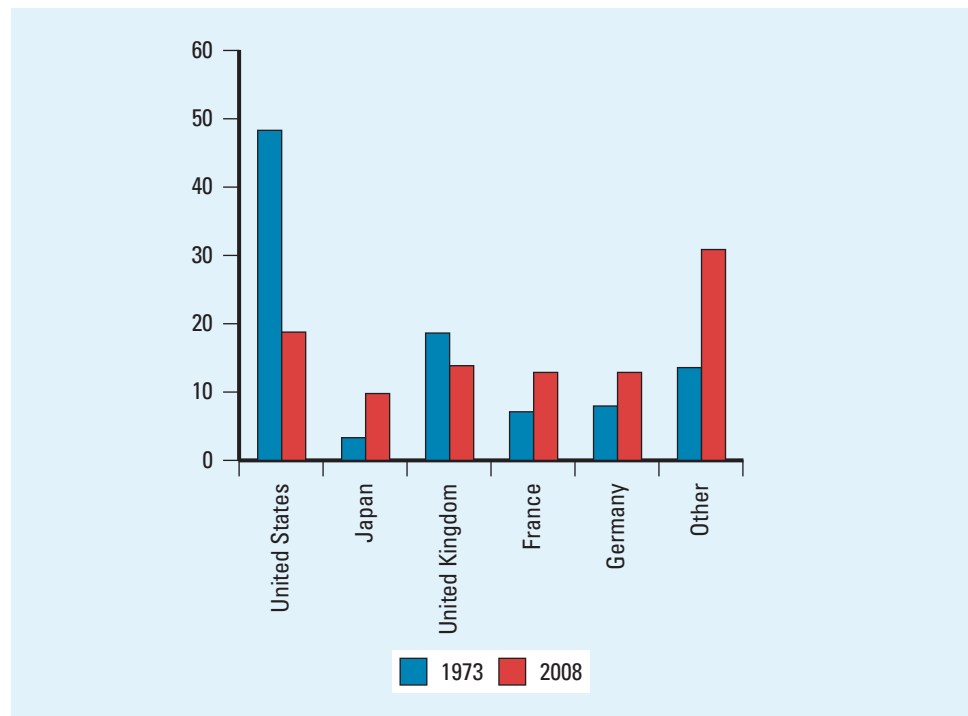
Non-U.S. Multinationals In the 1960s, global business activity was dominated by large U.S. multinational corporations. With U.S. firms accounting for about two-thirds of foreign direct investment during the 1960s, one would expect most multinationals to be U.S. enterprises. According to the data summarized in Figure 1.4, 48.5 percent of the world's 260 largest multinationals were U.S. firms in 1973. The second-largest source country was the United Kingdom, with 18.8 percent of the largest multinationals. Japan accounted for 3.5 percent of the world's largest multinationals at the time. The large number of U.S. multinationals reflected U.S. economic dominance in the three decades after World War II, while the large number of British multinationals reflected that country's industrial dominance in the early decades of the twentieth century.

By 2008 things had shifted significantly. Some 19 of the world's 100 largest nonfinancial multinationals were now U.S. enterprises; 13 were French; 13, German; 14, British;

figure 1.4

National Origin of Largest Multinational Enterprises, 1973 and 2008

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





China's Hisense—An Emerging Multinational

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

Under Zhou's leadership, Hisense entered a period of rapid growth, product diversification, and global expansion. By 2009 the company had sales of more than \$7 billion and had emerged as one of China's premier makers of TV sets (with a 12 percent share of the domestic market), air conditioners, refrigerators, personal computers, and telecommunications equipment. Hisense sold around 10 million TV sets, 3 million air conditioners, 4 million CDMA wireless phones, 6 million refrigerators, and 1 million personal computers. International sales accounted for over \$500 million, or more than 15 percent of total revenue. The company had established overseas manufacturing subsidiaries in Algeria, Hungary, Iran, Pakistan, and South Africa, and it was growing rapidly in developing markets where it was taking share away from long-established consumer electronics and appliance makers.

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

To this end, Hisense established its first R&D center in China in the mid-1990s. This was followed by a South African R&D center in 1997 and a European R&D center in 2007. The company also has plans for an R&D center in the United States. By 2009 these R&D centers had filed for more than 600 patents.

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

Sources: Harold L. Sirkin, "Someone May Be Gaining on Us," *Barron's*, February 5, 2007, p. 53; "Hisense Plans to Grab More International Sales," *Sino Cast China IT Watch*, November 30, 2006; "Hisense's Wonder Chip," *Financial Times Information Limited—Asian Intelligence Wire*, October 30, 2006; and Hisense Web site, www.hisense.com/en/index.jsp, accessed June 14, 2007.

and 10, Japanese.³⁶ Although the 1973 data are not strictly comparable with the later data, they illustrate the trend (the 1973 figures are based on the largest 260 firms, whereas the later figures are based on the largest 100 multinationals). The globalization of the world economy has resulted in a relative decline in the dominance of U.S. firms in the global marketplace.

According to UN data, the ranks of the world's largest 100 multinationals are still dominated by firms from developed economies.³⁷ However, seven firms from developing economies had entered the UN's list of the 100 largest multinationals by 2008. The largest was Hutchison Whampoa of Hong Kong, China, which ranked 22.³⁸ We can reasonably expect more growth of new multinational enterprises from the world's developing nations. Firms from developing nations can be expected to emerge as important competitors in global markets, further shifting the axis of the world economy away from North America and Western Europe and threatening the long dominance of Western companies. One such rising competitor, Hisense, one of China's premier manufacturers of consumer appliances and telecommunications equipment, is profiled in the accompanying Management Focus.

The Rise of Mini-Multinationals Another trend in international business has been the growth of medium-size and small multinationals (mini-multinationals).³⁹ When people think of international businesses, they tend to think of firms such as Exxon, General Motors, Ford, Fuji, Kodak, Matsushita, Procter & Gamble, Sony, and Unilever—large, complex multinational corporations with operations that span the globe. Although most international trade and investment is still conducted by large firms, many medium-size and small businesses are becoming increasingly involved in international trade and investment. The rise of the Internet is lowering the barriers that small firms face in building international sales.

For example, consider Lubricating Systems, Inc., of Kent, Washington. Lubricating Systems, which manufactures lubricating fluids for machine tools, employs 25 people and generates sales of \$6.5 million. It's hardly a large, complex multinational, yet more than \$2 million of the company's sales are generated by exports to a score of countries, including Japan, Israel, and the United Arab Emirates. Lubricating Systems also has set up a joint venture with a German company to serve the European market.⁴⁰ Consider also Lixi, Inc., a small U.S. manufacturer of industrial X-ray equipment; 70 percent of Lixi's \$4.5 million in revenues comes from exports to Japan.⁴¹ Or take G.W. Barth, a manufacturer of cocoa-bean roasting machinery based in Ludwigsburg, Germany. Employing just 65 people, this small company has captured 70 percent of the global market for cocoa-bean roasting machines.⁴² International business is conducted not just by large firms but also by medium-size and small enterprises.

THE CHANGING WORLD ORDER Between 1989 and 1991 a series of democratic revolutions swept the Communist world. For reasons that are explored in more detail in Chapter 2, in country after country throughout Eastern Europe and eventually in the Soviet Union itself, Communist Party governments collapsed. The Soviet Union receded into history, having been replaced by 15 independent republics. Czechoslovakia divided itself into two states, while Yugoslavia dissolved into a bloody civil war among its five successor states.

Many of the former Communist nations of Europe and Asia seem to share a commitment to democratic politics and free market economics. If this continues, the opportunities for international businesses are significant. For half a century, these countries were essentially closed to Western international businesses. Now they present a host of export and investment opportunities. Just how this will play out over the next 10 to 20 years is difficult to say. The economies of many of the former Communist states are still relatively undeveloped, and their continued commitment to democracy and free market economics cannot be taken for granted. Disturbing signs of growing unrest and totalitarian tendencies continue to be seen in several Eastern European and Central Asian states, including Russia, which has shown signs of shifting back toward greater state involvement in economic activity and authoritarian government.⁴³ Thus, the risks involved in doing business in such countries are high, but so may be the returns.

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

The potential consequences for international business are enormous. On the one hand, with more than 1 billion people, China represents a huge and largely untapped market. Reflecting this, between 1983 and 2009, annual foreign direct investment in China increased from less than \$2 billion to \$100 billion annually. On the other hand, China's new firms are proving to be very capable competitors, and they could take global market share away from Western and Japanese enterprises (for example, see the Management Focus about Hisense). Thus, the changes in China are creating both opportunities and threats for established international businesses.

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



Another Perspective

How the Chinese See the World Order

Some world observers suggest there's a "push-pull" relationship among Europe, China, and the United States: When China is feuding with Europe, they say, conditions with the United States improve. Or when China and the United States are at odds, China warms up to Europe. Lately, some Chinese have perceived a shift, thanks to their nation's emerging economy while Europe and the United States are recovering slowly from the global economic downturn. They also pay close attention to recent speeches by President Barack Obama, in which he characterizes the United States as "one of the most important countries," not "the most important." (Yu Xiang, "U.S., Europe Adjust to Changing World Order," *China Post*, February 28, 2010, www.chinapost.com)

THE GLOBAL ECONOMY OF THE TWENTY-FIRST CENTURY As discussed, the past quarter century has seen rapid changes in the global economy. Barriers to the free flow of goods, services, and capital have been coming down. The volume of cross-border trade and investment has been growing more rapidly than global output, indicating that national economies are becoming more closely integrated into a single, interdependent, global economic system. As their economies advance, more nations are joining the ranks of the developed world. A generation ago, South Korea and Taiwan were viewed as second-tier developing nations. Now they boast large economies, and their firms are major players in many global industries, from shipbuilding and steel to electronics and chemicals. The move toward a global economy has been further strengthened by the widespread adoption of liberal economic policies by countries that had firmly opposed them for two generations or more. Thus, in keeping with the normative prescriptions of liberal economic ideology, in country after country we have seen state-owned businesses privatized, widespread deregulation adopted, markets opened to more competition, and commitment increased to removing barriers to cross-border trade and investment. This suggests that over the next few



Another Perspective

Globalization and Complexity

Another way to understand globalization is to think of it as the result of our increasing ability to deal with complexity. Some cultures such as the Chinese, Japanese, and Middle Eastern (see Chapter 3 for high context and high power distance) are inclined to work well with complexity. Will these cultural traits serve as a comparative advantage as globalization proceeds?

decades, countries such as the Czech Republic, Mexico, Poland, Brazil, China, India, and South Africa may build powerful market-oriented economies. In short, current trends indicate that the world is moving toward an economic system that is more favorable for international business.

But it is always hazardous to use established trends to predict the future. The world may be moving toward a more global economic system, but globalization is not inevitable. Countries may pull back from the recent commitment to liberal economic ideology if their experiences do not

match their expectations. There are clear signs, for example, of a retreat from liberal economic ideology in Russia. If Russia's hesitation were to become more permanent and widespread, the liberal vision of a more prosperous global economy based on free market principles might not occur as quickly as many hope. Clearly, this would be a tougher world for international businesses.

Also, greater globalization brings with it risks of its own. This was starkly demonstrated in 1997 and 1998 when a financial crisis in Thailand spread first to other East Asian nations and then in 1998 to Russia and Brazil. Ultimately, the crisis threatened to plunge the economies of the developed world, including the United States, into a recession. We explore the causes and consequences of this and other similar global financial crises in Chapter 10. Even from a purely economic perspective, globalization is not all good. The opportunities for doing business in a global economy may be significantly enhanced, but as we saw in 1997–98, the risks associated with global financial contagion are also greater. Indeed, during 2008–09 a crisis that started in the financial sector of America, where banks had been too liberal in their lending policies to homeowners, swept around the world and plunged the global economy into its deepest recession since the early 1980s, illustrating once more that in an interconnected world a severe crisis in one region can impact the entire globe. Still, as explained later in this book, firms can exploit the opportunities associated with globalization, while at the same time reducing the risks through appropriate hedging strategies.

The Globalization Debate

LEARNING OBJECTIVE 4

Explain the main arguments in the debate over the impact of globalization.

Is the shift toward a more integrated and interdependent global economy a good thing? Many influential economists, politicians, and business leaders seem to think so.⁴⁴ They argue that falling barriers to international trade and investment are the twin engines driving the global economy toward greater prosperity. They say increased international trade and cross-border investment will result in lower prices for goods and services. They believe that globalization stimulates economic growth, raises the incomes of consumers, and helps to create jobs in all countries that participate in the global trading system. The arguments of those who support globalization are covered in detail in Chapters 5, 6, and 7. As we shall see, there are good theoretical reasons for believing that declining barriers to international trade and investment do stimulate economic growth, create jobs, and raise income levels. As described in Chapters 6 and 7, empirical evidence lends support to the predictions of this theory. However, despite the existence of a compelling body of theory and evidence, globalization has its critics.⁴⁵ Some of these critics have become increasingly vocal and active, taking to the streets to demonstrate their opposition to globalization. Here we look at the nature of protests against globalization and briefly review the main themes of the debate concerning the merits of globalization. In later chapters we elaborate on many of the points mentioned below.

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

Emboldened by the experience in Seattle, antiglobalization protesters now turn up at almost every major meeting of a global institution. Smaller-scale protests have occurred in several countries, such as France, where antiglobalization activists destroyed a McDonald’s restaurant in August 1999 to protest the impoverishment of French culture by American imperialism (see the Country Focus, “Protesting Globalization in France,” for details). While violent protests may give the antiglobalization effort a bad name, it is clear from the scale of the demonstrations that support for the cause goes beyond a core of anarchists. Large segments of the population in many countries believe that globalization has detrimental effects on living standards and the environment, and the media have often fed on this fear. For example, former CNN news anchor Lou Dobbs ran TV shows that were highly critical of the trend by



Demonstrators at the WTO meeting in Seattle in December 1999 began looting and rioting in the city’s downtown. Why do you think they felt that behavior was necessary?



Country FOCUS

Protesting Globalization in France

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

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

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

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

Sources: "Behind the Bluster," *The Economist*, May 26, 2001; "The French Farmers' Anti-global Hero," *The Economist*, July 8, 2000; C. Trueheart, "France's Golden Arch Enemy?" *Toronto Star*, July 1, 2000; J. Henley, "Grapes of Wrath Scare Off U.S. Firm," *The Economist*, May 18, 2001, p. 11; and United Nations, *World Investment Report, 2006* (New York and Geneva: United Nations, 2006).

American companies to take advantage of globalization and "export jobs" overseas. As the world slipped into a recession in 2008, Dobbs stepped up his antiglobalization rhetoric (Dobbs left CNN in 2009).

Both theory and evidence suggest that many of these fears are exaggerated, but this may not have been communicated clearly and both politicians and businesspeople need to do more to counter these fears. Many protests against globalization

are tapping into a general sense of loss at the passing of a world in which barriers of time and distance, and vast differences in economic institutions, political institutions, and the level of development of different nations, produced a world rich in the diversity of human cultures. This world is now passing into history. However, while the rich citizens of the developed world may have the luxury of mourning the fact that they can now see McDonald's restaurants and Starbucks coffeehouses on their vacations to exotic locations such as Thailand, fewer complaints are heard from the citizens of those countries, who welcome the higher living standards that progress brings.

GLOBALIZATION, JOBS, AND INCOME One concern frequently voiced by globalization opponents is that falling barriers to international trade destroy manufacturing jobs in wealthy advanced economies such as the United States and Western Europe. The critics argue that falling trade barriers allow firms to move manufacturing activities to countries where wage rates are much lower.⁴⁶ Indeed, due to the entry of China, India, and states from Eastern Europe into the global trading system, along with global population growth, estimates suggest that the pool of global labor may have quadrupled between 1985 and 2005, with most of the increase taking place after 1990.⁴⁷ Other things being equal, one might conclude that this enormous expansion in the global labor force, when coupled with expanding international trade, would have depressed wages in developed nations.

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

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

Supporters of globalization reply that critics of these trends miss the essential point about free trade—the benefits outweigh the costs.⁴⁹ They argue that free trade will result in countries specializing in the production of those goods and services that they can produce most efficiently, while importing goods and services that they cannot produce as efficiently. When a country embraces free trade, there is always some dislocation—lost textile jobs at Harwood Industries, or lost call center jobs at Dell—but the whole economy is better off as a result. According to this view, it makes little sense for the United States to produce textiles at home when they can be produced at a lower cost in Honduras or China (which, unlike Honduras, is a major source of U.S. textile imports). Importing textiles from China leads to lower prices for clothes in the United States,



Some U.S. companies have outsourced service activities to foreign suppliers, such as this call center in India, which has drawn both criticism and support.

which enables consumers to spend more of their money on other items. At the same time, the increased income generated in China from textile exports increases income levels in that country, which helps the Chinese to purchase more products produced in the United States, such as pharmaceuticals from Amgen, Boeing jets, Intel-based computers, Microsoft software, and Cisco routers.

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

If the critics of globalization are correct, the evidence would show that the share of national income received by labor, as opposed to the share received by the owners of capital (e.g, stockholders and bondholders), had declined in advanced nations as a result of downward pressure on wage rates, and that decline in labor's share of national income must be due to moving production to low-wage countries, as opposed to improvement in production technology and productivity. To counter this, supporters of globalization would argue, even though labor's share of the economic pie may have declined, this does not mean lower living standards if the size of the total pie increased sufficiently to offset any decline in labor's share; in other words, evidence would show that free trade has caused economic growth and rising living standards in advanced economies to offset declines in labor's share of national income.

So what does the data say? Several recent studies shed some light.⁵⁰ First, the data suggest that over the past two decades labor's share of national income has declined. The decline in share is much more pronounced in continental Europe and Japan (about 10 percentage points) than in the United States and the United Kingdom (where it is 3 to 4 percentage points). However, detailed analysis suggests that the share of national income enjoyed by *skilled labor* has actually *increased*, suggesting that the fall in labor's share has been due to a fall in the share taken by *unskilled labor*. For illustration, a study of long-term trends in income distribution in the United States concluded:

Nationwide, from the late 1970s to the late 1990s, the average income of the lowest-income families fell by over 6 percent after adjustment for inflation, and the average real income of the middle fifth of families grew by about 5 percent. By contrast, the average real income of the highest-income fifth of families increased by over 30 percent.⁵¹

Another study suggested that the earnings gap between workers in skilled and unskilled sectors has widened by 25 percent over the last two decades.⁵² In sum, unskilled labor in developed nations has seen its share of national income decline over the past two decades.

However, this does not mean that the *living standards* of unskilled workers in developed nations have declined. It is possible that economic growth in developed nations has offset the fall in the share of national income enjoyed by unskilled workers, raising their living standards. Evidence suggests that real labor compensation has expanded in most developed nations since the 1980s, including the United States. A study by the Organization for Economic Cooperation and Development, whose members include the 20 richest economies in the world, noted that while the gap between the poorest and richest segments of society in some OECD countries had widened, this trend was by no means universal.⁵³ Contrary to the results of the study cited above, the OECD study found that in the United States, while income inequality increased from the

mid-1970s to the mid-1980s, it did not widen further in the next decade. The report also notes that in almost all countries, real income levels rose over the 20-year period looked at in the study, including the incomes of the poorest segment of most OECD societies. To add to the mixed research results, a 2002 U.S. study that included data from 1990 to 2000 concluded that during those years, falling unemployment rates brought gains to low-wage workers and fairly broad-based wage growth, especially in the latter half of the 1990s. The income of the worst-paid 10 percent of the population actually rose twice as fast as that of the average worker during 1998–2000.⁵⁴ If such trends continued—and they may not have—the argument that globalization leads to growing income inequality may lose some of its punch.

As noted earlier, globalization critics argue that the decline in unskilled wage rates is due to the migration of low-wage manufacturing jobs offshore and a corresponding reduction in demand for unskilled workers. However, supporters of globalization see a more complex picture. They maintain that the apparent decline in real wage rates of unskilled workers owes far more to a technology-induced shift within advanced economies away from jobs where the only qualification was a willingness to turn up for work every day and toward jobs that require significant education and skills. They point out that many advanced economies report a shortage of highly skilled workers and an excess supply of unskilled workers. Thus, growing income inequality is a result of the wages for skilled workers being bid up by the labor market and the wages for unskilled workers being discounted. In fact, evidence suggests that technological change has had a bigger impact than globalization on the declining share of national income enjoyed by labor.⁵⁵ This indicates that to the problem of stagnant incomes among the unskilled is to be found not in limiting free trade and globalization, but in increasing society's investment in education to reduce the supply of unskilled workers.⁵⁶

Finally, it is worth noting that the wage gap between developing and developed nations is closing as developing nations experience rapid economic growth. For example, one estimate suggests that wages in China will approach Western levels in about 30 years.⁵⁷ To the extent that this is the case, any migration of unskilled jobs to low-wage countries is a temporary phenomenon representing a structural adjustment on the way to a more tightly integrated global economy.

GLOBALIZATION, LABOR POLICIES, AND THE ENVIRONMENT

A second source of concern is that free trade encourages firms from advanced nations to move manufacturing facilities to less developed countries that lack adequate regulations to protect labor and the environment from abuse by the unscrupulous.⁵⁸ Globalization critics often argue that adhering to labor and environmental regulations significantly increases the costs of manufacturing enterprises and puts them at a competitive disadvantage in the global marketplace vis-à-vis firms based in developing nations that do not have to comply with such regulations. Firms deal with this cost disadvantage, the theory goes, by moving their production facilities to nations that do not have such burdensome regulations or that fail to enforce the regulations they have.

If this were the case, one might expect free trade to lead to an increase in pollution and result in firms from advanced nations exploiting the labor of less developed nations.⁵⁹ This argument was used repeatedly by those who opposed the 1994 formation of the North American Free Trade Agreement (NAFTA) between Canada, Mexico, and the United States. They painted a picture of U.S. manufacturing firms moving to Mexico in droves so that they would be free to pollute the environment, employ child labor, and ignore workplace safety and health issues, all in the name of higher profits.⁶⁰



Another Perspective

Economic Freedom and Globalization: A Different Picture

The Fraser Institute's annual "Economic Freedom of the World Report," which measures economic freedom using 42 variables, indicates a strong correlation between economic freedom, per capita growth, and life expectancy. In the 2009 report, Hong Kong has the highest rating for economic freedom (8.97 of 10), followed by Singapore (8.66), New Zealand (8.30), Switzerland (8.19), and Chile (8.14). The United States was next, with a rating of 8.06. With a rating of 7.19 and a world rank of 49, Zambia is the highest-ranking African economy, ahead of such European nations as Italy (61) and Poland (74). See the 2009 report results and data at www.freetheworld.com.

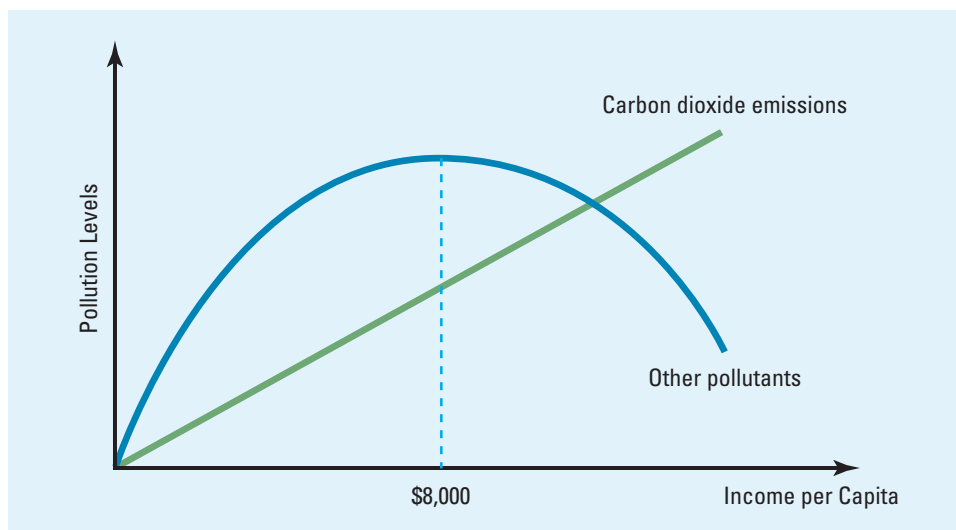
Supporters of free trade and greater globalization express doubts about this scenario. They argue that tougher environmental regulations and stricter labor standards go hand in hand with economic progress.⁶¹ In general, as countries get richer, they enact tougher environmental and labor regulations.⁶² Because free trade enables developing countries to increase their economic growth rates and become richer, this should lead to tougher environmental and labor laws. In this view, the critics of free trade have got it backward—free trade does not lead to more pollution and labor exploitation, it leads to less. By creating wealth and incentives for enterprises to produce technological innovations, the free market system and free trade could make it easier for the world to cope with pollution and population growth. Indeed, while pollution levels are rising in the world's

poorer countries, they have been falling in developed nations. In the United States, for example, the concentration of carbon monoxide and sulfur dioxide pollutants in the atmosphere decreased by 60 percent between 1978 and 1997, while lead concentrations decreased by 98 percent—and these reductions have occurred against a background of sustained economic expansion.⁶³

A number of econometric studies have found consistent evidence of a hump-shaped relationship between income levels and pollution levels (see Figure 1.5).⁶⁴ As an economy grows and income levels rise, initially pollution levels also rise. However, past some point, rising income levels lead to demands for greater environmental protection, and pollution levels then fall. A seminal study by Grossman and Krueger found that the turning point generally occurred before per capita income levels reached \$8,000.⁶⁵

While the hump-shaped relationship depicted in Figure 1.5 seems to hold across a wide range of pollutants—from sulfur dioxide to lead concentrations and water

figure 1.5
Income Levels and
Environmental Pollution



quality—carbon dioxide emissions are an important exception, rising steadily with higher income levels. Given that increased atmospheric carbon dioxide concentrations are a cause of global warming, this should be of serious concern. The solution to the problem, however, is probably not to roll back the trade liberalization efforts that have fostered economic growth and globalization, but to get the nations of the world to agree to tougher standards on limiting carbon emissions. Although UN-sponsored talks have had this as a central aim since the 1992 Earth Summit in Rio de Janeiro, there has been little success in moving toward the ambitious goals for reducing carbon emissions laid down in the Earth Summit and subsequent talks in Kyoto, Japan, in 1997 and in Copenhagen in 2009. In part this is because the largest emitters of carbon dioxide, the United States and China, have failed to reach agreements about how to proceed. China, a country whose carbon emissions are increasing at an alarming rate, has so far shown little appetite to adopt tighter pollution controls. As for the United States, political divisions in the U.S. Congress, where a strong minority sees no reason to put policies in place to limit carbon emissions, has made it difficult for even a progressive administration such as that of President Barack Obama to move forward with tight legislation on climate change.

Notwithstanding this, supporters of free trade point out that it is possible to tie free trade agreements to the implementation of tougher environmental and labor laws in less developed countries. NAFTA, for example, was passed only after side agreements had been negotiated that committed Mexico to tougher enforcement of environmental protection regulations. Thus, supporters of free trade argue that factories based in Mexico are now cleaner than they would have been without the passage of NAFTA.⁶⁶

They also argue that business firms are not the amoral organizations that critics suggest. While there may be some rotten apples, most business enterprises are staffed by managers who are committed to behave in an ethical manner and would be unlikely to move production offshore just so they could pump more pollution into the atmosphere or exploit labor. Furthermore, the relationship between pollution, labor exploitation, and production costs may not be that suggested by critics. In general, a well-treated labor force is productive, and it is productivity rather than base wage rates that often has the greatest influence on costs. The vision of greedy managers who shift production to low-wage countries to exploit their labor force may be misplaced.

GLOBALIZATION AND NATIONAL SOVEREIGNTY Another concern voiced by critics of globalization is that today's increasingly interdependent global economy shifts economic power away from national governments and toward supranational organizations such as the World Trade Organization, the European Union, and the United Nations. As perceived by critics, unelected bureaucrats now impose policies on the democratically elected governments of nation-states, thereby undermining the sovereignty of those states and limiting the nation's ability to control its own destiny.⁶⁷

The World Trade Organization is a favorite target of those who attack the headlong rush toward a global economy. As noted earlier, the WTO was founded in 1994 to police the world trading system established by the General Agreement on Tariffs and Trade. The WTO arbitrates trade disputes between the 150 states that are signatories to the GATT. The arbitration panel can issue a ruling instructing a member state to change trade policies that violate GATT regulations. If the violator refuses to comply with the ruling, the WTO allows other states to impose appropriate trade sanctions on the transgressor. As a result, according to one prominent critic, U.S.

environmentalist, consumer rights advocate, and sometime presidential candidate Ralph Nader:

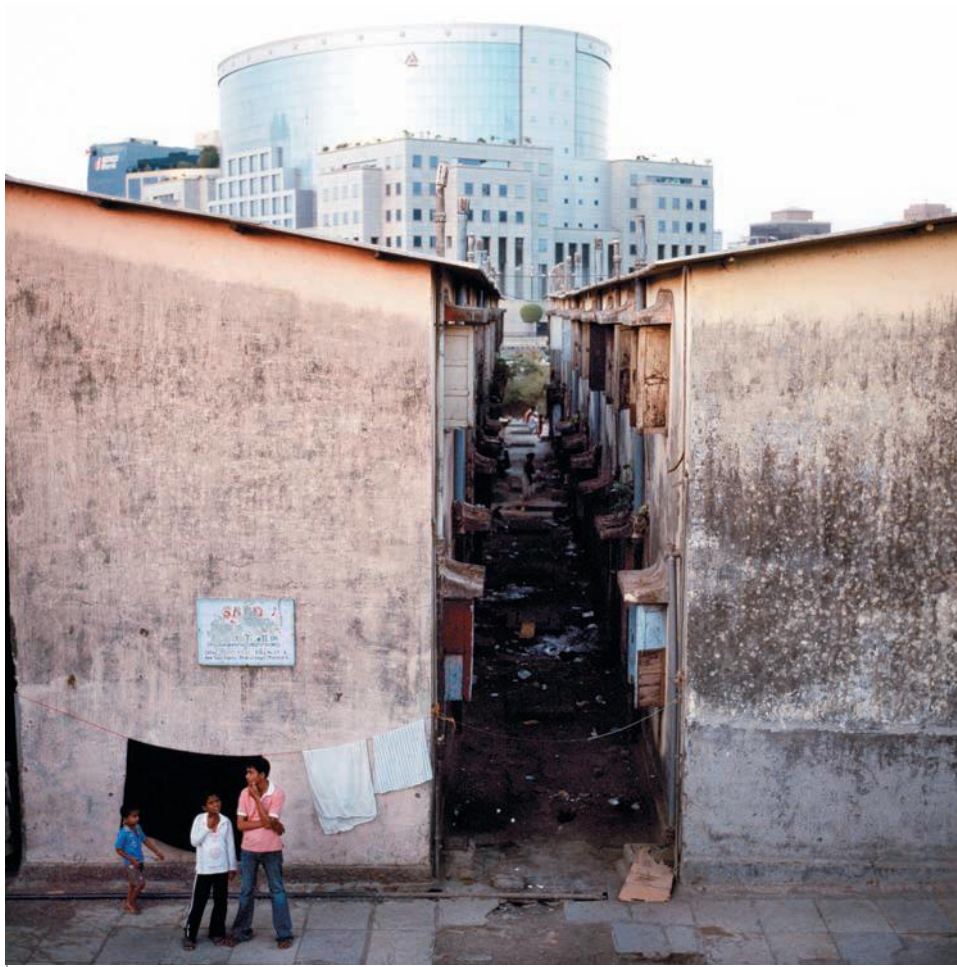
Under the new system, many decisions that affect billions of people are no longer made by local or national governments but instead, if challenged by any WTO member nation, would be deferred to a group of unelected bureaucrats sitting behind closed doors in Geneva (which is where the headquarters of the WTO are located). The bureaucrats can decide whether or not people in California can prevent the destruction of the last virgin forests or determine if carcinogenic pesticides can be banned from their foods; or whether European countries have the right to ban dangerous biotech hormones in meat. . . . At risk is the very basis of democracy and accountable decision making.⁶⁸

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

GLOBALIZATION AND THE WORLD'S POOR Critics of globalization argue that despite the supposed benefits associated with free trade and investment, over the past hundred years or so the gap between the rich and poor nations of the world has gotten wider. In 1870, the average income per capita in the world's 17 richest nations was 2.4 times that of all other countries. In 1990, the same group was 4.5 times as rich as the rest.⁶⁹ While recent history has shown that some of the world's poorer nations are capable of rapid periods of economic growth—witness the transformation that has occurred in some Southeast Asian nations such as South Korea, Thailand, and Malaysia—there appear to be strong forces for stagnation among the world's poorest nations. A quarter of the countries with a GDP per capita of less than \$1,000 in 1960 had growth rates of less than zero from 1960 to 1995, and a third had growth rates of less than 0.05 percent.⁷⁰ Critics argue that if globalization is such a positive development, this divergence between the rich and poor should not have occurred.

Although the reasons for economic stagnation vary, several factors stand out, none of which have anything to do with free trade or globalization.⁷¹ Many of the world's poorest countries have suffered from totalitarian governments, economic policies that destroyed wealth rather than facilitated its creation, endemic corruption, scant protection for property rights, and war. Such factors help explain why countries such as Afghanistan, Cambodia, Cuba, Haiti, Iraq, Libya, Nigeria, Sudan, Vietnam, and Zaire have failed to improve the economic lot of their citizens during recent decades. A complicating factor is the rapidly expanding populations in many of these countries. Without a major change in government, population growth may exacerbate their problems. Promoters of free trade argue that the best way for these countries to improve their lot is to lower their barriers to free trade and investment and to implement economic policies based on free market economics.⁷²

Many of the world's poorer nations are being held back by large debt burdens. Of particular concern are the 40 or so “highly indebted poor countries” (HIPC), which are home to some 700 million people. Among these countries, the average government debt burden has been as high as 85 percent of the value of the economy, as



Even as India makes strides toward economic development, it continues to carry a high budget deficit that cannot meet the needs of its soaring population.

measured by gross domestic product, and the annual costs of serving government debt consumed 15 percent of the country's export earnings.⁷³ Servicing such a heavy debt load leaves the governments of these countries with little left to invest in important public infrastructure projects, such as education, health care, roads, and power. The result is the HIPC's are trapped in a cycle of poverty and debt that inhibits economic development. Free trade alone, some argue, is a necessary but not sufficient prerequisite to help these countries bootstrap themselves out of poverty. Instead, large-scale debt relief is needed for the world's poorest nations to give them the opportunity to restructure their economies and start the long climb toward prosperity. Supporters of debt relief also argue that new democratic governments in poor nations should not be forced to honor debts that were incurred and mismanaged long ago by their corrupt and dictatorial predecessors.

In the late 1990s, a debt relief movement began to gain ground among the political establishment in the world's richer nations.⁷⁴ Fueled by high-profile endorsements from Irish rock star Bono (who has been a tireless and increasingly effective advocate for debt relief), the Dalai Lama, and influential Harvard economist Jeffrey Sachs, the debt relief movement was instrumental in persuading the United States to enact legislation in 2000 that provided \$435 million in debt relief for HIPC's.

More important perhaps, the United States also backed an IMF plan to sell some of its gold reserves and use the proceeds to help with debt relief. The IMF and World Bank have now picked up the banner and have embarked on a systematic debt relief program.

For such a program to have a lasting effect, however, debt relief must be matched by wise investment in public projects that boost economic growth (such as education) and by the adoption of economic policies that facilitate investment and trade. The rich nations of the world also can help by reducing barriers to the importation of products from the world's poorer nations, particularly tariffs on imports of agricultural products and textiles. High tariff barriers and other impediments to trade make it difficult for poor countries to export more of their agricultural production. The World Trade Organization has estimated that if the developed nations of the world eradicated subsidies to their agricultural producers and removed tariff barriers to trade in agriculture, this would raise global economic welfare by \$128 billion, with \$30 billion of that going to developing nations, many of which are highly indebted. The faster growth associated with expanded trade in agriculture could reduce the number of people living in poverty by as much as 13 percent by 2015, according to the WTO.⁷⁵

Managing in the Global Marketplace

LEARNING OBJECTIVE 5

Understand how the process of globalization is creating opportunities and challenges for business managers.

International Business

Any firm that engages in international trade or investment.

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

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

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

A further way in which international business differs from domestic business is the greater complexity of managing an international business. In addition to the problems that arise from the differences between countries, a manager in an international business is confronted with a range of other issues that the manager in a domestic

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

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

Cross-border transactions also require that money be converted from the firm's home currency into a foreign currency and vice versa. Because currency exchange rates vary in response to changing economic conditions, managers in an international business must develop policies for dealing with exchange rate movements. A firm that adopts a wrong policy can lose large amounts of money, whereas one that adopts the right policy can increase the profitability of its international transactions.

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

In this book we examine all these issues in depth, paying close attention to the different strategies and policies that managers pursue to deal with the various challenges created when a firm becomes an international business. Chapters 2 and 3 explore how countries differ from each other with regard to their political, economic, legal, and cultural institutions. Chapter 4 takes a detailed look at the ethical issues that arise in international business. Chapters 5 to 8 look at the international trade and investment environment within which international businesses must operate. Chapters 9 to 10 review the international monetary system. These chapters focus on the nature of the foreign exchange market and the emerging global monetary system. Chapters 11 and 12 explore the strategy of international businesses. Chapters 13 to 16 look at the management of various functional operations within an international business, including production, marketing, and human relations. By the time you complete this book, you should have a good grasp of the issues that managers working within international business have to grapple with on a daily basis, and you should be familiar with the range of strategies and operating policies available to compete more effectively in today's rapidly emerging global economy.

Key Terms

globalization, p. 7	World Trade Organization (WTO), p. 10	foreign direct investment (FDI), p. 12
globalization of markets, p. 7		Moore's law, p. 15
globalization of production, p. 8	International Monetary Fund (IMF), p. 10	stock of foreign direct investment, p. 20
factors of production, p. 8	World Bank, p. 10	multinational enterprise (MNE), p. 22
General Agreement on Tariffs and Trade (GATT), p. 10	United Nations, p. 11	international business, p. 36
	international trade, p. 12	

Summary

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

1. Over the past two decades, we have witnessed the globalization of markets and production.
2. The globalization of markets implies that national markets are merging into one huge marketplace. However, it is important not to push this view too far.
3. The globalization of production implies that firms are basing individual productive activities at the optimal world locations for the particular activities. As a consequence, it is increasingly irrelevant to talk about American products, Japanese products, or German products, since these are being replaced by "global" products.
4. Two factors seem to underlie the trend toward globalization: declining trade barriers and changes in communication, information, and transportation technologies.
5. Since the end of World War II, barriers to the free flow of goods, services, and capital have been lowered significantly. More than anything else, this has facilitated the trend toward the globalization of production and has enabled firms to view the world as a single market.
6. As a consequence of the globalization of production and markets, in the past decade world trade has grown faster than world output, foreign direct investment has surged, imports have penetrated more deeply into the world's industrial nations, and competitive pressures have increased in industry after industry.
7. The development of the microprocessor and related developments in communication and information processing technology have helped firms link their worldwide operations into sophisticated information networks. Jet air travel, by shrinking travel time, has also helped to link the worldwide operations of international businesses. These changes have enabled firms to achieve tight coordination of their worldwide operations and to view the world as a single market.
8. In the 1960s, the U.S. economy was dominant in the world, U.S. firms accounted for most of the foreign direct investment in the world economy, U.S. firms dominated the list of large multinationals, and roughly half the world—the centrally planned economies of the Communist world—was closed to Western businesses.
9. By the mid-1990s, the U.S. share of world output had been cut in half, with major shares

now being accounted for by Western European and Southeast Asian economies. The U.S. share of worldwide foreign direct investment had also fallen, by about two-thirds. U.S. multinationals were now facing competition from a large number of Japanese and European multinationals. In addition, the emergence of mini-multinationals was noted.

10. One of the most dramatic developments of the past 20 years has been the collapse of communism in Eastern Europe, which has created enormous long-run opportunities for international businesses. In addition, the move toward free market economies in China and Latin America is creating opportunities (and threats) for Western international businesses.
11. The benefits and costs of the emerging global economy are being hotly debated among businesspeople, economists, and politicians. The debate focuses on the impact of globalization on jobs, wages, the environment, working conditions, and national sovereignty.
12. Managing an international business is different from managing a domestic business for at least four reasons: (a) countries are different, (b) the range of problems confronted by a manager in an international business is wider and the problems themselves more complex than those confronted by a manager in a domestic business, (c) managers in an international business must find ways to work within the limits imposed by governments' intervention in the international trade and investment system, and (d) international transactions involve converting money into different currencies.

Critical Thinking and Discussion Questions

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

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

Exercise 1

Your company has developed a new product that is expected to achieve high penetration rates in all the countries in which it is introduced, regardless of the average income status of the local population. Considering the costs of the product launch, the management team has decided to initially introduce the product only in countries that have a sizeable population base. Using the *Population Reference Bureau* as a resource, you are required to prepare a preliminary report with the top 10 countries of the world in terms of population size. Since growth

opportunities are another major concern, the average population growth rates should be listed for management's consideration.

Exercise 2

The United Nations Conference on Trade and Development (UNCTAD) provides ranking of the largest *transnational corporations* (TNCs) in the world, including a ranking of the 100 largest financial TNCs from developing countries. Identify the largest 25 TNCs listed in the most recent ranking. What countries are these TNCs from? In what industries are they classified? Do you notice any trends in terms of the countries and industries that are represented in the ranking?



closing case

The Globalization of Health Care

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

the attending physician when he or she arrived for work the following morning.

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

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

countries generally run from 20 to 35 percent of those in the United States.

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

Singapore, where the company reckons that the quality of care is better than at the average American hospital.

Sources: G. Colvin, “Think Your Job Can’t Be Sent to India?” *Fortune*, December 13, 2004, p. 80; A. Pollack, “Who’s Reading Your X-Ray,” *The New York Times*, November 16, 2003, pp. 1, 9; “Sun, Sand and Scalpels,” *The Economist*, March 10, 2007, p. 62; “Operating Profit,” *The Economist*, August 16, 2008, pp. 74–76; and R. Bailey, “Hips Abroad,” *Reason*, May 2009, p. 14.

Case Discussion Questions

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



part 2

Country Differences

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Understand how the political systems of countries differ.
- 2 Recognize how the economic systems of countries differ.
- 3 Understand how the legal systems of countries differ.
- 4 Explain what determines the level of economic development of a nation.
- 5 Identify the macro-political and economic changes taking place worldwide.
- 6 Describe how transition economies are moving toward market-based systems.
- 7 Explain the implications for management practice of national differences in political economy.

National Differences in Political Economy

The Polish Surprise

opening case

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

In 1989, Poland elected its first democratic government after more than four decades of Communist rule. Since then, like many other Eastern European countries, Poland has embraced free market economic policies and free trade, and has privatized many of its state-owned businesses. In 2004 the country joined the European Union, giving it easy access to the large consumer markets of Western Europe. All this helped transform Poland into a major exporter. Exports account for about 40 percent of GDP (in contrast, they account for around 12 percent in the United States). As a consequence, between 1989 and 2009 the country recorded the highest sustained growth in the region—real GDP doubled over this period, compared to a 70 percent increase in neighboring Slovakia and 45 percent in the Czech Republic.

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

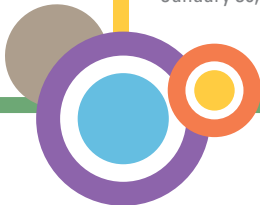
Poland also got lucky. A tight monetary squeeze in the early 2000s, which was designed to curb inflation and ease Poland's entry into the

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

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

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

Sources: J. Rostowski, “The Secret of Poland’s Success,” *The Wall Street Journal*, February 1, 2010, p. 15; “Not Like the Neighbors,” *The Economist*, April 25, 2009, p. 55; and “Horse Power to Horsepower,” *The Economist*, January 30, 2010, pp. 60–61.



Introduction

International business is much more complicated than domestic business because countries differ in many ways. Countries have different political, economic, and legal systems. Cultural practices can vary dramatically, as can the education and skill level of the population, and countries are at different stages of economic development. All these differences can and do have major implications for the practice of international business. They have a profound impact on the benefits, costs, and risks associated with doing business in different countries; the way in which operations in different countries should be managed; and the strategy international firms should pursue in different countries. A main function of this chapter and the next is to develop an awareness of and appreciation for the significance of country differences in political systems,

economic systems, legal systems, and national culture. Another function of the two chapters is to describe how the political, economic, legal, and cultural systems of many of the world's nation-states are evolving and to draw out the implications of these changes for the practice of international business.

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

More generally, this chapter focuses on how the political, economic, and legal systems of countries differ. Collectively we refer to these systems as constituting the political economy of a country. We use the term **political economy** to stress that the political, economic, and legal systems of a country are interdependent; they interact and influence each other, and in doing so they affect the level of economic well-being. In addition to reviewing these systems, we also explore how differences in political economy influence the benefits, costs, and risks associated with doing business in different countries, and how they affect management practice and strategy. In the next chapter, we will look at how differences in culture influence the practice of international business. As noted, the political economy and culture of a nation are not independent of each other. As will become apparent in Chapter 3, culture can exert an impact on political economy—on political, economic, and legal systems in a nation—and the converse can also hold true.

Political Economy

The political, economic, and legal systems of a country.

Political Systems

The political system of a country shapes its economic and legal systems.¹ As such, we need to understand the nature of different political systems before discussing economic and legal systems. By **political system** we mean the system of government in a nation. Political systems can be assessed according to two dimensions. The first is the degree to which they emphasize collectivism as opposed to individualism. The second is the degree to which they are democratic or totalitarian. These dimensions are interrelated; systems that emphasize collectivism tend toward totalitarian, whereas those that place a high value on individualism tend to be democratic. However, a large gray area exists in the middle. It is possible to have democratic societies that emphasize a mix of collectivism and individualism. Similarly, it is possible to have totalitarian societies that are not collectivist.

LEARNING OBJECTIVE 1

Understand how the political systems of countries differ.

Political System

The system of government in a nation.

COLLECTIVISM AND INDIVIDUALISM **Collectivism** refers to a political system that stresses the primacy of collective goals over individual goals.² When collectivism is emphasized, the needs of society as a whole are generally viewed as being more important than individual freedoms. In such circumstances, an individual's right

Collectivism

A political system that emphasizes collective goals over individual goals.

to do something may be restricted on the grounds that it runs counter to “the good of society” or to “the common good.” Advocacy of collectivism can be traced to the ancient Greek philosopher Plato (427–347 BC), who in *The Republic* argued that individual rights should be sacrificed for the good of the majority and that property should be owned in common. Plato did not equate collectivism with equality; he believed that society should be stratified into classes, with those best suited to rule (which for Plato, naturally, were philosophers and soldiers) administering society for the benefit of all. In modern times, the collectivist mantle has been picked up by socialists.

Socialism

A political philosophy advocating substantial public involvement, through government ownership, in the means of production and distribution.

Socialism Modern **socialism** traces its intellectual roots to Karl Marx (1818–83), although socialist thought clearly predates Marx (elements of it can be traced to Plato). Marx argued that the few benefit at the expense of the many in a capitalist society where individual freedoms are not restricted. While successful capitalists accumulate considerable wealth, Marx postulated that the wages earned by the majority of workers in a capitalist society would be forced down to subsistence levels. He argued that capitalists expropriate for their own use the value created by workers, while paying workers only subsistence wages in return. According to Marx, the pay of workers does not reflect the full value of their labor. To correct this perceived wrong, Marx advocated state ownership of the basic means of production, distribution, and exchange (i.e., businesses). His logic was that if the state owned the means of production, the state could ensure that workers were fully compensated for their labor. Thus, the idea is to manage state-owned enterprise to benefit society as a whole, rather than individual capitalists.³

Communists

Those who believe socialism can be achieved only through revolution and totalitarian dictatorship.

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

Social Democrats

Those committed to achieving socialism by democratic means.

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

monopoly in the telecommunications, electricity, gas, coal, railway, and shipbuilding industries, as well as substantial interests in the oil, airline, auto, and steel industries.

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

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

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

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

The sole end for which mankind are warranted, individually or collectively, in interfering with the liberty of action of any of their number is self-protection. . . . The only purpose for which power can be rightfully exercised over any member



Another Perspective

Armenia: From Collectivism to Individualism

After the collapse of the Soviet Union, Armenia was one of 15 former Communist republics to win independence. In creating its new economy, Armenia privatized nearly all business and instituted a strong presidency—this despite calls from the Armenian Revolutionary Federation-Dashnaktsutyun (a political party) to create a parliamentary system that would allow for greater participation. Today in Armenia, economic power rests in the hands of a few. In addition, Armenia recently privatized its pension plans—a move opponents claim will jeopardize the well-being of senior citizens. Calls for reform include the establishment of real democracy for all, not just a few. (Levon Mkrtchyan, “Social Democracy in Armenia,” speech delivered to Social Democracy in South Caucasus conference, March 28, 2010, www.arfd.info)

Privatization

The sale of state-owned enterprises to private investors.

Individualism

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

of a civilized community, against his will, is to prevent harm to others. His own good, either physical or moral, is not a sufficient warrant. . . . The only part of the conduct of any one, for which he is amenable to society, is that which concerns others. In the part which merely concerns himself, his independence is, of right, absolute. Over himself, over his own body and mind, the individual is sovereign.⁴

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

led by an invisible hand to promote an end which was no part of his intention. Nor is it always worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who effect to trade for the public good.⁵

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

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

Democracy

Political system in which government is by the people, exercised either directly or through elected representatives.

Totalitarianism

Form of government in which one person or political party exercises absolute control over all spheres of human life and prohibits opposing political parties.

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



Country FOCUS

Chavez's Venezuela

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

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

On the economic front, things remained rough. The economy shrank by 9 percent in 2002 and another 8 percent in 2003. Unemployment remained persistently high at 15 to 17 percent, and the poverty rate rose to more than 50 percent of the population. A 2003 study by the World Bank concluded that Venezuela was one of the most regulated economies in the world and that state controls over business activities gave public officials ample opportunities to enrich themselves by demanding bribes in return for permission to expand operations or enter new lines of business. Indeed, despite Chavez's anticorruption rhetoric, Transparency International, which ranks the world's nations according to the extent of public corruption, has noted that corruption has increased under Chavez. In 2008, Transparency International ranked Venezuela 162 out of 180 nations, down from 114 in 2004. Consistent with his socialist rhetoric, Chavez has progressively taken various enterprises into state ownership and has required that other enterprises be restructured as "workers' cooperatives" in return for government loans. In addition, the government has begun to seize large rural farms and ranches that Chavez claims are not

sufficiently productive, turning them into state-owned cooperatives.

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

Riding a wave of popularity at home, in December 2006 Chavez won reelection as president. He celebrated his victory by stepping on the revolutionary accelerator. Parliament gave him the power to legislate by decree for 18 months, and a committee of his supporters started to draft a constitutional reform to turn Venezuela into an avowedly socialist country and to allow the president to stand for reelection indefinitely. However, in a sign that Chavez's popularity may have reached a high-water mark, on December 2, 2007, in a nationwide referendum, Venezuelan voters narrowly rejected a revised constitution that would have placed more power in Chavez's hands. Another setback occurred in late 2008, when the price of oil started to slide, indicating the boom in government spending that had been funded by oil revenues was coming to an end.

Sources: D. Luhnow and P. Millard, "Chavez Plans to Take More Control of Oil away from Foreign Firms," *The Wall Street Journal*, April 24, 2006, p. A1; R. Gallego, "Chavez's Agenda Takes Shape," *The Wall Street Journal*, December 27, 2005, p. A12; "The Sickly Stench of Corruption: Venezuela," *The Economist*, April 1, 2006, p. 50; "Chavez Squeezes the Oil Firms," *The Economist*, November 12, 2005, p. 61; "Glimpsing the Bottom of the Barrel: Venezuela," *The Economist*, February 3, 2007, p. 51; and "The Wind Goes Out of the Revolution—Defeat for Hugo Chavez," *The Economist*, December 8, 2007, pp. 30–32.

economic sphere, but the country is still ruled by a totalitarian dictatorship that constrains political freedom.

Representative Democracy

A political system in which citizens periodically elect individuals to represent them.

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

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

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

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

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

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

Communist Totalitarianism

A version of collectivism advocating that socialism can be achieved only through a totalitarian dictatorship.

Theocratic Totalitarianism

A political system in which political power is monopolized by a party, group, or individual that governs according to religious principles.

Tribal Totalitarianism

A political system in which a party, group, or individual that represents the interests of a particular tribe (ethnic group) monopolizes political power.



Communist totalitarianism is still the political system in Vietnam, where red banners in the Hanoi marketplace remind citizens and visitors of the government's control.

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

Right-Wing Totalitarianism

A political system in which political power is monopolized by a party, group, or individual that generally permits individual economic freedom but restricts individual political freedom, including free speech, frequently on the grounds that it would lead to the rise of communism.

Economic Systems

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

MARKET ECONOMY In a pure **market economy**, all productive activities are privately owned, as opposed to being owned by the state. The goods and services that a country produces are not planned by anyone. Production is determined by the interaction of supply and demand and signaled to producers through the price system. If demand for a product exceeds supply, prices will rise, signaling producers to produce more. If supply exceeds demand, prices will fall, signaling producers to produce less. In

LEARNING OBJECTIVE 2

Recognize how the economic systems of countries differ.

Market Economy

An economic system in which the interaction of supply and demand determines the quantity in which goods and services are produced.

this system consumers are sovereign. The purchasing patterns of consumers, as signaled to producers through the mechanism of the price system, determine what is produced and in what quantity.

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

Given the dangers inherent in monopoly, the role of government in a market economy is to encourage vigorous free and fair competition between private producers. Governments do this by outlawing monopolies and restrictive business practices designed to monopolize a market (antitrust laws serve this function in the United States). Private ownership also encourages vigorous competition and economic efficiency. Private ownership ensures that entrepreneurs have a right to the profits generated by their own efforts. This gives entrepreneurs an incentive to search for better ways of serving consumer needs. That may be through introducing new products, by developing more efficient production processes, by pursuing better marketing and after-sale service, or simply through managing their businesses more efficiently than their competitors. In turn, the constant improvement in product and process that results from such an incentive has been argued to have a major positive impact on economic growth and development.⁷

Command Economy

An economic system in which the government plans the goods and services that a country produces, the quantity in which they are produced, and the prices at which they are sold.

COMMAND ECONOMY In a pure **command economy**, the government plans the goods and services that a country produces, the quantity in which they are produced, and the prices at which they are sold. Consistent with the collectivist ideology, the objective of a command economy is for government to allocate resources for “the good of society.” In addition, in a pure command economy, all businesses are state owned, the rationale being that the government can then direct them to make investments that are in the best interests of the nation as a whole rather than in the interests of private individuals. Historically, command economies were found in Communist countries where collectivist goals were given priority over individual goals. Since the demise of communism in the late 1980s, the number of command economies has fallen dramatically. Some elements of a command economy were also evident in a number of democratic nations led by socialist-inclined governments. France and India both experimented with extensive government planning and state ownership, although government planning has fallen into disfavor in both countries.

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

MIXED ECONOMY Between market economies and command economies can be found mixed economies. In a mixed economy, certain sectors of the economy are left to private ownership and free market mechanisms while other sectors have significant state ownership and government planning. Mixed economies were once

common throughout much of the world, although they are becoming much less so. Until the 1980s, Great Britain, France, and Sweden were mixed economies, but extensive privatization has reduced state ownership of businesses in all three nations. A similar trend occurred in many other countries where there was once a large state sector, such as Brazil, Italy, and India (in India, however, the state sector remains large, still accounting for 38 percent of nonfarm output).

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

Legal Systems

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

Like the economic system of a country, the legal system is influenced by the prevailing political system (although it is also strongly influenced by historical tradition). The government of a country defines the legal framework within which firms do business—and often the laws that regulate business reflect the rulers' dominant political ideology. For example, collectivist-inclined totalitarian states tend to enact laws that severely restrict private enterprise, whereas the laws enacted by governments in democratic states where individualism is the dominant political philosophy tend to be pro-private enterprise and pro-consumer.

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

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

LEARNING OBJECTIVE 3

Understand how the legal systems of countries differ.

Legal System

System of rules that regulate behavior and the processes by which the laws are enforced and through which redress of grievances is obtained.

Common law

A system of law based on tradition, precedent, and custom.

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

Civil Law System

A system of law based on a detailed set of written laws and codes.

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

Theocratic Law System

A system of law based on religious teachings.

Theocratic Law A **theocratic law system** is one in which the law is based on religious teachings. Islamic law is the most widely practiced theocratic legal system in the modern world, although usage of both Hindu and Jewish law persisted into the twentieth century. Islamic law is primarily a moral rather than a commercial law and is intended to govern all aspects of life.⁸ The foundation for Islamic law is the holy book of Islam, the Koran, along with the Sunnah, or decisions and sayings of the Prophet Muhammad, and the writings of Islamic scholars who have derived rules by analogy from the principles established in the Koran and the Sunnah. Because the Koran and Sunnah are holy documents, the basic foundations of Islamic law cannot be changed. However, in practice Islamic jurists and scholars are constantly debating the application of Islamic law to the modern world. In reality, many Muslim countries have legal systems that are a blend of Islamic law and a common or civil law system.

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

which is considered usury and outlawed by the Koran. To the devout Muslim, acceptance of interest payments is seen as a grave sin; the giver and the taker are equally damned. This is not just a matter of theology; in several Islamic states it has also become a matter of law. In the 1990s, for example, Pakistan's Federal Shariat Court, the highest Islamic lawmaking body in the country, pronounced interest to be un-Islamic and therefore illegal and demanded that the government amend all financial laws accordingly. In 1999, Pakistan's Supreme Court ruled that Islamic banking methods should be used in the country after July 1, 2001.⁹ By 2008, some 500 Islamic financial institutions in the world collectively managed more than \$500 billion in assets. In addition to Pakistan, Islamic financial institutions are found in many of the Gulf states, Egypt, and Malaysia.¹⁰



Another Perspective

No Interest in Islamic Banking? Why?

How can a banking system operate without interest (*riba* in Arabic)? The basic economic idea is that commercial risk should be shared. In the Western approach, interest guarantees the banker a return, so on a collateralized loan, the banker avoids much of the commercial risk that's inherent in business. No matter what happens to the business, the banker gets a return. In contrast, Islam requires that the banker share this commercial risk. If the business venture is successful, the banker shares the profit. If the venture doesn't do well, neither does the banker. The value of community in Islam is stronger than the value of individual profit. See Chapter 3 for more on this point.

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

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

When contract disputes arise in international trade, there is always the question of which country's laws to apply. To resolve this issue, a number of countries, including the United States, have ratified the **United Nations Convention on Contracts for the International Sale of Goods (CIGS)**. The CIGS establishes a uniform set of rules governing certain aspects of the making and performance of everyday commercial contracts between sellers and buyers who have their places of business in different nations. By adopting the CIGS, a nation signals to other adopters that it will treat the convention's rules as part of its law. The CIGS applies automatically to all contracts for the sale of goods between different firms based in countries that have ratified the convention, unless the parties to the contract explicitly opt out. One problem with the CIGS, however, is that fewer than 70 nations have ratified the convention (the CIGS went into effect in 1988).¹¹ Many of the world's larger trading nations, including Japan and the United Kingdom, have not ratified the CIGS.

When firms do not wish to accept the CIGS, they often opt for arbitration by a recognized arbitration court to settle contract disputes. The most well known of these courts is the International Court of Arbitration of the International Chamber of Commerce in Paris which handles more than 500 requests per year for arbitration typically from over 100 countries.¹²

PROPERTY RIGHTS AND CORRUPTION In a legal sense, the term *property* refers to a resource over which an individual or business holds a legal title; that is, a resource that it owns. Resources include land, buildings, equipment, capital, mineral rights, businesses, and intellectual property (ideas, which are protected by patents, copyrights, and trademarks). **Property rights** refer to the legal rights over the use to which a resource is put and over the use made of any income that may be derived from that resource.¹³ Countries differ in the extent to which their legal systems define and protect property rights. Almost all countries now have laws on their books that protect property rights. Even China, still nominally a Communist state despite its booming market economy, finally enacted a law to protect the rights of private property holders in 2007 (the law gives individuals the same legal protection for their property as the state).¹⁴ However, in many countries these laws are not enforced by the authorities and property rights are violated. Property rights can be violated in two ways—through private action and through public action.

Contract

A document that specifies the conditions under which an exchange is to occur and details the rights and obligations of the parties involved.

Contract Law

The body of law that governs contract enforcement.

United Nations Convention on Contracts for the International Sale of Goods (CIGS)

A set of rules governing certain aspects of the making and performance of commercial contracts between sellers and buyers who have their places of business in different nations.

Property Rights

The bundle of legal rights over the use to which a resource is put and over the use made of any income that may be derived from that resource.

Private Action

The theft, piracy, blackmail, and the like by private individuals or groups.

Private Action In this context, **private action** refers to theft, piracy, blackmail, and the like by private individuals or groups. Although theft occurs in all countries, a weak legal system allows for a much higher level of criminal action in some than in others. For example, in Russia in the chaotic period following the collapse of communism, an outdated legal system, coupled with a weak police force and judicial system, offered both domestic and foreign businesses scant protection from blackmail by the “Russian Mafia.” Successful business owners in Russia often had to pay “protection money” to the Mafia or face violent retribution, including bombings and assassinations (about 500 contract killings of businessmen occurred in 1995 and again in 1996).¹⁵

Russia is not alone in having Mafia problems (and the situation in Russia has improved significantly since the mid-1990s). The Mafia has a long history in the United States (Chicago in the 1930s was similar to Moscow in the 1990s). In Japan, the local version of the Mafia, known as the *yakuza*, runs protection rackets, particularly in the food and entertainment industries.¹⁶ However, there was a big difference between the magnitude of such activity in Russia in the 1990s and its limited impact in Japan and the United States. This difference arose because the legal enforcement apparatus, such as the police and court system, was so weak in Russia following the collapse of communism. Many other countries from time to time have had problems similar to or even greater than those experienced by Russia.

Public Action

The extortion of income or resources of property holders by public officials, such as politicians and government bureaucrats.

Public Action and Corruption **Public action** to violate property rights occurs when public officials, such as politicians and government bureaucrats, extort income, resources, or the property itself from property holders. This can be done through legal mechanisms such as levying excessive taxation, requiring expensive licenses or permits from property holders, taking assets into state ownership without compensating the owners, or redistributing assets without compensating the prior owners. It can also be done through illegal means, or corruption, by demanding bribes from businesses in return for the rights to operate in a country, industry, or location.¹⁷

Corruption has been well documented in every society, from the banks of the Congo River to the palace of the Dutch royal family, from Japanese politicians to Brazilian bankers, and from Indonesian government officials to the New York City Police Department. The government of the late Ferdinand Marcos in the Philippines was famous for demanding bribes from foreign businesses wishing to set up operations in that country.¹⁸ The same was true of government officials in Indonesia under the rule of former president Suharto. No society is immune to corruption. However, there are systematic differences in the extent of corruption. In some countries, the rule of law minimizes corruption. Corruption is seen and treated as illegal, and when discovered, violators are punished by the full force of the law. In other countries, the rule of law is weak and corruption by bureaucrats and politicians is rife. Corruption is so endemic in some countries that politicians and bureaucrats regard it as a perk of office and openly flout laws against corruption.

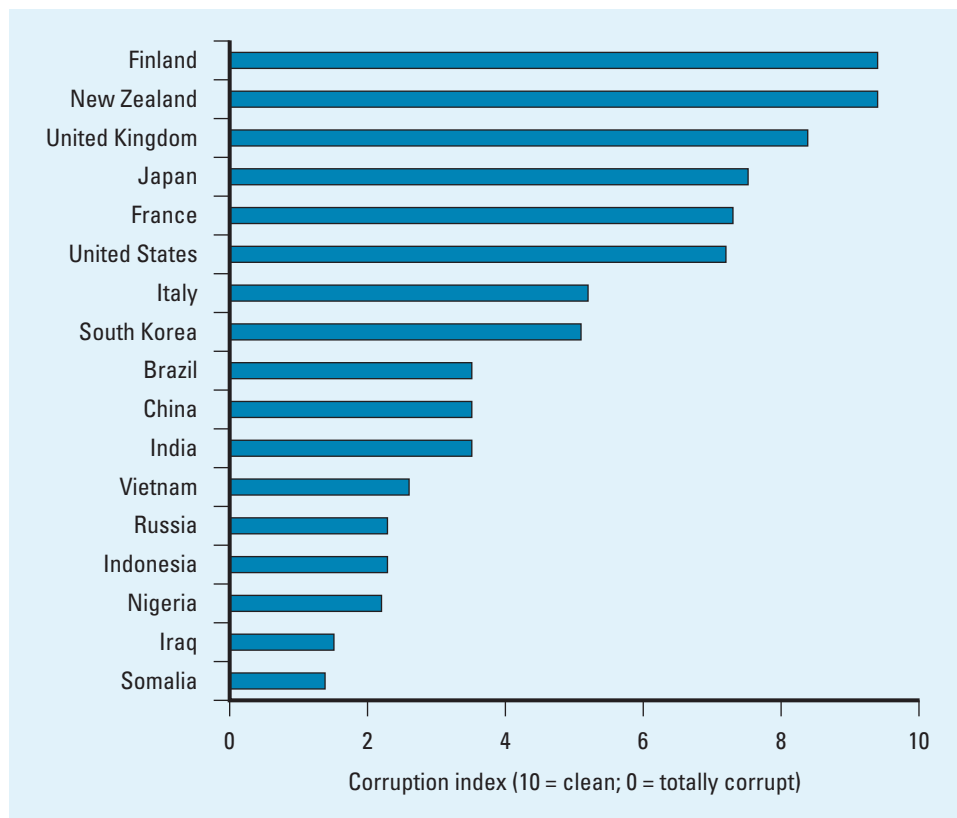
According to Transparency International, an independent nonprofit organization dedicated to exposing and fighting corruption, businesses and individuals spend some \$400 billion a year worldwide on bribes related to government procurement contracts alone.¹⁹ Transparency International has also measured the level of corruption among public officials in different countries.²⁰ As can be seen in Figure 2.1, the organization rated countries such as Finland and New Zealand as clean; it rated others, such as Russia, India, and Indonesia as corrupt. Somalia ranked last out of all 180 countries in the survey (the country is often described as a “failed state”).

Economic evidence suggests that high levels of corruption significantly reduce the foreign direct investment, level of international trade, and economic growth rate in a country.²¹ By siphoning off profits, corrupt politicians and bureaucrats reduce the

2.1 figure

Ranking of Corruption by Country, 2009

Source: Constructed by the author from raw data in Transparency International, *Global Corruption Report*, 2009.



returns to business investment and, hence, reduce the incentive of both domestic and foreign businesses to invest in that country. The lower level of investment that results hurts economic growth. Thus, we would expect countries such as Indonesia, Nigeria, and Russia to have a much lower rate of economic growth than might otherwise have been the case. A detailed example of the negative effect that corruption can have on economic progress is given in the accompanying Country Focus, which looks at the impact of corruption on economic growth in Nigeria.

Foreign Corrupt Practices Act In the 1970s, the United States passed the **Foreign Corrupt Practices Act** following revelations that U.S. companies had bribed government officials in foreign countries in an attempt to win lucrative contracts. This law makes it illegal to bribe a foreign government official to obtain or maintain business over which that foreign official has authority, and it requires all publicly traded companies (whether or not they are involved in international trade) to keep detailed records that would reveal whether a violation of the act has occurred. Along the same lines, in 1997 trade and finance ministers from the member states of the Organization for Economic Cooperation and Development (OECD), an association of the world's 30 most powerful economies, adopted the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.²² The convention obliges member states to make the bribery of foreign public officials a criminal offense.

However, both the U.S. law and OECD convention include language that allows for exceptions known as facilitating or expediting payments (also called *grease payments* or *speed money*), the purpose of which is to expedite or to secure the performance of a routine governmental action.²³ For example, they allow for small payments made to

Foreign Corrupt Practices Act

U.S. law regulating behavior regarding the conduct of international business in the taking of bribes and other unethical actions.



Country FOCUS

Corruption in Nigeria

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

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

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

is not surprising that corruption could be found throughout the political and bureaucratic apparatus.

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

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

Sources: "A Tale of Two Giants," *The Economist*, January 15, 2000, p. 5; J. Coolidge and S. Rose Ackerman, "High Level Rent Seeking and Corruption in African Regimes," World Bank policy research working paper no. 1780, June 1997; D. L. Bevan, P. Collier, and J. W. Gunning, *Nigeria and Indonesia: The Political Economy of Poverty, Equity and Growth* (Oxford: Oxford University Press, 1999); "Democracy and Its Discontents," *The Economist*, January 29, 2005, p. 55; A. Field, "Can Reform Save Nigeria?" *Journal of Commerce*, November 21, 2005, p. 1; "A Blacklist to Bolster Democracy," *The Economist*, February 17, 2007, p. 59; and J. P. Luna, "Back on Track: Nigeria's Hard Path towards Reform," *Harvard International Review* 29, no. 3 (2007), p. 7.

speed up the issuance of permits or licenses, process paperwork, or just get vegetables off the dock and on their way to market. The explanation for this exception to general antibribery provisions is that while grease payments are, technically, bribes, they are distinguishable from (and, apparently, less offensive than) bribes used to obtain or maintain business, because they merely facilitate performance of duties that the recipients are already obligated to perform.

THE PROTECTION OF INTELLECTUAL PROPERTY

Intellectual property refers to property that is the product of intellectual activity, such as computer software, a screenplay, a music score, or the chemical formula for a new drug. Patents, copyrights, and trademarks establish ownership rights over intellectual property. A **patent** grants the inventor of a new product or process exclusive rights for a defined period to the manufacture, use, or sale of that invention. **Copyrights** are the exclusive legal rights of authors, composers, playwrights, artists, and publishers to publish and disperse their work as they see fit. **Trademarks** are designs and names, often officially registered, by which merchants or manufacturers designate and differentiate their products (e.g., Christian Dior clothes). In the high-technology “knowledge” economy of the twenty-first century, intellectual property has become an increasingly important source of economic value for businesses. Protecting intellectual property has also become increasingly problematic, particularly if it can be rendered in a digital form and then copied and distributed at very low cost via pirated CDs or over the Internet (e.g., computer software, music and video recordings).²⁴

The philosophy behind intellectual property laws is to reward the originator of a new invention, book, musical record, clothes design, restaurant chain, and the like, for his or her idea and effort. Such laws stimulate innovation and creative work. They provide an incentive for people to search for novel ways of doing things, and they reward creativity. For example, consider innovation in the pharmaceutical industry. A patent will grant the inventor of a new drug a 20-year monopoly in production of that drug. This gives pharmaceutical firms an incentive to undertake the expensive, difficult, and time-consuming basic research required to generate new drugs (it can cost \$800 million in R&D and take 12 years to get a new drug on the market). Without the guarantees provided by patents, companies would be unlikely to commit themselves to extensive basic research.²⁵

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

Piracy in music recordings is rampant. The International Federation of the Phonographic Industry claims that about one-third of all recorded music products sold worldwide are pirated (illegal) copies, suggesting that piracy costs the industry more than \$4.5 billion annually.²⁶ The computer software industry also suffers from lax enforcement of intellectual property rights. Estimates suggest that violations of intellectual property rights cost personal computer software firms revenues equal to \$53 billion in 2008.²⁷ According to the Business Software Alliance, a software industry association, in 2008 some 41 percent of all software applications used in the world were pirated. The worst region was Central and Eastern Europe where the piracy rate was 66 percent (see Figure 2.2). One of the worst countries was China, where the piracy rate in 2008 ran at 80 percent and cost the industry more than \$6.7 billion in lost sales, up from \$444 million in 1995. The piracy rate in the United States was much lower at 20 percent; however, the value of sales lost was more significant because of the size of the U.S. market, reaching an estimated \$9.1 billion in 2008.²⁸

Intellectual Property

Products of the mind, such as computer software, a screenplay, a music score, or the chemical formula for a new drug; can be protected by patents, copyrights, and trademarks.

Patent

Grants the inventor of a new product or process exclusive rights for a defined period to the manufacture, use, or sale of that invention.

Copyright

The exclusive legal rights of authors, composers, playwrights, artists, and publishers to publish and disperse their work as they see fit.

Trademark

Designs and names, often officially registered, by which merchants or manufacturers designate and differentiate their products.

World Intellectual Property Organization

An international organization whose members sign treaties designed to protect intellectual property.

Paris Convention for the Protection of Industrial Property

International agreement to protect intellectual property; dates to 1883 and has been signed by some 170 nations.



The software piracy rate in China in 2008 ran at 80 percent and cost the industry more than \$6.7 billion in lost sales.

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

(or TRIPS), as of 1995 a council of the World Trade Organization is overseeing enforcement of much stricter intellectual property regulations. These regulations oblige WTO members to grant and enforce patents lasting at least 20 years and copyrights lasting 50 years. Rich countries had to comply with the rules within a year. Poor countries, in which such protection generally was much weaker, had five years of grace, and the very poorest have 10 years.²⁹ (For further details of the TRIPS agreement, see Chapter 6.)

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

Product Safety Laws

Set certain safety standards to which a product must adhere.

Product Liability

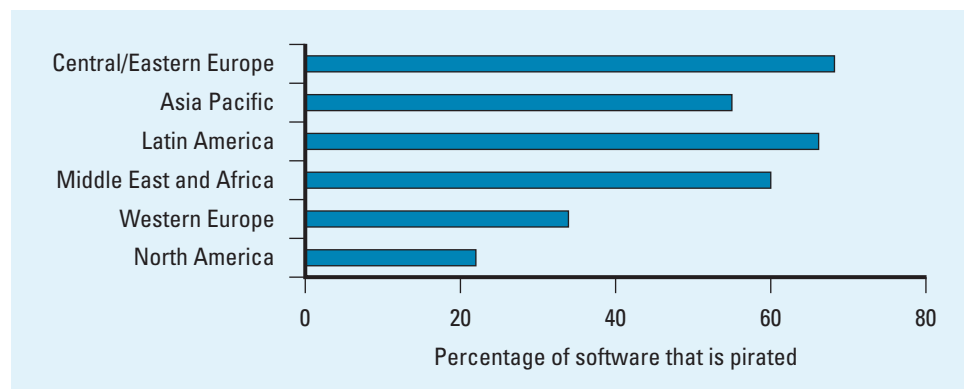
Involves holding a firm and its officers responsible when a product causes injury, death, or damage.

PRODUCT SAFETY AND PRODUCT LIABILITY Product safety laws set certain safety standards to which a product must adhere. Product liability involves holding a firm and its officers responsible when a product causes injury, death, or damage. Product liability can be much greater if a product does not conform to required safety standards. Both civil and criminal product liability laws exist. Civil laws call for payment and monetary damages. Criminal liability laws result in fines or imprisonment. Both civil and criminal liability laws are probably more extensive in the United States than in any other country, although many other Western nations also have comprehensive liability laws. Liability laws are typically least extensive in less developed nations. A boom in product liability suits and awards in the United States resulted in a dramatic increase in the

figure 2.2

Regional Piracy Rates for Computer Software, 2008

Source: Business Software Alliance, "Sixth Annual BSA and IDC Global Software Piracy Study," May 2009, www.bsa.org, accessed April 5, 2010.





Management FOCUS

Starbucks Wins Key Trademark Case in China

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

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

time," claimed the manager, "so how could I imitate its brand and logo?"

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

Sources: M. Dickie, "Starbucks Wins Case against Chinese Copycat," *Financial Times*, January 3, 2006, p. 1; "Starbucks: Chinese Court Backs Company over Trademark Infringement," *The Wall Street Journal*, January 2, 2006, p. A11; and "Starbucks Calls China Its Top Growth Focus," *The Wall Street Journal*, February 14, 2006, p.1.

cost of liability insurance. Many business executives argue that the high costs of liability insurance make American businesses less competitive in the global marketplace.

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

The Determinants of Economic Development

The political, economic, and legal systems of a country can have a profound impact on the level of economic development and hence on the attractiveness of a country as a possible market or production location for a firm. Here we look first at how countries differ in their level of development. Then we look at how political economy affects economic progress.

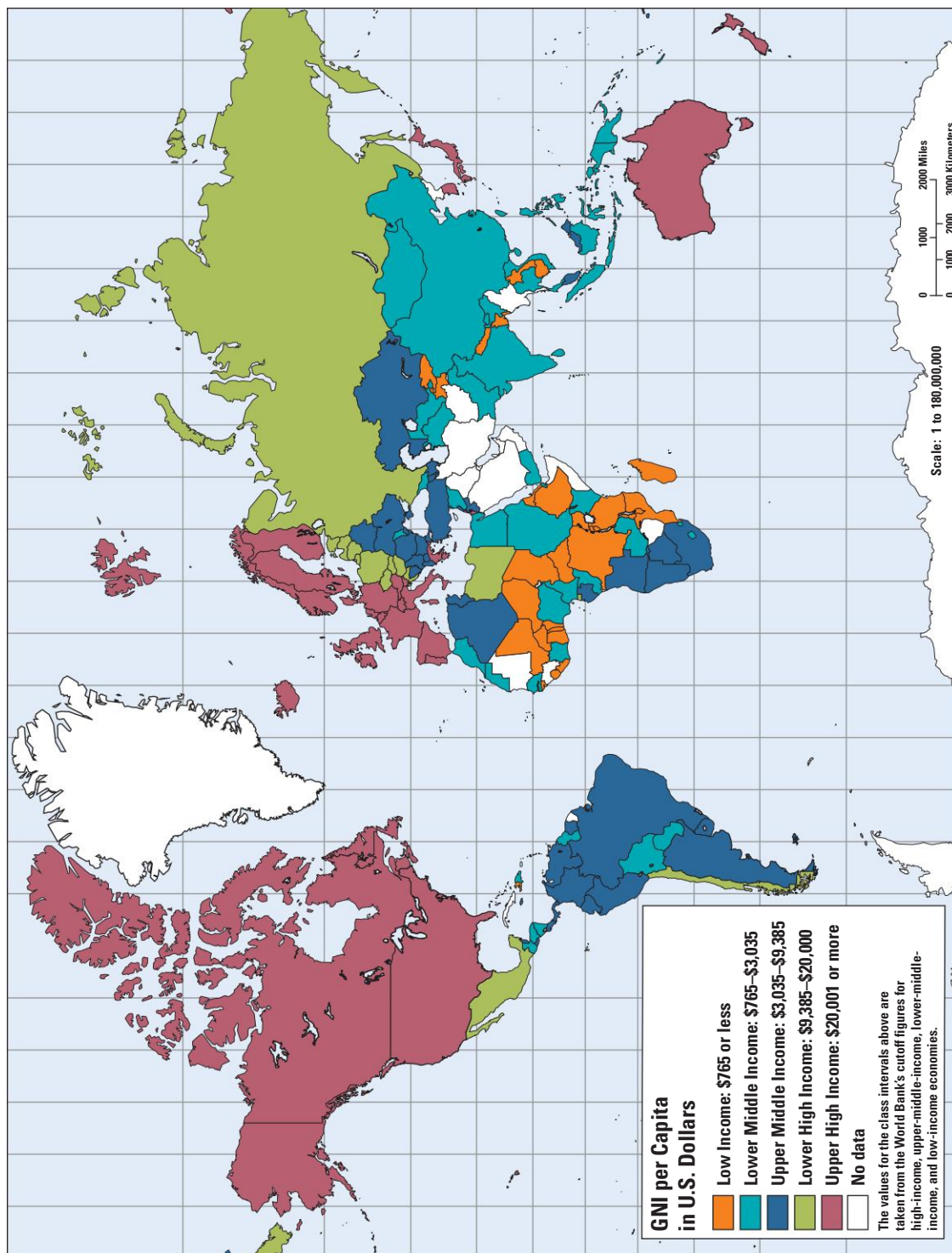
DIFFERENCES IN ECONOMIC DEVELOPMENT Different countries have dramatically different levels of economic development. One common measure of economic development is a country's **gross national income (GNI)** per head of population. GNI is regarded as a yardstick for the economic activity of a country; it measures the total annual income received by residents of a nation. Map 2.1 summarizes

LEARNING OBJECTIVE 4

Explain what determines the level of economic development of a nation.

Gross National Income (GNI)

The yardstick for measuring the economic activity of a country; it measures the total annual income received by a nation's residents.



2.1 map Gross National Income per Capita, 2008

Source: Data from World Bank, "World Development Indicators Online, 2010." Reprinted by permission from the International Bank for Reconstruction and Development. ©2010 by the World Bank.

the GNI per capita of the world's nations in 2008. As can be seen, countries such as Japan, Sweden, Switzerland, and the United States are among the richest on this measure, whereas the large countries of China and India are among the poorest. Japan, for example, had a 2008 GNI per capita of \$38,210, but China achieved only \$2,940 and India just \$1,070.³⁰

GNI per person figures can be misleading because they don't consider differences in the cost of living. For example, although the 2008 GNI per capita of Switzerland at \$65,330 exceeded that of the United States, which was \$47,580, the higher cost of living in Switzerland meant that U.S. citizens could actually afford more goods and services than Swiss citizens. To account for differences in the cost of living, one can adjust GNI per capita by purchasing power. Referred to as a **purchasing power parity (PPP)** adjustment, it allows for a more direct comparison of living standards in different countries. The base for the adjustment is the cost of living in the United States. The PPP for different countries is then adjusted (up or down) depending upon whether the cost of living is lower or higher than in the United States. For example, in 2008 the GNI per capita for China was \$2,940, but the PPP per capita was \$6,020, suggesting that the cost of living was lower in China and that \$2,940 in China would buy as much as \$6,020 in the United States. Table 2.1 gives the GNI per capita measured at PPP in 2008 for a selection of countries, along with their GNI per capita and their growth rate in gross domestic product (GDP) from 1998 to 2008. Map 2.2 summarizes the GNI PPP per capita in 2008 for the nations of the world.

As can be seen, there are striking differences in the standards of living between countries. Table 2.1 suggests that the average Indian citizen can afford to consume only around 6 percent of the goods and services consumed by the average U.S. citizen on a PPP basis. Given this, one might conclude that, despite having a population of 1.1 billion, India is unlikely to be a very lucrative market for the consumer products produced by many Western international businesses. However, this would be incorrect because India has a fairly wealthy middle class of close to 200 million people, despite its large number of very poor. In absolute terms, the Indian economy now rivals that of Brazil and Russia (see Table 2.1).

Purchasing Power Parity (PPP)

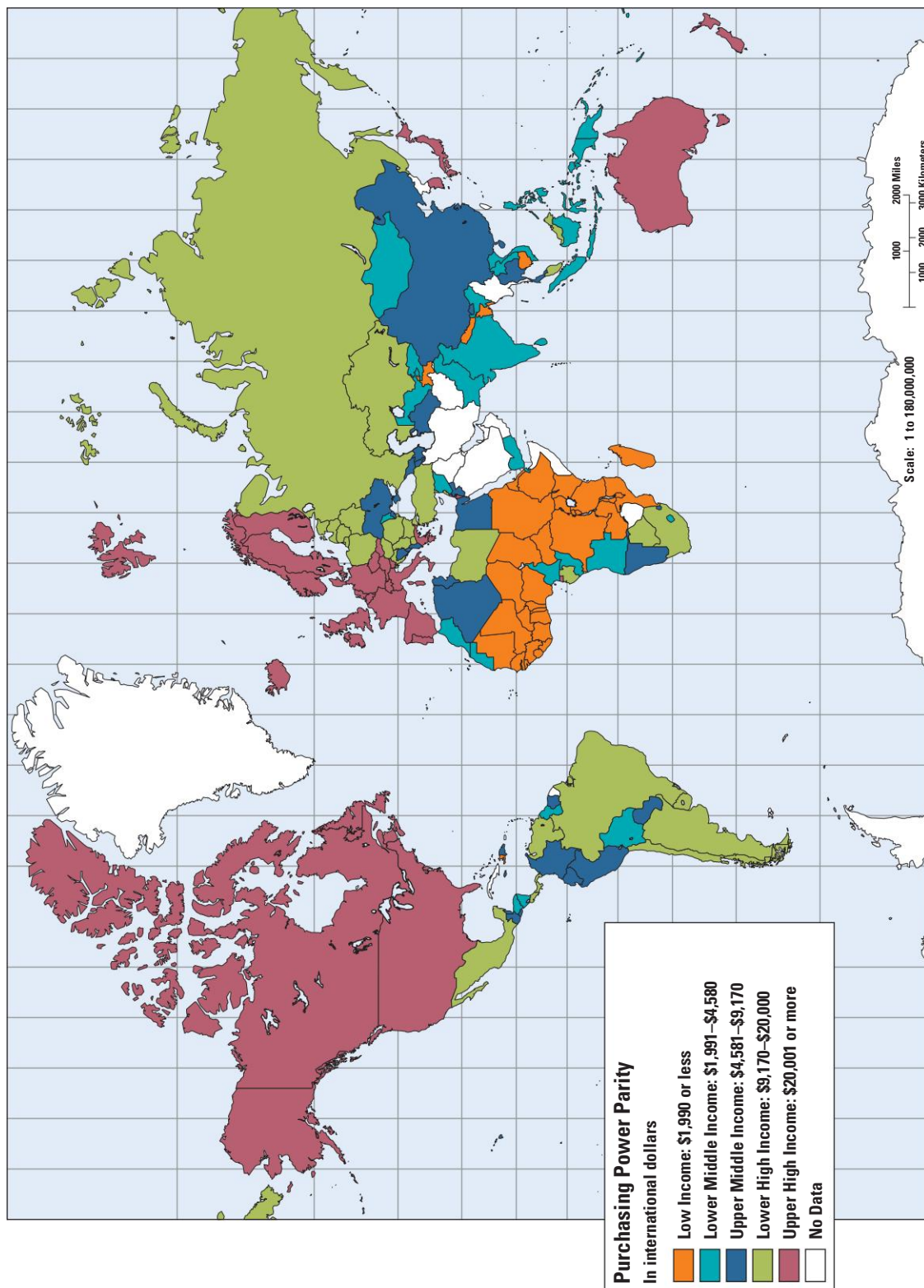
An adjustment in gross domestic product per capita to reflect differences in the cost of living.

Country	GNI per Capita, 2008	GNI PPP per Capita, 2008	GDP Growth Rate, 1999–2008	Size of Economy GDP, 2007 (billions)
Brazil	\$7,350	\$10,070	3.33%	\$1,612
China	2,940	6,020	9.75	4,326
Germany	42,440	35,940	1.47	3,653
India	950	2,960	7.22	1,218
Japan	37,670	35,220	1.31	4,909
Nigeria	1,070	1,940	5.54	213
Poland	11,880	17,310	4.20	527
Russia	9,620	15,630	6.99	1,608
Switzerland	65,330	46,460	1.94	488
United Kingdom	45,390	36,130	2.58	2,646
United States	46,580	46,970	2.58	14,200

2.1 table

Economic Data for Select Countries

Source: World Bank, "World Development Indicators Online, 2010."



2.2 map Gross National Income PPP per Capita, 2008

Source: Data from World Bank, "World Development Indicators Online, 2010." Reprinted by permission from the International Bank for Reconstruction and Development. © 2010 by the World Bank.

The GNI and PPP data give a static picture of development. They tell us, for example, that China is much poorer than the United States, but they do not tell us if China is closing the gap. To assess this, we have to look at the economic growth rates achieved by countries. Table 2.1 gives the rate of growth in gross domestic product (GDP) achieved by a number of countries between 1999 and 2008. Map 2.3 summarizes the growth rate in GDP from 1999 to 2008. Although countries such as China and India are currently poor, their economies are large in absolute terms and growing more rapidly than those of many advanced nations. They are already huge markets for the products of international businesses. If it maintains its growth rates, China in particular will be larger than all but that of the United States within a decade, and India too will be among the largest economies in the world. Given that potential, many international businesses are trying to gain a foothold in these markets now. Even though their current contributions to an international firm's revenues might be relatively small, their future contributions could be much larger.

BROADER CONCEPTIONS OF DEVELOPMENT: AMARTYA SEN

The Nobel Prize-winning economist Amartya Sen has argued that development should be assessed less by material output measures such as GNI per capita and more by the capabilities and opportunities that people enjoy.³¹ According to Sen, development should be seen as a process of expanding the real freedoms that people experience. Hence, development requires the removal of major impediments to freedom: poverty as well as tyranny, poor economic opportunities as well as systematic social deprivation, neglect of public facilities as well as the intolerance of repressive states. In Sen's view, development is not just an economic process, but it is a political one too, and to succeed requires the "democratization" of political communities to give citizens a voice in the important decisions made for the community. This perspective leads Sen to emphasize basic health care, especially for children, and basic education, especially for women. Not only are these factors desirable for their instrumental value in helping to achieve higher income levels, but they are also beneficial in their own right. People cannot develop their capabilities if they are chronically ill or woefully ignorant.

Sen's influential thesis has been picked up by the United Nations, which has developed the **Human Development Index (HDI)** to measure the quality of human life in different nations. The HDI is based on three measures: life expectancy at birth (a function of health care), educational attainment (measured by a combination of the adult literacy rate and enrollment in primary, secondary, and tertiary education), and whether average incomes, based on PPP estimates, are sufficient to meet the basic needs of life in a country (adequate food, shelter, and health care). As such, the HDI comes much closer to Sen's conception of how development should be measured than narrow economic measures such as GNI per capita—although Sen's thesis suggests that political freedoms should also be included in the index, and they are not. The HDI is scaled from 0 to 1. Countries scoring less than 0.5 are classified as having low human development (the quality of life is poor); those scoring from 0.5 to 0.8 are classified as having medium human development; and those that score above 0.8 are classified as having high human development. Map 2.4 summarizes the HDI scores for 2007, the most recent year for which data are available.

Human Development Index (HDI)

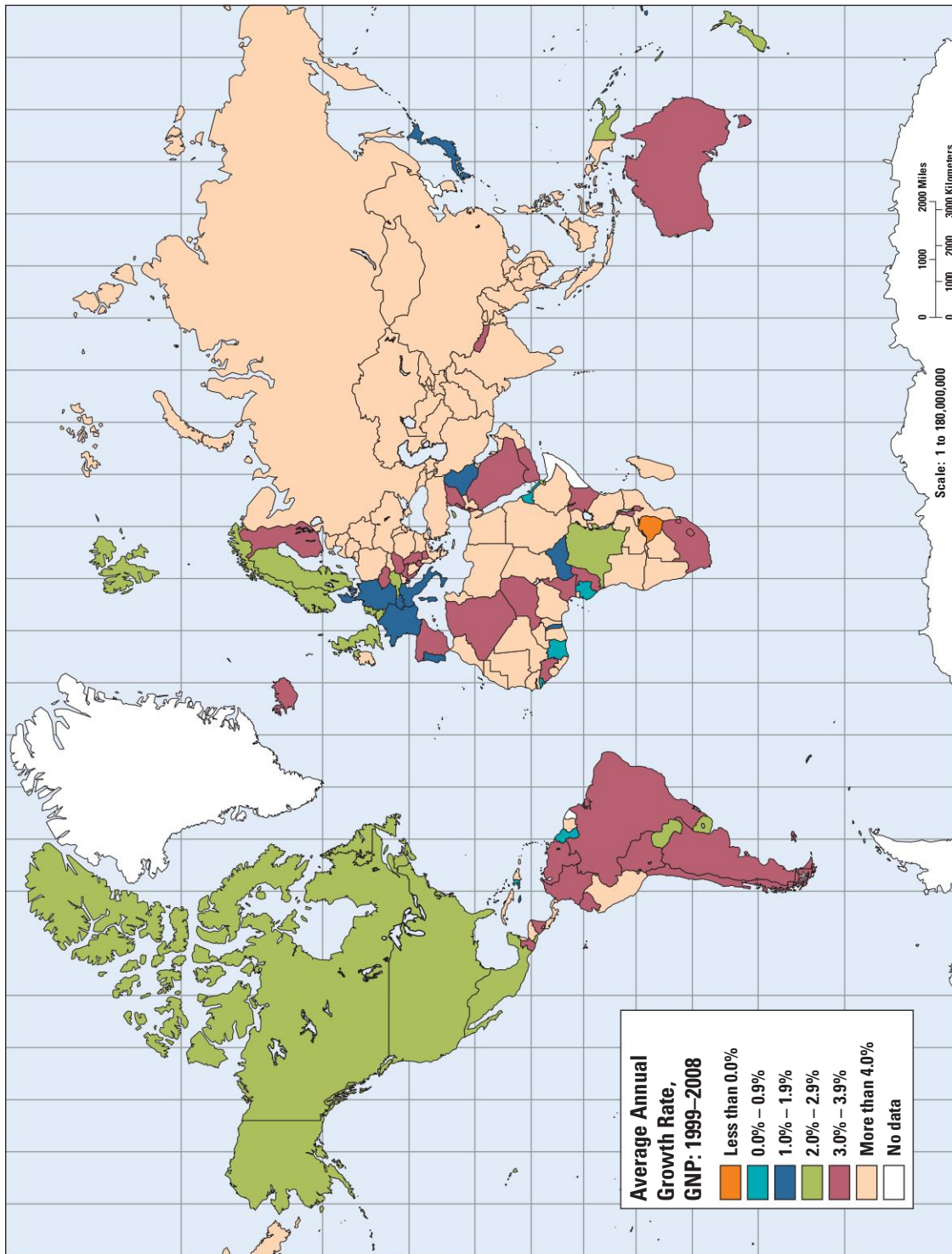
An attempt by the UN to assess the impact of a number of factors on the quality of human life in a country.



Another Perspective

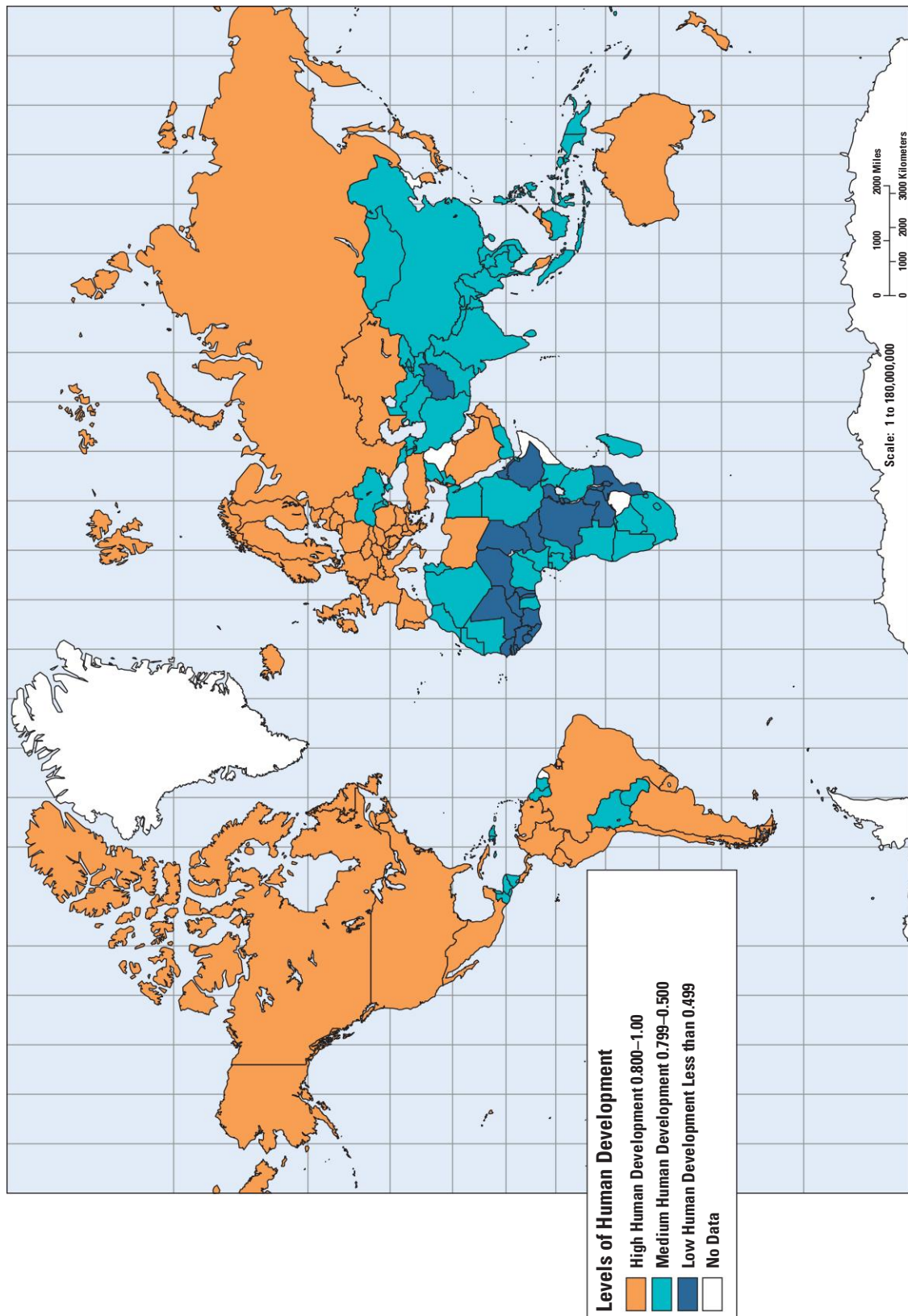
If We Were a Community of 100 People

To get a good sense of the scale of economic and demographic measures that this chapter describes, if we were a community of 100, 61 of us would be Asian, 12 European, 13 North and South American, 13 African, and 1 Australian. Six of us would own 59 percent of the community's wealth. Thirteen would be hungry or malnourished, 14 could not read, and 7 would be educated (secondary level). Thirty would have bank accounts and 53 would live on \$2.00 a day or less. To learn more and to see the video that offers these meaningful metrics, visit www.miniature-earth.com.



2.3 map Growth Rate in GDP per Capita, 1999–2008

Sources: Data from World Bank, "World Development Indicators Online, 2010." Reprinted by permission from the International Bank for Reconstruction and Development. © 2010 by the World Bank.



2.4 map Human Development Index, 2007

Source: Data from United Nations, *Human Development Report, 2007*, *Human Development Index, 2007*.

POLITICAL ECONOMY AND ECONOMIC PROGRESS It is often argued that a country's economic development is a function of its economic and political systems. What then is the nature of the relationship between political economy and economic progress? This question has been the subject of vigorous debate among academics and policy makers for some time. Despite the long debate, this remains a question for which it is not possible to give an unambiguous answer. However, it is possible to untangle the main threads of the arguments and make a few generalizations as to the nature of the relationship between political economy and economic progress.

Innovation and Entrepreneurship Are the Engines of Growth There is substantial agreement among economists that innovation and entrepreneurial activity are the engines of long-run economic growth.³² Those who make this argument define **innovation** broadly to include not just new products but also new processes, new organizations, new management practices, and new strategies. Thus, the Toys "R" Us strategy of establishing large warehouse-style toy stores and then engaging in heavy advertising and price discounting to sell the merchandise can be classified as an innovation because it was the first company to pursue this strategy. Innovation and entrepreneurial activity help to increase economic activity by creating new products and markets that did not previously exist. Plus, innovations in production and business processes lead to an increase in the productivity of labor and capital, which further boosts economic growth rates.³³

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

Innovation

Development of new products, processes, organizations, management practices, and strategies.

Entrepreneurs

Those who first commercialize innovations.



Another Perspective

Mobile Phones Figure in Banking Innovation

For people in underdeveloped countries, banking is next to impossible. But that's changing for people in India, now that Eko, a not-for-profit organization, has partnered with the State Bank of India to create an innovative banking system. In areas where no bank exists, local merchants serve as "human ATMs," accepting payments and deposits and processing withdrawals, using mobile phones and special encryption pads to record transactions. Eko's brainstorm—harnessing the potential of mobile phones—has seen almost immediate success in a country where over 403 million people have a phone yet 187 million have no bank account. Eko's 350 outlets across India serve about 42,000 customers daily. ("Geithner: India Innovations Add Bank Customers," *Reuters*, April 6, 2010, www.reuters.com)

Innovation and Entrepreneurship Require a Market Economy

This leads logically to a further question: What is required for the business environment of a country to be conducive to innovation and entrepreneurial activity? Those who have considered this issue highlight the advantages of a market economy.³⁴ It has been argued that the economic freedom associated with a market economy creates greater incentives for innovation and entrepreneurship than either a planned or a mixed economy. In a market economy, any individual who has an innovative idea is free to try to make money out of that idea by starting a business (by engaging in entrepreneurial activity). Similarly, existing businesses are free to improve their operations through innovation. To the extent that they are successful, both individual entrepreneurs and established businesses can reap rewards in the form of high profits. Thus, market economies contain enormous incentives to develop innovations.

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

A study of 102 countries over a 20-year period provided evidence of a strong relationship between economic freedom (as provided by a market economy) and economic growth.³⁵ The study found that the more economic freedom a country had between 1975 and 1995, the more economic growth it achieved and the richer its citizens became. The six countries that had persistently high ratings of economic freedom from 1975 to 1995 (Hong Kong, Switzerland, Singapore, the United States, Canada, and Germany) were also all in the top 10 in terms of economic growth rates. In contrast, no country with persistently low economic freedom achieved a respectable growth rate. In the 16 countries for which the index of economic freedom declined the most during 1975 to 1995, gross domestic product fell at an annual rate of 0.6 percent.

Innovation and Entrepreneurship Require Strong Property Rights Strong legal protection of property rights is another requirement for a business environment to be conducive to innovation, entrepreneurial activity, and hence economic growth.³⁶ Both individuals and businesses must be given the opportunity to profit from innovative ideas. Without strong property rights protection, businesses and individuals run the risk that the profits from their innovative efforts will be expropriated, either by criminal elements or by the state. The state can expropriate the profits from innovation through legal means, such as excessive taxation, or through illegal means, such as demands from state bureaucrats for kickbacks in return for granting an individual or firm a license to do business in a certain area (i.e., corruption). According to the Nobel Prize-winning economist Douglass North, throughout history many governments have displayed a tendency to engage in such behavior. Inadequately enforced property rights reduce the incentives for innovation and entrepreneurial activity—because the profits from such activity are “stolen”—and hence reduce the rate of economic growth.

The influential Peruvian development economist Hernando de Soto has argued that much of the developing world will fail to reap the benefits of capitalism until property rights are better defined and protected.³⁷ De Soto’s arguments are interesting because he claims that the key problem is not the risk of expropriation but the chronic inability of property owners to establish legal title to the property they own. As an example of the scale of the problem, he cites the situation in Haiti where individuals must take 176 steps over 19 years to own land legally. Because most property in poor countries is informally “owned,” the absence of legal proof of ownership means that property holders cannot convert their assets into capital, which could then be used to finance business ventures. Banks will not lend money to the poor to start businesses because the poor possess no proof that they own property, such as farmland, that can be used as collateral for a loan. By de Soto’s calculations, the total value of real estate held by the poor in Third World and former Communist states amounted to more than \$9.3 trillion in 2000. If those assets could be converted into capital, the result could be an economic revolution that would allow the poor to bootstrap their way out



Country FOCUS

Emerging Property Rights in China

A new property law took effect in China on October 1, 2007. The law, the accumulation of 14 years of effort, granted rural and urban landholders far more secure property rights. The law was a much-needed response to how much China's economy has changed over the past 30 years as it transitions from a centrally planned system to a dynamic market-based economy where two-thirds of economic activity is in the hands of private enterprises.

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

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

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

Sources: “China's Next Revolution—Property Rights in China,” *The Economist*, March 10, 2007, p. 11; “Caught between the Right and Left,” *The Economist*, March 10, 2007, pp. 25–27; and Z. Keliang and L. Ping, “Rural Land Rights under the PRC Property Law,” *China Law and Practice*, November 2007, pp. 10–15.

of poverty. Interestingly enough, the Chinese seem to have taken de Soto's arguments to heart. Despite still being nominally a Communist country, in October 2007 the government passed a law that gave private property owners the same rights as the state and significantly improved the rights of urban and rural landowners to the land that they use (see the accompanying Country Focus for details).

The Required Political System Much debate surrounds which kind of political system best achieves a functioning market economy with strong protection for property rights.³⁸ People in the West tend to associate a representative democracy with a market economic system, strong property rights protection, and economic progress. Building on this, we tend to argue that democracy is good for growth. However, some totalitarian regimes have fostered a market economy and strong property rights protection and have experienced rapid economic growth. Five of the fastest-growing economies of the past 30 years—China, South Korea, Taiwan, Singapore, and Hong Kong—had one thing in common at the start of their economic growth: undemocratic governments. At the same time, countries with stable democratic governments, such as India, experienced sluggish economic growth for long periods. In 1992, Lee Kuan Yew, Singapore's leader for many years, told an audience, “I do not believe that democracy necessarily leads to development. I believe that a country needs to develop discipline more than democracy. The exuberance of democracy leads to undisciplined and disorderly conduct which is inimical to development.”³⁹

However, those who argue for the value of a totalitarian regime miss an important point: If dictators made countries rich, then much of Africa, Asia, and Latin America should have been growing rapidly during 1960 to 1990, and this was not the case. Only a totalitarian regime that is committed to a market system and strong protection of property rights is capable of promoting economic growth. Also, there is no guarantee that a dictatorship will continue to pursue such progressive policies. Dictators are rarely benevolent. Many are tempted to use the apparatus of the state to further their own private ends, violating property rights and stalling economic growth. Given this, it seems likely that democratic regimes are far more conducive to long-term economic growth than are dictatorships, even benevolent ones. Only in a well-functioning, mature democracy are property rights truly secure.⁴⁰ Nor should we forget Amartya Sen's arguments that we reviewed earlier. Totalitarian states, by limiting human freedom, also suppress human development and therefore are detrimental to progress.

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

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

GEOGRAPHY, EDUCATION, AND ECONOMIC DEVELOPMENT While a country's political and economic systems are probably the big engine driving its rate of economic development, other factors are also important. One that has received attention recently is geography.⁴¹ But the belief that geography can influence economic policy, and hence economic growth rates, goes back to Adam Smith. The influential Harvard University economist Jeffrey Sachs argues:

throughout history, coastal states, with their long engagements in international trade, have been more supportive of market institutions than landlocked states, which have tended to organize themselves as hierarchical (and often military) societies. Mountainous states, as a result of physical isolation, have often neglected market-based trade. Temperate climates have generally supported higher densities of population and thus a more extensive division of labor than tropical regions.⁴²

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

slowly than coastal economies and that being entirely landlocked reduced a country's growth rate by roughly 0.7 percent per year. He also found that tropical countries grew 1.3 percent more slowly each year than countries in the temperate zone.

Education emerges as another important determinant of economic development (a point that Amartya Sen emphasizes). The general assertion is that nations that invest more in education will have higher growth rates because an educated population is a more productive population. Anecdotal comparisons suggest this is true. In 1960, Pakistanis and South Koreans were on equal footing economically. However, just 30 percent of Pakistani children were enrolled in primary schools, while 94 percent of South Koreans were. By the mid-1980s, South Korea's GNP per person was three times that of Pakistan's.⁴³ A survey of 14 statistical studies that looked at the relationship between a country's investment in education and its subsequent growth rates concluded investment in education did have a positive and statistically significant impact on a country's rate of economic growth.⁴⁴ Similarly, the work by Sachs discussed above suggests that investments in education help explain why some countries in Southeast Asia, such as Indonesia, Malaysia, and Singapore, have been able to overcome the disadvantages associated with their tropical geography and grow far more rapidly than tropical nations in Africa and Latin America.

States in Transition

LEARNING OBJECTIVE 5

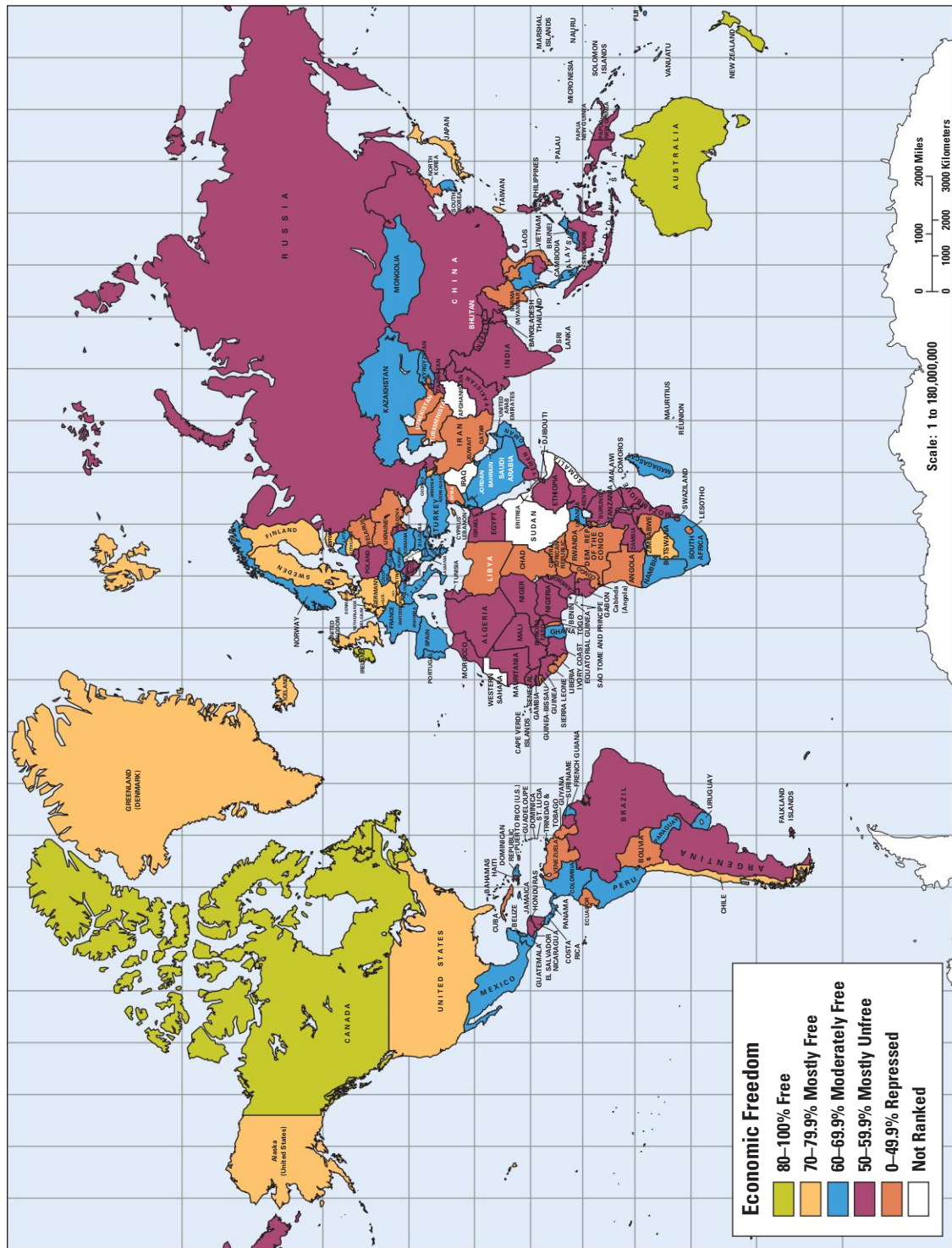
Identify the macro-political and economic changes taking place worldwide.

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

THE SPREAD OF DEMOCRACY One notable development of the past 20 years has been the spread of democracy (and, by extension, the decline of totalitarianism). Map 2.5 reports on the extent of totalitarianism in the world as determined by Freedom House.⁴⁵ This map charts political freedom in 2009, grouping countries into three broad groupings—free, partly free, and not free. In “free” countries, citizens enjoy a high degree of political and civil freedoms. “Partly free” countries are characterized by some restrictions on political rights and civil liberties, often in the context of corruption, weak rule of law, ethnic strife, or civil war. In “not free” countries, the political process is tightly controlled and basic freedoms are denied.

Freedom House classified 89 countries as free in 2009, accounting for some 46 percent of the world's nations. These countries respect a broad range of political rights. Another 58 countries accounting for 30 percent of the world's nations were classified as partly free, while 47 countries representing 24 percent of the world's nations were classified as not free. The number of democracies in the world has increased from 69 nations in 1987 to 116 in 2009, slightly below the 2006 total of 123. But not all democracies are free, according to Freedom House, because some democracies still restrict certain political and civil liberties. For example, Russia was rated “not free.” According to Freedom House,

Russia's step backwards into the Not Free category is the culmination of a growing trend . . . to concentrate political authority, harass and intimidate the media, and politicize the country's law-enforcement system.⁴⁶



2.5 map Political Freedom in 2009

Source: Map data from Freedom House, *Freedom in the World*, 2010; *The Annual Survey of Political Rights and Civil Liberties*, www.freedomhouse.org. Reprinted with permission.

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

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

Three main reasons account for the spread of democracy.⁴⁷ First, many totalitarian regimes failed to deliver economic progress to the vast bulk of their populations. The collapse of communism in Eastern Europe, for example, was precipitated by the growing gulf between the vibrant and wealthy economies of the West and the stagnant economies of the Communist East. In looking for alternatives to the socialist model, the populations of these countries could not have failed to notice that most of the world's strongest economies were governed by representative democracies. Today, the economic success of many of the newer democracies, such as Poland and the Czech Republic in the former Communist bloc, the Philippines and Taiwan in Asia, and Chile in Latin America, has strengthened the case for democracy as a key component of successful economic advancement.

Second, new information and communication technologies, including shortwave radio, satellite television, fax machines, desktop publishing, and, most important, the Internet, have reduced the state's ability to control access to uncensored information. These technologies have created new conduits for the spread of democratic ideals and information from free societies. Today, the Internet is allowing democratic ideals to penetrate closed societies as never before.⁴⁸

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

Despite this, it would be naive to conclude that the global spread of democracy will continue unchallenged. Democracy is still rare in large parts of the world. In sub-Saharan Africa in 2009, only 9 countries were considered free, 23 were partly free, and 16 were not free. Among the post-Communist countries in Eastern and Central Europe and the former Soviet Union, 8 are still not electoral democracies and Freedom House classifies only 14 of these states as free (primarily in Eastern Europe). And there is only 1 free state among the 17 nations of the Middle East and North Africa.

THE NEW WORLD ORDER AND GLOBAL TERRORISM The end of the Cold War and the “new world order” that followed the collapse of communism in Eastern Europe and the former Soviet Union, taken together with the demise of many authoritarian regimes in Latin America, have given rise to intense speculation about the future shape of global geopolitics. Author Francis Fukuyama has argued, “We may be witnessing . . . the end of history as such: that is, the end point of mankind's ideological evolution and the universalization of Western liberal democracy as the final form of human government.”⁴⁹ Fukuyama goes on to say that the war of ideas may be at an end and that liberal democracy has triumphed.

Others question Fukuyama's vision of a more harmonious world dominated by a universal civilization characterized by democratic regimes and free market capitalism. In a controversial book, the influential political scientist Samuel Huntington argues that there is no "universal" civilization based on widespread acceptance of Western liberal democratic ideals.⁵⁰ Huntington maintains that while many societies may be modernizing—they are adopting the material paraphernalia of the modern world, from automobiles to Coca-Cola and MTV—they are not becoming more Western. On the contrary, Huntington theorizes that modernization in non-Western societies can result in a retreat toward the traditional, such as the resurgence of Islam in many traditionally Muslim societies. He writes,

The Islamic resurgence is both a product of and an effort to come to grips with modernization. Its underlying causes are those generally responsible for indigenization trends in non-Western societies: urbanization, social mobilization, higher levels of literacy and education, intensified communication and media consumption, and expanded interaction with Western and other cultures. These developments undermine traditional village and clan ties and create alienation and an identity crisis. Islamist symbols, commitments, and beliefs meet these psychological needs, and Islamist welfare organizations, the social, cultural, and economic needs of Muslims caught in the process of modernization. Muslims feel a need to return to Islamic ideas, practices, and institutions to provide the compass and the motor of modernization.⁵¹

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

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

If Huntington's views are even partly correct, they have important implications for international business. They suggest many countries may be increasingly difficult places in which to do business, either because they are shot through with violent conflicts or because they are part of a civilization that is in conflict with an enterprise's home country. Huntington's views are speculative and controversial. It is not clear that his predictions will come to pass. More likely is the evolution of a global political system that is positioned somewhere between Fukuyama's universal global civilization based on liberal democratic ideals and Huntington's vision of a fractured world. That would still be a world, however, in which geopolitical forces periodically limit the ability of business enterprises to operate in certain foreign countries.

In Huntington's thesis, global terrorism is a product of the tension between civilizations and the clash of value systems and ideology. Others point to terrorism's

roots in long-standing conflicts that seem to defy political resolution, the Palestinian, Kashmir, and Northern Ireland conflicts being obvious examples. It should also be noted that a substantial amount of terrorist activity in some parts of the world, such as Colombia, has been interwoven with the illegal drug trade. The attacks of September 11, 2001, created the impression that global terror is on the rise, although accurate statistics on this are hard to come by. What we do know is that according to data from the U.S. Department of State, in 2008 there were some 11,770 terrorist attacks worldwide, about the same as in 2005 and a decline from 14,507 in 2007. These attacks resulted in 15,765 deaths. The Middle East accounted for 40 percent of the attacks and 35 percent of the fatalities.⁵² Other global hot spots for terrorist incidents in 2007 included the Sudan, Nigeria, and Afghanistan. As former U.S. Secretary of State Colin Powell has maintained, terrorism represents one of the major threats to world peace and economic progress in the twenty-first century.⁵³

THE SPREAD OF MARKET-BASED SYSTEMS Paralleling the spread of democracy since the 1980s has been the transformation from centrally planned command economies to market-based economies. More than 30 countries that were in the former Soviet Union or the Eastern European Communist bloc have changed their economic systems. A complete list of countries where change is now occurring also would include Asian states such as China and Vietnam, as well as African countries such as Angola, Ethiopia, and Mozambique.⁵⁴ There has been a similar shift away from a mixed economy. Many states in Asia, Latin America, and Western Europe have sold state-owned businesses to private investors (privatization) and deregulated their economies to promote greater competition.

The rationale for economic transformation has been the same the world over. In general, command and mixed economies failed to deliver the kind of sustained economic performance that was achieved by countries adopting market-based systems, such as the United States, Switzerland, Hong Kong, and Taiwan. As a consequence, even more states have gravitated toward the market-based model. Map 2.6, based on data from the Heritage Foundation, a politically conservative U.S. research foundation, gives some idea of the degree to which the world has shifted toward market-based economic systems. The Heritage Foundation's index of economic freedom is based on 10 indicators, such as the extent to which the government intervenes in the economy, trade policy, the degree to which property rights are protected, foreign investment regulations, and taxation rules. A country can score between 1 (most free) and 5 (least free) on each of these indicators. The lower a country's average score across all 10 indicators, the more closely its economy represents the pure market model. According to the 2009 index, which is summarized in Map 2.6, the world's freest economies are (in rank order) Hong Kong, Singapore, Australia, New Zealand, Ireland, Switzerland, Canada, United States, Denmark, and Chile. Japan came in at 19; Mexico at 41; France at 64; Brazil, 113; India, 124; China 140; and Russia, 143. The



Another Perspective

Business Students Visualize World Peace Through Commerce

Interested in world peace? Business students worldwide can participate in Peace Through Commerce, an integrated program that shows how business schools can promote peace. The program is sponsored by the Association to Advance Collegiate Schools of Business (AACSB), the global accrediting organization of business schools. Peace Through Commerce is built on the premise that commerce represents the most overlooked—yet most effective—means of facilitating widespread peace. The idea of encouraging peace through commerce isn't new; it was espoused by philosophers as early as the 1700s. Again after World War II, the concept of world peace through commerce gained momentum when the United Nations was formed. It's also a basic tenet of the European Union: Countries that trade together don't go to war. As the AACSB puts it: "If we educate students that it's their responsibility to advance society, over a generation we may be able to have more impact than governments have had." For more information, visit www.peacethroughcommerce.com.

economies of Cuba, Laos, Iran, Venezuela, and North Korea are to be found near the bottom of the rankings.⁵⁵

Economic freedom does not necessarily equate with political freedom, as detailed in Map 2.6. For example, the two top states in the Heritage Foundation index, Hong Kong and Singapore, cannot be classified as politically free. Hong Kong was reabsorbed into Communist China in 1997, and the first thing Beijing did was shut down Hong Kong's freely elected legislature. Singapore is ranked as only partly free on Freedom House's index of political freedom due to practices such as widespread press censorship.

The Nature of Economic Transformation

LEARNING OBJECTIVE 6

Describe how transition economies are moving toward market-based systems.

Deregulation

Removal of government restrictions concerning the conduct of business.

The shift toward a market-based economic system often entails a number of steps: deregulation, privatization, and creation of a legal system to safeguard property rights.⁵⁶

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

In mixed economies, the role of the state was more limited; but here too, in certain sectors the state set prices, owned businesses, limited private enterprise, restricted investment by foreigners, and restricted international trade. For these countries, deregulation has involved the same kind of initiatives that we have seen in former command economies, although the transformation has been easier because these countries often had a vibrant private sector.

PRIVATIZATION Hand in hand with deregulation has come a sharp increase in privatization. Privatization, as we discussed earlier in this chapter, transfers the ownership of state property into the hands of private individuals, frequently by the sale of state assets through an auction.⁵⁷ Privatization is seen as a way to stimulate gains in economic efficiency by giving new private owners a powerful incentive—the reward of greater profits—to search for increases in productivity, to enter new markets, and to exit losing ones.⁵⁸

The privatization movement started in Great Britain in the early 1980s when then Prime Minister Margaret Thatcher started to sell state-owned assets such as the British telephone company, British Telecom (BT). In a pattern that has been repeated around the world, this sale was linked with the deregulation of the British telecommunications industry. By allowing other firms to compete head-to-head with BT, deregulation ensured that privatization did not simply replace a state-owned monopoly with a private monopoly. Since the 1980s, privatization has become a worldwide phenomenon. More than 8,000 acts of privatization were completed around the world between 1995 and 1999.⁵⁹ Some of the most dramatic privatization programs occurred in the economies of the former Soviet Union and its Eastern European satellite states. In the Czech Republic, for example, three-quarters of all state-owned

enterprises were privatized between 1989 and 1996, helping to push the share of gross domestic product accounted for by the private sector up from 11 percent in 1989 to 60 percent in 1995.⁶⁰

As privatization has proceeded around the world, it has become clear that simply selling state-owned assets to private investors is not enough to guarantee economic growth. Studies of privatization in central Europe have shown that the process often fails to deliver predicted benefits if the newly privatized firms continue to receive subsidies from the state and if they are protected from foreign competition by barriers to international trade and foreign direct investment.⁶¹ In such cases, the newly privatized firms are sheltered from competition and continue acting like state monopolies. When these circumstances prevail, the newly privatized entities often have little incentive to restructure their operations to become more efficient. For privatization to work, it must also be accompanied by a more general deregulation and opening of the economy. Thus, when Brazil decided to privatize the state-owned telephone monopoly, Telebras Brazil, the government also split the company into four independent units that were to compete with each other and removed barriers to foreign direct investment in telecommunications services. This action ensured that the newly privatized entities would face significant competition and thus would have to improve their operating efficiency to survive.

The ownership structure of newly privatized firms also is important.⁶² Many former command economies, for example, lack the legal regulations regarding corporate governance that are found in advanced Western economies. In advanced market economies, boards of directors are appointed by shareholders to make sure managers consider the interests of shareholders when making decisions and try to manage the firm in a manner that is consistent with maximizing the wealth of shareholders. However, some former Communist states still lack laws requiring corporations to establish effective boards. In such cases, managers with a small ownership stake can often gain control over the newly privatized entity and run it for their own benefit, while ignoring the interests of other shareholders. Sometimes these managers are the same Communist bureaucrats who ran the enterprise before privatization. Because they have been schooled in the old ways of doing things, they often hesitate to take drastic action to increase the efficiency of the enterprise. Instead, they continue to run the firm as a private fiefdom, seeking to extract whatever economic value they can for their own betterment (in the form of perks that are not reported) while doing little to increase the economic efficiency of the enterprise so that shareholders benefit. Such developments seem less likely to occur, however, if a foreign investor takes a stake in the newly privatized entity. The foreign investor, who usually is a major provider of capital, is often able to use control over a critical resource (money) to push through needed change.

LEGAL SYSTEMS As noted earlier in this chapter, a well-functioning market economy requires laws protecting private property rights and providing mechanisms for contract enforcement. Without a legal system that protects property rights, and without the machinery to enforce that system, the incentive to engage in economic activity can be reduced substantially by private and public entities, including organized crime, that expropriate the profits generated by the efforts of private-sector entrepreneurs. When communism collapsed, many of these countries lacked the legal structure required to protect property rights, all property having been held by the state. Although many nations have made big strides toward instituting the required system, it will be many more years before the legal system is functioning as smoothly as it does in the West. For example, in most Eastern European nations, the title to urban and agricultural property is often uncertain because of incomplete and

inaccurate records, multiple pledges on the same property, and unsettled claims resulting from demands for restitution from owners in the pre-Communist era. Also, although most countries have improved their commercial codes, institutional weaknesses still undermine contract enforcement. Court capacity is often inadequate, and procedures for resolving contract disputes out of court are often lacking or poorly developed.⁶³ Nevertheless, progress is being made. In 2004, for example, China amended its constitution to state that “private property was not to be encroached upon,” and in 2007 it enacted a new law on property rights that gave private property holders many of the same protections as those enjoyed by the state (see the Country Focus, “Emerging Property Rights in China”).⁶⁴

Implications of Changing Political Economy

LEARNING OBJECTIVE 7

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

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

Notwithstanding the crisis of 2008–2009, the implications for business of the trends of the past two decades are enormous. For nearly 50 years, half of the world was off-limits to Western businesses. Now much of that has changed. Many of the national markets of Eastern Europe, Latin America, Africa, and Asia may still be undeveloped and impoverished, but they are potentially enormous. With a population of more than 1.2 billion, the Chinese market alone is potentially bigger than that of the United States, the European Union, and Japan combined. Similarly India, with its nearly 1.1 billion people, is a potentially huge market. Latin America has another 400 million potential consumers. It is unlikely that China, Russia, Vietnam, or any of the other states now moving toward a market system will attain the living standards of the West soon. Nevertheless, the upside potential is so large that companies need to consider making inroads now. For example, if China and Japan continue to grow at the rate they did during 1996–2008, China will surpass Japan and become the world’s second-largest national economy behind the United States by 2020.

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



Focus on Managerial Implications

The material discussed in this chapter has two broad implications for international business. First, the political, economic, and legal systems of a country raise important ethical issues that have implications for the practice of international business. For example, what ethical implications are associated with doing business in totalitarian countries where citizens are denied basic human rights, corruption is rampant, and bribes are necessary to gain permission to do business? Is it right to operate in such a setting? A full discussion of the ethical implications of country differences in political economy is reserved for Chapter 4, where we explore ethics in international business in much greater depth.

Second, the political, economic, and legal environments of a country clearly influence the attractiveness of that country as a market or investment site. The benefits, costs, and risks associated with doing business in a country are a function of that country's political, economic, and legal systems. The overall attractiveness of a country as a market or investment site depends on balancing the likely long-term benefits of doing business in that country against the likely costs and risks. Below we consider the determinants of benefits, costs, and risks.

Benefits

In the most general sense, the long-run monetary benefits of doing business in a country are a function of the size of the market, the present wealth (purchasing power) of consumers in that market, and the likely future wealth of consumers. While some markets are very large when measured by number of consumers (e.g., China and India), low living standards may imply limited purchasing power and therefore a relatively small market when measured in economic terms. International businesses need to be aware of this distinction, but they also need to keep in mind the likely future prospects of a country. In 1960, South Korea was viewed as just another impoverished Third World nation. By 2008 it was the world's 11th-largest economy, measured in terms of GDP. International firms that recognized South Korea's potential in 1960 and began to do business in that country may have reaped greater benefits than those that wrote off South Korea.

By identifying and investing early in a potential future economic star, international firms may build brand loyalty and gain experience in that country's business practices. These will pay back substantial dividends if that country achieves sustained high economic growth rates. In contrast, late entrants may find that they lack the brand loyalty and experience necessary to achieve a significant presence in the market. In the language of business strategy, early entrants into potential future economic stars may be able to reap substantial first-mover advantages, while late entrants may fall victim to late-mover disadvantages.⁶⁵ (**First-mover advantages** are the advantages that accrue to early entrants into a market. **Late-mover disadvantages** are the handicaps that late entrants might suffer.) This kind of reasoning has been driving significant inward investment into China, which may become the world's second-largest economy by 2020 if it continues growing at current rates (China is already the world's fourth-largest national economy). For more than a decade, China has been the largest recipient of foreign direct investment in the developing world as international businesses including General Motors, Volkswagen, Coca-Cola, and Unilever try to establish a sustainable advantage in this nation.

A country's economic system and property rights regime are reasonably good predictors of economic prospects. Countries with free market economies in which property rights are protected tend to achieve greater economic growth rates than command economies or economies where property rights are poorly protected. It follows that a country's

First-Mover Advantages

Advantages that accrue to the first to enter a market.

Late-Mover Disadvantages

Handicaps experienced by being a late entrant into a market.

economic system, property rights regime, and market size (in terms of population) probably constitute reasonably good indicators of the potential long-run benefits of doing business in a country. In contrast, countries where property rights are not well respected and where corruption is rampant tend to have lower levels of economic growth. One must be careful about generalizing too much from this, however, since both China and India have achieved high growth rates despite relatively weak property rights regimes and high levels of corruption. In both countries, the shift toward a market-based economic system has produced large gains despite weak property rights and endemic corruption.

Costs

A number of political, economic, and legal factors determine the costs of doing business in a country. With regard to political factors, a company may have to pay off politically powerful entities in a country before the government allows it to do business there. The need to pay what are essentially bribes is greater in closed totalitarian states than in open democratic societies where politicians are held accountable by the electorate (although this is not a hard-and-fast distinction). Whether a company should actually pay bribes in return for market access should be determined on the basis of the legal and ethical implications of such action. We discuss this consideration in Chapter 4, when we look closely at the issue of business ethics.

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

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

Risks

As with costs, the risks of doing business in a country are determined by a number of political, economic, and legal factors. **Political risk** has been defined as the likelihood that political forces will cause drastic changes in a country's business environment that adversely affect the profit and other goals of a business enterprise.⁶⁶ So defined, political risk tends to be greater in countries experiencing social unrest and disorder or in countries where the underlying nature of a society increases the likelihood of social unrest. Social unrest typically finds expression in strikes, demonstrations, terrorism, and violent conflict. Such unrest is more likely to be found in countries that contain more than one

Political Risk

The likelihood that political forces will cause drastic changes in a country's business environment that will adversely affect the profit and other goals of a business enterprise.

ethnic nationality, in countries where competing ideologies are battling for political control, in countries where economic mismanagement has created high inflation and falling living standards, or in countries that straddle the “fault lines” between civilizations.

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

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

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

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

On the legal front, risks arise when a country’s legal system fails to provide adequate safeguards in the case of contract violations or to protect property rights. When legal safeguards are weak, firms are more likely to break contracts or steal intellectual property if they perceive it as being in their interests to do so. Thus, a **legal risk** can be

Economic Risk

The likelihood that events, including economic mismanagement, will cause drastic changes in a country’s business environment that hurt the profit and other goals of a particular business enterprise.

Legal Risk

The likelihood that a trading partner will opportunistically break a contract or expropriate property rights.

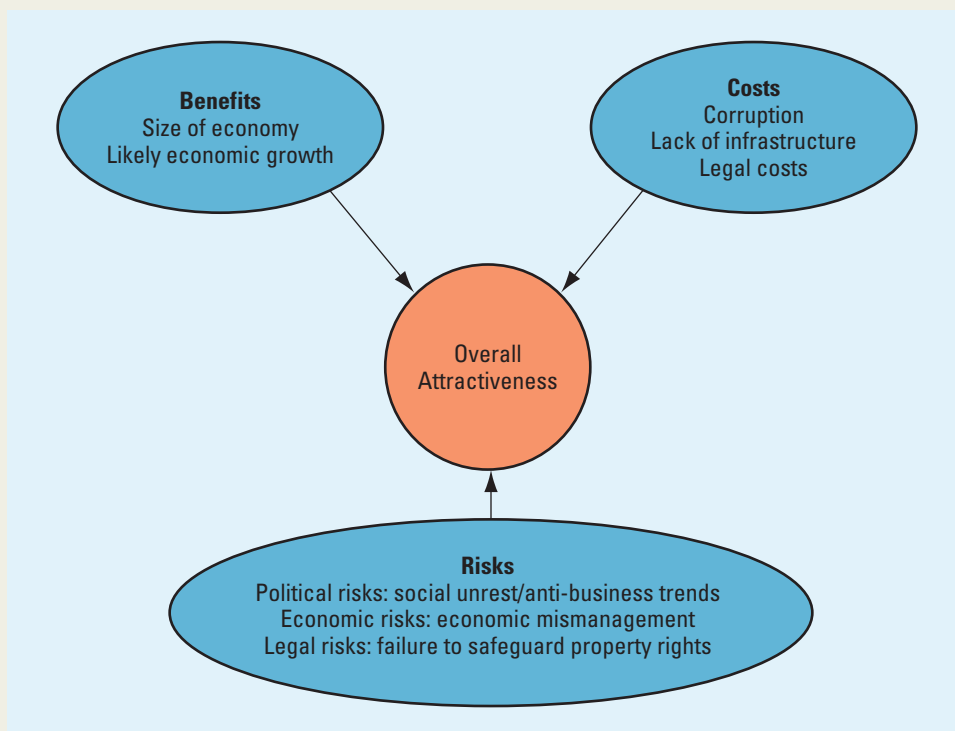
defined as the likelihood that a trading partner will opportunistically break a contract or expropriate property rights. When legal risks in a country are high, an international business might hesitate entering into a long-term contract or joint-venture agreement with a firm in that country. For example, in the 1970s when the Indian government passed a law requiring all foreign investors to enter into joint ventures with Indian companies, U.S. companies such as IBM and Coca-Cola closed their investments in India. They believed that the Indian legal system did not provide for adequate protection of intellectual property rights, creating the very real danger that their Indian partners might expropriate the intellectual property of the American companies—which for IBM and Coca-Cola amounted to the core of their competitive advantage.

Overall Attractiveness

The overall attractiveness of a country as a potential market or investment site for an international business depends on balancing the benefits, costs, and risks associated with doing business in that country (see Figure 2.3). Generally, the costs and risks associated with doing business in a foreign country are typically lower in economically advanced and politically stable democratic nations and greater in less developed and politically unstable nations. The calculus is complicated, however, because the potential long-run benefits are dependent not only upon a nation's current stage of economic development or political stability but also on likely future economic growth rates. Economic growth appears to be a function of a free market system and a country's capacity for growth (which may be greater in less developed nations). This leads one to conclude that, other things being equal, the benefit–cost–risk trade-off is likely to be most favorable in politically stable developed and developing nations that have free market systems and no dramatic upsurge in either inflation rates or private-sector debt. It is likely to be least favorable in politically unstable developing nations that operate with a mixed or command economy or in developing nations where speculative financial bubbles have led to excess borrowing.

figure 2.3

Country Attractiveness



political economy, p. 45	common law, p. 54	Paris Convention for the Protection of Industrial Property, p. 59
political system, p. 45	civil law system, p. 54	product safety laws, p. 60
collectivism, p. 45	theocratic law system, p. 54	product liability, p. 60
socialism, p. 46	contract, p. 55	gross national income (GNI), p. 61
communists, p. 46	contract law, p. 55	purchasing power parity (PPP), p. 63
social democrats, p. 46	United Nations Convention on Contracts for the International Sale of Goods (CIGS), p. 55	Human Development Index (HDI), p. 65
privatization, p. 47	property rights, p. 55	innovation, p. 68
individualism, p. 47	private action, p. 56	entrepreneurs, p. 68
democracy, p. 48	public action, p. 56	deregulation, p. 78
totalitarianism, p. 48	Foreign Corrupt Practices Act, p. 56	first-mover advantages, p. 81
representative democracy, p. 50	intellectual property, p. 59	late-mover disadvantages, p. 81
communist totalitarianism, p. 50	patent, p. 59	political risk, p. 82
theocratic totalitarianism, p. 50	copyright, p. 59	economic risk, p. 83
tribal totalitarianism, p. 50	trademark, p. 59	legal risk, p. 83
right-wing totalitarianism, p. 51	World Intellectual Property Organization, p. 59	
market economy, p. 51		
command economy, p. 52		
legal system, p. 53		

Summary

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

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

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

Critical Thinking and Discussion Questions

1. Free market economies stimulate greater economic growth, whereas state-directed economies stifle growth. Discuss.
2. A democratic political system is an essential condition for sustained economic progress. Discuss.
3. What is the relationship between corruption in a country (i.e., bribe taking by government officials) and economic growth? Is corruption always bad?
4. The Nobel Prize-winning economist Amartya Sen argues that the concept of development should be broadened to include more than just economic development. What other factors does Sen think should be included in an assessment of development? How might adoption of Sen's views influence government policy? Do you think Sen is correct that development is about more than just economic development? Explain.
5. You are the CEO of a company that has to choose between making a \$100 million investment in Russia or the Czech Republic. Both investments promise the same long-run return, so your choice is driven by risk considerations. Assess the various risks of doing business in each of these nations. Which investment would you favor and why?
6. Read the Country Focus on Chavez's Venezuela, then answer the following questions:
 - a. Under Chavez's leadership, what kind of economic system is being put in place in Venezuela? How would you characterize the political system?
 - b. How do you think that Chavez's unilateral changes to contracts with foreign oil companies will impact upon future investment by foreigners in Venezuela?
 - c. How will the high level of public corruption in Venezuela impact future growth rates?
 - d. Currently Venezuela is benefiting from a boom in oil prices. What do you think might happen if oil prices retreat from their current high level?
 - e. In your estimation, what is the long-run prognosis for the Venezuelan economy? Is this a country that is attractive to international businesses?

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

Exercise 1

You work for a manufacturing company that has operations in the United States and Western Europe. However, increasing competition has prompted the firm to examine the option of shifting production to a lower-cost location. You have narrowed the list of potential countries to Taiwan, South Africa, and Argentina. Based on political and economic *risk ratings*, how would you rate the attractiveness of these three countries for your company? Prepare a brief report summarizing your

assessment, including a detailed evaluation of risks for your top country choice.

Exercise 2

The *Market Potential Index* (MPI) is an indexing study conducted by the Michigan State University Center for International Business Education and Research (MSU-CIBER) to compare emerging markets on a variety of dimensions. Provide a description of the indicators used in the indexing procedure. Which of the indicators should have greater importance for a company that markets cellular telephones? Considering the MPI rankings, which five developing countries would you advise a company selling laptops to enter first?



closing case

Egypt, the Troubled Giant

With 75 million people, Egypt is the most populous Arab state. On the face of it, over the past few years Egypt has made significant economic progress. In 2004, Prime Minister Ahmed Nazif and his team, many of them Western-educated businessmen, enacted a series of long-delayed economic reforms. These included trade liberalization, with deep cuts in tariffs, tax cuts, deregulation, and changes in investment regulations that allowed for more foreign direct investment in the Egyptian economy. Economic growth, which had been in the 2 to 4 percent range during the early 2000s, accelerated to 7 percent in 2005–2008. Exports almost tripled, from \$9 billion in 2004 to more than \$25 billion in 2008. Foreign direct investment increased from \$4 billion in 2004 to \$11 billion in 2008, while unemployment fell from 11 percent to 8 percent over the same period.

By 2008, Egypt seemed to be displaying many of the features of other emerging economies. On Cairo's outskirts, clusters of construction cranes could be seen where gleaming new offices were being built for companies such as Microsoft, Oracle and Vodafone, as well as for several fast-growing domestic information technology companies. New highways were being built, hypermarkets were opening their doors, sales of private cars quadrupled between 2004 and 2008, and high-scale beach resorts catering to a growing tourist trade were expanding.

However, underneath the surface, Egypt still has significant economic and political problems. Inflation, long a concern in Egypt, remains high, hitting 23 percent in 2008.

Moreover, as the global economic crisis took hold in late 2008 and the world economy started to enter a recession, Egypt saw many of its growth drivers slow. In 2008, tourism brought some \$11 billion into the country, accounting for 8.5 percent of the GDP, but it fell sharply in 2009. Remittances from Egypt expatriates working overseas also declined. In 2008, expatriate workers sent \$8.5 billion back to Egypt, but 30,000 of those workers were predicted to return home in 2009 as construction projects in the Gulf, where many of them worked, were cut back or shut down. Earnings from the Suez Canal, which stood at \$5.2 billion in 2008, also declined by 25 percent in 2009 as the volume of world shipping slumped in the wake of the global economic slowdown.

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

The gap between rich and poor, when coupled with a sharp economic slowdown, seems likely to fuel long-simmering social and political tensions. Nominally a stable democracy with a secular government, Egypt is, in fact, an autocratic state. President Hosni Mubarak has been in power for over a quarter of a century. Now 80, there are signs that Mubarak will

try to hand over power to his son. Although elections are held, they are hardly free and fair. Opposition parties are kept in check by police harassment, and their leaders have been jailed on trumped-up charges. In recent municipal elections, the regime disqualified all but a handful of members from the opposition Muslim Brotherhood, which has strong Islamic roots, from standing for office. This allowed the ruling National Democratic Party to run unopposed in 80 percent of districts, winning all but 1,000 of 52,000 seats. But voter turnout, at 5 percent, reflected how disenfranchised the population felt. Given all of this, one can easily envisage a situation where economic turmoil spills over into the political arena, destabilizing the country and setting it on an uncertain future path.

Sources: "Will the Dam Burst?" *The Economist*, September 13, 2008, pp. 31–34; Y. Zhongwen and C. Gongzheng, "Egypt's Economy Slowing Down Due to Global Financial Crisis," Xinhua news agency, April 5, 2009, www.xinhuanet.com; and D. C. Kurtzer, "Where Is Egypt Headed?" Spero Forum, April 4, 2009, www.speroforum.com.

Case Discussion Questions

1. How would you describe the economic policy that Egypt implemented during 2004–2008? Do you think that this policy helped to boost Egypt's growth rate? Why?
2. How vulnerable is the Egyptian economy to a slowdown in global economic activity such as that which occurred in 2008–2009?
3. What are the potential risks inherent in Egypt's current political system? What is the best case scenario going forward? What is the worst-case scenario?
4. All things considered, is Egypt an attractive market for international business? What advice would you give to a multinational enterprise considering investment in Egypt?



part 2

Country Differences

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Explain what is meant by the culture of a society.
- 2 Identify the forces that lead to differences in social culture.
- 3 Identify the business and economic implications of differences in culture.
- 4 Recognize how differences in social culture influence values in the workplace.
- 5 Demonstrate an appreciation for the economic and business implications of cultural change.

Differences in Culture

Business Culture in China

opening case

The first McDonald's restaurant to open in China was located on the corner of Wangfujing Street and the Avenue of Eternal Peace, just two blocks from Tiananmen Square, the very heart of China's capital, Beijing. The choice of location seemed auspicious, and within two years, sales at the restaurant were surpassing all expectations. Then the Beijing city government dropped a bombshell; officials abruptly informed McDonald's that it would have to vacate the location to make way for a commercial, residential, and office complex planned by Hong Kong developer Li Ka-shing. At the time, McDonald's still had 18 years to run on its 20-year lease. A stunned McDonald's did what any good Western company would do—it took the Beijing city government to court to try to enforce the lease. The court refused and McDonald's had to move. Chinese observers had a simple explanation for the outcome. McDonald's, they said, lacked the *guanxi* of Li Ka-shing. Given this, the company could not expect to prevail. Company executives should have accepted the decision in good grace and moved on, but instead, McDonald's filed a lawsuit—a move that would only serve to reduce what *guanxi* McDonald's might have had with the city government!

This example illustrates a basic difference between doing business in the West and doing business in China. In the advanced economies of the West, business transactions are conducted and regulated by the centuries-old framework of contract law, which specifies the rights and obligations of parties to a business contract and provides mechanisms for seeking to redress grievances should one party in the exchange fail to live up to the legal agreement. In the West, McDonald's could have relied on the courts to enforce its legal contract with the city government. In China, this approach didn't work. China does not have the same legal infrastructure. Personal power and relationships or connections, rather than the rule of law, have always been the key to getting things done in China. The key to understanding this process is the concept of *guanxi*.

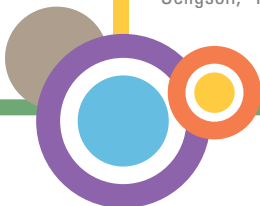
Guanxi literally means relationships, although in business settings it can be better understood as “connections.” McDonald's lost its lease in central Beijing because it lacked the *guanxi* enjoyed by the powerful Li Ka-shing. The concept of *guanxi* is deeply rooted in Chinese culture, particularly the Confucian philosophy of valuing social hierarchy and reciprocal obligations. Confucian ideology has a 2,000-year-old history in China, and 60 years of Communist rule has done little to dent its influence on everyday life in China. Confucianism stresses the importance

of relationships, both within the family and between master and servant. Confucian ideology teaches that people are not created equal. In Confucian thought, loyalty and obligations to one's superiors (or to family) is regarded as a sacred duty, but at the same time, this loyalty has its price. Social superiors are obligated to reward the loyalty of their social inferiors by bestowing "blessings" upon them; thus, the obligations are reciprocal.

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

As they have come to understand this, many Western businesses have tried to build *guanxi* to grease the wheels required to do business in China. Indeed, *guanxi* has become a commodity that is for sale to foreigners. Many of the sons and daughters of high-ranking government officials have set up "consulting" firms and offered to mobilize their *guanxiwang* or those of their parents to help Western companies navigate their way through Chinese bureaucracy. Taking advantage of such services, however, requires good ethical judgment. There is a fine line between relationship building, which may require doing favors to meet obligations, and bribery. Consider the case of a lucrative business contract that was under consideration for more than a year between a large Chinese state-owned enterprise and two competing multinational firms. After months of negotiations, the Chinese elected to continue discussions with just one of the competitors—the one that had recently hired the son of the principal Chinese negotiator at a significant salary. This occurred even though the favored firm's equipment was less compatible with Chinese equipment already in place than that offered by the multinational that was rejected. The clear implication is that the son of the negotiator had mobilized his *guanxiwang* to help his new employer gain an advantage in the contract negotiations. While hiring the son of the principal negotiator may be viewed as good business practice by some in the context of Chinese culture, others might argue that this action was ethically suspect and could be viewed as little more than a thinly concealed bribe. ●

Sources: S. D. Seligman, "Guanxi: Grease for the Wheels of China," *China Business Review*, September–October 1999, pp. 34–38; L. Dana, "Culture Is the Essence of Asia," *Financial Times*, November 27, 2000, p. 12; L. Minder, "McDonald's to Close Original Beijing Store," *USA Today*, December 2, 1996, p. 1A; M. W. Peng, *Business Strategies in Transition Economies* (Thousand Oaks, CA: Sage Publications, 2000); and Hannah Seligson, "For American Workers in China: a Cultural Clash," *The New York Times*, December 24, 2009, p. B1.



Introduction

In Chapter 2, we saw how national differences in political, economic, and legal systems influence the benefits, costs, and risks associated with doing business in different countries. In this chapter, we will explore how differences in culture across and within countries can affect international business. Several themes run through this chapter. The first is that business success in a variety of countries requires cross-cultural literacy. By **cross-cultural literacy**, we mean an understanding of how cultural differences across and within nations can affect the way business is practiced. In these days of global communications, rapid transportation, and worldwide markets, when the era of the global village seems just around the corner, it is easy to forget just how different various cultures really are. Underneath the veneer of modernism, deep cultural differences often remain. Take the Chinese. Increasingly, they are embracing the material products of modern society. Anyone who has visited Shanghai cannot fail to be struck by how modern the city seems, with its skyscrapers, department stores, and freeways. Yet beneath the veneer of Western modernism, long-standing cultural traditions rooted in a 2,000-year-old ideology continue to have an important influence on the way business is transacted in China. As the opening case illustrates, in China, *guanxi*, or a network of social relationships with others backed by reciprocal obligations, is central to getting business done. Firms that lack sufficient *guanxi* may find themselves at a disadvantage when doing business in China. The lesson: To succeed in China you have to play by Chinese rules. More generally, in this chapter, we shall argue that it is important for foreign businesses to understand the culture that prevails in those countries where they do business, and that success requires a foreign enterprise to adapt to the culture of its host country.¹

Another theme developed in this chapter is that a relationship may exist between the culture and the cost of doing business in a country or region. Different cultures are more or less supportive of the capitalist mode of production and may increase or lower the costs of doing business. For example, some observers have argued that cultural factors lowered the costs of doing business in Japan and helped to explain Japan's rapid economic ascent during the 1960s, 70s, and 80s.² Similarly, cultural factors can sometimes raise the costs of doing business. Historically, class divisions were an important aspect of British culture, and for a long time, firms operating in Great Britain found it difficult to achieve cooperation between management and labor. Class divisions led to a high level of industrial disputes in that country during the 1960s and 1970s and raised the costs of doing business relative to the costs in countries such as Switzerland, Norway, Germany, or Japan, where class conflict was historically less prevalent.

The British example, however, brings us to another theme we will explore in this chapter. Culture is not static. It can and does evolve, although the rate at which culture can change is the subject of some dispute. Important aspects of British culture have changed significantly over the past 30 years, and this is reflected in weaker class distinctions and a lower level of industrial disputes. Indeed, in recent years the number of days lost due to strikes in the United Kingdom has been significantly less than in Australia, the United States, Ireland, and Canada.³ Finally, multinational enterprises can themselves be engines of cultural change, particularly with regard to material culture. For example, Western fast-food companies such as McDonald's may help to change the dining culture in developing nations such as India, drawing people away from traditional restaurants and toward fast-food outlets.

Cross-Cultural Literacy

An understanding of how cultural differences across and within nations can affect the way business is practiced.

What Is Culture?

LEARNING OBJECTIVE 1

Explain what is meant by the culture of a society.

Culture

A system of values and norms that are shared among a group of people and that when taken together constitute a design for living.

Values

Abstract ideas about what a group believes to be good, right, and desirable.

Norms

Social rules and guidelines that prescribe appropriate behavior in particular situations.

Society

A group of people who share a common set of values and norms.

Folkways

Routine conventions of everyday life.

Scholars have never been able to agree on a simple definition of *culture*. In the 1870s, the anthropologist Edward Tylor defined culture as “that complex whole which includes knowledge, belief, art, morals, law, custom, and other capabilities acquired by man as a member of society.”⁴ Since then hundreds of other definitions have been offered. Geert Hofstede, an expert on cross-cultural differences and management, defined culture as “the collective programming of the mind which distinguishes the members of one human group from another. . . . Culture, in this sense, includes systems of values; and values are among the building blocks of culture.”⁵ Another definition of culture comes from sociologists Zvi Namenwirth and Robert Weber, who see culture as a system of ideas and argue that these ideas constitute a design for living.⁶

Here we follow both Hofstede and Namenwirth and Weber by viewing **culture** as a system of values and norms that are shared among a group of people and that when taken together constitute a design for living. By **values** we mean abstract ideas about what a group believes to be good, right, and desirable. Put differently, values are shared assumptions about how things ought to be.⁷ By **norms** we mean the social rules and guidelines that prescribe appropriate behavior in particular situations. We shall use the term **society** to refer to a group of people who share a common set of values and norms. While a society may be equivalent to a country, some countries harbor several societies (i.e., they support multiple cultures), and some societies embrace more than one country.

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

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

A good example of folkways concerns attitudes toward time in different countries. People are keenly aware of the passage of time in the United States and Northern European cultures such as Germany and Britain. Businesspeople are very conscious about scheduling their time and are quickly irritated when their time is wasted because a business associate is late for a meeting or if they are kept waiting. They talk about time as though it were money, as something that can be spent, saved, wasted, and lost.⁸ Alternatively, in Arab, Latin, and Mediterranean cultures, time has a more elastic character. Keeping to a schedule is viewed as less important than finishing an interaction with people. For example, an American businesswoman might feel slighted if she is kept waiting for 30 minutes outside the office of a Latin American executive before a meeting, but the Latin American may simply be completing an interaction with an associate and view the information gathered from this as more important than sticking to a rigid schedule.

The Latin American executive intends no disrespect, but due to a mutual misunderstanding about the importance of time, the American may see things differently. Similarly, Saudi attitudes to time have been shaped by their nomadic Bedouin heritage, in which precise time played no real role and arriving somewhere tomorrow might mean next week. Like Latin Americans, many Saudis are unlikely to understand the American obsession with precise time and schedules, and Americans need to adjust their expectations accordingly.

Folkways include rituals and symbolic behavior. Rituals and symbols are the most visible manifestations of a culture and constitute the outward expression of deeper values. For example, upon meeting a foreign business executive, a Japanese executive will hold his business card in both hands and bow while presenting the card to the foreigner.⁹ This ritual behavior is loaded with deep cultural symbolism. The card specifies the rank of the Japanese executive, which is a very important piece of information in a hierarchical society such as Japan (Japanese often have business cards with Japanese printed on one side, and English printed on the other). The bow is a sign of respect, and the deeper the angle of the bow, the greater the reverence one person shows for the other. The person receiving the card is expected to examine it carefully, which is a way of returning respect and acknowledging the card giver's position in the hierarchy. The foreigner is also expected to bow when taking the card and to return the greeting by presenting the Japanese executive with his own card, similarly bowing in the process. To not do so, and to fail to read the card that he has been given, instead casually placing it in his jacket, violates this important folkway and is considered rude.

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

CULTURE, SOCIETY, AND THE NATION-STATE We have defined a society as a group of people that share a common set of values and norms; that is, people who are bound together by a common culture. There is not a strict one-to-one correspondence between a society and a nation-state. Nation-states are political creations. They may contain a single culture or several cultures. While the French nation can be thought of as the political embodiment of French culture, the nation of Canada has at least three cultures—an Anglo culture, a French-speaking “Quebecois” culture, and a Native American culture. Similarly, many African nations have important cultural differences between tribal groups, as exhibited in the early 1990s when Rwanda dissolved into a bloody civil war between two tribes, the Tutsis and Hutus. Africa is not alone in this regard. India is composed of many distinct cultural groups. During the first Gulf War, the prevailing view



Another Perspective

Doing Business Overseas

Going overseas for business? Be aware of cultural differences. For example, not all cultures regard time as Americans do. In Germany or Switzerland, meetings start promptly, but not in Saudi Arabia or Mexico, where meetings often begin with lengthy socializing to establish rapport. Be careful how you say things: Americans and Europeans tend to speak plainly and in a straightforward manner, but the Chinese, Japanese, Koreans, and some Latin Americans are indirect and rely on body language and context to make their point. And be careful *what* you say. Americans describe business in financial terms; Swedes are more likely to speak in terms of number of employees. A good rule of thumb: Pay attention to cues and don't assume that your customs are observed everywhere. (“Cultural Differences,” Iowa State University Web site, <http://www.celt.iastate.edu>, accessed March 25, 2010; and Bill Decker, “Important Questions to Ask While Conducting Business,” *Portfolio.com*, March 11, 2010, <http://www.portfolio.com>)

Mores

Norms that are seen as central to the functioning of a society and to its social life.



Another Perspective

Online View of Other Cultures

Visit the online versions of some English-language foreign newspapers in major international cities to get a sense of their cultural values, social structure, and markets. Look at the ads and business names. Check out the classifieds. A good list link is at www.newhopepa.com/News/Intl_News/default.htm.

presented to Western audiences was that Iraq was a homogenous Arab nation. However, since then we have learned that several different societies exist within Iraq, each with its own culture. The Kurds in the north do not view themselves as Arabs and have their own distinct history and traditions. There are two Arab societies: the Shiites in the South and the Sunnis who populate the middle of the country and who ruled Iraq under the regime of Saddam Hussein (the terms *Shiites* and *Sunnis* refer to different sects within the religion of Islam). Among the southern

Sunnis is another distinct society of 500,000 Marsh Arabs who live at the confluence of the Tigris and Euphrates rivers, pursuing a way of life that dates back 5,000 years.¹⁰

At the other end of the scale are cultures that embrace several nations. Several scholars argue that we can speak of an Islamic society or culture that is shared by the citizens of many different nations in the Middle East, Asia, and Africa. As you will recall from the last chapter, this view of expansive cultures that embrace several nations underpins Samuel Huntington's view of a world that is fragmented into different civilizations, including Western, Islamic, and Sinic (Chinese).¹¹

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

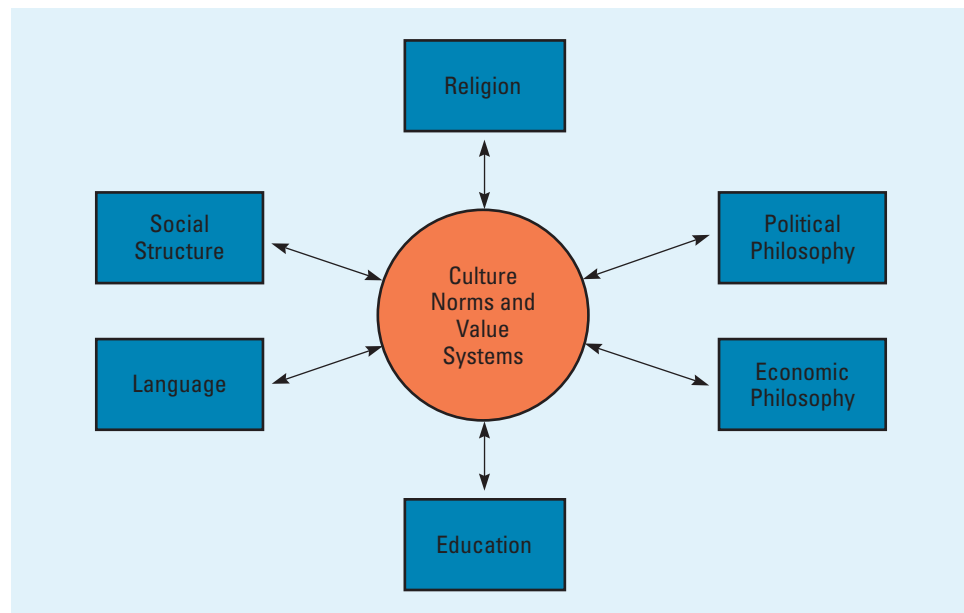
LEARNING OBJECTIVE 2

Identify the forces that lead to differences in social culture.

THE 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 philosophies, the social structure of a society, and the dominant religion, language, and education (see Figure 3.1). We

figure 3.1

The Determination of Culture



discussed political and economic philosophies at length in Chapter 2. Such philosophies clearly influence the value systems of a society. For example, the values found in Communist North Korea toward freedom, justice, and individual achievement are clearly different from the values found in the United States, precisely because each society operates according to different political and economic philosophies. Below we will discuss the influence of social structure, religion, language, and education. The chain of causation runs both ways. While factors such as social structure and religion clearly influence the values and norms of a society, the values and norms of a society can influence social structure and religion.

Social Structure

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

Social Structure

The basic social organization of a society.

INDIVIDUALS AND GROUPS A **group** is an association of two or more individuals who have a shared sense of identity and who interact with each other in structured ways on the basis of a common set of expectations about each other's behavior.¹² Human social life is group life. Individuals are involved in families, work groups, social groups, recreational groups, and so on. However, while groups are found in all societies, societies differ according to the degree to which the group is viewed as the primary means of social organization.¹³ In some societies, individual attributes and achievements are viewed as being more important than group membership; in others the reverse is true.

Group

An association of two or more individuals who have a shared sense of identity and who interact with each other in structured ways on the basis of a common set of expectations about each other's behavior.

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

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

LEARNING OBJECTIVE 3

Identify the business and economic implications of differences in culture.

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

The emphasis on individualism may also make it difficult to build teams within an organization to perform collective tasks. If individuals are always competing with each other on the basis of individual performance, it may be difficult for them to cooperate. A study of U.S. competitiveness by the Massachusetts Institute of Technology suggested that U.S. firms are being hurt in the global economy by a failure to achieve cooperation both within a company (e.g., between functions; between management and labor) and between companies (e.g., between a firm and its suppliers). Given the emphasis on individualism in the American value system, this failure is not surprising.¹⁴ The emphasis on individualism in the United States, while helping to create a dynamic entrepreneurial economy, may raise the costs of doing business due to its adverse impact on managerial stability and cooperation.

The Group In contrast to the Western emphasis on the individual, the group is the primary unit of social organization in many other societies. For example, in Japan, the social status of an individual is determined as much by the standing of the group to which he or she belongs as by his or her individual performance.¹⁵ In traditional Japanese society, the group was the family or village to which an individual belonged. Today, the group has frequently come to be associated with the work team or business organization to which an individual belongs. In a now-classic study of Japanese society, Nakane noted how this expresses itself in everyday life:

When a Japanese faces the outside (confronts another person) and affixes some position to himself socially he is inclined to give precedence to institution over kind of occupation. Rather than saying, “I am a typesetter” or “I am a filing clerk,” he is likely to say, “I am from B Publishing Group” or “I belong to S company.”¹⁶

LEARNING OBJECTIVE 3

Identify the business and economic implications of differences in culture.

Nakane goes on to observe that the primacy of the group to which an individual belongs often evolves into a deeply emotional attachment in which identification with the group becomes all-important in one's life. One central value of Japanese culture is the importance attached to group membership. This may have beneficial implications for business firms. Strong identification with the group is argued to create pressures for mutual self-help and collective action. If the worth of an individual is closely linked to the achievements of the group (e.g., firm), as Nakane maintains is the case in Japan, this creates a strong incentive for individual members of the group to work together for the common good. Some argue that the success of Japanese enterprises in the global economy has been based partly on their ability to achieve close cooperation between individuals within a company and between companies. This has found expression in the widespread diffusion of self-managing work teams within Japanese organizations, the

close cooperation among different functions within Japanese companies (e.g., among manufacturing, marketing, and R&D), and the cooperation between a company and its suppliers on issues such as design, quality control, and inventory reduction.¹⁷ In all of these cases, cooperation is driven by the need to improve the performance of the group (i.e., the business firm).

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

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

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

Social Mobility The term **social mobility** refers to the extent to which individuals can move out of the strata into which they are born. Social mobility varies significantly from society to society. The most rigid system of stratification is a caste system. A **caste system** is a closed system of stratification in which social position is determined by the family into which a person is born, and change in that position is usually not possible during an individual's lifetime. Often a caste position carries with it a specific occupation. Members of one caste might be shoemakers, members of another might be butchers, and so on. These occupations are embedded in the caste and passed down through the family to succeeding generations. Although the number of societies with caste systems diminished rapidly during the twentieth century, one partial example still remains. India has four main castes and several thousand subcastes. Even though the caste system was officially abolished in 1949, two years after India became independent, it is still a force in rural Indian society where occupation and marital opportunities are still partly related to caste (for more details, see the Country Focus feature on the caste system in India today).¹⁸

A **class system** is a less rigid form of social stratification in which social mobility is possible. It is a form of open stratification in which the position a person has by birth can be changed through his or her own achievements or luck. Individuals born into a

LEARNING OBJECTIVE 2

Identify the forces that lead to differences in social culture.

Social Strata

Hierarchical social categories often based on family background, occupation, and income.

Social Mobility

The extent to which individuals can move out of the strata into which they are born.

Caste System

A closed system of stratification in which social position is determined by the family into which a person is born, and change in that position is usually not possible during an individual's lifetime.

Class System

A system of social stratification in which the position a person has by birth can be changed through his or her own achievements or luck.



Country FOCUS

Breaking India's Caste System

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

For example, a young female engineer at Infosys who grew up in a small rural village and is a *Dalit* recounts how she never entered the house of a *Brahmin*, India's elite priestly cast, even though half of her village was *Brahmins*. When a *Dalit* was hired to cook at the school in her native village, *Brahmins* withdrew their children from the school. The engineer herself is the beneficiary of a charitable training system that Infosys launched in 2006. Her caste is

among the poorest in India, with some 91 percent making less than \$100 a month, compared to 65 percent of *Brahmins*.

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

Sources: "With Reservations: Business and Caste in India," *The Economist*, October 6, 2007, pp. 81–83; and Eric Bellman, "Reversal of Fortune Isolates India's Brahmins," *The Wall Street Journal*, December 24, 2007, p. 4.

class at the bottom of the hierarchy can work their way up; conversely, individuals born into a class at the top of the hierarchy can slip down.

While many societies have class systems, social mobility within a class system varies from society to society. For example, some sociologists have argued that Britain has a more rigid class structure than certain other Western societies, such as the United States.¹⁹ Historically, British society was divided into three main classes: the upper class, which was made up of individuals whose families for generations had wealth, prestige, and occasionally power; the middle class, whose members were involved in professional, managerial, and clerical occupations; and the working class, whose members earned their living from manual occupations. The middle class was further subdivided into the upper-middle class, whose members were involved in important managerial occupations and the prestigious professions (e.g., lawyers, accountants, doctors), and the lower-middle class, whose members were involved in clerical work (e.g., bank tellers) and the less prestigious professions (e.g., schoolteachers).

The British class system exhibited significant divergence between the life chances of members of different classes. The upper and upper-middle classes typically sent

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

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

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

According to many commentators, modern British society is now rapidly leaving this class structure behind and moving toward a classless society. However, sociologists continue to dispute this finding and present evidence that this is not the case. For example, one study reported that state schools in the London suburb of Islington, which has a population of 175,000, had only 79 candidates for university, while one prestigious private school alone, Eton, sent more than that number to Oxford and Cambridge.²⁰ This, according to the study's authors, implies that "money still begets money." They argue that a good school means a good university, a good university means a good job, and merit has only a limited chance of elbowing its way into this tight little circle.

The class system in the United States is less pronounced than in Britain and mobility is greater. Like Britain, the United States has its own upper, middle, and working classes. However, class membership is determined to a much greater degree by individual economic achievements, as opposed to background and schooling. Thus, an individual can, by his or her own economic achievement, move smoothly from the working class to the upper class in a lifetime. Successful individuals from humble origins are highly respected in American society.

Another society where class divisions have historically been of some importance has been China, where there has been a long-standing difference between the life chances of the rural peasantry and urban dwellers. Ironically, this historic division was strengthened during the high point of Communist rule because of a rigid system of household registration that restricted most Chinese to the place of their birth for their lifetime. Bound to collective farming, peasants were cut off from many urban privileges—compulsory education, quality schools, health care, public housing, varieties of foodstuffs, to name only a few—and they largely lived in poverty. Social mobility was thus very limited. This system crumbled following reforms of the late 1970s and early 1980s, and as a consequence, migrant peasant laborers have flooded into China's cities looking for work. Sociologists now hypothesize that a new class system is emerging in China based less on the rural-urban divide and more on urban occupation.²¹



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

LEARNING OBJECTIVE 3

Identify the business and economic implications of differences in culture.

Class Consciousness

A tendency for people to perceive themselves in terms of their class background.

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

This has been played out in British society in the traditional hostility between upper-middle-class managers and their working-class employees. Mutual antagonism and lack of respect historically made it difficult to achieve cooperation between management and labor in many British companies and resulted in a relatively high level of industrial disputes. However, as noted earlier, the last two decades have seen a dramatic reduction in industrial disputes, which bolsters the arguments of those who claim that the country is moving toward a classless society (the level of industrial disputes in the United Kingdom is now lower than in the United States). Alternatively, as noted above, class consciousness may be reemerging in urban China, and it may ultimately prove to be significant there.

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

Religious and Ethical Systems

Religion may be defined as a system of shared beliefs and rituals that are concerned with the realm of the sacred.²² **Ethical systems** refer to a set of moral principles, or values, that are used to guide and shape behavior. Most of the world's ethical systems are the product of religions. Thus, we can talk about Christian ethics and Islamic ethics. However, there is a major exception to the principle that ethical systems are grounded in religion. Confucianism and Confucian ethics influence behavior and shape culture in parts of Asia, yet it is incorrect to characterize Confucianism as a religion.

The relationship among religion, ethics, and society is subtle and complex. Among the thousands of religions in the world today, four dominate in terms of numbers of adherents: Christianity with 1.7 billion adherents, Islam with around 1 billion adherents, Hinduism with 750 million adherents (primarily in India), and Buddhism with 350 million adherents (see Map 3.1). Although many other religions have an important influence in certain parts of the modern world (for example, Judaism, which has 18 million adherents), their numbers pale in comparison with these dominant religions (however, as the precursor of both Christianity and Islam, Judaism has an indirect influence that goes beyond its numbers). We will review these four religions, along with Confucianism, focusing on their business implications. Some scholars have argued that the most important business implications of religion center on the extent to which different religions shape attitudes toward work and entrepreneurship and the degree to which the religious ethics affect the costs of doing business in a country.

It is hazardous to make sweeping generalizations about the nature of the relationship between religion and ethical systems and business practice. While some scholars argue that there is a relationship between religious and ethical systems and business practice in a society, in a world where nations with Catholic, Protestant, Muslim, Hindu, and Buddhist majorities all show evidence of entrepreneurial activity and sustainable economic growth, it is important to view such proposed relationships with a degree of skepticism. The proposed relationships may exist, but their impact is probably small compared to the impact of economic policy. Alternatively, research by economists Robert Barro and Rachel McCleary suggests that strong religious beliefs, and particularly beliefs in heaven, hell, and an afterlife, have a positive impact on economic growth rates, irrespective of the particular religion in question.²³ Barro and McCleary looked at religious beliefs and economic growth rates in 59 countries during the 1980s and 1990s. Their conjecture was that higher religious beliefs stimulate economic growth because they help to sustain aspects of individual behavior that lead to higher productivity.

CHRISTIANITY Christianity is the most widely practiced religion in the world. Approximately 20 percent of the world's people identify themselves as Christians. The vast majority of Christians live in Europe and the Americas, although their numbers are growing rapidly in Africa. Christianity grew out of Judaism. Like Judaism, it is a monotheistic religion (monotheism is the belief in one god). A religious division in the eleventh century led to the establishment of two major Christian organizations—the Roman Catholic Church and the Orthodox Church. Today, the Roman Catholic Church accounts for more than half of all Christians, most of whom are found in Southern Europe and Latin America. The Orthodox Church, while less influential, is still of major importance in several countries (e.g., Greece and Russia). In the sixteenth century, the Reformation led to a further split with Rome; the result was Protestantism. The nonconformist nature of Protestantism has facilitated the emergence of numerous denominations under the Protestant umbrella (e.g., Baptist, Methodist, Calvinist).

LEARNING OBJECTIVE 2

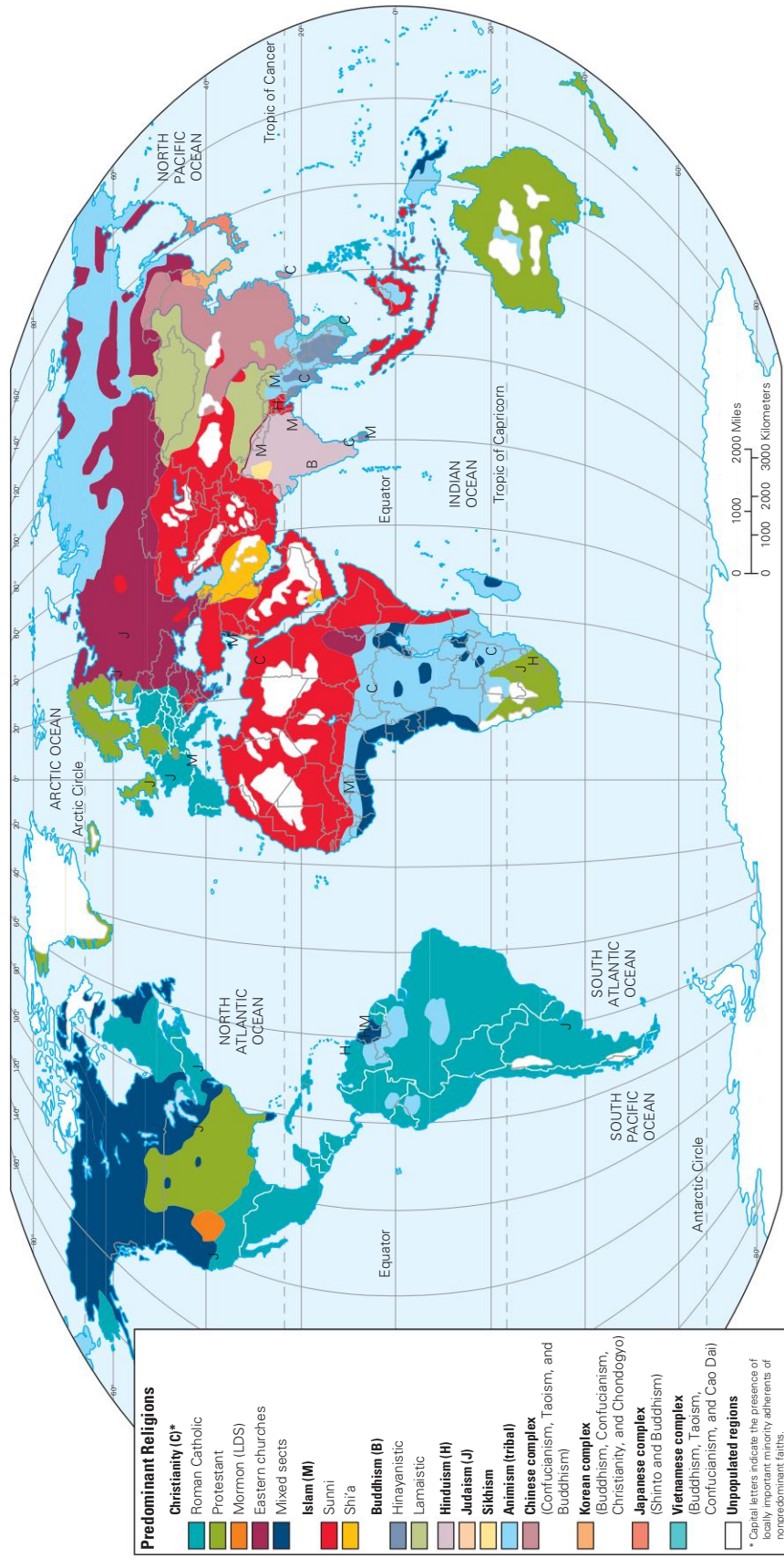
Identify the forces that lead to differences in social culture.

Religion

A system of shared beliefs and rituals that are concerned with the realm of the sacred.

Ethical Systems

A set of moral principles, or values, that are used to guide and shape behavior.



3.1 map World Religions

Source: John L. Allen, Student Atlas of World Politics, 7th ed. Map 8, © 2006 by the McGraw-Hill Companies, Inc. All rights reserved. Reprinted by permission of McGraw-Hill Contemporary Learning Series.

Economic Implications of Christianity: The Protestant Work Ethic Several sociologists have argued that of the main branches of Christianity—Catholic, Orthodox, and Protestant—the latter has the most important economic implications. In 1904, a German sociologist, Max Weber, made a connection between Protestant ethics and “the spirit of capitalism” that has since become famous.²⁴ Weber noted that capitalism emerged in Western Europe, where

business leaders and owners of capital, as well as the higher grades of skilled labor, and even more the higher technically and commercially trained personnel of modern enterprises, are overwhelmingly Protestant.²⁵

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

Protestantism also may have encouraged capitalism’s development in another way. By breaking away from the hierarchical domination of religious and social life that characterized the Catholic Church for much of its history, Protestantism gave individuals significantly more freedom to develop their own relationship with God. The right to freedom of form of worship was central to the nonconformist nature of early Protestantism. This emphasis on individual religious freedom may have paved the way for the subsequent emphasis on individual economic and political freedoms and the development of individualism as an economic and political philosophy. As we saw in Chapter 2, such a philosophy forms the bedrock on which entrepreneurial free market capitalism is based. Building on this, some scholars claim there is a connection between individualism, as inspired by Protestantism, and the extent of entrepreneurial activity in a nation.²⁶ Again, one must be careful not to generalize too much from this historical sociological view. While nations with a strong Protestant tradition such as Britain, Germany, and the United States were early leaders in the industrial revolution, nations with Catholic or Orthodox majorities show significant and sustained entrepreneurial activity and economic growth in the modern world.

ISLAM With about 1 billion adherents, Islam is the second largest of the world’s major religions. Islam dates back to AD 610 when the prophet Muhammad began spreading the word, although the Muslim calendar begins in AD 622 when, to escape growing opposition, Muhammad left Mecca for the oasis settlement of Yathrib, later known as Madina. Adherents of Islam are referred to as Muslims. Muslims constitute a majority in more than 35 countries and inhabit a nearly contiguous stretch of land from the northwest coast of Africa, through the Middle East, to China and Malaysia in the Far East.

Islam has roots in both Judaism and Christianity (Islam views Jesus Christ as one of God’s prophets). Like Christianity and Judaism, Islam is a monotheistic religion. The central principle of Islam is that there is but the one true omnipotent God. Islam requires unconditional acceptance of the uniqueness, power, and authority of God and the understanding that the objective of life is to fulfill the dictates of his will in the hope of admission to paradise. According to Islam, worldly gain and temporal power

LEARNING OBJECTIVE 3

Identify the business and economic implications of differences in culture.

LEARNING OBJECTIVE 2

Identify the forces that lead to differences in social culture.

are an illusion. Those who pursue riches on earth may gain them, but those who forgo worldly ambitions to seek the favor of Allah may gain the greater treasure—entry into paradise. Other major principles of Islam include (1) honoring and respecting parents, (2) respecting the rights of others, (3) being generous but not a squanderer, (4) avoiding killing except for justifiable causes, (5) not committing adultery, (6) dealing justly and equitably with others, (7) being of pure heart and mind, (8) safeguarding the possessions of orphans, and (9) being humble and unpretentious.²⁷ Obvious parallels exist with many of the central principles of both Judaism and Christianity.

Islam is an all-embracing way of life governing the totality of a Muslim's being.²⁸ As God's surrogate in this world, a Muslim is not a totally free agent but is circumscribed by religious principles—by a code of conduct for interpersonal relations—in social and economic activities. Religion is paramount in all areas of life. The Muslim lives in a social structure that is shaped by Islamic values and norms of moral conduct. The ritual nature of everyday life in a Muslim country is striking to a Western visitor. Among other things, orthodox Muslim ritual requires prayer five times a day (business meetings may be put on hold while the Muslim participants engage in their daily prayer ritual), requires that women should be dressed in a certain manner, and forbids the consumption of pork and alcohol.

Islamic Fundamentalism The past three decades have witnessed the growth of a social movement often referred to as Islamic fundamentalism.²⁹ In the West, Islamic fundamentalism is associated in the media with militants, terrorists, and violent upheavals, such as the bloody conflict occurring in Algeria, the killing of foreign tourists in Egypt, and the September 11, 2001, attacks on the World Trade Center and Pentagon in the United States. This characterization is misleading. Just as Christian fundamentalists are motivated by sincere and deeply held religious values firmly rooted in their faith, so are Islamic fundamentalists. The violence that the Western media



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

associates with Islamic fundamentalism is perpetrated by a small minority of radical “fundamentalists” who have hijacked the religion to further their own political and violent ends. (Some Christian “fundamentalists” have done exactly the same, including Jim Jones and David Koresh.) The vast majority of Muslims point out that Islam teaches peace, justice, and tolerance, not violence and intolerance, and that Islam explicitly repudiates the violence that a radical minority practices.

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

Fundamentalists demand commitment to traditional religious beliefs and rituals. The result has been a marked increase in the use of symbolic gestures that confirm Islamic values. In areas where fundamentalism is strong, women have resumed wearing floor-length, long-sleeved dresses and covering their hair; religious studies have increased in universities; the publication of religious tracts has increased; and public religious orations have risen.³⁰ Also, the sentiments of some fundamentalist groups are often anti-Western. Rightly or wrongly, Western influence is blamed for a range of social ills, and many fundamentalists’ actions are directed against Western governments, cultural symbols, businesses, and even individuals.

In several Muslim countries, fundamentalists have gained political power and have used this to try to make Islamic law (as set down in the Koran, the bible of Islam) the law of the land. There are good grounds for this in Islam. Islam makes no distinction between church and state. It is not just a religion; Islam is also the source of law, a guide to statecraft, and an arbiter of social behavior. Muslims believe that every human endeavor is within the purview of the faith—and this includes political activity—because the only purpose of any activity is to do God’s will.³¹ (Some Christian fundamentalists also share this view.) Muslim fundamentalists have been most successful in Iran, where a fundamentalist party has held power since 1979, but they also have had an influence in many other countries, such as Algeria, Afghanistan (where the Taliban established an extreme fundamentalist state until removed by the U.S.-led coalition in 2002), Egypt, Pakistan, the Sudan, and Saudi Arabia.

Economic Implications of Islam The Koran establishes some explicit economic principles, many of which are pro-free enterprise.³² The Koran speaks approvingly of free enterprise and of earning legitimate profit through trade and commerce (the prophet Mohammed was once a trader). The protection of the right to private property is also embedded within Islam, although Islam asserts that all property is a favor from Allah (God), who created and so owns everything. Those who hold property are regarded as trustees rather than owners in the Western sense of the word. As trustees they are entitled to receive profits from the property but are admonished to use it in a righteous, socially beneficial, and prudent manner. This reflects Islam’s concern with social justice. Islam is critical of those who earn profit through the exploitation of others. In the Islamic view of the world, humans are part of a collective in which the wealthy and successful have obligations to help the disadvantaged. Put simply, in Muslim countries, it is fine to earn a profit, so long as that profit is justly earned and not based on the exploitation of others for one’s own advantage. It also

LEARNING OBJECTIVE 3

Identify the business and economic implications of differences in culture.



Country FOCUS

Islamic Capitalism in Turkey

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

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

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

At the Kayseri sugar factory, one of the most profitable in the region, a senior manager claims that Islam has played a large part in improving the profitability of the enterprise.

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

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

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

Sources: D. Bilefsky, "Turks Knock on Europe's Door with Evidence that Islam and Capitalism Can Coexist," *The New York Times*, August 27, 2006, p. 4; and European Stability Initiative, *Islamic Calvinists*, September 19, 2005, archived at www.esiweb.org.

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

Given the Islamic proclivity to favor market-based systems, Muslim countries are likely to be receptive to international businesses as long as those businesses behave in a manner that is consistent with Islamic ethics. Businesses that are perceived as making an unjust profit through the exploitation of others, by deception, or by breaking contractual

obligations are unlikely to be welcomed in an Islamic country. In addition, in Islamic countries where fundamentalism is on the rise, hostility toward Western-owned businesses is likely to increase.

In the previous chapter, we noted that one economic principle of Islam prohibits the payment or receipt of interest, which is considered usury. This is not just a matter of theology; in several Islamic states, it is also a matter of law. The Koran clearly condemns interest, which is called *riba* in Arabic, as exploitative and unjust. For many years, banks operating in Islamic countries conveniently ignored this condemnation, but about 30 years ago, starting with the establishment of an Islamic bank in Egypt, Islamic banks began to appear in predominantly Muslim countries. By 2008, more than 200 Islamic financial institutions worldwide managed more than \$700 billion in assets.³³ Even conventional banks are entering the market—both Citigroup and HSBC, two of the world's largest financial institutions, now offer Islamic financial services. While only Iran and the Sudan enforce Islamic banking conventions, in an increasing number of countries, customers can choose between conventional banks and Islamic banks.

Conventional banks make a profit on the spread between the interest rate they have to pay to depositors and the higher interest rate they charge borrowers. Because Islamic banks cannot pay or charge interest, they must find a different way of making money. Islamic banks have experimented with two different banking methods—the *mudarabah* and the *murabaha*.³⁴

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

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

HINDUISM Hinduism has approximately 750 million adherents, most of them on the Indian subcontinent. Hinduism began in the Indus Valley in India more than 4,000 years ago, making it the world's oldest major religion. Unlike Christianity and Islam, its founding is not linked to a particular person. Nor does it have an officially sanctioned sacred book such as the Bible or the Koran. Hindus believe that a moral force in society requires the acceptance of certain responsibilities, called *dharma*. Hindus believe in reincarnation, or rebirth into a different body, after death. Hindus also believe in *karma*, the spiritual progression of each person's soul. A person's karma is affected by the way he or she lives. The moral state of an individual's karma determines the challenges he or she will face in the next life. By perfecting the soul in each new life, Hindus believe that an individual can eventually achieve *nirvana*, a state of

LEARNING OBJECTIVE 2

Identify the forces that lead to differences in social culture.

complete spiritual perfection that renders reincarnation no longer necessary. Many Hindus believe that the way to achieve nirvana is to lead a severe ascetic lifestyle of material and physical self-denial, devoting life to a spiritual rather than material quest.

One of the interesting aspects of Hindu culture is the reverence for the cow, which Hindus see as a gift of the gods to the human race. The sacred status of the cow created some unique problems for McDonald's when it entered India in the 1990s, since devout Hindus do not eat beef (and many are also vegetarians).

LEARNING OBJECTIVE 3

Identify the business and economic implications of differences in culture.

Economic Implications of Hinduism Max Weber, famous for expounding on the Protestant work ethic, also argued that the ascetic principles embedded in Hinduism do not encourage the kind of entrepreneurial activity in pursuit of wealth creation that we find in Protestantism.³⁵ According to Weber, traditional Hindu values emphasize that individuals should be judged not by their material achievements but by their spiritual achievements. Hindus perceive the pursuit of material well-being as making the attainment of nirvana more difficult. Given the emphasis on an ascetic lifestyle, Weber thought that devout Hindus would be less likely to engage in entrepreneurial activity than devout Protestants.

Mahatma Gandhi, the famous Indian nationalist and spiritual leader, was certainly the embodiment of Hindu asceticism. It has been argued that the values of Hindu asceticism and self-reliance that Gandhi advocated had a negative impact on the economic development of postindependence India.³⁶ But one must be careful not to read too much into Weber's arguments. Modern India is a very dynamic entrepreneurial society, and millions of hardworking entrepreneurs form the economic backbone of the country's rapidly growing economy.

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

LEARNING OBJECTIVE 2

Identify the forces that lead to differences in social culture.

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

Economic Implications of Buddhism The emphasis on wealth creation that is embedded in Protestantism is not found in Buddhism. Thus, in Buddhist societies, we do not see the same kind of historical cultural stress on entrepreneurial behavior that Weber claimed could be found in the Protestant West. But unlike Hinduism, the lack of support for the caste system and extreme ascetic behavior suggests that a Buddhist society may represent a more fertile ground for entrepreneurial activity than a Hindu culture.

LEARNING OBJECTIVE 3

Identify the business and economic implications of differences in culture.

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

LEARNING OBJECTIVE 2

Identify the forces that lead to differences in social culture.

Economic Implications of Confucianism Some scholars maintain that Confucianism may have economic implications as profound as those Weber argued were to be found in Protestantism, although they are of a different nature.³⁷ Their basic thesis is that the influence of Confucian ethics on the culture of China, Japan, South Korea, and Taiwan, by lowering the costs of doing business in those countries, may help explain their economic success. In this regard, three values central to the Confucian system of ethics are of particular interest: loyalty, reciprocal obligations, and honesty in dealings with others.

LEARNING OBJECTIVE 3

Identify the business and economic implications of differences in culture.

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

However, in a Confucian culture, loyalty to one's superiors, such as a worker's loyalty to management, is not blind loyalty. The concept of reciprocal obligations is important. Confucian ethics stress that superiors are obliged to reward the loyalty of their subordinates by bestowing blessings on them. If these "blessings" are not forthcoming, then neither will be the loyalty. This Confucian ethic is central to the Chinese concept of *guanxi*, which refers to relationship networks supported by reciprocal obligations.³⁸ As discussed in the opening case, *guanxi* means relationships, although in business settings it can be better understood as



Another Perspective

Shamans: Staying Abreast of the Times in South Korea

Since the 1960s, South Korea has enjoyed tremendous economic growth. And as the nation becomes increasingly global, even its shamans—local religious practitioners who channel the spirits on behalf of believers—have had to adapt to changing times. For centuries, shamans played a significant role in traditional village life, helping households deal with family problems, illnesses, and other worries. But now, as the economy has grown and urban development crowded out the South Korean countryside, shamans have moved with the times. Today, they carry cell phones and perform modern-day rituals, or *kut*, in commercial shrines. A twenty-first-century *kut* is likely to focus more on the concerns of business ownership—worries about market downturns, cash flow, and the competition—than on personal matters. ("South Korean Shamans Fluidly Absorb Cultural Change," *Physorg.com*, February 23, 2010, <http://www.physorg.com>)



DMG-Shanghai

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

In a society that lacks a strong rule-based legal tradition, and thus legal ways of redressing wrongs such as violations of business agreements, *guanxi* is an important mechanism for building long-term business relationships and getting business done in China. There is a tacit acknowledgment that if you have the right *guanxi*, legal rules can be broken, or at least bent.

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

large part by leveraging the contacts of Wu and Xiao, and by backing up their connections with what the Chinese call *shi li*, the ability to do good work.

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

Sources: J. Bryan, "The Mintz Dynasty," *Fast Company*, April 2006, pp. 56–62; and M. Graser, "Featured Player," *Variety*, October 18, 2004, p. 6.

connections. Today, Chinese will often cultivate a *guanxiwang*, or "relationship network," for help. Reciprocal obligations are the glue that holds such networks together. If those obligations are not met—if favors done are not paid back or reciprocated—the reputation of the transgressor is tarnished and the person will be less able to draw on his or her *guanxiwang* for help in the future. Thus, the implicit threat of social sanctions is often sufficient to ensure that favors are repaid, obligations are met, and relationships are honored. In a society that lacks a rule-based legal tradition, and thus legal ways of redressing wrongs such as violations of business agreements, *guanxi* is an important mechanism for building long-term business relationships and getting business done in China. For an example of the importance of *guanxi*, read the Management Focus on DMG-Shanghai.

A third concept found in Confucian ethics is the importance attached to honesty. Confucian thinkers emphasize that, although dishonest behavior may yield short-term benefits for the transgressor, dishonesty does not pay in the long run. The importance attached to honesty has major economic implications. When companies can trust each other not to break contractual obligations, the costs of doing business are lowered. Expensive lawyers are not needed to resolve contract disputes. In a Confucian society, people may be less hesitant to commit substantial resources to cooperative ventures than in a society where honesty is less pervasive. When companies adhere to Confucian

ethics, they can trust each other not to violate the terms of cooperative agreements. Thus, the costs of achieving cooperation between companies may be lower in societies such as Japan relative to societies where trust is less pervasive.

For example, it has been argued that the close ties between the automobile companies and their component parts suppliers in Japan are facilitated by a combination of trust and reciprocal obligations. These close ties allow the auto companies and their suppliers to work together on a range of issues, including inventory reduction, quality control, and design. The competitive advantage of Japanese auto companies such as Toyota may in part be explained by such factors.³⁹ Similarly, the combination of trust and reciprocal obligations is central to the workings and persistence of *guanxi* networks in China. Someone seeking and receiving help through a *guanxi* network is then obligated to return the favor and faces social sanctions if that obligation is not reciprocated when it is called upon. If the person does not return the favor, his or her reputation will be tarnished and he or she will be unable to draw on the resources of the network in the future. It is claimed that these relationship-based networks can be more important in helping to enforce agreements between businesses than the Chinese legal system. Some claim that *guanxi* networks are a substitute for the legal system.⁴⁰

Language

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

SPOKEN LANGUAGE Language does far more than just enable people to communicate with each other. The nature of a language also structures the way we perceive the world. The language of a society can direct the attention of its members to certain features of the world rather than others. The classic illustration of this phenomenon is that whereas the English language has but one word for snow, the language of the Inuit (Eskimos) lacks a general term for it. Instead, because distinguishing different forms of snow is so important in the lives of the Inuit, they have 24 words that describe different types of snow (e.g., powder snow, falling snow, wet snow, drifting snow).⁴¹

Because language shapes the way people perceive the world, it also helps define culture. Countries with more than one language often have more than one culture. Canada has an English-speaking culture and a French-speaking culture. Tensions between the two can run quite high, with a substantial proportion of the French-speaking minority demanding independence from a Canada “dominated by English speakers.” The same phenomenon can be observed in many other countries. Belgium is divided into Flemish and French speakers, and tensions between the two groups exist; in Spain, a Basque-speaking minority with its own distinctive culture has been agitating for independence from the Spanish-speaking majority for decades; on the Mediterranean island of Cyprus, the culturally diverse Greek- and Turkish-speaking populations of the island engaged in open conflict in the 1970s, and the island is now partitioned into two parts. While it does not necessarily follow that language differences create differences in culture and, therefore, separatist pressures (e.g., witness the harmony in Switzerland, where four languages are spoken), there certainly seems to be a tendency in this direction.⁴²

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

LEARNING OBJECTIVE 2

Identify the forces that lead to differences in social culture.

LEARNING OBJECTIVE 3

Identify the business and economic implications of differences in culture.



Another Perspective

Helping Teens Speak Their Parents' Language

Minneapolis and St. Paul, Minnesota, are home to the largest concentration of Hmong refugees in the United States. Their children—some born in their native Laos but many others born in the United States or in refugee camps in Thailand—are increasingly embracing Western life. While Hmong is spoken at home, high-school-age children have discovered they lack the language skills to explain such Western concepts as “scholarship” or “honor roll” to their parents. Even the words *Asian Club* defy translation into Hmong. Schools often assume—incorrectly—that students of foreign descent are fluent in their parents’ language. To help preserve their culture and create better school–family relations, Minneapolis students recently petitioned the school board to provide literacy classes that include reading, writing, and lessons on Hmong history and culture. (Kristal Leebrick, “Hmong Teens Make It Happen: Minneapolis School Offers Hmong Language Class,” *Twin Cities Daily Planet*, March 16, 2010, <http://www.tcdailyplanet.com>)

to do business, it is almost certain that they will communicate in English. However, although English is widely used, learning the local language yields considerable advantages. Most people prefer to converse in their own language, and being able to speak the local language can build rapport, which may be very important for a business deal. International businesses that do not understand the local language can make major blunders through improper translation. For example, the Sunbeam Corporation used the English words for its “Mist-Stick” mist-producing hair curling iron when it entered the German market, only to discover after an expensive advertising campaign that *mist* means excrement in German. General Motors was troubled by the lack of enthusiasm among Puerto Rican dealers for its new Chevrolet Nova. When literally translated into Spanish, *nova* means star. However, when spoken it sounds like “no va,” which in Spanish means “it doesn’t go.” General Motors changed the name of the car to Caribe.⁴³

LEARNING OBJECTIVE 2

Identify the forces that lead to differences in social culture.

UNSPOKEN LANGUAGE

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

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

Education

Formal education plays a key role in a society. Formal education is the medium through which individuals learn many of the language, conceptual, and mathematical skills that are indispensable in a modern society. Formal education also supplements the family’s role in socializing the young into the values and norms of a society. Values and norms are taught both directly and indirectly. Schools generally teach basic facts about the social and political nature of a society. They also focus on the fundamental obligations of citizenship. Cultural norms are also taught indirectly at school. Respect for others, obedience to authority, honesty, neatness, being on time, and so on, are all

LEARNING OBJECTIVE 2

Identify the forces that lead to differences in social culture.

part of the hidden curriculum of schools. The use of a grading system also teaches children the value of personal achievement and competition.⁴⁴

From an international business perspective, one important aspect of education is its role as a determinant of national competitive advantage.⁴⁵ The availability of a pool of skilled and educated workers seems to be a major determinant of the likely economic success of a country. In analyzing the competitive success of Japan since 1945, for example, Michael Porter notes that after the war, Japan had almost nothing except for a pool of skilled and educated human resources.

With a long tradition of respect for education that borders on reverence, Japan possessed a large pool of literate, educated, and increasingly skilled human resources. . . . Japan has benefited from a large pool of trained engineers. Japanese universities graduate many more engineers per capita than in the United States. . . . A first-rate primary and secondary education system in Japan operates based on high standards and emphasizes math and science. Primary and secondary education is highly competitive. . . . Japanese education provides most students all over Japan with a sound education for later education and training. A Japanese high school graduate knows as much about math as most American college graduates.⁴⁶

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

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

Culture and the Workplace

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

Probably the most famous study of how culture relates to values in the workplace was undertaken by Geert Hofstede.⁴⁷ As part of his job as a psychologist working for IBM, Hofstede collected data on employee attitudes and values for more than 100,000 individuals from 1967 to 1973. These data enabled him to compare dimensions of culture across 40 countries. Hofstede isolated four dimensions that he

LEARNING OBJECTIVE 3

Identify the business and economic implications of differences in culture.

LEARNING OBJECTIVE 4

Recognize how differences in social culture influence values in the workplace.

Power Distance

Theory of how a society deals with the fact that people are unequal in physical and intellectual capabilities. High power distance cultures are found in countries that let inequalities grow over time into inequalities of power and wealth. Low power distance cultures are found in societies that try to play down such inequalities as much as possible.

Individualism versus Collectivism

Theory focusing on the relationship between the individual and his or her fellows; in individualistic societies, the ties between individuals are loose and individual achievement and freedom are highly valued; in societies where collectivism is emphasized, the ties between individuals are tight; people are born into collectives, such as extended families, and everyone is supposed to look after the interests of the collective.

Uncertainty Avoidance

Extent to which different cultures socialize their members into accepting ambiguous situations and tolerating uncertainty.

Masculinity versus Femininity

Theory of the relationship between gender and work roles. In masculine cultures, sex roles are sharply differentiated and traditional “masculine values,” such as achievement and the effective exercise of power, determine cultural ideals; in feminine cultures, sex roles are less sharply distinguished, and little differentiation is made between men and women in the same job.

claimed summarized different cultures—power distance, uncertainty avoidance, individualism versus collectivism, and masculinity versus femininity.

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

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

Hofstede’s **uncertainty avoidance** dimension measured the extent to which different cultures socialized their members into accepting ambiguous situations and tolerating uncertainty. Members of high uncertainty avoidance cultures placed a premium on job security, career patterns, retirement benefits, and so on. They also had a strong need for rules and regulations; the manager was expected to issue clear instructions, and subordinates’ initiatives were tightly controlled. Lower uncertainty avoidance cultures were characterized by a greater readiness to take risks and less emotional resistance to change.

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

Hofstede created an index score for each of these four dimensions that ranged from 0 to 100 and scored high for high individualism, high power distance, high uncertainty avoidance, and high masculinity. He averaged the score for all employees from a given country. Table 3.1 summarizes these data for 20 selected countries. Western nations such as the United States, Canada, and Britain score high on the individualism scale and low on the power distance scale. At the other extreme are a group of Latin American and Asian countries that emphasize collectivism over individualism and score high on the power distance scale. Table 3.1 also reveals that Japan’s culture has strong uncertainty avoidance and high masculinity. This characterization fits the standard stereotype of Japan as a country that is male dominant and where uncertainty avoidance exhibits itself in the institution of lifetime employment. Sweden and Denmark stand out as countries that have both low uncertainty avoidance and low masculinity (high emphasis on “feminine” values).

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

However, one should be careful about reading too much into Hofstede’s research. It has been criticized on a number of points.⁴⁸ First, Hofstede assumes there is a one-to-one correspondence between culture and the nation-state, but as we saw earlier,

3.1 table

Work-Related Values for 20 Selected Countries

Source: G. Hofstede, *Culture's Consequences*. © 1980, Sage Publications. Cited in G. Hofstede, "The Cultural Relativity of Organizational Practices and Theories," *Journal of International Business Studies* 14 (Fall 1983), pp. 75–89. Reprinted by permission of Geert Hofstede.

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

many countries have more than one culture. Hofstede's results do not capture this distinction. Second, the research may have been culturally bound. The research team was composed of Europeans and Americans. The questions they asked of IBM employees and their analysis of the answers may have been shaped by their own cultural biases and concerns. So it is not surprising that Hofstede's results confirm Western stereotypes, because it was Westerners who undertook the research.

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

Still, just as it should not be accepted without question, Hofstede's work should not be dismissed either. It represents a starting point for managers trying to figure out how cultures differ and what that might mean for management practices. Also, several other scholars have found strong evidence that differences in culture affect values and

Confucian Dynamism

Theory that Confucian teachings affect attitudes toward time, persistence, ordering by status, protection of face, respect for tradition, and reciprocation of gifts and favors.

practices in the workplace, and Hofstede's basic results have been replicated using more diverse samples of individuals in different settings.⁴⁹ Still, managers should use the results with caution, for they are not necessarily accurate.

Hofstede subsequently expanded his original research to include a fifth dimension that he argued captured additional cultural differences not brought out in his earlier work.⁵⁰ He referred to this dimension as "Confucian dynamism" (sometimes called *long-term orientation*). According to Hofstede, **Confucian dynamism** captures attitudes toward time, persistence, ordering by status, protection of face, respect for tradition, and reciprocation of gifts and favors. The label refers to these "values" being derived from Confucian teachings. As might be expected, East Asian countries such as Japan, Hong Kong, and Thailand scored high on Confucian dynamism, while nations such as the United States and Canada scored low. Hofstede and his associates went on to argue that their evidence suggested that nations with higher economic growth rates scored high on Confucian dynamism and low on individualism—the implication being Confucianism is good for growth. However, subsequent studies have shown that this finding does not hold up under more sophisticated statistical analysis.⁵¹ During the past decade countries with high individualism and low Confucian dynamics such as the United States have attained high growth rates, while some Confucian cultures such as Japan have had stagnant economic growth. In reality, while culture might influence the economic success of a nation, it is just one of many factors, and while its importance should not be ignored, it should not be overstated either. The factors discussed in Chapter 2—economic, political, and legal systems—are probably more important than culture in explaining differential economic growth rates over time.

Cultural Change

LEARNING OBJECTIVE 5

Demonstrate the economic and business implications of cultural change.

Culture is not a constant; it evolves over time.⁵² Changes in value systems can be slow and painful for a society. In the 1960s, for example, American values toward the role of women, love, sex, and marriage underwent significant changes. Much of the social turmoil of that time reflected these changes. Change can often be quite profound. For example, at the beginning of the 1960s, the idea that women might hold senior management positions in major corporations was not widely accepted. Many scoffed at the idea. Today, it is a reality, and few in the mainstream of American society question

the development or the capability of women in the business world. American culture has changed (although it is still more difficult for women to gain senior management positions than men). Similarly, the value systems of many ex-communist states, such as Russia, are undergoing significant changes as those countries move away from values that emphasize collectivism and toward those that emphasize individualism. While social turmoil is an inevitable outcome of such a shift, the shift will still probably occur.

Similarly, some claim that a major cultural shift has been occurring in Japan, with a move toward greater individualism.⁵³ The model Japanese office worker, or "salaryman," is characterized as being loyal to his boss and the organization to the point of giving up evenings, weekends, and vacations to serve the organization, which is the collective of



Another Perspective

The Chinese as Conspicuous Consumers?

By all accounts, the growth of consumerism in China would appear to be a gold mine for marketers in the West looking to promote "the next new thing." In her book *Brand New China*, Massachusetts Institute of Technology Professor Jing Wang characterizes this cultural change as "a mockery of the Communist revolution." And although she agrees that Chinese culture is changing, Wang says it's not happening as fast as Western marketers might believe. Traditional Chinese values, she says, have not disappeared altogether, and Wang advises marketers to keep those values in mind when targeting the Chinese market. ("Party Times: Marketing through Events," *BusinessWeek*, June 19, 2007, www.businessweek.com)

which the employee is a member. However, a new generation of office workers does not seem to fit this model. An individual from the new generation is likely to be more direct than the traditional Japanese. He acts more like a Westerner, a *gaijin*. He does not live for the company and will move on if he gets the offer of a better job. He is not keen on overtime, especially if he has a date. He has his own plans for his free time, and they may not include drinking or playing golf with the boss.⁵⁴

Several studies have suggested that economic advancement and globalization may be important factors in societal change.⁵⁵ For example, there is evidence that economic progress is accompanied by a shift in values away from collectivism and toward individualism.⁵⁶ Thus, as Japan has become richer, the cultural emphasis on collectivism has declined and greater individualism is being witnessed. One reason for this shift may be that richer societies exhibit less need for social and material support structures built on collectives, whether the collective is the extended family or the paternalistic company. People are better able to take care of their own needs. As a result, the importance attached to collectivism declines, while greater economic freedoms lead to an increase in opportunities for expressing individualism.

The culture of societies may also change as they become richer because economic progress affects a number of other factors, which in turn influence culture. For example, increased urbanization and improvements in the quality and availability of education are both a function of economic progress, and both can lead to declining emphasis on the traditional values associated with poor rural societies. A 25-year study of values in 78 countries, known as the World Values Survey, coordinated by the University of Michigan's Institute for Social Research, has documented how values change. The study linked these changes in values to changes in a country's level of economic development.⁵⁷ According to this research, as countries get richer, a shift occurs away from "traditional values" linked to religion, family, and country, and toward "secular rational" values. Traditionalists say religion is important in their lives. They have a strong sense of national pride; they also think that children should be taught to obey and that the first duty of a child is to make his or her parents proud. They say abortion, euthanasia, divorce, and suicide are never justified. At the other end of this spectrum are secular rational values.



The 2006 MTV awards show in India demonstrates the globalization of what was originally American pop culture. Do you think traditional Indian values are at risk from the importation of MTV?

Another category in the World Values Survey is quality of life attributes. At one end of this spectrum are “survival values,” the values people hold when the struggle for survival is of paramount importance. These values tend to stress that economic and physical security are more important than self-expression. People who cannot take food or safety for granted tend to be xenophobic, are wary of political activity, have authoritarian tendencies, and believe that men make better political leaders than women. “Self-expression” or “well-being” values stress the importance of diversity, belonging, and participation in political processes.

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

With regard to globalization, some have argued that advances in transportation and communication technologies, the dramatic increase in trade since World War II, and the rise of global corporations such as Hitachi, Disney, Microsoft, and Levi Strauss, whose products and operations can be found around the globe, are creating conditions for the merging of cultures.⁵⁸ With McDonald’s hamburgers in China, The Gap in India, iPods in South Africa, and MTV everywhere helping to foster a ubiquitous youth culture, some argue that the conditions for less cultural variation have been created. At the same time, one must not ignore important countertrends, such as the shift toward Islamic fundamentalism in several countries; the separatist movement in Quebec, Canada; or the continuing ethnic strains and separatist movements in Russia. Such countertrends in many ways are a reaction to the pressures for cultural convergence. In an increasingly modern and materialistic world, some societies are trying to reemphasize their cultural roots and uniqueness. Cultural change is not unidirectional, with national cultures converging toward some homogenous global entity. Also, while some elements of culture change quite rapidly—particularly the use of material symbols—other elements change slowly if at all. Thus, just because people the world over wear blue jeans and eat at McDonald’s, one should not assume that they have also adopted American values—for more often than not, they have not.



Focus on Managerial Implications

LEARNING OBJECTIVE 3

Identify the business and economic implications of differences in culture.

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

Cross-Cultural Literacy

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

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

Simple examples illustrate how important cross-cultural literacy can be. Anthropologist Edward T. Hall has described how Americans, who tend to be informal in nature, react strongly to being corrected or reprimanded in public.⁵⁹ This can cause problems in Germany, where a cultural tendency toward correcting strangers can shock and offend most Americans. For their part, Germans can be a bit taken aback by the tendency of Americans to call everyone by their first name. This is uncomfortable enough among executives of the same rank, but it can be seen as insulting when a young and junior American executive addresses an older and more senior German manager by his first name without having been invited to do so. Hall concludes it can take a long time to get on a first-name basis with a German; if you rush the process you will be perceived as overfriendly and rude, and that may not be good for business.

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

Ethnocentrism

A belief in the superiority of one's own ethnic group or culture; often results in disregard or contempt for the culture of other countries.



Social networking and the importance of communal eating are some of the collectivist values Arabs bring to business.

is important, finishing the discussion with a friend is more important than adhering to a strict schedule. Indeed, the Arab may be puzzled as to why the American attaches so much importance to time and schedule.

Culture and Competitive Advantage

One theme that continually surfaces in this chapter is the relationship between culture and national competitive advantage. Put simply, the value systems and norms of a country influence the costs of doing business in that country. The costs of doing business in a country influence the ability of firms to establish a competitive advantage in the global marketplace. We have seen how attitudes toward cooperation between management and labor, toward work, and toward the payment of interest are influenced by social structure and religion. It can be argued that the class-based conflict between workers and management in class-conscious societies, when it leads to industrial disruption, raises the costs of doing business in that society. Similarly, we have seen how some sociologists have argued that the ascetic “other-worldly” ethics of Hinduism may not be as supportive of capitalism as the ethics embedded in Protestantism and Confucianism. Also, Islamic laws banning interest payments may raise the costs of doing business by constraining a country’s banking system.

Japan presents an interesting case study of how culture can influence competitive advantage. Some scholars have argued that the culture of modern Japan lowers the costs of doing business relative to the costs in most Western nations. Japan’s emphasis on group affiliation, loyalty, reciprocal obligations, honesty, and education all boost the competitiveness of Japanese companies. The emphasis on group affiliation and loyalty encourages individuals to identify strongly with the companies in which they work. This tends to foster an ethic of hard work and cooperation between management and labor “for the good of the company.” Similarly, reciprocal obligations and honesty help foster an atmosphere of trust between companies and their suppliers. This encourages them to enter into long-term relationships with each other to work on inventory reduction, quality control, and design—all of which have been shown to improve an organization’s competitiveness. This level of cooperation has often been lacking in the West, where the relationship between a company and its suppliers tends to be a short-term one structured around competitive bidding rather than one based on long-term mutual commitments. In addition, the availability of a pool of highly skilled labor, particularly engineers, has helped Japanese enterprises develop cost-reducing process innovations that have boosted their productivity.⁶⁰ Thus, cultural factors may help explain the competitive advantage enjoyed by many Japanese businesses in the global marketplace. The rise of Japan as an economic power during the second half of the twentieth century may be in part attributed to the economic consequences of its culture.

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

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

Second, the connection between culture and competitive advantage has important implications for the choice of countries in which to locate production facilities and do business. Consider a hypothetical case when a company has to choose between two countries, A and B, for locating a production facility. Both countries are characterized by low labor costs and good access to world markets. Both countries are of roughly the same size (in terms of population) and both are at a similar stage of economic development. In country A, the education system is undeveloped, the society is characterized by a marked stratification between the upper and lower classes, and there are six major linguistic groups. In country B, the education system is well developed, social stratification is lacking, group identification is valued by the culture, and there is only one linguistic group. Which country makes the best investment site?

Country B probably does. In country A, conflict between management and labor, and between different language groups, can be expected to lead to social and industrial disruption, thereby raising the costs of doing business.⁶¹ The lack of a good education system also can be expected to work against the attainment of business goals.

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

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

Key Terms

cross-cultural literacy, p. 93
culture, p. 94
values, p. 94
norms, p. 94
society, p. 94
folkways, p. 94
mores, p. 95
social structure, p. 97

group, p. 97
social strata, p. 99
social mobility, p. 99
caste system, p. 99
class system, p. 99
class consciousness, p. 102
religion, p. 103
ethical systems, p. 103

power distance, p. 116
individualism versus collectivism, p. 116
uncertainty avoidance, p. 116
masculinity versus femininity, p. 116
Confucian dynamism, p. 118
ethnocentrism, p. 121

Summary

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

1. Culture is a complex whole that includes knowledge, beliefs, art, morals, law, customs, and other capabilities acquired by people as members of society.
2. Values and norms are the central components of a culture. Values are abstract ideals about what a society believes to be good, right, and desirable. Norms are social rules and guidelines that prescribe appropriate behavior in particular situations.
3. Values and norms are influenced by political and economic philosophy, social structure, religion, language, and education.
4. The social structure of a society refers to its basic social organization. Two main dimensions along which social structures differ are the individual–group dimension and the stratification dimension.
5. In some societies, the individual is the basic building block of social organization. These societies emphasize individual achievements above all else. In other societies, the group is the basic building block of social organization. These societies emphasize group membership and group achievements above all else.
6. All societies are stratified into different classes. Class-conscious societies are characterized by low social mobility and a high degree of stratification. Less class-conscious societies are characterized by high social mobility and a low degree of stratification.
7. Religion may be defined as a system of shared beliefs and rituals that is concerned with the realm of the sacred. Ethical systems refer to a set of moral principles, or values, that are used to guide and shape behavior. The world's major religions are Christianity, Islam, Hinduism, and Buddhism. Although not a religion, Confucianism has an impact on behavior that is as profound as that of many religions. The value systems of different religious and ethical systems have different implications for business practice.
8. Language is one defining characteristic of a culture. It has both spoken and unspoken dimensions. In countries with more than one spoken language, we tend to find more than one culture.
9. Formal education is the medium through which individuals learn skills and are socialized into the values and norms of a society. Education plays an important role in the determination of national competitive advantage.
10. Geert Hofstede studied how culture relates to values in the workplace. He isolated four dimensions that he claimed summarized different cultures: power distance, uncertainty avoidance, individualism versus collectivism, and masculinity versus femininity.
11. Culture is not a constant; it evolves. Economic progress and globalization seem to be two important engines of cultural change.
12. One danger confronting a company that goes abroad for the first time is being ill-informed. To develop cross-cultural literacy, international businesses need to employ host-country nationals, build a cadre of cosmopolitan executives, and guard against the dangers of ethnocentric behavior.
13. The value systems and norms of a country can affect the costs of doing business in that country.

Critical Thinking and Discussion Questions

1. Outline why the culture of a country might influence the costs of doing business in that country. Illustrate your answer with examples.
2. Do you think that business practices in an Islamic country are likely to differ from business practices in the United States? If so, how?
3. What are the implications for international business of differences in the dominant religion or ethical system of a country?
4. Choose two countries that appear to be culturally diverse. Compare the cultures of those countries and then indicate how cultural

- differences influence (a) the costs of doing business in each country, (b) the likely future economic development of that country, and (c) business practices.
5. Reread the Country Focus about Islamic capitalism in Turkey. Then answer the following questions:
 - a. Can you see anything in the value of Islam that is hostile to business?
 - b. What does the experience of the region around Kayseri teach us about the relationship between Islam and business?
 - c. What are the implications of Islamic values towards business for the participation of a country like Turkey in the global economy?
 6. Reread the Management Focus on DMG-Shanghai and answer the follow questions:
 - a. Why do you think that it is so important to cultivate *guanxi* and *guanxiwang* in China?
 - b. What does the experience of DMG tell us about the way things work in China? What would likely happen to a business that obeyed all of the rules and regulations, rather than trying to find a way around them as Dan Mintz apparently did?
 - c. What are the ethical issues that might arise when drawing upon *guanxiwang* to get things done in China? What does this suggest about the limits of using *guanxiwang* for a Western business committed to high ethical standards?

<http://globalEDGE.msu.edu>



Research Task

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

1. You have been assigned to negotiate a business deal with the representatives of a potential distributor in South Africa. Since having *intercultural skills* is critical for a successful international experience, you consider collecting information regarding the local culture before your departure. Prepare a short description of the most striking cultural characteristics involved in communicating with the local people that may affect business interactions in this country.
2. Asian cultures exhibit significant differences in *business etiquette* when compared to Western cultures. For example, in China, large hand movements are usually distracting, and it is considered offensive to point while speaking. Find five similar tips regarding the business etiquette of the United Arab Emirates.



closing case

Panasonic and Japan's Changing Culture

Established in 1920, the consumer electronics giant Panasonic was at the forefront of the rise of Japan to the status of major economic power during the 1970s and 1980s (before 2009 Panasonic was known as Matsushita). Like many other long-standing Japanese businesses, Panasonic was regarded as a bastion of traditional Japanese values based on strong group identification, reciprocal obligations, and loyalty to the company. Several commentators attributed Panasonic's success, and that of the Japanese economy,

to the existence of Confucian values in the workplace. At Panasonic, employees were taken care of by the company from "cradle to the grave." Panasonic provided them with a wide range of benefits including cheap housing, guaranteed lifetime employment, seniority-based pay systems, and generous retirement bonuses. In return, Panasonic expected, and got, loyalty and hard work from its employees. To Japan's postwar generation, struggling to recover from the humiliation of defeat, it seemed like a fair bargain. The

employees worked hard for the greater good of Panasonic, and Panasonic reciprocated by bestowing “blessings” on employees.

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

Panasonic was one of the last companies to turn its back on Japanese traditions, but in 1998, after years of poor performance, it began to modify traditional practices. The principle agents of change were a group of managers who had extensive experience in Panasonic’s overseas operations, and included Kunio Nakamura, who became the chief executive of Panasonic in 2000.

First, Panasonic changed the pay scheme for its 11,000 managers. In the past, the traditional twice-a-year bonuses had been based almost entirely on seniority, but now Panasonic said they would be based on performance. In 1999, Panasonic announced this process would be made transparent; managers would be shown what their performance rankings were and how these fed into pay bonuses. As elementary as this might sound in the West, for Panasonic it represented the beginning of a revolution in human resource practices.

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

the third option—suggesting there is still a hankering for the traditional paternalistic relationship—but 41 percent took the second option.

In other ways Panasonic’s designs are grander still. As the company has moved into new industries such as software engineering and network communications technology, it has begun to sing the praises of democratization of employees, and it has sought to encourage individuality, initiative taking, and risk seeking among its younger employees. But while such changes may be easy to articulate, they are hard to implement. For all of its talk, Panasonic has been slow to dismantle its lifetime employment commitment to those hired under the traditional system. This was underlined in early 2001 when, in response to continued poor performance, Panasonic announced it would close 30 factories in Japan, cut 13,000 jobs including 1,000 management jobs, and sell a “huge amount of assets” over the next three years. While this seemed to indicate a final break with the lifetime employment system—it represented the first layoffs in the company’s history—the company also said unneeded management staff would not be fired but instead transferred to higher growth areas such as health care.

With so many of its managers a product of the old way of doing things, a skeptic might question the ability of the company to turn its intentions into a reality. As growth has slowed, Panasonic has had to cut back on its hiring, but its continued commitment to long-standing employees means that the average age of its workforce is rising. In the 1960s it was around 25; by the early 2000s it was 35, a trend that might counteract Panasonic’s attempts to revolutionize the workplace, for surely those who benefited from the old system will not give way easily to the new. Still, by the mid-2000s it was clear that Panasonic was making progress. After significant losses in 2002, the company broke even in 2003 and started to make profits again in 2004. New growth drivers, such as sales of DVD equipment, helped, but so did the cultural and organizational changes that enabled the company to better exploit these new opportunities. The company continued to make solid profits until 2009, when, like most enterprises, it was hit by the global recession. Panasonic’s response to this showed how much the company had changed. The company quickly announced that it would close 27 plants and lay off 15,000 employees, half of them in Japan, signaling perhaps, the final end of its lifetime employment commitments.

Sources: “Putting the Bounce Back into Matsushita,” *The Economist*, May 22, 1999, pp. 67–68; “In Search of the New Japanese Dream,” *The Economist*, February 19, 2000, pp. 59–60; P. Landers, “Matsushita to Restructure in Bid to Boost Thin Profits,” *The Wall Street Journal*, December 1, 2000, p. A13; M. Tanikawa, “A Pillar of Japan Inc. Finally Turns Around; Work in Progress,” *International Herald Tribune*, August 28, 2004, pp. 17–18; and “Panasonic Will Slash Jobs, Shut 27 Plants,” *Los Angeles Times*, February 5, 2009, p. C3.

Case Discussion Questions

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



part 2

Country Differences

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Understand the ethical issues faced by international businesses.
- 2 Recognize an ethical dilemma.
- 3 Identify the causes of unethical behavior by managers.
- 4 Describe the different philosophical approaches to ethics.
- 5 Explain how managers can incorporate ethical considerations into their decision making.

Ethics in International Business

Working Conditions in a Chinese Factory

opening case

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

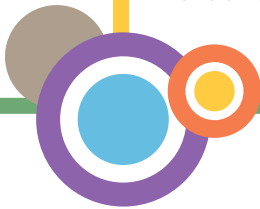
According to the report, at the Metai factory in Guangdong, the workers sit at the assembly line on wooden stools, without backrests, 12 hours a day with just two days off a month. Every 7.2 seconds a keyboard passes each worker, who has to snap six or seven keys into place—one key every 1.1 seconds. The assembly line never stops. The workplace is frantic, monotonous, numbing, and relentless. Each worker inserts 3,250 keys an hour; 35,750 keys during the official 11-hour shift; 250,250 a week, performing over 1 million operations a month. While working, employees cannot talk, listen to music, or even lift their heads to look around. Workers cannot use the bathroom until there is a break. Security guards spy on the workers, who are prohibited from putting their hands in their pockets and are searched when they enter and leave the factory. The factory operates 24 hours a day on two 12-hour shifts, with the workers rotating between day and night shifts each month. The workers are at the factory for up to 87 hours a week, and all overtime is mandatory. There are two half-hour meal breaks per shift, during which the workers race to the cafeteria to line up to get food, leaving them about 15 minutes to eat. The base wage is 64 cents an hour, which drops to a take-home wage of just 41 cents an hour after deductions for primitive room and board. Workers bathe using a small plastic bucket. Summer temperatures routinely reach into the high 90s. Ten to 12 workers share each dorm room, sleeping on narrow metal bunk beds that line the walls.

Comments from the workers, most of whom are young women between 18 and 25 years old, reinforce how harsh the conditions are.

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

When informed of these findings, a spokesman for Microsoft said the factory supplied one of its contract manufacturers, but the company would still investigate the issue. Representatives from Hewlett-Packard and Lenovo also stated the factory was not a direct supplier, but they too stated they would look into the issue. A spokesman for Dell, for whom the factory is a direct supplier, said it was actively investigating the issue. The spokesman went on to note, "I can tell you that any reports of poor working conditions in Dell's supply chain are investigated and appropriate action is taken." As of early 2010, no reports could be found indicating whether any of these companies had investigated the situation and decided upon a course of action. ●

Sources: "The Dehumanization of Young Workers Producing Our Keyboards," The National Labor Committee, February 2009, accessed at <http://www.nlcnet.org/article.php?id=613#intro>; A. Butler, "29p an Hour Slaves Make Our Cut Price Computers," *Sunday Mirror*, February 22, 2009, p. 34; and R. Thompson, "Prison-like Conditions for Workers Making IBM, Dell, HP, Microsoft and Lenovo Products," *ComputerWeekly.com*, February 17, 2009.



Introduction

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

The term *ethics* refers to accepted principles of right or wrong that govern the conduct of a person, the members of a profession, or the actions of an organization. **Business ethics** are the accepted principles of right or wrong governing the conduct of businesspeople, and an **ethical strategy** is a strategy, or course of action, that does not violate these accepted principles. This chapter looks at how ethical issues should be incorporated into decision making in an international business. Next, we review the reasons for poor ethical decision making. Then we discuss different philosophical

Business Ethics

The accepted principles of right or wrong governing the conduct of businesspeople.

Ethical Strategy

A strategy, or course of action, that does not violate the accepted principles of right or wrong governing the conduct of businesspeople.

approaches to business ethics. We close the chapter by reviewing the different processes that managers can adopt to make sure that ethical considerations are incorporated into decision making in an international business firm.

Ethical Issues in International Business

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

LEARNING OBJECTIVE 1

Understand the ethical issues faced by international businesses.

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

In the 1990s Nike found itself at the center of a storm of protests when news reports revealed that working conditions at many of its subcontractors were very poor. Typical of the allegations were those detailed in a *48 Hours* program that aired on CBS-TV in 1996. The report painted a picture of young women at a Vietnamese subcontractor who worked with toxic materials six days a week in poor conditions for only 20 cents an hour. The report also stated that a living wage in Vietnam was at least \$3 a day, an income that could not be achieved at the subcontractor without working substantial overtime. Nike and its subcontractors were not breaking any laws, but this report, and others like it, raised questions about the ethics of using sweatshop labor to make what were essentially fashion accessories. It may have been legal, but was it ethical to use subcontractors who by Western standards clearly exploited their workforce? Nike's critics thought not, and the company found itself the focus of a wave of demonstrations and consumer boycotts. These exposés surrounding Nike's use of subcontractors forced the company to reexamine its policies. Realizing that, even though it was breaking no law, its subcontracting policies were perceived as unethical, Nike's management established a code of conduct for Nike subcontractors and instituted annual monitoring by independent auditors of all subcontractors.¹

As the Nike case demonstrate, a strong argument can be made that it is not OK for a multinational firm to tolerate poor working conditions in its foreign operations or those of its subcontractors. However, this still leaves unanswered the question of what standards should be applied. We shall return to and



It may have been legal for a Vietnamese contractor to allow employees to work with toxic materials six days a week in poor conditions for 20 cents an hour at a Nike factory. But was it ethical for Nike to use subcontractors who by Western standards clearly exploited their workers?



Making Apple's iPod

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

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

Within six weeks, Apple had completed its audit. The company's report suggested that although workers had not been forced to work overtime and were earning at least the local minimum wage, many had worked more than the 60 hours a

week allowed for by Apple, and their housing was substandard. Under pressure from Apple, management at Hongfujin agreed to bring practices in line with Apple's code, committing themselves to building new housing for employees and limiting work to 60 hours a week.

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

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

Sources: E. Kurtenbach, "The Foreign Factory Factor," *Seattle Times*, August 31, 2006, pp. C1, C3; Elaine Kurtenbach, "Apple Says It's Trying to Resolve Dispute over Labor Conditions at Chinese iPod Factory," *Associated Press Financial Wire*, August 30, 2006; and "Chinese iPod Supplier Pulls Suit," *Associated Press Financial Wire*, September 3, 2006.

consider this issue in more detail later in the chapter. For now, note that establishing minimal acceptable standards that safeguard the basic rights and dignity of employees, auditing foreign subsidiaries and subcontractors on a regular basis to make sure those standards are met, and taking corrective action if they are not, is a good way to guard against ethical abuses. Another Western company, Levi Strauss, has long taken such an approach. The company terminated a long-term contract with one of its large suppliers, the Tan family, after it discovered the Tans were allegedly forcing 1,200 Chinese and Filipino women to work 74 hours per week in guarded compounds on the Mariana Islands.² For another example of problems with working practices among suppliers, see the accompanying Management Focus, which looks at working conditions in a factory that supplied Apple with iPods.

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

Several Western businesses started to change their policies in the late 1970s and early 1980s.³ General Motors, which had significant activities in South Africa, was at the forefront of this trend. GM adopted what came to be called the *Sullivan principles*, named after Leon Sullivan, a black Baptist minister and a member of GM's board of directors. Sullivan argued that it was ethically justified for GM to operate in South Africa so long as two conditions were fulfilled. First, the company should not obey the apartheid laws in its own South African operations (a form of passive resistance). Second, the company should do everything within its power to promote the abolition of apartheid laws. Sullivan's principles were widely adopted by U.S. firms operating in South Africa. Their violation of the apartheid laws was ignored by the South African government, which clearly did not want to antagonize important foreign investors.

However, after 10 years, Leon Sullivan concluded that simply following the principles was not sufficient to break down the apartheid regime and that any American company, even those adhering to his principles, could not ethically justify their continued presence in South Africa. Over the next few years, numerous companies divested their South African operations, including Exxon, General Motors, Kodak, IBM, and Xerox. At the same time, many state pension funds signaled they would no longer hold stock in companies that did business in South Africa, which helped to persuade several companies to divest their South African operations. These divestments, coupled with the imposition of economic sanctions from the U.S. and other governments, contributed to the abandonment of white minority rule and apartheid in South Africa and the introduction of democratic elections in 1994. Thus, adopting an ethical stance was argued to have helped improve human rights in South Africa.⁴

Although change has come in South Africa, many repressive regimes still exist in the world. Is it ethical for multinationals to do business in them? It is often argued that inward investment by a multinational can be a force for economic, political, and social progress that ultimately improves the rights of people in repressive regimes. This position was first discussed in Chapter 2, when we noted that economic progress in a nation could create pressure for democratization. In general,



Another Perspective

Human Rights Violations in Honduras

In 2009, the army in Honduras overthrew President Manuel Zelaya after he attempted to gather public views about holding a citizen assembly to rewrite the nation's constitution. As Honduras struggles to right itself under a newly elected government, human rights observers have learned that Honduran citizens peacefully protesting the coup have been tear-gassed and pepper-sprayed. Some protesters have been imprisoned, tortured, and beaten with chains. Also under the new government, Honduran women—who constitute up to 70 percent of the protestors in this Central American nation—reportedly have been sexually abused, raped, and killed. (Joe Tiano, "Human Rights Violations Abound during Honduras Coup, Speaker Says," *Daily Free Press*, February 11, 2010, <http://www.dailyfreepress.com>)

this belief suggests it is ethical for a multinational to do business in nations that lack the democratic structures and human rights records of developed nations. Investment in China, for example, is frequently justified on the grounds that although China's human rights record is often questioned by human rights groups, and although the country is not a democracy, continuing inward investment will help boost economic growth and raise living standards. These developments will ultimately create pressures from the Chinese people for more participative government, political pluralism, and freedom of expression and speech.

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

Nigeria is another country where serious questions have arisen over the extent to which foreign multinationals doing business in the country have contributed to human rights violations. Most notably, the largest foreign oil producer in the country, Royal Dutch Shell, has been repeatedly criticized.⁵ In the early 1990s, several ethnic groups in Nigeria, which was ruled by a military dictatorship, protested against foreign oil companies for causing widespread pollution and failing to invest in the communities from which they extracted oil. Shell reportedly requested the assistance of Nigeria's Mobile Police Force (MPF) to quell the demonstrations. According to the human rights group Amnesty International, the results were bloody. In 1990, the MPF put down protests against Shell in the village of Umuechem, killing 80 people and destroying 495 homes. In 1993, following protests in the Ogoni region of Nigeria that were designed to stop contractors from laying a new pipeline for Shell, the MPF raided the area to quell the unrest. In the chaos that followed, it has been alleged that 27 villages were razed, 80,000 Ogoni people displaced, and 2,000 people killed.

Critics argued that Shell shouldered some of the blame for the massacres. Shell never acknowledged this, and the MPF probably used the demonstrations as a pretext for punishing an ethnic group that had been agitating against the central government for some time. Nevertheless, these events did prompt Shell to look at its own ethics and to set up internal mechanisms to ensure that its subsidiaries acted in a manner that was consistent with basic human rights.⁶ More generally, the question remains, what is the responsibility of a foreign multinational when operating in a country where basic human rights are trampled on? Should the company be there at all, and if it is there, what actions should it take to avoid the situation Shell found itself in?

ENVIRONMENTAL POLLUTION Ethical issues arise when environmental regulations in host nations are inferior to those in the home nation. Many developed nations have substantial regulations governing the emission of pollutants, the dumping of toxic chemicals, the use of toxic materials in the workplace, and so on. Those regulations are often lacking in developing nations, and according to critics, the result can be higher levels of pollution from the operations of multinationals than would be allowed at home. For example, consider again the case of foreign oil companies in



Unocal in Myanmar

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

However, Unocal's investment quickly became highly controversial. Under the terms of the contract, the government of Myanmar was contractually obliged to clear a corridor for the pipeline through Myanmar's tropical forests and to protect the pipeline from attacks by the government's enemies. According to human rights groups, the Myanmar army forcibly moved villages and ordered hundreds of local peasants

to work on the pipeline in conditions that were no better than slave labor. Those who refused suffered retaliation. News reports cite the case of one woman who was thrown into a fire, along with her baby, after her husband tried to escape from troops forcing him to work on the project. The baby died and she suffered burns. Other villagers report being beaten, tortured, raped, and otherwise mistreated when the alleged slave labor conditions were occurring.

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

Sources: Jim Carlton, "Unocal Trial for Slave Labor Claims Is Set to Start Today," *The Wall Street Journal*, December 9, 2003, p. A19; Seth Stern, "Big Business Targeted for Rights Abuse," *Christian Science Monitor*, September 4, 2003, p. 2; "Trouble in the Pipeline," *The Economist*, January 18, 1997, p. 39; Irtani Evelyn, "Feeling the Heat: Unocal Defends Myanmar Gas Pipeline Deal," *Los Angeles Times*, February 20, 1995, p. D1; and "Unocal Settles Myanmar Human Rights Cases," *Business and Environment*, February 2005, pp. 14–16.

Nigeria. According to a 1992 report prepared by environmental activists in Nigeria, in the Niger Delta region:

Apart from air pollution from the oil industry's emissions and flares day and night, producing poisonous gases that are silently and systematically wiping out vulnerable airborne biota and endangering the life of plants, game, and man himself, we have widespread water pollution and soil/land pollution that results in the death of most aquatic eggs and juvenile stages of the life of fin fish and shell fish on the one hand, whilst, on the other hand, agricultural land contaminated with oil spills becomes dangerous for farming, even where they continue to produce significant yields.⁷

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

Should a multinational feel free to pollute in a developing nation? (To do so hardly seems ethical.) Is there a danger that amoral management might move production to a developing nation precisely because costly pollution controls are not required, and the company is therefore free to despoil the environment and perhaps endanger local people in its quest to lower production costs and gain a competitive advantage? What

is the right and moral thing to do in such circumstances—pollute to gain an economic advantage, or make sure that foreign subsidiaries adhere to common standards regarding pollution controls?

These questions take on added importance because some parts of the environment are a public good that no one owns, but anyone can despoil. No one owns the atmosphere or the oceans, but polluting both, no matter where the pollution originates, harms all.⁸ The atmosphere and oceans can be viewed as a global commons from which everyone benefits but for which no one is specifically responsible. In such cases, a phenomenon known as the *tragedy of the commons* becomes applicable. The tragedy of the commons occurs when a resource held in common by all, but owned by no one, is overused by individuals, resulting in its degradation. The phenomenon was first named by Garrett Hardin when describing a particular problem in sixteenth century England. Large open areas, called commons, were free for all to use as pasture. The poor put out livestock on these commons and supplemented their meager incomes. It was advantageous for each to put out more and more livestock, but the social consequence was far more livestock than the commons could handle. The result was overgrazing, degradation of the commons, and the loss of this much-needed supplement.⁹

In the modern world, corporations can contribute to the global tragedy of the commons by moving production to locations where they are free to pump pollutants into the atmosphere or dump them in oceans or rivers, thereby harming these valuable global commons. While such action may be legal, is it ethical? Again, such actions seem to violate basic societal notions of ethics and social responsibility. This issue is taking on greater importance as concerns about human-induced global warming

move to center stage. Most climate scientists argue that (a) human industrial and commercial activity is increasing the amount of carbon dioxide in the atmosphere; (b) carbon dioxide is a greenhouse gas, which reflects heat back to the earth's surface, warming the globe; and (c) as a result, the average temperature of the earth is increasing. The accumulated scientific evidence supports this argument.¹⁰ Given this, societies around the world are starting to restrict the amount of carbon dioxide that can be emitted into the atmosphere as a by-product of industrial and commercial activity. However, regulations differ from nation to nation. Given this, is it ethical for a company to try to escape tight emission limits by moving production to a country with lax regulations, given that doing so will contribute to global warming? Again, many would argue that doing so violates basic ethical principles.

CORRUPTION As noted in Chapter 2, corruption has been a problem in almost every society in history, and it continues to be one today.¹¹ There always have been and always will be corrupt government officials. International businesses can and have gained economic advantages by making payments to those officials. A classic example concerns a well-publicized incident in the 1970s. Carl Kotchian, the president of Lockheed, made a \$12.5 million payment to Japanese agents and government officials to secure a large order



A marketplace in Myanmar/Burma. Many activists question Unocal's continued involvement in Myanmar/Burma because the state's dictatorship harshly punishes proponents of democracy.

for Lockheed's TriStar jet from Nippon Air. When the payments were discovered, U.S. officials charged Lockheed with falsification of its records and tax violations. Although such payments were supposed to be an accepted business practice in Japan (they might be viewed as an exceptionally lavish form of gift giving), the revelations created a scandal there too. The government ministers in question were criminally charged, one committed suicide, the government fell in disgrace, and the Japanese people were outraged. Apparently, such a payment was not an accepted way of doing business in Japan! The payment was nothing more than a bribe, paid to corrupt officials, to secure a large order that might otherwise have gone to another manufacturer, such as Boeing. Kotchian clearly engaged in unethical behavior, and to argue that the payment was an "acceptable form of doing business in Japan" was self-serving and incorrect.

The Lockheed case was the impetus for the 1977 passage of the **Foreign Corrupt Practices Act** in the United States, which we first discussed in Chapter 2. The act outlawed the paying of bribes to foreign government officials to gain business. Some U.S. businesses immediately objected that the act would put U.S. firms at a competitive disadvantage (there is no evidence that subsequently occurred).¹² The act was subsequently amended to allow for "facilitating payments." Sometimes known as speed money or grease payments, facilitating payments are *not* payments to secure contracts that would not otherwise be secured and nor are they payments to obtain exclusive preferential treatment. Rather they are payments to ensure receiving the standard treatment that a business ought to receive from a foreign government, but might not due to the obstruction of a foreign official.

In 1997, the trade and finance ministers from the member states of the Organization for Economic Cooperation and Development (OECD) followed the U.S. lead and adopted the **Convention on Combating Bribery of Foreign Public Officials in International Business Transactions**.¹³ The convention, which went into force in 1999, obliges member states and other signatories to make the bribery of foreign public officials a criminal offense. The convention excludes facilitating payments made to expedite routine government action from the convention.

While facilitating payments, or speed money, are excluded from both the Foreign Corrupt Practices Act and the OECD convention on bribery, the ethical implications of making such payments are unclear. In many countries, payoffs to government officials in the form of speed money are a part of life. One can argue that not investing because government officials demand speed money ignores the fact that such investment can bring substantial benefits to the local populace in terms of income and jobs. From a pragmatic standpoint, giving bribes, although a little evil might be the price that must be paid to do a greater good (assuming the investment creates jobs where none existed and assuming the practice is not illegal). Several economists advocate this reasoning, suggesting that in the context of pervasive and cumbersome regulations in developing countries, corruption may improve efficiency and help growth! These economists theorize that in a country where preexisting political structures distort or limit the workings of the market mechanism, corruption in the form of black marketeering, smuggling, and side payments to government bureaucrats to "speed up" approval for business investments may enhance welfare.¹⁴ Arguments such as this persuaded the U.S. Congress to exempt facilitating payments from the Foreign Corrupt Practices Act.

In contrast, other economists have argued that corruption reduces the returns on business investment and leads to low economic growth.¹⁵ In a country where corruption is common, unproductive bureaucrats who demand side payments for granting the enterprise permission to operate may siphon off the profits from a business activity. This reduces businesses' incentive to invest and may retard a country's economic growth rate. One study of the connection between corruption and economic growth in 70 countries found that corruption had a significant negative impact on a country's growth rate.¹⁶

Foreign Corrupt Practices Act

A U.S. law regulating behavior regarding the conduct of international business in the taking of bribes and other unethical actions.

Convention on Combating Bribery of Foreign Public Officials in International Business Transactions

OECD convention that obliges member states to make the bribery of foreign public officials a criminal offense.



In addition to a commitment to introduce cleaner fuels and renewable energy, BP also supports urban renewal programs, art sponsorships, literacy drives, and conservation programs.

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

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

Dow Corning employees will not authorize or give payments or gifts to government employees or their beneficiaries or anyone else in order to obtain or retain business. Facilitating

payments to expedite the performance of routine services are strongly discouraged. In countries where local business practice dictates such payments and there is no alternative, facilitating payments are to be for the minimum amount necessary and must be accurately documented and recorded.¹⁷

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

MORAL OBLIGATIONS Multinational corporations have power that comes from their control over resources and their ability to move production from country to country. Although that power is constrained not only by laws and regulations, but also by the discipline of the market and the competitive process, it is nevertheless substantial. Some moral philosophers argue that with power comes the social responsibility for multinationals to give something back to the societies that enable them to prosper and grow. The concept of **social responsibility** refers to the idea that businesspeople should consider the social consequences of economic actions when making business decisions, and that there should be a presumption in favor of decisions that have both good economic and social consequences.¹⁸ In its purest form, social responsibility can be supported for its own sake simply because it is the right way for a business to behave. Advocates of this approach argue that businesses, particularly large successful businesses, need to recognize their *noblesse oblige* and give something back to the societies that have made their success possible. *Noblesse oblige* is a French term that refers to honorable and benevolent behavior considered the responsibility of people of high (noble) birth. In a business setting, it is taken to mean benevolent behavior that is the responsibility of *successful* enterprises. This has long been recognized by many businesspeople, resulting in a substantial and venerable history of

Social Responsibility

The idea that businesspeople should consider the social consequences of economic actions when making business decisions.



News Corporation in China

Rupert Murdoch built News Corporation into one of the largest media conglomerates in the world with interests that include newspapers, publishing, and television broadcasting. According to critics, however, Murdoch abused his power to gain preferential access to the Chinese media market by systematically suppressing media content that was critical of China and by publishing material designed to ingratiate the company with the Chinese leadership.

In 1994, News Corporation excluded BBC news broadcasts from Star TV coverage in the region after it had become clear that Chinese politicians were unhappy with the BBC's continual reference to repression in China, and most notably, the 1989 massacre of student protesters for democracy in Beijing's Tiananmen Square. In 1995, News Corporation's book publishing subsidiary, HarperCollins, published a flattering biography of Deng Xiaoping, the former leader of China, written by his daughter. Then in 1998, HarperCollins dropped plans to publish the memoirs of Chris Patten, the last governor of Hong Kong before its transfer to the Chinese. Patten, a critic of Chinese leaders, had aroused their wrath by attempting to introduce a degree of democracy into the administration of the old British territory before its transfer back to China in 1997.

In a 1998 interview in *Vanity Fair*, Murdoch took another opportunity to ingratiate himself with the Chinese leadership when he described the Dalai Lama, the exiled leader of Chinese-occupied Tibet, as "a very political old monk shuffling around in Gucci shoes." On the heels of this, in 2001 Murdoch's son James, who was in charge of running Star TV, made disparaging remarks about Falun Gong, a spiritual movement involving breathing exercises and meditation that had become so popular in China that the Communist

regime regarded it as a political threat and suppressed its activities. According to James Murdoch, Falun Gong was a "dangerous," "apocalyptic cult" that "clearly does not have the success of China at heart."

Critics argued that these events were all part of a deliberate effort on the part of News Corporation to curry favor with the Chinese. The company received its reward in 2001 when Star TV struck an agreement with the Chinese government to launch a Mandarin-language entertainment channel for the affluent southern coastal province of Guangdong. Earlier that year, China's leader, Jiang Zemin, had publicly praised Murdoch and Star TV for their efforts "to present China objectively and to cooperate with the Chinese press."

Once in China, News Corporation was soon tugging at the constraints imposed on it by the Chinese government. Starting in 2002, News Corp set up shell companies, owned by News Corp employees, which resold News Corp programming to local cable TV networks throughout China, in direct violation of Chinese regulations. Payments, sometimes in the form of briefcases stuffed with cash, were channeled to News Corp through the shell companies. One such deal involved selling News Corp programming through a shell company known as Runde Investments to a nationwide satellite TV channel, Qinghai Satellite, based in the remote Qinghai province of China. Runde was partly owned by the son of former hard-line Communist Party propaganda minister Ding Guangen. If News Corp was hoping that its political connections would help it to get away with these actions, it was badly disappointed. In 2005, Chinese authorities raided News Corp headquarters and seized documents and equipment. They also quickly terminated the deal with Qinghai Satellite.

Sources: Daniel Litvin, *Empires of Profit* (New York: Texere, 2003); and M. Forney, "Testing Beijing's Limits," *Time*, September 5, 2005, p. 50.

corporate giving to society and in businesses making social investments designed to enhance the welfare of the communities in which they operate.

However, there are examples of multinationals that have abused their power for private gain. The most famous historic example relates to one of the earliest multinationals, the British East India Company. Established in 1600, the East India Company grew to dominate the entire Indian subcontinent in the nineteenth century. At the height of its power, the company deployed over 40 warships, possessed the largest standing army in the world, was the de facto ruler of India's 240 million people, and even hired its own church bishops, extending its dominance into the spiritual realm.¹⁹

Power itself is morally neutral; how power is used is what matters. It can be used in a positive way to increase social welfare, which is ethical, or it can be used in a manner that is ethically and morally suspect. Consider the case of News Corporation, one of the largest media conglomerates in the world, which is profiled in the accompanying Management Focus. The power of media companies derives from their ability to

shape public perceptions by the material they choose to publish. News Corporation founder and CEO Rupert Murdoch has long considered China to be one of the most promising media markets in the world and has sought permission to expand News Corporation's operations in China, particularly the satellite broadcasting operations of Star TV. Some critics believe that Murdoch used the power of News Corporation in an unethical way to attain this objective.

Some multinationals have acknowledged a moral obligation to use their power to enhance social welfare in the communities where they do business. BP, one of the world's largest oil companies, has made it part of the company policy to undertake "social investments" in the countries where it does business.²⁰ In Algeria, BP has been investing in a major project to develop gas fields near the desert town of Salah. When the company noticed the lack of clean water in Salah, it built two desalination plants to provide drinking water for the local community and distributed containers to residents so they could take water from the plants to their homes. There was no economic reason for BP to make this social investment, but the company believes it is morally obligated to use its power in constructive ways. The action, while a small thing for BP, is a very important thing for the local community.

Ethical Dilemmas

LEARNING OBJECTIVE 2

Recognize an ethical dilemma.

The ethical obligations of a multinational corporation toward employment conditions, human rights, corruption, environmental pollution, and the use of power are not always clear-cut. There may be no agreement about accepted ethical principles. From an international business viewpoint, some argue that what is ethical depends upon one's cultural perspective.²¹ In the United States, it is considered acceptable to execute murderers, but in many cultures this is not acceptable; execution is viewed as an affront to human dignity and the death penalty is outlawed. Many Americans find this attitude very strange, but many Europeans find the American approach barbaric. For a more business-oriented example, consider the practice of "gift giving" between the parties to a business negotiation. While this is considered right and proper behavior in many Asian cultures, some Westerners view the practice as a form of bribery, and therefore unethical, particularly if the gifts are substantial.

Managers often confront very real ethical dilemmas where the appropriate course of action is not clear. For example, imagine that a visiting American executive finds that a foreign subsidiary in a poor nation has hired a 12-year-old girl to work on a factory floor. Appalled to find that the subsidiary is using child labor in direct violation of the company's own ethical code, the American instructs the local manager to replace the child with an adult. The local manager dutifully complies. The girl, an orphan, who is the only breadwinner for herself and her 6-year-old brother, is unable to find another job, so in desperation she turns to prostitution. Two years later she dies of AIDS. Meanwhile, her brother takes up begging. He encounters the American while begging outside the local McDonald's. Oblivious that this was the man responsible for his fate, the boy begs him for money. The American quickens his pace and walks rapidly past the outstretched hand into the restaurant, where he orders a quarter-pound cheeseburger with fries and a cold milk shake. A year later, the boy contracts tuberculosis and dies.

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

There is no easy answer to these questions. That is the nature of **ethical dilemmas**—they are situations in which none of the available alternatives seems ethically acceptable.²² In this case, employing child labor was not acceptable, but given that she was employed, neither was denying the child her only source of income. What the American executive needed, what all managers need, was a moral compass, or perhaps an ethical algorithm, that would guide him through such an ethical dilemma to find an acceptable solution. Later we will outline what such a moral compass, or ethical algorithm, might look like. For now, it is enough to note that ethical dilemmas exist because many real-world decisions are complex; difficult to frame; and involve first-, second-, and third-order consequences that are hard to quantify. Doing the right thing, or even knowing what the right thing might be, is often far from easy.²³

Ethical Dilemma
A situation in which none of the available alternatives seems ethically acceptable.

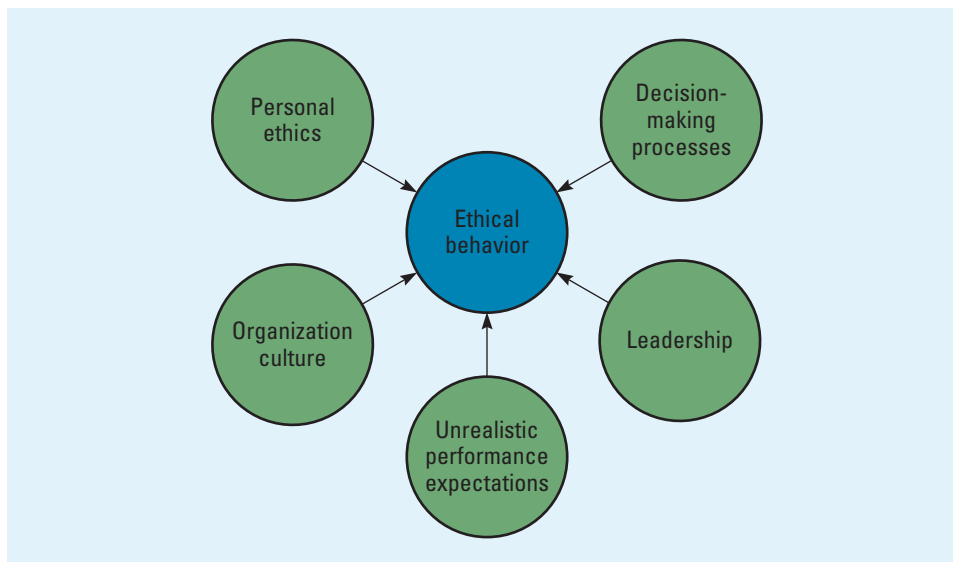
The Roots of Unethical Behavior

As we have seen, examples abound of managers behaving in a manner that might be judged unethical in an international business setting. Why do managers behave in an unethical manner? There is no simple answer to this question, for the causes are complex, but some generalizations can be made (see Figure 4.1).²⁴

LEARNING OBJECTIVE 3
Identify the causes of unethical behavior by managers.

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

Home-country managers working abroad in multinational firms (expatriate managers) may experience more than the usual degree of pressure to violate their personal



4.1 figure
Determinants of Ethical Behavior

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

DECISION-MAKING PROCESSES Several studies of unethical behavior in a business setting have concluded that businesspeople sometimes do not realize they are behaving unethically, primarily because they simply fail to ask, "Is this decision or action ethical?"²⁵ Instead, they apply a straightforward business calculus to what they perceive to be a business decision, forgetting that the decision may also have an important ethical dimension. The fault lies in processes that do not incorporate ethical considerations into business decision making. This may have been the case at Nike when managers originally made subcontracting decisions (see the earlier discussion). Those decisions were probably made based on good economic logic. Subcontractors were probably chosen based on business variables such as cost, delivery, and product quality, and the key managers simply failed to ask, "How does this subcontractor treat its workforce?" If they thought about the question at all, they probably reasoned that it was the subcontractor's concern, not theirs.

ORGANIZATION CULTURE The climate in some businesses does not encourage people to think through the ethical consequences of business decisions. This brings us to the third cause of unethical behavior in businesses—an organizational culture that deemphasizes business ethics, reducing all decisions to the purely economic. The term **organization culture** refers to the values and norms that are shared among employees of an organization. You will recall from Chapter 3 that *values* are abstract ideas about what a group believes to be good, right, and desirable, while *norms* are the social rules and guidelines that prescribe appropriate behavior in particular situations. Just as societies have cultures, so do business organizations. Together, values and norms shape the culture of a business organization, and that culture has an important influence on the ethics of business decision making.

Author Robert Bryce has explained how the organization culture at now-bankrupt multinational energy company Enron was built on values that emphasized greed and deception.²⁶ According to Bryce, the tone was set by top managers who engaged in self-dealing to enrich themselves and their own families. Bryce tells how former Enron CEO Kenneth Lay made sure his own family benefited handsomely from Enron. Much of Enron's corporate travel business was handled by a travel agency part owned by Lay's sister. When an internal auditor recommended that the company could do better by using another travel agency, the auditor soon found himself out of a job. In 1997, Enron acquired a company owned by Kenneth Lay's son, Mark Lay, which was trying to establish a business trading paper and pulp products. At the time, Mark Lay and another company he controlled were targets of a federal criminal investigation of bankruptcy fraud and embezzlement. As part of the deal, Enron hired Mark Lay as an executive with a three-year contract that guaranteed him at least \$1 million in pay

Organization Culture

The values and norms shared among an organization's employees.

over that period, plus options to purchase about 20,000 shares of Enron. Bryce also details how Lay's grown daughter used an Enron jet to transport her king-sized bed to France. With Kenneth Lay as an example, it is perhaps not surprising that self-dealing soon became endemic at Enron. The most notable example was Chief Financial Officer Andrew Fastow, who set up "off balance sheet" partnerships that not only hid Enron's true financial condition from investors, but also paid tens of millions of dollars directly to Fastow. (Fastow was subsequently indicted by the government for criminal fraud and went to jail.)

UNREALISTIC PERFORMANCE EXPECTATIONS

A fourth cause of unethical behavior has already been hinted at—it is pressure from the parent company to meet unrealistic performance goals that can be attained only by cutting corners or acting in an unethical manner. Again, Bryce discusses how this may have occurred at Enron. Lay's successor as CEO, Jeff Skilling, put a performance evaluation system in place that weeded out 15 percent of underperformers every six months. This created a pressure-cooker culture with a myopic focus on short-run performance, and some executives and energy traders responded to that pressure by falsifying their performance—inflating the value of trades, for example—to make it look as if they were performing better than was actually the case.

The lesson from the Enron debacle is that an organizational culture can legitimize behavior that society would judge as unethical, particularly when this is mixed with a focus on unrealistic performance goals, such as maximizing short-term economic performance, no matter what the costs. In such circumstances, there is a greater than average probability that managers will violate their own personal ethics and engage in unethical behavior. Conversely, an organization culture can do just the opposite and reinforce the need for ethical behavior. At Hewlett-Packard, for example, Bill Hewlett and David Packard, the company's founders, propagated a set of values known as The HP Way. These values, which shape the way business is conducted both within and by the corporation, have an important ethical component. Among other things, they stress the need for confidence in and respect for people, open communication, and concern for the individual employee.

LEADERSHIP The Enron and Hewlett-Packard examples suggest a fifth root cause of unethical behavior—leadership. Leaders help to establish the culture of an organization, and they set the example that others follow. Other employees in a business often take their cue from business leaders, and if those leaders do not behave in an ethical manner, they might not either. It is not what leaders say that matters, but what they do. Enron, for example, had a code of ethics that Kenneth Lay himself often referred to, but Lay's own actions to enrich family members spoke louder than any words.

Philosophical Approaches to Ethics

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



Enron executive Jeff Skilling has become a well-known example of corporate greed and deception.

LEARNING OBJECTIVE 4

Describe the different philosophical approaches to ethics.

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

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

The Friedman Doctrine The Nobel Prize-winning economist Milton Friedman wrote an article in 1970 that has since become a classic straw man that business ethics scholars outline only to then tear down.²⁷ Friedman's basic position is that the only social responsibility of business is to increase profits, so long as the company stays within the rules of law. He explicitly rejects the idea that businesses should undertake social expenditures beyond those mandated by the law and required for the efficient running of a business. For example, his arguments suggest that improving working conditions beyond the level required by the law *and* necessary to maximize employee productivity will reduce profits and are therefore not appropriate. His belief is that a firm should maximize its profits because that is the way to maximize the returns that accrue to the owners of the firm, its stockholders. If stockholders then wish to use the proceeds to make social investments, that is their right, according to Friedman, but managers of the firm should not make that decision for them.

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

There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say that it engages in open and free competition without deception or fraud.²⁸

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

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

Cultural Relativism
The belief that ethics are culturally determined and that firms should adopt the ethics of the cultures in which they operate.

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

should adopt the ethics of the culture in which it is operating.²⁹ This approach is often summarized by the maxim *when in Rome do as the Romans*. As with Friedman's approach, cultural relativism does not stand up to a closer look. At its extreme, cultural relativism suggests that if a culture supports slavery, it is OK to use slave labor in a country. Clearly, it is not! Cultural relativism implicitly rejects the idea that universal notions of morality transcend different cultures, but, as we shall argue later in the chapter, some universal notions of morality are found across cultures.

While dismissing cultural relativism in its most sweeping form, some ethicists argue there is residual value in this approach.³⁰ As we noted in Chapter 3, societal values and norms do vary from culture to culture, customs do differ, so it might follow that certain business practices are ethical in one country, but not another. Indeed, the facilitating payments allowed in the Foreign Corrupt Practices Act can be seen as an acknowledgment that in some countries, the payment of speed money to government officials is necessary to get business done, and if not ethically desirable, it is at least ethically acceptable.

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

Some oil product sales in Vietnam involved inappropriate commission payments to the managers of customers in return for placing orders with BP. These were stopped during 2002 with the result that BP failed to win certain tenders with potential profit totaling \$300k. In addition, two sales managers resigned over the issue. The business, however, has recovered using more traditional sales methods and has exceeded its targets at year-end.³¹

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

The Righteous Moralist Righteous moralism contends that a multinational's home-country standards of ethics are the appropriate ones for companies to follow in foreign countries. This approach is typically associated with managers from developed nations. While this seems reasonable at first blush, the approach can create problems. Consider the following example: An American bank manager was sent to Italy and was appalled to learn that the local branch's accounting department recommended grossly underreporting the bank's profits for income tax purposes.³² The manager insisted that the bank report its earnings accurately, American style. When he was called by the Italian tax department to the firm's tax hearing, he was told the firm owed three times as much tax as it had paid, reflecting the department's standard assumption that each



Another Perspective

Child Labor: India's Ethical Dilemma

As India strives to become an industrialized nation, it faces an ethical dilemma: tens of millions of its workers are children. While most countries regard child labor as unacceptable, the practice is legal in India, and families depend on their child's earnings for survival.

After the government banned children under 14 from holding certain hazardous jobs, the changes in the law forced many children "underground"—into jobs where monitoring is more difficult and where they may suffer abuse and neglect. The prospect of children on the production floor represents a huge concern for U.S. manufacturers with plants in India.

Believing it will take time to eliminate child labor, advocacy groups in India argue that the government should instead support and protect child workers. (Laurie Goering, "Ending Child Labor Tricky Job for India," *Chicago Tribune*, April 17, 2008, www.chicagotribune.com)

Righteous Moralism

The belief that a multinational's home-country standards of ethics are the appropriate ones for companies to follow in foreign countries.

firm underreports its earnings by two-thirds. Despite his protests, the new assessment stood. In this case, the righteous moralist has run into a problem caused by the prevailing cultural norms in the country where he is doing business. How should he respond? The righteous moralist would argue for maintaining the position, while a more pragmatic view might be that in this case, the right thing to do is to follow the prevailing cultural norms, since there is a big penalty for not doing so.

The main criticism of the righteous moralist approach is that its proponents go too far. While there are some universal moral principles that should not be violated, it does not always follow that the appropriate thing to do is adopt home-country standards. For example, U.S. laws set strict guidelines with regard to minimum wage and working conditions. Does this mean it is ethical to apply the same guidelines in a foreign country, paying people the same as they are paid in the United States, providing the same benefits and working conditions? Probably not, because doing so might nullify the reason for investing in that country and therefore deny locals the benefits of inward investment by the multinational. Clearly, a more nuanced approach is needed.

Naïve Immoralism

The belief that if a manager of a multinational sees that firms from other nations are not following ethical norms in a host nation, that manager should not either.

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

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

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

UTILITARIAN AND KANTIAN ETHICS In contrast to the straw men just discussed, most moral philosophers see value in utilitarian and Kantian approaches to business ethics. These approaches were developed in the eighteenth and nineteenth

centuries and although they have been largely superseded by more modern approaches, they form part of the tradition upon which newer approaches have been constructed.

The utilitarian approach to business ethics dates to philosophers such as David Hume (1771–1776), Jeremy Bentham (1784–1832), and John Stuart Mill (1806–1873). **Utilitarian approaches** to ethics hold that the moral worth of actions or practices is determined by their consequences.³³ An action is judged desirable if it leads to the best possible balance of good consequences over bad consequences. Utilitarianism is committed to the maximization of good and the minimization of harm. Utilitarianism recognizes that actions have multiple consequences, some of which are good in a social sense and some of which are harmful. As a philosophy for business ethics, it focuses attention on the need to weigh carefully all of the social benefits and costs of a business action and to pursue only those actions where the benefits outweigh the costs. The best decisions, from a utilitarian perspective, are those that produce the greatest good for the greatest number of people.

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

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

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

Kantian ethics are based on the philosophy of Immanuel Kant (1724–1804). **Kantian ethics** hold that people should be treated as ends and never purely as *means* to the ends of others. People are not instruments, like a machine. People have dignity and need to be respected as such. Employing people in sweatshops, making them work long hours for low pay in poor work conditions, is a violation of ethics, according to Kantian philosophy, because it treats people as mere cogs in a machine and not as conscious moral beings that have dignity. Although contemporary moral

Utilitarian Approaches

These approaches to ethics hold that the moral worth of actions or practices is determined by their consequences.

Kantian ethics

The belief that people should be treated as ends and never as means to the ends of others.

philosophers tend to view Kant's ethical philosophy as incomplete—for example, his system has no place for moral emotions or sentiments such as sympathy or caring—the notion that people should be respected and treated with dignity still resonates in the modern world.

Rights Theories

Twentieth century theories that recognize human beings have fundamental rights and privileges that transcend national boundaries and cultures.

RIGHTS THEORIES Developed in the twentieth century, **rights theories** recognize that human beings have fundamental rights and privileges that transcend national boundaries and cultures. Rights establish a minimum level of morally acceptable behavior. One well-known definition of a fundamental right construes it as something that takes precedence over or “trumps” a collective good. Thus, we might say that the right to free speech is a fundamental right that takes precedence over all but the most compelling collective goals and overrides, for example, the interest of the state in civil harmony or moral consensus.³⁴ Moral theorists argue that fundamental human rights form the basis for the *moral compass* that managers should navigate by when making decisions that have an ethical component. More precisely, they should not pursue actions that violate these rights.

The notion that there are fundamental rights that transcend national borders and cultures was the underlying motivation for the United Nations **Universal Declaration of Human Rights**, which has been ratified by almost every country on the planet and lays down basic principles that should always be adhered to irrespective of the culture in which one is doing business.³⁵ Echoing Kantian ethics, Article 1 of this declaration states:

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

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

Everyone has the right to work, to free choice of employment, to just and favorable conditions of work, and to protection against unemployment.

Everyone, without any discrimination, has the right to equal pay for equal work.

Everyone who works has the right to just and favorable remuneration ensuring for himself and his family an existence worthy of human dignity, and supplemented, if necessary, by other means of social protection.

Everyone has the right to form and to join trade unions for the protection of his interests.

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

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

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

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

Universal Declaration of Human Rights

A United Nations document that lays down the basic principles of human rights that should always be adhered to.

person or institution that is capable of moral action such as a government or corporation).

For example, to escape the high costs of toxic waste disposal in the West, in the late 1980s several firms shipped their waste in bulk to African nations, where it was disposed of at a much lower cost. In 1987, five European ships unloaded toxic waste containing dangerous poisons in Nigeria. Workers wearing sandals and shorts unloaded the barrels for \$2.50 a day and placed them in a dirt lot in a residential area. They were not told about the contents of the barrels.³⁶ Who bears the obligation for protecting the rights of workers and residents to safety in a case like this? According to rights theorists, the obligation rests not on the shoulders of one moral agent, but on the shoulders of all moral agents whose actions might harm or contribute to the harm of the workers and residents. Thus, it was the obligation not just of the Nigerian government but also of the multinational firms that shipped the toxic waste to make sure it did no harm to residents and workers. In this case, both the government and the multinationals apparently failed to recognize their basic obligation to protect the fundamental human rights of others.

JUSTICE THEORIES Justice theories focus on the attainment of a just distribution of economic goods and services. A **just distribution** is one that is considered fair and equitable. There is no one theory of justice, and several theories of justice conflict with each other in important ways.³⁷ Here we shall focus on one particular theory of justice that is both very influential and has important ethical implications. The theory is attributed to philosopher John Rawls.³⁸ Rawls argues that all economic goods and services should be distributed equally except when an unequal distribution would work to everyone's advantage.

According to Rawls, valid principles of justice are those with which all persons would agree if they could freely and impartially consider the situation. Impartiality is guaranteed by a conceptual device that Rawls calls the *veil of ignorance*. Under the veil of ignorance, everyone is imagined to be ignorant of all of his or her particular characteristics, for example, race, sex, intelligence, nationality, family background, and special talents. Rawls then asks what system people would design under a veil of ignorance. Under these conditions, people would unanimously agree on two fundamental principles of justice.

The first principle is that each person be permitted the maximum amount of basic liberty compatible with a similar liberty for others. Rawls takes these to be political liberty (e.g., the right to vote), freedom of speech and assembly, liberty of conscience and freedom of thought, the freedom and right to hold personal property, and freedom from arbitrary arrest and seizure.

The second principle is that once equal basic liberty is assured, inequality in basic social goods—such as income and wealth distribution, and opportunities—is to be allowed *only* if such inequalities benefit everyone. Rawls accepts that inequalities can be just if the system that produces inequalities is to the advantage of everyone. More precisely, he formulates what he calls the *difference principle*, which is that inequalities are justified if they benefit the position of the least-advantaged person. So, for example, wide variations in income and wealth can be considered just if the market-based



Another Perspective

Cyber-Freedom in China

Nearly 400 million surf the Web in China, and the number continues to grow. That's a market too huge for Google to ignore. However, the Chinese government censors Internet use—a practice Google refused to tolerate, so it closed its Beijing headquarters and rerouted search traffic through Hong Kong, where censorship is not practiced. Secretary of State Hillary Clinton has characterized Internet freedom as a universal right, but is it? Such freedom is a widely held value in North America, South America, and Europe. In China, reaction to Google's departure has been mixed, perhaps because Chinese search engine Baidu is more popular. (Bruce Nussbaum, "Internet Freedom Is Not a Universal Value, Secretary of State Hillary Clinton," *BusinessWeek*, January 22, 2010, <http://www.businessweek.com>)

Just Distribution

A distribution of economic goods and services that is considered fair and equitable.



Another Perspective

Ethical Analysis: *In a Different Voice*

In addition to utilitarian, Kantian, rights, and justice approaches to business ethics, Carol Gilligan offers another way to think about our moral actions: as a series of caring relationships that evolve over time, focused first on the self, then on dependent others, and finally, on establishing equality of needs between self and others so that dynamic relationships can replace dependent ones. Such an approach (self, dependent other, dynamic equality) may be a helpful way of thinking about a multinational's evolving corporate involvement in a developing country. (Carol Gilligan, *In a Different Voice*, 1982)

system that produces this unequal distribution also benefits the least-advantaged members of society. One can argue that a well-regulated, market-based economy and free trade, by promoting economic growth, benefit the least-advantaged members of society. In principle at least, the inequalities inherent in such systems are therefore just (in other words, the rising tide of wealth created by a market-based economy and free trade lifts all boats, even those of the most disadvantaged).

In the context of international business ethics, Rawls's theory creates an interesting perspective. Managers could ask themselves whether the policies they adopt in foreign operations would be considered just under Rawls's veil of ignorance. Is it just, for example, to pay foreign workers less than

workers in the firm's home country? Rawls's theory would suggest it is, so long as the inequality benefits the least-advantaged members of the global society (which is what economic theory suggests). Alternatively, it is difficult to imagine that managers operating under a veil of ignorance would design a system where foreign employees were paid subsistence wages to work long hours in sweatshop conditions and where they were exposed to toxic materials. Such working conditions are clearly unjust in Rawls's framework, and therefore, it is unethical to adopt them. Similarly, operating under a veil of ignorance, most people would probably design a system that imparts some protection from environmental degradation to important global commons, such as the oceans, atmosphere, and tropical rain forests. To the extent that this is the case, it follows that it is unjust, and by extension unethical, for companies to pursue actions that contribute toward extensive degradation of these commons. Thus, Rawls's veil of ignorance is a conceptual tool that contributes to the moral compass that managers can use to help them navigate through difficult ethical dilemmas.



Focus on Managerial Implications

LEARNING OBJECTIVE 5

Explain how managers can incorporate ethical considerations into their decision making.

What then is the best way for managers in a multinational firm to make sure that ethical considerations figure into international business decisions? How do managers decide upon an ethical course of action when confronted with decisions pertaining to working conditions, human rights, corruption, and environmental pollution? From an ethical perspective, how do managers determine the moral obligations that flow from the power of a multinational? In many cases, there are no easy answers to these questions, for many of the most vexing ethical problems arise because there are very real dilemmas inherent in them and no obvious correct action. Nevertheless, managers can and should do many things to make sure that basic ethical principles are adhered to and that ethical issues are routinely inserted into international business decisions.

Here we focus on five things that an international business and its managers can do to make sure ethical issues are considered in business decisions. These are (1) favor hiring and promoting people with a well-grounded sense of personal ethics; (2) build an organizational culture that places a high value on ethical behavior; (3) make sure that leaders within the business not only articulate the rhetoric of ethical behavior, but also act in a manner that is consistent with that rhetoric; (4) put decision-making processes in place that require people to consider the ethical dimension of business decisions; and (5) develop moral courage.

Hiring and Promotion

It seems obvious that businesses should strive to hire people who have a strong sense of personal ethics and would not engage in unethical or illegal behavior. Similarly, you would not expect a business to promote people, and perhaps to fire people, whose behavior does not match generally accepted ethical standards. However, actually doing so is very difficult. How do you know that someone has a poor sense of personal ethics? In our society, we have an incentive to hide a lack of personal ethics from public view. Once people realize that you are unethical, they will no longer trust you.

Is there anything that businesses can do to make sure they do not hire people who subsequently turn out to have poor personal ethics, particularly given that people have an incentive to hide this from public view (indeed, the unethical person may lie about his or her nature)? Businesses can give potential employees psychological tests to try to discern their ethical predisposition, and they can check with prior employees regarding someone's reputation (e.g., by asking for letters of reference and talking to people who have worked with the prospective employee). The latter is common and does influence the hiring process. Promoting people who have displayed poor ethics should not occur in a company where the organization culture values the need for ethical behavior and where leaders act accordingly.

Not only should businesses strive to identify and hire people with a strong sense of personal ethics, but it also is in the interests of prospective employees to find out as much as they can about the ethical climate in an organization. Who wants to work at a multinational such as Enron, which ultimately entered bankruptcy because unethical executives had established risky partnerships that were hidden from public view and that existed in part to enrich those same executives? Table 4.1 lists questions job seekers might want to ask a prospective employer.

Some probing questions to ask about a prospective employer:

1. Is there a formal code of ethics? How widely is it distributed? Is it reinforced in other formal ways such as through decision-making systems?
2. Are workers at all levels trained in ethical decision making? Are they also encouraged to take responsibility for their behavior or to question authority when asked to do something they consider wrong?
3. Do employees have formal channels available to make their concerns known confidentially? Is there a formal committee high in the organization that considers ethical issues?
4. Is misconduct disciplined swiftly and justly within the organization?
5. Is integrity emphasized to new employees?
6. How are senior managers perceived by subordinates in terms of their integrity? How do such leaders model ethical behavior?

4.1 table

A Job Seeker's Ethics Audit

Source: Linda K. Trevino, chair of the Department of Management and Organization, Smeal College of Business, Pennsylvania State University. Reported in K. Maher, "Career Journal: Wanted: Ethical Employer," *The Wall Street Journal*, July 9, 2002, p. B1.

Organization Culture and Leadership

Code of Ethics

A business's formal statement of ethical priorities.

To foster ethical behavior, businesses need to build an organization culture that values ethical behavior. Three things are particularly important in building an organization culture that emphasizes ethical behavior. First, the businesses must explicitly articulate values that emphasize ethical behavior. Many companies now do this by drafting a **code of ethics**, which is a formal statement of the ethical priorities a business adheres to. Often, the code of ethics draws heavily upon documents such as the UN Universal Declaration of Human Rights, which itself is grounded in Kantian and rights-based theories of moral philosophy. Others have incorporated ethical statements into documents that articulate the values or mission of the business. For example, the food and consumer products multinational Unilever has a code of ethics that includes the following points:³⁹

Employees: Unilever is committed to diversity in a working environment where there is mutual trust and respect and where everyone feels responsible for the performance and reputation of our company. We will recruit, employ, and promote employees on the sole basis of the qualifications and abilities needed for the work to be performed. We are committed to safe and healthy working conditions for all employees. We will not use any form of forced, compulsory, or child labor. We are committed to working with employees to develop and enhance each individual's skills and capabilities. We respect the dignity of the individual and the right of employees to freedom of association. We will maintain good communications with employees through company-based information and consultation procedures.

Business Integrity: Unilever does not give or receive, whether directly or indirectly, bribes or other improper advantages for business or financial gain. No employee may offer, give, or receive any gift or payment which is, or may be construed as being, a bribe. Any demand for, or offer of, a bribe must be rejected immediately and reported to management. Unilever accounting records and supporting documents must accurately describe and reflect the nature of the underlying transactions. No undisclosed or un-recorded account, fund, or asset will be established or maintained.

It is clear from these principles, that among other things, Unilever will not tolerate substandard working conditions, use child labor, or give bribes under any circumstances. Note also the reference to respecting the dignity of employees, a statement that is grounded in Kantian ethics. Unilever's principles send a very clear message about appropriate ethics to managers and employees.

Having articulated values in a code of ethics or some other document, leaders in the business must give life and meaning to those words by repeatedly emphasizing their importance *and then acting on them*. This means using every relevant opportunity to stress the importance of business ethics and making sure that key business decisions not only make good economic sense but also are ethical. Many companies have gone a step further, hiring independent auditors to make sure they are behaving in a manner consistent with their ethical codes. Nike, for example, has hired independent auditors to make sure subcontractors used by the company are living up to Nike's code of conduct.



Another Perspective

How "Fair Trade" Makes Business "Fair"

Like many breakfast eaters, you probably enjoy bananas on your morning cereal. But do you ever think about who grew those bananas? Increasingly, consumers are paying attention to the sources of their food. Massachusetts-based Oké USA imports "fair trade" organic bananas and sells them to grocers such as Whole Foods Market and Stop & Shop. Oké buys produce from grower cooperatives in Ecuador, paying the farmers a fair, internationally predetermined price that affords them a living wage. The price of Oké bananas is structured to ensure that the bulk of the profits stays in the country of origin and helps develop the nation's economy. (Robert Knox, "Fair Trade Importer Says It's Ripe for Success," *Boston.com*, January 4, 2010, <http://www.boston.com>)

Finally, building an organization culture that places a high value on ethical behavior requires incentive and reward systems, including promotions that reward people who engage in ethical behavior and sanction those who do not. At General Electric, for example, the former CEO Jack Welch has described how he reviewed the performance of managers, dividing them into several groups. These included over-performers who displayed the right values and were singled out for advancement and bonuses and over-performers who displayed the wrong values and were let go. Welch was not willing to tolerate leaders within the company who did not act in accordance with the central values of the company, even if they were in all other respects skilled managers.⁴⁰

Decision-Making Processes

In addition to establishing the right kind of ethical culture in an organization, businesspeople must be able to think through the ethical implications of decisions in a systematic way. To do this, they need a moral compass, and both rights theories and Rawls's theory of justice help to provide such a compass. Beyond these theories, some experts on ethics have proposed a straightforward practical guide—or ethical algorithm—to determine whether a decision is ethical.⁴¹ According to these experts, a decision is acceptable on ethical grounds if a businessperson can answer yes to each of these questions:

- Does my decision fall within the accepted values or standards that typically apply in the organizational environment (as articulated in a code of ethics or some other corporate statement)?
- Am I willing to see the decision communicated to all stakeholders affected by it—for example, by having it reported in newspapers or on television?
- Would the people with whom I have a significant personal relationship, such as family members, friends, or even managers in other businesses, approve of the decision?

Others have recommended a five-step process to think through ethical problems (this is another example of an ethical algorithm).⁴² In step one, businesspeople should identify which stakeholders a decision would affect and in what ways. A firm's **stakeholders** are individuals or groups that have an interest, claim, or stake in the company, in what it does, and in how well it performs.⁴³ They can be divided into internal stakeholders and external stakeholders. **Internal stakeholders** are individuals or groups who work for or own the business. They include all employees, the board of directors, and stockholders. **External stakeholders** are all other individuals and groups that have some claim on the firm. Typically, this group comprises customers, suppliers, lenders, governments, unions, local communities, and the general public.

All stakeholders are in an exchange relationship with the company. Each stakeholder group supplies the organization with important resources (or contributions), and in exchange each expects its interests to be satisfied (by inducements).⁴⁴ For example, employees provide labor, skills, knowledge, and time and in exchange expect commensurate income, job satisfaction, job security, and good working conditions. Customers provide a company with its revenues and in exchange they want quality products that represent value for money. Communities provide businesses with local infrastructure and in exchange they want businesses that are responsible citizens and seek some assurance that the quality of life will be improved as a result of the business firm's existence.

Stakeholder analysis involves a certain amount of what has been called *moral imagination*.⁴⁵ This means standing in the shoes of a stakeholder and asking how a proposed decision might impact that stakeholder. For example, when considering outsourcing to subcontractors, managers might need to ask themselves how it might feel to be working under substandard health conditions for long hours.

Stakeholders

The individuals or groups that have an interest, stake, or claim in the actions and overall performance of a company.

Internal Stakeholders

People who work for or own the business, such as employees, directors, and stockholders.

External Stakeholders

The individuals and groups that have some claim on the firm, such as customers, suppliers, and unions.



Another Perspective

How Do You Know What Is Really Happening? Giving Meaning across Cultures

One of the difficulties in making ethical decisions across cultural borders is that expatriate managers may tend to interpret a local cultural practice in the ways such behavior would be understood in their home culture. If the manager's process of meaning-giving stops there, rather than continue in an attempt to understand the practice's meaning *in the local culture*, the manager may miss a huge step in ethical analysis. For example, if women's covering their heads and faces in conservative Muslim cultures is given meaning in a Western context, it would lead to different conclusions than were it given meaning with knowledge of the specific, local, Muslim context. Remember to consider context when conducting an ethical analysis. In such a process, a local informant can be helpful. At the same time, be aware of the ethical trap of cultural relativism. (Example from H. Lane, M. Maznevski, M. Mendenhall, and J. McNett, *The Blackwell Handbook of Global Management: A Guide to Managing Complexity* [New York: John Wiley & Sons, Inc., 2004])

Step two involves judging the ethics of the proposed strategic decision, given the information gained in step one. Managers need to determine whether a proposed decision would violate the *fundamental rights* of any stakeholders. For example, we might argue that the right to information about health risks in the workplace is a fundamental entitlement of employees. Similarly, the right to know about potentially dangerous features of a product is a fundamental entitlement of customers (something tobacco companies violated when they did not reveal to their customers what they knew about the health risks of smoking). Managers might also want to ask themselves whether they would allow the proposed strategic decision if they were designing a system under Rawls's veil of ignorance. For example, if the issue under consideration was whether to outsource work to a subcontractor with low pay and poor working conditions, managers might want to ask themselves whether they would allow such action if they were considering it under a veil of ignorance, where they themselves might ultimately be the ones to work for the subcontractor.

The judgment at this stage should be guided by various moral principles that should not be violated. The principles might be those articulated in a corporate code of ethics or other company documents. In addition, certain moral principles that we have adopted as members of society—for instance, the prohibition on stealing—should not be violated. The judgment at this stage will also be guided by the decision rule that is chosen to assess the proposed strategic decision. Although maximizing long-run profitability is the decision rule that most businesses stress, it should be applied subject to the constraint that no moral principles are violated—that the business behaves in an ethical manner.

Step three requires managers to establish moral intent. This means the business must resolve to place moral concerns ahead of other concerns in cases where either the fundamental rights of stakeholders or key moral principles have been violated. At this stage, input from top management might be particularly valuable. Without the proactive encouragement of top managers, middle-level managers might tend to place the narrow economic interests of the company before the interests of stakeholders. They might do so in the (usually erroneous) belief that top managers favor such an approach.

Step four requires the company to engage in ethical behavior. Step five requires the business to audit its decisions, reviewing them to make sure they were consistent with ethical principles, such as those stated in the company's code of ethics. This final step is critical and often overlooked. Without auditing past decisions, businesspeople may not know if their decision process is working and if changes should be made to ensure greater compliance with a code of ethics.

Ethics Officers

To make sure that a business behaves in an ethical manner, a number of firms now have ethics officers. These individuals are responsible for making sure that all employees are trained to be ethically aware, that ethical considerations enter the

business decision-making process, and that the company's code of ethics is followed. Ethics officers may also be responsible for auditing decisions to make sure they are consistent with this code. In many businesses, ethics officers act as an internal ombudsperson with responsibility for handling confidential inquiries from employees, investigating complaints from employees or others, reporting findings, and making recommendations for change.

For example, United Technologies, a multinational aerospace company with worldwide revenues of more than \$30 billion, has had a formal code of ethics since 1990.⁴⁶ United Technologies has some 160 business practice officers (this is the company's name for ethics officers). They are responsible for making sure the code is followed. United Technologies also established an ombudsperson program in 1986 that lets employees inquire anonymously about ethics issues. The program has received some 60,000 inquiries since 1986, and over 10,000 cases have been handled by an ombudsperson.



United Technologies, the maker of Sikorsky helicopters, demonstrates its commitment to ethical behavior by employing over 160 business practices officers.

Moral Courage

Finally, it is important to recognize that employees in an international business may need significant *moral courage*. Moral courage enables managers to walk away from a decision that is profitable, but unethical. Moral courage gives an employee the strength to say no to a superior who instructs her to pursue actions that are unethical. Moral courage gives employees the integrity to go public to the media and blow the whistle on persistent unethical behavior in a company. Moral courage does not come easily; there are well-known cases where individuals have lost their jobs because they blew the whistle on corporate behaviors they thought unethical, telling the media about what was occurring.⁴⁷

However, companies can strengthen the moral courage of employees by committing themselves to not retaliate against employees who exercise moral courage, say no to superiors, or otherwise complain about unethical actions. For example, consider the following extract from Unilever's code of ethics:

Any breaches of the Code must be reported in accordance with the procedures specified by the Joint Secretaries. The Board of Unilever will not criticize management for any loss of business resulting from adherence to these principles and other mandatory policies and instructions. The Board of Unilever expects employees to bring to their attention, or to that of senior management, any breach or suspected breach of these principles. Provision has been made for employees to be able to report in confidence and no employee will suffer as a consequence of doing so.⁴⁸

This statement gives permission to employees to exercise moral courage. Companies can also set up ethics hotlines, which allow employees to anonymously register a complaint with a corporate ethics officer.

Summary of Decision-Making Steps

All of the steps discussed here—hiring and promoting people based upon ethical considerations as well as more traditional metrics of performance, establishing an ethical culture in the organization, instituting ethical decision-making processes, appointing

ethics officers, and creating an environment that facilitates moral courage—can help to make sure that when making business decisions, managers are cognizant of the ethical implications and do not violate basic ethical prescriptions. At the same time, it must be recognized that not all ethical dilemmas have a clean and obvious solution—that is why they are dilemmas. There are clearly things that international businesses should not do and there are things that they should do but there are also actions that present managers with true dilemmas. In these cases, a premium is placed on managers' ability to make sense out of complex situations and make balanced decisions that are as just as possible.

Key Terms

business ethics, p. 130

ethical strategy, p. 130

Foreign Corrupt Practices Act,
p. 137

Convention on Combating Bribery
of Foreign Public Officials in
International Business Transactions,
p. 137

social responsibility, p. 138

ethical dilemma, p. 141

organization culture, p. 142

cultural relativism, p. 144

righteous moralism, p. 145

naïve immoralism, p. 146

utilitarian approaches, p. 147

Kantian ethics, p. 147

rights theories, p. 148

Universal Declaration of Human
Rights, p. 148

just distribution, p. 149

code of ethics, p. 152

stakeholders, p. 153

internal stakeholders, p. 153

external stakeholders, p. 153

Summary

This chapter has discussed the source and nature of ethical issues in international businesses, the different philosophical approaches to business ethics, and the steps managers can take to ensure that ethical issues are respected in international business decisions. The chapter made the following points:

1. The term *ethics* refers to accepted principles of right or wrong that govern the conduct of a person, the members of a profession, or the actions of an organization. Business ethics are the accepted principles of right or wrong governing the conduct of businesspeople, and an ethical strategy is one that does not violate these accepted principles.
2. Ethical issues and dilemmas in international business are rooted in the variations among political systems, law, economic development, and culture from nation to nation.
3. The most common ethical issues in international business involve employment practices, human rights, environmental regulations, corruption, and the moral obligation of multinational corporations.
4. Ethical dilemmas are situations in which none of the available alternatives seems ethically acceptable.
5. Unethical behavior is rooted in poor personal ethics, the psychological and geographical distances of a foreign subsidiary from the home office, a failure to incorporate ethical issues into strategic and operational decision making, a dysfunctional culture, and failure of leaders to act in an ethical manner.
6. Moral philosophers contend that approaches to business ethics such as the Friedman doctrine, cultural relativism, the righteous moralist, and the naive immoralist are unsatisfactory in important ways.
7. The Friedman doctrine states that the only social responsibility of business is to increase profits, as long as the company stays within the rules of law. Cultural relativism contends that

- one should adopt the ethics of the culture in which one is doing business. The righteous moralist monolithically applies home-country ethics to a foreign situation, while the naive immoralist believes that if a manager of a multinational sees that firms from other nations are not following ethical norms in a host nation, that manager should not either.
8. Utilitarian approaches to ethics hold that the moral worth of actions or practices is determined by their consequences, and the best decisions are those that produce the greatest good for the greatest number of people.
 9. Kantian ethics state that people should be treated as ends and never purely as *means* to the ends of others. People are not instruments, like a machine. People have dignity and need to be respected as such.
 10. Rights theories recognize that human beings have fundamental rights and privileges that transcend national boundaries and cultures.
- These rights establish a minimum level of morally acceptable behavior.
11. The concept of justice developed by John Rawls suggests that a decision is just and ethical if people would allow for it when designing a social system under a veil of ignorance.
 12. To make sure that ethical issues are considered in international business decisions, managers should (a) favor hiring and promoting people with a well-grounded sense of personal ethics; (b) build an organization culture that places a high value on ethical behavior; (c) make sure that leaders within the business not only articulate the rhetoric of ethical behavior, but also act in a manner that is consistent with that rhetoric; (d) put decision-making processes in place that require people to consider the ethical dimension of business decisions; and (e) be morally courageous and encourage others to do the same.

Critical Thinking and Discussion Questions

1. A visiting American executive finds that a foreign subsidiary in a poor nation has hired a 12-year-old girl to work on a factory floor, in violation of the company's prohibition on child labor. He tells the local manager to replace the child and tell her to go back to school. The local manager tells the American executive that the child is an orphan with no other means of support, and she will probably become a street child if she is denied work. What should the American executive do?
2. Drawing upon John Rawls's concept of the veil of ignorance, develop an ethical code that will (a) guide the decisions of a large oil multinational toward environmental protection, and (b) influence the policies of a clothing company to outsourcing of the manufacturing process.
3. Under what conditions is it ethically defensible to outsource production to the developing world where labor costs are lower when such actions also involve laying off long-term employees in the firm's home country?
4. Are facilitating payments ethical?
5. A manager from a developing country is overseeing a multinational's operations in a country where drug trafficking and lawlessness are rife. One day, a representative of a local "big man" approaches the manager and asks for a "donation" to help the "big man" provide housing for the poor. The representative tells the manager that in return for the donation, the "big man" will make sure that the manager has a productive stay in his country. No threats are made, but the manager is well aware that the "big man" heads a criminal organization that is engaged in drug trafficking. He also knows that the big man does indeed help the poor in the run-down neighborhood of the city where he was born. What should the manager do?
6. Reread the Management Focus feature on Unocal and answer the following questions:
 - a. Was it ethical for Unocal to enter into a partnership with a brutal military dictatorship for financial gain?
 - b. What actions could Unocal have taken, short of not investing, to safeguard the human rights of people impacted by the gas pipeline project?

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

1. The Organization for Economic Cooperation and Development (OECD) *Guidelines for Multinational Enterprises* is a set of voluntary principles and standards for responsible business conduct addressed by governments for multinational enterprises. The guidelines provide recommendations in a number of areas including labor relations, the environment, bribery, competition, and taxation. Find the text of the guidelines and prepare an outline of the guidelines in the area of employment and industrial relations.
2. The *Corruption Perceptions Index* (CPI) is a comparative assessment of integrity performance in a variety of countries. Provide a description of this index and its ranking. Identify the five countries with the lowest and the highest CPI scores. Do you notice any trends or similarities among the countries listed?



closing case

Siemens Bribery Scandal

In December 2008 Siemens, the large German electronics firm, agreed to pay \$1.6 billion in fines to settle legal suits bought by the American and German governments. The governments asserted that Siemens had used bribes to win business in countries around the world. These were the largest fines ever levied against a company for bribes, reflecting the scale of the problem at Siemens. Since 1999, the company had apparently paid some \$1.4 billion in bribes. In Bangladesh, Siemens paid \$5 million to the son of the prime minister to win a mobile phone contract. In Nigeria, it paid \$12.7 million to various officials to win government telecommunications contracts. In Argentina, Siemens paid at least \$40 million in bribes to win a \$1 billion contract to produce national identity cards. In Israel, the company “provided” \$20 million to senior government officials in order to win a contract to build power plants. In China, it paid \$14 million to government officials to win a contract to supply medical equipment. And so on.

Corruption at Siemens was apparently deeply embedded in the business culture. Before 1999, bribery of foreign officials was not illegal in Germany; bribes could be deducted as a business expense under the German tax code. In this permissive environment, Siemens subscribed to the straightforward rule of adhering to local practices. If bribery was common in a country, Siemens would routinely use bribes to win business. Inside Siemens, bribes were referred to as “useful money.”

When the German law changed in 1999, Siemens carried on as before, but put in place elaborate mechanisms to hide what it was doing. Money was transferred into hard-to-trace bank

accounts in Switzerland. These funds were then used to hire an outside “consultant” to help win a contract. The consultant would deliver the cash to the ultimate recipient, typically a government official. Siemens apparently had more than 2,700 such consultants worldwide. Bribes, which were viewed as a cost of doing business, typically ranged between 5 and 6 percent of a contract’s value, although in corrupt countries bribes could be as much as 40 percent of the value of a contract. In justifying this behavior, one former Siemens employee stated, “It was about keeping the business alive and not jeopardizing thousands of jobs overnight.” But the practice left behind angry competitors who were shut out of contracts and local residents in poor countries who paid too much for government services because of rigged deals. Moreover, by engaging in bribery, Siemens helped to foster a culture of corruption in those countries where it made illegal payouts.

During this period, Siemens put in place a formal process for monitoring payments to make sure no illegal payments were made. Senior executives even made some of the individuals responsible for managing the bribery funds sign compliance forms stating they had not engaged in any such activity, while knowing this was not the case.

This scheme began to collapse at Siemens when investigators in several countries started to examine suspicious transactions. Prosecutors in Italy, Liechtenstein, and Switzerland sent requests for help to counterparts in Germany, providing a list of Siemens employees who were implicated in making illegal payments. In late 2006 the German police

raided the company, seizing data and arresting several executives. Soon afterward, the United States started to look into these charges. Since Siemens had a listing on the New York Stock Exchange, the company had to adhere to the Foreign Corrupt Practices Act, which outlaws payments to government officials to win contracts. In total, Siemens had to pay not only \$1.6 billion in fines, but also commit to spending another \$1 billion to improve its internal compliance process, while several executives went to jail.

Sources: S. Schubert and C. Miller, "Where Bribery Was Just a Line Item," *The New York Times*, December 21, 2008, p. B1; J. Ewing, "Siemens Braces for a Slap from Uncle Sam," *BusinessWeek*, November 11, 2007, pp. 78–79; and J. Ewing, "Siemens Settlement: Relief, but Is It Over?" *BusinessWeek*, December 12, 2008, p. 8.

Case Discussion Questions

1. What explains the high level of corruption at Siemens? How did managers engaged in corruption rationalize it?
2. What do you think would have happened to a manager at Siemens if he or she had taken a stand against corrupt practices?
3. How does the kind of corruption Siemens engaged in distort competition?
4. What is the impact of corrupt behavior by Siemens on the countries where it does business?
5. If you were a manager at Siemens, and you became aware of these activities, what would you have done?



part 3

Cross-Border Trade and Investment

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Understand why nations trade with each other.
- 2 Summarize the different theories explaining trade flows between nations.
- 3 Recognize why many economists believe that unrestricted free trade between nations will raise the economic welfare of countries that participate in a free trade system.
- 4 Explain the arguments of those who maintain that government can play a proactive role in promoting national competitive advantage in certain industries.
- 5 Understand the important implications that international trade theory holds for business practice.

International Trade Theory

Bangladesh's Textile Trade

opening case

Bangladesh, one of the world's poorest countries, has long depended heavily upon exports of textile products to generate income, employment, and economic growth. Most of these exports are low-cost finished garments sold to Western mass-market retailers, such as Walmart. For decades, Bangladesh was able to take advantage of a quota system for textile exports that gave it, and other poor countries, preferential access to rich markets such as the United States and the European Union. On January 1, 2005, however, that system was scrapped in favor of one that was based on free trade principles. From that point on, exporters in Bangladesh would have to compete for business against producers from other nations such as China and Indonesia. Many analysts predicted the quick collapse of Bangladesh's textile industry. They predicted a sharp jump in unemployment, a decline in the country's balance of payments accounts, and a negative impact upon economic growth.

The collapse didn't happen. On the contrary, Bangladesh's exports of textiles continued to grow, even as the rest of the world plunged into an economic crisis in 2008. Bangladesh's exports of garments rose to \$10.7 billion in 2008, up from \$9.3 billion in 2007 and \$8.9 billion in 2006. Apparently, Bangladesh has a comparative advantage in the production of textiles—it is one of the world's low-cost producers—and this is allowing the country to grow its share of world markets. Indeed, as a deep economic recession took hold in developed nations during 2008–09, big importers such as Walmart increased their purchases of inexpensive garments from Bangladesh to better serve their customers, who were looking for low prices. Obviously this benefits producers in Bangladesh, but it also benefits consumers in developed nations who can use money saved on garment purchases to buy other goods and services.

Bangladesh's advantage is based on a number of factors. First, labor costs are low, in part due to low hourly wage rates, and in part due to textile manufacturers' investments in productivity-boosting technology during the previous decade. Today, wage rates in Bangladesh's textile industry are

about \$40 to \$50 a month, barely half the minimum wage in China. While this pay rate seems dismally low by Western standards, in a country where the gross national income per capita is only \$470 a year, the textile industry provides a living wage and a source of employment for some 2.5 million people, 85 percent of whom are women with few alternative employment opportunities.

Another source of advantage for Bangladesh is that it has a vibrant network of supporting industries that supply inputs to its garment manufacturers. Some three-quarters of all inputs are made locally. This saves garment manufacturers transport and storage costs, import duties, and the long lead times that come with the imported woven fabrics used to make shirts and trousers. In other words, the local supporting industries help to boost the productivity of Bangladesh's garment manufacturers, giving them a cost advantage that goes beyond low wage rates.

A third advantage for Bangladesh is that it is not China! Many importers in the West have grown cautious about becoming too dependent upon China for imports of specific goods for fear that a disruption, economic or other, would decimate their supply chains unless they had an alternative source. Thus, Bangladesh has benefitted from the trend by Western importers to diversify their supply sources. ●

Source: K. Bradsher, "Jobs Vanish as Exports Fall in Asia," *The New York Times*, January 22, 2009, p. B1; "Knitting Pretty," *The Economist*, July 18, 2008, p. 54; and K. Bradsher, "Competition Means Learning to Offer More Than Just Low Wages," *The New York Times*, December 14, 2004, p. C1.



Introduction

The growth of the garment industry in Bangladesh is a striking example of the benefits of free trade and globalization. Low barriers to trade have enabled Bangladesh to exploit its comparative advantage in the production of garments and enabled the country to grow its exports, even during a global economic downturn. This benefits Bangladesh, one of the world's poorest nations, whose strong garment exports help support 2.5 million jobs and may help the country to attain sustainable economic growth. It also benefits consumers in developed nations, who can save on their garment purchases and, as a consequence, have more money available for spending on other goods and services, thereby helping to improve their living standards. The losers in this process are higher-cost garment producers in more developed nations, who have lost business to enterprises from Bangladesh.

In the world of international trade, there are always winners and losers, but as economists have long argued, the benefits to the winners outweigh the costs born by the losers, resulting in a net gain to society. Economists argue that in the long-run, free trade stimulates economic growth and raises living standards across the board. The economic arguments surrounding the benefits and costs of free trade in goods and services are not abstract academic ones. International trade theory has shaped the

economic policy of many nations for the past 50 years. It was the driver behind the formation of the World Trade Organization and regional trade blocs such as the European Union and the North American Free Trade Agreement (NAFTA). The 1990s, in particular, saw a global move toward greater free trade. Therefore, it is crucially important to understand these theories and why they have been so successful in shaping the economic policy of so many nations and the competitive environment in which international businesses compete.

This chapter has two goals that go to the heart of the debate over the benefits and costs of free trade. The first is to review a number of theories that explain why it is beneficial for a country to engage in international trade. The second goal is to explain the pattern of international trade that we observe in the world economy. With regard to the pattern of trade, we will be primarily concerned with explaining the pattern of exports and imports of goods and services between countries. The pattern of foreign direct investment between countries is discussed in Chapter 7.

An Overview of Trade Theory

We open this chapter with a discussion of mercantilism. Propagated in the sixteenth and seventeenth centuries, mercantilism advocated that countries should simultaneously encourage exports and discourage imports. Although mercantilism is an old and largely discredited doctrine, its echoes remain in modern political debate and in the trade policies of many countries. Next, we will look at Adam Smith's theory of absolute advantage. Proposed in 1776, Smith's theory was the first to explain why unrestricted free trade is beneficial to a country. **Free trade** refers to a situation where a government does not attempt to influence through quotas or duties what its citizens can buy from another country, or what they can produce and sell to another country. Smith argued that the invisible hand of the market mechanism, rather than government policy, should determine what a country imports and what it exports. His arguments imply that such a laissez-faire stance toward trade was in the best interests of a country. Building on Smith's work are two additional theories that we shall review. One is the theory of comparative advantage, advanced by the nineteenth century English economist David Ricardo. This theory is the intellectual basis of the modern argument for unrestricted free trade. In the twentieth century, Ricardo's work was refined by two Swedish economists, Eli Heckscher and Bertil Ohlin, whose theory is known as the Heckscher-Ohlin theory.

Free Trade

The absence of government barriers to the free flow of goods and services between countries.

THE BENEFITS OF TRADE The great strength of the theories of Smith, Ricardo, and Heckscher-Ohlin is that they identify with precision the specific benefits of international trade. Common sense suggests that some international trade is beneficial. For example, nobody would suggest that Iceland should grow its own oranges. Iceland can benefit from trade by exchanging some of the products that it can produce at a low cost (fish) for some products that it cannot produce at all (oranges). Thus, by engaging in international trade, Icelanders are able to add oranges to their diet of fish.

The theories of Smith, Ricardo, and Heckscher-Ohlin go beyond this common-sense notion, however, to show why it is beneficial for a country to engage in international trade *even for products it is able to produce for itself*. This is a difficult concept for people to grasp. For example, many people in the United States believe that American consumers should buy products made in the United States by American companies whenever possible to help save American jobs from foreign competition. The same kind of nationalistic sentiments can be observed in many other countries.

LEARNING OBJECTIVE 1

Understand why nations trade with each other.



Another Perspective

Outsourcing: Putting Jobs into Growing Markets

Another way of looking at the hollowing out of the American knowledge-based economy through outsourcing is to see the process from the perspective of developing nations. To them, outsourcing brings with it the benefits of trade. It is one of the positive outcomes of globalization. Multinational corporations doing some business in their markets can locate their production in the very markets into which they are selling. As India, the Philippines, and China develop a knowledge-based labor supply, companies such as Intel and EMC that are selling into these markets may want to locate some of their research and development and other knowledge-based activities in these markets as a commitment to a local presence, as a way to learn more about the customer, and as a way to establish sustained and sustaining relationships. Yes, there are cost savings, especially on labor, but long term, such cost savings may be secondary.

However, the theories of Smith, Ricardo, and Heckscher-Ohlin tell us that a country's economy may gain if its citizens buy certain products from other nations that could be produced at home. The gains arise because international trade allows a country to specialize in the manufacture and export of products that can be produced most efficiently in that country, while importing products that can be produced more efficiently in other countries. Thus, it may make sense for the United States to specialize in the production and export of commercial jet aircraft, since the efficient production of commercial jet aircraft requires resources that are abundant in the United States, such as a highly skilled labor force and cutting-edge technological know-how. On the other hand, it may make sense for the United States to import textiles from China since the efficient production of textiles requires a relatively cheap labor force—and cheap labor is not abundant in the United States.

Of course, this economic argument is often difficult for segments of a country's population to accept. With their future threatened by imports, U.S. textile companies and their employees have tried hard to persuade the government to limit the importation of textiles by demanding quotas and tariffs. Although such import controls may benefit particular groups, such as textile businesses and their employees, the theories of Smith, Ricardo, and Heckscher-Ohlin suggest that the economy as a whole is hurt by such action. Limits on imports are often in the interests of domestic producers, but not domestic consumers.

THE PATTERN OF INTERNATIONAL TRADE The theories of Smith, Ricardo, and Heckscher-Ohlin help to explain the pattern of international trade that we observe in the world economy. Some aspects of the pattern are easy to understand. Climate and natural resource endowments explain why Ghana exports cocoa, Brazil exports coffee, Saudi Arabia exports oil, and China exports crawfish. However, much of the observed pattern of international trade is more difficult to explain. For example, why does Japan export automobiles, consumer electronics, and machine tools? Why does Switzerland export chemicals, pharmaceuticals, watches, and jewelry? Why does Bangladesh export garments? David Ricardo's theory of comparative advantage offers an explanation in terms of international differences in labor productivity. The more sophisticated Heckscher-Ohlin theory emphasizes the interplay between the proportions in which the factors of production (such as land, labor, and capital) are available in different countries and the proportions in which they are needed for producing particular goods. This explanation rests on the assumption that countries have varying endowments of the various factors of production. Tests of this theory, however, suggest that it is a less powerful explanation of real-world trade patterns than once thought.

One early response to the failure of the Heckscher-Ohlin theory to explain the observed pattern of international trade was the product life-cycle theory. Proposed by Raymond Vernon, this theory suggests that early in their life cycle, most new products are produced in and exported from the country in which they were developed. As a new product becomes widely accepted internationally, however, production starts in

other countries. As a result, the theory suggests, the product may ultimately be exported back to the country of its original innovation.

In a similar vein, during the 1980s economists such as Nobel Prize winner Paul Krugman developed what has come to be known as the new trade theory. **New trade theory** (for which Krugman won the Nobel Prize in 2008) stresses that in some cases countries specialize in the production and export of particular products not because of underlying differences in factor endowments, but because in certain industries the world market can support only a limited number of firms. (This is argued to be the case for the commercial aircraft industry.) In such industries, firms that enter the market first are able to build a competitive advantage that is subsequently difficult to challenge. Thus, the observed pattern of trade between nations may be due in part to the ability of firms within a given nation to capture first-mover advantages. The United States is a major exporter of commercial jet aircraft because American firms such as Boeing were first movers in the world market. Boeing built a competitive advantage that has subsequently been difficult for firms from countries with equally favorable factor endowments to challenge (although Europe's Airbus Industries has succeeded in doing that). In a work related to the new trade theory, Michael Porter developed a theory, referred to as the theory of national competitive advantage. This attempts to explain why particular nations achieve international success in particular industries. In addition to factor endowments, Porter points out the importance of country factors such as domestic demand and domestic rivalry in explaining a nation's dominance in the production and export of particular products.

New Trade Theory

Theory that sometimes countries specialize in the production and export of particular products not because of underlying differences in factor endowments, but because in certain industries the world market can support only a limited number of firms.

TRADE THEORY AND GOVERNMENT POLICY Although all these theories agree that international trade is beneficial to a country, they lack agreement in their recommendations for government policy. Mercantilism makes a crude case for government involvement in promoting exports and limiting imports. The theories of Smith, Ricardo, and Heckscher-Ohlin form part of the case for unrestricted free trade. The argument for unrestricted free trade is that both import controls and export incentives (such as subsidies) are self-defeating and result in wasted resources. Both the new trade theory and Porter's theory of national competitive advantage can be interpreted as justifying some limited government intervention to support the development of certain export-oriented industries. We will discuss the pros and cons of this argument, known as strategic trade policy, as well as the pros and cons of the argument for unrestricted free trade, in Chapter 6.

Mercantilism

The first theory of international trade, mercantilism, emerged in England in the mid-sixteenth century. The principle assertion of mercantilism was that gold and silver were the mainstays of national wealth and essential to vigorous commerce. At that time, gold and silver were the currency of trade between countries; a country could earn gold and silver by exporting goods. Conversely, importing goods from other countries would result in an outflow of gold and silver to those countries. The main tenet of **mercantilism** was that it was in a country's best interests to maintain a trade surplus, to export more than it imported. By doing so, a country would accumulate gold and silver and, consequently, increase its national wealth, prestige, and power. As the English mercantilist writer Thomas Mun put it in 1630:

The ordinary means therefore to increase our wealth and treasure is by foreign trade, wherein we must ever observe this rule: to sell more to strangers yearly than we consume of theirs in value.¹

LEARNING OBJECTIVE 2

Summarize the different theories explaining trade flows between nations.

Mercantilism

An economic philosophy advocating that countries should simultaneously encourage exports and discourage imports.



Country FOCUS

Is China a Neo-mercantilist Nation?

China's rapid rise in economic power has been built on export-led growth. The country, using its cheap labor, has converted raw material imports into products that it sells to developed nations. For years, the country's exports have been growing faster than its imports, leading some critics to claim that China is pursuing a neo-mercantilist policy, trying to amass record trade surpluses and foreign currency that will give it economic power over developed nations. This rhetoric reached new heights in 2008 when China's trade surplus hit a record \$280 billion and its foreign exchange reserves exceeded \$1.95 trillion, some 70 percent of which are held in U.S. dollars. Observers worry that if China ever decides to sell its holdings of U.S. currency, this could depress the value of the dollar against other currencies and increase the price of imports into America.

Throughout 2005–2008, China's exports grew much faster than its imports, leading some to argue that China was limiting imports by pursuing an import substitution policy, encouraging domestic investment in the production of products such as steel, aluminum, and paper, which it had historically imported from other nations. The trade deficit with the United States has been a particular cause for concern. In 2008, this reached \$260 billion, the largest deficit ever recorded with a single country. At the same time, China has long resisted attempts to let its currency float freely against the U.S. dollar. Many claim that China's currency is too cheap, and that this keeps the

prices of China's goods artificially low, which fuels the country's exports.

So is China a neo-mercantilist nation that is deliberately discouraging imports and encouraging exports in order to grow its trade surplus and accumulate foreign exchange reserves, which might give it economic power? The jury is out on this issue. Skeptics suggest that the slowdown in imports to China is temporary and that the country will have no choice but to increase imports of commodities that it lacks, such as oil. They also note that China did start allowing the value of the *renminbi* (China's currency) to appreciate against the dollar in July 2005, and between then and January 2010 it appreciated 17 percent in value. Moreover, although China's overall trade surplus was up sharply in 2008, import growth exceeded export growth for 2008, and exports slowed sharply toward the end of the year as the global economic crisis took hold. In 2009, China's trade surplus contracted somewhat, and its deficit with America appears to have shrunk by some \$100 billion, as the global economic crisis of 2008–2009 hit Chinese exporters hard. While this suggests that China's trade surplus may have peaked for now, it is still significant.

Source: A. Browne, "China's Wild Swings Can Roil the Global Economy," *The Wall Street Journal*, October 24, 2005, p. A2; S. H. Hanke, "Stop the Mercantilists," *Forbes*, June 20, 2005, p. 164; G. Dyer and A. Balls, "Dollar Threat as China Signals Shift," *Financial Times*, January 6, 2006, p. 1; Tim Annett, "Righting the Balance," *The Wall Street Journal*, January 10, 2007, p. 15; "China's Trade Surplus Peaks," *Financial Times*, January 12, 2008, p. 1; and W. Chong, "China's Trade Surplus to U.S. to Narrow," *China Daily*, December 7, 2009.

Consistent with this belief, the mercantilist doctrine advocated government intervention to achieve a surplus in the balance of trade. The mercantilists saw no virtue in a large volume of trade. Rather, they recommended policies to maximize exports and minimize imports. To achieve this, imports were limited by tariffs and quotas, while exports were subsidized.

The classical economist David Hume pointed out an inherent inconsistency in the mercantilist doctrine in 1752. According to Hume, if England had a balance-of-trade surplus with France (it exported more than it imported) the resulting inflow of gold and silver would swell the domestic money supply and generate inflation in England. In France, however, the outflow of gold and silver would have the opposite effect. France's money supply would contract, and its prices would fall. This change in relative prices between France and England would encourage the French to buy fewer English goods (because they were becoming more expensive) and the English to buy more French goods (because they were becoming cheaper). The result would be a deterioration in the English balance of trade and an improvement in France's trade balance, until the English surplus was eliminated. Hence, according to Hume, in the

long run no country could sustain a surplus on the balance of trade and so accumulate gold and silver as the mercantilists had envisaged.

The flaw with mercantilism was that it viewed trade as a zero-sum game. (A **zero-sum game** is one in which a gain by one country results in a loss by another.) It was left to Adam Smith and David Ricardo to show the shortsightedness of this approach and to demonstrate that trade is a positive-sum game, or a situation in which all countries can benefit. Unfortunately, the mercantilist doctrine is by no means dead. Neo-mercantilists equate political power with economic power and economic power with a balance-of-trade surplus. Critics argue that many nations have adopted a neo-mercantilist strategy that is designed to simultaneously boost exports and limit imports.² For example, critics charge that China is pursuing a neo-mercantilist policy, deliberately keeping its currency value low against the U.S. dollar in order to sell more goods to the United States, and thus amass a trade surplus and foreign exchange reserves (see the accompanying Country Focus).

Zero-Sum Game

A situation in which an economic gain by one country results in an economic loss by another.

Absolute Advantage

In his 1776 landmark book *The Wealth of Nations*, Adam Smith attacked the mercantilist assumption that trade is a zero-sum game. Smith argued that countries differ in their ability to produce goods efficiently. In his time, the English, by virtue of their superior manufacturing processes, were the world's most efficient textile manufacturers. Due to the combination of favorable climate, good soils, and accumulated expertise, the French had the world's most efficient wine industry. The English had an *absolute advantage* in the production of textiles, while the French had an *absolute advantage* in the production of wine. Thus, a country has an **absolute advantage** in the production of a product when it is more efficient than any other country in producing it.

LEARNING OBJECTIVE 2

Summarize the different theories explaining trade flows between nations.

According to Smith, countries should specialize in the production of goods for which they have an absolute advantage and then trade these for goods produced by other countries. In Smith's time, this suggested that the English should specialize in the production of textiles while the French should specialize in the production of wine. England could get all the wine it needed by selling its textiles to France and buying wine in exchange. Similarly, France could get all the textiles it needed by selling wine to England and buying textiles in exchange. Smith's basic argument, therefore, is that a country should never produce goods at home that it can buy at a lower cost from other countries. Smith demonstrates that, by specializing in the production of goods in which each has an absolute advantage, both countries benefit by engaging in trade.

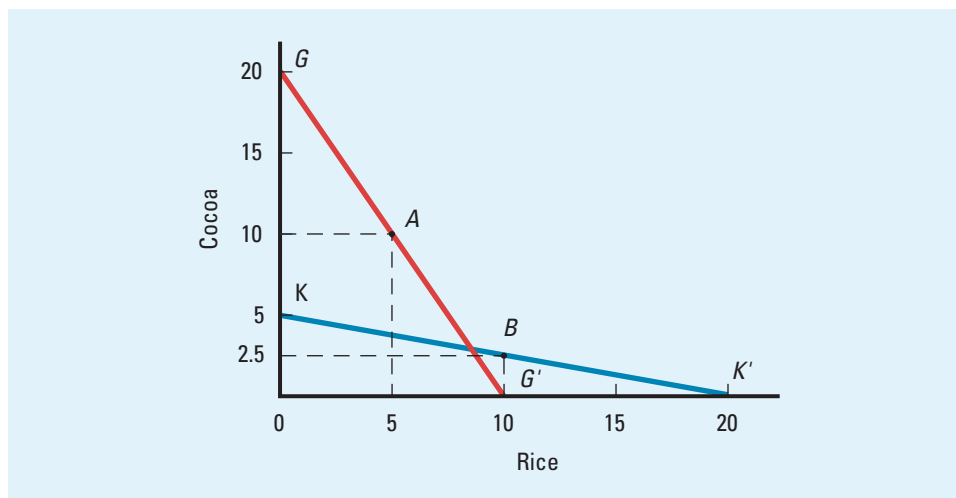
Absolute Advantage

A country has an absolute advantage in the production of a product when it is more efficient than any other country in producing it.

Consider the effects of trade between two countries, Ghana and South Korea. The production of any good (output) requires resources (inputs) such as land, labor, and capital. Assume that Ghana and South Korea both have the same amount of resources and that these resources can be used to produce either rice or cocoa. Assume further that 200 units of resources are available in each country. Imagine that in Ghana it takes 10 resources to produce one ton of cocoa and 20 resources to produce one ton of rice. Thus, Ghana could produce 20 tons of cocoa and no rice, 10 tons of rice and no cocoa, or some combination of rice and cocoa between these two extremes. The different combinations that Ghana could produce are represented by the line GG' in Figure 5.1. This is referred to as Ghana's *production possibility frontier* (PPF). Similarly, imagine that in South Korea it takes 40 resources to produce one ton of cocoa and 10 resources to produce one ton of rice. Thus, South Korea could produce 5 tons of cocoa and no rice, 20 tons of rice and no cocoa, or

figure 5.1

The Theory of Absolute Advantage



some combination between these two extremes. The different combinations available to South Korea are represented by the line KK' in Figure 5.1, which is South Korea's PPF. Clearly, Ghana has an absolute advantage in the production of cocoa. (More resources are needed to produce a ton of cocoa in South Korea than in Ghana.) By the same token, South Korea has an absolute advantage in the production of rice.

Now consider a situation in which neither country trades with any other. Each country devotes half of its resources to the production of rice and half to the production of cocoa. Each country must also consume what it produces. Ghana would be able to produce 10 tons of cocoa and 5 tons of rice (point A in Figure 5.1), while South Korea would be able to produce 10 tons of rice and 2.5 tons of cocoa (point B in Figure 5.1). Without trade, the combined production of both countries would be 12.5 tons of cocoa (10 tons in Ghana plus 2.5 tons in South Korea) and 15 tons of rice (5 tons in Ghana and 10 tons in South Korea). If each country were to specialize in producing the good for which it had an absolute advantage and then trade with the other for the good it lacks, Ghana could produce 20 tons of cocoa, and South Korea could produce 20 tons of rice. Thus, by specializing, the production of both goods could be increased. Production of cocoa would increase from 12.5 tons to 20 tons, while production of rice would increase from 15 tons to 20 tons. The increase in production that would result from specialization is therefore 7.5 tons of cocoa and 5 tons of rice. Table 5.1 summarizes these figures.

By engaging in trade and swapping one ton of cocoa for one ton of rice, producers in both countries could consume more of both cocoa and rice. Imagine that Ghana and South Korea swap cocoa and rice on a one-to-one basis; that is, the price of one ton of cocoa is equal to the price of one ton of rice. If Ghana decided to export 6 tons of cocoa to South Korea and import 6 tons of rice in return, its final consumption after trade would be 14 tons of cocoa and 6 tons of rice. This is 4 tons more cocoa than it could have consumed before specialization and trade and 1 ton more rice. Similarly, South Korea's final consumption after trade would be 6 tons of cocoa and 14 tons of rice. This is 3.5 tons more cocoa than it could have consumed before specialization and trade and 4 tons more rice. Thus, as a result of specialization and trade, output of both cocoa and rice would be increased, and consumers in both nations would be able to consume more. Thus, we can see that trade is a positive-sum game; it produces net gains for all involved.

5.1 table

Absolute Advantage
and the Gains
from Trade

Resources Required to Produce 1 Ton of Cocoa and Rice		
	Cocoa	Rice
Ghana	10	20
South Korea	40	10
Production and Consumption without Trade		
	Cocoa	Rice
Ghana	10.0	5.0
South Korea	2.5	10.0
Total production	12.5	15.0
Production with Specialization		
	Cocoa	Rice
Ghana	20.0	0.0
South Korea	0.0	20.0
Total production	20.0	20.0
Consumption after Ghana Trades 6 Tons of Cocoa for 6 Tons of South Korean Rice		
	Cocoa	Rice
Ghana	14.0	6.0
South Korea	6.0	14.0
Increase in Consumption as a Result of Specialization and Trade		
	Cocoa	Rice
Ghana	4.0	1.0
South Korea	3.5	4.0

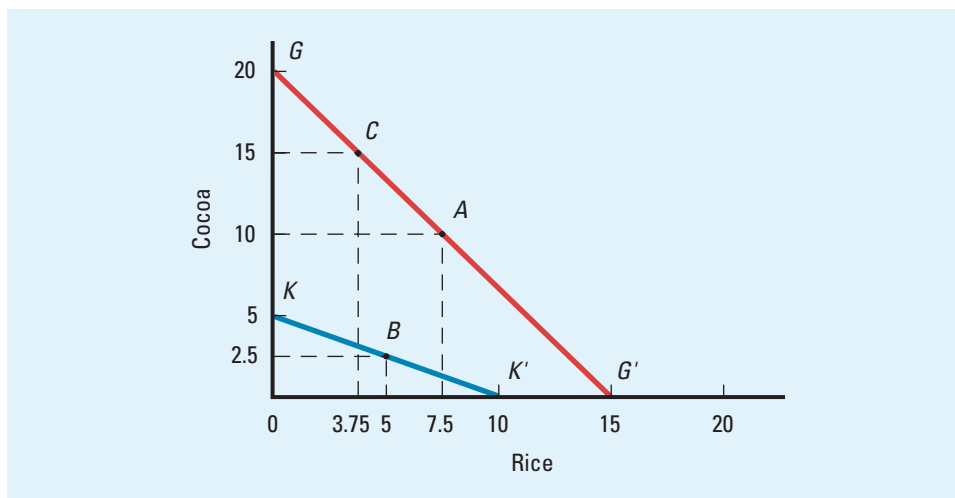
Comparative Advantage

David Ricardo took Adam Smith's theory one step further by exploring what might happen when one country has an absolute advantage in the production of all goods.³ Smith's theory of absolute advantage suggests that such a country might derive no benefits from international trade. In his 1817 book *Principles of Political Economy*, Ricardo showed that this was not the case. According to Ricardo's theory of comparative advantage, it makes sense for a country to specialize in the production of those goods that it produces most efficiently and to buy the goods that it produces less efficiently from other countries, even if this means buying goods from other countries that it could produce more efficiently itself.⁴ While this may seem counterintuitive, the logic can be explained with a simple example.

LEARNING OBJECTIVE 2

Summarize the different theories explaining trade flows between nations.

figure 5.2
The Theory of
Comparative Advantage



Assume that Ghana is more efficient in the production of both cocoa and rice; that is, Ghana has an absolute advantage in the production of both products. In Ghana it takes 10 resources to produce one ton of cocoa and $13\frac{1}{3}$ resources to produce one ton of rice. Thus, given its 200 units of resources, Ghana can produce 20 tons of cocoa and no rice, 15 tons of rice and no cocoa, or any combination in between on its PPF (the line GG' in Figure 5.2). In South Korea it takes 40 resources to produce one ton of cocoa and 20 resources to produce one ton of rice. Thus, South Korea can produce 5 tons of cocoa and no rice, 10 tons of rice and no cocoa, or any combination on its PPF (the line KK' in Figure 5.2). Again assume that without trade, each country uses half of its resources to produce rice and half to produce cocoa. Thus, without trade, Ghana will produce 10 tons of cocoa and 7.5 tons of rice (point A in Figure 5.2), while South Korea will produce 2.5 tons of cocoa and 5 tons of rice (point B in Figure 5.2).

In light of Ghana's absolute advantage in the production of both goods, why should it trade with South Korea? Although Ghana has an absolute advantage in the production of both cocoa and rice, it has a comparative advantage only in the production of cocoa: Ghana can produce 4 times as much cocoa as South Korea, but only 1.5 times as much rice. Ghana is *comparatively* more efficient at producing cocoa than it is at producing rice.

Without trade the combined production of cocoa will be 12.5 tons (10 tons in Ghana and 2.5 in South Korea), and the combined production of rice will also be 12.5 tons (7.5 tons in Ghana and 5 tons in South Korea). Without trade each country must consume what it produces. By engaging in trade, the two countries can increase their combined production of rice and cocoa, and consumers in both nations can consume more of both goods.

THE GAINS FROM TRADE Imagine that Ghana exploits its comparative advantage in the production of cocoa to increase its output from 10 tons to 15 tons. This uses 150 units of resources, leaving the remaining 50 units of resources to use in producing 3.75 tons of rice (point C in Figure 5.2). Meanwhile, South Korea specializes in the production of rice, producing 10 tons. The combined output of both cocoa and rice has now increased. Before specialization, the combined output was 12.5 tons of cocoa and 12.5 tons of rice. Now it is 15 tons of cocoa and 13.75 tons of rice (3.75 tons in Ghana and 10 tons in South Korea). The source of the increase in production is summarized in Table 5.2.

Resources Required to Produce 1 Ton of Cocoa and Rice		
	Cocoa	Rice
Ghana	10	13.33
South Korea	40	20
Production and Consumption without Trade		
	Cocoa	Rice
Ghana	10.0	7.5
South Korea	2.5	5.0
Total production	12.5	12.5
Production with Specialization		
	Cocoa	Rice
Ghana	15.0	3.75
South Korea	0.0	10.0
Total production	15.0	13.75
Consumption after Ghana Trades 4 Tons of Cocoa for 4 Tons of South Korean Rice		
	Cocoa	Rice
Ghana	11.0	7.75
South Korea	4.0	6.0
Increase in Consumption as a Result of Specialization and Trade		
	Cocoa	Rice
Ghana	1.0	0.25
South Korea	1.5	1.0

Not only is output higher, but both countries also can now benefit from trade. If Ghana and South Korea swap cocoa and rice on a one-to-one basis, with both countries choosing to exchange 4 tons of their export for 4 tons of the import, both countries are able to consume more cocoa and rice than they could before specialization and trade (see Table 5.2). Thus, if Ghana exchanges 4 tons of cocoa with South Korea for 4 tons of rice, it is still left with 11 tons of cocoa, which is 1 ton more than it had before trade. The 4 tons of rice it gets from South Korea in exchange for its 4 tons of cocoa, when added to the 3.75 tons it now produces domestically, leaves it with a total of 7.75 tons of rice, which is .25 of a ton more than it had before specialization. Similarly, after swapping 4 tons of rice with Ghana, South Korea still ends up with 6 tons of rice, which is more than it had before specialization. In addition, the 4 tons of cocoa it receives in exchange is 1.5 tons more than it produced before trade. Thus, consumption of cocoa and rice can increase in both countries as a result of specialization and trade.

LEARNING OBJECTIVE 3

Recognize why many economists believe that unrestricted free trade between nations will raise the economic welfare of countries that participate in a free trade system.

The basic message of the theory of comparative advantage is that *potential world production is greater with unrestricted free trade than it is with restricted trade*. Ricardo's theory suggests that consumers in all nations can consume more if there are no restrictions on trade. This occurs even in countries that lack an absolute advantage in the production of any good. In other words, to an even greater degree than the theory of absolute advantage, *the theory of comparative advantage suggests that trade is a positive-sum game in which all countries that participate realize economic gains*. As such, this theory provides a strong rationale for encouraging free trade. So powerful is Ricardo's theory that it remains a major intellectual weapon for those who argue for free trade.

QUALIFICATIONS AND ASSUMPTIONS The conclusion that free trade is universally beneficial is a rather bold one to draw from such a simple model. Our simple model includes many unrealistic assumptions:

1. We have assumed a simple world in which there are only two countries and two goods. In the real world, there are many countries and many goods.
2. We have assumed away transportation costs between countries.
3. We have assumed away differences in the prices of resources in different countries. We have said nothing about exchange rates, simply assuming that cocoa and rice could be swapped on a one-to-one basis.
4. We have assumed that resources can move freely from the production of one good to another within a country. In reality, this is not always the case.
5. We have assumed constant returns to scale; that is, that specialization by Ghana or South Korea has no effect on the amount of resources required to produce one ton of cocoa or rice. In reality, both diminishing and increasing returns to specialization exist. The amount of resources required to produce a good might decrease or increase as a nation specializes in production of that good.
6. We have assumed that each country has a fixed stock of resources and that free trade does not change the efficiency with which a country uses its resources. This static assumption makes no allowances for the dynamic changes in a country's stock of resources and in the efficiency with which the country uses its resources that might result from free trade.
7. We have assumed away the effects of trade on income distribution within a country.

Given these assumptions, can the conclusion that free trade is mutually beneficial be extended to the real world of many countries, many goods, positive transportation costs, volatile exchange rates, immobile domestic resources, non-constant returns to specialization, and dynamic changes? Although a detailed extension of the theory of comparative advantage is beyond the scope of this book, economists have shown that the basic result derived from our simple model can be generalized to a world composed of many countries producing many different goods.⁵ Despite the shortcomings of the Ricardian model, research suggests that the basic proposition that countries will export the goods that they are most efficient at producing is borne out by the data.⁶

However, once all the assumptions are dropped, the case for unrestricted free trade, while still positive, has been argued by some economists associated with the "new trade theory" to lose some of its strength.⁷ We return to this issue later in this chapter and in the next when we discuss the new trade theory. Moreover, in a recent and widely discussed analysis, the Nobel Prize winning economist Paul Samuelson argued that contrary to the standard interpretation, in certain circumstances the theory of comparative advantage predicts that a rich country might actually be *worse* off by switching to a free trade regime with a poor nation.⁸ We will consider Samuelson's critique in the next section.

EXTENSIONS OF THE RICARDIAN MODEL Let us explore the effect of relaxing three of the assumptions identified above in the simple comparative advantage model. Below we relax the assumptions that resources move freely from the production of one good to another within a country, that there are constant returns to scale, and that trade does not change a country's stock of resources or the efficiency with which those resources are utilized.

Immobile Resources In our simple comparative model of Ghana and South Korea, we assumed that producers (farmers) could easily convert land from the production of cocoa to rice, and vice versa. While this assumption may hold for some agricultural products, resources do not always shift quite so easily from producing one good to another. A certain amount of friction is involved. For example, embracing a free trade regime for an advanced economy such as the United States often implies that the country will produce less of some labor-intensive goods, such as textiles, and more of some knowledge-intensive goods, such as computer software or biotechnology products. Although the country as a whole will gain from such a shift, textile producers will lose. A textile worker in South Carolina is probably not qualified to write software for Microsoft. Thus, the shift to free trade may mean that she becomes unemployed or has to accept another less attractive job, such as working at a fast-food restaurant.

Resources do not always move easily from one economic activity to another. The process creates friction and human suffering too. While the theory predicts that the benefits of free trade outweigh the costs by a significant margin, this is of cold comfort to those who bear the costs. Accordingly, political opposition to the adoption of a free trade regime typically comes from those whose jobs are most at risk. In the United States, for example, textile workers and their unions have long opposed the move toward free trade precisely because this group has much to lose from free trade. Governments often ease the transition toward free trade by helping to retrain those who lose their jobs as a result. The pain caused by the movement toward a free trade regime is a short-term phenomenon, while the gains from trade once the transition has been made are both significant and enduring.

Diminishing Returns The simple comparative advantage model developed above assumes constant returns to specialization. By **constant returns to specialization** we mean the units of resources required to produce a good (cocoa or rice) are assumed to remain constant no matter where one is on a country's production possibility frontier (PPF). Thus, we assumed that it always took Ghana 10 units of resources to produce one ton of cocoa. However, it is more realistic to assume diminishing returns to specialization. Diminishing returns to specialization occurs when more units of resources are required to produce each additional unit. While 10 units of resources may be sufficient to increase Ghana's output of cocoa from 12 tons to 13 tons, 11 units of resources may be needed to increase output from 13 to 14 tons, 12 units of resources to increase output from 14 tons to 15 tons, and so on. Diminishing returns implies a convex PPF for Ghana (see Figure 5.3), rather than the straight line depicted in Figure 5.2.

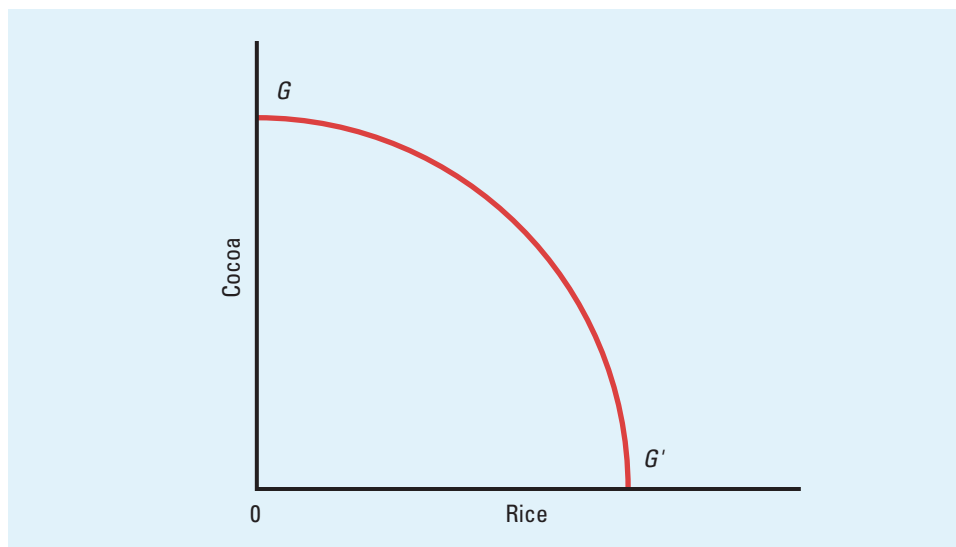
It is more realistic to assume diminishing returns for two reasons. First, not all resources are of the same quality. As a country tries to increase its output of a certain good, it is increasingly likely to draw on more marginal resources whose productivity is not as great as those initially employed. The result is that it requires ever more resources to produce an equal increase in output. For example, some land is more productive than other land. As Ghana tries to expand its output of cocoa, it might have to utilize increasingly marginal land that is less fertile than the land it originally used. As yields per acre decline, Ghana must use more land to produce one ton of cocoa.

Constant Returns to Specialization

The units of resources required to produce a good are assumed to remain constant no matter where one is on a country's production possibility frontier.

figure 5.3

Ghana's PPF under
Diminishing Returns



A second reason for diminishing returns is that different goods use resources in different proportions. For example, imagine that growing cocoa uses more land and less labor than growing rice, and that Ghana tries to transfer resources from rice production to cocoa production. The rice industry will release proportionately too much labor and too little land for efficient cocoa production. To absorb the additional resources of labor and land, the cocoa industry will have to shift toward more labor-intensive methods of production. The effect is that the efficiency with which the cocoa industry uses labor will decline, and returns will diminish.

Diminishing returns show that it is not feasible for a country to specialize to the degree suggested by the simple Ricardian model outlined earlier. Diminishing returns to specialization suggest that the gains from specialization are likely to be exhausted before specialization is complete. In reality, most countries do not specialize, but instead, produce a range of goods. However, the theory predicts that it is worthwhile to specialize until that point where the resulting gains from trade are outweighed by diminishing returns. Thus, the basic conclusion that unrestricted free trade is beneficial still holds, although because of diminishing returns, the gains may not be as great as suggested in the constant returns case.

LEARNING OBJECTIVE 3

Recognize why many economists believe that unrestricted free trade between nations will raise the economic welfare of countries that participate in a free trade system.

Dynamic Effects and Economic Growth The simple comparative advantage model assumed that trade does not change a country's stock of resources or the efficiency with which it utilizes those resources. This static assumption makes no allowances for the dynamic changes that might result from trade. If we relax this assumption, it becomes apparent that opening an economy to trade is likely to generate dynamic gains of two sorts.⁹ First, free trade might increase a country's stock of resources as increased supplies of labor and capital from abroad become available for use within the country. For example, this has been occurring in Eastern Europe since the early 1990s, with many Western businesses investing significant capital in the former Communist countries.

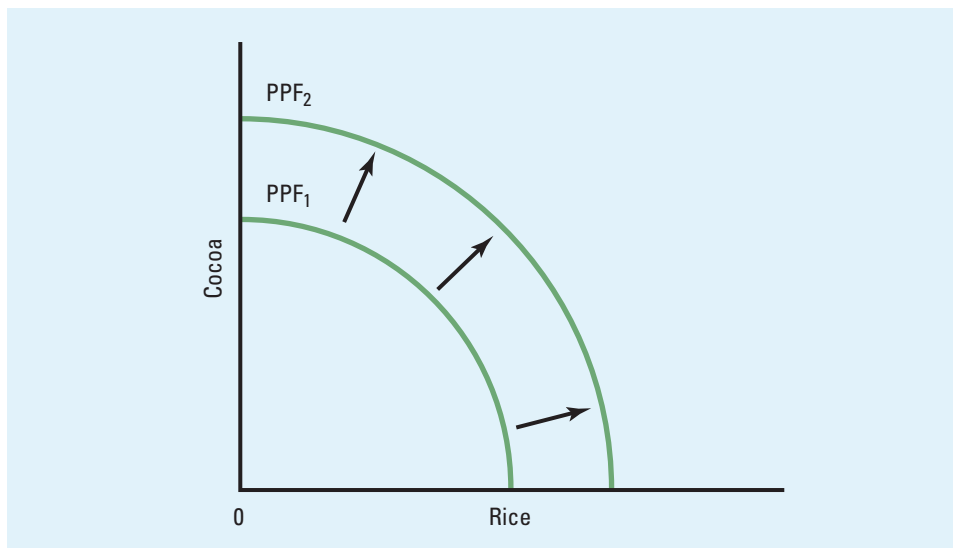
Second, free trade might also increase the efficiency with which a country uses its resources. Gains in the efficiency of resource utilization could arise from a number of factors. For example, economies of large-scale production might become available as trade expands the size of the total market available to domestic firms. Trade might make better technology from abroad available to domestic firms; better technology can increase labor

productivity or the productivity of land. (The so-called green revolution had this effect on agricultural outputs in developing countries.) Also, opening an economy to foreign competition might stimulate domestic producers to look for ways to increase their efficiency. Again, this phenomenon has arguably been occurring in the once-protected markets of Eastern Europe, where many former state monopolies have had to increase the efficiency of their operations to survive in the competitive world market.

Dynamic gains in both the stock of a country's resources and the efficiency with which resources are utilized will cause a country's PPF to shift outward. This is illustrated in Figure 5.4, where the shift from PPF_1 to PPF_2 results from the dynamic gains that arise from free trade. As a consequence of this outward shift, the country in Figure 5.4 can produce more of both goods than it did before introduction of free trade. The theory suggests that opening an economy to free trade not only results in static gains of the type discussed earlier, but also results in dynamic gains that stimulate economic growth. If this is so, then one might think that the case for free trade becomes stronger still, and in general it does. However, as noted above, in a recent article one of the leading economic theorists of the twentieth century, Paul Samuelson, argued that in some circumstances, dynamic gains can lead to an outcome that is not so beneficial.

The Samuelson Critique Paul Samuelson's critique looks at what happens when a rich country—the United States—enters into a free trade agreement with a poor country—China—that rapidly improves its productivity after the introduction of a free trade regime (i.e., there is a dynamic gain in the efficiency with which resources are used in the poor country). Samuelson's model suggests that in such cases, the lower prices that U.S. consumers pay for goods imported from China following the introduction of a free trade regime *may* not be enough to produce a net gain to for the U.S. economy if the dynamic effect of free trade is to lower real wage rates in the United States. As he stated in a *New York Times* interview, “Being able to purchase groceries 20 percent cheaper at Walmart (due to international trade) does not necessarily make up for the wage losses (in America).”¹⁰

Samuelson goes on to note that he is particularly concerned about the ability to off-shore service jobs that traditionally were not internationally mobile, such as software debugging, call center jobs, accounting jobs, and even medical diagnosis of MRI scans (see the accompanying Country Focus for details). Recent advances in communications



5.4 figure
The Influence of Free Trade on the PPF



Country FOCUS

Moving U.S. White-Collar Jobs Offshore

Economists have long argued that free trade produces gains for all countries that participate in a free trading system, but as the next wave of globalization sweeps through the U.S. economy, many people are wondering if this is true, particularly those who stand to lose their jobs because of this wave of globalization. In the popular imagination for much of the past quarter century, free trade was associated with the movement of low-skill, blue-collar manufacturing jobs out of rich countries such as the United States and toward low-wage countries—textiles to Costa Rica, athletic shoes to the Philippines, steel to Brazil, electronic products to Malaysia, and so on. While many observers bemoaned the “hollowing out” of U.S. manufacturing, economists stated that high-skilled and high-wage white-collar jobs associated with the knowledge-based economy would stay in the United States. Computers might be assembled in Malaysia, so the argument went, but they would continue to be designed in Silicon Valley by high-skilled U.S. engineers.

Recent developments have some people questioning this assumption. As the global economy slowed after 2000 and corporate profits fell, many American companies responded by moving white-collar “knowledge-based” jobs to developing nations where they could be performed for a fraction of the cost. During the long economic boom of the 1990s, Bank of America had to compete with other organizations for the scarce talents of information technology specialists, driving annual salaries to more than \$100,000. However, with business under pressure, the bank cut nearly 5,000 jobs from its 25,000-strong U.S.-based IT workforce. Some of these jobs were transferred to India, where work that costs \$100 an hour in the United States can be done for \$20 an hour.

One beneficiary of Bank of America’s downsizing is Infosys Technologies Ltd., a Bangalore, India, information

technology firm where 250 engineers now develop IT applications for the bank. Other Infosys employees are busy processing home loan applications for Greenpoint Mortgage of Novato, California. Nearby in the offices of another Indian firm, Wipro Ltd., five radiologists interpret 30 CT scans a day for Massachusetts General Hospital that are sent over the Internet. At yet another Bangalore business, engineers earn \$10,000 a year designing leading-edge semiconductor chips for Texas Instruments. Nor is India the only beneficiary of these changes. Accenture, a large U.S. management consulting and information technology firm, moved 5,000 jobs in software development and accounting to the Philippines. Also in the Philippines, Procter & Gamble employs 650 professionals who prepare the company’s global tax returns. The work used to be done in the United States, but now it is done in Manila, with just final submission to local tax authorities in the United States and other countries handled locally.

Some architectural work also is being outsourced to lower-cost locations. Fluor Corp., a Texas-based construction company, employs some 1,200 engineers and draftsmen in the Philippines, Poland, and India to turn layouts of industrial facilities into detailed specifications. For a Saudi Arabian chemical plant Fluor is designing, 200 young engineers based in the Philippines earning less than \$3,000 a year collaborate in real time over the Internet with elite U.S. and British engineers who make up to \$90,000 a year. Why does Fluor do this? According to the company, the answer is simple. Doing so reduces the prices of a project by 15 percent, giving the company a cost-based competitive advantage in the global market for construction design.

Sources: P. Engardio, A. Bernstein, and M. Kripalani, “Is Your Job Next?” *BusinessWeek*, February 3, 2003, pp. 50–60; “America’s Pain, India’s Gain,” *The Economist*, January 11, 2003, p. 57; and M. Schroeder and T. Aeppel, “Skilled Workers Mount Opposition to Free Trade, Swaying Politicians,” *The Wall Street Journal*, October 10, 2003, pp. A1, A11.

technology have made this possible, effectively expanding the labor market for these jobs to include educated people in places such as India, the Philippines, and China. When coupled with rapid advances in the productivity of foreign labor due to better education, the effect on middle-class wages in the United States, according to Samuelson, may be similar to mass inward migration into the United States—it will lower the market clearing wage rate, *perhaps* by enough to outweigh the positive benefits of international trade.

Having said this, it should be noted that Samuelson concedes that free trade has historically benefited rich countries (as data discussed below seem to confirm). Moreover, he notes that introducing protectionist measures (e.g., trade barriers) to guard against the theoretical possibility that free trade may harm the United States in the future may produce a situation that is worse than the disease the measures are trying to prevent. To quote Samuelson: “Free trade may turn out pragmatically to be still best

for each region in comparison to lobbyist-induced tariffs and quotas which involve both a perversion of democracy and non-subtle deadweight distortion losses.”¹¹

Some economists have been quick to dismiss Samuelson’s fears.¹² While not questioning his analysis, they note that developing nations are unlikely to be able to upgrade the skill level of their workforce rapidly enough to give rise to the situation in Samuelson’s model. In other words, the countries will quickly run into diminishing returns. To quote one such rebuttal: “The notion that India and China will quickly educate 300 million of their citizens to acquire sophisticated and complex skills at stake borders on the ludicrous. The educational sectors in these countries face enormous difficulties.”¹³ Notwithstanding such rebuttals, however, Samuelson’s stature is such that his work will undoubtedly be debated for some time.

Evidence for the Link between Trade and Growth Many economic studies have looked at the relationship between trade and economic growth.¹⁴ In general, these studies suggest that, as predicted by the standard theory of comparative advantage, countries that adopt a more open stance toward international trade enjoy higher growth rates than those that close their economies to trade (the opening case provides evidence of the link between trade and growth). Jeffrey Sachs and Andrew Warner created a measure of how “open” to international trade an economy was and then looked at the relationship between “openness” and economic growth for a sample of more than 100 countries from 1970 to 1990.¹⁵ Among other findings, they reported:

We find a strong association between openness and growth, both within the group of developing and the group of developed countries. Within the group of developing countries, the open economies grew at 4.49 percent per year, and the closed economies grew at 0.69 percent per year. Within the group of developed economies, the open economies grew at 2.29 percent per year, and the closed economies grew at 0.74 percent per year.¹⁶

A study by Wacziarg and Welch updated the Sachs and Warner data through the late 1990s. They found that from 1950 to 1998, countries that liberalized their trade regimes experienced, on average, increases in their annual growth rates of 1.5 percent compared to preliberalization times.¹⁷

The message of these studies seems clear: Adopt an open economy and embrace free trade, and your nation will be rewarded with higher economic growth rates. Higher growth will raise income levels and living standards. This last point has been confirmed by a study that looked at the relationship between trade and growth in incomes. The study, undertaken by Jeffrey Frankel and David Romer, found that on average, a one percentage point increase in the ratio of a country’s trade to its gross domestic product increases income per person by at least one-half percent.¹⁸ For every 10 percent increase in the importance of international trade in an economy, average income levels will rise by at least 5 percent. Despite the short-term adjustment costs associated with adopting a free trade regime, trade would seem to produce greater economic growth and higher living standards in the long run, just as the theory of Ricardo would lead us to expect.¹⁹

Heckscher-Ohlin Theory

Ricardo’s theory stresses that comparative advantage arises from differences in productivity. Thus, whether Ghana is more efficient than South Korea in the production of cocoa depends on how productively it uses its resources. Ricardo stressed labor productivity and argued that differences in labor productivity between nations underlie the notion of comparative advantage. Swedish economists Eli Heckscher (in 1919)

LEARNING OBJECTIVE 3

Recognize why many economists believe that unrestricted free trade between nations will raise the economic welfare of countries that participate in a free trade system.

LEARNING OBJECTIVE 2

Summarize the different theories explaining trade flows between nations.

Factor Endowments

The extent to which a country is endowed with such resources as land, labor, and capital.

and Bertil Ohlin (in 1933) put forward a different explanation of comparative advantage. They argued that comparative advantage arises from differences in national factor endowments.²⁰ By **factor endowments** they meant the extent to which a country is endowed with such resources as land, labor, and capital. Nations have varying factor endowments, and different factor endowments explain differences in factor costs; specifically, the more abundant a factor, the lower its cost. The Heckscher-Ohlin theory predicts that countries will export those goods that make intensive use of factors that are locally abundant, while importing goods that make intensive use of factors that are locally scarce. Thus, the Heckscher-Ohlin theory attempts to explain the pattern of international trade that we observe in the world economy. Like Ricardo's theory, the Heckscher-Ohlin theory argues that free trade is beneficial. Unlike Ricardo's theory, however, the Heckscher-Ohlin theory argues that the pattern of international trade is determined by differences in factor endowments, rather than differences in productivity.

The Heckscher-Ohlin theory has commonsense appeal. For example, the United States has long been a substantial exporter of agricultural goods, reflecting in part its unusual abundance of arable land. In contrast, China excels in the export of goods produced in labor-intensive manufacturing industries, such as textiles and footwear. This reflects China's relative abundance of low-cost labor. The United States, which lacks abundant low-cost labor, has been a primary importer of these goods. Note that it is relative, not absolute, endowments that are important; a country may have larger absolute amounts of land and labor than another country, but be relatively abundant in one of them.

THE LEONTIEF PARADOX The Heckscher-Ohlin theory has been one of the most influential theoretical ideas in international economics. Most economists prefer the Heckscher-Ohlin theory to Ricardo's theory because it makes fewer simplifying assumptions. Because of its influence, the theory has been subjected to many empirical tests. Beginning with a famous study published in 1953 by Wassily Leontief (winner of the Nobel Prize in economics in 1973), many of these tests have raised questions about the validity of the Heckscher-Ohlin theory.²¹ Using the Heckscher-Ohlin theory, Leontief postulated that since the United States was relatively abundant in capital compared to other nations, the United States would be an exporter of capital-intensive goods and an importer of labor-intensive goods. To his surprise, however, he found that U.S. exports were less capital intensive than U.S. imports. Since this result was at variance with the predictions of the theory, it has become known as the Leontief paradox.

No one is quite sure why we observe the Leontief paradox. One possible explanation is that the United States has a special advantage in producing new products or goods made with innovative technologies. Such products may be less capital intensive than products whose technology has had time to mature and become suitable for mass production. Thus, the United States may be exporting goods that heavily use skilled labor and innovative entrepreneurship, such as computer software, while importing heavy manufacturing products that use large amounts of capital. Some empirical studies tend to confirm this.²² Still, tests of the Heckscher-Ohlin theory using data for a large number of countries tend to confirm the existence of the Leontief paradox.²³

This leaves economists with a difficult dilemma. They prefer the Heckscher-Ohlin theory on theoretical grounds, but it is a relatively poor predictor of real-world international trade patterns. On the other hand, the theory they regard as being too limited, Ricardo's theory of comparative advantage, actually predicts trade patterns with greater accuracy. The best solution to this dilemma may be to return to the Ricardian idea that trade patterns are largely driven by international differences in productivity.

Thus, one might argue that the United States exports commercial aircraft and imports textiles not because its factor endowments are especially suited to aircraft manufacture and not suited to textile manufacture, but because the United States is relatively more efficient at producing aircraft than textiles. A key assumption in the Heckscher-Ohlin theory is that technologies are the same across countries. This may not be the case. Differences in technology may lead to differences in productivity, which in turn, drives international trade patterns.²⁴ Thus, Japan's success in exporting automobiles since the 1970s has been not just because of the relative abundance of capital, but also because of its development of innovative manufacturing technology that enabled it to achieve higher productivity levels in automobile production than other countries that also had abundant capital. More recent empirical work suggests that this theoretical explanation may be correct.²⁵ The new research shows that once differences in technology across countries are controlled for, countries do indeed export those goods that make intensive use of factors that are locally abundant, while importing goods that make intensive use of factors that are locally scarce. In other words, once the impact of differences of technology on productivity is controlled for, the Heckscher-Ohlin theory seems to gain predictive power.

The Product Life-Cycle Theory

Raymond Vernon initially proposed the product life-cycle theory in the mid-1960s.²⁶ Vernon's theory was based on the observation that for most of the twentieth century a very large proportion of the world's new products had been developed by U.S. firms and sold first in the U.S. market (e.g., mass-produced automobiles, televisions, instant cameras, photocopiers, personal computers, and semiconductor chips). To explain this, Vernon argued that the wealth and size of the U.S. market gave U.S. firms a strong incentive to develop new consumer products. In addition, the high cost of U.S. labor gave U.S. firms an incentive to develop cost-saving process innovations.

Just because a new product is developed by a U.S. firm and first sold in the U.S. market, it does not follow that the product must be produced in the United States. It could be produced abroad at some low-cost location and then exported back into the United States. However, Vernon argued that most new products were initially produced in America. Apparently, the pioneering firms believed it was better to keep production facilities close to the market and to the firm's center of decision making, given the uncertainty and risks inherent in introducing new products. Also, the demand for most new products tends to be based on non-price factors. Consequently, firms can charge relatively high prices for new products, which obviates the need to look for low-cost production sites in other countries.

Vernon went on to argue that early in the life cycle of a typical new product, while demand is starting to grow rapidly in the United States, demand in other advanced countries is limited to high-income groups. The limited initial demand in other advanced countries does not make it worthwhile for firms in those countries to start producing the new product, but it does necessitate some exports from the United States to those countries.

Over time, demand for the new product starts to grow in other advanced countries (e.g., Great Britain, France, Germany, and Japan). As it does, it becomes worthwhile for foreign producers to begin producing for their home markets. In addition, U.S. firms might set up production facilities in those advanced countries where demand is growing. Consequently, production within other advanced countries begins to limit the potential for exports from the United States.

As the market in the United States and other advanced nations matures, the product becomes more standardized, and price becomes the main competitive weapon. As

LEARNING OBJECTIVE 2

Summarize the different theories explaining trade flows between nations.

this occurs, cost considerations start to play a greater role in the competitive process. Producers based in advanced countries where labor costs are lower than in the United States (e.g., Italy, Spain) might now be able to export to the United States. If cost pressures become intense, the process might not stop there. The cycle by which the United States lost its advantage to other advanced countries might be repeated once more, as developing countries (e.g., Thailand) begin to acquire a production advantage over advanced countries. Thus, the locus of global production initially switches from the United States to other advanced nations and then from those nations to developing countries.

The consequence of these trends for the pattern of world trade is that over time the United States switches from being an exporter of the product to an importer of the product as production becomes concentrated in lower-cost foreign locations. Figure 5.5 shows the growth of production and consumption over time in the United States, other advanced countries, and developing countries.

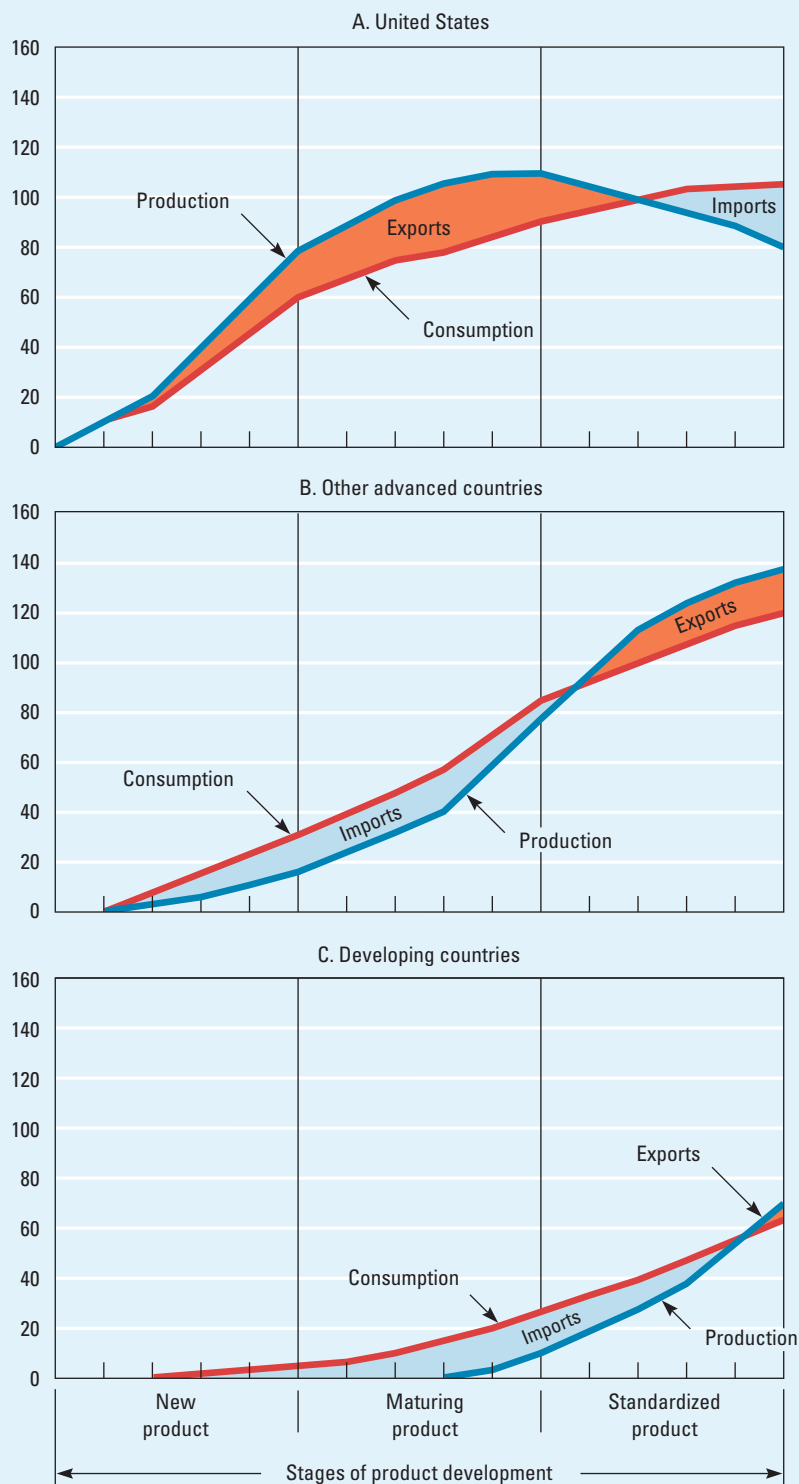
EVALUATING THE PRODUCT LIFE-CYCLE THEORY Historically, the product life-cycle theory seems to be an accurate explanation of international trade patterns. Consider photocopiers; the product was first developed in the early 1960s by Xerox in the United States and sold initially to U.S. users. Originally Xerox exported photocopiers from the United States, primarily to Japan and the advanced countries of Western Europe. As demand began to grow in those countries, Xerox entered into joint ventures to set up production in Japan (Fuji-Xerox) and Great Britain (Rank-Xerox). In addition, once Xerox's patents on the photocopier process expired, other foreign competitors began to enter the market (e.g., Canon in Japan, Olivetti in Italy). As a consequence, exports from the United States declined, and U.S. users began to buy some of their photocopiers from lower-cost foreign sources, particularly Japan. More recently, Japanese companies have found that manufacturing costs are too high in their own country, so they have begun to switch production to developing countries such as Singapore and Thailand. Thus, initially the United States and now other advanced countries (e.g., Japan and Great Britain) have switched from being exporters of photocopiers to importers. This evolution in the pattern of international trade in photocopiers is consistent with the predictions of the product life-cycle theory that mature industries tend to go out of the United States and into low-cost assembly locations.

However, the product life-cycle theory is not without weaknesses. Viewed from an Asian or European perspective, Vernon's argument that most new products are developed and introduced in the United States seems ethnocentric and increasingly dated. Although it may be true that during U.S. dominance of the global economy (from 1945 to 1975), most new products were introduced in the United States, there have always been important exceptions. These exceptions appear to have become more common in recent years. Many new products are now first introduced in Japan (e.g., videogame consoles) or Europe (new wireless phones). Moreover, with the increased globalization and integration of the world economy discussed in Chapter 1, a growing number of new products (e.g., laptop computers, compact disks, and digital cameras) are now introduced simultaneously in the United States, Japan, and the advanced European nations. This may be accompanied by globally dispersed production, with particular components of a new product being produced in those locations around the globe where the mix of factor costs and skills is most favorable (as predicted by the theory of comparative advantage). In sum, although Vernon's theory may be useful for explaining the pattern of international trade during the brief period of American global dominance, its relevance in the modern world seems more limited.

5.5 figure

The Product Life Cycle Theory

Source: Adapted from R. Vernon and L. T. Wells, *The Economic Environment of International Business*, 4th ed., © 1986. Reprinted by permission of Pearson Education, Inc. Upper Saddle River, N.J.



New Trade Theory

LEARNING OBJECTIVE 2

Summarize the different theories explaining trade flows between nations.

Economies of Scale

Cost advantages associated with large-scale production.

The new trade theory began to emerge in the 1970s when a number of economists pointed out that the ability of firms to attain economies of scale might have important implications for international trade.²⁷ **Economies of scale** are unit cost reductions associated with a large scale of output. Economies of scale have a number of sources, including the ability to spread fixed costs over a large volume, and the ability of large-volume producers to utilize specialized employees and equipment that are more productive than less-specialized employees and equipment. Economies of scale are a major source of cost reductions in many industries, from computer software to automobiles, and from pharmaceuticals to aerospace. For example, Microsoft realizes economies of scale by spreading the fixed costs of developing new versions of its Windows operating system, which runs to about \$5 billion, over the 250 million or so personal computers upon which each new system is ultimately installed. Similarly, automobile companies realize economies of scale by producing a high volume of automobiles from an assembly line where each employee has a specialized task.

New trade theory makes two important points: First, through its impact on economies of scale, trade can increase the variety of goods available to consumers and decrease the average costs of those goods. Second, in those industries where the output required to attain economies of scale represents a significant proportion of total world demand, the global market may be able to support only a small number of enterprises. Thus, world trade in certain products may be dominated by countries whose firms were first movers in their production.

LEARNING OBJECTIVE 3

Recognize why many economists believe that unrestricted free trade between nations will raise the economic welfare of countries that participate in a free trade system.

INCREASING PRODUCT VARIETY AND REDUCING COSTS Imagine first a world without trade. In industries where economies of scale are important, both the variety of goods that a country can produce and the scale of production are limited by the size of the market. If a national market is small, there may not be enough demand to enable producers to realize economies of scale for certain products. Accordingly, those products may not be produced, thereby limiting the variety of products available to consumers. Alternatively, they may be produced, but at such low volumes that unit costs and prices are considerably higher than they might be if economies of scale could be realized.

Now consider what happens when nations trade with each other. Individual national markets are combined into a larger world market. As the size of the market expands due to trade, individual firms may be able to better attain economies of scale. The implication, according to new trade theory, is that each nation may be able to specialize in producing a narrower range of products than it would in the absence of trade, yet by buying goods that it does not make from other countries, each nation can simultaneously increase the *variety* of goods available to its consumers and *lower the costs* of those goods—thus trade offers an opportunity for mutual gain even when countries do not differ in their resource endowments or technology.

Suppose there are two countries, each with an annual market for 1 million automobiles. By trading with each other, these countries can create a combined market for 2 million cars. In this combined market, due to the ability to better realize economies of scale, more varieties (models) of cars can be produced, and cars can be produced at a lower average cost, than in either market alone. For example, demand for a sports car may be limited to 55,000 units in each national market, while a total output of at least 100,000 per year may be required to realize significant scale economies. Similarly, demand for a minivan may be 80,000 units in each national market, and again a total output of at least 100,000 per year may be required to realize significant

scale economies. Faced with limited domestic market demand, firms in each nation may decide not to produce a sports car, since the costs of doing so at such low volume are too great. Although they may produce minivans, the cost of doing so will be higher, as will prices, than if significant economies of scale had been attained. Once the two countries decide to trade, however, a firm in one nation may specialize in producing sports cars, while a firm in the other nation may produce minivans. The combined demand for 110,000 sports cars and 160,000 minivans allows each firm to realize scale economies. Consumers in this case benefit from having access to a product (sports cars) that was not available before international trade and from the lower price for a product (minivans) that could not be produced at the most efficient scale before international trade. Trade is thus mutually beneficial because it allows for the specialization of production, the realization of scale economies, the production of a greater variety of products, and lower prices.

ECONOMIES OF SCALE, FIRST MOVER ADVANTAGES AND THE PATTERN OF TRADE

A second theme in new trade theory is that the pattern of trade we observe in the world economy may be the result of economies of scale and first-mover advantages. **First-mover advantages** are the economic and strategic advantages that accrue to early entrants into an industry.²⁸ The ability to capture scale economies ahead of later entrants, and thus benefit from a lower cost structure, is an important first-mover advantage. New trade theory argues that for those products where economies of scale are significant and represent a substantial proportion of world demand, the first movers in an industry can gain a scale-based cost advantage that later entrants find almost impossible to match. Thus, the pattern of trade that we observe for such products may reflect first-mover advantages. Countries may dominate in the export of certain goods because economies of scale are important in their production and because firms located in those countries were the first to capture scale economies, giving them a first-mover advantage.

For example, consider the commercial aerospace industry, where substantial scale economies come from the ability to spread the fixed costs of developing a new jet aircraft over a large number of sales. It has cost Airbus some \$15 billion to develop its new super-jumbo jet, the 550-seat A380. To recoup those costs and break even, Airbus will have to sell at least 250 A380 planes. If Airbus can sell over 350 A380 planes, it will apparently be a profitable venture. Total demand over the next 20 years for this class of aircraft is estimated to be somewhere between 400 and 600 units. Thus, the global market can probably profitably support only one producer of jet aircraft in the super-jumbo category. It follows that the European Union might come to dominate in the export of very large jet aircraft, primarily because a European-based firm, Airbus, was the first to produce a super-jumbo jet and realize scale economies. Other potential producers, such as Boeing, might be shut out of the market because they will lack the scale economies that Airbus will enjoy. By pioneering this market category, Airbus may have captured a first-mover advantage based on scale economies that will be difficult for rivals to match, and that will result in the European Union becoming the leading exporter of very large jet aircraft. (Boeing does not believe the market to be large enough to profitably support even one producer, hence its decision not to build a similar aircraft, and instead focus on its super-efficient 787.)

IMPLICATIONS OF NEW TRADE THEORY New trade theory has important implications. The theory suggests that nations may benefit from trade even when they do not differ in resource endowments or technology. Trade allows a nation to specialize in the production of certain products, attaining scale economies and lowering

First-Mover Advantages

Advantages accruing to the first to enter a market.

LEARNING OBJECTIVE 3

Recognize why many economists believe that unrestricted free trade between nations will raise the economic welfare of countries that participate in a free trade system.



The European Union may come to dominate in the export of super-jumbo jets primarily because Airbus, a European-based firm, was the first to produce a 550-seat aircraft and realize economies of scale.

the costs of producing those products, while buying products that it does not produce from other nations that specialize in the production of those products. By this mechanism, the variety of products available to consumers in each nation is increased, while the average costs of those products should fall, as should their price, freeing resources to produce other goods and services.

The theory also suggests that a country may predominate in the export of a good simply because it was lucky enough to have one or more firms among the first to produce that good. Because they are able to gain economies of scale, the first movers in an industry may get a lock on the world market that discourages subsequent entry. First movers' ability to benefit from increasing returns creates a barrier to entry. In the commercial aircraft industry, the fact that Boeing and Airbus are already in the industry and have the benefits of economies of scale discourages new entry and reinforces the dominance of America and Europe in the trade of mid-sized and large jet aircraft. This dominance is further reinforced because global demand may not be sufficient to profitably support another producer of mid-sized and large jet aircraft in the industry. So although Japanese firms might be able to compete in the market, they have decided not to enter the industry but to ally themselves as major subcontractors with primary producers (e.g., Mitsubishi Heavy Industries is a major subcontractor for Boeing on the 777 and 787 programs).

New trade theory is at variance with the Heckscher-Ohlin theory, which suggests that a country will predominate in the export of a product when it is particularly well endowed with those factors used intensively in its manufacture. New trade theorists argue that the United States is a major exporter of commercial jet aircraft not because it is better endowed with the factors of production required to manufacture aircraft, but because one of the first movers in the industry, Boeing, was a U.S. firm. The new trade theory is not at variance with the theory of comparative advantage. Economies of scale increase productivity. Thus, the new trade theory identifies an important source of comparative advantage.

This theory is quite useful in explaining trade patterns. Empirical studies seem to support the predictions of the theory that trade increases the specialization of production

within an industry, increases the variety of products available to consumers, and results in lower average prices.²⁹ With regard to first-mover advantages and international trade, a study by Harvard business historian Alfred Chandler suggests the existence of first-mover advantages is an important factor in explaining the dominance of firms from certain nations in specific industries.³⁰ The number of firms is very limited in many global industries, including the chemical industry, the heavy construction-equipment industry, the heavy truck industry, the tire industry, the consumer electronics industry, the jet engine industry, and the computer software industry.

Perhaps the most contentious implication of the new trade theory is the argument that it generates for government intervention and strategic trade policy.³¹ New trade theorists stress the role of luck, entrepreneurship, and innovation in giving a firm first-mover advantages. According to this argument, the reason Boeing was the first mover in commercial jet aircraft manufacture—rather than firms such as Great Britain’s DeHavilland and Hawker Siddeley, or Holland’s Fokker, all of which could have been—was that Boeing was both lucky and innovative. One way Boeing was lucky is that DeHavilland’s Comet jet airliner, introduced two years earlier than Boeing’s first jet airliner, the 707, was found to be full of serious technological flaws. Had DeHavilland not made serious technological mistakes, Great Britain might have become the world’s leading exporter of commercial jet aircraft. Boeing’s innovativeness was demonstrated by its independent development of the technological know-how required to build a commercial jet airliner. Several new trade theorists have pointed out, however, that Boeing’s R&D was largely paid for by the U.S. government; the 707 was a spin-off from a government-funded military program (the entry of Airbus into the industry was also supported by significant government subsidies). Herein is a rationale for government intervention; by the sophisticated and judicious use of subsidies, could a government increase the chances of its domestic firms becoming first movers in newly emerging industries, as the U.S. government apparently did with Boeing (and the European Union did with Airbus)? If this is possible, and the new trade theory suggests it might be, we have an economic rationale for a proactive trade policy that is at variance with the free trade prescriptions of the trade theories we have reviewed so far. We will consider the policy implications of this issue in Chapter 6.

LEARNING OBJECTIVE 4

Explain the arguments of those who maintain that government can play a proactive role in promoting national competitive advantage in certain industries.

National Competitive Advantage: Porter’s Diamond

In 1990 Michael Porter of the Harvard Business School published the results of an intensive research effort that attempted to determine why some nations succeed and others fail in international competition.³² Porter and his team looked at 100 industries in 10 nations. Like the work of the new trade theorists, Porter’s work was driven by a belief that existing theories of international trade told only part of the story. For Porter, the essential task was to explain why a nation achieves international success in a particular industry. Why does Japan do so well in the automobile industry? Why does Switzerland excel in the production and export of precision instruments and pharmaceuticals? Why do Germany and the United States do so well in the chemical industry? These questions cannot be answered easily by the Heckscher-Ohlin theory, and the theory of comparative advantage offers only a partial explanation. The theory of comparative advantage would say that Switzerland excels in the production and export of precision instruments because it uses its resources very productively in these industries. Although this may be correct, this does not explain why Switzerland

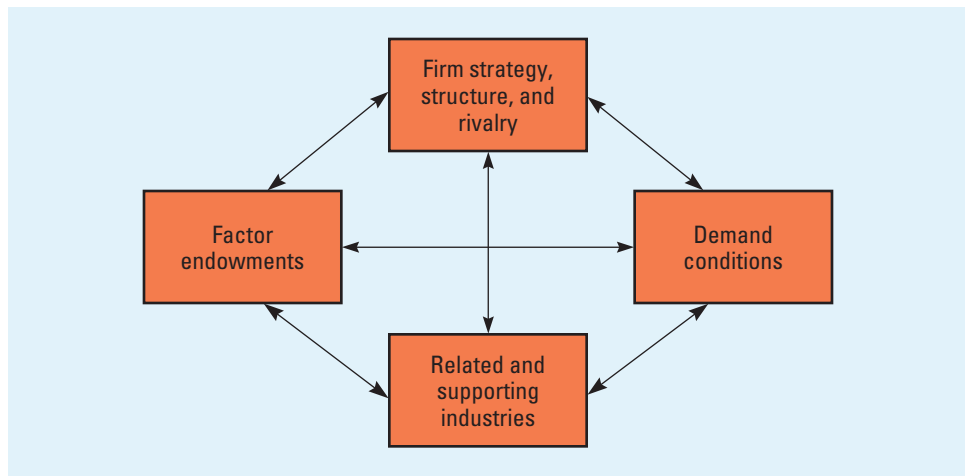
LEARNING OBJECTIVE 2

Summarize the different theories explaining trade flows between nations.

figure 5.6

Determinants of National Competitive Advantage: Porter's Diamond

Source: Reprinted by permission of the *Harvard Business Review*. "The Competitive Advantage of Nations" by Michael E. Porter, March–April 1990, p. 77. Copyright © 1990 by The President and Fellows of Harvard College; all rights reserved.



is more productive in this industry than Great Britain, Germany, or Spain. Porter tries to solve this puzzle.

Porter theorizes that four broad attributes of a nation shape the environment in which local firms compete, and these attributes promote or impede the creation of competitive advantage (see Figure 5.6). These attributes are

- *Factor endowments*—a nation's position in factors of production such as skilled labor or the infrastructure necessary to compete in a given industry.
- *Demand conditions*—the nature of home demand for the industry's product or service.
- *Related and supporting industries*—the presence or absence of supplier industries and related industries that are internationally competitive.
- *Firm strategy, structure, and rivalry*—the conditions governing how companies are created, organized, and managed and the nature of domestic rivalry.

Porter speaks of these four attributes as constituting the *diamond*. He argues that firms are most likely to succeed in industries or industry segments where the diamond is most

favorable. He also argues that the diamond is a mutually reinforcing system. The effect of one attribute is contingent on the state of others. For example, Porter argues favorable demand conditions will not result in competitive advantage unless the state of rivalry is sufficient to cause firms to respond to them.

Porter maintains that two additional variables can influence the national diamond in important ways: chance and government. Chance events, such as major innovations, can reshape industry structure and provide the opportunity for one nation's firms to supplant another's. Government, by its choice of policies, can detract from or improve national advantage. For example, regulation can alter home demand conditions, antitrust policies can influence the intensity of rivalry within an industry, and government investments in education can change factor endowments.



Another Perspective

North Dakota: Oil Capital of the Plains?

When you think "North Dakota," what comes to mind? Perhaps you think endless fields of winter wheat, the Minot Air Force Base, or the Coen brothers' award-winning film, *Fargo*. You're probably unlikely to think oil—but if you did, you'd be right. Thanks to recent technology improvements, oil has become North Dakota's fastest-growing industry and an important new factor endowment for the state. In 2009, oil production doubled in North Dakota, rendering it the fourth-largest oil producer in the United States. If estimates are accurate, some observers believe North Dakota could outperform Alaska in oil production by 2019. (Ben Castleman, "Oil Industry Booms—in North Dakota," *The Wall Street Journal*, February 26, 2010, <http://online.wsj.com>)

FACTOR ENDOWMENTS Factor endowments lie at the center of the Heckscher-Ohlin theory. While Porter does not propose anything radically new, he does analyze the characteristics of factors of production. He recognizes hierarchies among factors, distinguishing between *basic factors* (e.g., natural resources, climate, location, and demographics) and *advanced factors* (e.g., communication infrastructure, sophisticated and skilled labor, research facilities, and technological know-how). He argues that advanced factors are the most significant for competitive advantage. Unlike the naturally endowed basic factors, advanced factors are a product of investment by individuals, companies, and governments. Thus, government investments in basic and higher education, by improving the general skill and knowledge level of the population and by stimulating advanced research at higher education institutions, can upgrade a nation's advanced factors.

The relationship between advanced and basic factors is complex. Basic factors can provide an initial advantage that is subsequently reinforced and extended by investment in advanced factors. Conversely, disadvantages in basic factors can create pressures to invest in advanced factors. An obvious example of this phenomenon is Japan, a country that lacks arable land and mineral deposits and yet through investment has built a substantial endowment of advanced factors. Porter notes that Japan's large pool of engineers (reflecting a much higher number of engineering graduates per capita than almost any other nation) has been vital to Japan's success in many manufacturing industries.

DEMAND CONDITIONS Porter emphasizes the role home demand plays in upgrading competitive advantage. Firms are typically most sensitive to the needs of their closest customers. Thus, the characteristics of home demand are particularly important in shaping the attributes of domestically made products and in creating pressures for innovation and quality. Porter argues that a nation's firms gain competitive advantage if their domestic consumers are sophisticated and demanding. Such consumers pressure local firms to meet high standards of product quality and to produce innovative products. Porter notes that Japan's sophisticated and knowledgeable buyers of cameras helped stimulate the Japanese camera industry to improve product quality and to introduce innovative models. A similar example can be found in the wireless telephone equipment industry, where sophisticated and demanding local customers in Scandinavia helped push Nokia of Finland and Ericsson of Sweden to invest in cellular phone technology long before demand for cellular phones took off in other developed nations. The case of Nokia is reviewed in more depth in the accompanying Management Focus.

RELATED AND SUPPORTING INDUSTRIES The third broad attribute of national advantage in an industry is the presence of suppliers or related industries that are internationally competitive. The benefits of investments in advanced factors of production by related and supporting industries can spill over into an industry,



Another Perspective

Factor Endowments: A Quiz

One of the most significant factor endowments is education, with important measures being literacy rate and the literacy rate gap between the genders. Which of the following countries do you think has the largest literacy gap between males and females? (a) Iraq, (b) Rwanda, (c) Chile, (d) India.

The answer may surprise you. It's not Iraq, although in nearly all countries of the Middle East, men are more likely than women to be literate. With 74 percent literacy overall, Iraq has a nearly 20-point gap between males and females. Nor is it Rwanda, with a 12-point gap and a 70 percent literacy rate overall. And it certainly isn't Chile, with its 96 percent literacy rate and less than a 1-point gap between the sexes. It is India, with an overall adult literacy rate of 61 percent and a gap of nearly 26 points between males and females. (U.S. Central Intelligence Agency, *World Factbook 2010*, www.cia.gov)



The Rise of Finland's Nokia

The wireless phone market is one of the great growth stories of the last decade. Starting from a very low base in 1990, annual global sales of wireless phones surged to reach about 1.2 billion units in 2009. By the end of 2009, the number of wireless subscriber accounts worldwide was around 4.5 billion, up from less than 10 million in 1990. Nokia is one of the dominant players in the world market for mobile phones with a 37 percent share of the market in 2008. Nokia's roots are in Finland, not normally a country that comes to mind when one talks about leading-edge technology companies. In the 1980s, Nokia was a rambling Finnish conglomerate with activities that embraced tire manufacturing, paper production, consumer electronics, and telecommunications equipment. By the early 2000s it had transformed itself into a focused telecommunications equipment manufacturer with a global reach. How has this former conglomerate emerged to take a global leadership position in wireless telecommunications equipment? Much of the answer lies in the history, geography, and political economy of Finland and its Nordic neighbors.

In 1981 the Nordic nations cooperated to create the world's first international wireless telephone network. They had good reason to become pioneers: It cost far too much to lay a traditional wire-line telephone service in those sparsely populated and inhospitably cold countries. The same features made telecommunications all the more valuable: People driving through the Arctic winter and owners of remote northern houses needed a telephone to summon help if things went wrong. As a result, Sweden, Norway, and Finland became the first nations in the world to take wireless telecommunications seriously. They found, for example, that although it cost up to \$800 per subscriber to bring a traditional wire-line service to remote locations, the same locations could be linked by wireless cellular for only \$500 per person. As a consequence, 12 percent of people in Scandinavia owned cellular phones by 1994, compared with less than 6 percent in the United States, the world's second most developed market. This lead continued over the next decade. By 2008, 90 percent of the popu-

lation in Finland owned a wireless phone, compared with 70 percent in the United States.

Nokia, a longtime telecommunications equipment supplier, was well positioned to take advantage of this development from the start, but other forces were also at work to help Nokia develop its competitive edge. Unlike virtually every other developed nation, Finland has never had a national telephone monopoly. Instead, the country's telephone services have long been provided by about 50 autonomous local telephone companies whose elected boards set prices by referendum (which naturally means low prices). This army of independent and cost-conscious telephone service providers prevented Nokia from taking anything for granted in its home country. With typical Finnish pragmatism, its customers were willing to buy from the lowest-cost supplier, whether that was Nokia, Ericsson, Motorola, or some other company. This situation contrasted sharply with that prevailing in most developed nations until the late 1980s and early 1990s, where domestic telephone monopolies typically purchased equipment from a dominant local supplier or made it themselves. Nokia responded to this competitive pressure by doing everything possible to drive down its manufacturing costs while staying at the leading edge of wireless technology.

The consequences of these forces are clear. Nokia is now a leader in digital wireless technology. Many now regard Finland as one of the lead markets for wireless telephone services. If you want to see the future of wireless, you don't go to New York or San Francisco; you go to Helsinki, where Finns use their wireless handsets not just to talk to each other or browse the Web, but also to control household heating and lighting systems, or purchase Coke from a wireless-enabled vending machine. Nokia has gained this lead because Scandinavia started switching to digital technology five years before the rest of the world.

Sources: "Lessons from the Frozen North," *The Economist*, October 8, 1994, pp. 76–77; "A Finnish Fable," *The Economist*, October 14, 2000; D. O'Shea and K. Fitchard, "The First 3 Billion Is Always the Hardest," *Wireless Review* 22 (September 2005), pp. 25–31; P. Taylor, "Big Names Dominate in Mobile Phones," *Financial Times*, September 29, 2006, p. 26; and Nokia Web site at www.nokia.com.

thereby helping it achieve a strong competitive position internationally. Swedish strength in fabricated steel products (e.g., ball bearings and cutting tools) has drawn on strengths in Sweden's specialty steel industry. Technological leadership in the U.S. semiconductor industry provided the basis for U.S. success in personal computers and several other technically advanced electronic products. Similarly, Switzerland's success in pharmaceuticals is closely related to its previous international success in the technologically related dye industry.

One consequence of this process is that successful industries within a country tend to be grouped into clusters of related industries. This was one of the most pervasive findings of Porter's study. One such cluster Porter identified was in the German textile and apparel sector, which included high-quality cotton, wool, synthetic fibers, sewing machine needles, and a wide range of textile machinery. Such clusters are important because valuable knowledge can flow between the firms within a geographic cluster, benefiting all within that cluster. Knowledge flows occur when employees move between firms within a region and when national industry associations bring employees from different companies together for regular conferences or workshops.³³

FIRM STRATEGY, STRUCTURE, AND RIVALRY The fourth broad attribute of national competitive advantage in Porter's model is the strategy, structure, and rivalry of firms within a nation. Porter makes two important points here. First, different nations are characterized by different management ideologies, which either help them or do not help them to build national competitive advantage. For example, Porter noted the predominance of engineers in top management at German and Japanese firms. He attributed this to these firms' emphasis on improving manufacturing processes and product design. In contrast, Porter noted a predominance of people with finance backgrounds leading many U.S. firms. He linked this to U.S. firms' lack of attention to improving manufacturing processes and product design. He argued that the dominance of finance led to an overemphasis on maximizing short-term financial returns. According to Porter, one consequence of these different management ideologies was a relative loss of U.S. competitiveness in those engineering-based industries where manufacturing processes and product design issues are all-important (e.g., the automobile industry).

Porter's second point is that there is a strong association between vigorous domestic rivalry and the creation and persistence of competitive advantage in an industry. Vigorous domestic rivalry induces firms to look for ways to improve efficiency, which makes them better international competitors. Domestic rivalry creates pressures to innovate, to improve quality, to reduce costs, and to invest in upgrading advanced factors. All this helps to create world-class competitors. Porter cites the case of Japan:

Nowhere is the role of domestic rivalry more evident than in Japan, where it is all-out warfare in which many companies fail to achieve profitability. With goals that stress market share, Japanese companies engage in a continuing struggle to outdo each other. Shares fluctuate markedly. The process is prominently covered in the business press. Elaborate rankings measure which companies are most popular with university graduates. The rate of new product and process development is breathtaking.³⁴

A similar point about the stimulating effects of strong domestic competition can be made with regard to the rise of Nokia of Finland to global preeminence in the market for cellular telephone equipment. For details, see the Management Focus.

EVALUATING PORTER'S THEORY Porter contends that the degree to which a nation is likely to achieve international success in a certain industry is a function of the combined impact of factor endowments, domestic demand conditions, related and supporting industries, and domestic rivalry. He argues that the presence of all four components is usually required for this diamond to boost competitive performance (although there are exceptions). Porter also contends that government can influence each of the four components of the diamond—either

LEARNING OBJECTIVE 4

Explain the arguments of those who maintain that government can play a proactive role in promoting national competitive advantage in certain industries.

positively or negatively. Factor endowments can be affected by subsidies, policies toward capital markets, policies toward education, and so on. Government can shape domestic demand through local product standards or with regulations that mandate or influence buyer needs. Government policy can influence supporting and related industries through regulation and influence firm rivalry through such devices as capital market regulation, tax policy, and antitrust laws.

If Porter is correct, we would expect his model to predict the pattern of international trade that we observe in the real world. Countries should be exporting products from those industries where all four components of the diamond are favorable, while importing in those areas where the components are not favorable. Is he correct? We simply do not know. Porter's theory has not been subjected to detailed empirical testing. Much about the theory rings true, but the same can be said for the new trade theory, the theory of comparative advantage, and the Heckscher-Ohlin theory. It may be that each of these theories, which complement each other, explains something about the pattern of international trade.



Focus on Managerial Implications

LEARNING OBJECTIVE 5

Understand the important implications that international trade theory holds for business practice.

Why does all this matter for business? There are at least three main implications for international businesses of the material discussed in this chapter: location implications, first-mover implications, and policy implications.

Location

Underlying most of the theories we have discussed is the notion that different countries have particular advantages in different productive activities. Thus, from a profit perspective, it makes sense for a firm to disperse its productive activities to those countries where, according to the theory of international trade, they can be performed most efficiently. If design can be performed most efficiently in France, that is where design facilities should be located; if the manufacture of basic components can be performed most efficiently in Singapore, that is where they should be manufactured; and if final assembly can be performed most efficiently in China, that is where final assembly should be performed. The result is a global web of productive activities, with different activities being performed in different locations around the globe depending on considerations of comparative advantage, factor endowments, and the like. If the firm does not do this, it may find itself at a competitive disadvantage relative to firms that do.

Consider the production of a laptop computer, a process with four major stages: (1) basic research and development of the product design, (2) manufacture of standard electronic components (e.g., memory chips), (3) manufacture of advanced components (e.g., flat-top color display screens and microprocessors), and (4) final assembly. Basic R&D requires a pool of highly skilled and educated workers with good backgrounds in microelectronics. The two countries with a comparative advantage in basic microelectronics R&D and design are Japan and the United States, so most producers of laptop computers locate their R&D facilities in one, or both, of these countries. (Apple, IBM, Motorola, Texas Instruments, Toshiba, and Sony all have major R&D facilities in both Japan and the United States.)

The manufacture of standard electronic components is a capital-intensive process requiring semiskilled labor, and cost pressures are intense. The best locations for such activities today are places such as Taiwan, Malaysia, and South Korea. These countries have pools of relatively skilled, moderate-cost labor. Thus, many producers of laptop computers have standard components, such as memory chips, produced at these locations.

The manufacture of advanced components such as microprocessors is a capital-intensive process requiring skilled labor. Because cost pressures are not so intense at this stage, these components can be—and are—manufactured in countries with high labor costs that also have pools of highly skilled labor (e.g. Japan and the United States).

Finally, assembly is a relatively labor-intensive process requiring only low-skilled labor, and cost pressures are intense. As a result, final assembly may be carried out in a country such as Mexico, which has an abundance of low-cost, low-skilled labor. A laptop computer produced by a U.S. manufacturer may be designed in California, have its standard components produced in Taiwan and Singapore, its advanced components produced in Japan and the United States, its final assembly in Mexico, and be sold in the United States or elsewhere in the world. By dispersing production activities to different locations around the globe, the U.S. manufacturer is taking advantage of the differences between countries identified by the various theories of international trade.

First-Mover Advantages

According to the new trade theory, firms that establish a first-mover advantage with regard to the production of a particular new product may subsequently dominate global trade in that product. This is particularly true in industries where the global market can profitably support only a limited number of firms, such as the aerospace market, but early commitments also seem to be important in less concentrated industries such as the market for cellular telephone equipment (see the Management Focus on Nokia). For the individual firm, the clear message is that it pays to invest substantial financial resources in trying to build a first-mover, or early-mover, advantage, even if that means several years of losses before a new venture becomes profitable. The idea is to preempt the available demand, gain cost advantages related to volume, build an enduring brand ahead of later competitors, and, consequently, establish a long-term sustainable competitive advantage. Although the details of how to achieve this are beyond the scope of this book, many publications offer strategies for exploiting first-mover advantages, and for avoiding the traps associated with pioneering a market (first-mover disadvantages).³⁵

Government Policy

The theories of international trade also matter to international businesses because firms are major players on the international trade scene. Business firms produce exports, and business firms import the products of other countries. Because of their pivotal role in international trade, businesses can exert a strong influence on government trade policy, lobbying to promote free trade or trade restrictions. The theories of international trade claim that promoting free trade is generally in the best interests of a country, although it may not always be in the best interest of an individual firm. Many firms recognize this and lobby for open markets.

For example, when the U.S. government announced its intention to place a tariff on Japanese imports of liquid-crystal display (LCD) screens in the 1990s, IBM and Apple Computer protested strongly. Both IBM and Apple pointed out that (1) Japan was the lowest-cost source of LCD screens, (2) they used these screens in their own laptop

computers, and (3) the proposed tariff, by increasing the cost of LCD screens, would increase the cost of laptop computers produced by IBM and Apple, thus making them less competitive in the world market. In other words, the tariff, designed to protect U.S. firms, would be self-defeating. In response to these pressures, the U.S. government reversed its posture.

Unlike IBM and Apple, however, businesses do not always lobby for free trade. In the United States, for example, restrictions on imports of steel are the result of direct pressure by U.S. firms on the government. In some cases, the government has responded to pressure by getting foreign companies to agree to “voluntary” restrictions on their imports, using the implicit threat of more comprehensive formal trade barriers to get them to adhere to these agreements (historically, this has occurred in the automobile industry). In other cases, the government used what are called “antidumping” actions to justify tariffs on imports from other nations (these mechanisms will be discussed in detail in the next chapter).

As predicted by international trade theory, many of these agreements have been self-defeating, such as the voluntary restriction on machine tool imports agreed to in 1985. Due to limited import competition from more efficient foreign suppliers, the prices of machine tools in the United States rose to higher levels than would have prevailed under free trade. Because machine tools are used throughout the manufacturing industry, the result was to increase the costs of U.S. manufacturing in general, creating a corresponding loss in world market competitiveness. Shielded from international competition by import barriers, the U.S. machine tool industry had no incentive to increase its efficiency. Consequently, it lost many of its export markets to more efficient foreign competitors. Because of this misguided action, the U.S. machine tool industry shrunk during the period when the agreement was in force. For anyone schooled in international trade theory, this was not surprising.³⁶ A similar scenario unfolded in the U.S. steel industry, where tariff barriers erected by the government in 2001 raised the cost of steel to important U.S. users, such as automobile companies and appliance makers, making their products more uncompetitive.

Finally, Porter’s theory of national competitive advantage also contains policy implications. Porter’s theory suggests that it is in the best interest of business for a firm to invest in upgrading advanced factors of production; for example, to invest in better training for its employees and to increase its commitment to research and development. It is also in the best interests of business to lobby the government to adopt policies that have a favorable impact on each component of the national diamond. Thus, according to Porter, businesses should urge government to increase investment in education, infrastructure, and basic research (since all these enhance advanced factors) and to adopt policies that promote strong competition within domestic markets (since this makes firms stronger international competitors, according to Porter’s findings).

Key Terms

free trade, p. 163
new trade theory, p. 165
mercantilism, p. 165
zero-sum game, p. 167

absolute advantage, p. 167
constant returns to specialization,
p. 173
factor endowments, p. 178

economies of scale, p. 182
first-mover advantages, p. 183

This chapter 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 observed 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 promote exports through subsidies and to limit imports through tariffs and quotas.

In explaining the pattern of international trade, the second objective of this chapter, 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, the product life-cycle theory, the new trade theory, and Porter's theory of national competitive advantage do suggest which factors are important. Comparative advantage tells us that productivity differences are important; Heckscher-Ohlin tells us that factor endowments matter; the product life-cycle theory tells us that where a new product is introduced is important; the new trade theory tells us that increasing returns to specialization and first-mover advantages matter; and Porter tells us that all these factors may be important insofar as they impact the four components of the national diamond. The chapter made these major points:

1. Mercantilists argued that it was in a country's best interests to run a balance-of-trade surplus. They viewed trade as a zero-sum game, in which one country's gains cause losses for other countries.
2. The theory of absolute advantage suggests that countries differ in their ability to produce goods efficiently. The theory suggests that a country should specialize in producing goods in areas where it has an absolute advantage and import goods in areas where other countries have absolute advantages.
3. The theory of comparative advantage suggests that it makes sense for a country to specialize in producing those goods that it can produce most efficiently, while buying goods that it can

produce relatively less efficiently from other countries—even if that means buying goods from other countries that it could produce more efficiently itself.

4. The theory of comparative advantage suggests that unrestricted free trade brings about increased world production; that is, that trade is a positive-sum game.
5. The theory of comparative advantage also suggests that opening a country to free trade stimulates economic growth, which creates dynamic gains from trade. The empirical evidence seems to be consistent with this claim.
6. The Heckscher-Ohlin theory argues that the pattern of international trade is determined by differences in factor endowments. It predicts that countries will export those goods that make intensive use of locally abundant factors and will import goods that make intensive use of factors that are locally scarce.
7. The product life-cycle theory suggests that trade patterns are influenced by where a new product is introduced. In an increasingly integrated global economy, the product life-cycle theory seems to be less predictive than it once was.
8. New trade theory states that trade allows a nation to specialize in the production of certain goods, attaining scale economies and lowering the costs of producing those goods, while buying goods that it does not produce from other nations that are similarly specialized. By this mechanism, the variety of goods available to consumers in each nation is increased, while the average costs of those goods should fall.
9. New trade theory also states that in those industries where substantial economies of scale imply that the world market will profitably support only a few firms, countries may predominate in the export of certain products simply because they had a firm that was a first mover in that industry.
10. Some new trade theorists have promoted the idea of strategic trade policy. The argument is that government, by the sophisticated and judicious use of subsidies, might be able to increase the chances of domestic firms becoming first movers in newly emerging industries.

11. Porter's theory of national competitive advantage suggests that the pattern of trade is influenced by four attributes of a nation: (a) factor endowments, (b) domestic demand conditions, (c) relating and supporting industries, and (d) firm strategy, structure, and rivalry.
12. Theories of international trade are important to an individual business firm primarily because they can help the firm decide where to locate its various production activities.
13. Firms involved in international trade can and do exert a strong influence on government policy toward trade. By lobbying government, business firms can promote free trade or trade restrictions.

Critical Thinking and Discussion Questions

1. Mercantilism is a bankrupt theory that has no place in the modern world. Discuss.
2. Is free trade fair? Discuss.
3. Unions in developed nations often oppose imports from low-wage countries and advocate trade barriers to protect jobs from what they often characterize as "unfair" import competition. Is such competition "unfair"? Do you think that this argument is in the best interests of (a) the unions, (b) the people they represent, and/or (c) the country as a whole?
4. What are the potential costs of adopting a free trade regime? Do you think governments should do anything to reduce these costs? What?
5. Reread the Country Focus "Is China a Neo-mercantilist Nation?"
 - a. Do you think China is pursuing an economic policy that can be characterized as neo-mercantilist?
 - b. What should the United States, and other countries, do about this?
6. Reread the Country Focus "Moving U.S. White-Collar Jobs Offshore."
 - a. Who benefits from the outsourcing of skilled white-collar jobs to developing nations? Who are the losers?
 - b. Will developing nations like the United States suffer from the loss of high-skilled and high-paying jobs?
 - c. Is there a difference between the transference of high-paying white-collar jobs, such as computer programming and accounting, to developing nations and low-paying blue-collar jobs? If so, what is the difference, and should government do anything to stop the flow of white-collar jobs out of the country to countries such as India?
7. Drawing upon the new trade theory and Porter's theory of national competitive advantage, outline the case for government policies that would build national competitive advantage in biotechnology. What kinds of policies would you recommend that the government adopt? Are these policies at variance with the basic free trade philosophy?
8. The world's poorest countries are at a competitive disadvantage in every sector of their economies. They have little to export. They have no capital; their land is of poor quality; they often have too many people given available work opportunities; and they are poorly educated. Free trade cannot possibly be in the interests of such nations! Discuss.

Research Task



<http://globalEDGE.msu.edu>

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

1. You work for a telecommunications company and your current project is to determine the five African countries that, in your estimation, should have an advantage in telecommunications infrastructure. Use a resource that tracks *statistics on economic factors* such as Internet use of each country. Develop a list and brief report on the top five African countries in telecommunications infrastructure. Were you surprised by any countries listed? Why (or, why not)?

2. Your coffee firm is seeking new locations to source coffee from to sustain its growth as it internationalizes. Currently, your company only purchases green coffee beans from South America and is hoping to begin purchasing coffee from the Central American countries of Costa Rica, El Salvador, Guatemala, Honduras,

and Panama. Applying the most current information from *FAOSTAT*, a UN agency Web site that gathers data on food and agricultural trade flows, determine which three countries have the highest export value of green coffee as well as growth of export value over the most recent year of data available.



Logitech

closing case

Best known as one of the world's largest producers of computer mice, Logitech is in many ways the epitome of the modern global corporation. Founded in 1981 in Apples, Switzerland, by two Italians and a Swiss, the company now generates annual sales of more than \$2.2 billion, most from products such as mice, keyboards and low-cost video-cams. Logitech made its name as a technological innovator in the highly competitive business of personal computer peripherals. It was the first company to introduce a mouse that used infrared tracking, rather than a tracking ball, and the first to introduce the wireless mouse and keyboard. Logitech is differentiated from competitors by its continuing innovation, its high brand recognition, and strong retail presence. Less obvious to consumers, but equally important, has been the way the company has configured its global value chain to lower production costs while maintaining the value of those assets that lead to differentiation.

Logitech still undertakes basic R&D work (primarily software programming) in Switzerland where it has several hundred employees. The company is still legally Swiss, but most of the corporate functions are run out of offices in Fremont, California, close to many of America's high-technology enterprises, where it has more than 500 employees. Some R&D work (again, primarily software programming) is also carried out in Fremont. Most significantly though, Fremont is the headquarters for the company's global marketing, finance, and logistics operations. The ergonomic design of Logitech's products—their look and feel—is done in Ireland by an outside design firm. Most of Logitech's products are manufactured in Asia.

Logitech's expansion into Asian manufacturing began in the late 1980s when it opened a factory in Taiwan. At the time, most of its mice were produced in the United States. Logitech was trying to win two of the most prestigious OEM customers—Apple Computer and IBM. Both bought their mice from Alps, a large Japanese firm that supplied Microsoft. To attract

discerning customers such as Apple, Logitech not only needed the capacity to produce at high volume and low cost, but it also had to offer a better-designed product. The solution: manufacture in Taiwan. Cost was a factor in the decision, but it was not as significant as might be expected, since direct labor accounted for only 7 percent of the cost of Logitech's mouse. Taiwan offered a well-developed supply base for parts, qualified people, and a rapidly expanding local computer industry. As an inducement to fledgling innovators, Taiwan provided space in its Hsinchu Science and Industrial Park for the modest fee of \$200,000. Sizing this up as a deal that was too good to pass up, Logitech signed the lease. Soon afterward, Logitech won the OEM contract with Apple. The Taiwanese factory was soon outproducing Logitech's U.S. facility. After the Apple contract, Logitech's other OEM business started being served from Taiwan; the plant's total capacity increased to 10 million mice per year.

By the late 1990s, Logitech needed more production capacity. This time it turned to China. A wide variety of the company's retail products are now made there. Take one of Logitech's biggest sellers, a wireless infrared mouse called Wanda. The mouse itself is assembled in Suzhou, China, in a factory that Logitech owns. The factory employs 4,000 people, mostly young women such as Wang Yan, an 18-year-old employee from the impoverished rural province of Anhui. She is paid \$75 a month to sit all day at a conveyor belt plugging three tiny bits of metal into circuit boards. She does this about 2,000 times each day. The mouse Wang Yan helps assemble sells to American consumers for about \$40. Of this, Logitech takes about \$8, which is used to fund R&D, marketing, and corporate overhead. What remains from the \$8 is the profit attributable to Logitech's shareholders. Distributors and retailers around the world take a further \$15. Another \$14 goes to the suppliers that make Wanda's parts. For example, a Motorola plant in Malaysia makes the mouse's chips and another American company, Agilent Technologies, supplies

the optical sensors from a plant in the Philippines. That leaves just \$3 for the Chinese factory, which is used to cover wages, power, transport, and other overhead costs.

Logitech is not alone in exploiting China to manufacture products. According to China's Ministry of Commerce, foreign companies account for three-quarters of China's high-tech exports. China's top 10 exporters include American companies with Chinese operations, such as Motorola and Seagate Technology, a maker of disk drives for computers. Intel now produces some 50 million chips a year in China, the majority of which end up in computers and other goods that are exported to other parts of Asia, or back to the United States. Yet Intel's plant in Shanghai doesn't really make chips; it tests and assembles chips from silicon wafers made in Intel plants abroad, mostly in the United States. China adds less than 5 percent of the value. The U.S. operations of Intel generate the bulk of the value and profits.

Sources: V. K. Jolly and K. A. Bechler, "Logitech: The Mouse that Roared," *Planning Review* 20, no. 6 (1992), pp. 20–34; K. Guerrino, "Lord of the Mice," *Chief Executive*, July 2003, pp. 42–44; A. Higgins, "As China Surges, It Also Proves a Buttress to American Strength," *The Wall Street Journal*, January 30, 2004, pp. A1, A8; J. Fox, "Where Is Your Job Going?" *Fortune*, November 24, 2003, pp. 84–88; and R. Wray, "Logitech Cuts 500 Jobs and Abandons Targets," *The Guardian*, January 7, 2009, p. 28.

Case Discussion Questions

1. In a world without trade, what would happen to the costs that American consumers would have to pay for Logitech's products?

2. Explain how trade lowers the costs of making computer peripherals such as mice and keyboards.
3. Use the theory of comparative advantage to explain the way in which Logitech has configured its global operations. Why does the company manufacture in China and Taiwan, undertake basic R&D in California and Switzerland, design products in Ireland, and coordinate marketing and operations from California?
4. Who creates more value for Logitech—the 650 people it employs in California and Switzerland, or the 4,000 employees at its Chinese factory? What are the implications of this observation for the argument that free trade is beneficial?
5. Why do you think the company decided to shift its corporate headquarters from Switzerland to Fremont?
6. To what extent can Porter's diamond help explain the choice of Taiwan as a major manufacturing site for Logitech?
7. Why do you think China is now a favored location for so much high-technology manufacturing activity? How will China's increasing involvement in global trade help that country? How will it help the world's developed economies? What potential problems are associated with moving work to China?

International Trade and the Balance of Payments

International trade involves the sale of goods and services to residents in other countries (exports) and the purchase of goods and services from residents in other countries (imports). A country's **balance-of-payments accounts** keep track of the payments to and receipts from other countries for a particular time period. These include payments to foreigners for imports of goods and service, and receipts from foreigners for goods and services exported to them. A summary copy of the U.S. balance-of-payments accounts for 2008 is given in Table A.1. Any transaction resulting in a payment to other countries is entered in the balance-of-payments accounts as a debit and given a negative (−) sign. Any transaction resulting in a receipt from other countries is entered as a credit and given a positive (+) sign. In this appendix we briefly describe the form of the balance-of-payments accounts, and we discuss whether a current account deficit, often a cause of much concern in the popular press, is something to worry about.

Balance-of-Payments Accounts

National accounts that track both payments to and receipts from foreigners.

Balance of Payments Accounts

Balance-of-payments accounts are divided into three main sections: the current account, the capital account, and the financial account (to confuse matters, what is now called the *capital account* was until recently part of the current account, and the financial account use to be called the capital account). The **current account** records transactions that pertain to three categories, all of which can be seen in Table A.1. The first category, *goods*, refers to the export or import of physical goods (e.g., agricultural foodstuffs, autos, computers, chemicals). The second category is the export or import of *services* (e.g., intangible products such as banking and insurance services). The third category, *income receipts and payments*, refers to income from foreign investments and payments that have to be made to foreigners investing in a country. For example, if a U.S. citizen owns a share of a Finnish company and receives a dividend payment of \$5, that payment shows up on the U.S. current account as the receipt of \$5 of investment income. Also included in the current account are unilateral current transfers, such as U.S. government grants to foreigners (including foreign aid), and private payments to foreigners (such as when a foreign worker in the United States sends money to his or her home country).

Current Account

In the balance of payments, records transactions involving the export or import of goods and services.

table A.1

U.S. Balance of Payments Accounts, 2008 (\$ millions)

Source: Bureau of Economic Analysis

CURRENT ACCOUNT		\$ Millions
Exports of Goods, Services, and Income Receipts		\$ 2,591,233
Goods		1,276,994
Services		549,602
Income Receipts		764,637
Imports of Goods, Services, and Income Payments		−3,168,938
Goods		−2,117,245
Services		−405,287
Income Payments		−646,406
Unilateral current transfers (net)		−128,363
Current Account Balance		−706,068
CAPITAL ACCOUNT		
Capital Account Transactions (net)		953
FINANCIAL ACCOUNT		
U.S.-Owned Assets Abroad, net		−106
U.S. Official Reserve Assets		−4,848
U.S. Government Assets		−529,615
U.S. Private Assets		534,357
Foreign-Owned Assets in the United States		534,071
Foreign Official Assets in the United States		487,021
Other Foreign Assets in the United States		47,050
Statistical Discrepancy		200,055

Current Account Deficit

Occurs when a country imports more good, services, and income than it exports.

Current Account Surplus

Occurs when a country exports more goods, services, and income than it imports.

A **current account deficit** occurs when a country imports more goods, services, and income than it exports. A **current account surplus** occurs when a country exports more goods, services, and income than it imports. Table A.1 shows that in 2008 the United States ran a current account deficit of \$706 billion. This is often a headline-grabbing figure and is widely reported in the news media. In recent years the U.S. current account deficit has been getting steadily larger, primarily because America imports far more physical goods than it exports (you will notice that America actually runs a surplus on trade in services and is close to balance on income payments).

The 2006 current account deficit of \$803 billion was the largest on record and was equivalent to about 6.5 percent of the country's GDP. The deficit shrank a little in 2007 and 2008, and provisional estimates suggested it would fall to about \$450 billion in 2009. Many people find these figures disturbing, the common assumption being that high imports of goods displaces domestic production, causes unemployment, and reduces the growth of the U.S. economy. For example, *The New York Times* responded to the record current account deficit in 2006 by stating:

A growing trade deficit acts as a drag on overall economic growth. Economists said that they expect that, in light of the new numbers, the government will have to revise its estimate of the nation's fourth quarter gross domestic product to show slightly slower expansion.³⁷

However, the issue is somewhat more complex than implied by statements like this. Fully understanding the implications of a large and persistent deficit requires that we look at the rest of the balance-of-payments accounts.

The **capital account** records onetime changes in the stock of assets. As noted above, until recently this item was included in the current account. The capital account includes capital transfers, such as debt forgiveness and migrants' transfers (the goods and financial assets that accompany migrants as they enter or leave the country). In the big scheme of things, this is a relatively small figure amounting to \$953 million in 2008.

The **financial account** (formally the capital account) records transactions that involve the purchase or sale of assets. Thus, when a German firm purchases stock in a U.S. company, or buys a U.S. bond, the transaction enters the U.S. balance of payments as a credit on the capital account. This is because capital is flowing into the country. When capital flows out of the United States, it enters the capital account as a debit.

The financial account is comprised of a number of elements. The net change in U.S.-owned assets abroad includes the change in assets owned by the U.S. government (U.S. official reserve assets and U.S. government assets) and the change in assets owned by private individuals and corporations. As can be seen from Table A.1, in 2008 there was a -\$106 million reduction in U.S. assets owned abroad, primarily due to a \$529 billion fall in the amount of foreign assets owned by the U.S. government. In other words, the government was selling foreign assets, such as foreign bonds and currencies, during 2008. On the other hand, there was a \$534 billion increase in the amount of foreign assets owned by private entities, indicating that U.S.-owned enterprises and private individuals were net buyers of foreign assets in 2008, including foreign stocks, bonds, and real estate.

Also included in the financial account are foreign-owned assets in the United States. These are divided into assets owned by foreign governments (foreign official assets) and assets owed by other foreign entities such as corporations and individuals (other foreign assets in the United States). As can be seen, in 2008 foreigners increased their holdings of U.S. assets, including treasury bills, corporate stocks and bonds, and direct investments in the United States, by \$534 billion. Some \$487 billion of this was due to an increase in the holding of U.S. assets by foreign governments, with the remainder being due to investments by private corporations and individuals in U.S. assets.

It is important at this point to understand that a basic principle of balance-of-payments accounting is double-entry bookkeeping. Every international transaction automatically enters the balance of payments twice—once as a credit and once as a debit. Imagine that you purchase a car produced in Japan by Toyota for \$20,000. Since your purchase represents a payment to another country for goods, it will enter the balance of payments as a debit on the current account. Toyota now has the \$20,000 and must do something with it. If Toyota deposits the money at a U.S. bank, Toyota has purchased a U.S. asset—a bank deposit worth \$20,000—and the transaction will show up as a \$20,000 credit on the financial account. Or Toyota might deposit the cash in a Japanese bank in return for Japanese yen. Now the Japanese bank must decide what to do with the \$20,000. Any action that it takes will ultimately result in a credit for the U.S. balance of payments. For example, if the bank lends the \$20,000 to a Japanese firm that uses it to import personal computers from the United States, then the \$20,000 must be credited to the U.S. balance-of-payments current account. Or the Japanese bank might use the \$20,000 to purchase U.S. government bonds, in which case it will show up as a credit on the U.S. balance-of-payments financial account.

Thus, any international transaction automatically gives rise to two offsetting entries in the balance of payments. Because of this, *the sum of the current account balance, the*

Capital Account

Records onetime changes in the stock of assets.

Financial Account

Records transactions that involve the purchase or sale of assets.

capital account, and the financial account balance should always add up to zero. In practice, this does not always occur due to the existence of “statistical discrepancies,” the source of which need not concern us here (in 2008 the statistical discrepancy amounted to \$200 billion).

Does the Current Account Deficit Matter?

As discussed above, there is some concern when a country is running a deficit on the current account of its balance of payments.³⁸ In recent years a number of rich countries, including most notably the United States, have run persistent and growing current account deficits. When a country runs a current account deficit, the money that flows to other countries can then be used by those countries to purchase assets in the deficit country. Thus, when the United States runs a trade deficit with China, the Chinese use the money that they receive from U.S. consumers to purchase U.S. assets such as stocks, bonds, and the like. Put another way, a deficit on the current account is financed by selling assets to other countries; that is, by a surplus on the financial account. Thus, the persistent U.S. current account deficit is being financed by a steady sale of U.S. assets (stocks, bonds, real estate, and whole corporations) to other countries. In short, countries that run current account deficits become net debtors.

For example, as a result of financing its current account deficit through asset sales, the United States must deliver a stream of interest payments to foreign bondholders, rents to foreign landowners, and dividends to foreign stockholders. One might argue that such payments to foreigners drain resources from a country and limit the funds available for investment within the country. Since investment within a country is necessary to stimulate economic growth, a persistent current account deficit can choke off a country's future economic growth. This is the basis of the argument that persistent deficits are bad for an economy.

However, things are not this simple. For one thing, in an era of global capital markets money is efficiently directed toward its highest value uses, and over the past quarter of a century many of the highest value uses of capital have been in the United States. So even though capital is flowing out of the United States in the form of payments to foreigners, much of that capital finds its way right back into the country to fund productive investments in the United States. In short, it is not clear that the current account deficit chokes off U.S. economic growth. In fact, notwithstanding the 2008–2009 recession, the U.S. economy has grown at an impressive rate over the past 25 years, despite running a persistent current account deficit, and despite financing that deficit by selling U.S. assets to foreigners. This is precisely because foreigners reinvest much of the income earned from U.S. assets, and from exports to the United States, right back into the United States. This revisionist view, which has gained in popularity in recent years, suggests that a persistent current account deficit might not be the drag on economic growth it was once thought to be.³⁹

Having said this, there is still a nagging fear that at some point the appetite that foreigners have for U.S. assets might decline. If foreigners suddenly reduce their investments in the United States, what would happen? In short, instead of reinvesting the dollars that they earn from exports and investment in the United States back into the country, they would sell those dollars for another currency, European euros, Japanese yen, or Chinese yuan, for example, and invest in euro-, yen- and yuan-denominated assets instead. This would lead to a fall in the value of the dollar on foreign exchange markets, and that in turn would increase the price of imports, and lower the price of U.S. exports making them more competitive, which should reduce the overall level of the current account deficit. Thus, in the long run the persistent U.S.

current account deficit could be corrected via a reduction in the value of the U.S. dollar. The concern is that such adjustments may not be smooth. Rather than a controlled decline in the value of the dollar, the dollar might suddenly lose a significant amount of its value in a very short time, precipitating a “dollar crisis.”⁴⁰ Since the U.S. dollar is the world’s major reserve currency, and is held by many foreign governments and banks, any dollar crisis could deliver a body blow to the world economy and at the very least trigger a global economic slowdown. That would not be a good thing.

Key Terms

balance-of-payments accounts, p. 197
current account, p. 197

current account deficit, p. 198
current account surplus, p. 198

capital account, p. 199
financial account, p. 199



part 3

Cross-Border Trade and Investment

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Identify the policy instruments used by governments to influence international trade flows.
- 2 Understand why governments sometimes intervene in international trade.
- 3 Summarize and explain the arguments against strategic trade policy.
- 4 Describe the development of the world trading system and the current trade issues.
- 5 Explain the implications for managers of developments in the world trading system.

The Political Economy of International Trade

The Global Financial Crisis and Protectionism

opening case

Over the past 25 years two facts have characterized international trade. First, the volume of world trade has grown every single year, creating an increasingly interdependent global economy, and second, barriers to international trade have been progressively reduced. Between 1990 and 2007, international trade grew by 6 percent per annum compounded, while import tariffs on goods fell from an average of 26 percent in 1986 to 8.8 percent in 2007. In the wake of the global financial crisis that started in the United States in 2008 and quickly spread around the world, this has now changed. As global demand slumped and financing for international trade dried up in the wake of tight credit conditions, so did the volume of international trade. The volume of world trade fell by 2 percent in 2008, the first decline since 1982, and a further 9 percent in 2009.

This contraction is alarming because, in the past, sharp declines in trade have been followed by calls for greater protectionism from foreign competition as governments try to protect jobs at home in the wake of declining demand. This occurred in the 1930s, when shrinking trade was followed quickly by increases in trade barriers, mostly in the form of higher tariffs. This actually made the situation far worse and led to the Great Depression.

Much has changed since the 1930s. Treaties now limit the ability of national governments to raise trade barriers. Most notably, World Trade Organization rules in theory constrain the ability of countries to implement significant increases in trade barriers. But WTO rules are not perfect, and evidence shows that countries are raising barriers to international trade. Many developing countries have latitude under WTO rules to raise some tariffs, and, according to the World Bank, in 2008 and 2009 they were doing just that. For example, Ecuador raised duties on 600 goods, Russia increased import tariffs on used cars, while India placed them on some steel imports.

According to the World Bank, however, two-thirds of the protectionist measures taken in 2008 and 2009 are various kinds of “nontariff” barriers that are designed to get around WTO rules. Indonesia, for example, specified that certain kinds of goods, including clothes, shoes, and toys, can be imported only through five ports. Since these ports have limited capacity, this constrains the ability of foreign companies to sell into the Indonesian market. Argentina has imposed discretionary licensing requirements on a range of goods including car parts, textiles, and televisions. If you can’t get a license, you can’t sell into Argentina. China has stopped a wide range of imports of food and drink products from Europe, citing safety rules and environmental concerns, while India has banned imports of toys from China for safety reasons.

Developed nations have in general not taken similar actions, but they have sharply increased subsidies to troubled domestic producers, which gives them an advantage against unsubsidized international competitors, and therefore distorts trade. The key example of this in 2008 and 2009 was the automobile industry. To protect national producers, hold on to jobs, and stave off bankruptcies, rich countries including the United States, Great Britain, Canada, France, Germany, Italy, and Sweden gave over \$45 billion in subsidies to car companies between mid-2008 and mid-2009. Such subsidies could cause production to switch from more-efficient plants to less-efficient plants that have an advantage due to state support. Although the WTO has rules against trade-distorting subsidies, its enforcement mechanisms are weaker than in the case of tariffs, and so far countries that have been increasing subsidies have not been challenged. ●

Source: “The Nuts and Bolts Come Apart,” *The Economist*, March 28, 2009, pp. 79–81; “Barriers to Entry,” *The Economist*, December 20, 2008, p. 121; and “Beyond Doha,” *The Economist*, October 11, 2008, pp. 30–33.



Introduction

Our review of the classical trade theories of Smith, Ricardo, and Heckscher-Ohlin in Chapter 5 showed us that in a world without trade barriers, trade patterns are determined by the relative productivity of different factors of production in different countries. Countries will specialize in products that they can make most efficiently, while importing products that they can produce less efficiently. Chapter 5 also laid out the intellectual case for free trade. Remember, **free trade** refers to a situation in which a government does not attempt to restrict what its citizens can buy from or sell to another country. As we saw in Chapter 5, the theories of Smith, Ricardo, and Heckscher-Ohlin predict that the consequences of free trade include both static economic gains (because free trade supports a higher level of domestic consumption and more efficient utilization of resources) and dynamic economic gains (because free trade stimulates economic growth and the creation of wealth).

Free Trade

The absence of government barriers to the free flow of goods and services between countries.

In this chapter, we look at the political reality of international trade. Although many nations are nominally committed to free trade, they tend to intervene in international trade to protect the interests of politically important groups or promote the interests of key domestic producers. The opening case illustrates the nature of such political realities. In the wake of the global economic slowdown that followed the financial crisis of 2008–2009, a wide range of countries have been increasing tariffs and non-tariff barriers to international trade in an attempt to protect domestic producers, and hold onto jobs. While such actions are understandable from a political perspective, international trade theory teaches us that they are self-defeating. Ultimately, protecting inefficient producers raises the price of goods and services, and results in lower economic growth.

In this chapter, 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 domestic production and exports. As in 2008 and 2009, normally their motives are to protect domestic producers. In recent years, social issues have intruded into the decision-making calculus. In the United States, for example, a movement is growing to ban imports of goods from countries that do not abide by the same labor, health, and environmental regulations as the United States.

We start this chapter by describing the range of policy instruments that governments use to intervene in international trade. This is followed by a detailed review of the various political and economic motives that governments have for intervention. In the third section of this chapter, we consider how the case for free trade stands up in view of the various justifications given for government intervention in international trade. Then we look at the emergence of the modern international trading system, which is based on the General Agreement on Tariffs and Trade and its successor, the WTO. The GATT and WTO are the creations of a series of multinational treaties. The most recent was completed in 1995, involved more than 120 countries, and resulted in the creation of the WTO. The purpose of these treaties has been to lower barriers to the free flow of goods and services between nations. Like the GATT before it, the WTO promotes free trade by limiting the ability of national governments to adopt policies that restrict imports into their nations. In the final section of this chapter, we discuss the implications of this material for management practice.



Another Perspective

Rankings of the World Economic Forum (WEF)

The World Economic Forum (WEF) is an independent economic organization whose mission is to improve the state of the world. Based in Geneva, Switzerland, it hosts meetings that serve as a forum for the collaboration of international leaders. The WEF also conducts global economic research and annually publishes country competitive rankings. In the latest report (2009–2010), the top countries in competitiveness were Switzerland, the United States, and Singapore, followed by Sweden, Denmark, Finland, and Germany. If you review the report's complete list of rankings, you'll note a strong correlation between a country's ranking and its political system. Visit www.weforum.org.

Instruments of Trade Policy

Trade policy uses seven main instruments: tariffs, subsidies, import quotas, voluntary export restraints, local content requirements, administrative policies, and antidumping duties. Tariffs are the oldest and simplest instrument of trade policy. As we shall see later in this chapter, they are also the instrument that the GATT and WTO have

LEARNING OBJECTIVE 1

Identify the policy instruments used by governments to influence international trade flows.

been most successful in limiting. A fall in tariff barriers in recent decades has been accompanied by a rise in nontariff barriers, such as subsidies, quotas, voluntary export restraints, and antidumping duties.

Tariff

A tax levied on imports.

Specific Tariff

A tariff levied as a fixed charge for each unit of good imported.

Ad Valorem Tariff

A tariff levied as a proportion of the value of an imported good.

TARIFFS A **tariff** is a tax levied on imports (or exports). Tariffs fall into two categories. **Specific tariffs** are levied as a fixed charge for each unit of a good imported (for example, \$3 per barrel of oil). **Ad valorem tariffs** are levied as a proportion of the value of the imported good. In most cases, tariffs are placed on imports to protect domestic producers from foreign competition by raising the price of imported goods. However, tariffs also produce revenue for the government. Until the income tax was introduced, for example, the U.S. government received most of its revenues from tariffs.

The important thing to understand about an import tariff is who suffers and who gains. The government gains, because the tariff increases government revenues. Domestic producers gain, because the tariff affords them some protection against foreign competitors by increasing the cost of imported foreign goods. Consumers lose because they must pay more for certain imports. For example, in 2002 the U.S. government placed an ad valorem tariff of 8 percent to 30 percent on imports of foreign steel. The idea was to protect domestic steel producers from cheap imports of foreign steel. The effect, however, was to raise the price of steel products in the United States between 30 and 50 percent. A number of U.S. steel consumers, ranging from appliance makers to automobile companies, objected that the steel tariffs would raise their costs of production and make it more difficult for them to compete in the global marketplace. Whether the gains to the government and domestic producers exceed the loss to consumers depends on various factors such as the amount of the tariff, the importance of the imported good to domestic consumers, the number of jobs saved in the protected industry, and so on. In the steel case, many argued that the losses to steel consumers apparently outweighed the gains to steel producers. In November 2003, the World Trade Organization declared that the tariffs represented a violation of the WTO treaty, and the United States removed them in December of that year.

In general, two conclusions can be derived from economic analysis of the effect of import tariffs.¹ First, tariffs are pro-producer and anti-consumer. While they protect producers from foreign competitors, this restriction of supply also raises domestic prices. For example, a study by Japanese economists calculated that tariffs

on imports of foodstuffs, cosmetics, and chemicals into Japan cost the average Japanese consumer about \$890 per year in the form of higher prices.² Almost all studies find that import tariffs impose significant costs on domestic consumers in the form of higher prices.³

Second, import tariffs reduce the overall efficiency of the world economy. They reduce efficiency because a protective tariff encourages domestic firms to produce products at home that, in theory, could be produced more efficiently abroad. The consequence is an inefficient utilization of resources. For example, tariffs on the importation of rice into South Korea have led to an increase in rice production in that country; however, rice farming is an unproductive use of land in South Korea. It would make more sense for the



Another Perspective

U.S. Tariff Rates

Because the United States takes a free trade public position, many people assume the U.S. government has few tariffs. Information about U.S. trade is readily available online.

For example, you can review the U.S. government's current tariffs at the U.S. Office of Trade and Trade Agreements site (www.usitc.gov/tata/index.htm). However, with many schedules and fine distinctions made within product groups, this site can be a challenge to browse. For interesting statistics on imports and exports of the United States, as well as of other nations, check out the World Trade Organization Web site at www.wto.org.

South Koreans to purchase their rice from lower-cost foreign producers and to utilize the land now employed in rice production in some other way, such as growing foodstuffs that cannot be produced more efficiently elsewhere or for residential and industrial purposes.

Sometimes tariffs are levied on exports of a product from a country. Export tariffs are far less common than import tariffs. In general, export tariffs have two objectives: first, to raise revenue for the government, and second, to reduce exports from a sector, often for political reasons. For example, in 2004 China imposed a tariff on textile exports. The primary objective was to moderate the growth in exports of textiles from China, thereby alleviating tensions with other trading partners.

SUBSIDIES A **subsidy** is a government payment to a domestic producer. Subsidies take many forms, including cash grants, low-interest loans, tax breaks, and government equity participation in domestic firms. By lowering production costs, subsidies help domestic producers in two ways: (1) competing against foreign imports and (2) gaining export markets. According to the World Trade Organization, in the mid-2000s countries spent some \$300 billion on subsidies, \$250 billion of which was spent by 21 developed nations.⁴ As noted in the opening case, between mid-2008 and mid-2009 some developed nations gave \$45 billion in subsidies to their automobile makers. While the purpose of the subsidies was to help them survive a very difficult economic climate, one of the consequences was to give subsidized companies an unfair competitive advantage in the global auto industry.

Agriculture tends to be one of the largest beneficiaries of subsidies in most countries. In the mid-2000s, the European Union was paying about €44 billion annually (\$55 billion) in farm subsidies. Not to be outdone, in May 2002 President George W. Bush signed into law a bill that contained subsidies of more than \$180 billion for U.S. farmers spread out over 10 years. This was followed in 2007 by a farm bill that contained \$286 billion in subsidies for the next 10 years. The Japanese also have a long history of supporting inefficient domestic producers with farm subsidies. The accompanying Country Focus looks at subsidies to wheat producers in Japan.

Nonagricultural subsidies are much lower, but they are still significant. For example, subsidies historically were given to Boeing and Airbus to help them lower the cost of developing new commercial jet aircraft. In Boeing's case, subsidies came in the form of tax credits for R&D spending or Pentagon money that was used to develop military technology, which then was transferred to civil aviation projects. In the case of Airbus, subsidies took the form of government loans at below-market interest rates.

The main gains from subsidies accrue to domestic producers, whose international competitiveness is increased as a result. Advocates of strategic trade policy (which, as you will recall from Chapter 5, is an outgrowth of the new trade theory) favor subsidies to help domestic firms achieve a dominant position in those industries in which economies of scale are important and the world market is not large enough to profitably support more than a few firms (aerospace and semiconductors are two such industries). According to this argument, subsidies can help a firm achieve a first-mover advantage in an emerging industry (just as U.S. government subsidies, in the form of substantial R&D grants, allegedly helped Boeing). If this is achieved, further gains to the domestic economy arise from the employment and tax revenues that a major global company can generate. However, government subsidies must be paid for, typically by taxing individuals and corporations.

Whether subsidies generate national benefits that exceed their national costs is debatable. In practice, many subsidies are not that successful at increasing the



Subsidy

Government financial assistance to a domestic producer.



Country FOCUS

Subsidized Wheat Production in Japan

Japan is not a particularly good environment for growing wheat. Wheat produced on large fields in the dry climates of North America, Australia, and Argentina is far cheaper and of much higher quality than anything produced in Japan, which imports some 80 percent of its wheat from foreign producers. Yet tens of thousands of farmers in Japan still grow wheat, usually on small fields where yields are low and costs high, and production is rising. They do this because government subsidies keep inefficient Japanese wheat producers in business. In the mid-2000s, Japanese farmers were selling their output at market prices, which were running at \$9 per bushel, but they received an average of at least \$35 per bushel for their production! The difference—\$26 a bushel—was government subsidies paid to producers. The estimated costs of these subsidies were more than \$700 million a year.

To finance its production subsidy, Japan operates a tariff rate quota on wheat imports in which a higher tariff rate is imposed once wheat imports exceed the quota level. The in-quota rate tariff is zero, while the over-quota tariff rate for wheat is \$500 a ton. The tariff raises the cost so much that it deters over-quota imports, essentially restricting supply and raising the price for wheat inside Japan. The Japanese Ministry of Agriculture, Forestry and Fisheries (MAFF) has the sole right to purchase wheat imports within the quota (and since there are very few over-quota imports, the MAFF is a monopoly buyer on wheat imports into Japan). The MAFF buys wheat at world prices then resells it to millers in Japan at the artificially high prices that arise

due to the restriction on supply engineered by the tariff rate quota. Estimates suggest that in 2004, the world market price for wheat was \$5.96 per bushel, but within Japan the average price for imported wheat was \$10.23 a bushel. The markup of \$4.27 a bushel yielded the MAFF in excess of \$450 million in profit. This “profit” was then used to help cover the \$700 million cost of subsidies to inefficient wheat farmers, with the rest of the funds coming from general government tax revenues.

Thanks to these policies, the price of wheat in Japan can be anything from 80 to 120 percent higher than the world price, and Japanese wheat production, which exceeded 850,000 tons in 2004, is significantly greater than it would be if a free market were allowed to operate. Indeed, under free market conditions, there would be virtually no wheat production in Japan since the costs of production are simply too high. The beneficiaries of this policy are the thousands of small farmers in Japan who grow wheat. The losers include Japanese consumers, who must pay more for products containing wheat and who must finance wheat subsidies through taxes, and foreign producers, who are denied access to a chunk of the Japanese market by the over-quota tariff rate. Why then does the Japanese government continue to pursue this policy? It continues because small farmers are an important constituency and Japanese politicians want their votes.

Sources: J. Dyck and H. Fukuda, “Taxes on Imports Subsidize Wheat Production in Japan,” *Amber Waves*, February 2005, p. 2; and H. Fukuda, J. Dyck, and J. Stout, “Wheat and Barley Policies in Japan,” U.S. Department of Agriculture research report, WHS-04i-01, November 2004.

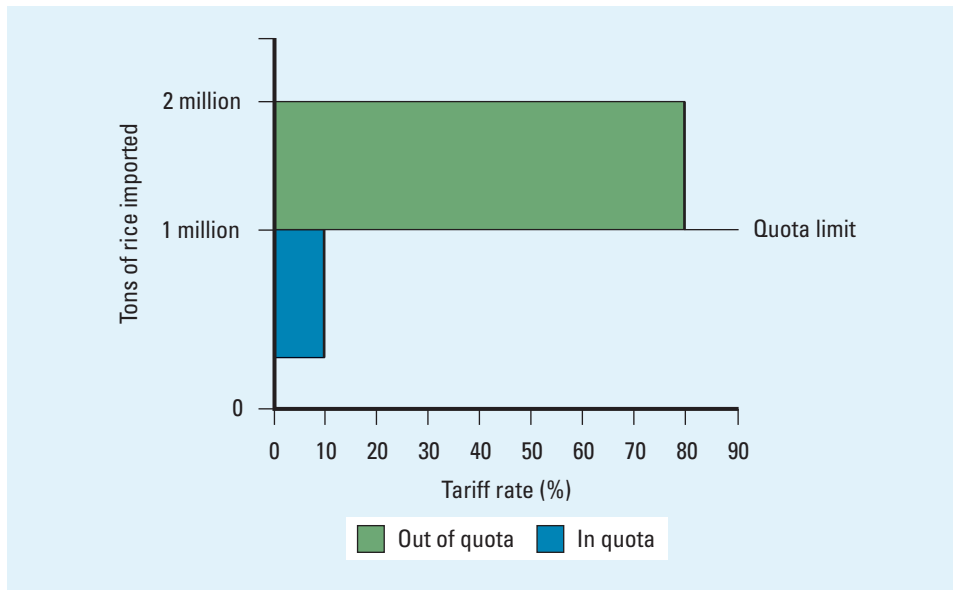
international competitiveness of domestic producers. Rather, they tend to protect the inefficient and promote excess production. One study estimated that if advanced countries abandoned subsidies to farmers, global trade in agricultural products would be 50 percent higher and the world as a whole would be better off by \$160 billion.⁵ Another study estimated that removing all barriers to trade in agriculture (both subsidies and tariffs) would raise world income by \$182 billion.⁶ This increase in wealth arises from the more efficient use of agricultural land. For a specific example, see the Country Focus on wheat subsidies in Japan.

IMPORT QUOTAS AND VOLUNTARY EXPORT RESTRAINTS An **import quota** is a direct restriction on the quantity of some good that may be imported into a country. The restriction is usually enforced by issuing import licenses to a group of individuals or firms. For example, the United States has a quota on cheese imports. The only firms allowed to import cheese are certain trading companies, each of which is allocated the right to import a maximum number of

Import Quota

A direct restriction on the quantity of some good that may be imported into a country.

6.1 figure
Hypothetical Tariff Rate
Quota



pounds of cheese each year. In some cases, the right to sell is given directly to the governments of exporting countries. Historically this is the case for sugar and textile imports in the United States. However, the international agreement governing the imposition of import quotas on textiles, the Multi-Fiber Agreement, expired in December 2004.

A common hybrid of a quota and a tariff is known as a tariff rate quota. Under a **tariff rate quota**, a lower tariff rate is applied to imports within the quota than those over the quota. For example, as illustrated in Figure 6.1, an ad valorem tariff rate of 10 percent might be levied on rice imports into South Korea of 1 million tons, after which an out-of-quota rate of 80 percent might be applied. Thus, South Korea might import 2 million tons of rice, 1 million at a 10 percent tariff rate and another 1 million at an 80 percent tariff. Tariff rate quotas are common in agriculture, where their goal is to limit imports over quota. For an example, see the Country Focus that looks at how Japan uses the combination of a tariff rate quota and subsidies to protect inefficient Japanese wheat farmers from foreign competition.

A variant on the import quota is the voluntary export restraint. A **voluntary export restraint (VER)** is a quota on trade imposed by the exporting country, typically at the request of the importing country's government. One of the most famous historical examples is the limitation on auto exports to the United States enforced by Japanese automobile producers in 1981. A response to direct pressure from the U.S. government, this VER limited Japanese imports to no more than 1.68 million vehicles per year. The agreement was revised in 1984 to allow 1.85 million Japanese vehicles per year. The agreement was allowed to lapse in 1985, but the Japanese government indicated its intentions at that time to continue to restrict exports to the United States to 1.85 million vehicles per year.⁷ Foreign producers agree to VERs because they fear more damaging punitive tariffs or import quotas might follow if they do not. Agreeing to a VER is seen as a way to make the best of a bad situation by appeasing protectionist pressures in a country.

As with tariffs and subsidies, both import quotas and VERs benefit domestic producers by limiting import competition. As with all restrictions on trade, quotas do not

Tariff Rate Quota
The process of applying a lower tariff rate to imports within the quota than those over the quota.

Voluntary Export Restraint (VER)
A quota on trade imposed by the exporting country, typically at the request of the importing country's government.

benefit consumers. An import quota or VER always raises the domestic price of an imported good. When imports are limited to a low percentage of the market by a quota or VER, the price is bid up for that limited foreign supply. The automobile industry VER mentioned above increased the price of the limited supply of Japanese imports. According to a study by the U.S. Federal Trade Commission, the automobile VER cost U.S. consumers about \$1 billion per year between 1981 and 1985. That \$1 billion per year went to Japanese producers in the form of higher prices.⁸ The extra profit that producers make when supply is artificially limited by an import quota is referred to as a **quota rent**.

Quota Rent

The extra profit producers make when supply is artificially limited by an import quota.

If a domestic industry lacks the capacity to meet demand, an import quota can raise prices for *both* the domestically produced and the imported good. This happened in the U.S. sugar industry, in which a tariff rate quota system has long limited the amount foreign producers can sell in the U.S. market. According to one study, import quotas have caused the price of sugar in the United States to be as much as 40 percent greater than the world price.⁹ These higher prices have translated into greater profits for U.S. sugar producers, which have lobbied politicians to keep the lucrative agreement. They argue U.S. jobs in the sugar industry will be lost to foreign producers if the quota system is scrapped.

LOCAL CONTENT REQUIREMENTS A **local content requirement** is a requirement that some specific fraction of a good be produced domestically. The requirement can be expressed either in physical terms (e.g., 75 percent of component parts for this product must be produced locally) or in value terms (e.g., 75 percent of the value of this product must be produced locally). Local content regulations have been widely used by developing countries to shift their manufacturing base from the simple assembly of products whose parts are manufactured elsewhere into the local manufacture of component parts. They have also been used in developed countries to try to protect local jobs and industry from foreign competition. For example, a little-known law in the United States, the Buy America Act, specifies that government agencies must give preference to American products when putting contracts for equipment out to bid unless the foreign products have a significant price advantage. The law specifies a product as “American” if 51 percent of the materials by value are produced domestically. This amounts to a local content requirement. If a foreign company, or an American one for that matter, wishes to win a contract from a U.S. government agency to provide some equipment, it must ensure that at least 51 percent of the product by value is manufactured in the United States.

Local content regulations provide protection for a domestic producer of parts in the same way an import quota does: by limiting foreign competition. The aggregate economic effects are also the same; domestic producers benefit, but the restrictions on imports raise the prices of imported components. In turn, higher prices for imported components are passed on to consumers of the final product in the form of higher final prices. So as with all trade policies, local content regulations tend to benefit producers and not consumers.

ADMINISTRATIVE POLICIES In addition to the formal instruments of trade policy, governments of all types sometimes use informal or administrative policies to restrict imports and boost exports. **Administrative trade policies** are bureaucratic rules designed to make it difficult for imports to enter a country. It has been argued that the Japanese are the masters of this trade barrier. In recent decades, Japan’s formal tariff and nontariff barriers have been among the lowest in the world.

Administrative Trade Policies

Bureaucratic rules designed to make it difficult for imports to enter a country.

However, critics charge that the country's informal administrative barriers to imports more than compensate for this. For example, at one point the Netherlands exported tulip bulbs to almost every country in the world except Japan. In Japan, customs inspectors insisted on checking every tulip bulb by cutting it vertically down the middle, and even Japanese ingenuity could not put them back together. Federal Express also initially had a tough time expanding its global express shipping services into Japan because Japanese customs inspectors insist on opening a large proportion of express packages to check for pornography, a process that delayed an "express" package for days. Japan is not the only country that engages in such policies. France once required that all imported videotape recorders arrive through a small customs entry point that was both remote and poorly staffed. The resulting delays kept Japanese VCRs out of the French market until a VER agreement was negotiated.¹⁰ As with all instruments of trade policy, administrative instruments benefit producers and hurt consumers, who are denied access to possibly superior foreign products.

ANTIDUMPING POLICIES In the context of international trade, **dumping** is variously defined as selling goods in a foreign market at below their costs of production or as selling goods in a foreign market at below their "fair" market value. There is a difference between these two definitions; the fair market value of a good is normally judged to be greater than the costs of producing that good because the former includes a "fair" profit margin. Dumping is viewed as a method by which firms unload excess production in foreign markets. Some dumping may be the result of predatory behavior, with producers using substantial profits from their home markets to subsidize prices in a foreign market with a view to driving indigenous competitors out of that market. Once this has been achieved, so the argument goes, the predatory firm can raise prices and earn substantial profits.

An alleged example of dumping occurred in 1997, when two South Korean manufacturers of semiconductors, LG Semicon and Hyundai Electronics, were accused of selling dynamic random access memory chips (DRAMs) in the U.S. market at below their costs of production. This action occurred in the middle of a worldwide glut of chip-making capacity. It was alleged that the firms were trying to unload their excess production in the United States.

Antidumping policies are designed to punish foreign firms that engage in dumping. The ultimate objective is to protect domestic producers from unfair foreign competition. Although antidumping policies vary somewhat from country to country, the majority are similar to those used in the United States. If a domestic producer believes that a foreign firm is dumping production in the U.S. market, it can file a petition with two government agencies, the Commerce Department and the International Trade Commission. In the Korean DRAM case, Micron Technology, a U.S. manufacturer of DRAMs, filed the petition. The government agencies then investigate the complaint. If a complaint has merit, the Commerce Department may impose an antidumping duty on the offending foreign imports (antidumping duties are often called **countervailing duties**). These duties, which represent a special tariff, can be fairly substantial and stay in place for up to five years. For example, after reviewing Micron's complaint, the Commerce Department imposed 9 percent and 4 percent countervailing duties on LG Semicon and Hyundai DRAM chips, respectively. The accompanying Management Focus discusses another example of how a firm, U.S. Magnesium, used antidumping legislation to gain protection from unfair foreign competitors.

Dumping
selling goods in a foreign market at below their costs of production or below their "fair" market value.

Antidumping Policies
Policies designed to punish foreign firms that engage in dumping and thus protect domestic producers from unfair foreign competition.

Countervailing Duties
Antidumping duties.



U.S. Magnesium Seeks Protection

In February 2004, U.S. Magnesium, the sole surviving U.S. producer of magnesium, a metal that is primarily used in the manufacture of certain automobile parts and aluminum cans, filed a petition with the U.S. International Trade Commission (ITC) contending that a surge in imports had caused material damage to the U.S. industry's employment, sales, market share, and profitability. According to U.S. Magnesium, Russian and Chinese producers had been selling the metal at prices significantly below market value. During 2002 and 2003, imports of magnesium into the United States rose 70 percent, while prices fell by 40 percent and the market share accounted for by imports jumped to 50 percent from 25 percent.

"The United States used to be the largest producer of magnesium in the world," a U.S. Magnesium spokesman said at the time of the filing. "What's really sad is that you can be state of the art and have modern technology, and if the Chinese, who pay people less than 90 cents an hour, want to run you out of business, they can do it. And that's why we are seeking relief."

During a yearlong investigation, the ITC solicited input from various sides in the dispute. Foreign producers and consumers of magnesium in the United States argued that falling prices for magnesium during 2002 and 2003 simply reflected an imbalance between supply and demand due to additional capacity coming on stream not from Russia or China but from a new Canadian plant that opened in 2001 and from a planned Australian plant. The Canadian plant shut down in 2003, the Australian plant never came on stream, and prices for magnesium rose again in 2004.

Magnesium consumers in the United States also argued to the ITC that imposing antidumping duties on foreign imports of magnesium would raise prices in the United States significantly above world levels. A spokesman for Alcoa, which mixes magnesium with aluminum to make

alloys for cans, predicted that if antidumping duties were imposed, high magnesium prices in the United States would force Alcoa to move some production out of the United States. Alcoa also noted that in 2003, U.S. Magnesium was unable to supply all of Alcoa's needs, forcing the company to turn to imports. Consumers of magnesium in the automobile industry asserted that high prices in the United States would drive engineers to design magnesium out of automobiles, or force manufacturing elsewhere, which would ultimately hurt everyone.

The six members of the ITC were not convinced by these arguments. In March 2005, the ITC ruled that both China and Russia had been dumping magnesium in the United States. The government decided to impose duties ranging from 50 percent to more than 140 percent on imports of magnesium from China. Russian producers faced duties ranging from 19 percent to 22 percent. The duties were to be levied for five years, after which the ITC will revisit the situation.

According to U.S. Magnesium, the favorable ruling would allow the company to reap the benefits of nearly \$50 million in investments made in its manufacturing plant and enable the company to boost its capacity by 28 percent by the end of 2005. Commenting on the favorable ruling, a U.S. Magnesium spokesman noted, "Once unfair trade is removed from the marketplace we'll be able to compete with anyone." U.S. Magnesium's customers and competitors, however, did not view the situation in the 2002–2003 period as one of unfair trade. While the imposition of antidumping duties no doubt will help to protect U.S. Magnesium and the 400 people it employs from foreign competition, magnesium consumers in the United States are left wondering if they will be the ultimate losers.

Sources: D. Anderton, "U.S. Magnesium Lands Ruling on Unfair Imports," *Deseret News*, October 1, 2004, p. D10; "U.S. Magnesium and Its Largest Consumers Debate before U.S. ITC," *Platt's Metals Week*, February 28, 2005, p. 2; and S. Oberbeck, "U.S. Magnesium Plans Big Utah Production Expansion," *Salt Lake Tribune*, March 30, 2005.

LEARNING OBJECTIVE 2

Understand why governments sometimes intervene in international trade.

The Case for Government Intervention

Now that we have reviewed the various instruments of trade policy that governments can use, it is time to look at the case for government intervention in international trade. Arguments for government intervention take two paths: political and economic. Political arguments for intervention are concerned with protecting the interests of certain groups within a nation (normally producers), often at the expense of other groups (normally consumers), or with achieving some political objective that lies outside the sphere of economic relationships, such as protecting the environment or human rights. Economic arguments for intervention are typically concerned with boosting the overall wealth of a nation (to the benefit of all, both producers and consumers).

POLITICAL ARGUMENTS FOR INTERVENTION Political arguments for government intervention cover a range of issues, including preserving jobs, protecting industries deemed important for national security, retaliating against unfair foreign competition, protecting consumers from “dangerous” products, furthering the goals of foreign policy, and advancing the human rights of individuals in exporting countries.

Protecting Jobs and Industries Perhaps the most common political argument for government intervention is that it is necessary for protecting jobs and industries from unfair foreign competition. The tariffs placed on imports of foreign steel by President George W. Bush in 2002 were designed to do this. (Many steel producers were located in states that Bush needed to win reelection in 2004.) A political motive also underlay establishment of the Common Agricultural Policy (CAP) by the European Union. The CAP was designed to protect the jobs of Europe’s politically powerful farmers by restricting imports and guaranteeing prices. However, the higher prices that resulted from the CAP have cost Europe’s consumers dearly. This is true of many attempts to protect jobs and industries through government intervention. For example, the imposition of steel tariffs in 2002 raised steel prices for American consumers, such as automobile companies, making them less competitive in the global marketplace.

National Security Countries sometimes argue that it is necessary to protect certain industries because they are important for national security. Defense-related industries often get this kind of attention (e.g., aerospace, advanced electronics, semiconductors, etc.). Although not as common as it used to be, this argument is still made. Those in favor of protecting the U.S. semiconductor industry from foreign competition, for example, argue that semiconductors are now such important components of defense products that it would be dangerous to rely primarily on foreign producers for them. In 1986, this argument helped persuade the federal government to support Sematech, a consortium of 14 U.S. semiconductor companies that accounted for 90 percent of the U.S. industry’s revenues. Sematech’s mission was to conduct joint research into manufacturing techniques that can be parceled out to members. The government saw the venture as so critical that Sematech was specially protected from antitrust laws. Initially, the U.S. government provided Sematech with \$100 million per year in subsidies. By the mid-1990s, however, the U.S. semiconductor industry had regained its leading market position, largely through the personal computer boom and demand for microprocessor chips made by Intel. In 1994, the consortium’s board voted to seek an end to federal funding, and since 1996 the consortium has been funded entirely by private money.¹¹

Retaliation Some argue that governments should use the threat to intervene in trade policy as a bargaining tool to help open foreign markets and force trading partners to “play by the rules of the game.” The U.S. government has used the threat of punitive trade sanctions to try to get the Chinese government to enforce its intellectual property laws. Lax enforcement of these laws had given rise to massive copyright infringements in China that had been costing U.S. companies such as Microsoft hundreds of millions of dollars per year in lost sales revenues. After the United States threatened to impose 100 percent tariffs on a range of Chinese imports, and after harsh words between officials from the two countries, the Chinese agreed to tighter enforcement of intellectual property regulations.¹²

If it works, such a politically motivated rationale for government intervention may liberalize trade and bring with it resulting economic gains. It is a risky strategy,

however. A country that is being pressured may not back down and instead may respond to the imposition of punitive tariffs by raising trade barriers of its own. This is exactly what the Chinese government threatened to do when pressured by the United States, although it ultimately did back down. If a government does not back down, however, the results could be higher trade barriers all around and an economic loss to all involved.

Protecting Consumers Many governments have long had regulations to protect consumers from unsafe products. The indirect effect of such regulations often is to limit or ban the importation of such products. For example, in 2003 several countries, including Japan and South Korea, decided to ban imports of American beef after a single case of mad cow disease was found in Washington State. The ban was motivated to protect consumers from what was seen to be an unsafe product. Together, Japan and South Korea accounted for about \$2 billion of U.S. beef sales, so the ban had a significant impact on U.S. beef producers. After two years, both countries lifted the ban, although they placed stringent requirements on U.S. beef imports to reduce the risk of importing beef that might be tainted by mad cow disease (for example, Japan required that all beef must come from cattle under 21 months of age).¹³

The accompanying Country Focus describes how the European Union banned the sale and importation of hormone-treated beef. The ban was motivated by a desire to protect European consumers from the possible health consequences of eating meat from animals treated with growth hormones. The conflict over the importation of hormone-treated beef into the EU may prove to be a taste of things to come. In addition to the use of hormones to promote animal growth and meat production, biotechnology has made it possible to genetically alter many crops so that they resist common herbicides, produce proteins that are natural insecticides, grow dramatically improved yields, or withstand inclement weather conditions. A new breed of



A genetically engineered cotton seed that protects against three common insects has been met with resistance in Europe due to a fear that these genetically altered seeds could potentially be harmful to humans.



Country FOCUS

Trade in Hormone-Treated Beef

In the 1970s, scientists discovered how to synthesize certain hormones and use them to accelerate the growth rate of livestock animals, reduce the fat content of meat, and increase milk production. Bovine somatotropin (BST), a growth hormone produced by cattle, was first synthesized by the biotechnology firm Genentech. Injections of BST could be used to supplement an animal's own hormone production and increase its growth rate. These hormones soon became popular among farmers, who found that they could cut costs and help satisfy consumer demands for leaner meat. Although these hormones occurred naturally in animals, consumer groups in several countries soon raised concerns about the practice. They argued that the use of hormone supplements was unnatural and that the health consequences of consuming hormone-treated meat were unknown but might include hormonal irregularities and cancer.

The European Union responded to these concerns in 1989 by banning the use of growth-promoting hormones in the production of livestock and the importation of hormone-treated meat. The ban was controversial because a reasonable consensus existed among scientists that the hormones posed no health risk. Although the EU banned hormone-treated meat, many other countries did not, including big meat-producing countries such as Australia, Canada, New Zealand, and the United States. The use of hormones soon became widespread in these countries. According to trade officials outside the EU, the European ban constituted an unfair restraint on trade. As a result of this ban, exports of meat to the EU fell. For example, U.S. red meat exports to the EU declined from \$231 million in 1988 to \$98 million in 1994. The complaints of meat exporters were bolstered in 1995 when Codex Alimentarius, the international food standards body of the UN's Food and Agriculture Organization and the World Health Organization, approved the use of growth hormones. In making this decision, Codex reviewed the scientific literature and found no

evidence of a link between the consumption of hormone-treated meat and human health problems, such as cancer.

Fortified by such decisions, in 1995 the United States pressed the EU to drop the import ban on hormone-treated beef. The EU refused, citing "consumer concerns about food safety." In response, both Canada and the United States independently filed formal complaints with the World Trade Organization. The United States was joined in its complaint by a number of other countries, including Australia and New Zealand. The WTO created a trade panel of three independent experts. After reviewing evidence and hearing from a range of experts and representatives of both parties, the panel in May 1997 ruled that the EU ban on hormone-treated beef was illegal because it had no scientific justification. The EU immediately indicated it would appeal the finding to the WTO court of appeals. The WTO court heard the appeal in November 1997 and in February 1998 agreed with the findings of the trade panel that the EU had not presented any scientific evidence to justify the hormone ban.

This ruling left the EU in a difficult position. Legally, the EU had to lift the ban or face punitive sanctions, but the ban had wide public support in Europe. The EU feared that lifting the ban could produce a consumer backlash. Instead the EU did nothing, so in February 1999 the United States asked the WTO for permission to impose punitive sanctions on the EU. The WTO responded by allowing the United States to impose punitive tariffs valued at \$120 million on EU exports to the United States. The EU decided to accept these tariffs rather than lift the ban on hormone-treated beef, and as of 2010, the ban and punitive tariffs were still in place.

Sources: C. Southey, "Hormones Fuel a Meaty EU Row," *Financial Times*, September 7, 1995, p. 2; E. L. Andrews, "In Victory for U.S., European Ban on Treated Beef Is Ruled Illegal," *The New York Times*, May 9, 1997, p. A1; F. Williams and G. de Jonquieres, "WTO's Beef Rulings Give Europe Food for Thought," *Financial Times*, February 13, 1998, p. 5; R. Baily, "Food and Trade: EU Fearmongers' Lethal Harvest," *Los Angeles Times*, August 18, 2002, p. M3; "The US-EU Dispute over Hormone-Treated Beef," *The Kiplinger Agricultural Letter*, January 10, 2003; and Scott Miller, "EU Trade Sanctions Have Duel Edge," *The Wall Street Journal*, February 26, 2004, p. A3.

genetically modified tomatoes has an antifreeze gene inserted into its genome and can thus be grown in colder climates than hitherto possible. Another example is a genetically engineered cotton seed produced by Monsanto. The seed has been engineered to express a protein that protects against three common insect pests: the cotton bollworm, tobacco budworm, and pink bollworm. Use of this seed reduces or eliminates the need for traditional pesticide applications for these pests.

As enticing as such innovations sound, they have met with intense resistance from consumer groups, particularly in Europe. The fear is that the widespread use of genetically altered seed corn could have unanticipated and harmful effects on human

health and may result in “genetic pollution.” (An example of genetic pollution would be when the widespread use of crops that produce natural pesticides stimulates the evolution of “superbugs” that are resistant to those pesticides.) Such concerns have led Austria and Luxembourg to outlaw the importation, sale, or use of genetically altered organisms. Sentiment against genetically altered organisms also runs strong in several other European countries, most notably Germany and Switzerland. It seems likely, therefore, that the World Trade Organization will be drawn into the conflict between those that want to expand the global market for genetically altered organisms, such as Monsanto, and those that want to limit it, such as Austria and Luxembourg.¹⁴

Furthering Foreign Policy Objectives Governments sometimes use trade policy to support their foreign policy objectives.¹⁵ A government may grant preferential trade terms to a country with which it wants to build strong relations. Trade policy has also been used several times to pressure or punish “rogue states” that do not abide by international law or norms. Iraq labored under extensive trade sanctions after the UN coalition defeated the country in the 1991 Gulf War until the 2003 invasion of Iraq by U.S.-led forces. The theory is that such pressure might persuade the rogue state to mend its ways, or it might hasten a change of government. In the case of Iraq, the sanctions were seen as a way of forcing that country to comply with several UN resolutions. The United States has maintained long-running trade sanctions against Cuba. Their principal function is to impoverish Cuba in the hope that the resulting economic hardship will lead to the downfall of Cuba’s Communist government and its replacement with a more democratically inclined (and pro-U.S.) regime. The United States also has had trade sanctions in place against Libya and Iran, both of which it accuses of supporting terrorist action against U.S. interests and building weapons of mass destruction. In late 2003, the sanctions against Libya seemed to yield some returns when that country announced it would terminate a program to build nuclear weapons, and the U.S. government responded by relaxing those sanctions.

Other countries can undermine unilateral trade sanctions. The U.S. sanctions against Cuba, for example, have not stopped other Western countries from trading with Cuba. The U.S. sanctions have done little more than help create a vacuum into which other trading nations, such as Canada and Germany, have stepped. In an attempt to halt this and further tighten the screws on Cuba, in 1996 the U.S. Congress passed the **Helms-Burton Act**. This act allows Americans to sue foreign firms that use property in Cuba confiscated from them after the 1959 revolution. Later in 1996, Congress passed a similar law, the **D’Amato Act**, aimed at Libya and Iran.

The passage of Helms-Burton elicited protests from America’s trading partners, including the European Union, Canada, and Mexico, all of which claim the law violates their sovereignty and is illegal under World Trade Organization rules. For example, Canadian companies that have been doing business in Cuba for years see no reason they should suddenly be sued in U.S. courts when Canada does not restrict trade with Cuba. They are not violating Canadian law, and they are not U.S. companies, so why should they be subject to U.S. law? Despite such protests, the law is still on the books in the United States, although the U.S. government has not enforced this act—probably because it is unenforceable.

Protecting Human Rights Protecting and promoting human rights in other countries is an important element of foreign policy for many democracies. Governments sometimes use trade policy to try to improve the human rights policies of trading partners. For years, the most obvious example of this was the annual debate in the United States over whether to grant most favored nation (MFN) status to China.

Helms-Burton Act

Act passed in 1996 that allowed Americans to sue foreign firms that use Cuban property confiscated from them after the 1959 revolution.

D’Amato Act

Act passed in 1996, similar to the Helms-Burton Act, aimed at Libya and Iran.

MFN status allows countries to export goods to the United States under favorable terms. Under MFN rules, the average tariff on Chinese goods imported into the United States was 8 percent. If China's MFN status were rescinded, tariffs could have risen to about 40 percent. Trading partners who are signatories of the World Trade Organization, as most are, automatically receive MFN status. However, China did not join the WTO until 2001, so historically the decision of whether to grant MFN status to China was a real one. The decision was made more difficult by the perception that China had a poor human rights record. As indications of the country's disregard for human rights, critics of China often point to the 1989 Tiananmen Square massacre, China's continuing subjugation of Tibet (which China occupied in the 1950s), and the squashing of political dissent in China.¹⁶ These critics argue that it was wrong for the United States to grant MFN status to China, and that instead, the United States should withhold MFN status until China showed measurable improvement in its human rights record. The critics argue that trade policy should be used as a political weapon to force China to change its internal policies toward human rights.

Others contend that limiting trade with such countries would make matters worse, not better. They argue that the best way to change the internal human rights stance of a country is to engage it through international trade. At its core, the argument is simple: Growing bilateral trade raises the income levels of both countries, and as a state becomes richer, its people begin to demand, and generally receive, better treatment with regard to their human rights. This is a variant of the argument in Chapter 2 that economic progress begets political progress (if political progress is measured by the adoption of a democratic government that respects human rights). This argument ultimately won the day in 1999 when the Clinton administration blessed China's application to join the WTO and announced that trade and human rights issues should be decoupled.

Protecting the Environment Protecting the environment has become an important policy objective of many nations. Increasingly, environmental interest groups such as Friends of the Earth and the Sierra Club have been pressuring governments to regulate international trade in a way that protects the environment. The growing concern over global warming has added an important dimension to this debate.

One argument frequently made by environmental organizations is that there is a strong relationship between income levels and environmental pollution and degradation (i.e., industrial development leads to more pollution). Thus, to the extent that international trade leads to higher income levels, it can also be expected to lead to a decline in environmental quality. Organizations such as the Sierra Club argue that as a consequence, strong environmental safeguards need to be part of any trade agreements, and governments should be allowed to restrict trade if doing so benefits the environment.

As noted in Chapter 1, the empirical evidence suggests the relationship between income levels and pollution is not a linear one—rather it is an inverted U-shaped relationship (see Figure 1.5).¹⁷ To begin with, as countries start to climb the ladder of economic progress, pollution levels do increase, but past some threshold, they start to decline. The reason being that as societies get richer, citizens lobby for environmental protections, and governments tend to respond. We can see this process starting to unfold today in China. China has had an awful reputation for pollution, but in the last



Beijing's Tiananmen Square, a tangible reminder of China's history of human rights abuses.

few years the Chinese government has been working hard to improve the air quality in its major cities (although the country still has a considerable way to go). In developed nations such as the United States and United Kingdom, the air is much cleaner than it was half a century ago. This data suggests that international trade, and the growth that results from it, may not be damaging to the environment.

There is a very important exception to these trends, however, and that is emissions of carbon dioxide. Carbon dioxide emissions do rise with income levels. Thus, the country with the highest income per capita, the United States, also produces the greatest carbon dioxide emissions per capita. The reason is that carbon dioxide emissions are a by-product of energy use (i.e., oil, gas, or coal burning). Richer societies are more energy intensive, and to the extent that they use hydrocarbons to produce that energy, this leads to higher carbon dioxide emissions.

Carbon dioxide is the greenhouse gas at the center of concerns over global warming. These concerns can be stated simply.¹⁸ First, the burning of fossil fuels to produce energy also releases carbon dioxide into the atmosphere (and atmospheric carbon dioxide concentrations have steadily increased since preindustrial times). Second, carbon dioxide absorbs heat radiated from the earth, warming the atmosphere. Third, as a consequence, average global temperatures will increase. Indeed, estimates suggest that average global temperatures increased by 0.7 degree centigrade during the past century, and they are forecasted to rise by between 1.1 and 6.4 degrees centigrade this century.¹⁹ Fourth, as global temperatures increase, there will be environmental dislocation, ice caps will melt and sea levels will rise, flooding low-lying coastal areas; weather patterns will change; the frequency of violent storms will increase; tropical diseases (such as malaria) will move northward; species will go extinct; and so on.

Of course, the global climate varies naturally due too, for example, changes in solar radiation connected with the well-known sun spot cycle, volcanic activity (which can inject large amounts of sulfur dioxide particles into the atmosphere, temporarily cooling it), changes in the circulation of ocean currents, and long-term changes in the orbit of the earth and the tilt of its axis. Human-induced global warming is overlaid on these natural variations. Thus, a natural cooling trend might be moderated by greater atmospheric carbon dioxide concentrations, and a natural warming trend exacerbated by them.

Although there is debate over the precise relationship between carbon dioxide concentrations and the extent of future global warming, the vast majority of climate scientists have concluded that unless we take rapid action, we face a rate of warming that is unprecedented during the history of our civilization and may cause major environmental dislocation.²⁰ Given this, they advocate restricting greenhouse gas emissions, particularly carbon dioxide. The first international agreement to limit global warming, the Kyoto Protocol, was signed in 1997, although its impact was reduced by the failure of two of the world's largest producers of carbon dioxide, the United States and China, to sign. A second international agreement was reached in Copenhagen in 2009, this time with the participation of the United States and China.

What does this have to do with international trade? So far, there has been little direct connection between the global warming debate and international trade. However, looking forward, adherence to targets regarding carbon emissions might start to factor into trade agreements. Specifically, if countries do not meet their targets for reducing carbon emissions specified in international treaties, they may find themselves the targets of retaliatory action. The EU, for example, might respond to the failure of the United States to meet its treaty commitments by placing a carbon tariff on the import of certain goods from the United States. Ten years ago this was a remote possibility. Ten years from now it may be a significant factor in the international trade environment.

A second argument made with regard to environmental regulations is that, to save money, corporations will move production to countries where environmental regulations are lax. Thus, for example, if tight environmental standards in the United States raise costs, a manufacturing firm might move production to a pollution haven such as Mexico where environmental standards are weaker. To protect against this possibility, environmental organizations argue that governments should place tariffs or other limitations on goods imported from countries where environmental regulations are lax.

Economists have studied this issue but have found little evidence that firms do move production in response to changes in pollution regulations.²¹ Their findings suggest that pollution abatement costs are a relatively small component of the cost structure of most enterprises, and that other factors, such as labor productivity, access to technological know-how, and transportation costs are far more important in determining location decisions. It is also worth noting that migrating to a pollution haven would violate the ethical principles of many (but not all) organizations (see Chapter 4 for details).

In sum, although environmental concerns have not figured significantly in trade treaties to date, there is a good chance that they will do so in the future, particularly with regard to the emission of carbon dioxide and other greenhouse gases.

ECONOMIC ARGUMENTS FOR INTERVENTION With the development of the new trade theory and strategic trade policy (see Chapter 5), the economic arguments for government intervention have undergone a renaissance in recent years. Until the early 1980s, most economists saw little benefit in government intervention and strongly advocated a free trade policy. This position has changed at the margins with the development of strategic trade policy, although as we will see in the next section, there are still strong economic arguments for sticking to a free trade stance.

The Infant Industry Argument The **infant industry argument** is by far the oldest economic argument for government intervention. Alexander Hamilton proposed it in 1792. According to this argument, many developing countries have a potential comparative advantage in manufacturing, but new manufacturing industries cannot initially compete with established industries in developed countries. To allow manufacturing to get a toehold, the argument is that governments should temporarily support new industries (with tariffs, import quotas, and subsidies) until they have grown strong enough to meet international competition.

This argument has had substantial appeal for the governments of developing nations during the past 50 years, and the GATT has recognized the infant industry argument as a legitimate reason for protectionism. Nevertheless, many economists remain critical of this argument for two main reasons. First, protection of manufacturing from foreign competition does no good unless the protection helps make the industry efficient. In case after case, however, protection seems to have done little more than foster the development of inefficient industries that have little hope of ever competing in the world market. Brazil, for example, built the world's tenth-largest auto industry behind tariff barriers and quotas. Once those barriers were removed in the late 1980s, however, foreign imports soared, and the industry was forced to face up to the fact that after 30 years of protection, the Brazilian industry was one of the world's most inefficient.²²

Second, the infant industry argument relies on an assumption that firms are unable to make efficient long-term investments by borrowing money from the domestic or international capital market. Consequently, governments have been required to

Infant Industry Argument

New industries in developing countries must be temporarily protected from international competition to help them reach a position where they can compete on world markets with the firms of developed nations.

subsidize long-term investments. Given the development of global capital markets over the past 20 years, this assumption no longer looks as valid as it once did. Today, if a developing country has a potential comparative advantage in a manufacturing industry, firms in that country should be able to borrow money from the capital markets to finance the required investments. Given financial support, firms based in countries with a potential comparative advantage have an incentive to endure the necessary initial losses in order to make long-run gains without requiring government protection. Many Taiwanese and South Korean firms did this in industries such as textiles, semiconductors, machine tools, steel, and shipping. Thus, given efficient global capital markets, the only industries that would require government protection would be those that are not worthwhile.

Strategic Trade Policy Some new trade theorists have proposed the strategic trade policy argument.²³ We reviewed the basic argument in Chapter 5 when we considered the new trade theory. The new trade theory argues that in industries in which the existence of substantial economies of scale implies that the world market will profitably support only a few firms, countries may predominate in the export of certain products simply because they had firms that were able to capture first-mover advantages. The long-term dominance of Boeing in the commercial aircraft industry has been attributed to such factors.

Strategic Trade Policy
Government policy aimed at improving the competitive position of a domestic industry or domestic firm in the world market.

The **strategic trade policy** argument has two components. First, it is argued that by appropriate actions, a government can help raise national income if it can somehow ensure that the firm or firms that gain first-mover advantages in an industry are domestic rather than foreign enterprises. Thus, according to the strategic trade policy argument, a government should use subsidies to support promising firms that are active in newly emerging industries. Advocates of this argument point out that the substantial R&D grants that the U.S. government gave Boeing in the 1950s and 1960s probably helped tilt the field of competition in the newly emerging market for passenger jets in Boeing's favor. (Boeing's first commercial jet airliner, the 707, was derived from a military plane.) Similar arguments have been made with regard to Japan's dominance in the production of liquid crystal display screens (used in laptop computers). Although these screens were invented in the United States, the Japanese government, in cooperation with major electronics companies, targeted this industry for research support in the late 1970s and early 1980s. The result was that Japanese firms, not U.S. firms, subsequently captured first-mover advantages in this market.

The second component of the strategic trade policy argument is that it might pay a government to intervene in an industry by helping domestic firms overcome the barriers to entry created by foreign firms that have already reaped first-mover advantages. This argument underlies government support of Airbus, Boeing's major competitor. Formed in 1966 as a consortium of four companies from Great Britain, France, Germany, and Spain, Airbus had less than 5 percent of the world commercial aircraft market when it began production in the mid-1970s. By 2009, it had increased its share to 45 percent, threatening Boeing's long-term dominance of the market. How did Airbus achieve this? According to the U.S. government, the answer is a \$15 billion subsidy from the governments of Great Britain, France, Germany, and Spain.²⁴ Without this subsidy, Airbus would never have been able to break into the world market.

If these arguments are correct, they support a rationale for government intervention in international trade. Governments should target technologies that may be important in the future and use subsidies to support development work aimed at commercializing those technologies. Furthermore, government should provide export subsidies until the domestic firms have established first-mover advantages in the world

market. Government support may also be justified if it can help domestic firms overcome the first-mover advantages enjoyed by foreign competitors and emerge as viable competitors in the world market (as in the Airbus and semiconductor examples). In this case, a combination of home-market protection and export-promoting subsidies may be needed.

The Revised Case for Free Trade

The strategic trade policy arguments of the new trade theorists suggest an economic justification for government intervention in international trade. This justification challenges the rationale for unrestricted free trade found in the work of classic trade theorists such as Adam Smith and David Ricardo. In response to this challenge to economic orthodoxy, a number of economists—including some of those responsible for the development of the new trade theory, such as Paul Krugman—point out that although strategic trade policy looks appealing in theory, in practice it may be unworkable. This response to the strategic trade policy argument constitutes the revised case for free trade.²⁵

LEARNING OBJECTIVE 3
Summarize and explain the arguments against strategic trade policy.

RETALIATION AND TRADE WAR Krugman argues that a strategic trade policy aimed at establishing domestic firms in a dominant position in a global industry is a beggar-thy-neighbor policy that boosts national income at the expense of other countries. A country that attempts to use such policies will probably provoke retaliation. In many cases, the resulting trade war between two or more interventionist governments will leave all countries involved worse off than if a hands-off approach had been adopted in the first place. If the U.S. government were to respond to the Airbus subsidy by increasing its own subsidies to Boeing, for example, the result might be that the subsidies would cancel each other out. In the process, both European and U.S. taxpayers would end up supporting an expensive and pointless trade war, and both Europe and the United States would be worse off.

Krugman may be right about the danger of a strategic trade policy leading to a trade war. The problem, however, is how to respond when one's competitors are already being supported by government subsidies; that is, how should Boeing and the United States respond to the subsidization of Airbus? According to Krugman, the answer is probably not to engage in retaliatory action but to help establish rules of the game that minimize the use of trade-distorting subsidies. This is what the World Trade Organization seeks to do.

DOMESTIC POLICIES Governments do not always act in the national interest when they intervene in the economy; politically important interest groups often influence them. The European Union's support for the Common Agricultural Policy (CAP), which arose because of the political power of French and German farmers, is an example. The CAP benefited inefficient farmers and the politicians who relied on the farm vote, but not consumers in the EU, who end up paying more for their food-stuffs. Thus, a further reason for not embracing strategic trade policy, according to Krugman, is that such a policy is almost certain to be captured by special-interest groups within the economy, who will distort it to their own ends. Krugman concludes that in the United States,

To ask the Commerce Department to ignore special-interest politics while formulating detailed policy for many industries is not realistic: To establish a blanket policy of free trade, with exceptions granted only under extreme pressure, may not be the optimal policy according to the theory but may be the best policy that the country is likely to get.²⁶

LEARNING OBJECTIVE 4

Describe the development of the world trading system and the current trade issues.

Development of the World Trading System

Strong economic arguments support unrestricted free trade. While many governments have recognized the value of these arguments, they have been unwilling to unilaterally lower their trade barriers for fear that other nations might not follow suit. Consider the problem that two neighboring countries, say, Brazil and Argentina, face when deciding whether to lower trade barriers between them. In principle, the government of Brazil might favor lowering trade barriers, but it might be unwilling to do so for fear that Argentina will not do the same. Instead, the government might fear that the Argentines will take advantage of Brazil's low barriers to enter the Brazilian market, while at the same time continuing to shut Brazilian products out of their market through high trade barriers. The Argentinean government might believe that it faces the same dilemma. The essence of the problem is a lack of trust. Both governments recognize that their respective nations will benefit from lower trade barriers between them, but neither government is willing to lower barriers for fear that the other might not follow.²⁷

Such a deadlock can be resolved if both countries negotiate a set of rules to govern cross-border trade and lower trade barriers. But who is to monitor the governments to make sure they are playing by the trade rules? And who is to impose sanctions on a government that cheats? Both governments could set up an independent body to act as a referee. This referee could monitor trade between the countries, make sure that no side cheats, and impose sanctions on a country if it does cheat in the trade game.

While it might sound unlikely that any government would compromise its national sovereignty by submitting to such an arrangement, since World War II an international trading framework has evolved that has exactly these features. For its first 50 years, this framework was known as the General Agreement on Tariffs and Trade. Since 1995, it has been known as the World Trade Organization. Here we look at the evolution and workings of the GATT and WTO.

FROM SMITH TO THE GREAT DEPRESSION As noted in Chapter 5, the theoretical case for free trade dates to the late eighteenth century and the work of Adam Smith and David Ricardo. Free trade as a government policy was first officially embraced by Great Britain in 1846, when the British Parliament repealed the Corn Laws. The Corn Laws placed a high tariff on imports of foreign corn. The objectives of the Corn Laws tariff were to raise government revenues and to protect British corn producers. There had been annual motions in Parliament in favor of free trade since the 1820s when David Ricardo was a member. However, agricultural protection was withdrawn only as a result of a protracted debate when the effects of a harvest failure in Great Britain were compounded by the imminent threat of famine in Ireland. Faced with considerable hardship and suffering among the populace, Parliament narrowly reversed its long-held position.

During the next 80 years or so, Great Britain, as one of the world's dominant trading powers, pushed the case for trade liberalization; but the British government was a voice in the wilderness. Its major trading partners did not reciprocate the British policy of unilateral free trade. The only reason Britain kept this policy for so long was that as the world's largest exporting nation, it had far more to lose from a trade war than did any other country.

By the 1930s, the British attempt to stimulate free trade was buried under the economic rubble of the Great Depression. The Great Depression had roots in the failure of the world economy to mount a sustained economic recovery after the end of World War I in 1918. Things got worse in 1929 with the U.S. stock market collapse and the subsequent run on the U.S. banking system. Economic problems were compounded

in 1930 when the U.S. Congress passed the Smoot-Hawley tariff. Aimed at avoiding rising unemployment by protecting domestic industries and diverting consumer demand away from foreign products, the **Smoot-Hawley Act** erected an enormous wall of tariff barriers. Almost every industry was rewarded with its “made-to-order” tariff. A particularly odd aspect of the Smoot-Hawley tariff-raising binge was that the United States was running a balance-of-payment surplus at the time and it was the world’s largest creditor nation. The Smoot-Hawley Act had a damaging effect on employment abroad. Other countries reacted to the U.S. action by raising their own tariff barriers. U.S. exports tumbled in response, and the world slid further into the Great Depression.²⁸

Smoot-Hawley Act
Enacted in 1930 by the U.S. Congress, this tariff erected a wall of barriers against imports into the United States.

1947–1979: GATT, TRADE LIBERALIZATION, AND ECONOMIC GROWTH

Economic damage caused by the beggar-thy-neighbor trade policies that the Smoot-Hawley Act ushered in exerted a profound influence on the economic institutions and ideology of the post–World War II world. The United States emerged from the war both victorious and economically dominant. After the debacle of the Great Depression, opinion in the U.S. Congress had swung strongly in favor of free trade. Under U.S. leadership, the GATT was established in 1947.

The GATT was a multilateral agreement whose objective was to liberalize trade by eliminating tariffs, subsidies, import quotas, and the like. From its foundation in 1947 until it was superseded by the WTO, the GATT’s membership grew from 19 to more than 120 nations. The GATT did not attempt to liberalize trade restrictions in one fell swoop; that would have been impossible. Rather, tariff reduction was spread over eight rounds. The last, the Uruguay Round, was launched in 1986 and completed in December 1993. In these rounds, mutual tariff reductions were negotiated among all members, who then committed themselves not to raise import tariffs above negotiated rates. GATT regulations were enforced by a mutual monitoring mechanism. If a country believed that one of its trading partners was violating a GATT regulation, it could ask the Geneva-based bureaucracy that administered the GATT to investigate. If GATT investigators found the complaints to be valid, member countries could be asked to pressure the offending party to change its policies. In general, such pressure was sufficient to get an offending country to change its policies. If it were not, the offending country could be expelled from the GATT.

In its early years, the GATT was by most measures very successful. For example, the average tariff declined by nearly 92 percent in the United States between the Geneva Round of 1947 and the Tokyo Round of 1973–79. Consistent with the theoretical arguments first advanced by Ricardo and reviewed in Chapter 5, the move toward free trade under the GATT appeared to stimulate economic growth. From 1953 to 1963, world trade grew at an annual rate of 6.1 percent, and world income grew at an annual rate of 4.3 percent. Performance from 1963 to 1973 was even better; world trade grew at 8.9 percent annually, and world income grew at 5.1 percent annually.²⁹

1980–1993: PROTECTIONIST TRENDS During the 1980s and early 1990s, the world trading system erected by the GATT came under strain as pressures for greater protectionism increased around the world. Three reasons caused the rise in such pressures during the 1980s. First, the economic success of Japan strained the world trading system. Japan was in ruins when the GATT was created. By the early 1980s, however, it had become the world’s second-largest economy and its largest exporter. Japan’s success in such industries as automobiles and semiconductors might have been enough to strain the world trading system. Things were made worse by the widespread perception in the West that despite low tariff rates

and subsidies, Japanese markets were closed to imports and foreign investment by administrative trade barriers.

Second, the world trading system was strained by the persistent trade deficit in the world's largest economy, the United States. Although the deficit peaked in 1987 at more than \$170 billion, by the end of 1992 the annual rate was still running about \$80 billion. From a political perspective, the matter was worsened in 1992 by the \$45 billion U.S. trade deficit with Japan, a country perceived as not playing by the rules. The consequences of the U.S. deficit included painful adjustments in industries such as automobiles, machine tools, semiconductors, steel, and textiles, where domestic producers steadily lost market share to foreign competitors. The resulting unemployment gave rise to renewed demands in the U.S. Congress for protection against imports.

A third reason for the trend toward greater protectionism was that many countries found ways to get around GATT regulations. Bilateral voluntary export restraints, or VERs, circumvent GATT agreements, because neither the importing country nor the exporting country complain to the GATT bureaucracy in Geneva—and without a complaint, the GATT bureaucracy can do nothing. Exporting countries agree to VERs to avoid more damaging punitive tariffs. One of the best-known examples is the automobile VER between Japan and the United States, under which Japanese producers promised to limit their auto imports into the United States as a way of defusing growing trade tensions. According to a World Bank study, 13 percent of the imports of industrialized countries in 1981 were subjected to nontariff trade barriers such as VERs. By 1986, this figure had increased to 16 percent. The most rapid rise was in the United States, where the value of imports affected by nontariff barriers (primarily VERs) increased by 23 percent between 1981 and 1986.³⁰

THE URUGUAY ROUND AND THE WORLD TRADE ORGANIZATION

Against the background of rising pressures for protectionism, in 1986 GATT members embarked on their eighth round of negotiations to reduce tariffs, the Uruguay Round (so named because it occurred in Uruguay). This was the most difficult round of negotiations yet, primarily because it was also the most ambitious. Until then, GATT rules had applied only to trade in manufactured goods and commodities. In the Uruguay Round, member countries sought to extend GATT rules to cover trade in services. They also sought to write rules governing the protection of intellectual property, to reduce agricultural subsidies, and to strengthen the GATT's monitoring and enforcement mechanisms.

The Uruguay Round dragged on for seven years before an agreement was reached December 15, 1993. It went into effect July 1, 1995. The Uruguay Round contained the following provisions:

1. Tariffs on industrial goods were to be reduced by more than one-third, and tariffs were to be scrapped on more than 40 percent of manufactured goods.
2. Average tariff rates imposed by developed nations on manufactured goods were to be reduced to less than 4 percent of value, the lowest level in modern history.
3. Agricultural subsidies were to be substantially reduced.
4. GATT fair trade and market access rules were to be extended to cover a wide range of services.
5. GATT rules also were to be extended to provide enhanced protection for patents, copyrights, and trademarks (intellectual property).
6. Barriers on trade in textiles were to be significantly reduced over 10 years.
7. The World Trade Organization was to be created to implement the GATT agreement.

Services and Intellectual Property In the long run, the extension of GATT rules to cover services and intellectual property may be particularly significant. Until 1995, GATT rules applied only to industrial goods (i.e., manufactured goods and commodities). In 2007, world trade in services amounted to \$3.260 billion (compared to world trade in goods of \$13,570 billion).³¹ Ultimately, extension of GATT rules to this important trading arena could significantly increase both the total share of world trade accounted for by services and the overall volume of world trade. The extension of GATT rules to cover intellectual property will make it much easier for high-technology companies to do business in developing nations where intellectual property rules historically have been poorly enforced (see Chapter 2 for details).

The World Trade Organization The clarification and strengthening of GATT rules and the creation of the World Trade Organization also hold out the promise of more effective policing and enforcement of GATT rules. The WTO acts as an umbrella organization that encompasses the GATT along with two new sister bodies, one on services and the other on intellectual property. The WTO's General Agreement on Trade in Services (GATS) has taken the lead to extending free trade agreements to services. The WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) is an attempt to narrow the gaps in the way intellectual property rights are protected around the world and to bring them under common international rules. WTO has taken over responsibility for arbitrating trade disputes and monitoring the trade policies of member countries. While the WTO operates on the basis of consensus as the GATT did, in the area of dispute settlement, member countries are no longer able to block adoption of arbitration reports. Arbitration panel reports on trade disputes between member countries are automatically adopted by the WTO unless there is a consensus to reject them. Countries that have been found by the arbitration panel to violate GATT rules may appeal to a permanent appellate body, but its verdict is binding. If offenders fail to comply with the recommendations of the arbitration panel, trading partners have the right to compensation or, in the last resort, to impose (commensurate) trade sanctions. Every stage of the procedure is subject to strict time limits. Thus, the WTO has something that the GATT never had—teeth.³²

WTO: Experience to Date By 2010, the WTO had 153 members, including China, which joined at the end of 2001, who collectively account for 97 percent of world trade. Another 25 countries, including the Russian Federation, were negotiating for membership. Since its formation, the WTO has remained at the forefront of efforts to promote global free trade. Its creators expressed the hope that the enforcement mechanisms granted to the WTO would make it more effective than the GATT had been at policing global trade rules. The great hope was that the WTO might emerge as an effective advocate and facilitator of future trade deals, particularly in areas such as services. The experience so far has been encouraging, although the collapse of WTO talks in Seattle in late 1999, slow progress with the next round of trade talks (the Doha Round), and a shift back toward some limited protectionism in 2008–2009 have raised a number of questions about the future direction of the WTO.

WTO as Global Police The first decade in the life of the WTO suggests that its policing and enforcement mechanisms are having a positive effect.³³ Between 1995 and early 2010 more than 400 trade disputes between member countries were brought to the WTO.³⁴ This record compares with a total of 196 cases handled by the GATT over almost half a century. Of the cases brought to the WTO, three-fourths had been resolved by informal consultations between the disputing countries. Resolving the remainder has involved more formal procedures, but these have been largely successful.

In general, countries involved have adopted the WTO's recommendations. The fact that countries are using the WTO represents an important vote of confidence in the organization's dispute resolution procedures.

Expanding Trade Agreements As explained above, the Uruguay Round of GATT negotiations extended global trading rules to cover trade in services. The WTO was given the role of brokering future agreements to open global trade in services. The WTO was also encouraged to extend its reach to encompass regulations governing foreign direct investment, something the GATT had never done. Two of the first industries targeted for reform were the global telecommunication and financial services industries.

In February 1997, the WTO brokered a deal to get countries to agree to open their telecommunication markets to competition, allowing foreign operators to purchase ownership stakes in domestic telecommunication providers and establishing a set of common rules for fair competition. Under the pact, 68 countries accounting for more than 90 percent of world telecommunication revenues pledged to start opening their markets to foreign competition and to abide by common rules for fair competition in telecommunications. Most of the world's biggest markets, including the United States, European Union, and Japan, were fully liberalized by January 1, 1998, when the pact went into effect. All forms of basic telecommunication service are covered, including voice telephony, data and fax transmissions, and satellite and radio communications. Many telecommunication companies responded positively to the deal, pointing out that it would give them a much greater ability to offer their business customers one-stop shopping—a global, seamless service for all their corporate needs and a single bill.³⁵

This was followed in December 1997 with an agreement to liberalize cross-border trade in financial services.³⁶ The deal covers more than 95 percent of the world's financial services market. Under the agreement, which took effect at the beginning of March 1999, 102 countries pledged to open to varying degrees their banking, securities, and insurance sectors to foreign competition. In common with the telecommunication deal, the accord covers not just cross-border trade but also foreign direct investment. Seventy countries agreed to dramatically lower or eradicate barriers to foreign direct investment in their financial services sector. The United States and the European Union, with minor exceptions, are fully open to inward investment by foreign banks, insurance, and securities companies. As part of the deal, many Asian countries made important concessions that allow significant foreign participation in their financial services sectors for the first time.

The WTO in Seattle: A Watershed? At the end of November 1999, representatives from the WTO's member states met in Seattle, Washington. The goal of the meeting was to launch a new round of talks—dubbed “the millennium round”—aimed at further reducing barriers to cross-border trade and investment. Prominent on the agenda was an attempt to get the assembled countries to agree to work toward the reduction of barriers to cross-border trade in agricultural products and trade and investment in services.

These expectations were dashed on the rocks of a hard and unexpected reality. The talks ended



WTO protesters gather in front of the Niketown store at Fifth Avenue and Pike Street in downtown Seattle before the opening of the WTO session in 1999.

December 3, 1999, without any agreement being reached. Inside the meeting rooms, the problem was an inability to reach consensus on the primary goals for the next round of talks. A major stumbling block was friction between the United States and the European Union over whether to endorse the aim of ultimately eliminating subsidies to agricultural exporters. The United States wanted the elimination of such subsidies to be a priority. The EU, with its politically powerful farm lobby and long history of farm subsidies, was unwilling to take this step. Another stumbling block was related to efforts by the United States to write “basic labor rights” into the law of the world trading system. The United States wanted the WTO to allow governments to impose tariffs on goods imported from countries that did not abide by what the United States saw as fair labor practices. Representatives from developing nations reacted angrily to this proposal, suggesting it was simply an attempt by the United States to find a legal way of restricting imports from poorer nations.

While the disputes inside the meeting rooms were acrimonious, it was events outside that captured the attention of the world press. The WTO talks proved to be a lightning rod for a diverse collection of organizations from environmentalists and human rights groups to labor unions. For various reasons, these groups oppose free trade. All these organizations argued that the WTO is an undemocratic institution that was usurping the national sovereignty of member states and making decisions of great importance behind closed doors. They took advantage of the Seattle meetings to voice their opposition, which the world press recorded.

Environmentalists expressed concern about the impact that free trade in agricultural products might have on the rate of global deforestation. They argued that lower tariffs on imports of lumber from developing nations will stimulate demand and accelerate the rate at which virgin forests are logged, particularly in nations such as Malaysia and Indonesia. They also pointed to the adverse impact that some WTO rulings have had on environmental policies. For example, the WTO had blocked a U.S. rule that ordered shrimp nets be equipped with a device that allows endangered sea turtles to escape. The WTO found the rule discriminated against foreign importers who lacked such nets.³⁷ Environmentalists argued that the rule was necessary to protect the turtles from extinction.

Human rights activists see WTO rules as outlawing the ability of nations to stop imports from countries where child labor is used or working conditions are hazardous. Similarly, labor unions oppose trade laws that allow imports from low-wage countries and result in a loss of jobs in high-wage countries. They buttress their position by arguing that American workers are losing their jobs to imports from developing nations that do not have adequate labor standards.

Supporters of the WTO and free trade dismiss these concerns. They have repeatedly pointed out that the WTO exists to serve the interests of its member states, not subvert them. The WTO lacks the ability to force any member nation to take an action to which it is opposed. The WTO can allow member nations to impose retaliatory tariffs on countries that do not abide by WTO rules, but that is the limit of its power. Furthermore, supporters argue, it is rich countries that pass strict environmental laws and laws governing labor standards, not poor ones. In their view, free trade, by raising living standards in developing nations, will be followed by the passage of such laws in these nations. Using trade regulations to try to impose such practices on developing nations, they believe, will produce a self-defeating backlash.

Many representatives from developing nations, which make up about 70 percent of the WTO’s members, also reject the position taken by environmentalists and advocates of human and labor rights. Poor countries, which depend on exports to boost their economic growth rates and work their way out of poverty, fear that rich countries will use environmental concerns, human rights, and labor-related issues to erect

barriers to the products of the developing world. They believe that attempts to incorporate language about the environment or labor standards in future trade agreements will amount to little more than trade barriers by another name.³⁸ If this were to occur, they argue that the effect would be to trap the developing nations of the world in a grinding cycle of poverty and debt.

These pro-trade arguments fell on deaf ears. As the WTO representatives gathered in Seattle, environmentalists, human rights activists, and labor unions marched in the streets. Some of the more radical elements in these organizations, together with groups of anarchists who were philosophically opposed to “global capitalism” and “the rape of the world by multinationals,” succeeded not only in shutting down the opening ceremonies of the WTO but also in sparking violence in the normally peaceful streets of Seattle. A number of demonstrators damaged property and looted; and the police responded with tear gas, rubber bullets, pepper spray, and baton charges. When it was over, 600 demonstrators had been arrested, millions of dollars in property had been damaged in downtown Seattle, and the global news media had their headline: “WTO Talks Collapse amid Violent Demonstrations.”

What happened in Seattle is notable because it may have been a watershed of sorts. In the past, previous trade talks were pursued in relative obscurity with only interested economists, politicians, and businesspeople paying much attention. Seattle demonstrated that the issues surrounding the global trend toward free trade have moved to center stage in the popular consciousness, and they have remained there since. The debate on the merits of free trade and globalization has become mainstream. Whether further liberalization occurs, therefore, may depend on the importance that popular opinion in countries such as the United States attaches to issues such as human rights and labor standards, job security, environmental policies, and national sovereignty. It will also depend on the ability of advocates of free trade to articulate in a clear and compelling manner the argument that, in the long run, free trade is the best way of promoting adequate labor standards, of providing more jobs, and of protecting the environment.

THE FUTURE OF THE WTO: UNRESOLVED ISSUES AND THE DOHA ROUND

Much remains to be done on the international trade front. Four issues at the forefront of the current agenda of the WTO are the increase in anti-dumping policies, the high level of protectionism in agriculture, the lack of strong protection for intellectual property rights in many nations, and continued high tariff rates on nonagricultural goods and services in many nations. We shall look at each in turn before discussing the latest round of talks between WTO members aimed at reducing trade barriers, the Doha Round, which began in 2001 and were still ongoing as of 2010.

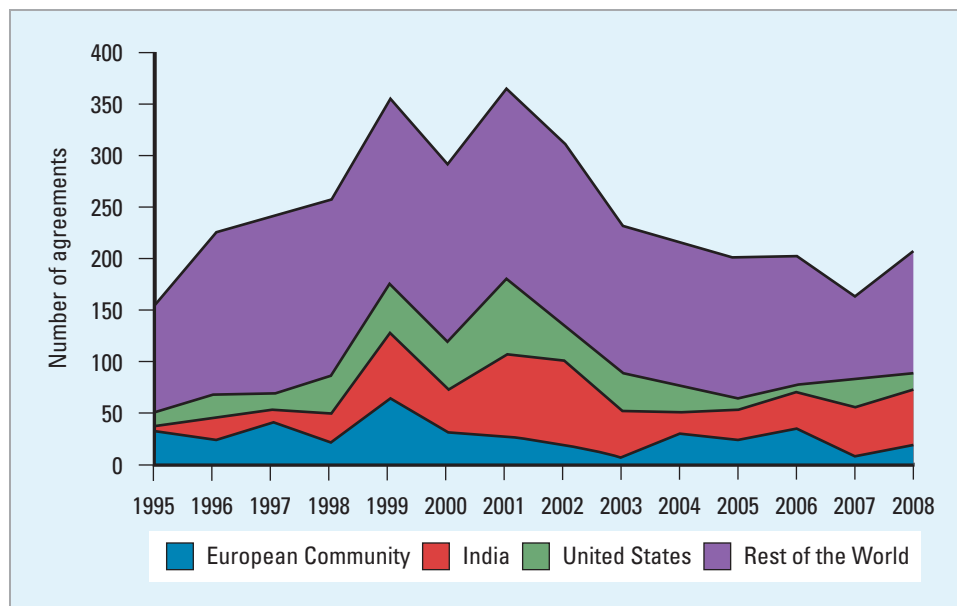
Antidumping Actions Antidumping actions proliferated during the 1990s. WTO rules allow countries to impose antidumping duties on foreign goods that are being sold cheaper than at home, or below their cost of production, when domestic producers can show that they are being harmed. Unfortunately, the rather vague definition of what constitutes “dumping” has proved to be a loophole that many countries are exploiting to pursue protectionism.

Between 1995 and 2008, WTO members had reported implementation of some 3,427 antidumping actions to the WTO. India initiated the largest number of antidumping actions, some 564; the EU initiated 391 over the same period, and the United States 418 (see Figure 6.2). Antidumping actions seem to be concentrated in certain sectors of the economy such as basic metal industries (e.g., aluminum and steel), chemicals, plastics, and machinery and electrical equipment.³⁹ These sectors account

6.2 figure

Antidumping Actions, 1995–2008

Source: Constructed by author from WTO data.



for some 70 percent of all antidumping actions reported to the WTO. These four sectors since 1995 have been characterized by periods of intense competition and excess productive capacity, which have led to low prices and profits (or losses) for firms in those industries. It is not unreasonable, therefore, to hypothesize that the high level of antidumping actions in these industries represents an attempt by beleaguered manufacturers to use the political process in their nations to seek protection from foreign competitors, who they claim are engaging in unfair competition. While some of these claims may have merit, the process can become very politicized as representatives of businesses and their employees lobby government officials to “protect domestic jobs from unfair foreign competition,” and government officials, mindful of the need to get votes in future elections, oblige by pushing for antidumping actions. The WTO is clearly worried by this trend, suggesting that it reflects persistent protectionist tendencies and pushing members to strengthen the regulations governing the imposition of antidumping duties.

Figure 6.2 suggests that antidumping actions peaked in the 1999–2001 time period and declined thereafter. However, the WTO reported a rise in antidumping actions in 2008 and 2009 as the global financial crisis took hold (the 2009 data are not included in Figure 6.2, since at the time of writing the data had not been finalized). Many of these actions seem to have been a direct response to the decline in global demand that followed the financial crisis and suggest that countries were using antidumping actions as a means of protecting domestic producers. The most frequent target of these actions was China.

Protectionism in Agriculture Another recent focus of the WTO has been the high level of tariffs and subsidies in the agricultural sector of many economies. Tariff rates on agricultural products are generally much higher than tariff rates on manufactured products or services. For example, in the mid-2000s the average tariff rates on nonagricultural products were 4.2 percent for Canada, 3.8 percent for the European Union, 3.9 percent for Japan, and 4.4 percent for the United States. On agricultural products, however, the average tariff rates were 21.2 percent for Canada, 15.9 percent for the European Union, 18.6 percent for Japan, and 10.3 percent for the United



Another Perspective

Brazil Wins against U.S. Cotton

The United States is known for aggressively protecting its agriculture from overseas competition, but this time it may carry a cost.

Claiming for years U.S. subsidies drove down cotton prices worldwide, Brazil recently won its suit against the United States before the World Trade Organization (WTO). Not only does the WTO ruling permit Brazil to retaliate against the United States, but it also apparently gives Brazil the right to breach U.S. patents. Accordingly, Brazil said it would impose higher tariffs on U.S. goods totaling nearly \$830 million per year, with about \$240 million targeting intellectual property. That's likely to hit America where it lives. ("Brazil Takes on Washington," *Forbes*, March 26, 2010, www.forbes.com; "Brazil, U.S.: An Intellectual Property Precedent," *Stratfor.com*, February 11, 2010, www.stratfor.com; and Steve LeVine, "Brazil Bests U.S. in Cotton Battle," *BusinessWeek*, August 31, 2009, www.businessweek.com)

States.⁴⁰ The implication is that consumers in these countries are paying significantly higher prices than necessary for agricultural products imported from abroad, which leaves them with less money to spend on other goods and services.

The historically high tariff rates on agricultural products reflect a desire to protect domestic agriculture and traditional farming communities from foreign competition. In addition to high tariffs, agricultural producers also benefit from substantial subsidies. According to estimates from the Organization for Economic Cooperation and Development (OECD), government subsidies on average account for some 17 percent of the cost of agricultural production in Canada, 21 percent in the United States, 35 percent in the European Union, and 59 percent in Japan.⁴¹ In total, OECD countries spend more than \$300 billion a year in subsidies to agricultural producers.

Not surprising, the combination of high tariff barriers and significant subsidies introduces sig-

nificant distortions into the production of agricultural products and international trade of those products. The net effect is to raise prices to consumers, reduce the volume of agricultural trade, and encourage the overproduction of products that are heavily subsidized (with the government typically buying the surplus). Because global trade in agriculture currently amounts to 10.5 percent of total merchandized trade, or about \$750 billion per year, the WTO argues that removing tariff barriers and subsidies could significantly boost the overall level of trade, lower prices to consumers, and raise global economic growth by freeing consumption and investment resources for more productive uses. According to estimates from the International Monetary Fund, removal of tariffs and subsidies on agricultural products would raise global economic welfare by \$128 billion annually.⁴² Others suggest gains as high as \$182 billion.⁴³

The biggest defenders of the existing system have been the advanced nations of the world, which want to protect their agricultural sectors from competition by low-cost producers in developing nations. In contrast, developing nations have been pushing hard for reforms that would allow their producers greater access to the protected markets of the developed nations. Estimates suggest that removing all subsidies on agricultural production alone in OECD countries could return to the developing nations of the world three times more than all the foreign aid they currently receive from the OECD nations.⁴⁴ In other words, free trade in agriculture could help to jump-start economic growth among the world's poorer nations and alleviate global poverty.

Protecting Intellectual Property Another issue that has become increasingly important to the WTO has been protecting intellectual property. The 1995 Uruguay agreement that established the WTO also contained an agreement to protect intellectual property (the Trade-Related Aspects of Intellectual Property Rights, or TRIPS, agreement). The TRIPS regulations oblige WTO members to grant and enforce patents lasting at least 20 years and copyrights lasting 50 years. Rich countries had to comply with the rules within a year. Poor countries, in which such protection generally was much weaker, had five years' grace, and the very poorest had

10 years. The basis for this agreement was a strong belief among signatory nations that the protection of intellectual property through patents, trademarks, and copyrights must be an essential element of the international trading system. Inadequate protections for intellectual property reduce the incentive for innovation. Because innovation is a central engine of economic growth and rising living standards, the argument has been that a multilateral agreement is needed to protect intellectual property.

Without such an agreement it is feared that producers in a country, let's say India, might market imitations of patented innovations pioneered in a different country, say the United States. This can affect international trade in two ways. First, it reduces the export opportunities in India for the original innovator in the United States. Second, to the extent that the Indian producer is able to export its pirated imitation to additional countries, it also reduces the export opportunities in those countries for the U.S. inventor. Also, one can argue that because the size of the total world market for the innovator is reduced, its incentive to pursue risky and expensive innovations is also reduced. The net effect would be less innovation in the world economy and less economic growth.

Something very similar to this has been occurring in the pharmaceutical industry, with Indian drug companies making copies of patented drugs discovered elsewhere. In 1970, the Indian government stopped recognizing product patents on drugs, but it elected to continue respecting process patents. This permitted Indian companies to reverse-engineer Western pharmaceuticals without paying licensing fees. As a result, foreigners' share of the Indian drug market fell from 75 percent in 1970 to 30 percent in 2000. For example, an Indian company sells a version of Bayer's patented antibiotic Cipro for \$0.12 a pill, versus the \$5.50 it costs in the United States. Under the WTO TRIPS agreement, India agreed to adopt and enforce the international drug patent regime by 2005.⁴⁵

As noted in Chapter 2, intellectual property rights violation is also an endemic problem in several other industries, most notably computer software and music. The WTO believes that reducing piracy rates in areas such as drugs, software, and music recordings would have a significant impact on the volume of world trade and increase the incentive for producers to invest in the creation of intellectual property. A world without piracy would have more new drugs, computer software, and music recordings produced every year. In turn, this would boost economic and social welfare, and global economic growth rates. It is thus in the interests of WTO members to make sure that intellectual property rights are respected and enforced. While the 1995 Uruguay agreement that created the WTO did make headway with the TRIPS agreement, some believe these requirements do not go far enough and further commitments are necessary.

Market Access for Nonagricultural Goods and Services Although the WTO and the GATT have made big strides in reducing the tariff rates on nonagricultural products, much work remains. Although most developed nations have brought their tariff rates on industrial products down to an *average* of 3.8 percent of value, exceptions still remain. In particular, while average tariffs are low, high tariff rates persist on certain imports into developed nations, which limit market access and economic growth. For example, Australia and South Korea, both OECD countries, still have bound tariff rates of 15.1 percent and 24.6 percent, respectively, on imports of transportation equipment (*bound tariff rates* are the highest rate that can be charged, which is often, but not always, the rate that is charged). In contrast, the bound tariff rates on imports of transportation equipment into the United States, EU, and Japan

table 6.1

Bound Tariffs on Select Industrial Products (simple averages)

Source: WTO.

Country	Metals	Transportation Equipment	Electric Machinery
Canada	2.8%	6.8%	5.2%
United States	1.8	2.7	2.1
Brazil	33.4	33.6	31.9
Mexico	34.7	35.8	34.1
European Union	1.6	4.7	3.3
Australia	4.5	15.1	13.3
Japan	0.9	0.0	0.2
South Korea	7.7	24.6	16.1

are 2.7 percent, 4.7 percent, and 0 percent, respectively (see Table 6.1). A particular area for concern is high tariff rates on imports of selected goods from developing nations into developed nations.

In addition, tariffs on services remain higher than on industrial goods. The average tariff on business and financial services imported into United States, for example, is 8.2 percent, into the EU it is 8.5 percent, and into Japan it is 19.7 percent.⁴⁶ Given the rising value of cross-border trade in services, reducing these figures can be expected to yield substantial gains.

The WTO would like to bring down tariff rates still further and reduce the scope for the selective use of high tariff rates. The ultimate aim is to reduce tariff rates to zero. Although this might sound ambitious, 40 nations have already moved to zero tariffs on information technology goods, so a precedent exists. Empirical work suggests that further reductions in average tariff rates toward zero would yield substantial gains. One estimate by economists at the World Bank suggests that a broad global trade agreement coming out of the current Doha negotiations could increase world income by \$263 billion annually, of which \$109 billion would go to poor countries.⁴⁷ Another estimate from the OECD suggests a figure closer to \$300 billion annually.⁴⁸ See the accompanying Country Focus for estimates of the benefits to the American economy from free trade.

Looking further out, the WTO would like to bring down tariff rates on imports of nonagricultural goods into developing nations. Many of these nations use the infant industry argument to justify the continued imposition of high tariff rates; however, ultimately these rates need to come down for these nations to reap the full benefits of international trade. For example, the bound tariff rates of 53.9 percent on imports of transportation equipment into India and 33.6 percent on imports into Brazil, by raising domestic prices, help to protect inefficient domestic producers and limit economic growth by reducing the real income of consumers who must pay more for transportation equipment and related services.

A New Round of Talks: Doha Antidumping actions, trade in agricultural products, better enforcement of intellectual property laws, and expanded market access were four of the issues the WTO wanted to tackle at the 1999 meetings in Seattle, but those meetings were derailed. In late 2001, the WTO tried again to launch a new round of talks between member states aimed at further liberalizing the global trade and investment framework. For this meeting, it picked the remote location of Doha in the Persian Gulf state of Qatar, no doubt with an eye on the



Country FOCUS

Estimating the Gains from Trade for America

A study published by the Institute for International Economics tried to estimate the gains to the American economy from free trade. According to the study, due to reductions in tariff barriers under the GATT and WTO since 1947, by 2003 the GDP of the United States was 7.3 percent higher than would otherwise be the case. The benefits of that amount to roughly \$1 trillion a year, or \$9,000 extra income for each American household per year.

The same study tried to estimate what would happen if America reached free trade deals with all its trading partners, reducing tariff barriers on all goods and services to zero. Using several methods to estimate the impact, the study concluded that additional annual gains of between \$450 billion and \$1.3 trillion could be realized. This final march to free trade, according to the authors of the study, could safely be expected to raise incomes of the average American household by an additional \$4,500 per year.

The authors also tried to estimate the scale and cost of employment disruption that would be caused by a move to universal free trade. Jobs would be lost in certain sectors

and gained in others if the country abolished all tariff barriers. Using historical data as a guide, they estimated that 226,000 jobs would be lost every year due to expanded trade, although some two-thirds of those losing jobs would find reemployment after a year. Reemployment, however, would be at a wage that was 13 to 14 percent lower. The study concluded that the disruption costs would total some \$54 billion annually, primarily in the form of lower lifetime wages to those whose jobs were disrupted as a result of free trade. Offset against this, however, must be the higher economic growth resulting from free trade, which creates many new jobs and raises household incomes, creating another \$450 billion to \$1.3 trillion annually in net gains to the economy. In other words, the estimated annual gains from trade are far greater than the estimated annual costs associated with job disruption, and more people benefit than lose as result of shift to a universal free trade regime.

Source: S. C. Bradford, P. L. E. Grieco, and G. C. Hufbauer, "The Payoff to America from Global Integration," in *The United States and the World Economy: Foreign Policy for the Next Decade*, ed. C. F. Bergsten (Washington, DC: Institute for International Economics, 2005).

difficulties that antiglobalization protesters would have in getting there. Unlike the Seattle meetings, at Doha, the member states of the WTO agreed to launch a new round of talks and staked out an agenda. The talks were originally scheduled to last three years, although they have already gone on longer and may not be concluded for a while.

The agenda includes cutting tariffs on industrial goods and services, phasing out subsidies to agricultural producers, reducing barriers to cross-border investment, and limiting the use of antidumping laws. Some difficult compromises were made to reach agreement on this agenda. The EU and Japan had to give significant ground on the issue of agricultural subsidies, which are used extensively by both entities to support politically powerful farmers. The United States bowed to pressure from virtually every other nation to negotiate revisions of antidumping rules, which the United States has used extensively to protect its steel producers from foreign competition. Europe had to scale back its efforts to include environmental policy in the trade talks, primarily because of pressure from developing nations that see environmental protection policies as trade barriers by another name. Excluded from the agenda was any language pertaining to attempts to tie trade to labor standards in a country.

Countries with big pharmaceutical sectors acquiesced to demands from African, Asian, and Latin American nations on the issue of drug patents. Specifically, the language in the agreement declares that WTO regulation on intellectual property "does not and should not prevent members from taking measures to protect public health." This language was meant to assure the world's poorer nations that they can make or buy generic equivalents to fight such killers as AIDS and malaria.

Clearly, it is one thing to agree to an agenda and quite another to reach a consensus on a new treaty. Nevertheless, if an agreement is reached there are some clear potential winners. These include low-cost agricultural producers in the developing world and developed nations such as Australia and the United States. If the talks are successful, agricultural producers in these nations will ultimately see the global markets for their goods expand. Developing nations also gain from the lack of language on labor standards, which many saw as an attempt by rich nations to erect trade barriers. The sick and poor of the world also benefit from guaranteed access to cheaper medicines. There are also clear losers in this agreement, including EU and Japanese farmers, U.S. steelmakers, environmental activists, and pharmaceutical firms in the developed world. These losers can be expected to lobby their governments hard during the ensuing years to make sure that the final agreement is more in their favor.⁴⁹ In general, though, if ultimately successful, the Doha Round of negotiations could significantly raise global economic welfare. As noted above, estimates suggest that a successful Doha Round would raise global incomes by as much as \$300 billion annually, with 60 percent of the gain going to the world's poorer nations, which would help to pull 150 million people out of poverty.⁵⁰

The talks are currently ongoing, and as seems normal in these cases, they are characterized by halting progress punctuated by significant setbacks and missed deadlines. A September 2003 meeting in Cancun, Mexico, broke down, primarily because there was no agreement on how to proceed with reducing agricultural subsidies and tariffs; the EU, United States, and India, among others, proved less than willing to reduce tariffs and subsidies to their politically important farmers, while countries such as Brazil and certain West African nations wanted free trade as quickly as possible. In 2004, both the United States and the EU made a determined push to start the talks again. However, since then little progress has been made and the talks are in deadlock, primarily because of disagreements over how deep the cuts in subsidies to agricultural produces should be. As of early 2010, the goal was to reduce tariffs for manufactured and agricultural goods by 60 to 70 percent, and to cut subsidies to half of their current level, but getting nations to agree to these goals was proving exceedingly difficult.



Focus on Managerial Implications

LEARNING OBJECTIVE 5

Explain the implications for managers of developments in the world trading system.

What are the implications of all this for business practice? Why should the international manager care about the political economy of free trade or about the relative merits of arguments for free trade and protectionism? There are two answers to this question. The first concerns the impact of trade barriers on a firm's strategy. The second concerns the role that business firms can play in promoting free trade or trade barriers.

Trade Barriers and Firm Strategy

To understand how trade barriers affect a firm's strategy, consider first the material in Chapter 5. Drawing on the theories of international trade, we discussed how it makes sense for the firm to disperse its various production activities to those countries around the globe where they can be performed most efficiently. Thus, it may make sense for a

firm to design and engineer its product in one country, to manufacture components in another, to perform final assembly operations in yet another country, and then export the finished product to the rest of the world.

Clearly, trade barriers constrain a firm's ability to disperse its productive activities in such a manner. First and most obvious, tariff barriers raise the costs of exporting products to a country (or of exporting partly finished products between countries). This may put the firm at a competitive disadvantage to indigenous competitors in that country. In response, the firm may then find it economical to locate production facilities in that country so that it can compete on an even footing. Second, quotas may limit a firm's ability to serve a country from locations outside of that country. Again, the response by the firm might be to set up production facilities in that country—even though it may result in higher production costs. Such reasoning was one of the factors behind the rapid expansion of Japanese automaking capacity in the United States during the 1980s and 1990s. This followed the establishment of a VER agreement between the United States and Japan that limited U.S. imports of Japanese automobiles.

Third, to conform to local content regulations, a firm may have to locate more production activities in a given market than it would otherwise. Again, from the firm's perspective, the consequence might be to raise costs above the level that could be achieved if each production activity was dispersed to the optimal location for that activity. And finally, even when trade barriers do not exist, the firm may still want to locate some production activities in a given country to reduce the threat of trade barriers being imposed in the future.

All these effects are likely to raise the firm's costs above the level that could be achieved in a world without trade barriers. The higher costs that result need not translate into a significant competitive disadvantage relative to other foreign firms, however, if the countries imposing trade barriers do so to the imported products of all foreign firms, irrespective of their national origin. But when trade barriers are targeted at exports from a particular nation, firms based in that nation are at a competitive disadvantage to firms of other nations. The firm may deal with such targeted trade barriers by moving production into the country imposing barriers. Another strategy may be to move production to countries whose exports are not targeted by the specific trade barrier.

Finally, the threat of antidumping action limits the ability of a firm to use aggressive pricing to gain market share in a country. Firms in a country also can make strategic use of antidumping measures to limit aggressive competition from low-cost foreign producers. For example, the U.S. steel industry has been very aggressive in bringing antidumping actions against foreign steelmakers, particularly in times of weak global demand for steel and excess capacity. In 1998 and 1999, the United States faced a surge in low-cost steel imports as a severe recession in Asia left producers there with excess capacity. The U.S. producers filed several complaints with the International Trade Commission. One argued that Japanese producers of hot rolled steel were selling it at below cost in the United States. The ITC agreed and levied tariffs ranging from 18 percent to 67 percent on imports of certain steel products from Japan (these tariffs are separate from the steel tariffs discussed earlier).⁵¹

Policy Implications

As noted in Chapter 5, business firms are major players on the international trade scene. Because of their pivotal role in international trade, firms can and do exert a strong influence on government policy toward trade. This influence can encourage protectionism or it can encourage the government to support the WTO and push for

open markets and freer trade among all nations. Government policies with regard to international trade can have a direct impact on business.

Consistent with strategic trade policy, examples can be found of government intervention in the form of tariffs, quotas, antidumping actions, and subsidies helping firms and industries establish a competitive advantage in the world economy. In general, however, the arguments contained in this chapter and in Chapter 5 suggest that government intervention has three drawbacks. Intervention can be self-defeating because it tends to protect the inefficient rather than help firms become efficient global competitors. Intervention is dangerous; it may invite retaliation and trigger a trade war. Finally, intervention is unlikely to be well executed, given the opportunity for such a policy to be captured by special-interest groups. Does this mean that business should simply encourage government to adopt a *laissez-faire* free trade policy?

Most economists would probably argue that the best interests of international business are served by a free trade stance, but not a *laissez-faire* stance. It is probably in the best long-run interests of the business community to encourage the government to aggressively promote greater free trade by, for example, strengthening the WTO. Business probably has much more to gain from government efforts to open protected markets to imports and foreign direct investment than from government efforts to support certain domestic industries in a manner consistent with the recommendations of strategic trade policy.

This conclusion is reinforced by a phenomenon we touched on in Chapter 1—the increasing integration of the world economy and internationalization of production that has occurred over the past two decades. We live in a world where many firms of all national origins increasingly depend for their competitive advantage on globally dispersed production systems. Such systems are the result of freer trade. Freer trade has brought great advantages to firms that have exploited it and to consumers who benefit from the resulting lower prices. Given the danger of retaliatory action, business firms that lobby their governments to engage in protectionism must realize that by doing so they may be denying themselves the opportunity to build a competitive advantage by constructing a globally dispersed production system. By encouraging their governments to engage in protectionism, their own activities and sales overseas may be jeopardized if other governments retaliate. This does not mean a firm should never seek protection in the form of antidumping actions and the like, but it should review its options carefully and think through the larger consequences.

Key Terms

free trade, p. 204
tariff, p. 206
specific tariff, p. 206
ad valorem tariff, p. 206
subsidy, p. 207
import quota, p. 208
tariff rate quota, p. 209

voluntary export restraint
(VER), p. 209
quota rent, p. 210
local content requirement, p. 210
administrative trade policies, p. 210
dumping, p. 211
antidumping policies, p. 211

countervailing duties, p. 211
Helms-Burton Act, p. 216
D'Amato Act, p. 216
infant industry argument, p. 219
strategic trade policy, p. 220
Smoot-Hawley Act, p. 223

The goal of this chapter was to describe how the reality of international trade deviates from the theoretical ideal of unrestricted free trade reviewed in Chapter 5. In this chapter, we have reported the various instruments of trade policy, reviewed the political and economic arguments for government intervention in international trade, reexamined the economic case for free trade in light of the strategic trade policy argument, and looked at the evolution of the world trading framework. While a policy of free trade may not always be the theoretically optimal policy (given the arguments of the new trade theorists), in practice it is probably the best policy for a government to pursue. In particular, the long-run interests of business and consumers may be best served by strengthening international institutions such as the WTO. Given the danger that isolated protectionism might escalate into a trade war, business probably has far more to gain from government efforts to open protected markets to imports and foreign direct investment (through the WTO) than from government efforts to protect domestic industries from foreign competition. The chapter made the following points:

1. Trade policies, such as tariffs, subsidies, antidumping regulations, and local content requirements tend to be pro-producer and anti-consumer. Gains accrue to producers (who are protected from foreign competitors), but consumers lose because they must pay more for imports.
2. There are two types of arguments for government intervention in international trade: political and economic. Political arguments for intervention are concerned with protecting the interests of certain groups, often at the expense of other groups, or with promoting goals with regard to foreign policy, human rights, consumer protection, and the like. Economic arguments for intervention are about boosting the overall wealth of a nation.
3. A common political argument for intervention is that it is necessary to protect jobs. However, political intervention often hurts consumers and it can be self-defeating. Countries sometimes argue that it is important to protect certain industries for reasons of national security. Some argue that government should use the threat to intervene in trade policy as a bargaining tool to open foreign markets. This can be a risky policy; if it fails, the result can be higher trade barriers.
4. The infant industry argument for government intervention contends that to let manufacturing get a toehold, governments should temporarily support new industries. In practice, however, governments often end up protecting the inefficient.
5. Strategic trade policy suggests that with subsidies, government can help domestic firms gain first-mover advantages in global industries where economies of scale are important. Government subsidies may also help domestic firms overcome barriers to entry into such industries.
6. The problems with strategic trade policy are twofold: (a) such a policy may invite retaliation, in which case all will lose, and (b) strategic trade policy may be captured by special-interest groups, which will distort it to their own ends.
7. The GATT was a product of the postwar free trade movement. The GATT was successful in lowering trade barriers on manufactured goods and commodities. The move toward greater free trade under the GATT appeared to stimulate economic growth.
8. The completion of the Uruguay Round of GATT talks and the establishment of the World Trade Organization have strengthened the world trading system by extending GATT rules to services, increasing protection for intellectual property, reducing agricultural subsidies, and enhancing monitoring and enforcement mechanisms.
9. Trade barriers act as a constraint on a firm's ability to disperse its various production activities to optimal locations around the globe. One response to trade barriers is to establish more production activities in the protected country.
10. Business may have more to gain from government efforts to open protected markets to imports and foreign direct investment than from government efforts to protect domestic industries from foreign competition.

Critical Thinking and Discussion Questions

1. Do you think governments should consider human rights when granting preferential trading rights to countries? What are the arguments for and against taking such a position?
2. Whose interests should be the paramount concern of government trade policy—the interests of producers (businesses and their employees) or those of consumers?
3. Given the arguments relating to the new trade theory and strategic trade policy, what kind of trade policy should business be pressuring government to adopt?
4. You are an employee of a U.S. firm that produces personal computers in Thailand and then exports them to the United States and other countries for sale. The personal computers were originally produced in Thailand to take advantage of relatively low labor costs and a skilled workforce. Other possible locations considered at the time were Malaysia and Hong Kong. The U.S. government decides to impose punitive 100 percent ad valorem tariffs on imports of computers from Thailand to punish the country for administrative trade barriers that restrict U.S. exports to Thailand. How should your firm respond? What does this tell you about the use of targeted trade barriers?
5. Reread the Management Focus “U.S. Magnesium Seeks Protection.” Who gains most from the antidumping duties levied by the United States on imports of magnesium from China and Russia? Who are the losers? Are these duties in the best national interests of the United States?

Research Task



<http://globalEDGE.msu.edu>

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

1. Your company is considering exporting its pharmaceutical products to Japan, but management's current knowledge of the country's trade policies and barriers for this sector is limited. Conduct the appropriate level of research in a *trade barriers database* to identify any information on Japan's current standards and technical requirements for pharmaceutical products. Prepare an executive summary of your findings.
2. You work for a national chain of clothing stores that is considering importing textiles from India into the United States. You want to determine whether the goods are subject to import quotas. Using information provided by the *U.S. Customs and Border Protections*, prepare a report highlighting the elements that determine whether a shipment is subject to this type of trade restriction.



closing case

Why Did Global Food Prices Rise?

For a quarter of a century, global food prices had been falling, driven by the increased productivity and output of the farm sector worldwide. In 2007, this came to an abrupt end as global food prices soared. By September 2007, the world price of wheat rose to more than \$400 a ton—the highest ever recorded and up from \$200 a ton in May. The price of corn (maize) surged to \$175 a ton, some 60 percent above its average for 2006. An

index of food prices, which *The Economist* magazine has kept since 1845 and is adjusted for inflation, hit its highest level ever in December 2007!

One explanation for rising food prices has been increased demand. The increased demand has been driven by greater food consumption in rapidly developing nations, most notably China and India. Rising consumption of meat, in particular,

has driven up demand for grains; it takes eight kilograms of cereals to produce one kilogram of beef, so as demand for meat rises, consumption of grains by cattle surges. Farmers now feed 200 million to 250 million more tons of grain to their animals than they did 20 years ago, driving up grain prices.

Then there is the issue of biofuel subsidies. Both the United States and the European Union have adopted policies to increase production of ethanol and biodiesel to slow global warming (both products are argued to produce fewer CO₂ emissions, although how effective they are at doing this is actively debated). In 2000, about 15 million tons of American corn was turned into ethanol; in 2007 the figure reached 85 million tons. To promote increased production, governments have given subsidies to farmers. In the United States, subsidies amount to between \$0.29 and \$0.36 per liter of ethanol. In Europe, the subsidies are as high as \$1 a liter. Not surprisingly, the subsidies have created an incentive for farmers to plant more crops that can be turned into biofuels (primarily corn and soybeans). This has diverted land away from production of corn and soy for food and reduced the supply of land devoted to growing crops that don't receive biofuel subsidies, such as wheat. This highly subsidized source of demand seems to be having a dramatic effect on demand for corn and soybeans. In 2007, for example, the U.S. increase in demand for corn-based ethanol accounted for more than half of the global increase in demand for corn.

Complicating the situation are the high tariffs that shut producers of alternative products that can be turned into biofuels, most notably sugar cane, out of the American and EU markets. Brazil, the world's most efficient producer of sugar cane, confronts import tariffs of at least 25 percent by value in the United States and 50 percent in the EU, raising the price of imported sugar cane and making it uncompetitive with subsidized corn and soybeans. This is unfortunate because sugar cane is widely seen as a more environmentally friendly raw material for biofuels than either corn or soy. Sugar cane uses less fertilizer than corn or soy and produces a higher yield per hectare, in terms of its energy content. Ethanol is also produced from what used to be considered a waste product—the fiber removed from the cane during processing.

If policy makers have their way, however, the situation may get even worse. Plans in both the United States and EU call for an increase in the production of biofuels, but neither political entity has agreed to reduce tariff barriers on sugar cane, nor remove the trade-distorting subsidies given to those who produce corn and soy for biofuels. Brazil is not sitting on the sidelines; in 2007 it asked the World Trade Organization to probe U.S. subsidies to corn farmers for ethanol production.

Sources: "Cheap No More: Food Prices," *The Economist*, December 8, 2007, p. 84; "Brazil Seeks WTO Probe of U.S. Farm Subsidies," *Journal of Commerce*, September 13, 2007, p. 1; M. Wolf, "Biofuels: An Everyday Story of Special Interests and Subsidies," *Financial Times*, October 31, 2007, p. 11; and J. Von Braun and R. K. Pachauri, *The Promises and Challenges of Biofuels for the Poor in Developing Countries: IFPRI 2005–2006 Annual Report Essay* (Washington, DC: International Food Policy Research Institute, 2007).

Case Discussion Questions

1. Who benefits from government policies to (a) promote production of ethanol and (b) place tariff barriers on imports of sugar cane? Who suffers from these policies?
2. One estimate suggests that if food prices rise by one-third, they will reduce living standards in rich countries by about 3 percent, but in very poor ones by about 20 percent. According to the International Food Policy Research Institute, unless there is a change in policies, cereal prices will rise by 10 to 20 percent by 2015, and the expansion of biofuel production could reduce calorie intake by 2 to 8 percent by 2020 in many of the world's poorest nations. Should rich countries do anything about this? If so, what?
3. The argument for giving subsidies to ethanol producers rests upon the assumption that ethanol results in lower CO₂ emissions than gasoline and therefore benefits the environment. If we accept that global warming is a serious problem, should we not be encouraging governments to increase such subsidies? What are the arguments for and against doing so? On balance, what do you think is the best policy?



part 3

Cross-Border Trade and Investment

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Recognize current trends regarding foreign direct investment in the world economy.
- 2 Explain the different theories of foreign direct investment.
- 3 Understand how political ideology shapes a government's attitudes toward FDI.
- 4 Describe the benefits and costs of FDI to home and host countries.
- 5 Explain the range of policy instruments that governments use to influence FDI.
- 6 Identify the implications for management practice of the theory and government policies associated with FDI.

Foreign Direct Investment

Walmart in Japan

opening case

Japan has been a tough market for foreign firms to enter. The level of foreign direct investment (FDI) in Japan is a fraction of that found in many other developed nations. In 2008, for example, the stock of foreign direct investment as a percentage of GDP was 4.1 percent in Japan. In the United States, the comparable figure was 16 percent; in Germany, 19.2 percent; in France, 34.7 percent; and in the United Kingdom, 36.9 percent.

Various reasons account for the lack of FDI into Japan. Until the 1990s, government regulations made it difficult for companies to establish a direct presence in the nation. In the retail sector, for example, the Large Scale Retail Store Law, which was designed to protect politically powerful small retailers, made it all but impossible for foreign retailers to open large-volume stores in the country (the law was repealed in 1994). Despite deregulation during the 1990s, FDI into Japan remained at low levels. Some cite cultural factors in explaining this. Many Japanese companies have resisted acquisitions by foreign enterprises (acquisitions are a major vehicle for FDI). They did so because of fears that new owners would restructure too harshly, cutting jobs and breaking long-standing commitments with suppliers. Foreign investors also state that they find it difficult to find managerial talent in Japan, since most managers tend to stay with a single employer for their entire career, leaving very few managers in the labor market for foreign firms to hire. Furthermore, a combination of slow economic growth, sluggish consumer spending, and an aging population makes the Japanese economy less attractive than it once was, particularly when compared to the dynamic and rapidly growing economies of India and China, or even the United States and the United Kingdom.

The Japanese government, however, has come around to the view that the country needs more foreign investment. Foreign firms can bring competition to Japan where local ones may not, because they do not feel bound by existing business practices or relationships. They can be a source of new management ideas, business policies, and technology, all of which boost productivity. Indeed, a study by the Organization for Economic Cooperation and Development (OECD) suggests that labor productivity at the Japanese affiliates of foreign firms is as much as 60 percent higher than at domestic firms, and in services

firms it is as much as 80 percent higher. (The OECD is a Paris-based inter-governmental organization of “wealthy” nations whose purpose is to provide its 29 member states with a forum in which governments can compare their experiences, discuss the problems they share, and seek solutions that can then be applied within their own national contexts. The members include most European Union countries, the United States, Canada, Japan, and South Korea).

It was the opportunity to help restructure Japan’s retail sector, boosting productivity, gaining market share, and profiting in the process, that attracted Walmart to Japan. The world’s largest retailer, Walmart entered Japan in 2002 by acquiring a stake in Seiyu, which was then the fifth-largest retailer in Japan. Under the terms of the deal, Walmart increased its ownership stake over the next five years, becoming a majority owner by 2006. Seiyu was considered an inefficient retailer. According to one top officer, “Seiyu is bogged down in old customs that are wasteful. Walmart brings proven skills in managing big supermarkets, which is what we would like to learn to do.”

Walmart’s goal was to transfer best practice from its U.S. stores and use them to improve the performance of Seiyu. This meant implementing Walmart’s cutting-edge information systems, adopting tight inventory control, leveraging its global supply chain to bring low-cost goods into Japan, introducing everyday low prices, retraining employees to improve customer service, extending opening hours, renovating stores, and investing in new ones.

It’s proven to be more difficult than Walmart hoped. Walmart’s entry prompted local rivals to change their strategies. They began to make acquisitions to grow and started to cut their prices to match Walmart’s discounting strategy. Walmart also found that it had to alter its merchandising approach, offering more high-value items to match Japanese shopping habits, which were proving to be difficult to change. Also, many Japanese suppliers were reluctant to work closely with Walmart. Despite this, after years of losses, it looked as if Seiyu would become profitable in 2010, indicating that Walmart might ultimately reap a return on its investment. ●

Sources: D. R. John, “Wal-Mart in Japan: Survival and Future of Its Japanese Business,” *Icfai University Journal of International Business* 3 (2008), pp. 45–67; United Nations, *World Investment Report, 2009* (New York and Geneva: United Nations, 2009); “Challenges Persist in Japan,” *MMR*, December 14, 2009, p. 45; and J. Matusitz and M. Forrester, “Successful Globalization Practices: The Case of Seiyu in Japan,” *Journal of Transnational Management* 14, no. 2 (April 2009), pp. 155–76.



Introduction

Foreign direct investment (FDI) occurs when a firm invests directly in facilities to produce or market a product in a foreign country. According to the U.S. Department of Commerce, in the United States FDI occurs whenever a U.S. citizen, organization, or affiliated group takes an interest of 10 percent or more in a foreign business entity. Once a firm undertakes FDI, it becomes a *multinational enterprise*. An example of FDI

is given in the opening case: Walmart's investment in Japan. Walmart first became a multinational in the early 1990s when it invested in Mexico.

FDI takes on two main forms. The first is a **greenfield investment**, which involves the establishment of a new operation in a foreign country. The second involves acquiring or merging with an existing firm in the foreign country (Walmart's entry into Japan was in the form of an acquisition). Acquisitions can be a minority (where the foreign firm takes a 10 percent to 49 percent interest in the firm's voting stock), majority (foreign interest of 50 percent to 99 percent), or full outright stake (foreign interest of 100 percent).¹

We begin this chapter by looking at the importance of foreign direct investment in the world economy. Next, we review the theories that have been used to explain foreign direct investment. The chapter then moves on to look at government policy toward foreign direct investment and closes with a section on implications for business.

Foreign Direct Investment in the World Economy

When discussing foreign direct investment, it is important to distinguish between the flow of FDI and the stock of FDI. The **flow of FDI** refers to the amount of FDI undertaken over a given time period (normally a year). The **stock of FDI** refers to the total accumulated value of foreign-owned assets at a given time. We also talk of **outflows of FDI**, meaning the flow of FDI out of a country, and **inflows of FDI**, the flow of FDI into a country.

TRENDS IN FDI The past 30 years have seen a marked increase in both the flow and stock of FDI in the world economy. The average yearly outflow of FDI increased from \$25 billion in 1975 to a record \$1.8 trillion in 2007 (see Figure 7.1). However, FDI outflows did contract to \$1.2 trillion in 2009 in the wake of the global financial crisis, although they are forecasted to recover in 2011.² In general, however, over the past three decades the flow of FDI has accelerated faster than the growth in world trade and world output. For example, between 1992 and 2008, the total flow of FDI from all countries increased more than eightfold while world trade by value grew by some 150 percent and world output by around 45 percent.³ As a result of the strong FDI flow, by 2009 the global stock of FDI was about \$15 trillion. At least 82,000 parent companies had 810,000 affiliates in foreign markets that collectively employed more than 77 million people abroad and generated value accounting for about 11 percent of global GDP. The foreign affiliates of multinationals had over \$30 trillion in global sales, higher than the value of global exports of goods and services, which stood at close to \$19.9 trillion.⁴

FDI has grown more rapidly than world trade and world output for several reasons. First, despite the general decline in trade barriers over the past 30 years, business firms still fear protectionist pressures. Executives see FDI as a way of circumventing future trade barriers. Second, much of the increase in FDI has been driven by the political and economic changes that have been occurring in many of the world's developing nations. The general shift toward democratic political institutions and free market economies that we discussed in Chapter 2 has encouraged FDI. Across much of Asia, Eastern Europe, and Latin America, economic growth, economic deregulation, privatization programs that are open to foreign investors, and removal of many restrictions on FDI have made these countries more attractive to foreign multinationals. According to the United Nations, some 90 percent of the 2,600 changes made worldwide between 1992 and 2008 in the laws governing foreign direct investment created a more favorable environment for FDI (see Figure 7.2).⁵ However, since 2002, the number of regulations that are less favorable toward FDI has increased, suggesting the pendulum may be starting to swing

Greenfield Investment

Establishing a new operation in a foreign country.

LEARNING OBJECTIVE 1

Recognize current trends regarding foreign direct investment in the world economy.

Flow of FDI

The amount of FDI undertaken over a given time period (normally a year).

Stock of FDI

The total accumulated value of foreign-owned assets at a given time.

Outflows of FDI

The flow of FDI out of a country.

Inflows of FDI

The flow of FDI into a country.

figure 7.1

FDI Outflows, 1982–2009
(\$ billion)

Source: Constructed by the author from data in United Nations, *World Investment Report, 2009* (New York and Geneva: United Nations, 2009).

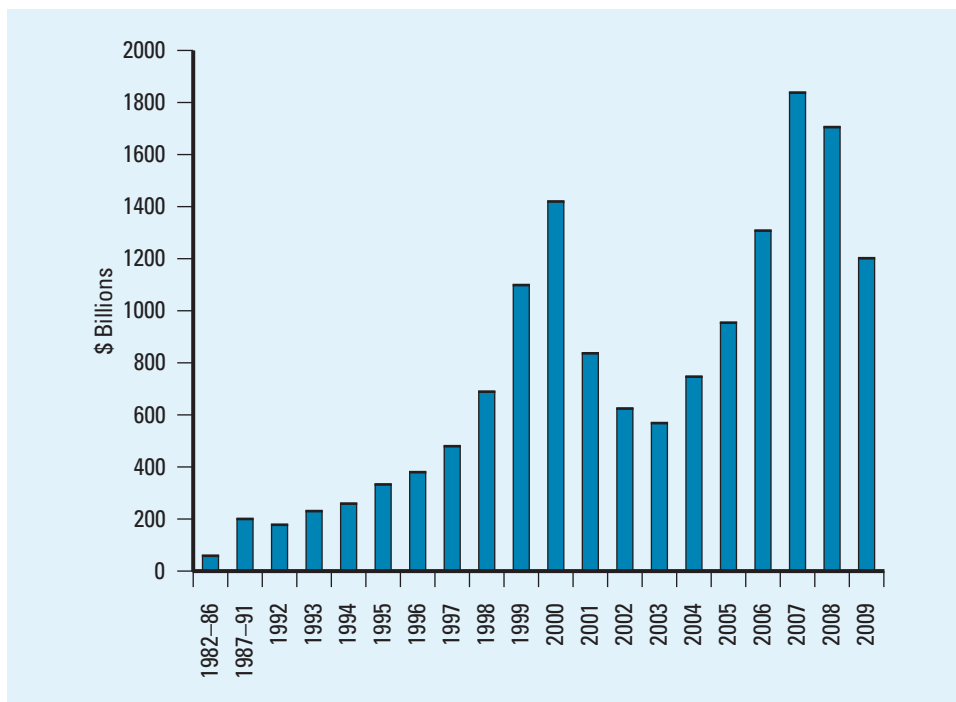
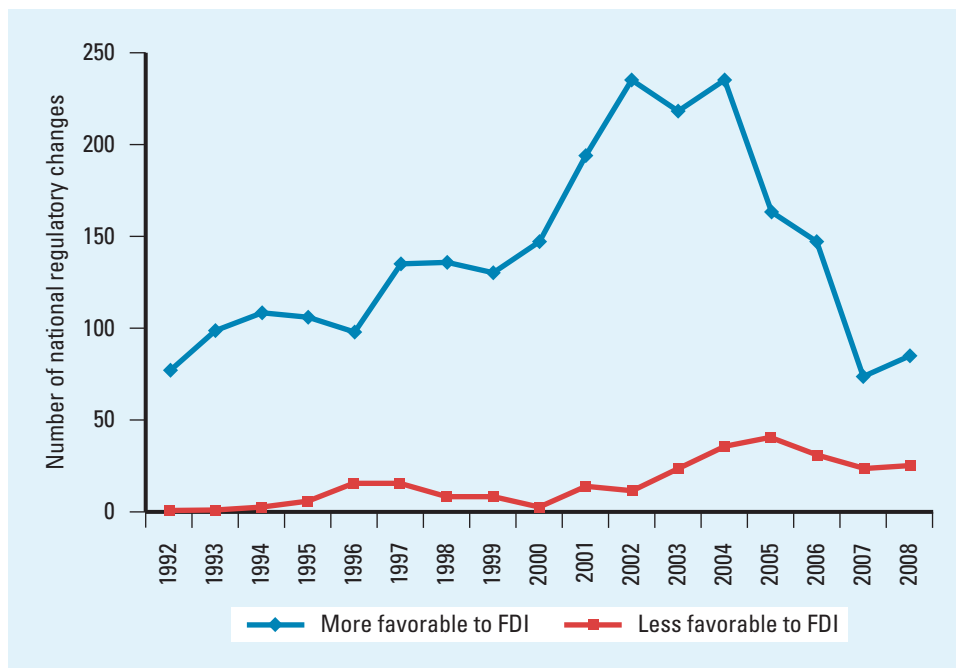


figure 7.2

National Regulatory Changes Governing FDI, 1992–2008

Source: Constructed by the author from data in United Nations, *World Investment Report, 2009* (New York and Geneva: United Nations, 2009).



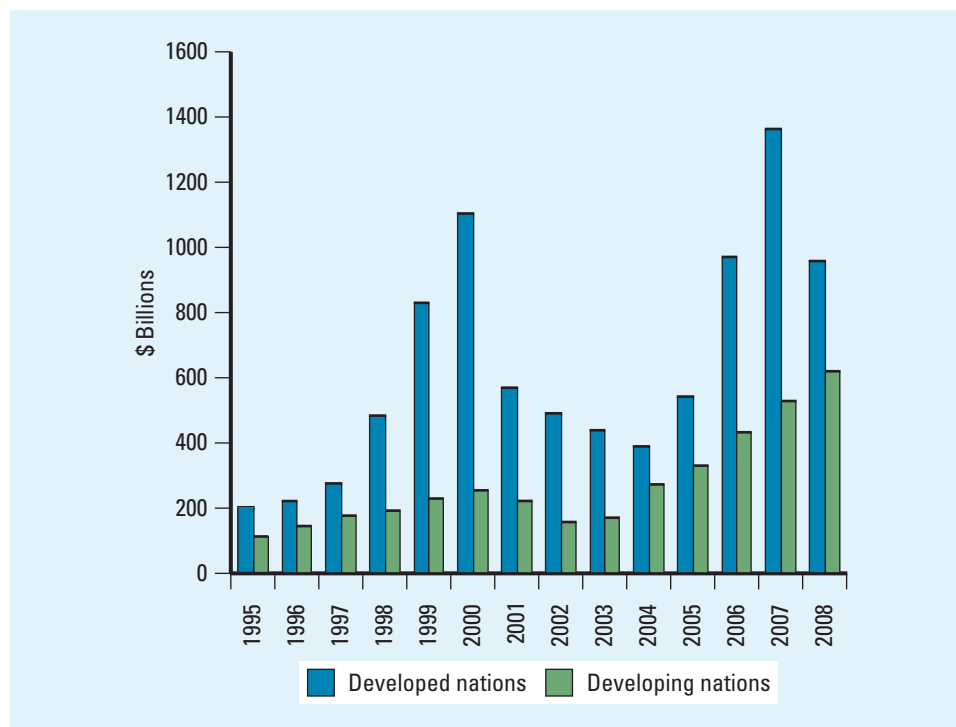
the other way. Latin America, in particular, has seen an increase in regulations that are less favorable to FDI; two-thirds of the reported changes in 2005 and 2008 made the environment for direct investment less welcome there. Most of these unfavorable changes were focused on extractive industries, such as oil and gas, where governments seem focused on limiting FDI and capturing more of the economic value from FDI through, for example, higher taxes and royalty rates applied to foreign enterprises.

Notwithstanding recent adverse developments in some nations, the general desire of governments to facilitate FDI also has been reflected in a sharp increase in the number of bilateral investment treaties designed to protect and promote investment between two countries. As of 2009, 2,676 such treaties involved more than 180 countries, a 12-fold increase from the 181 treaties that existed in 1980.⁶

The globalization of the world economy is also having a positive impact on the volume of FDI. Many firms (such as Walmart profiled in the opening case) now see the whole world as their market, and they are undertaking FDI in an attempt to make sure they have a significant presence in many regions. For reasons that we shall explore later in this book, many firms now believe it is important to have production facilities based close to their major customers. This, too, creates pressure for greater FDI.

THE DIRECTION OF FDI Historically, most FDI has been directed at the developed nations of the world as firms based in advanced countries invested in the others' markets (see Figure 7.3). During the 1980s and 1990s, the United States was often the favorite target for FDI inflows. The United States has been an attractive target for FDI because of its large and wealthy domestic markets, its dynamic and stable economy, a favorable political environment, and the openness of the country to FDI. Investors include firms based in Great Britain, Japan, Germany, Holland, and France. Inward investment into the United States remained high during the 2000s, totaling \$271 billion in 2007 and \$316 billion in 2008. The developed nations of the European Union have also been recipients of significant FDI inflows, principally from U.S. and Japanese enterprises and from other member states of the EU. In 2007, inward investment into the EU reached a record \$842 billion, although it fell to \$503 billion in 2008. The United Kingdom and France were the largest national recipients. Some \$280 billion was invested in the United Kingdom in 2007 and 2008 combined, and \$275 billion in France.⁷

Even though developed nations still account for the largest share of FDI inflows, FDI into developing nations has increased (see Figure 7.3). From 1985 to 1990, the annual



7.3 figure
FDI Inflows by Region, 1995–2008 (\$ billion)
 Source: Constructed by the author from data in United Nations, *World Investment Report, 2009* (New York and Geneva: United Nations, 2009).

inflow of FDI into developing nations averaged \$27.4 billion, or 17.4 percent of the total global flow. In the mid- to late 1990s, the inflow into developing nations was generally between 35 and 40 percent of the total, before falling back to account for about 25 percent of the total in the 2000–2002 period and then rising to 31 to 40 percent between 2004 and 2008. Most recent inflows into developing nations have been targeted at the emerging economies of South, East, and Southeast Asia. Driving much of the increase has been the growing importance of China as a recipient of FDI, which attracted around \$60 billion of FDI in 2004 and rose steadily to hit \$108 billion in 2008.⁸ The reasons for the strong flow of investment into China are discussed in the accompanying Country Focus.

Latin America emerged as the next most important region in the developing world for FDI inflows. In 2008, total inward investments into this region reached about \$144 billion. Mexico and Brazil have historically been the two top recipients of inward FDI in Latin America, a trend that continued in 2008. At the other end of the scale, Africa has long received the smallest amount of inward investment, although the continent did receive a record \$87 billion in 2008. In recent years, Chinese enterprises have emerged as major investors in Africa, particularly in extraction industries where they seem to be trying to assure future supplies of valuable raw materials. The inability of Africa to attract greater investment is in part a reflection of the political unrest, armed conflict, and frequent changes in economic policy in the region.⁹

Another way of looking at the importance of FDI inflows is to express them as a percentage of gross fixed capital formation. **Gross fixed capital formation** summarizes the total amount of capital invested in factories, stores, office buildings, and the like. Other things being equal, the greater the capital investment in an economy, the more favorable its future growth prospects are likely to be. Viewed this way, FDI can be seen as an important source of capital investment and a determinant of the future growth rate of an economy. Figure 7.4 summarizes inward flows of FDI as a percentage of gross fixed

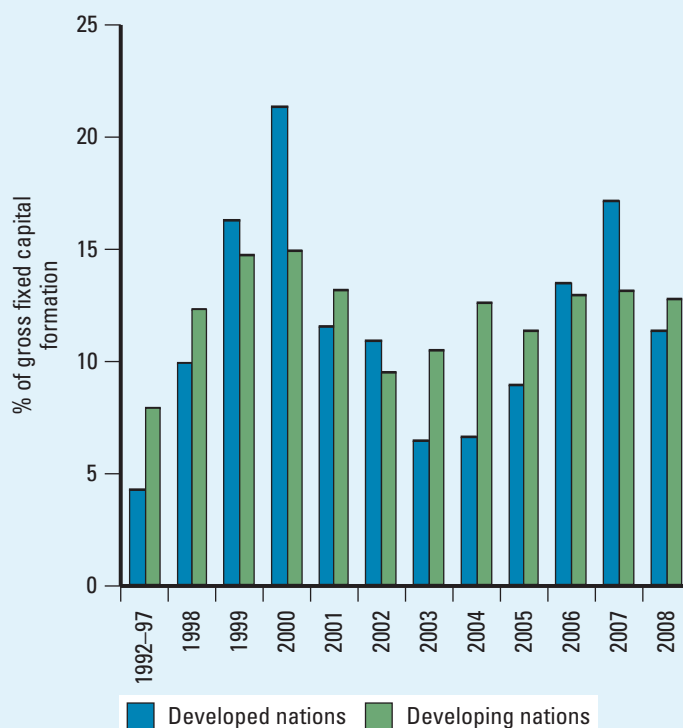
Gross Fixed Capital Formation

Summarizes the total amount of capital invested in factories, stores, office buildings, and the like.

figure 7.4

Inward FDI as a Percentage of Gross Fixed Capital Formation, 1992–2008

Source: Constructed by the author from data in United Nations, *World Investment Report, 2009* (New York and Geneva: United Nations, 2009).





Country FOCUS

Foreign Direct Investment in China

Beginning in late 1978, China's leadership decided to move the economy away from a centrally planned socialist system to one that was more market driven. The result has been close to three decades of sustained high economic growth rates of about 10 percent annually compounded. This rapid growth has attracted substantial foreign investment. Starting from a tiny base, foreign investment increased to an annual average rate of \$2.7 billion between 1985 and 1990 and then surged to \$40 billion annually in the late 1990s, making China the second-biggest recipient of FDI inflows in the world after the United States. By the late 2000s, China was attracting between \$80 billion and \$100 billion of FDI annually, with another \$60 billion a year going into Hong Kong.

Over the past 20 years, this inflow has resulted in establishment of over 300,000 foreign-funded enterprises in China. The total stock of FDI in mainland China grew from effectively zero in 1978 to \$378 billion in 2008 (another \$835 billion of FDI stock was in Hong Kong). FDI amounted to about 8 percent of annualized gross fixed capital formation in China between 1998 and 2008, suggesting that FDI is an important source of economic growth in China.

The reasons for the investment are fairly obvious. With a population of more than 1 billion people, China represents one of the world's largest markets. Historically, import tariffs made it difficult to serve this market via exports, so FDI was required if a company wanted to tap into the country's huge potential. Although China joined the World Trade Organization in 2001, which will ultimately mean a reduction in import tariffs, this will occur slowly, so this motive for investing in China will persist. Also, many foreign firms believe that doing business in China requires a substantial presence in the country to build *guanxi*, the crucial relationship networks (see Chapter 3 for details). Furthermore, a combination of cheap labor and tax incentives, particularly for enterprises that establish themselves in special economic zones, makes China an attractive base from which to serve Asian or world markets with exports.

Less obvious, at least to begin with, was how difficult it would be for foreign firms to do business in China. Blinded by the size and potential of China's market, many firms have paid less attention than perhaps they should have to the complexities of operating a business in this country until after the investment has been made. China may have a huge population, but despite two decades of rapid growth, it is still relatively poor. The lack of purchasing power

translates into relative weak markets for many Western consumer goods. Another problem is the lack of a well-developed transportation infrastructure or distribution system outside of major urban areas. PepsiCo discovered this problem at its subsidiary in Chongqing. Perched above the Yangtze River in southwest Sichuan province, Chongqing lies at the heart of China's massive hinterland. The Chongqing municipality, which includes the city and its surrounding regions, contains more than 30 million people, but according to Steve Chen, the manager of the PepsiCo subsidiary, the lack of well-developed road and distribution systems means he can reach only about half of this population with his product.

Other problems include a highly regulated environment, which can make it problematic to conduct business transactions, and shifting tax and regulatory regimes. For example, a few years ago, the Chinese government suddenly scrapped a tax credit scheme that had made it attractive to import capital equipment into China. This immediately made it more expensive to set up operations in the country. Then there are problems with local joint-venture partners that are inexperienced, opportunistic, or simply operate according to different goals. One U.S. manager explained that when he laid off 200 people to reduce costs, his Chinese partner hired them all back the next day. When he inquired why they had been hired back, the executive of the Chinese partner, which was government owned, explained that as an agency of the government, it had an "obligation" to reduce unemployment.

To continue to attract foreign investment, the Chinese government has committed itself to invest more than \$800 billion in infrastructure projects over the next 10 years. This should improve the nation's poor highway system. By giving preferential tax breaks to companies that invest in special regions, such as that around Chongqing, the Chinese have created incentives for foreign companies to invest in China's vast interior where markets are underserved. They have been pursuing a macroeconomic policy that includes an emphasis on maintaining steady economic growth, low inflation, and a stable currency, all of which are attractive to foreign investors. Given these developments, it seems likely that the country will continue to be an important magnet for foreign investors well into the future.

Sources: Interviews by the author while in China; United Nations, *World Investment Report, 2009* (New York and Geneva: United Nations, 2009); Linda Ng and C. Tuan, "Building a Favorable Investment Environment: Evidence for the Facilitation of FDI in China," *The World Economy*, 2002, pp. 1095–114; and S. Chan and G. Qingyang, "Investment in China Migrates Inland," *Far Eastern Economic Review*, May 2006, pp. 52–57.



Another Perspective

Diageo Makes “Spirited” Entry into China

London-based Diageo, the world’s largest seller of premium spirits, beer, and wine, operates in 180 markets worldwide. Its family includes such well-known brands as Baileys, Captain Morgan, Guinness, Johnny Walker, Jose Cuervo, Smirnoff, and Tanqueray. The company traditionally has generated about three-fourths of its revenues in Europe and North America. However, when sales were down in those regions, the company decided to introduce its premium Johnny Walker brand in China shortly before the Chinese New Year. The product, which retails for an eye-popping \$300 per bottle, sold out quickly. Diageo plans to deepen its reach into China as well as the rest of Asia. (“Diageo Makes Play for Asia,” *Foreign Direct Investments*, April 15, 2010, <http://fdimagazine.com>)

capital formation for developed and developing economies for 1992–2008. During 1992–1997, FDI flows accounted for about 4 percent of gross fixed capital formation in developed nations and 8 percent in developing nations. By 2006–2008, the figure was 14 percent worldwide, suggesting that FDI had become an increasingly important source of investment in the world’s economies.

These gross figures hide important individual country differences. For example, in 2008, inward FDI accounted for some 47 percent of gross fixed capital formation in Sweden and 21 percent in the United Kingdom, but 2.3 percent in Venezuela and 2.2 percent in Japan—suggesting that FDI is an important source of investment capital, and thus economic growth, in the first two countries but not the latter two. These differences can be explained by several factors, including the perceived ease and attractiveness of investing in a nation. To the extent

that burdensome regulations limit the opportunities for foreign investment in countries such as Japan and Venezuela, these nations may be hurting themselves by limiting their access to needed capital investments (see the opening case for more details on Japan).

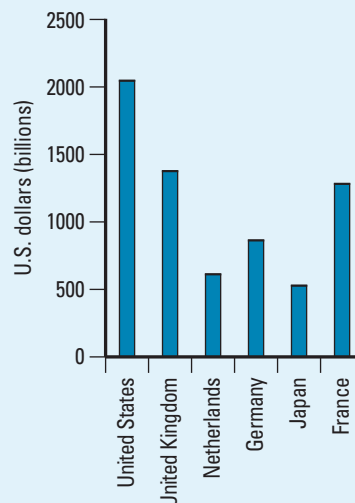
THE SOURCE OF FDI Since World War II, the United States has been the largest source country for FDI, a position it retained during the late 1990s and early 2000s. Other important source countries include the United Kingdom, France, Germany, the Netherlands, and Japan. Collectively, these six countries accounted for 56 percent of all FDI outflows for the 1998–2008 period and 61 percent of the total global stock of FDI in 2008 (see Figure 7.5). As might be expected, these countries also predominate in rankings of the world’s largest multinationals.¹⁰ These nations dominate primarily because they were the most developed nations with the largest economies during much of the postwar period and therefore home

figure 7.5

Cumulative FDI Outflows, 1998–2008 (\$ billions)

Note: Share accounted for by the United States would have been larger were it not for significant one-time investment inflows in 2005 due to changes in U.S. tax laws.

Source: Constructed by the author from data in United Nations, *World Investment Report, 2009* (New York and Geneva: United Nations, 2009).



to many of the largest and best-capitalized enterprises. Many of these countries also had a long history as trading nations and naturally looked to foreign markets to fuel their economic expansion. Thus, it is no surprise that enterprises based there have been at the forefront of foreign investment trends.

THE FORM OF FDI: ACQUISITIONS VERSUS GREENFIELD INVESTMENTS

FDI can take the form of a greenfield investment in a new facility or an acquisition of or a merger with an existing local firm. The data suggest the majority of cross-border investment is in the form of mergers and acquisitions rather than greenfield investments. UN estimates indicate that some 40 to 80 percent of all FDI inflows per annum were in the form of mergers and acquisitions between 1998 and 2008. In 2001, for example, mergers and acquisitions accounted for some 78 percent of all FDI inflows. In 2004, the figure was 59 percent, while in 2008 it was 40 percent.¹¹

However, FDI flows into developed nations differ markedly from those into developing nations. In the case of developing nations, only about one-third of FDI is in the form of cross-border mergers and acquisitions. The lower percentage of mergers and acquisitions may simply reflect the fact that there are fewer target firms to acquire in developing nations.

When contemplating FDI, why do firms apparently prefer to acquire existing assets rather than undertake greenfield investments? We shall consider it in greater depth in Chapter 12; for now we will make only a few basic observations. First, mergers and acquisitions are quicker to execute than greenfield investments. This is an important consideration in the modern business world where markets evolve very rapidly. Many firms apparently believe that if they do not acquire a desirable target firm, then their global rivals will. Second, foreign firms are acquired because those firms have valuable strategic assets, such as brand loyalty, customer relationships, trademarks or patents, distribution systems, production systems, and the like. It is easier and perhaps less risky for a firm to acquire those assets than to build them from the ground up through a greenfield investment. Third, firms make acquisitions because they believe they can increase the efficiency of the acquired unit by transferring capital, technology, or management skills. However, there is evidence that many mergers and acquisitions fail to realize their anticipated gains.¹²



When you see a BP gas station as you are driving down the road, do you realize that the company is British owned? BP = British Petroleum.

Theories of Foreign Direct Investment

In this section, we review several theories of foreign direct investment. These theories approach the various phenomena of foreign direct investment from three complementary perspectives. One set of theories seeks to explain why a firm will favor direct investment as a means of entering a foreign market when two other alternatives, exporting and licensing, are open to it. Another set of theories seeks to explain why firms in the same industry often undertake foreign direct investment at the same time, and why they favor certain locations over others as targets for foreign direct investment. Put differently, these theories attempt to explain the observed *pattern* of foreign direct

LEARNING OBJECTIVE 2

Explain the different theories of foreign direct investment.

Eclectic Paradigm

Argument that combining location-specific assets or resource endowments and the firm's own unique assets often requires FDI; it requires the firm to establish production facilities where those foreign assets or resource endowments are located.

Exporting

Sale of products produced in one country to residents of another country.

Licensing

Occurs when a firm (the licensor) licenses the right to produce its product, its production processes, or its brand name or trademark to another firm (the licensee); in return for giving the licensee these rights, the licensor collects a royalty fee on every unit the licensee sells.

investment flows. A third theoretical perspective, known as the **eclectic paradigm**, attempts to combine the two other perspectives into a single holistic explanation of foreign direct investment (this theoretical perspective is *eclectic* because the best aspects of other theories are taken and combined into a single explanation).

WHY FOREIGN DIRECT INVESTMENT? Why do firms go to all of the trouble of establishing operations abroad through foreign direct investment when two alternatives, exporting and licensing, are available for exploiting the profit opportunities in a foreign market? **Exporting** involves producing goods at home and then shipping them to the receiving country for sale. **Licensing** involves granting a foreign entity (the licensee) the right to produce and sell the firm's product in return for a royalty fee on every unit sold. The question is important, given that a cursory examination of the topic suggests that foreign direct investment may be both expensive and risky compared with exporting and licensing. FDI is expensive because a firm must bear the costs of establishing production facilities in a foreign country or of acquiring a foreign enterprise. FDI is risky because of the problems associated with doing business in a different culture where the rules of the game may be very different. Relative to indigenous firms, there is a greater probability that a foreign firm undertaking FDI in a country for the first time will make costly mistakes due to its ignorance. When a firm exports, it need not bear the costs associated with FDI, and it can reduce the risks associated with selling abroad by using a native sales agent. Similarly, when a firm allows another enterprise to produce its products under license, the licensee bears the costs or risks. So why do so many firms apparently prefer FDI over either exporting or licensing? The answer can be found by examining the limitations of exporting and licensing as means for capitalizing on foreign market opportunities.

Limitations of Exporting The viability of an exporting strategy is often constrained by transportation costs and trade barriers. When transportation costs are added to production costs, it becomes unprofitable to ship some products over a large distance. This is particularly true of products that have a low value-to-weight ratio and that can be produced in almost any location. For such products, the attractiveness of exporting decreases, relative to either FDI or licensing. This is the case, for example, with cement. Thus, Cemex, the large Mexican cement maker, has expanded internationally by pursuing FDI, rather than exporting (see the Management Focus feature on Cemex). For products with a high value-to-weight ratio, however, transportation costs are normally a minor component of total landed cost (e.g., electronic components, personal computers, medical equipment, computer software, etc.) and have little impact on the relative attractiveness of exporting, licensing, and FDI.

Transportation costs aside, some firms undertake foreign direct investment as a response to actual or threatened trade barriers such as import tariffs or quotas. By placing tariffs on imported goods, governments can increase the cost of exporting relative to foreign direct investment and licensing. Similarly, by limiting imports through quotas, governments increase the attractiveness of FDI and licensing. For example, the wave of FDI by Japanese auto companies in the United States during the 1980s and 1990s was partly driven by protectionist threats from Congress and by quotas on the importation of Japanese cars. For Japanese auto companies, these factors decreased the profitability of exporting and increased that of foreign direct investment. In this context, it is important to understand that trade barriers do not have to be physically in place for FDI to be favored over exporting. Often, the desire to reduce the threat that trade barriers might be imposed is enough to justify foreign direct investment as an alternative to exporting.



Foreign Direct Investment by Cemex

In little more than a decade, Mexico's largest cement manufacturer, Cemex, has transformed itself from a primarily Mexican operation into the third-largest cement company in the world behind Holcim of Switzerland and Lafarge Group of France. Cemex has long been a powerhouse in Mexico and currently controls more than 60 percent of the market for cement in that country. Cemex's domestic success has been based in large part on an obsession with efficient manufacturing and a focus on customer service that is tops in the industry.

Cemex is a leader in using information technology to match production with consumer demand. The company sells ready-mixed cement that can survive for only about 90 minutes before solidifying, so precise delivery is important. But Cemex can never predict with total certainty what demand will be on any given day, week, or month. To better manage unpredictable demand patterns, Cemex developed a system of seamless information technology, including truck-mounted global positioning systems, radio transmitters, satellites, and computer hardware, that allows it to control the production and distribution of cement like no other company can, responding quickly to unanticipated changes in demand and reducing waste. The results are lower costs and superior customer service, both differentiating factors for Cemex.

The company also pays lavish attention to its distributors—some 5,000 in Mexico alone—who can earn points toward rewards for hitting sales targets. The distributors can then convert those points into Cemex stock. High-volume distributors can purchase trucks and other supplies through Cemex at significant discounts. Cemex also is known for its marketing drives that focus on end users, the builders themselves. For example, Cemex trucks drive around Mexican building sites, and if Cemex cement is being used, the construction crews win soccer balls, caps, and T-shirts.

Cemex's international expansion strategy was driven by a number of factors. First, the company wished to reduce its reliance on the Mexican construction market, which was characterized by very volatile demand. Second, the company realized there was tremendous demand for cement in many developing countries, where significant construction was being undertaken or needed. Third, the company believed that it understood the needs of construction businesses in developing nations better than the established multinational cement companies, all of which were from developed nations. Fourth, Cemex believed that it could create significant value by acquiring inefficient cement companies in other markets and transferring its skills in

customer service, marketing, information technology, and production management to those units.

The company embarked in earnest on its international expansion strategy in the early 1990s. Initially, Cemex targeted other developing nations, acquiring established cement makers in Venezuela, Colombia, Indonesia, the Philippines, Egypt, and several other countries. It also purchased two stagnant companies in Spain and turned them around. Bolstered by the success of its Spanish ventures, Cemex began to look for expansion opportunities in developed nations. In 2000, Cemex purchased Houston-based Southland, one of the largest cement companies in the United States, for \$2.5 billion. Following the Southland acquisition, Cemex had 56 cement plants in 30 countries, most of which were gained through acquisitions. In all cases, Cemex devoted great attention to transferring its technological, management, and marketing know-how to acquired units, thereby improving their performance.

In 2004, Cemex made another major foreign investment move, purchasing RMC of Great Britain for \$5.8 billion. RMC was a huge multinational cement firm with sales of \$8.0 billion, only 22 percent of which were in the United Kingdom, and operations in more than 20 other nations, including many European nations where Cemex had no presence. Finalized in March 2005, the RMC acquisition has transformed Cemex into a global powerhouse in the cement industry with more than \$15 billion in annual sales and operations in 50 countries. Only about 15 percent of the company's sales are now generated in Mexico. Following the acquisition of RMC, Cemex found that the RMC plant in Rugby was running at only 70 percent of capacity, partly because repeated production problems kept causing a kiln shutdown. Cemex brought in an international team of specialists to fix the problem and quickly increased production to 90 percent of capacity. Going forward, Cemex has made it clear that it will continue to expand and is eyeing opportunities in the fast-growing economies of China and India where currently it lacks a presence, and where its global rivals are already expanding.

Sources: C. Piggott, "Cemex's Stratospheric Rise," *Latin Finance*, March 2001, p. 76; J. F. Smith, "Making Cement a Household Word," *Los Angeles Times*, January 16, 2000, p. C1; D. Helft, "Cemex Attempts to Cement Its Future," *The Industry Standard*, November 6, 2000; Diane Lindquist, "From Cement to Services," *Chief Executive*, November 2002, pp. 48–50; "Cementing Global Success," *Strategic Direct Investor*, March 2003, p. 1; M. T. Derham, "The Cemex Surprise," *Latin Finance*, November 2004, pp. 1–2; "Holcim Seeks to Acquire Aggregate," *The Wall Street Journal*, January 13, 2005, p. 1; J. Lyons, "Cemex Prowls for Deals in Both China and India," *The Wall Street Journal*, January 27, 2006, p. C4; and S. Donnan, "Cemex Sells 25 Percent Stake in Semen Gresik," *FT.com*, May 4, 2006, p. 1.

Internalization Theory

The argument that firms prefer FDI over licensing to retain control over know-how, manufacturing, marketing, and strategy or because some firm capabilities are not amenable to licensing; also known as the market imperfections approach.

Limitations of Licensing A branch of economic theory known as **internalization theory** seeks to explain why firms often prefer foreign direct investment over licensing as a strategy for entering foreign markets (this approach is also known as the market imperfections approach).¹³ According to internalization theory, licensing has three major drawbacks as a strategy for exploiting foreign market opportunities. First, *licensing may result in a firm's giving away valuable technological know-how to a potential foreign competitor*. For example, in the 1960s, RCA licensed its leading-edge color television technology to a number of Japanese companies, including Matsushita and Sony. At the time, RCA saw licensing as a way to earn a good return from its technological know-how in the Japanese market without the costs and risks associated with foreign direct investment. However, Matsushita and Sony quickly assimilated RCA's technology and used it to enter the U.S. market to compete directly against RCA. As a result, RCA is now a minor player in its home market, while Matsushita and Sony have a much bigger market share.

A second problem is that *licensing does not give a firm the tight control over manufacturing, marketing, and strategy in a foreign country that may be required to maximize its profitability*. With licensing, control over manufacturing, marketing, and strategy 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. The rationale for wanting control over the strategy of a foreign entity is that a firm might want its foreign subsidiary to price and market very aggressively as a way of keeping a foreign competitor in check. Unlike a wholly owned subsidiary, a licensee would probably not accept such an imposition, because it would likely reduce the licensee's profit, or it might even cause the licensee to take a loss.

The rationale for wanting control over the operations of a foreign entity is that the firm might wish to take advantage of differences in factor costs across countries, producing only part of its final product in a given country, while importing other parts from elsewhere where they can be produced at lower cost. Again, a licensee would be unlikely to accept such an arrangement, since it would limit the licensee's autonomy. Thus, for these reasons, when tight control over a foreign entity is desirable, foreign direct investment is preferable to licensing.

A third problem with licensing arises when the firm's competitive advantage is based not as much on its products as on the management, marketing, and manufacturing capabilities that produce those products. The problem here is that *such capabilities are often not amenable to licensing*. While a foreign licensee may be able to physically reproduce the firm's product under license, it often may not be able to do so as efficiently as the firm could itself. As a result, the licensee may not be able to fully exploit the profit potential inherent in a foreign market.

For example, consider Toyota, a company whose competitive advantage in the global auto industry is acknowledged to come from its superior ability to manage the overall process of designing, engineering, manufacturing, and selling automobiles; that is, from its management and organizational capabilities. Indeed, Toyota is credited with pioneering the development of a new production process, known as *lean production*, that enables it to produce higher-quality automobiles at a lower cost than its global rivals.¹⁴ Although Toyota could license certain products, its real competitive advantage comes from its management and process capabilities. These kinds of skills are difficult to articulate or codify; they certainly cannot be written down in a simple licensing contract. They are organizationwide and have been developed over the years. They are not embodied in any one individual but instead are widely dispersed throughout the company. Put another way, Toyota's skills are embedded in its organizational culture, and culture is something that cannot be licensed. Thus, if Toyota were to allow a foreign entity to produce its cars under license, the chances are that the entity could not do so anywhere near as efficiently as could Toyota. In turn, this

would limit the ability of the foreign entity to fully develop the market potential of that product. Such reasoning underlies Toyota's preference for direct investment in foreign markets, as opposed to allowing foreign automobile companies to produce its cars under license.

All of this suggests that when one or more of the following conditions holds, markets fail as a mechanism for selling know-how and FDI is more profitable than licensing: (1) when the firm has valuable know-how that cannot be adequately protected by a licensing contract; (2) when the firm needs tight control over a foreign entity to maximize its market share and earnings in that country; and (3) when a firm's skills and know-how are not amenable to licensing.

Advantages of Foreign Direct Investment It follows that a firm will favor foreign direct investment over exporting as an entry strategy when transportation costs or trade barriers make exporting unattractive. Furthermore, the firm will favor foreign direct investment over licensing (or franchising) when it wishes to maintain control over its technological know-how, or over its operations and business strategy, or when the firm's capabilities are simply not amenable to licensing, as may often be the case.

THE PATTERN OF FOREIGN DIRECT INVESTMENT Observation suggests that firms in the same industry often undertaken foreign direct investment about the same time. There also is a clear tendency for firms to direct their investment activities toward certain locations. The two theories we consider in this section attempt to explain the patterns that we observe in FDI flows.

Strategic Behavior One theory is based on the idea that FDI flows are a reflection of strategic rivalry between firms in the global marketplace. An early variant of this argument was expounded by F. T. Knickerbocker, who looked at the relationship between FDI and rivalry in oligopolistic industries.¹⁵ An **oligopoly** is an industry composed of a limited number of large firms (e.g., an industry in which four firms control 80 percent of a domestic market would be defined as an oligopoly). A critical competitive feature of such industries is interdependence of the major players: What one firm does can have an immediate impact on the major competitors, forcing a response in kind. By cutting prices, one firm in an oligopoly can take market share away from its competitors, forcing them to respond with similar price cuts to retain their market share. Thus, the interdependence between firms in an oligopoly leads to imitative behavior; rivals often quickly imitate what a firm does in an oligopoly.

Imitative behavior can take many forms in an oligopoly. One firm raises prices, the others follow; one expands capacity, and the rivals imitate lest they be left at a disadvantage in the future. Knickerbocker argued that the same kind of imitative behavior characterizes FDI. Consider an oligopoly in the United States in which three firms—A, B, and C—dominate the market. Firm A establishes a subsidiary in France. Firms B and C decide that if successful, this new subsidiary may knock out their export business to France and give firm A a first-mover advantage. Furthermore, firm A might discover some competitive asset in France that it could repatriate to the United States to torment firms B and C on their native soil. Given these possibilities, firms B and C decide to follow firm A and establish operations in France.

Studies that looked at FDI by U.S. firms during the 1950s and 60s show that firms based in oligopolistic industries tended to imitate each other's FDI.¹⁶ The same phenomenon has been observed with regard to FDI undertaken by Japanese firms during the 1980s.¹⁷ For example, Toyota and Nissan responded to investments by Honda in the United States and Europe by undertaking their own FDI in the United States and Europe. More recently, research has shown that models of strategic behavior in a global oligopoly can explain the pattern of FDI in the global tire industry.¹⁸



Oligopoly

An industry composed of a limited number of large firms.

Multipoint Competition

Arises when two or more enterprises encounter each other in different regional markets, national markets, or industries.

Knickerbocker's theory can be extended to embrace the concept of multipoint competition. **Multipoint competition** arises when two or more enterprises encounter each other in different regional markets, national markets, or industries.¹⁹ Economic theory suggests that rather like chess players jockeying for advantage, firms will try to match each other's moves in different markets to try to hold each other in check. The idea is to ensure that a rival does not gain a commanding position in one market and then use the profits generated there to subsidize competitive attacks in other markets. Kodak and Fuji Photo Film Co., for example, compete against each other around the world. If Kodak enters a particular foreign market, Fuji will not be far behind. Fuji feels compelled to follow Kodak to ensure that Kodak does not gain a dominant position in the foreign market that it could then leverage to gain a competitive advantage elsewhere. The converse also holds, with Kodak following Fuji when the Japanese firm is the first to enter a foreign market.

Although Knickerbocker's theory and its extensions can help to explain imitative FDI behavior by firms in oligopolistic industries, it does not explain why the first firm in an oligopoly decides to undertake FDI rather than to export or license. Internalization theory addresses this phenomenon. The imitative theory also does not address the issue of whether FDI is more efficient than exporting or licensing for expanding abroad. Again, internalization theory addresses the efficiency issue. For these reasons, many economists favor internalization theory as an explanation for FDI, although most would agree that the imitative explanation tells an important part of the story.

The Product Life Cycle Raymond Vernon's product life-cycle theory, described in Chapter 5, also is used to explain FDI. Vernon argued that often the same firms that pioneer a product in their home markets undertake FDI to produce a product for consumption in foreign markets. Thus, Xerox introduced the photocopier in the United States, and it was Xerox that set up production facilities in Japan (Fuji Xerox) and Great Britain (Rank Xerox) to serve those markets. Vernon's view is that firms undertake FDI at particular stages in the life cycle of a product they have pioneered. They invest in other advanced countries when local demand in those countries grows large enough to support local production (as Xerox did). They subsequently shift production to developing countries when product standardization and market saturation give rise to price competition and cost pressures. Investment in developing countries, where labor costs are lower, is seen as the best way to reduce costs.

Vernon's theory has merit. Firms do invest in a foreign country when demand in that country will support local production, and they do invest in low-cost locations (e.g., developing countries) when cost pressures become intense.²⁰ However, Vernon's theory fails to explain why it is profitable for a firm to undertake FDI at such times, rather than continuing to export from its home base or licensing a foreign firm to produce its product. Just because demand in a foreign country is large enough to support local production, it does not necessarily follow that local production is the most profitable option. It may still be more profitable to produce at home and export to that country (to realize the economies of scale that arise from serving the global market from one location). Alternatively, it may be more profitable for the firm to license a foreign company to produce its product for sale in that country. The product life-cycle theory ignores these options and, instead, simply argues that once a foreign market is large enough to support local production, FDI will occur. This limits its explanatory power and its usefulness to business in that it fails to identify when it is profitable to invest abroad.

THE ECLECTIC PARADIGM The eclectic paradigm has been championed by the British economist John Dunning.²¹ Dunning argues that in addition to the various factors discussed above, location-specific advantages are also of considerable importance

in explaining both the rationale for and the direction of foreign direct investment. By **location-specific advantages**, Dunning means the advantages that arise from utilizing resource endowments or assets that are tied to a particular foreign location and that a firm finds valuable to combine with its own unique assets (such as the firm's technological, marketing, or management capabilities). Dunning accepts the argument of internalization theory that it is difficult for a firm to license its own unique capabilities and know-how. Therefore, he argues that combining location-specific assets or resource endowments with the firm's own unique capabilities often requires foreign direct investment. That is, it requires the firm to establish production facilities where those foreign assets or resource endowments are located.

An obvious example of Dunning's arguments are natural resources, such as oil and other minerals, which are by their character specific to certain locations. Dunning suggests that to exploit such foreign resources, a firm must undertake FDI. Clearly, this explains the FDI undertaken by many of the world's oil companies, which have to invest where oil is located to combine their technological and managerial capabilities with this valuable location-specific resource. Another obvious example are valuable human resources, such as low-cost, highly skilled labor. The cost and skill of labor varies from country to country. Since labor is not internationally mobile, according to Dunning it makes sense for a firm to locate production facilities in those countries where the cost and skills of local labor is most suited to its particular production processes.

However, Dunning's theory has implications that go beyond basic resources such as minerals and labor. Consider Silicon Valley, which is the world center for the computer and semiconductor industry. Many of the world's major computer and semiconductor companies, such as Apple Computer, Hewlett-Packard, and Intel, are located close to each other in the Silicon Valley region of California. As a result, much of the cutting-edge research and product development in computers and semiconductors occurs there. According to Dunning's arguments, there is knowledge being generated in Silicon Valley with regard to the design and manufacture of computers and semiconductors that is available nowhere else in the world. To be sure, as it is commercialized that knowledge diffuses throughout the world, but the leading edge of knowledge generation in the computer and semiconductor industries is to be found in Silicon Valley. In Dunning's language, this means that Silicon Valley has a *location-specific advantage* in the generation of knowledge related to the computer and semiconductor industries. In part, this advantage comes from the sheer concentration of intellectual talent in this area, and in part it arises from a network of informal contacts that allows firms to benefit from each others' knowledge generation. Economists refer to such knowledge "spillovers" as **externalities**, and a well-established theory suggests that firms can benefit from such externalities by locating close to their source.²²

In so far as this is the case, it makes sense for foreign computer and semiconductor firms to invest in research and, perhaps, production facilities so they too can learn about and utilize valuable new knowledge before those based elsewhere, thereby giving them a competitive advantage in the global marketplace.²³ Evidence suggests that European, Japanese, South Korean, and Taiwanese computer

Location-Specific Advantages

Advantages that arise from utilizing resource endowments or assets that are tied to a particular foreign location and that a firm finds valuable to combine with its own unique assets (such as the firm's technological, marketing, or management capabilities).

Externalities

Knowledge spillovers.



Silicon Valley has long been known as the epicenter of the computer and semiconductor industry.

and semiconductor firms are investing in the Silicon Valley region, precisely because they wish to benefit from the externalities that arise there.²⁴ Others have argued that direct investment by foreign firms in the U.S. biotechnology industry has been motivated by desires to gain access to the unique location-specific technological knowledge of U.S. biotechnology firms.²⁵ Dunning's theory, therefore, seems to be a useful addition to those outlined above, for it helps explain how location factors affect the direction of FDI.²⁶

Political Ideology and Foreign Direct Investment

LEARNING OBJECTIVE 3

Understand how political ideology shapes a government's attitudes toward FDI.

Historically, political ideology toward FDI within a nation has ranged from a dogmatic radical stance that is hostile to all inward FDI at one extreme to an adherence to the noninterventionist principle of free market economics at the other. Between these two extremes is an approach that might be called *pragmatic nationalism*.

THE RADICAL VIEW The radical view traces its roots to Marxist political and economic theory. Radical writers argue that the multinational enterprise (MNE) is an instrument of imperialist domination. They see the MNE as a tool for exploiting host countries to the exclusive benefit of their capitalist-imperialist home countries. They argue that MNEs extract profits from the host country and take them to their home country, giving nothing of value to the host country in exchange. They note, for example, that key technology is tightly controlled by the MNE, and that important jobs in the foreign subsidiaries of MNEs go to home-country nationals rather than to citizens of the host country. Because of this, according to the radical view, FDI by the MNEs of advanced capitalist nations keeps the less developed countries of the world relatively backward and dependent on advanced capitalist nations for investment, jobs, and technology. Thus, according to the extreme version of this view, no country should ever permit foreign corporations to undertake FDI, since they can never be instruments of economic development, only of economic domination. Where MNEs already exist in a country, they should be immediately nationalized.²⁷

From 1945 until the 1980s, the radical view was very influential in the world economy. Until the collapse of communism between 1989 and 1991, the countries of Eastern Europe were opposed to FDI. Similarly, communist countries elsewhere, such as China, Cambodia, and Cuba, were all opposed in principle to FDI (although in practice the Chinese started to allow FDI in mainland China in the 1970s). Many socialist countries, particularly in Africa where one of the first actions of many newly independent states was to nationalize foreign-owned enterprises, also embraced the radical position. Countries whose political ideology was more nationalistic than socialistic further embraced the radical position. This was true in Iran and India, for example, both of which adopted tough policies restricting FDI and nationalized many foreign-owned enterprises. Iran is a particularly interesting case because its Islamic government, while rejecting Marxist theory, has essentially embraced the radical view that FDI by MNEs is an instrument of imperialism.

By the end of the 1980s, the radical position was in retreat almost everywhere. There seem to be three reasons for this: (1) the collapse of communism in Eastern Europe; (2) the generally abysmal economic performance of those countries that embraced the radical position, and a growing belief by many of these countries that FDI can be an important source of technology and jobs and can stimulate economic growth; and (3) the strong economic performance of those developing countries that embraced capitalism rather than radical ideology (e.g., Singapore, Hong Kong, and Taiwan).

THE FREE MARKET VIEW The free market view traces its roots to classical economics and the international trade theories of Adam Smith and David Ricardo (see Chapter 5). The intellectual case for this view has been strengthened by the internalization explanation of FDI. The free market view argues that international production should be distributed among countries according to the theory of comparative advantage. Countries should specialize in the production of those goods and services that they can produce most efficiently. Within this framework, the MNE is an instrument for dispersing the production of goods and services to the most efficient locations around the globe. Viewed this way, FDI by the MNE increases the overall efficiency of the world economy.

Imagine that Dell decided to move assembly operations for many of its personal computers from the United States to Mexico to take advantage of lower labor costs in Mexico. According to the free market view, moves such as this can be seen as increasing the overall efficiency of resource utilization in the world economy. Mexico, due to its lower labor costs, has a comparative advantage in the assembly of PCs. By moving the production of PCs from the United States to Mexico, Dell frees U.S. resources for use in activities in which the United States has a comparative advantage (e.g., the design of computer software, the manufacture of high-value-added components such as microprocessors, or basic R&D). Also, consumers benefit because the PCs cost less than they would if they were produced domestically. In addition, Mexico gains from the technology, skills, and capital that the PC company transfers with its FDI. Contrary to the radical view, the free market view stresses that such resource transfers benefit the host country and stimulate its economic growth. Thus, the free market view argues that FDI is a benefit to both the source country and the host country.

For reasons explored earlier in this book (see Chapter 2), the free market view has been ascendant worldwide in recent years, spurring a global move toward the removal of restrictions on inward and outward foreign direct investment. However, in practice no country has adopted the free market view in its pure form (just as no country has adopted the radical view in its pure form). Countries such as Great Britain and the United States are among the most open to FDI, but the governments of these countries both have still reserved the right to intervene. Britain does so by reserving the right to block foreign takeovers of domestic firms if the takeovers are seen as “contrary to national security interests” or if they have the potential for “reducing competition.” (In practice, the British government has rarely exercised this right.) U.S. controls on FDI are more limited and largely informal. For political reasons, the United States will occasionally restrict U.S. firms from undertaking FDI in certain countries (e.g., Cuba and Iran). In addition, inward FDI meets some limited restrictions. For example, foreigners are prohibited from purchasing more than 25 percent of any U.S. airline or from acquiring a controlling interest in a U.S. television broadcast network. Since 1988, the government has had the right to review the acquisition of a U.S. enterprise by a foreign firm on the grounds of national security. However, of the 1,500 bids reviewed by the Committee on Foreign Investment in the United States under this law by 2008, only one has been nullified: the sale of a Seattle-based aircraft parts manufacturer to a Chinese enterprise in the early 1990s.²⁸

PRAGMATIC NATIONALISM In practice, many countries have adopted neither a radical policy nor a free market policy toward FDI, but instead a policy that can best be described as pragmatic nationalism.²⁹ The pragmatic nationalist view is that FDI has both benefits and costs. FDI can benefit a host country by bringing capital, skills, technology, and jobs, but those benefits come at a cost. When a foreign company rather than a domestic company produces products, the profits from that investment go abroad. Many countries are also concerned that a foreign-owned manufacturing plant may import many components from its home country, which has negative implications for the host country’s balance-of-payments position.

Recognizing this, countries adopting a pragmatic stance pursue policies designed to maximize the national benefits and minimize the national costs. According to this view, FDI should be allowed so long as the benefits outweigh the costs. Japan offers an example of pragmatic nationalism. Until the 1980s, Japan's policy was probably one of the most restrictive among countries adopting a pragmatic nationalist stance. This was due to Japan's perception that direct entry of foreign (especially U.S.) firms with ample managerial resources into the Japanese markets could hamper the development and growth of their own industry and technology.³⁰ This belief led Japan to block the majority of applications to invest in Japan. However, there were always exceptions to this policy. Firms that had important technology were often permitted to undertake FDI if they insisted that they would neither license their technology to a Japanese firm nor enter into a joint venture with a Japanese enterprise. IBM and Texas Instruments were able to set up wholly owned subsidiaries in Japan by adopting this negotiating position. From the perspective of the Japanese government, the benefits of FDI in such cases—the stimulus that these firms might impart to the Japanese economy—outweighed the perceived costs.

Another aspect of pragmatic nationalism is the tendency to aggressively court FDI believed to be in the national interest by, for example, offering subsidies to foreign MNEs in the form of tax breaks or grants. The countries of the European Union often seem to be competing with each other to attract U.S. and Japanese FDI by offering large tax breaks and subsidies. Britain has been the most successful at attracting Japanese investment in the automobile industry. Nissan, Toyota, and Honda now have major assembly plants in Britain and use the country as their base for serving the rest of Europe—with obvious employment and balance-of-payments benefits for Britain.

SHIFTING IDEOLOGY Recent years have seen a marked decline in the number of countries that adhere to a radical ideology. Although few countries have adopted a pure free market policy stance, an increasing number of countries are gravitating toward the free market end of the spectrum and have liberalized their foreign investment regime. This includes many countries that less than two decades ago were firmly in the radical camp (e.g., the former communist countries of Eastern Europe and many of the socialist countries of Africa) and several countries that until recently could best be described as pragmatic nationalists with regard to FDI (e.g., Japan, South Korea, Italy, Spain, and most Latin American countries). One result has been the surge in the volume of FDI worldwide, which, as we noted earlier, has been growing twice as fast as the growth in world trade. Another result has been an increase in the volume of FDI directed at countries that have recently liberalized their FDI regimes, such as China, India, and Vietnam.

As a counterpoint, there is recent evidence of the beginnings of what might become a shift to a more hostile approach to foreign direct investment. Venezuela and Bolivia have become increasingly hostile to foreign direct investment. In 2005 and 2006, the governments of both nations unilaterally rewrote contracts for oil and gas exploration, raising the royalty rate that foreign enterprises had to pay the government for oil and gas extracted in their territories. Bolivian President Evo Morales in 2006 nationalized the nation's gas fields and stated he would evict foreign firms unless they agreed to pay about 80 percent of their revenues to the state and relinquish production oversight. In some developed nations, too, there is increasing evidence of hostile reactions to inward FDI. In Europe in 2006, there was a hostile political reaction to the attempted takeover of Europe's largest steel company, Arcelor, by Mittal Steel, a global company controlled by the Indian entrepreneur Lakshmi Mittal. In mid-2005 China National Offshore Oil Company withdrew a takeover bid for Unocal of the United States after highly negative reaction in Congress about the proposed takeover of a "strategic asset" by a Chinese company. Similarly, as detailed in the accompanying Management Focus, in 2006 a Dubai-owned company withdrew



DP World and the United States

In February 2006, DP World, a ports operator owned by the government of Dubai, a member of the United Arab Emirates and a staunch U.S. ally, paid \$6.8 billion to acquire P&O, a British firm that runs a global network of marine terminals. With P&O came the management operations of six U.S. ports: Miami, Philadelphia, Baltimore, New Orleans, New Jersey, and New York. The acquisition had already been approved by U.S. regulators when it suddenly became front-page news. Upon hearing about the deal, several prominent U.S. senators raised concerns about the acquisition. Their objections were twofold. First, they raised questions about the security risks associated with management operations in key U.S. ports being owned by a foreign enterprise that was based in the Middle East. The implication was that terrorists could somehow take advantage of the ownership arrangement to infiltrate U.S. ports. Second, they were concerned that DP World was a state-owned enterprise and argued that foreign governments should not be in a position of owning key "U.S. strategic assets."

The Bush administration was quick to defend the takeover, stating that it posed no threat to national security. Others noted that DP World was a respected global firm with an

American chief operating officer and an American-educated chairman; the head of the global ports management operation would also be an American. DP World would not own the U.S. ports in question, just manage them, while security issues would remain in the hands of U.S. customs officials and the U.S. Coast Guard. Dubai was also a member of America's Container Security Initiative, which allows U.S. customs officials to inspect cargo in foreign ports before it leaves for the United States. Most of the DP World employees at American ports would be U.S. citizens, and any UAE citizen transferred to DP World would be subject to American visa approval.

These arguments fell on deaf ears. With several U.S. senators threatening to pass legislation to prohibit foreign ownership of U.S. port operations, DP World bowed to the inevitable and announced it would sell the right to manage the six U.S. ports for about \$750 million. Looking forward, however, DP World stated it would seek an initial public offering in 2007, and that the then-private firm would in all probability continue to look for ways to enter the United States. In the words of the firm's CEO, "This is the world's largest economy. How can you just ignore it?"

Sources: "Trouble at the Waterfront," *The Economist*, February 25, 2006, p. 48; "Paranoia about Dubai Ports Deals Is Needless," *Financial Times*, February 21, 2006, p. 16; and "DP World: We'll Be Back," *Traffic World*, May 29, 2006, p. 1.

its planned takeover of some operations at six U.S. ports after negative political reactions. So far, these countertrends are nothing more than isolated incidents, but if they become more widespread, the 30-year movement toward lower barriers to cross-border investment could be in jeopardy.

Benefits and Costs of FDI

To a greater or lesser degree, many governments can be considered pragmatic nationalists when it comes to FDI. Accordingly, their policy is shaped by a consideration of the costs and benefits of FDI. Here we explore the benefits and costs of FDI, first from the perspective of a host (receiving) country, and then from the perspective of the home (source) country. In the next section, we look at the policy instruments governments use to manage FDI.

HOST-COUNTRY BENEFITS The main benefits of inward FDI for a host country arise from resource-transfer effects, employment effects, balance-of-payments effects, and effects on competition and economic growth.

Resource-Transfer Effects Foreign direct investment can make a positive contribution to a host economy by supplying capital, technology, and management resources that would otherwise not be available and thus boost that country's economic growth rate (as the opening case makes clear, the Japanese government has recently come around to this view and has adopted a more permissive attitude to inward investment).³¹

LEARNING OBJECTIVE 4

Describe the benefits and costs of FDI to home and host countries.

With regard to capital, many MNEs, by virtue of their large size and financial strength, have access to financial resources not available to host-country firms. These funds may be available from internal company sources, or, because of their reputation, large MNEs may find it easier to borrow money from capital markets than host-country firms would.

As for technology, you will recall from Chapter 2 that technology can stimulate economic development and industrialization. Technology can take two forms, both of which are valuable. Technology can be incorporated in a production process (e.g., the technology for discovering, extracting, and refining oil) or it can be incorporated in a product (e.g., personal computers). However, many countries lack the research and development resources and skills required to develop their own indigenous product and process technology. This is particularly true in less developed nations. Such countries must rely on advanced industrialized nations for much of the technology required to stimulate economic growth, and FDI can provide it.

Research supports the view that multinational firms often transfer significant technology when they invest in a foreign country.³² For example, a study of FDI in Sweden found that foreign firms increased both the labor and total factor productivity of Swedish firms that they acquired, suggesting that significant technology transfers had occurred (technology typically boosts productivity).³³ Also, a study of FDI by the Organization for Economic Cooperation and Development (OECD) found that foreign investors invested significant amounts of capital in R&D in the countries in which they had invested, suggesting that not only were they transferring technology to those countries, but they may also have been upgrading existing technology or creating new technology in those countries.³⁴

Foreign management skills acquired through FDI may also produce important benefits for the host country. Foreign managers trained in the latest management techniques can often help to improve the efficiency of operations in the host country, whether those operations are acquired or greenfield developments. Beneficial spin-off effects may also arise when local personnel who are trained to occupy managerial, financial, and technical posts in the subsidiary of a foreign MNE leave the firm and help to establish indigenous firms. Similar benefits may arise if the superior management skills of a foreign MNE stimulate local suppliers, distributors, and competitors to improve their own management skills.



Another Perspective

Uganda Reaches Out to Foreign Investors

Unlikely though it may seem, the East African nation of Uganda is making strides in attracting foreign direct investment. Once the scene of bloody unrest and tribal war, today this landlocked country (bordered by Congo, Kenya, Rwanda, and Tanzania) works to maintain stable economic policies and provide the kind of predictable environment that makes foreign investment more appealing. Aided by its Investment Authority, a government body established to promote foreign investment, Uganda has attracted businesses in the agriculture, banking, energy, insurance, mining, and telecommunications sectors. Foreign direct investment has brought jobs, improved Uganda's communications and financial services sectors, and generally enhanced its infrastructure. (Keith Kallyegira, "Uganda Tops Region in FDIs," *New Vision Online*, February 18, 2010, www.newvision.co.ug)

Employment Effects Another beneficial employment effect claimed for FDI is that it brings jobs to a host country that would otherwise not be created there. The effects of FDI on employment are both direct and indirect. Direct effects arise when a foreign MNE employs a number of host-country citizens. Indirect effects arise when jobs are created in local suppliers as a result of the investment and when jobs are created because of increased local spending by employees of the MNE. The indirect employment effects are often as large as, if not larger than, the direct effects. For example, when Toyota decided to open a new auto plant in France, estimates suggested the plant would create 2,000 direct jobs and perhaps another 2,000 jobs in support industries.³⁵

Cynics argue that not all the "new jobs" created by FDI represent net additions in employment.

In the case of FDI by Japanese auto companies in the United States, some argue that the jobs created by this investment have been more than offset by the jobs lost in U.S.-owned auto companies, which have lost market share to their Japanese competitors. As a consequence of such substitution effects, the net number of new jobs created by FDI may not be as great as initially claimed by an MNE. The issue of the likely net gain in employment may be a major negotiating point between an MNE wishing to undertake FDI and the host government.

When FDI takes the form of an acquisition of an established enterprise in the host economy as opposed to a greenfield investment, the immediate effect may be to reduce employment as the multinational tries to restructure the operations of the acquired unit to improve its operating efficiency. However, even in such cases, research suggests that once the initial period of restructuring is over, enterprises acquired by foreign firms tend to grow their employment base at a faster rate than domestic rivals. For example, an OECD study found that foreign firms created new jobs at a faster rate than their domestic counterparts.³⁶ In America, the workforce of foreign firms grew by 1.4 percent per year, compared with 0.8 percent per year for domestic firms. In Britain and France, the workforce of foreign firms grew at 1.7 percent per year, while employment at domestic firms fell by 2.7 percent. The same study found that foreign firms tended to pay higher wage rates than domestic firms, suggesting that the quality of employment was better. Another study looking at FDI in Eastern European transition economies found that although employment fell following the acquisition of an enterprise by a foreign firm, often those enterprises were in competitive difficulties and would not have survived if they had not been acquired. Also, after an initial period of adjustment and retrenchment, employment downsizing was often followed by new investments, and employment either remained stable or increased.³⁷

Balance-of-Payments Effects FDI's effect on a country's balance-of-payments accounts is an important policy issue for most host governments. A country's **balance-of-payments accounts** track both its payments to and its receipts from other countries. Governments normally are concerned when their country is running a deficit on the current account of their balance of payments. The **current account** tracks the export and import of goods and services. A current account deficit, or trade deficit as it is often called, arises when a country is importing more goods and services than it is exporting. Governments typically prefer to see a current account surplus rather than a deficit. The only way in which a current account deficit can be supported in the long run is by selling assets to foreigners (for a detailed explanation of why this is the case, see the appendix to Chapter 5). For example, the persistent U.S. current account deficit since the 1980s has been financed by a steady sale of U.S. assets (stocks, bonds, real estate, and whole corporations) to foreigners. Since national governments invariably dislike seeing the assets of their country fall into foreign hands, they prefer their nation to run a current account surplus. There are two ways in which FDI can help a country to achieve this goal.

First, if the FDI is a substitute for imports of goods or services, the effect can be to improve the current account of the host country's balance of payments. Much of the FDI by Japanese automobile companies in the United States and Europe, for example, can be seen as substituting for imports from Japan. Thus, the current account of the U.S. balance of payments has improved somewhat because many Japanese companies are now supplying the U.S. market from production facilities in the United States, as opposed to facilities in Japan. Insofar as this has reduced the need to finance a current account deficit by asset sales to foreigners, the United States has clearly benefited.

A second potential benefit arises when the MNE uses a foreign subsidiary to export goods and services to other countries. According to a UN report, inward FDI by foreign multinationals has been a major driver of export-led economic growth in a number of

Balance-of-Payments Accounts

National accounts that track both payments to and receipts from other countries.

Current Account

In the balance of payments, records transactions involving the export and import of goods and services.

developing and developed nations over the last decade.³⁸ For example, in China exports increased from \$26 billion in 1985 to more than \$250 billion by 2001 and to \$969 billion in 2006. Much of this dramatic export growth was due to the presence of foreign multinationals that invested heavily in China during the 1990s. The subsidiaries of foreign multinationals accounted for 50 percent of all exports from that country in 2001, up from 17 percent in 1991. In mobile phones, for example, the Chinese subsidiaries of foreign multinationals—primarily Nokia, Motorola, Ericsson, and Siemens—accounted for 95 percent of China's exports.

Effect on Competition and Economic Growth Economic theory tells us that the efficient functioning of markets depends on an adequate level of competition between producers. When FDI takes the form of a greenfield investment, the result is to establish a new enterprise, increasing the number of players in a market and thus consumer choice. In turn, this can increase the level of competition in a national market, thereby driving down prices and increasing the economic welfare of consumers. Increased competition tends to stimulate capital investments by firms in plant, equipment, and R&D as they struggle to gain an edge over their rivals. The long-term results may include increased productivity growth, product and process innovations, and greater economic growth.³⁹ Such beneficial effects seem to have occurred in the South Korean retail sector following the liberalization of FDI regulations in 1996. FDI by large Western discount stores, including Walmart, Costco, Carrefour, and Tesco, seems to have encouraged indigenous discounters such as E-Mart to improve the efficiency of their own operations. The results have included more competition and lower prices, which benefit South Korean consumers.

FDI's impact on competition in domestic markets may be particularly important in the case of services, such as telecommunications, retailing, and many financial services, where exporting is often not an option because the service has to be produced where it is delivered.⁴⁰ For example, under a 1997 agreement sponsored by the World Trade Organization, 68 countries accounting for more than 90 percent of world telecommunications revenues pledged to start opening their markets to foreign investment and competition and to abide by common rules for fair competition in telecommunications. Before this agreement, most of the world's telecommunications markets were closed to foreign competitors, and in most countries the market was monopolized by a single carrier, which was often a state-owned enterprise. The agreement has dramatically increased the level of competition in many national telecommunications markets producing two major benefits. First, inward investment has increased competition and stimulated investment in the modernization of telephone networks around the world, leading to better service. Second, the increased competition has resulted in lower prices.

HOST-COUNTRY COSTS Three costs of FDI concern host countries. They arise from possible adverse effects on competition within the host nation, adverse effects on the balance of payments, and the perceived loss of national sovereignty and autonomy.

Adverse Effects on Competition Host governments sometimes worry that the subsidiaries of foreign MNEs may have greater economic power than indigenous competitors. If it is part of a larger international organization, the foreign MNE may be able to draw on funds generated elsewhere to subsidize its costs in the host market, which could drive indigenous companies out of business and allow the firm to monopolize the market. Once the market is monopolized, the foreign MNE could raise prices above those that would prevail in competitive markets, with harmful effects on the economic welfare of the host nation. This concern tends to be greater in countries that have few large firms of their own (generally less developed countries). It tends to be a relatively minor concern in most advanced industrialized nations.

In general, while FDI in the form of greenfield investments should increase competition, it is less clear that this is the case when the FDI takes the form of acquisition of an established enterprise in the host nation, as was the case when Cemex acquired RMC in Britain (see the Management Focus, “Foreign Direct Investment by Cemex”). Because an acquisition does not result in a net increase in the number of players in a market, the effect on competition may be neutral. When a foreign investor acquires two or more firms in a host country, and subsequently merges them, the effect may be to reduce the level of competition in that market, create monopoly power for the foreign firm, reduce consumer choice, and raise prices. For example, in India, Hindustan Lever Ltd., the Indian subsidiary of Unilever, acquired its main local rival, Tata Oil Mills, to assume a dominant position in the bath soap (75 percent) and detergents (30 percent) markets. Hindustan Lever also acquired several local companies in other markets, such as the ice cream makers Dollops, Kwality, and Milkfood. By combining these companies, Hindustan Lever’s share of the Indian ice cream market went from zero in 1992 to 74 percent in 1997.⁴¹ However, although such cases are of obvious concern, there is little evidence that such developments are widespread. In many nations, domestic competition authorities have the right to review and block any mergers or acquisitions that they view as having a detrimental impact on competition. If such institutions are operating effectively, this should be sufficient to make sure that foreign entities do not monopolize a country’s markets.

Adverse Effects on the Balance of Payments The possible adverse effects of FDI on a host country’s balance-of-payments position are twofold. First, set against the initial capital inflow that comes with FDI must be the subsequent outflow of earnings from the foreign subsidiary to its parent company. Such outflows show up as capital outflow on balance of payments accounts. Some governments have responded to such outflows by restricting the amount of earnings that can be repatriated to a foreign subsidiary’s home country. A second concern arises when a foreign subsidiary imports a substantial number of its inputs from abroad, which results in a debit on the current account of the host country’s balance of payments. One criticism leveled against Japanese-owned auto assembly operations in the United States, for example, is that they tend to import many component parts from Japan. Because of this, the favorable impact of this FDI on the current account of the U.S. balance-of-payments position may not be as great as initially supposed. The Japanese auto companies responded to these criticisms by pledging to purchase 75 percent of their component parts from U.S.-based manufacturers (but not necessarily U.S.-owned manufacturers). When the Japanese auto company Nissan invested in the United Kingdom, Nissan responded to concerns about local content by pledging to increase the proportion of local content to 60 percent and subsequently raising it to more than 80 percent.

National Sovereignty and Autonomy Some host governments worry that FDI is accompanied by some loss of economic independence. The concern is that key decisions that can affect the host country’s economy will be made by a foreign parent that has no real commitment to the host country, and over which the host country’s government has no real control. Most economists dismiss such concerns as groundless and irrational. Political scientist Robert Reich has noted that such concerns are the product of outmoded thinking because they fail to account for the growing interdependence of the world economy.⁴² In a world in which firms from all advanced nations are increasingly investing in each other’s markets, it is not possible for one country to hold another to “economic ransom” without hurting itself.

HOME-COUNTRY BENEFITS The benefits of FDI to the home (source) country arise from three sources. First, the home country’s balance of payments benefits



Another Perspective

FDI Effects: Look at the Whole Picture

Some critics of globalization suggest that FDI is an advanced form of colonialism that destroys local cultures in developing countries. What these critics say may have some limited validity, but it isn't the whole picture. Take Freeport McMoRan, a U.S.-based mining company with operations in West Papua, the former Irian Jaya, Indonesia, where the world's largest gold, mineral, and copper reserves have been found. Freeport formed a joint venture with the Indonesian government to mine a concession, an isolated tract of land the size of Massachusetts on a remote island, half of which is the country of Papua New Guinea.

Freeport has brought education, Internet connections, world-class health care, and the modern world to the isolated local tribes in West Papua, nomadic peoples who wear loincloths and hunt in the forest. Their traditional, subsistence way of life is threatened, while at the same time, they gain from their share of the operation's profits, from their increased health care and education, and from local employment opportunities with FCX. Is this colonialism or a kind of ethical investing? See more on this issue at www.FCX.com and www.corpwatch.org.

from the inward flow of foreign earnings. FDI can also benefit the home country's balance of payments if the foreign subsidiary creates demands for home-country exports of capital equipment, intermediate goods, complementary products, and the like.

Second, benefits to the home country from outward FDI arise from employment effects. As with the balance of payments, positive employment effects arise when the foreign subsidiary creates demand for home-country exports. Thus, Toyota's investment in auto assembly operations in Europe has benefited both the Japanese balance-of-payments position and employment in Japan, because Toyota imports some component parts for its European-based auto assembly operations directly from Japan.

Third, benefits arise when the home-country MNE learns valuable skills from its exposure to foreign markets that can subsequently be transferred back to the home country. This amounts to a reverse resource-transfer effect. Through its exposure to a foreign market, an MNE can learn about superior management techniques and superior product and process technologies. These resources can then be transferred back to the home country, contributing to the home country's economic growth rate.⁴³

For example, one reason General Motors and Ford invested in Japanese automobile companies (GM owned part of Isuzu, and Ford owns part of Mazda) was to learn about their production processes. If GM and Ford are successful in transferring this know-how back to their U.S. operations, the result may be a net gain for the U.S. economy.

HOME-COUNTRY COSTS Against these benefits must be set the apparent costs of FDI for the home (source) country. The most important concerns center on the balance-of-payments and employment effects of outward FDI. The home country's balance of payments may suffer in three ways. First, the balance of payments suffers from the initial capital outflow required to finance the FDI. This effect, however, is usually more than offset by the subsequent inflow of foreign earnings. Second, the current account of the balance of payments suffers if the purpose of the foreign investment is to serve the home market from a low-cost production location. Third, the current account of the balance of payments suffers if the FDI is a substitute for direct exports. Thus, insofar as Toyota's assembly operations in the United States are intended to substitute for direct exports from Japan, the current account position of Japan will deteriorate.

With regard to employment effects, the most serious concerns arise when FDI is seen as a substitute for domestic production. This was the case with Toyota's investments in the United States and Europe. One obvious result of such FDI is reduced home-country employment. If the labor market in the home country is already tight, with little unemployment, this concern may not be that great. However, if the home country is suffering from unemployment, concern about the export of jobs may arise. For example, one objection frequently raised by U.S. labor leaders to the free trade pact between the United States, Mexico, and Canada (see the next chapter) is that the United States will lose hundreds of thousands of jobs as U.S. firms invest in Mexico to take advantage of cheaper labor and then export back to the United States.⁴⁴

INTERNATIONAL TRADE THEORY AND FDI When assessing the costs and benefits of FDI to the home country, keep in mind the lessons of international trade theory (see Chapter 5). International trade theory tells us that home-country concerns about the negative economic effects of offshore production may be misplaced. The term **offshore production** refers to FDI undertaken to serve the home market. Far from reducing home-country employment, such FDI may actually stimulate economic growth (and hence employment) in the home country by freeing home-country resources to concentrate on activities where the home country has a comparative advantage. In addition, home-country consumers benefit if the price of the particular product falls as a result of the FDI. Also, if a company were prohibited from making such investments on the grounds of negative employment effects while its international competitors reaped the benefits of low-cost production locations, it would undoubtedly lose market share to its international competitors. Under such a scenario, the adverse long-run economic effects for a country would probably outweigh the relatively minor balance-of-payments and employment effects associated with offshore production.

Offshore Production

FDI undertaken to serve the home market.

Government Policy Instruments and FDI

We have now reviewed the costs and benefits of FDI from the perspective of both home country and host country. We now turn our attention to the policy instruments that home (source) countries and host countries can use to regulate FDI.

LEARNING OBJECTIVE 5

Explain the range of policy instruments that governments use to influence FDI.

HOME-COUNTRY POLICIES Through their choice of policies, home countries can both encourage and restrict FDI by local firms. We look at policies designed to encourage outward FDI first. These include foreign risk insurance, capital assistance, tax incentives, and political pressure. Then we will look at policies designed to restrict outward FDI.

Encouraging Outward FDI Many investor nations now have government-backed insurance programs to cover major types of foreign investment risk. The types of risks insurable through these programs include the risks of expropriation (nationalization), war losses, and the inability to transfer profits back home. Such programs are particularly useful in encouraging firms to undertake investments in politically unstable countries.⁴⁵ In addition, several advanced countries also have special funds or banks that make government loans to firms wishing to invest in developing countries. As a further incentive to encourage domestic firms to undertake FDI, many countries have eliminated double taxation of foreign income (i.e., taxation of income in both the host country and the home country). Last, and perhaps most significant, a number of investor countries (including the United States) have used their political influence to persuade host countries to relax their restrictions on inbound FDI. For example, in response to direct U.S. pressure, Japan relaxed many of its formal restrictions on inward FDI in the 1980s. Now, in response to further U.S. pressure, Japan moved toward relaxing its informal barriers to inward FDI. One beneficiary of this trend has been Toys “R” Us, which, after five years of intensive lobbying by company and U.S. government officials, opened its first retail stores in Japan in December 1991. By 2009, Toys “R” Us had more 170 stores in Japan, and its Japanese operation, in which Toys “R” Us retained a controlling stake, had a listing on the Japanese stock market.

Restricting Outward FDI Virtually all investor countries, including the United States, have exercised some control over outward FDI from time to time. One policy has been to limit capital outflows out of concern for the country’s balance of payments. From the early 1960s until 1979, for example, Britain had exchange-control regulations

that limited the amount of capital a firm could take out of the country. Although the main intent of such policies was to improve the British balance of payments, an important secondary intent was to make it more difficult for British firms to undertake FDI.

In addition, countries have occasionally manipulated tax rules to try to encourage their firms to invest at home. The objective behind such policies is to create jobs at home rather than in other nations. At one time, Britain adopted such policies. The British advance corporation tax system taxed British companies' foreign earnings at a higher rate than their domestic earnings. This tax code created an incentive for British companies to invest at home.

Finally, countries sometimes prohibit national firms from investing in certain countries for political reasons. Such restrictions can be formal or informal. For example, formal U.S. rules prohibited U.S. firms from investing in countries such as Cuba and Iran, whose political ideology and actions are judged to be contrary to U.S. interests. Similarly, during the 1980s, informal pressure was applied to dissuade U.S. firms from investing in South Africa. In this case, the objective was to pressure South Africa to change its apartheid laws, which happened during the early 1990s.

HOST-COUNTRY POLICIES Host countries adopt policies designed both to restrict and to encourage inward FDI. As noted earlier in this chapter, political ideology has determined the type and scope of these policies in the past. In the last decade of the twentieth century, many countries moved quickly away from a situation where they adhered to some version of the radical stance and prohibited much FDI and toward a situation where a combination of free market objectives and pragmatic nationalism took hold.

Encouraging Inward FDI It is common for governments to offer incentives to foreign firms to invest in their countries. Such incentives take many forms, but the most common are tax concessions, low-interest loans, and grants or subsidies. Incentives are motivated by a desire to gain from the resource-transfer and employment effects of FDI. They are also motivated by a desire to capture FDI away from other potential host countries. For example, in the mid-1990s, the governments of Britain and France competed with each other on the incentives they offered Toyota to invest in their respective countries. In the United States, state governments often compete with each other to attract FDI. For example, Kentucky offered Toyota an incentive package worth \$112 million to persuade it to build its U.S. automobile assembly plants there. The package included tax breaks, new state spending on infrastructure, and low-interest loans.⁴⁶



Often governments provide incentives to attract foreign firms. For example, Kentucky offered Toyota an incentive package worth \$112 million to build its assembly plant there.

Restricting Inward FDI Host governments use a wide range of controls to restrict FDI in one way or another. The two most common are ownership restraints and performance requirements. Ownership restraints can take several forms. In some countries, foreign companies are excluded from specific fields. They are excluded from tobacco and mining in Sweden and from the development of certain natural resources in Brazil, Finland, and Morocco. In other industries, foreign ownership may be permitted although a significant proportion of the equity of the subsidiary must be owned by local investors. Foreign ownership is restricted to 25 percent or less of an airline in the United States. In India, foreign firms were prohibited from

owning media businesses until 2001, when the rules were relaxed, allowing foreign firms to purchase up to 26 percent of a newspaper.⁴⁷

The rationale underlying ownership restraints seems to be twofold. First, foreign firms are often excluded from certain sectors on the grounds of national security or competition. Particularly in less developed countries, the feeling seems to be that local firms might not be able to develop unless foreign competition is restricted by a combination of import tariffs and controls on FDI. This is a variant of the infant industry argument discussed in Chapter 6.

Second, ownership restraints seem to be based on a belief that local owners can help to maximize the resource-transfer and employment benefits of FDI for the host country. Until the early 1980s, the Japanese government prohibited most FDI but allowed joint ventures between Japanese firms and foreign MNEs if the MNE had a valuable technology. The Japanese government clearly believed such an arrangement would speed up the subsequent diffusion of the MNE's valuable technology throughout the Japanese economy.

Performance requirements can also take several forms. Performance requirements are controls over the behavior of the MNE's local subsidiary. The most common performance requirements are related to local content, exports, technology transfer, and local participation in top management. As with certain ownership restrictions, the logic underlying performance requirements is that such rules help to maximize the benefits and minimize the costs of FDI for the host country. Many countries employ some form of performance requirements when it suits their objectives. However, performance requirements tend to be more common in less developed countries than in advanced industrialized nations.⁴⁸

INTERNATIONAL INSTITUTIONS AND THE LIBERALIZATION OF FDI

Until the 1990s, there was no consistent involvement by multinational institutions in the governing of FDI. This changed with the formation of the World Trade Organization in 1995. The WTO embraces the promotion of international trade in services. Since many services have to be produced where they are sold, exporting is not an option (for example, one cannot export McDonald's hamburgers or consumer banking services). Given this, the WTO has become involved in regulations governing FDI. As might be expected for an institution created to promote free trade, the thrust of the WTO's efforts has been to push for the liberalization of regulations governing FDI, particularly in services. Under the auspices of the WTO, two extensive multinational agreements were reached in 1997 to liberalize trade in telecommunications and financial services. Both these agreements contained detailed clauses that require signatories to liberalize their regulations governing inward FDI, essentially opening their markets to foreign telecommunications and financial services companies.

The WTO has had less success trying to initiate talks aimed at establishing a universal set of rules designed to promote the liberalization of FDI. Led by Malaysia and India, developing nations have so far rejected efforts by the WTO to start such discussions. In an attempt to make some progress on this issue, the OECD in 1995 initiated talks between its members. The aim of the talks was to draft a multilateral agreement on investment (MAI) that would make it illegal for signatory states to discriminate against foreign investors. This would liberalize rules governing FDI between OECD states.

These talks broke down in early 1998, primarily because the United States refused to sign the agreement. According to the United States, the proposed agreement contained too many exceptions that would weaken its powers. For example, the proposed agreement would not have barred discriminatory taxation of foreign-owned companies, and it would have allowed countries to restrict foreign television programs and music in the name of preserving culture. Environmental and labor groups also campaigned

against the MAI, criticizing the proposed agreement because it contained no binding environmental or labor agreements. Despite such setbacks, negotiations on a revised MAI treaty might restart in the future. As noted earlier, many individual nations have continued to liberalize their policies governing FDI to encourage foreign firms to invest in their economies.⁴⁹



Focus on Managerial Implications

LEARNING OBJECTIVE 6

Identify the implications for management practice of the theory and government policies associated with FDI.

Several implications for business are inherent in the material discussed in this chapter. In this section, we deal first with the implications of the theory and then turn our attention to the implications of government policy.

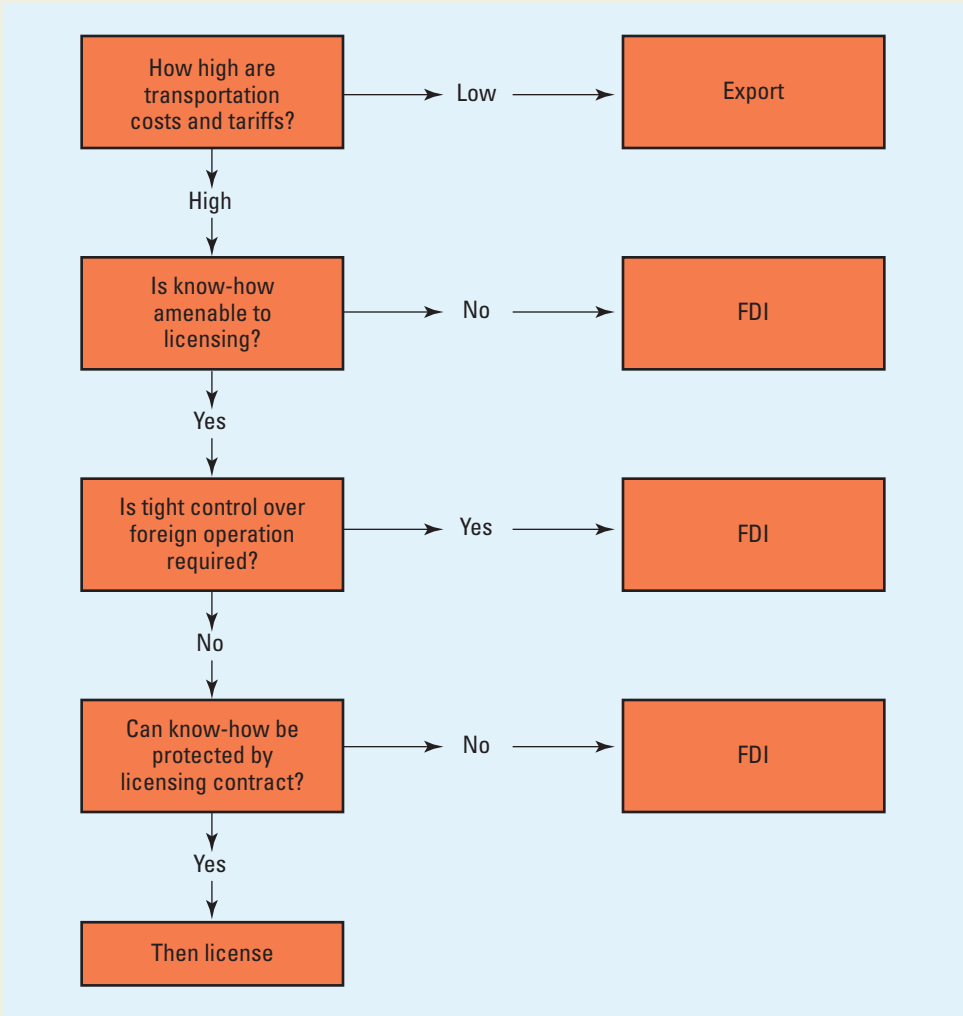
The Theory of FDI

The implications of the theories of FDI for business practice are straightforward. First, it is worth noting that the location-specific advantages argument associated with John Dunning does help explain the *direction* of FDI. However, the location-specific advantages argument does not explain *why* firms prefer FDI to licensing or to exporting. In this regard, from both an explanatory and a business perspective perhaps the most useful theories are those that focus on the limitations of exporting and licensing; that is, internalization theories. These theories are useful because they identify with some precision how the relative profitability of foreign direct investment, exporting, and licensing vary with circumstances. The theories suggest that exporting is preferable to licensing and FDI so long as transportation costs are minor and trade barriers are trivial. As transportation costs or trade barriers increase, exporting becomes unprofitable, and the choice is between FDI and licensing. Since FDI is more costly and more risky than licensing, other things being equal, the theories argue that licensing is preferable to FDI. Other things are seldom equal, however. Although licensing may work, it is not an attractive option when one or more of the following conditions exist: (a) the firm has valuable know-how that cannot be adequately protected by a licensing contract, (b) the firm needs tight control over a foreign entity to maximize its market share and earnings in that country, and (c) a firm's skills and capabilities are not amenable to licensing. Figure 7.6 presents these considerations as a decision tree.

Firms for which licensing is not a good option tend to be clustered in three types of industries:

1. High-technology industries in which protecting firm-specific expertise is of paramount importance and licensing is hazardous.
2. Global oligopolies, in which competitive interdependence requires that multinational firms maintain tight control over foreign operations so that they have the ability to launch coordinated attacks against their global competitors.
3. Industries in which intense cost pressures require that multinational firms maintain tight control over foreign operations (so that they can disperse manufacturing to locations around the globe where factor costs are most favorable in order to minimize costs).

Although empirical evidence is limited, the majority of the evidence seems to support these conjectures.⁵⁰ In addition, licensing is not a good option if the competitive advantage of a firm is based upon managerial or marketing knowledge that is embedded



in the routines of the firm or the skills of its managers, and that is difficult to codify in a “book of blueprints.” This would seem to be the case for firms based in a fairly wide range of industries.

Firms for which licensing is a good option tend to be in industries whose conditions are opposite to those specified above. That is, licensing tends to be more common, and more profitable, in fragmented, low-technology industries in which globally dispersed manufacturing is not an option. A good example is the fast-food industry. McDonald’s has expanded globally by using a franchising strategy. Franchising is essentially the service-industry version of licensing, although it normally involves much longer-term commitments than licensing. With franchising, the firm licenses its brand name to a foreign firm in return for a percentage of the franchisee’s profits. The franchising contract specifies the conditions that the franchisee must fulfill if it is to use the franchisor’s brand name. Thus McDonald’s allows foreign firms to use its brand name so long as they agree to run their restaurants on exactly the same lines as McDonald’s restaurants elsewhere in the world. This strategy makes sense for McDonald’s because (a) like many services, fast food cannot be exported; (b) franchising economizes the costs and risks associated with opening up foreign markets; (c) unlike technological know-how, brand names are relatively easy to protect using a contract; (d) there is no compelling reason for McDonald’s

to have tight control over franchisees; and (e) McDonald's know-how, in terms of how to run a fast-food restaurant, is amenable to being specified in a written contract (e.g., the contract specifies the details of how to run a McDonald's restaurant).

Finally, it should be noted that the product life-cycle theory and Knickerbocker's theory of FDI tend to be less useful from a business perspective. The problem with these two theories is that they are descriptive rather than analytical. They do a good job of describing the historical evolution of FDI, but they do a relatively poor job of identifying the factors that influence the relative profitability of FDI, licensing, and exporting. Indeed, the issue of licensing as an alternative to FDI is ignored by both of these theories.

Government Policy

A host government's attitude toward FDI should be an important variable in decisions about where to locate foreign production facilities and where to make a foreign direct investment. Other things being equal, investing in countries that have permissive policies toward FDI is clearly preferable to investing in countries that restrict FDI.

However, often the issue is not this straightforward. Despite the move toward a free market stance in recent years, many countries still have a rather pragmatic stance toward FDI. In such cases, a firm considering FDI must often negotiate the specific terms of the investment with the country's government. Such negotiations center on two broad issues. If the host government is trying to attract FDI, the central issue is likely to be the kind of incentives the host government is prepared to offer to the MNE and what the firm will commit in exchange. If the host government is uncertain about the benefits of FDI and might choose to restrict access, the central issue is likely to be the concessions that the firm must make to be allowed to go forward with a proposed investment.

To a large degree, the outcome of any negotiated agreement depends on the relative bargaining power of both parties. Each side's bargaining power depends on three factors:

- The value each side places on what the other has to offer.
- The number of comparable alternatives available to each side.
- Each party's time horizon.

From the perspective of a firm negotiating the terms of an investment with a host government, the firm's bargaining power is high when the host government places a high value on what the firm has to offer, the number of comparable alternatives open to the firm is greater, and the firm has a long time in which to complete the negotiations. The converse also holds. The firm's bargaining power is low when the host government places a low value on what the firm has to offer, the number of comparable alternatives open to the firm is fewer, and the firm has a short time in which to complete the negotiations.⁵¹

Key Terms

greenfield investment, p. 243

flow of FDI, p. 243

stock of FDI, p. 243

outflows of FDI, p. 243

inflows of FDI, p. 243

gross fixed capital formation, p. 246

eclectic paradigm, p. 250

exporting, p. 250

licensing, p. 250

internalization theory, p. 252

oligopoly, p. 253

multipoint competition, p. 254

location-specific advantages, p. 255

balance-of-payments accounts, p. 261

current account, p. 261

offshore production, p. 265

The objectives of this chapter were to review theories that attempt to explain the pattern of FDI between countries and to examine the influence of governments on firms' decisions to invest in foreign countries. The following points were made:

1. Any theory seeking to explain FDI must explain why firms go to the trouble of acquiring or establishing operations abroad, when the alternatives of exporting and licensing are available to them.
2. High transportation costs or tariffs imposed on imports help explain why many firms prefer FDI or licensing over exporting.
3. Firms often prefer FDI to licensing when (a) a firm has valuable know-how that cannot be adequately protected by a licensing contract, (b) a firm needs tight control over a foreign entity in order to maximize its market share and earnings in that country, and (c) a firm's skills and capabilities are not amenable to licensing.
4. Knickerbocker's theory suggests that much FDI is explained by imitative behavior by rival firms in an oligopolistic industry.
5. Vernon's product life-cycle theory suggests that firms undertake FDI at particular stages in the life cycle of products they have pioneered. However, Vernon's theory does not address the issue of whether FDI is more efficient than exporting or licensing for expanding abroad.
6. Dunning has argued that location-specific advantages are of considerable importance in explaining the nature and direction of FDI. According to Dunning, firms undertake FDI to exploit resource endowments or assets that are location specific.
7. Political ideology is an important determinant of government policy toward FDI. Ideology ranges from a radical stance that is hostile to FDI to a noninterventionist, free market stance. Between the two extremes is an approach best described as pragmatic nationalism.
8. Benefits of FDI to a host country arise from resource transfer effects, employment effects, and balance-of-payments effects.
9. The costs of FDI to a host country include adverse effects on competition and balance of payments and a perceived loss of national sovereignty.
10. The benefits of FDI to the home (source) country include improvement in the balance of payments as a result of the inward flow of foreign earnings, positive employment effects when the foreign subsidiary creates demand for home-country exports, and benefits from a reverse resource-transfer effect. A reverse resource-transfer effect arises when the foreign subsidiary learns valuable skills abroad that can be transferred back to the home country.
11. The costs of FDI to the home country include adverse balance-of-payments effects that arise from the initial capital outflow and from the export substitution effects of FDI. Costs also arise when FDI exports jobs abroad.
12. Home countries can adopt policies designed to both encourage and restrict FDI. Host countries try to attract FDI by offering incentives and try to restrict FDI by dictating ownership restraints and requiring that foreign MNEs meet specific performance requirements.

Critical Thinking and Discussion Questions

1. In 2004, inward FDI accounted for some 24 percent of gross fixed capital formation in Ireland, but only 0.6 percent in Japan. What do you think explains this difference in FDI inflows into the two countries?
2. Compare and contrast these explanations of FDI: internalization theory, Vernon's product life-cycle theory, and Knickerbocker's theory of FDI. Which theory do you think offers the best explanation of the historical pattern of FDI? Why?

3. Read the Management Focus on Cemex and then answer the following questions:
 - a. Which theoretical explanation, or explanations, of FDI best explains Cemex's FDI?
 - b. What is the value that Cemex brings to the host economy? Can you see any potential drawbacks of inward investment by Cemex in an economy?
 - c. Cemex has a strong preference for acquisitions over greenfield ventures as an entry mode. Why?
 - d. Why is majority control so important to Cemex?
4. You are the international manager of a U.S. business that has just developed a revolutionary

new personal computer that can perform the same functions as existing PCs but costs only half as much to manufacture. Several patents protect the unique design of this computer. Your CEO has asked you to formulate a recommendation for how to expand into Western Europe. Your options are (a) to export from the United States, (b) to license a European firm to manufacture and market the computer in Europe, or (c) to set up a wholly owned subsidiary in Europe. Evaluate the pros and cons of each alternative and suggest a course of action to your CEO.

Research Task <http://globalEDGE.msu.edu>

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

1. You are working for a company that is considering investing in a foreign country. Management has requested a report regarding the attractiveness of alternative countries based on the potential return of FDI. Accordingly, the ranking of the top 10 countries in terms of FDI attractiveness is a crucial ingredient for your report. A colleague mentioned a potentially useful tool called the *FDI Confidence Index*, which is updated periodically. Find this index and

provide additional information regarding how the index is constructed.

2. Your company is considering opening a new factory in Latin America, and management is evaluating the specific country locations for this direct investment. The pool of candidate countries has been narrowed to Argentina, Brazil, and Mexico. Prepare a short report comparing the foreign direct investment climate and regulations of these three countries, using the *Country Commercial Guides* prepared by the U.S. Department of Commerce.



Spain's Telefonica

closing case

Established in the 1920s, Spain's Telefonica was a typical state-owned national telecommunications monopoly until the 1990s. Then the Spanish government privatized the company and deregulated the Spanish telecommunications market. What followed was a sharp reduction in the workforce, rapid adoption of new technology, and focus on driving up profits and shareholder value.

In this new era, Telefonica was looking for growth. Its search first took it to Latin America. There, too, a wave of deregulation and privatization was sweeping across the region.

For Telefonica, Latin America seemed to be the perfect fit. Much of the region shared a common language and had deep cultural and historical ties to Spain. After decades of slow growth, Latin American markets were now growing rapidly, increasing the adoption rate and usage not just of traditional fixed-line telecommunications services, but also of mobile phones and Internet connections.

Having already transformed itself from a state-owned enterprise into an efficient and effective competitor, Telefonica now believed it could do the same for companies it acquired

in Latin America, many of which were once part of state-owned telecommunications monopolies. In the late 1990s, Telefonica invested some \$11 billion in Latin America, acquiring companies throughout the region. Its largest investments were reserved for Brazil, the biggest market in the region, where it spent some \$6 billion to purchase several companies, including the largest fixed-line operator in San Paulo, the leading mobile phone operator in Rio de Janeiro, and the principal carrier in the state of Rio Grande do Sul. In Argentina, it acquired 51 percent of the southern region's monopoly provider, a franchise that included the lucrative financial district of Buenos Aires. In Chile, it became the leading shareholder in the former state-owned monopoly, and so on. Indeed, by the early 2000s Telefonica was the No. 1 or 2 player in almost every Latin American country, had a continent-wide market share of around 40 percent, and was generating 18 percent of its revenues from the region.

Still, for all of its investment, Telefonica has not had it all its own way in Latin America. Other companies could also see the growth opportunities, and several foreign telecommunications enterprises entered Latin America's newly opened markets. In the fast-growing mobile segment, America Movil, controlled by the Mexican billionaire Carlos Slim, emerged as a strong challenger. By 2008, the Mexican company had 182 million wireless subscribers across Latin America, compared to Telefonica's 123 million, and intense price competition between the two companies was emerging.

With the die already cast in Latin America by the mid-2000s, Telefonica turned its attention to neighboring countries in Europe. For years, there had been a tacit agreement between

national telecommunications companies that they would not invade each other's markets. In 2005 this started to break down when France Telecom entered Spain, purchasing Amena, the country's second-largest mobile carrier behind Telefonica. Telefonica moved quickly to make its own European acquisition, acquiring Britain's major mobile phone operator, O2, for \$31.4 billion. O2 already had significant operations in Germany as well as the United Kingdom. The acquisition transformed Telefonica into the second-largest mobile phone operator in the world measured by customers, behind only China Mobile.

Sources: R. Tomlinson, "Dialing in on Latin America," *Fortune*, October 25, 1999, pp. 259–62; T. Serafin, "Spanish Armada," *Forbes*, January 9, 2006, p. 132; and G. Smith, "The Race for Numero Uno in Latin Wireless," *BusinessWeek Online*, November 27, 2006.

Case Discussion Questions

1. What changes in the political and economic environment allowed Telefonica to start expanding globally?
2. Why did Telefonica initially focus on Latin America? Why was it slower to expand in Europe, even though Spain is a member of the European Union?
3. Telefonica has used acquisitions, rather than greenfield ventures, as its entry strategy. Why do you think this has been the case? What are the potential risks associated with this entry strategy?
4. What is the value that Telefonica brings to the companies it acquires?
5. In your judgment, does inward investment by Telefonica benefit a host nation? Explain your reasoning?



part 3

Cross-Border Trade and Investment

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Describe the different levels of regional economic integration.
- 2 Understand the economic and political arguments for regional economic integration.
- 3 Understand the economic and political arguments against regional economic integration.
- 4 Explain the history, current scope, and future prospects of the world's most important regional economic agreements.
- 5 Understand the implications for business that are inherent in regional economic integration agreements.

Regional Economic Integration

NAFTA and Mexican Trucking

opening case

When the North American Free Trade Agreement (NAFTA) went into effect in 1994, the treaty specified that by 2000 trucks from each nation would be allowed to cross each other's borders and deliver goods to their ultimate destination. The argument was that such a policy would lead to great efficiencies. Before NAFTA, Mexican trucks stopped at the border, and goods had to be unloaded and reloaded onto American trucks, a process that took time and cost money. It was also argued that greater competition from Mexican trucking firms would lower the price of road transportation within NAFTA. Given that two-thirds of cross-border trade within NAFTA goes by road, supporters argued that the savings could be significant.

This provision was vigorously opposed by the Teamsters Union in the United States, which represents truck drivers. The union argued that Mexican truck drivers had poor safety records, and that Mexican trucks did not adhere to the strict safety and environmental standards of the United States. To quote James Hoffa, the president of the Teamsters: "Mexican trucks are older, dirtier and more dangerous than American trucks. American truck drivers are taken off the road if they commit a serious traffic violation in their personal vehicle. That's not so in Mexico. Limits on the hours a driver can spend behind the wheel are ignored in Mexico."

Although they did not state so explicitly, the Teamsters were also clearly motivated by a desire to protect the pay and employment opportunities for American truck drivers.

Under pressure from the Teamsters, the United States dragged its feet on implementation of the trucking agreement. Ultimately the Teamsters sued to stop implementation. An American court rejected the union's arguments and stated the country must honor the treaty. So did a NAFTA dispute settlement panel. This panel ruled in 2001 that the United States was violating the NAFTA treaty and gave Mexico the right to impose retaliatory tariffs.

Mexico decided not to do that, instead giving the United States a chance to honor its commitment. The Bush administration tried to do just that, but was thwarted by opposition in Congress, which approved a measure setting 22 new safety standards that Mexican trucks would have to meet before entering the United States.

In an attempt to break the stalemate, in 2007 the U.S. government set up a pilot program under which trucks from some 100 Mexican transportation companies could enter the United States, provided they passed American safety inspections. The Mexican trucks were tracked, and after 18 months, that program showed that the Mexican carriers actually had a slightly better safety record than their U.S. counterparts. The Teamsters immediately lobbied Congress to kill the pilot program. In March 2009 an amendment attached to a large spending bill did just that.

This time the Mexican government did not let the United States off the hook. As allowed to under the terms of the NAFTA agreement, Mexico immediately placed tariffs on some \$2.4 billion of goods shipped from the United States to Mexico. California, an important exporter of agricultural products to Mexico, was hit hard. Table grapes now faced a 45 percent tariff, while wine, almonds, and juices will pay a 20 percent tariff. Pears, which primarily come from Washington State, faced a 20 percent tariff (4 out of 10 pears that the United States exports go to Mexico). Other products hit with the 20 percent tariff include exports of personal hygiene products and jewelry from New York, tableware from Illinois, and oil seeds from North Dakota. The U.S. Chamber of Commerce has estimated that the current situation costs some 25,600 U.S. jobs. The U.S. government said it would try to come up with a new program that both addressed the “legitimate concerns” of Congress and honored its commitment to the NAFTA treaty. What that agreement will be, however, remains to be seen, and as of early 2010, there was no agreement in sight. ●

Sources: “Don’t Keep on Trucking,” *The Economist*, March 21, 2009, p. 39; “Mexico Retaliates,” *The Wall Street Journal*, March 19, 2009, p. A14; J. P. Hoffa, “Keep Mexican Trucks Out,” *USA Today*, March 1, 2009, p. 10; “The Mexican-American War of 2009,” *Washington Times*, March 24, 2009, p. A18; and J. Moreno, “In NAFTA Rift, Profits Take a Hit,” *HoustonChronical.com*, November 12, 2009.



Introduction

In this chapter we will take a close look at the arguments for regional economic integration through the establishment of trading blocs such as the European Union and the North American Free Trade Agreement. We will discuss the difficult process of forming such blocks and using them as an institutional means for lowering the barriers to cross-border trade and investment between member states. The opening case illustrates some of the promise and problems associated with integrating the

economies of different nations into regional trading blocs. The NAFTA provision to remove barriers to trucking across borders was meant to encourage greater efficiencies, with the lower costs benefitting the citizens of all three signatory countries. However, as described in the case, political opposition has stymied any attempt to implement this aspect of NAFTA. By 2009 Mexico was imposing retaliatory tariffs on imports of U.S. goods, as allowed for by the treaty, in an attempt to get the Americans to honor their commitment. Doing so will not be easy, however, given the strong opposition from the well-connected Teamsters Union in the United States.

By **regional economic integration** we mean agreements among countries in a geographic region to reduce, and ultimately remove, tariff and nontariff barriers to the free flow of goods, services, and factors of production between each other. The past two decades have witnessed an unprecedented proliferation of regional trade blocs that promote regional economic integration. World Trade Organization members are required to notify the WTO of any regional trade agreements in which they participate. By 2010, nearly all of the WTO's members had notified the organization of participation in one or more regional trade agreements. The total number of regional trade agreements currently in force is around 400.¹

Consistent with the predictions of international trade theory and particularly the theory of comparative advantage (see Chapter 5) agreements designed to promote freer trade within regions are believed to produce gains from trade for all member countries. As we saw in Chapter 6, the General Agreement on Tariffs and Trade and its successor, the World Trade Organization, also seek to reduce trade barriers. With 153 member states, the WTO has a worldwide perspective. By entering into regional agreements, groups of countries aim to reduce trade barriers more rapidly than can be achieved under the auspices of the WTO.

Nowhere has the movement toward regional economic integration been more successful than in Europe. On January 1, 1993, the European Union (EU) formally removed many barriers to doing business across borders within the EU in an attempt to create a single market with 340 million consumers. However, the EU did not stop there. The member states of the EU have launched a single currency, the euro; they are moving toward a closer political union. On May 1, 2004, the EU expanded from 15 to 25 countries and in 2007 two more countries joined, Bulgaria and Romania, making the total 27. Today, the EU has a population of almost 500 million and a gross domestic product of €11 trillion, making it larger than the United States in economic terms.

Similar moves toward regional integration are being pursued elsewhere in the world. Canada, Mexico, and the United States have implemented the North American Free Trade Agreement (NAFTA). Ultimately, this promises to remove all barriers to the free flow of goods and services between the three countries. While the implementation of NAFTA has resulted in job losses in some sectors of the American economy, in aggregate and consistent with the predications of international trade theory, most economists argue that the benefits of greater regional trade outweigh any costs. South America, too, has moved toward regional integration. In 1991, Argentina, Brazil, Paraguay, and Uruguay implemented an agreement known as Mercosur to start reducing barriers to trade between each other, and although progress within Mercosur has been halting, the institution is still in place. There are also active attempts at regional economic integration in Central America, the Andean region of South America, Southeast Asia, and parts of Africa.

While the move toward regional economic integration is generally seen as a good thing, some observers worry that it will lead to a world in which regional trade blocs compete against each other. In this possible future scenario, free trade will exist

Regional Economic Integration

Agreements among countries in a geographic region to reduce, and ultimately remove, tariff and nontariff barriers to the free flow of goods, services, and factors of production between each other.



Another Perspective

Economic Integration in the Classical World

Traditionally, the success of the Roman Empire has been explained by economic historians as an example of centralized, forced reallocation of goods. Recent scholarship, though, suggests that there was not a single empire-wide, centralized market for all goods, but that local markets were connected and that most exchanges were voluntary, based on reciprocity and exchange. Ancient Rome had an economic system that was an enormous, integrated conglomeration of interdependent markets. Transportation and communication took time, and the discipline of the market was loose. But there were many voluntary economic connections between even far-flung parts of the early Roman Empire. (Karl Polanyi, *The Livelihood of Man* [New York: Academic Press, 1977]; and Peter Temin, "Market Economy in the Early Roman Empire," University of Oxford, Discussion Papers in Economic and Social History)

within each bloc, but each bloc will protect its market from outside competition with high tariffs. The specter of the EU and NAFTA turning into economic fortresses that shut out foreign producers with high tariff barriers is worrisome to those who believe in unrestricted free trade. If such a situation were to materialize, the resulting decline in trade between blocs could more than offset the gains from free trade within blocs.

With these issues in mind, this chapter will explore the economic and political debate surrounding regional economic integration, paying particular attention to the economic and political benefits and costs of integration; review progress toward regional economic integration around the world; and map the important implications of regional economic integration for the practice of international business. Before tackling these objectives, we first need to examine the levels of integration that are theoretically possible.

LEARNING OBJECTIVE 1

Describe the different levels of regional economic integration.

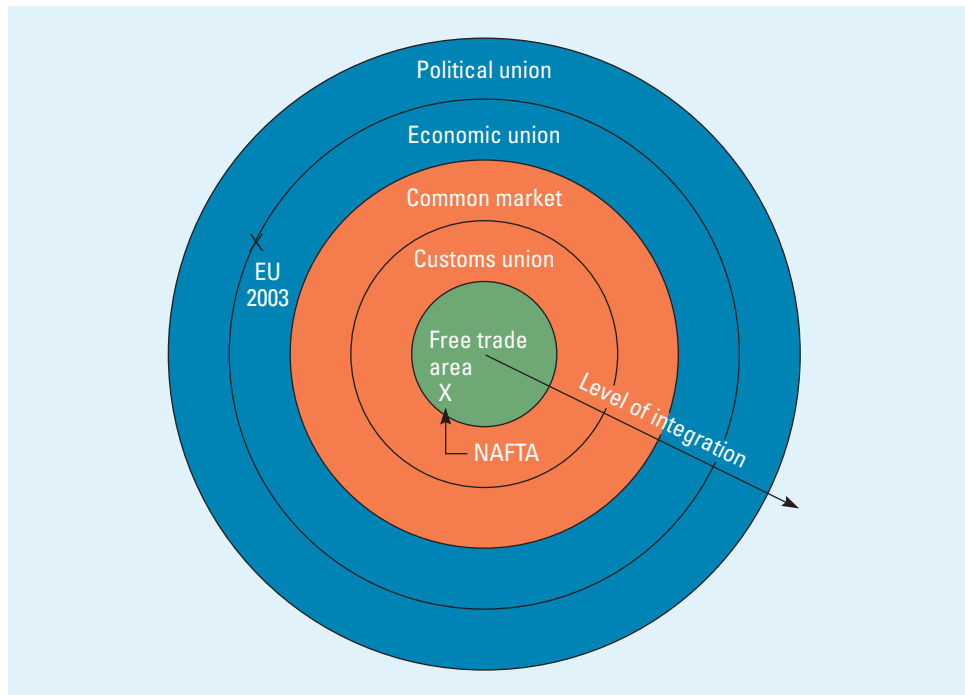
Levels of Economic Integration

Several levels of economic integration are possible in theory (see Figure 8.1). From least integrated to most integrated, they are a free trade area, a customs union, a common market, an economic union, and, finally, a full political union.

In a **free trade area**, all barriers to the trade of goods and services among member countries are removed. In the theoretically ideal free trade area, no discriminatory

figure 8.1

Levels of Economic Integration



tariffs, quotas, subsidies, or administrative impediments are allowed to distort trade between members. Each country, however, is allowed to determine its own trade policies with regard to nonmembers. Thus, for example, the tariffs placed on the products of nonmember countries may vary from member to member. Free trade agreements are the most popular form of regional economic integration, accounting for almost 90 percent of regional agreements.²

The most enduring free trade area in the world is the **European Free Trade Association (EFTA)**. Established in January 1960, EFTA currently joins four countries—Norway, Iceland, Liechtenstein, and Switzerland—down from seven in 1995 (three EFTA members, Austria, Finland, and Sweden, joined the EU on January 1, 1996). EFTA was founded by those Western European countries that initially decided not to be part of the European Community (the forerunner of the EU). Its original members included Austria, Great Britain, Denmark, Finland, and Sweden, all of which are now members of the EU. The emphasis of EFTA has been on free trade in industrial goods. Agriculture was left out of the arrangement, each member being allowed to determine its own level of support. Members are also free to determine the level of protection applied to goods coming from outside EFTA. Other free trade areas include the North American Free Trade Agreement, which we shall discuss in depth later in the chapter.

The customs union is one step farther along the road to full economic and political integration. A **customs union** eliminates trade barriers between member countries and adopts a common external trade policy. Establishment of a common external trade policy necessitates significant administrative machinery to oversee trade relations with nonmembers. Most countries that enter into a customs union desire even greater economic integration down the road. The EU began as a customs union, but has now moved beyond this stage. Other customs unions around the world include the current version of the Andean Community (formally known as the Andean Pact) between Bolivia, Colombia, Ecuador, Peru, and Venezuela. The Andean Community established free trade between member countries and imposes a common tariff, of 5 to 20 percent, on products imported from outside.³

The next level of economic integration, a **common market** has no barriers to trade between member countries, includes a common external trade policy, and allows factors of production to move freely between members. Labor and capital are free to move because there are no restrictions on immigration, emigration, or cross-border flows of capital between member countries. Establishing a common market demands a significant degree of harmony and cooperation on fiscal, monetary, and employment policies. Achieving this degree of cooperation has proven very difficult. For years, the European Union functioned as a common market, although it has now moved beyond this stage. Mercosur, the South American grouping of Argentina, Brazil, Paraguay, and Uruguay (Venezuela has also applied to join), hopes to eventually establish itself as a common market.

An economic union entails even closer economic integration and cooperation than a common market. Like the common market, an **economic union** involves the free flow of products and factors of production between member countries and the adoption of a common external trade policy, but it also requires a common currency, harmonization of members' tax rates, and a common monetary and fiscal policy. Such a high degree of integration demands a coordinating bureaucracy and the sacrifice of significant amounts of national sovereignty to that bureaucracy. The EU is an economic union, although an imperfect one since not all members of the EU have adopted the euro, the currency of the EU; differences in tax rates and regulations across countries still remain; and some markets, such as the market for energy, are still not fully deregulated.

Free Trade Area

A group of countries committed to removing all barriers to the free flow of goods and services between each other, but pursuing independent external trade policies.

European Free Trade Association (EFTA)

A free trade association including Norway, Iceland, Liechtenstein, and Switzerland.

Customs Union

A group of countries committed to (1) removing all barriers to the free flow of goods and services between each other and (2) the pursuit of a common external trade policy.

Common Market

A group of countries committed to (1) removing all barriers to the free flow of goods, services, and factors of production between each other and (2) the pursuit of a common external trade policy.

Economic Union

A group of countries committed to (1) removing all barriers to the free flow of goods, services, and factors of production; (2) the adoption of a common currency; (3) the harmonization of tax rates; and (4) the pursuit of a common external trade policy.

Political Union

A central political apparatus that coordinates economic, social, and foreign policy.

The move toward economic union raises the issue of how to make a coordinating bureaucracy accountable to the citizens of member nations. The answer is through **political union** in which a central political apparatus coordinates the economic, social, and foreign policy of the member states. The EU is on the road toward at least partial political union. The European Parliament, which is playing an ever more important role in the EU, has been directly elected by citizens of the EU countries since the late 1970s. In addition, the Council of Ministers (the controlling, decision-making body of the EU) is composed of government ministers from each EU member. The United States provides an example of even closer political union; in the United States, independent states are effectively combined into a single nation. Ultimately, the EU may move toward a similar federal structure.

The Case for Regional Integration

LEARNING OBJECTIVE 2

Understand the economic and political arguments for regional economic integration.

The case for regional integration is both economic and political. The case for integration is typically not accepted by many groups within a country, which explains why most attempts to achieve regional economic integration have been contentious and halting. In this section, we examine the economic and political cases for integration and two impediments to integration. In the next section, we look at the case against integration.

THE ECONOMIC CASE FOR INTEGRATION The economic case for regional integration is straightforward. We saw in Chapter 5 how economic theories of international trade predict that unrestricted free trade will allow countries to specialize in the production of goods and services that they can produce most efficiently. The result is greater world production than would be possible with trade restrictions. That chapter also revealed how opening a country to free trade stimulates economic growth, which creates dynamic gains from trade. Chapter 7 detailed how foreign direct investment (FDI) can transfer technological, marketing, and managerial know-how to host nations. Given the central role of knowledge in stimulating economic growth, opening a country to FDI also is likely to stimulate economic growth. In sum, economic theories suggest that free trade and investment is a positive-sum game, in which all participating countries stand to gain.

Given this, the theoretical ideal is an absence of barriers to the free flow of goods, services, and factors of production among nations. However, as we saw in Chapters 6 and 7, a case can be made for government intervention in international trade and FDI. Because many governments have accepted part or all of the case for intervention, un-

restricted free trade and FDI have proved to be only an ideal. Although international institutions such as the WTO have been moving the world toward a free trade regime, success has been less than total. In a world of many nations and many political ideologies, it is very difficult to get all countries to agree to a common set of rules.

Against this background, regional economic integration can be seen as an attempt to achieve additional gains from the free flow of trade and investment between countries beyond those attainable under international agreements such as the WTO. It is easier to establish a free trade and investment regime among a limited number of adjacent countries than among the world community.



Another Perspective

Economic Integration and the EU Worker

Being a citizen of a country that is regionally integrated, such as the countries of the European Union, may have benefits related to career development. From an employer's perspective, workers are more mobile. They can move from Spain to Finland, Latvia to France, and never have to think about work permits and, depending on the countries, currencies. In addition, labor and commercial law is becoming integrated across the EU. The mobility and flexibility of such employees may be attractive to a U.S. MNE as well, because it could use them in many markets.

Coordination and policy harmonization problems are largely a function of the number of countries that seek agreement. The greater the number of countries involved, the more perspectives that must be reconciled, and the harder it will be to reach agreement. Thus, attempts at regional economic integration are motivated by a desire to exploit the gains from free trade and investment.

THE POLITICAL CASE FOR INTEGRATION The political case for regional economic integration also has loomed large in several attempts to establish free trade areas, customs unions, and the like. Linking neighboring economies and making them increasingly dependent on each other creates incentives for political cooperation between the neighboring states and reduces the potential for violent conflict. In addition, by grouping their economies, the countries can enhance their political weight in the world.

These considerations underlay the 1957 establishment of the European Community (EC), the forerunner of the EU. Europe had suffered two devastating wars in the first half of the 20th century, both arising out of the unbridled ambitions of nation-states. Those who have sought a united Europe have always had a desire to make another war in Europe unthinkable. Many Europeans also believed that after World War II, the European nation-states were no longer large enough to hold their own in world markets and politics. The need for a united Europe to deal with the United States and the politically alien Soviet Union loomed large in the minds of many of the EC's founders.⁴ A long-standing joke in Europe is that the European Commission should erect a statue to Joseph Stalin, for without the aggressive policies of the former dictator of the old Soviet Union, the countries of Western Europe may have lacked the incentive to cooperate and form the EC.

IMPEDIMENTS TO INTEGRATION Despite the strong economic and political arguments in support, integration has never been easy to achieve or sustain for two main reasons. First, although economic integration aids the majority, it has its costs. While a nation as a whole may benefit significantly from a regional free trade agreement, certain groups may lose. Moving to a free trade regime involves painful adjustments. For example, due to the 1994 establishment of NAFTA, some Canadian and U.S. workers in such industries as textiles, which employ low-cost, low-skilled labor, lost their jobs as Canadian and U.S. firms moved production to Mexico. The promise of significant net benefits to the Canadian and U.S. economies as a whole is little comfort to those who lose as a result of NAFTA. Such groups have been at the forefront of opposition to NAFTA and will continue to oppose any widening of the agreement. Thus, as we saw in the opening case, the Teamsters Union in the United States has vigorously opposed the implementation of a trucking agreement in the treaty.

A second impediment to integration arises from concerns over national sovereignty. For example, Mexico's concerns about maintaining control of its oil interests resulted in an agreement with Canada and the United States to exempt the Mexican oil industry from any liberalization of foreign investment regulations achieved under NAFTA. Concerns about national sovereignty arise because close economic integration demands that countries give up some degree of control over such key issues as monetary policy, fiscal policy (e.g., tax policy), and trade policy. This has been a major stumbling block in the EU. To achieve full economic union, the EU introduced a common currency, the euro, controlled by a central EU bank. Although most member states have signed on, Great Britain remains an important holdout. A politically important segment of public opinion in that country opposes a common currency on the grounds that it would require relinquishing control of the country's

monetary policy to the EU, which many British perceive as a bureaucracy run by foreigners. In 1992, the British won the right to opt out of any single currency agreement, and as of 2010, the British government had yet to reverse its decision, nor did it seem likely to.

The Case Against Regional Integration

LEARNING OBJECTIVE 3

Understand the economic and political arguments against regional economic integration.

Trade Creation

Trade created due to regional economic integration; occurs when high-cost domestic producers are replaced by low-cost foreign producers in a free trade area.

Trade Diversion

Trade diverted due to regional economic integration; occurs when low-cost foreign suppliers outside a free trade area are replaced by higher-cost foreign suppliers in a free trade area.

Although the tide has been running in favor of regional free trade agreements in recent years, some economists have expressed concern that the benefits of regional integration have been oversold, while the costs have often been ignored.⁵ They point out that the benefits of regional integration are determined by the extent of trade creation, as opposed to trade diversion. **Trade creation** occurs when high-cost domestic producers are replaced by low-cost producers within the free trade area. It may also occur when higher-cost external producers are replaced by lower-cost external producers within the free trade area. **Trade diversion** occurs when lower-cost external suppliers are replaced by higher-cost suppliers within the free trade area. A regional free trade agreement will benefit the world only if the amount of trade it creates exceeds the amount it diverts.

Suppose the United States and Mexico imposed tariffs on imports from all countries, and then they set up a free trade area, scrapping all trade barriers between themselves but maintaining tariffs on imports from the rest of the world. If the United States began to import textiles from Mexico, would this change be for the better? If the United States previously produced all its own textiles at a higher cost than Mexico, then the free trade agreement has shifted production to the cheaper source. According to the theory of comparative advantage, trade has been created within the regional grouping, and there would be no decrease in trade with the rest of the world. Clearly, the change would be for the better. If, however, the United States previously imported textiles from Costa Rica, which produced them more cheaply than either Mexico or the United States, then trade has been diverted from a low-cost source—a change for the worse.

In theory, WTO rules should ensure that a free trade agreement does not result in trade diversion. These rules allow free trade areas to be formed only if the members set tariffs that are not higher or more restrictive to outsiders than the ones previously in effect. However, as we saw in Chapter 6, GATT and the WTO do not cover some nontariff barriers. As a result, regional trade blocs could emerge whose markets are protected from outside competition by high nontariff barriers. In such cases, the trade diversion effects might outweigh the trade creation effects. The only way to guard against this possibility, according to those concerned about this potential, is to increase the scope of the WTO so it covers nontariff barriers to trade. There is no sign that this is going to occur anytime soon, however; so the risk remains that regional economic integration will result in trade diversion.

LEARNING OBJECTIVE 4

Explain the history, current scope, and future prospects of the world's most important regional economic agreements.

European Union

An economic group of 27 European nations; established as a customs union, it is moving toward economic union; formerly the European Community.

Regional Economic Integration in Europe

Europe has two trade blocs—the European Union and the European Free Trade Association. Of the two, the EU is by far the more significant, not just in terms of membership (the EU currently has 27 members; the EFTA has 4), but also in terms of economic and political influence in the world economy. Many now see the EU as an emerging economic and political superpower of the same order as the United States. Accordingly, we will concentrate our attention on the EU.⁶

EVOLUTION OF THE EUROPEAN UNION The **European Union (EU)** is the product of two political factors: (1) the devastation of Western Europe during two world wars and the desire for a lasting peace, and (2) the European nations' desire

to hold their own on the world's political and economic stage. In addition, many Europeans were aware of the potential economic benefits of closer economic integration of the countries.

The forerunner of the EU, the European Coal and Steel Community was formed in 1951 by Belgium, France, West Germany, Italy, Luxembourg, and the Netherlands. Its objective was to remove barriers to intragroup shipments of coal, iron, steel, and scrap metal. With the signing of the **Treaty of Rome** in 1957, the European Community was established. The name changed again in 1994 when the European Community became the European Union following the ratification of the Maastricht Treaty (discussed later).

The Treaty of Rome provided for the creation of a common market. Article 3 of the treaty laid down the key objectives of the new community, calling for the elimination of internal trade barriers and the creation of a common external tariff and requiring member states to abolish obstacles to the free movement of factors of production among the members. To facilitate the free movement of goods, services, and factors of production, the treaty provided for any necessary harmonization of the member states' laws. Furthermore, the treaty committed the EC to establish common policies in agriculture and transportation.

The community grew in 1973, when Great Britain, Ireland, and Denmark joined. These three were followed in 1981 by Greece, in 1986 by Spain and Portugal, and in 1996 by Austria, Finland, and Sweden, bringing the total membership to 15 (East Germany became part of the EC after the reunification of Germany in 1990). Another 10 countries joined the EU on May 1, 2004, 8 of them from Eastern Europe plus the small Mediterranean nations of Malta and Cyprus. Bulgaria and Romania joined in 2007, bringing the total number of member states to 27 (see Map 8.1). With a population of almost 500 million and a GDP of €11 trillion, larger than that of the United States, the EU through these enlargements has become a global superpower.⁷

POLITICAL STRUCTURE OF THE EUROPEAN UNION The economic policies of the EU are formulated and implemented by a complex and still-evolving political structure. The four main institutions in this structure are the European Commission, the Council of the European Union, the European Parliament, and the Court of Justice.⁸

The **European Commission** is responsible for proposing EU legislation, implementing it, and monitoring compliance with EU laws by member states. Headquartered in Brussels, Belgium, the commission has more than 24,000 employees. It is run by a group of commissioners appointed by each member country for five-year renewable terms. There are 27 commissioners, one from each member state. A president of the commission is chosen by member states, and the president then chooses other members in consultation with the states. The entire commission has to be approved by the European Parliament before it can begin work. The commission has a monopoly in proposing European Union legislation. The commission makes a proposal, which goes to the Council of the European Union and then to the European Parliament. The council

Treaty of Rome

The 1957 treaty that established the European Community.

European Commission

Body responsible for proposing EU legislation, implementing it, and monitoring compliance.



L'Oréal Chief Executive Officer Lindsay Owen-Jones and L'Oréal Deputy Chief Executive Officer Jean-Paul Agon attend a press conference to announce that L'Oréal was buying Body Shop International, renowned for its ethical hair and skin products. L'Oréal, the world's leading cosmetics company, bought Body Shop for £652 million pounds (€940 million; \$1.143 billion). The European Commission reviews acquisitions such as this between competitors.



map 8.1

Member States of the European Union in 2010

Source: The European Union; http://europa.eu/abc/european_countries/index_en.htm.

cannot legislate without a commission proposal in front of it. The commission is also responsible for implementing aspects of EU law, although in practice much of this must be delegated to member states. Another responsibility of the commission is to monitor member states to make sure they are complying with EU laws. In this policing role, the commission will normally ask a state to comply with any EU laws that are being broken. If this persuasion is not sufficient, the commission can refer a case to the Court of Justice.

The European Commission's role in competition policy has become increasingly important to business in recent years. Since 1990 when the office was formally assigned a role in competition policy, the EU's competition commissioner has been steadily gaining influence as the chief regulator of competition policy in the member nations of the EU. As with antitrust authorities in the United States, which include the Federal Trade Commission and the Department of Justice, the role of the competition commissioner is to ensure that no one enterprise uses its market power to drive out



The European Commission and Media Industry Mergers

In late 1999, U.S. Internet giant AOL announced it would merge with the music and publishing conglomerate Time Warner. Both the U.S. companies had substantial operations in Europe. The European commissioner for competition, Mario Monti, announced the commission would investigate the impact of the merger on competition in Europe.

The investigation took on a new twist when Time Warner subsequently announced it would form a joint venture with British-based EMI. Time Warner and EMI are two of the top five music publishing companies in the world. The proposed joint venture would have been three times as large as its nearest global competitor. The European Commission now had two concerns. The first was that the joint venture between EMI and Time Warner would reduce the level of competition in the music publishing industry. The second was that a combined AOL–Time Warner would dominate the emerging market for downloading music over the Internet, particularly given the fact that AOL would be able to gain preferential access to the music libraries of both Warner and EMI. This would potentially put other online service providers at a disadvantage. The commission was also concerned that AOL Europe was a joint venture between AOL and Bertelsmann, a German media company that also had considerable music publishing interests. Accordingly, the commission announced it would undertake a separate investigation of the proposed deal between Time Warner and EMI.

These investigations continued into late 2000 and were resolved by a series of concessions extracted by the European Commission. First, under pressure from the commission, Time Warner and EMI agreed to drop their proposed joint venture, thereby maintaining the level of competition in the music publishing business. Second, AOL and Time Warner agreed to allow rival Internet service providers access to online music on the same terms as AOL would receive from Warner Music Group for the next five years. Third, AOL agreed to sever all ties with Bertelsmann, and the German company agreed to withdraw from AOL Europe. These developments alleviated the commission's concern that the AOL–Time Warner combination would dominate the emerging market for the digital download of music. With these concessions in hand, the commission approved the AOL–Time Warner merger in early October 2000.

By late 2000 the AOL–Time Warner merger had been completed. The shape of the media business, both in Europe and worldwide, now looked very different, and the European Commission had played a pivotal role in determining the outcome. Its demand for concessions altered the strategy of several companies, led to somewhat different combinations from those originally planned, and, the commission believed, preserved competition in the global media business.

Sources: W. Drozdak, "EU Allows Vivendi Media Deal," *Washington Post*, October 14, 2000, p. E2; D. Hargreaves, "Business as Usual in the New Economy," *Financial Times*, October 6, 2000, p. 1; and D. Hargreaves, "Brussels Clears AOL–Time Warner Deal," *Financial Times*, October 12, 2000, p. 12.

competitors and monopolize markets. The commissioner also reviews proposed mergers and acquisitions to make sure they do not create a dominant enterprise with substantial market power.⁹ For example, in 2000 a proposed merger between Time Warner of the United States and EMI of the United Kingdom, both music recording companies, was withdrawn after the commission expressed concerns that the merger would reduce the number of major record companies from five to four and create a dominant player in the \$40 billion global music industry. Similarly, the commission blocked a proposed merger between two U.S. telecommunication companies, WorldCom and Sprint, because their combined holdings of Internet infrastructure in Europe would give the merged companies so much market power that the commission argued the combined company would dominate that market. Another example of the commission's influence over business combinations is given in the accompanying Management Focus, which looks at the commission's role in shaping mergers and joint ventures in the media industry.

The **European Council** represents the interests of member states. It is clearly the ultimate controlling authority within the EU since draft legislation from the commission can become EU law only if the council agrees. The council is composed of one representative from the government of each member state. The membership,

European Council
The ultimate controlling
authority within the EU.

however, varies depending on the topic being discussed. When agricultural issues are being discussed, the agriculture ministers from each state attend council meetings; when transportation is being discussed, transportation ministers attend, and so on. Before 1993, all council issues had to be decided by unanimous agreement between member states. This often led to marathon council sessions and a failure to make progress or reach agreement on commission proposals. In an attempt to clear the resulting logjams, the Single European Act formalized the use of majority voting rules on issues “which have as their object the establishment and functioning of a single market.” Most other issues, however, such as tax regulations and immigration policy, still require unanimity among council members if they are to become law. The votes that a country gets in the council are related to the size of the country. For example, Britain, a large country, has 29 votes, whereas Denmark, a much smaller state, has 7 votes.

European Parliament

Elected EU body that consults on issues proposed by the European Commission.

The **European Parliament**, which now has 732 members, is directly elected by the populations of the member states. The parliament, which meets in Strasbourg, France, is primarily a consultative rather than legislative body. It debates legislation proposed by the commission and forwarded to it by the council. It can propose amendments to that legislation, which the commission and ultimately the council are not obliged to take up but often will. The power of the parliament recently has been increasing, although not by as much as parliamentarians would like. The European Parliament now has the right to vote on the appointment of commissioners as well as veto some laws (such as the EU budget and single-market legislation).

One major debate waged in Europe over the past few years is whether the council or the parliament should ultimately be the most powerful body in the EU. Some in Europe expressed concern over the democratic accountability of the EU bureaucracy. One side argued that the answer to this apparent democratic deficit lay in increasing the power of the parliament, while others think that true democratic legitimacy lies with elected governments, acting through the Council of the European Union.¹⁰ After significant debate, in December 2007 the member states signed a new treaty, the **Treaty of Lisbon**, under which the power of the European Parliament is increased. Ratified by all member states by the end of 2009, the treaty makes the European Parliament the co-equal legislator for almost all European laws.¹¹ The Treaty of Lisbon also creates a new position, a president of the European Council, who will serve a 30-month term and represent the nation-states that make up the European Union. Under the treaty, the European Commission will be reduced to 18 members, with a rotation system that ensures that every member state has regular and equal membership.

The Treaty of Lisbon

Treaty signed in 2007 that made the European Parliament the co-equal legislator for almost all European laws and also created the position of the president of the European Council.

The **Court of Justice**, which is comprised of one judge from each country, is the supreme appeals court for EU law. Like commissioners, the judges are required to act as independent officials, rather than as representatives of national interests. The commission or a member country can bring other members to the court for failing to meet treaty obligations. Similarly, member countries, companies, or institutions can bring the commission or council to the court for failure to act according to an EU treaty.

Court of Justice

Supreme appeals court for EU law.

Single European Act

A 1987 act, adopted by members of the European Community, that committed member countries to establishing an economic union.

THE SINGLE EUROPEAN ACT Two revolutions occurred in Europe in the late 1980s. The first was the collapse of communism in Eastern Europe. The second revolution was much quieter, but its impact on Europe and the world may have been just as profound as the first. It was the adoption of the **Single European Act** by the member nations of the European Community (EC) in 1987. This act committed member countries to work toward establishment of a single market by December 31, 1992.

The Single European Act was born of a frustration among members that the community was not living up to its promise. By the early 1980s, it was clear that the EC had fallen short of its objectives to remove barriers to the free flow of trade and investment between member countries and to harmonize the wide range of technical and legal standards for doing business. Against this background, many of the EC's prominent businesspeople mounted an energetic campaign in the early 1980s to end the EC's economic divisions. The EC responded by creating the Delors Commission. Under the chairmanship of Jacques Delors, the commission proposed that all impediments to the formation of a single market be eliminated by December 31, 1992. The result was the Single European Act, which was independently ratified by the parliaments of each member country and became EC law in 1987.

The Objectives of the Act The purpose of the Single European Act was to have one market in place by December 31, 1992. The act proposed the following changes:¹²

- Remove all frontier controls between EC countries, thereby abolishing delays and reducing the resources required for complying with trade bureaucracy.
- Apply the principle of “mutual recognition” to product standards. A standard developed in one EC country should be accepted in another, provided it meets basic requirements in such matters as health and safety.
- Open public procurement to nonnational suppliers, reducing costs directly by allowing lower-cost suppliers into national economies and indirectly by forcing national suppliers to compete.
- Lift barriers to competition in the retail banking and insurance businesses, which should drive down the costs of financial services, including borrowing, throughout the EC.
- Remove all restrictions on foreign exchange transactions between member countries by the end of 1992.
- Abolish restrictions on cabotage—the right of foreign truckers to pick up and deliver goods within another member state's borders—by the end of 1992. Estimates suggested this would reduce the cost of haulage within the EC by 10 to 15 percent.

All those changes were predicted to lower the costs of doing business in the EC, but the single-market program was also expected to have more complicated supply-side effects. For example, the expanded market was predicted to give EC firms greater opportunities to exploit economies of scale. In addition, it was thought that the increase in competitive intensity brought about by removing internal barriers to trade and investment would force EC firms to become more efficient. To signify the importance of the Single European Act, the European Community also decided to change its name to the European Union once the act took effect.

Impact The Single European Act has had a significant impact on the EU economy.¹³ The act provided the impetus for the restructuring of substantial sections of European industry. Many firms have shifted from national to pan-European production and distribution systems in an attempt to realize scale economies and better compete in a single market.



Creation of a single financial services market in the European Union has taken longer than expected due to member states' differing regulations and the significant amount of inertia involved in getting people to accept this change.



Country FOCUS

Creating a Single Market in Financial Services

The European Union in 1999 embarked upon an ambitious action plan to create a single market in financial services by January 1, 2005. Launched a few months after the euro, the EU's single currency, the goal was to dismantle barriers to cross-border activity in financial services, creating a continent-wide market for banking service, insurance services, and investment products. In this vision of a single Europe, a citizen of France might use a German firm for basic banking services, borrow a home mortgage from an Italian institution, buy auto insurance from a Dutch enterprise, and keep her savings in mutual funds managed by a British company. Similarly, an Italian firm might raise capital from investors across Europe, using a German firm as its lead underwriter to issue stock for sale through stock exchanges in London and Frankfurt.

One main benefit of a single market, according to its advocates, would be greater competition for financial services, which would give consumers more choices, lower prices, and require financial service firms in the EU to become more efficient, thereby increasing their global competitiveness. Another major benefit would be the creation of a single European capital market. The increased liquidity of a larger capital market would make it easier for firms to borrow funds, lowering their cost of capital (the price of money) and stimulating business investment in Europe, which would create more jobs. A European Commission study suggested that the creation of a single market in financial services would increase the EU's gross domestic product by 1.1 percent a year, creating an additional €130 billion in wealth over a decade. Total business investment would increase by 6 percent annually in the long run, private consumption by 0.8 percent, and total employment by 0.5 percent a year.

Creating a single market has been anything but easy. The financial markets of different EU member states have historically been segmented from each other, and each has its own regulatory framework. In the past, EU financial services firms rarely did business across national borders because of a host of different national regulations with regard to taxation, oversight, accounting information, cross-border

takeovers, and the like, all of which had to be harmonized. To complicate matters, long-standing cultural and linguistic barriers complicated the move toward a single market. While in theory an Italian might benefit by being able to purchase homeowners' insurance from a British company, in practice he might be predisposed to purchase it from a local enterprise, even if the price were higher.

By 2010 the EU had made significant progress. More than 40 measures designed to create a single market in financial services had become EU law and others were in the pipeline. The new rules embraced issues as diverse as the conduct of business by investment firms, stock exchanges, and banks; disclosure standards for listing companies on public exchanges; and the harmonization of accounting standards across nations. However, there had also been significant setbacks. Most notably, legislation designed to make it easier for firms to make hostile cross-border acquisitions was defeated, primarily due to opposition from German members of the European Parliament, making it more difficult for financial service firms to build pan-European operations. In addition, national governments have still reserved the right to block even friendly cross-border mergers between financial service firms. For example, Italian banking law still requires the governor of the Bank of Italy to give permission to any foreign enterprise that wishes to purchase more than 5 percent of an Italian bank—and no foreigners have yet to acquire a majority position in an Italian bank, primarily, say critics, due to nationalistic concerns on the part of the Italians.

The critical issue now is enforcement of the rules that have been put in place. Some believe that it will be at least another decade before the benefits of the new regulations become apparent. In the meantime, the changes may impose significant costs on financial institutions as they attempt to deal with the new raft of regulations.

Sources: C. Randzio-Plath, "Europe Prepares for a Single Financial Market," *Intereconomic*, May–June 2004, pp. 142–46; T. Buck, D. Hargreaves, and P. Norman, "Europe's Single Financial Market," *Financial Times*, January 18, 2005, p. 17; "The Gate-keeper," *The Economist*, February 19, 2005, p. 79; P. Hofheinz, "A Capital Idea: The European Union Has a Grand Plan to Make Its Financial Markets More Efficient," *The Wall Street Journal*, October 14, 2002, p. R4; and "Banking on McCreavy: Europe's Single Market," *The Economist*, November 26, 2005, p. 91.

The results have included faster economic growth than would otherwise have been the case.

However, nearly two decades after the formation of a single market, the reality still falls short of the ideal. For example, as described in the accompanying Country Focus, it has been hard work to establish a fully functioning single market for financial services

in the EU. Thus, although the EU is undoubtedly moving toward a single marketplace, established legal, cultural, and language differences between nations mean that implementation has been uneven.

THE ESTABLISHMENT OF THE EURO In December 1991, EC members signed a treaty (the **Maastricht Treaty**) that committed them to adopting a common currency by January 1, 1999.¹⁴ The euro is now used by 16 of the 27 member states of the European Union; these 16 states are members of what is often referred to as the euro zone. It encompasses 330 million EU citizens and includes the powerful economies of Germany and France. Many of the countries that joined the EU on May 1, 2004, and the two that joined in 2007, will adopt the euro when they fulfill certain economic criteria—a high degree of price stability, a sound fiscal situation, stable exchange rates, and converged long-term interest rates. The current members had to meet the same criteria.

Establishment of the euro has rightly been described as an amazing political feat with few historical precedents. Establishing the euro required participating national governments not only to give up their own currencies, but also to give up control over monetary policy. Governments do not routinely sacrifice national sovereignty for the greater good, indicating the importance that the Europeans attach to the euro. By adopting the euro, the EU has created the second most widely traded currency in the world after that of the U.S. dollar. Some believe that ultimately the euro could come to rival the dollar as the most important currency in the world.

Three long-term EU members, Great Britain, Denmark, and Sweden, are still sitting on the sidelines. The countries agreeing to the euro locked their exchange rates against each other January 1, 1999. Euro notes and coins were not actually issued until January 1, 2002. In the interim, national currencies circulated in each of the 12 countries. However, in each participating state, the national currency stood for a defined amount of euros. After January 1, 2002, euro notes and coins were issued and the national currencies were taken out of circulation. By mid-2002, all prices and routine economic transactions within the euro zone were in euros.

Benefits of the Euro Europeans decided to establish a single currency in the EU for a number of reasons. First, they believe that businesses and individuals will realize significant savings from having to handle one currency, rather than many. These savings come from lower foreign exchange and hedging costs. For example, people going from Germany to France no longer have to pay a commission to a bank to change German deutsche marks into French francs. Instead, they use euros. According to the European Commission, such savings amount to 0.5 percent of the European Union's GDP, or about \$55 billion a year.

Second, and perhaps more importantly, the adoption of a common currency makes it easier to compare prices across Europe. This has been increasing competition because it has become easier for consumers to shop around. For example, if a German finds that cars sell for less in France than Germany, he may be tempted to purchase from a French car dealer rather than his local car dealer. Alternatively, traders may engage in arbitrage to exploit such price differentials, buying cars in France and reselling them in Germany. The only way that German car dealers will be able to hold on to business in the face of such competitive pressures will be to reduce the prices they charge for cars. As a consequence of such pressures, the introduction of a common currency has led to lower prices, which translates into substantial gains for European consumers.

Third, faced with lower prices, European producers have been forced to look for ways to reduce their production costs to maintain their profit margins. The introduction

Maastricht Treaty

Treaty agreed to in 1991, but not ratified until January 1, 1994, that committed the 12 member states of the European Community to adopt a common currency.

of a common currency, by increasing competition, has produced long-run gains in the economic efficiency of European companies.

Fourth, the introduction of a common currency has given a boost to the development of a highly liquid pan-European capital market. Over time, the development of such a capital market should lower the cost of capital and lead to an increase in both the level of investment and the efficiency with which investment funds are allocated. This could be especially helpful to smaller companies that have historically had difficulty borrowing money from domestic banks. For example, the capital market of Portugal is very small and illiquid, which makes it extremely difficult for bright Portuguese entrepreneurs with a good idea to borrow money at a reasonable price. However, in theory, such companies can now tap a much more liquid pan-European capital market.

Finally, the development of a pan-European, euro-denominated capital market will increase the range of investment options open to both individuals and institutions. For example, it will now be much easier for individuals and institutions based in, let's say, Holland to invest in Italian or French companies. This will enable European investors to better diversify their risk, which again lowers the cost of capital, and should also increase the efficiency with which capital resources are allocated.¹⁵

Costs of the Euro The drawback, for some, of a single currency is that national authorities have lost control over monetary policy. Thus, it is crucial to ensure that the EU's monetary policy is well managed. The Maastricht Treaty called for establishment of the independent European Central Bank (ECB), similar in some respects to the U.S. Federal Reserve, with a clear mandate to manage monetary policy so as to ensure price stability. The ECB, based in Frankfurt, is meant to be independent from political pressure—although critics question this. Among other things, the ECB sets interest rates and determines monetary policy across the euro zone.

The implied loss of national sovereignty to the ECB underlies the decision by Great Britain, Denmark, and Sweden to stay out of the euro zone for now. Many in these countries are suspicious of the ECB's ability to remain free from political pressure and to keep inflation under tight control.

In theory, the design of the ECB should ensure that it remains free of political pressure. The ECB is modeled on the German Bundesbank, which historically has been the most independent and successful central bank in Europe. The Maastricht Treaty prohibits the ECB from taking orders from politicians. The executive board of the bank, which consists of a president, vice president, and four other members, carries out policy by issuing instructions to national central banks. The policy itself is determined by the governing council, which consists of the executive board plus the central bank governors from the 17 euro zone countries. The governing council votes on interest rate changes. Members of the executive board are appointed for eight-year nonrenewable terms, insulating them from political pressures to get reappointed. Nevertheless, the jury is still out on the issue of the ECB's independence, and it will take some time for the bank to establish its credentials.

According to critics, another drawback of the euro is that the EU is not what economists would call an optimal currency area. In an **optimal currency area**, similarities in the underlying structure of economic activity make it feasible to adopt a single currency and use a single exchange rate as an instrument of macroeconomic policy. Many of the European economies in the euro zone, however, are very dissimilar. For example, Finland and Portugal have different wage rates, tax regimes, and business cycles, and they may react very differently to external economic shocks. A change in the euro exchange rate that helps Finland may hurt Portugal. Obviously, such differences complicate macroeconomic policy. For example, when euro economies are not growing in unison, a common monetary policy may mean that interest

Optimal Currency Area

One where similarities in the underlying structure of economic activity make it feasible to adopt a single currency.

rates are too high for depressed regions and too low for booming regions. It will be interesting to see how the European Union copes with the strains caused by such divergent economic performance.

One way of dealing with such divergent effects within the euro zone might be for the EU to engage in fiscal transfers, taking money from prosperous regions and pumping it into depressed regions. Such a move, however, would open a political can of worms. Would the citizens of Germany forgo their “fair share” of EU funds to create jobs for underemployed Portuguese workers?

Some critics believe that the euro puts the economic cart before the political horse. In their view, a single currency should follow, not precede, political union. They argue that the euro will unleash enormous pressures for tax harmonization and fiscal transfers from the center, both policies that cannot be pursued without the appropriate political structure. The most apocalyptic vision that flows from these negative views is that far from stimulating economic growth, as its advocates claim, the euro will lead to lower economic growth and higher inflation within Europe. To quote one critic:

Imposing a single exchange rate and an inflexible exchange rate on countries that are characterized by different economic shocks, inflexible wages, low labor mobility, and separate national fiscal systems without significant cross-border fiscal transfers will raise the overall level of cyclical unemployment among EMU members. The shift from national monetary policies dominated by the (German) Bundesbank within the European Monetary System to a European Central Bank governed by majority voting with a politically determined exchange rate policy will almost certainly raise the average future rate of inflation.¹⁶

The Experience to Date Since its establishment January 1, 1999, the euro has had a volatile trading history against the world’s major currency, the U.S. dollar. After starting life in 1999 at €1 = \$1.17, the euro steadily fell until it reached a low of €1 = \$0.83 in October 2000, leading critics to claim the euro was a failure. A major reason for the fall in the euro’s value was that international investors were investing money in booming U.S. stocks and bonds and taking money out of Europe to finance this investment. In other words, they were selling euros to buy dollars so that they could invest in dollar-denominated assets. This increased the demand for dollars and decreased the demand for the euro, driving the value of the euro down.

The fortunes of the euro began improving in late 2001 when the dollar weakened, and the currency stood at a robust all-time high of €1 = \$1.54 in early March 2008. One reason for the rise in the value of the euro was that the flow of capital into the United States had stalled as the U.S. financial markets fell.¹⁷ Many investors were now taking money out of the United States, selling dollar-denominated assets such as U.S. stocks and bonds, and purchasing euro-denominated assets. Falling demand for U.S. dollars and rising demand for euros translated into a fall in the value of the dollar against the euro. Furthermore, in a vote of confidence in both the euro and the ability of the ECB to manage monetary policy within the euro zone, many foreign central banks added more



Another Perspective

What to Do about Greece?

Since its establishment in 1994, no member nation of the European Union (EU) has skated as close to insolvency as Greece, which in early 2010 announced its national deficit had soared to nearly 13 percent of gross domestic product. Under pressure from the EU, the Greek government crafted a stringent austerity program that includes sales tax hikes on alcohol, tobacco, and fuel; a tax on luxury goods; and deep wage cuts for civil servants. These moves persuaded the EU to announce it would support Greece with a bailout, if needed. The bailout, should it occur, would be the first in EU history. (Stephen Castle and Niki Kitsantonis, “E.U. Endorses Greek Austerity Efforts,” *The New York Times*, March 4, 2010, www.nytimes.com)



Country FOCUS

Crisis in the Euro Zone

When the euro was established, some critics worried that free-spending countries in the euro zone (such as Italy) might borrow excessively, running up large public-sector deficits that they could not finance. This would then rock the value of the euro, requiring their more sober brethren, such as Germany or France, to step in and bail out the profligate nation. In early 2010, this worry was fast becoming a reality as a financial crisis in Greece rocked the value of the euro.

The financial crisis had its roots in a decade of free spending by the Greek government. The government ran up a high level of debt to finance extensive spending in the public sector. Much of the increase in spending could be characterized as an attempt by the government to buy off powerful interest groups in Greek society, from teachers and farmers to public employees, rewarding them with high pay and extensive benefits. To make matters worse, the government misled the international community about the level of its indebtedness. In October 2009 a new government took power and quickly announced that the 2009 deficit, which had been projected to be around 5 percent, would actually be around 12.7 percent. The previous government had apparently been cooking the books.

This shattered any faith that international investors might have had in the Greek economy. Interest rates on Greek government debt soared to 7.1 percent, about 4 percentage points higher than the rate on German bonds.

Two of the three international rating agencies also cut their ratings on Greek bonds and warned that further downgrades were likely. The main concern now was that the Greek government might not be able to refinance some €20 billion of debt that matured in April or May 2010. A further concern was that the Greek government might lack the political willpower to make the large cuts in public spending necessary to bring down the deficit and restore investor confidence. This raised the specter that either the IMF, or the European Central Bank with the support of Germany and France, would have to step in and bail out the Greek government, imposing fiscal discipline on the country in return for loans that would keep the country from defaulting on its debt.

Nor was Greece alone in having large public-sector deficits. Three other euro zone countries—Spain, Portugal, and Ireland—also all had large debt loads, and interest rates on their bonds also surged as investors sold out. This raised the specter of financial contagion, with large-scale defaults among the weaker members of the euro zone. If this did occur, the EU and IMF would most certainly have to step in and rescue the troubled nations. With this possibility, once considered very remote, investors started to move money out of euros, and the value of the euro started to fall on the foreign exchange market.

Sources: "A very European Crisis," *The Economist*, February 6, 2010, pp. 75–77; and L. Thomas, "Is Debt Trashing the Euro?" *The New York Times*, February 7, 2010, pp. 1, 7.

euros to their supply of foreign currencies. In the first three years of its life, the euro never reached the 13 percent of global reserves made up by the deutsche mark and other former euro zone currencies. The euro didn't jump that hurdle until early 2002, but by 2004 it made up 20 percent of global reserves. Currency specialists expected the growing U.S. current account deficit, which reached 7 percent of GDP in 2005, to drive the dollar down further, and the euro still higher over the next two to four years.¹⁸ In 2007 this started to occur, with the euro appreciating steadily against the dollar from 2005 until early 2008. Since the euro has weakened somewhat, reflecting concerns over slow economic growth and growing budget deficits among several EU member states, particularly Greece, Portugal and Spain (see the accompanying Country Focus for more details). Nevertheless, in early 2010 the exchange rate, which stood at €1 = \$1.35, was still strong compared to the exchange rate in the early 2000s. While the strong euro has been a source of pride for Europeans, it does make it harder for euro zone exporters to sell their goods abroad.

ENLARGEMENT OF THE EUROPEAN UNION A major issue facing the EU over the past few years has been that of enlargement. Enlargement of the EU into Eastern Europe has been a possibility since the collapse of communism at the end of

the 1980s, and by the end of the 1990s, 13 countries had applied to become EU members. To qualify for EU membership the applicants had to privatize state assets, deregulate markets, restructure industries, and tame inflation. They also had to enshrine complex EU laws into their own systems, establish stable democratic governments, and respect human rights.¹⁹ In December 2002, the EU formally agreed to accept the applications of 10 countries, and they joined May 1, 2004. The new members include the Baltic countries, the Czech Republic, and the larger nations of Hungary and Poland. The only new members not in Eastern Europe are the Mediterranean island nations of Malta and Cyprus. Their inclusion in the EU expanded the union to 25 states, stretching from the Atlantic to the borders of Russia; added 23 percent to the land-mass of the EU; brought 75 million new citizens into the EU, building an EU with a population of 450 million people; and created a single continental economy with a GDP of close to €11 trillion. In 2007, Bulgaria and Romania joined, bringing total membership to 27 nations.

The new members were not able to adopt the euro until at least 2007 (and 2010 in the case of the latest entrants), and free movement of labor between the new and existing members was not allowed until then. Consistent with theories of free trade, the enlargement should create added benefits for all members. However, given the small size of the Eastern European economies (together they amount to only 5 percent of the GDP of current EU members) the initial impact will probably be small. The biggest notable change might be in the EU bureaucracy and decision-making processes, where budget negotiations among 27 nations are bound to prove more problematic than negotiations among 15 nations.

Left standing at the door is Turkey. Turkey, which has long lobbied to join the union, presents the EU with some difficult issues. The country has had a customs union with the EU since 1995, and about half of its international trade is already with the EU. However, full membership has been denied because of concerns over human rights issues (particularly Turkish policies toward its Kurdish minority). In addition, some on the Turk side suspect the EU is not eager to let a primarily Muslim nation of 66 million people, which has one foot in Asia, join the EU. The European Union formally indicated in December 2002 that it would allow the Turkish application to proceed with no further delay in December 2004 if the country improved its human rights record to the satisfaction of the EU. In 2004 the EU agreed to allow Turkey to start accession talks in October 2005, but those talks are not moving along rapidly, and the nation will not join until 2013, if at all.

Regional Economic Integration in the Americas

No other attempt at regional economic integration comes close to the EU in its boldness or its potential implications for the world economy, but regional economic integration is on the rise in the Americas. The most significant attempt is the North American Free Trade Agreement. In addition to NAFTA, several other trade blocs are in the offing in the Americas (see Map 8.2), the most significant of which appear to be the Andean Community and Mercosur. Also, negotiations are under way to establish a hemisphere-wide Free Trade Area of the Americas (FTAA), although currently they seem to be stalled.

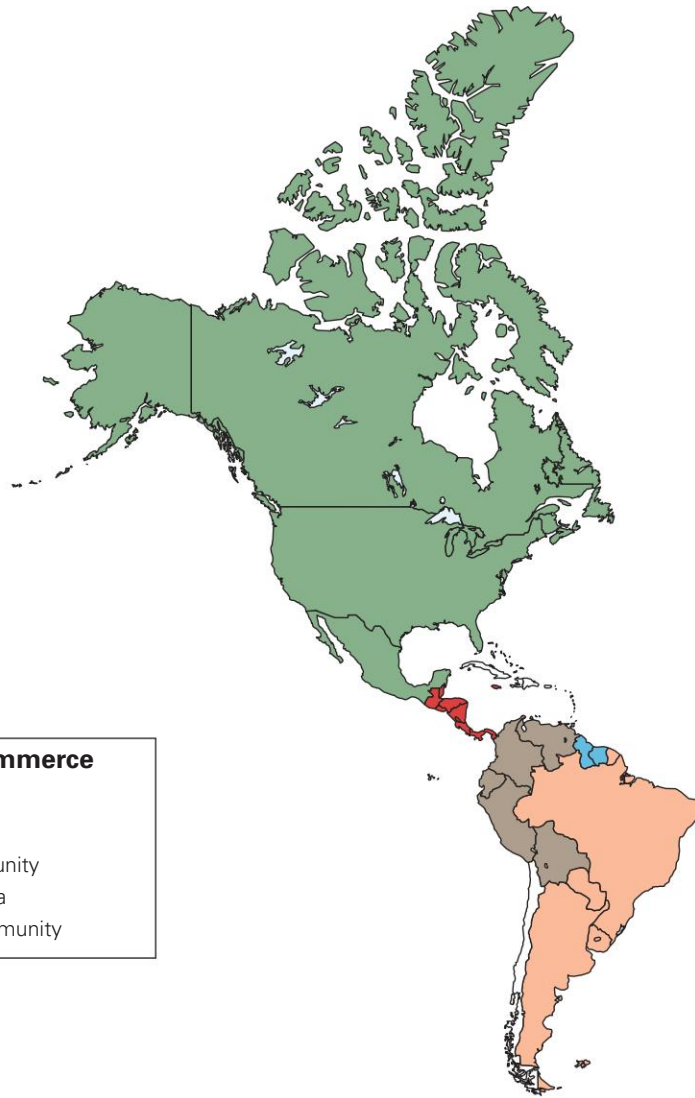
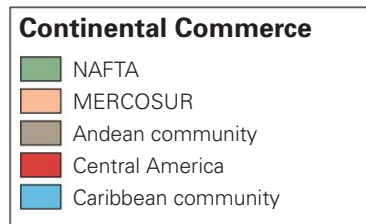
THE NORTH AMERICAN FREE TRADE AGREEMENT The governments of the United States and Canada in 1988 agreed to enter into a free trade agreement, which took effect January 1, 1989. The goal of the agreement was to eliminate

LEARNING OBJECTIVE 4

Explain the history, current scope, and future prospects of the world's most important regional economic agreements.

Economic Integration in the Americas

Source: *The Economist*, April 21, 2001, p. 20. Copyright © 2001 The Economist Newspaper Ltd. All rights reserved. Reprinted with permission. Further reproduction prohibited. www.economist.com



North American Free Trade Agreement (NAFTA)

Free trade area between Canada, Mexico, and the United States.

all tariffs on bilateral trade between Canada and the United States by 1998. This was followed in 1991 by talks among the United States, Canada, and Mexico aimed at establishing a **North American Free Trade Agreement** for the three countries. The talks concluded in August 1992 with an agreement in principle, and the following year the agreement was ratified by the governments of all three countries. The agreement became law January 1, 1994.²⁰

NAFTA'S Contents The contents of NAFTA include the following:

- Abolition by 2004 of tariffs on 99 percent of the goods traded between Mexico, Canada, and the United States.
- Removal of most barriers on the cross-border flow of services, allowing financial institutions, for example, unrestricted access to the Mexican market by 2000.
- Protection of intellectual property rights.

- Removal of most restrictions on foreign direct investment between the three member countries, although special treatment (protection) will be given to Mexican energy and railway industries, American airline and radio communications industries, and Canadian culture.
- Application of national environmental standards, provided such standards have a scientific basis. Lowering of standards to lure investment is described as being inappropriate.
- Establishment of two commissions with the power to impose fines and remove trade privileges when environmental standards or legislation involving health and safety, minimum wages, or child labor are ignored.

The Case for NAFTA Proponents of NAFTA have argued that the free trade area should be viewed as an opportunity to create an enlarged and more efficient productive base for the entire region. Advocates acknowledge that one effect of NAFTA would be that some U.S. and Canadian firms would move production to Mexico to take advantage of lower labor costs. (In 2004, the average hourly labor cost in Mexico was still one-tenth of that in the United States and Canada.) Movement of production to Mexico, they argued, was most likely to occur in low-skilled, labor-intensive manufacturing industries where Mexico might have a comparative advantage. Advocates of NAFTA argued that many would benefit from such a trend. Mexico would benefit from much-needed inward investment and employment. The United States and Canada would benefit because the increased incomes of the Mexicans would allow them to import more U.S. and Canadian goods, thereby increasing demand and making up for the jobs lost in industries that moved production to Mexico. U.S. and Canadian consumers would benefit from the lower prices of products made in Mexico. In addition, the international competitiveness of U.S. and Canadian firms that move production to Mexico to take advantage of lower labor costs would be enhanced, enabling them to better compete with Asian and European rivals.

The Case against NAFTA Those who opposed NAFTA claimed that ratification would be followed by a mass exodus of jobs from the United States and Canada into Mexico as employers sought to profit from Mexico's lower wages and less strict environmental and labor laws. According to one extreme opponent, Ross Perot, up to 5.9 million U.S. jobs would be lost to Mexico after NAFTA in what he famously characterized as a "giant sucking sound." Most economists, however, dismissed these numbers as being absurd and alarmist. They argued that Mexico would have to run a bilateral trade surplus with the United States of close to \$300 billion for job loss on such a scale to occur—and \$300 billion was the size of Mexico's GDP. In other words, such a scenario seemed implausible.

More sober estimates of the impact of NAFTA ranged from a net creation of 170,000 jobs in the United States (due to increased Mexican demand for U.S. goods and services) and an increase of \$15 billion per year to the joint U.S. and Mexican GDP, to a net loss of 490,000 U.S. jobs. To put these numbers in perspective, employment in the U.S. economy was predicted to grow by 18 million from 1993 to 2003. As most economists repeatedly stressed, NAFTA would have a small impact on both Canada and the United States. It could hardly be any other way, since the Mexican economy was only 5 percent of the size of the U.S. economy. Signing NAFTA required the largest leap of economic faith from Mexico rather than Canada or the United States. Falling trade barriers would expose Mexican firms to highly efficient U.S. and Canadian competitors that, when compared to the average Mexican firm, had



Many workers in the United States initially believed that NAFTA would take away their jobs as employers looked for cheaper labor in Mexico. However, a 1996 study by researchers at the University of California–Los Angeles concluded the impact on jobs was a net gain of 3,000 for the United States in the first two years of the NAFTA regime.

far greater capital resources, access to highly educated and skilled workforces, and much greater technological sophistication. The short-run outcome was likely to be painful economic restructuring and unemployment in Mexico. But advocates of NAFTA claimed there would be long-run dynamic gains in the efficiency of Mexican firms as they adjusted to the rigors of a more competitive marketplace. To the extent that this occurred, they argued, Mexico's economic growth rate would accelerate, and Mexico might become a major market for Canadian and U.S. firms.²¹

Environmentalists also voiced concerns about NAFTA. They pointed to the sludge in the Rio Grande River and the smog in the air over Mexico City and warned that Mexico could degrade clean air and toxic waste standards across the continent. They pointed out that the lower Rio Grande was the most polluted river in the United States, and that with NAFTA, chemical waste and sewage would increase along its course from El Paso, Texas, to the Gulf of Mexico.

There was also opposition in Mexico to NAFTA from those who feared a loss of national sovereignty. Mexican critics argued that their country would be dominated by U.S. firms that would not really contribute to Mexico's economic growth, but instead would use Mexico as a low-cost assembly site, while keeping their high-paying, high-skilled jobs north of the border.

NAFTA: The Results Studies of NAFTA's impact to date suggest its initial effects were at best muted, and both advocates and detractors may have been guilty of exaggeration.²² On average, studies indicate that NAFTA's overall impact has been small but positive.²³ From 1993 to 2005, trade between NAFTA's partners grew by 250 percent.²⁴ Canada and Mexico are now the number one and two trade partners of the United States, suggesting the economies of the three NAFTA nations have become more closely integrated. In 1990, U.S. trade with Canada and Mexico accounted for

about a quarter of total U.S. trade. By 2005, the figure was close to one-third. Canada's trade with its NAFTA partners increased from about 70 percent to more than 80 percent of all Canadian foreign trade between 1993 and 2005, while Mexico's trade with NAFTA increased from 66 percent to 80 percent over the same period. All three countries also experienced strong productivity growth over this period. In Mexico, labor productivity has increased by 50 percent since 1993, and the passage of NAFTA may have contributed to this. However, estimates suggest that employment effects of NAFTA have been small. The most pessimistic estimates suggest the United States lost 110,000 jobs per year due to NAFTA between 1994 and 2000—and many economists dispute this figure—which is tiny compared to the more than 2 million jobs a year created in the United States during the same period. Perhaps the most significant impact of NAFTA has not been economic, but political. Many observers credit NAFTA with helping to create the background for increased political stability in Mexico. Mexico is now viewed as a stable democratic nation with a steadily growing economy, something that is beneficial to the United States, which shares a 2,000-mile border with the country.²⁵

Enlargement One issue confronting NAFTA is that of enlargement. A number of other Latin American countries have indicated their desire to eventually join NAFTA. The governments of both Canada and the United States are adopting a wait-and-see attitude with regard to most countries. Getting NAFTA approved was a bruising political experience, and neither government is eager to repeat the process soon. Nevertheless, the Canadian, Mexican, and U.S. governments began talks in 1995 regarding Chile's possible entry into NAFTA. As of 2008, however, these talks had yielded little progress, partly because of political opposition in the U.S. Congress to expanding NAFTA. In December 2002, however, the United States and Chile did sign a bilateral free trade pact.

THE ANDEAN COMMUNITY Bolivia, Chile, Ecuador, Colombia, and Peru signed an agreement in 1969 to create the Andean Pact. The **Andean Pact** was largely based on the EU model, but was far less successful at achieving its stated goals. The integration steps begun in 1969 included an internal tariff reduction program, a common external tariff, a transportation policy, a common industrial policy, and special concessions for the smallest members, Bolivia and Ecuador.

By the mid-1980s, the Andean Pact had all but collapsed and had failed to achieve any of its stated objectives. There was no tariff-free trade between member countries, no common external tariff, and no harmonization of economic policies. Political and economic problems seem to have hindered cooperation between member countries. The countries of the Andean Pact have had to deal with low economic growth, hyperinflation, high unemployment, political unrest, and crushing debt burdens. In addition, the dominant political ideology in many of the Andean countries during this period tended toward the radical/socialist end of the political spectrum. Since such an ideology is hostile to the free market economic principles on which the Andean Pact was based, progress toward closer integration could not be expected.

The tide began to turn in the late 1980s when, after years of economic decline, the governments of Latin America began to adopt free market economic policies. In 1990, the heads of the five current members of the Andean Community—Bolivia, Ecuador, Peru, Colombia, and Venezuela—met in the Galápagos Islands. The resulting Galápagos Declaration effectively relaunched the Andean Pact, which was renamed the Andean Community in 1997. The declaration's objectives included the establishment of a free trade area by 1992, a customs union by 1994, and a common market by 1995. This last

Andean Pact

A 1969 agreement between Bolivia, Chile, Ecuador, Colombia, and Peru to establish a customs union.

milestone has not been reached. A customs union was implemented in 1995, although until 2003 Peru opted out and Bolivia received preferential treatment. The Andean Community now operates as a customs union. In December 2003, it signed an agreement with Mercosur to restart stalled negotiations on the creation of a free trade area between the two trading blocs. Those negotiations are currently proceeding at a slow pace. In late 2006, Venezuela withdrew from the Andean Community as part of that country's attempts to join Mercosur.

Mercosur

Pact between Argentina, Brazil, Paraguay, and Uruguay to establish a free trade area.

MERCOSUR Mercosur originated in 1988 as a free trade pact between Brazil and Argentina. The modest reductions in tariffs and quotas accompanying this pact reportedly helped bring about an 80 percent increase in trade between the two countries in the late 1980s.²⁶ This success encouraged the expansion of the pact in March 1990 to include Paraguay and Uruguay. In 2006, Venezuela signed a membership agreement, although this has yet to be ratified and it may take years for Venezuela to become a full member.

The initial aim of Mercosur was to establish a full free trade area by the end of 1994 and a common market sometime thereafter. In December 1995, Mercosur's members agreed to a five-year program under which they hoped to perfect their free trade area and move toward a full customs union—something that has yet to be achieved.²⁷ For its first eight years or so, Mercosur seemed to be making a positive contribution to the economic growth rates of its member states. Trade between Mercosur's four core members quadrupled between 1990 and 1998. The combined GDP of the four member states grew at an annual average rate of 3.5 percent between 1990 and 1996, a performance that is significantly better than the four attained during the 1980s.²⁸

However, Mercosur had its critics, including Alexander Yeats, a senior economist at the World Bank, who wrote a stinging critique of the pact.²⁹ According to Yeats, the trade diversion effects of Mercosur outweigh its trade creation effects. Yeats pointed out that the fastest-growing items in intra-Mercosur trade were cars, buses, agricultural equipment, and other capital-intensive goods that are produced relatively inefficiently in the four member countries. In other words, Mercosur countries, insulated from outside competition by tariffs that run as high as 70 percent of value on motor vehicles, are investing in factories that build products that are too expensive to sell to anyone but themselves. The result, according to Yeats, is that Mercosur countries might not be able to compete globally once the group's external trade barriers come down. In the meantime, capital is being drawn away from more efficient enterprises. In the near term, countries with more efficient manufacturing enterprises lose because Mercosur's external trade barriers keep them out of the market.

Mercosur hit a significant roadblock in 1998, when its member states slipped into recession and intrabloc trade slumped. Trade fell further in 1999 following a financial crisis in Brazil that led to the devaluation of the Brazilian real, which immediately made the goods of other Mercosur members 40 percent more expensive in Brazil, their largest export market. At this point, progress toward establishing a full customs union all but stopped. Things deteriorated further in 2001 when Argentina, beset by economic stresses, suggested the customs union be temporarily suspended. Argentina wanted to suspend Mercosur's tariff so that it could abolish duties on imports of capital equipment, while raising those on consumer goods to 35 percent (Mercosur had established a 14 percent import tariff on both sets of goods). Brazil agreed to this request, effectively halting Mercosur's quest to become a fully functioning customs union.³⁰ Hope for a revival arose in 2003 when new Brazilian President Lula da Silva announced his support for a revitalized and expanded Mercosur modeled after the

EU with a larger membership, a common currency, and a democratically elected parliament.³¹ As of 2010, however, little progress had been made in moving Mercosur down that road, and critics felt that the customs union was, if anything, becoming more imperfect over time.³²

CENTRAL AMERICAN COMMON MARKET, CAFTA, AND CARICOM

Two other trade pacts in the Americas have not made much progress. In the early 1960s, Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua attempted to set up a **Central American Common Market**. It collapsed in 1969 when war broke out between Honduras and El Salvador after a riot at a soccer match between teams from the two countries. Since then the six member countries have made some progress toward reviving their agreement (the five founding members were joined by the Dominican Republic). The proposed common market was given a boost in 2003 when the United States signaled its intention to enter into bilateral free trade negotiations with the group. These culminated in a 2005 agreement to establish a free trade agreement between the six countries and the United States. Known as the **Central America Free Trade Agreement**, or CAFTA, the aim is to lower trade barriers between the United States and the six countries for most goods and services.

A customs union was to have been created in 1991 between the English-speaking Caribbean countries under the auspices of the Caribbean Community. Referred to as **CARICOM**, it was established in 1973. However, it repeatedly failed to progress toward economic integration. A formal commitment to economic and monetary union was adopted by CARICOM's member states in 1984, but since then little progress has been made. In October 1991, the CARICOM governments failed, for the third consecutive time, to meet a deadline for establishing a common external tariff. Despite this, CARICOM expanded to 15 members by 2005. In early 2006, six CARICOM members established the **Caribbean Single Market and Economy (CSME)**. Modeled on the EU's single market, the goal of CSME is to lower trade barriers and harmonize macroeconomic and monetary policy between member states.³³

FREE TRADE AREA OF THE AMERICAS At a hemisphere-wide Summit of the Americas in December 1994, a Free Trade Area of the Americas (FTAA) was proposed. It took more than three years for the talks to start, but in April 1998, 34 heads of state traveled to Santiago, Chile, for the second Summit of the Americas where they formally inaugurated talks to establish an FTAA by January 1, 2005—something that didn't occur. The continuing talks have addressed a wide range of economic, political, and environmental issues related to cross-border trade and investment. Although both the United States and Brazil were early advocates of the FTAA, support from both countries seems to be mixed at this point. Because the United States and Brazil have the largest economies in North and South America, respectively, strong U.S. and Brazilian support is a precondition for establishment of the free trade area.

The major stumbling blocks so far have been twofold. First, the United States wants its southern neighbors to agree to tougher enforcement of intellectual property rights and lower manufacturing tariffs, which they do not seem to be eager to embrace. Second, Brazil and Argentina want the United States to reduce its subsidies to U.S. agricultural producers and scrap tariffs on agricultural imports, which the U.S. government does not seem inclined to do. For progress to be made, most observers agree that the United States and Brazil have to first reach an agreement on these crucial issues.³⁴ If the FTAA is eventually established, it will have major implications for

Central American Common Market

A trade pact between Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua, which began in the early 1960s but collapsed in 1969 due to war.

Central America Free Trade Agreement (CAFTA)

The agreement of the member states of the Central American Common Market joined by the Dominican Republic to trade freely with the United States.

CARICOM

An association of English-speaking Caribbean states that are attempting to establish a customs union.

Caribbean Single Market and Economy (CSME)

Unites six CARICOM members in agreeing to lower trade barriers and harmonize macroeconomic and monetary policies.

cross-border trade and investment flows within the hemisphere. The FTAA would open a free trade umbrella over 850 million people who accounted for some \$18 trillion in GDP in 2008.

Currently, however, FTAA is very much a work in progress, and the progress has been slow. The most recent attempt to get talks going again, in November 2005 at a summit of 34 heads of state from North and South America, failed when opponents, led by Venezuela's populist president, Hugo Chavez, blocked efforts by the Bush administration to set an agenda for further talks on FTAA. In voicing his opposition, Chavez condemned the U.S. free trade model as a "perversion" that would unduly benefit the United States, to the detriment of poor people in Latin America whom Chavez claims have not benefited from free trade details.³⁵ Such views make it unlikely that there will be much progress on establishing a FTAA in the near term.

Regional Economic Integration Elsewhere

LEARNING OBJECTIVE 4

Explain the history, current scope, and future prospects of the world's most important regional economic agreements.

Numerous attempts at regional economic integration have been tried throughout Asia and Africa. However, few exist in anything other than name. Perhaps the most significant is the Association of Southeast Asian Nations (ASEAN). In addition, the Asia-Pacific Economic Cooperation (APEC) forum has recently emerged as the seed of a potential free trade region.

ASSOCIATION OF SOUTHEAST ASIAN NATIONS Formed in 1967, the **Association of Southeast Asian Nations (ASEAN)** includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam. Laos, Myanmar, Vietnam, and Cambodia have all joined recently, creating a regional grouping of 500 million people with a combined GDP of some \$740 billion (see Map 8.3). The basic objective of ASEAN is to foster freer trade between member countries and to achieve cooperation in their industrial policies. Progress so far has been limited, however.

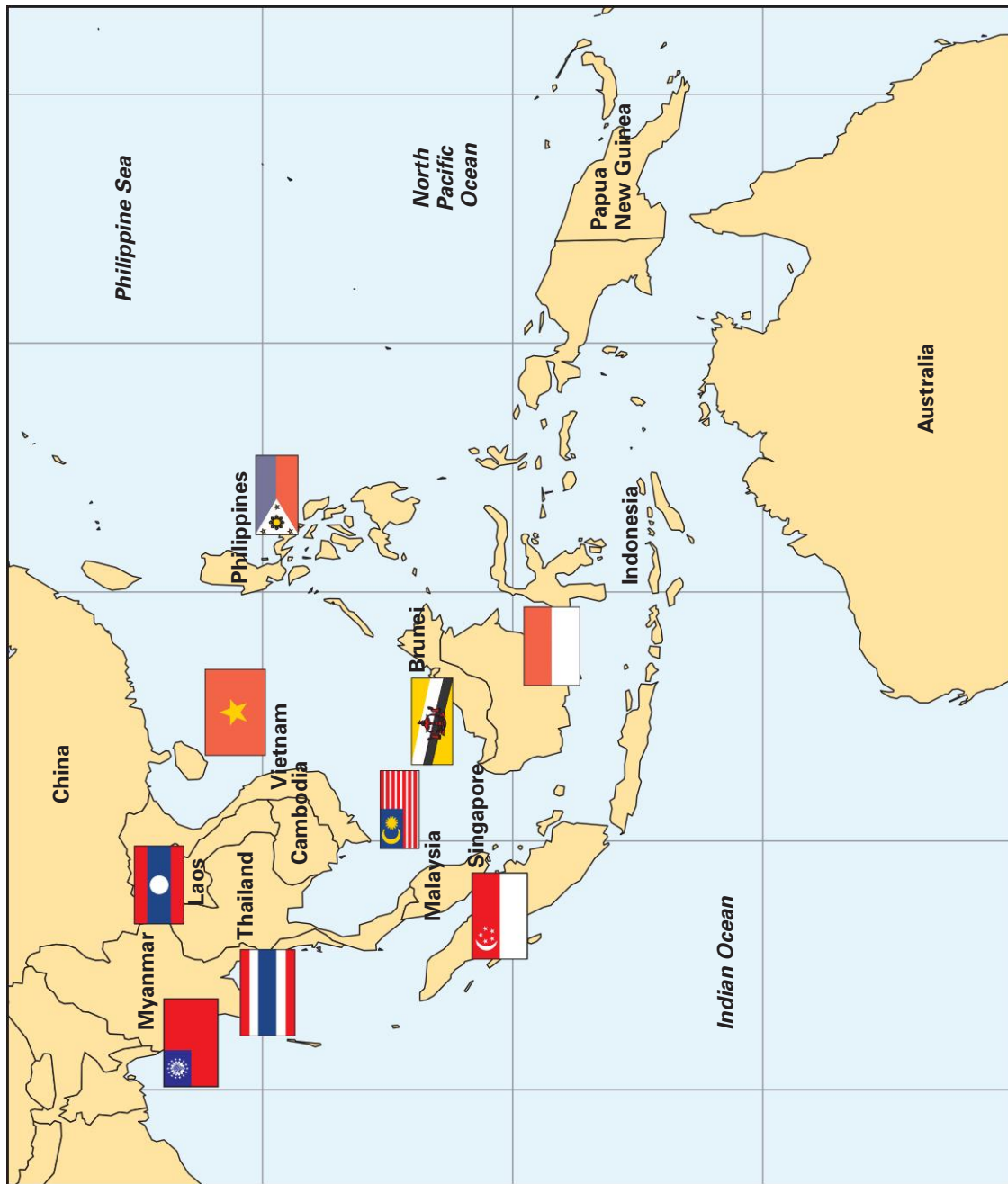
Until recently only 5 percent of intra-ASEAN trade consisted of goods whose tariffs had been reduced through an ASEAN preferential trade arrangement. This may be changing. In 2003, an ASEAN Free Trade Area (AFTA) between the six original members of ASEAN came into full effect. The AFTA has cut tariffs on manufacturing and agricultural products to less than 5 percent. However, there are some significant exceptions to this tariff reduction. Malaysia, for example, refused to bring down tariffs on imported cars until 2005 and then agreed to only lower the tariff to 20 percent, not the 5 percent called for under the AFTA. Malaysia wanted to protect Proton, an inefficient local carmaker, from foreign competition. Similarly, the Philippines has refused to lower tariff rates on petrochemicals, and rice, the largest agricultural product in the region, will remain subject to higher tariff rates until at least 2020.³⁶

Notwithstanding such issues, ASEAN and AFTA are at least progressing toward establishing a free trade zone. Vietnam joined the AFTA in 2006, Laos and Myanmar in 2008, and Cambodia in 2010. The goal was to reduce import tariffs among the six original members to zero by 2010, and to do so by 2015 for the newer members (although important exceptions to that goal, such as tariffs on rice, will persist).

ASEAN also recently signed a free trade agreement with China. This went into effect January 1, 2010. Trade between China and ASEAN members more than tripled during the first decade of the 21st century, and this agreement should spur further growth. The agreement between ASEAN and China removes tariffs on 90 percent of traded goods.³⁷

Association of Southeast Asian Nations (ASEAN)

An attempt to establish a free trade area between Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam.



8.3 map ASEAN Countries

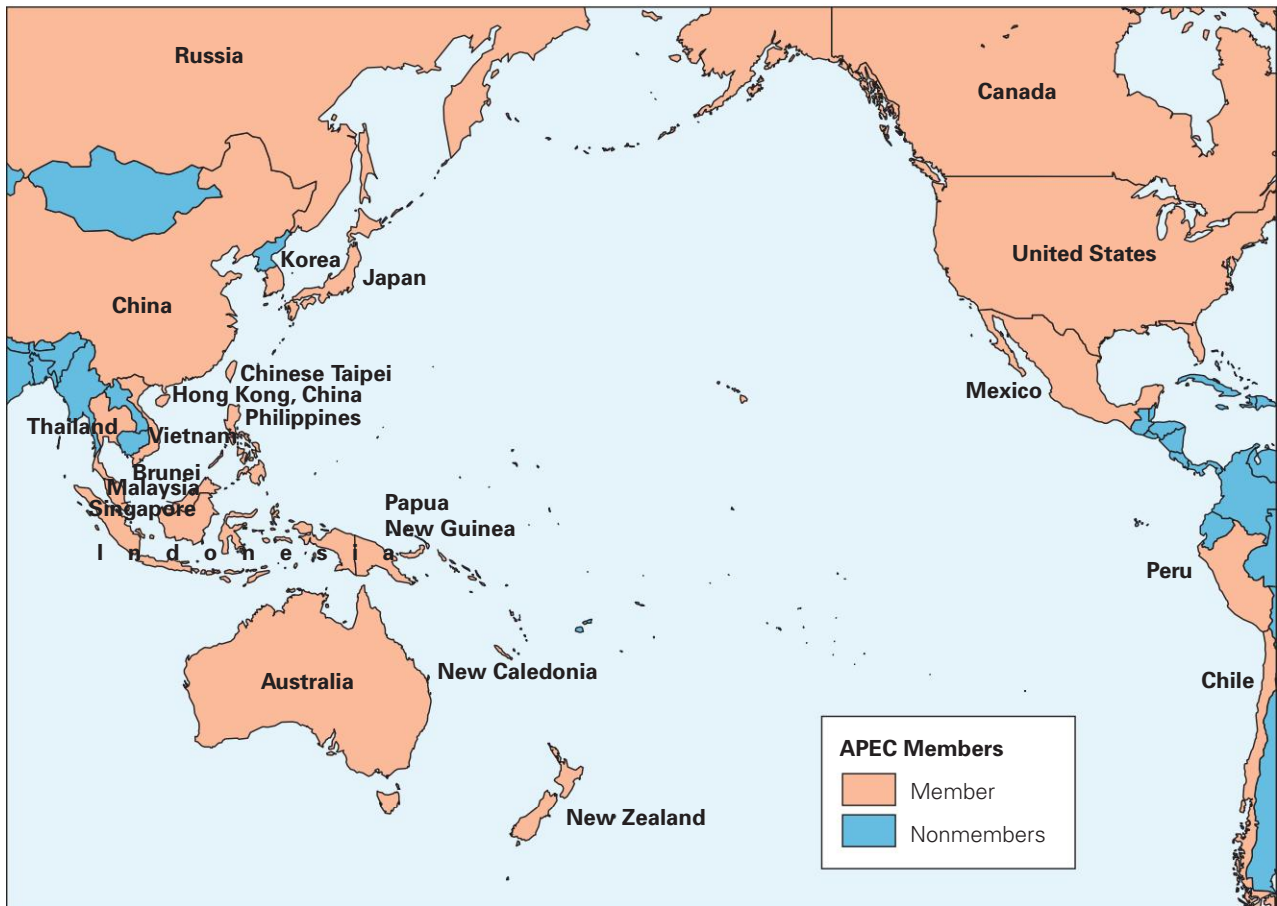
Source: www.aseansec.org

Asia-Pacific Economic Cooperation (APEC)

Made up of 21 member states whose goal is to increase multilateral cooperation in view of the economic rise of the Pacific nations.

ASIA-PACIFIC ECONOMIC COOPERATION Asia-Pacific Economic Cooperation (APEC) was founded in 1990 at the suggestion of Australia. APEC currently has 21 member states including such economic powerhouses as the United States, Japan, and China (see Map 8.4). Collectively, the member states account for about 55 percent of the world's GNP, 49 percent of world trade, and much of the growth in the world economy. The stated aim of APEC is to increase multilateral cooperation in view of the economic rise of the Pacific nations and the growing interdependence within the region. U.S. support for APEC was also based on the belief that it might prove a viable strategy for heading off any moves to create Asian groupings from which it would be excluded.

Interest in APEC was heightened considerably in November 1993 when the heads of APEC member states met for the first time at a two-day conference in Seattle. Debate before the meeting speculated on the likely future role of APEC. One view was that APEC should commit itself to the ultimate formation of a free trade area. Such a move would transform the Pacific Rim from a geographical expression into the world's largest free trade area. Another view was that APEC would produce no more than hot air and lots of photo opportunities for the leaders involved. As it turned out, the APEC meeting produced little more than some vague commitments from member states to work together for greater economic integration and a general lowering of trade barriers.



map

8.4

APEC Members

However, significantly, member states did not rule out the possibility of closer economic cooperation in the future.³⁸

The heads of state have met again on a number of occasions. At a 1997 meeting, member states formally endorsed proposals designed to remove trade barriers in 15 sectors, ranging from fish to toys. However, the vague plan committed APEC to doing no more than holding further talks, which is all that they have done to date. Commenting on the vagueness of APEC pronouncements, the influential Brookings Institution, a U.S.-based economic policy institution, noted that APEC “is in grave danger of shrinking into irrelevance as a serious forum.” Despite the slow progress, APEC is worth watching. If it eventually does transform itself into a free trade area, it will probably be the world’s largest.³⁹

REGIONAL TRADE BLOCS IN AFRICA African countries have been experimenting with regional trade blocs for half a century. There are now nine trade blocs on the African continent. Many countries are members of more than one group. Although the number of trade groups is impressive, progress toward the establishment of meaningful trade blocs has been slow.

Many of these groups have been dormant for years. Significant political turmoil in several African nations has persistently impeded any meaningful progress. Also, deep suspicion of free trade exists in several African countries. The argument most frequently heard is that because these countries have less developed and less diversified economies, they need to be “protected” by tariff barriers from unfair foreign competition. Given the prevalence of this argument, it has been hard to establish free trade areas or customs unions.

The most recent attempt to reenergize the free trade movement in Africa occurred in early 2001, when Kenya, Uganda, and Tanzania, member states of the East African Community (EAC), committed themselves to relaunching their bloc, 24 years after it collapsed. The three countries, with 80 million inhabitants, intend to establish a customs union, regional court, legislative assembly, and, eventually, a political federation.

Their program includes cooperation on immigration, road and telecommunication networks, investment, and capital markets. However, while local business leaders welcomed the relaunch as a positive step, they were critical of the EAC’s failure in practice to make progress on free trade. At the EAC treaty signing in November 1999, members gave themselves four years to negotiate a customs union, with a draft slated for the end of 2001. But that fell far short of earlier plans for an immediate free trade zone, shelved after Tanzania and Uganda, fearful of Kenyan competition, expressed concerns that the zone could create imbalances similar to those that contributed to the breakup of the first community.⁴⁰ Nevertheless, in 2005 the EAC did start to implement a customs union, although many tariffs remained in place until 2010. In 2007, Burundi and Rwanda joined the EAC.



Focus on Managerial Implications

Currently the most significant developments in regional economic integration are occurring in the European Union and NAFTA. Although some of the Latin American trade blocs, ASEAN, and the proposed FTAA may have economic significance in the future, the EU and NAFTA currently have more profound and immediate implications

LEARNING OBJECTIVE 5
Understand the implications for business that are inherent in regional economic integration agreements.

for business practice. Accordingly, in this section we will concentrate on the business implications of those two groups. Similar conclusions, however, could be drawn with regard to the creation of a single market anywhere in the world.

Opportunities

The creation of a single market through regional economic integration offers significant opportunities because markets that were formerly protected from foreign competition are increasingly open. For example, in Europe before 1992 the large French and Italian markets were among the most protected. These markets are now much more open to foreign competition in the form of both exports and direct investment. Nonetheless, to fully exploit such opportunities, it may pay non-EU firms to set up EU subsidiaries. Many major U.S. firms have long had subsidiaries in Europe. Those that do not would be advised to consider establishing them now, lest they run the risk of being shut out of the EU by nontariff barriers.

Additional opportunities arise from the inherent lower costs of doing business in a single market—as opposed to 27 national markets in the case of the EU or 3 national markets in the case of NAFTA. Free movement of goods across borders, harmonized product standards, and simplified tax regimes make it possible for firms based in the EU and the NAFTA countries to realize potentially significant cost economies by centralizing production in those EU and NAFTA locations where the mix of factor costs and skills is optimal. Rather than producing a product in each of the 27 EU countries or the 3 NAFTA countries, a firm may be able to serve the whole EU or North American market from a single location. This location must be chosen carefully, of course, with an eye on local factor costs and skills.

For example, in response to the changes created by EU after 1992, the St. Paul, Minnesota-based 3M Company consolidated its European manufacturing and distribution facilities to take advantage of economies of scale. Thus, a plant in Great Britain now produces 3M's printing products and a German factory its reflective traffic control materials for all of the EU. In each case, 3M chose a location for centralized production after carefully considering the likely production costs in alternative locations within the EU. The ultimate goal of 3M is to dispense with all national distinctions, directing R&D, manufacturing, distribution, and marketing for each product group from an EU headquarters.⁴¹ Similarly, Unilever, one of Europe's largest companies, began rationalizing its production in advance of 1992 to attain scale economies. Unilever concentrated its production of dishwashing powder for the EU in one plant, bath soap in another, and so on.⁴²

Even after the removal of barriers to trade and investment, enduring differences in culture and competitive practices often limit the ability of companies to realize cost economies by centralizing production in key locations and producing a standardized product for a single multi-country market. Consider the case of Atag Holdings NV, a Dutch maker of kitchen appliances.⁴³ Atag thought it was well placed to benefit from the single market, but found it tough going. Atag's plant is just one mile from the German border and near the center of the EU's population. The company thought it could cater to both the "potato" and "spaghetti" belts—marketers' terms for consumers in Northern and Southern Europe—by producing two main product lines and selling these standardized "euro-products" to "euro-consumers." The main benefit of doing so is the economy of scale derived from mass production of a standardized range of products. Atag quickly discovered that the "euro-consumer" was a myth. Consumer preferences vary much more across nations than Atag had thought. Consider ceramic cooktops; Atag planned to market just 2 varieties throughout the EU but has found it needs 11. Belgians, who cook in huge pots, require extra-large burners. Germans like oval pots and burners to fit. The French need small burners and very low temperatures for simmering sauces and broths. Germans like oven

knobs on the top; the French want them on the front. Most Germans and French prefer black and white ranges; the British demand a range of colors including peach, pigeon blue, and mint green.

Threats

Just as the emergence of single markets creates opportunities for business, it also presents a number of threats. For one thing, the business environment within each grouping will become more competitive. The lowering of barriers to trade and investment between countries is likely to lead to increased price competition throughout the EU and NAFTA. For example, before 1992 a Volkswagen Golf cost 55 percent more in Great Britain than in Denmark and 29 percent more in Ireland than in Greece.⁴⁴ Over time, such price differentials will vanish in a single market. This is a direct threat to any firm doing business in EU or NAFTA countries. To survive in the tougher single-market environment, firms must take advantage of the opportunities offered by the creation of a single market to rationalize their production and reduce their costs. Otherwise, they will be at a severe disadvantage.

A further threat to firms outside these trading blocs arises from the likely long-term improvement in the competitive position of many firms within the areas. This is particularly relevant in the EU, where many firms have historically been limited by a high cost structure in their ability to compete globally with North American and Asian firms. The creation of a single market and the resulting increased competition in the EU is beginning to produce serious attempts by many EU firms to reduce their cost structure by rationalizing production. This is transforming many EU companies into efficient global competitors. The message for non-EU businesses is that they need to prepare for the emergence of more capable European competitors by reducing their own cost structures.

Another threat to firms outside of trading areas is the threat of being shut out of the single market by the creation of a “trade fortress.” The charge that regional economic integration might lead to a fortress mentality is most often leveled at the EU. Although the free trade philosophy underpinning the EU theoretically argues against the creation of any fortress in Europe, occasional signs indicate the EU may raise barriers to imports and investment in certain “politically sensitive” areas, such as autos. Non-EU firms might be well advised, therefore, to set up their own EU operations. This could also occur in the NAFTA countries, but it seems less likely.

Finally, the emerging role of the European Commission in competition policy suggests the EU is increasingly willing and able to intervene and impose conditions on companies proposing mergers and acquisitions. This is a threat insofar as it limits the ability of firms to pursue the corporate strategy of their choice. The commission may require significant concessions from businesses as a precondition for allowing proposed mergers and acquisitions to proceed. While this constrains the strategic options for firms, it should be remembered that in taking such action, the commission is trying to maintain the level of competition in Europe’s single market, which should benefit consumers.

Key Terms

regional economic integration, p. 277

free trade area, p. 278

European Free Trade Association (EFTA), p. 279

customs union, p. 279

common market, p. 279

economic union, p. 279

political union, p. 280

trade creation, p. 282

trade diversion, p. 282

European Union, p. 282
 Treaty of Rome, p. 283
 European Commission, p. 283
 European Council, p. 285
 European Parliament, p. 286
 Treaty of Lisbon, p. 286
 Court of Justice, p. 286
 Single European Act, p. 286
 Maastricht Treaty, p. 289

optimal currency area, p. 290
 North American Free Trade Agreement, p. 294
 Andean Pact, p. 297
 Mercosur, p. 298
 Central American Common Market, p. 299
 Central America Free Trade Agreement (CAFTA), p. 299

CARICOM, p. 299
 Caribbean Single Market and Economy (CSME), p. 299
 Association of Southeast Asian Nations (ASEAN), p. 300
 Asia-Pacific Economic Cooperation (APEC), p. 302

Summary

This chapter pursued three main objectives: to examine the economic and political debate surrounding regional economic integration; to review the progress toward regional economic integration in Europe, the Americas, and elsewhere; and to distinguish the important implications of regional economic integration for the practice of international business. The chapter made the following points:

1. A number of levels of economic integration are possible in theory. In order of increasing integration, they include a free trade area, a customs union, a common market, an economic union, and full political union.
2. In a free trade area, barriers to trade between member countries are removed, but each country determines its own external trade policy. In a customs union, internal barriers to trade are removed and a common external trade policy is adopted. A common market is similar to a customs union, except that a common market also allows factors of production to move freely between countries. An economic union involves even closer integration, including the establishment of a common currency and the harmonization of tax rates. A political union is the logical culmination of attempts to achieve ever closer economic integration.
3. Regional economic integration is an attempt to achieve economic gains from the free flow of trade and investment between neighboring countries.
4. Integration is not easily achieved or sustained. Although integration brings benefits to the

majority, it is never without costs for the minority. Concerns over national sovereignty often slow or stop integration attempts.

5. Regional integration will not increase economic welfare if the trade creation effects in the free trade area are outweighed by the trade diversion effects.
6. The Single European Act sought to create a true single market by abolishing administrative barriers to the free flow of trade and investment between EU countries.
7. Sixteen EU members now use a common currency, the euro. The economic gains from a common currency come from reduced exchange costs, reduced risk associated with currency fluctuations, and increased price competition within the EU.
8. Increasingly, the European Commission is taking an activist stance with regard to competition policy, intervening to restrict mergers and acquisitions that it believes will reduce competition in the EU.
9. Although no other attempt at regional economic integration comes close to the EU in terms of potential economic and political significance, various other attempts are being made in the world. The most notable include NAFTA in North America, the Andean Pact and Mercosur in Latin America, ASEAN in Southeast Asia, and perhaps APEC.
10. The creation of single markets in the EU and North America means that many markets that were formerly protected from foreign competition are now more open. This creates

major investment and export opportunities for firms within and outside these regions.

11. The free movement of goods across borders, the harmonization of product standards, and the simplification of tax regimes make it possible for firms based in a free trade area to realize potentially enormous cost economies by centralizing production in those locations
12. The lowering of barriers to trade and investment between countries within a trade group will probably be followed by increased price competition.

Critical Thinking and Discussion Questions

1. NAFTA has produced significant net benefits for the Canadian, Mexican, and U.S. economies. Discuss.
2. What are the economic and political arguments for regional economic integration? Given these arguments, why don't we see more substantial examples of integration in the world economy?
3. What effect is creation of a single market and a single currency within the EU likely to have on competition within the EU? Why?
4. Do you think it is correct for the European Commission to restrict mergers between American companies that do business in Europe? (For example, the European Commission vetoed the proposed merger between WorldCom and Sprint, both U.S. companies, and it carefully reviewed the merger between AOL and Time Warner, again both U.S. companies.)
5. How should a U.S. firm that currently exports only to ASEAN countries respond to the creation of a single market in this regional grouping?
6. How should a firm with self-sufficient production facilities in several ASEAN countries respond to the creation of a single market? What are the constraints on its ability to respond in a manner that minimizes production costs?
7. After a promising start, Mercosur, the major Latin American trade agreement, has faltered and made little progress since 2000. What problems are hurting Mercosur? What can be done to solve these problems?
8. Would establishment of a Free Trade Area of the Americas (FTAA) be good for the two most advanced economies in the hemisphere, the United States and Canada? How might the establishment of the FTAA impact the strategy of North American firms?
9. Reread the Management Focus "The European Commission and Media Industry Mergers," then answer the following questions:
 - a. Given that both AOL and Time Warner were U.S.-based companies, do you think the European Commission had a right to review and regulate their planned merger?
 - b. Were the concessions extracted by the European Commission from AOL and Time Warner reasonable? Whose interests was the commission trying to protect?
 - c. What precedent do the actions of the European Commission in this case set? What are the implications for managers of foreign enterprises with substantial operations in Europe?

<http://globalEDGE.msu.edu>



Research Task

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

1. The enlargement of the European Union into Eastern Europe has brought together countries

with different levels of economic development. Choose two long-term EU member countries and two newer members. Compare and contrast the macroeconomic situation in these countries by analyzing each country's primary economic

indicators available from the most recent version of *Eurostatistics Data for Short-Term Economic Analysis*, a statistical book published periodically by Eurostat. Prepare a short report describing the similarities and differences between the two groups of countries.

2. The establishment of the Free Trade Area of the Americas could be a threat as well as an

opportunity for your company. Identify the countries participating in the negotiations for the FTAA. Are there any countries in the Americas not participating in the negotiations? What are the main issues covered in the negotiation process?



The European Energy Market

closing case

For several years now the European Union, the largest regional trading bloc in the world, has been trying to liberalize its energy market, replacing the markets of its 27 member states with a single continent-wide market for electricity and gas. The first phase of liberalization went into effect in June 2007. When fully implemented, the ability of energy producers to sell electricity and gas across national borders will increase competition. The road toward the creation of a single EU energy market, however, has been anything but easy. Many national markets are dominated by a single enterprise, often a former state-owned utility. Electricité de France, for example, has an 87 percent share of that country's electricity market. Injecting competition into such concentrated markets will prove difficult.

To complicate matters, most of these utilities are vertically integrated, producing, transmitting, and selling power. These vertically integrated producers have little interest in letting other utilities use their transmission grids to sell power to end users, or in buying power from other producers. For the full benefits of competition to take hold, the EU recognizes that utilities need to be split into generation, transmission, and marketing companies so that the business of selling energy can be separated from the businesses of producing it and transmitting it. Only then, so the thinking goes, will independent power marketing companies be able to buy energy from the cheapest source, whether it is within national borders or elsewhere in the EU, and resell it to consumers, thereby promoting competition.

For now, efforts to mandate the de-integration of utilities are some way off. Indeed, in February 2007 national energy ministers from the different EU states rejected a call from the European Commission, the top competition body in the EU, to break apart utilities. Instead the energy ministers asked the commission for more details about what such a move would

accomplish, thereby effectively delaying any attempt to de-integrate national power companies. In mid-2008, they reached a compromise that fell short of mandating the unbundling, or de-integration, of national energy companies due to powerful opposition from France and Germany among others (both nations have large vertically integrated energy companies).

The response of established utilities to the creation of a single continent-wide market for energy has been to try to acquire utilities in other EU nations in an effort to build systems that serve more than one country. The underlying logic is that larger utilities should be able to realize economies of scale, and this would enable them to compete more effectively in a liberalized market. However, some cross-border takeover bids have run into fierce opposition from local politicians who resent their "national energy companies" being taken over by foreign entities. Most notably, when E.ON, the largest German utility, made a bid to acquire Endesa, Spain's largest utility, in 2006, Spanish politicians sought to block the acquisition and keep ownership of Endesa in Spanish hands, imposing conditions on the deal that were designed to stop the Germans from acquiring the Spanish company. In response to this outburst of nationalism, the European Commission took the Spanish government to the European Union's highest court, arguing that Madrid had violated the commission's exclusive powers within the EU to scrutinize and approve big cross-border mergers in Europe. Subsequently, Enel, Italy's biggest power company, stepped in and purchased Endesa.

Sources: "Power Struggles: European Utilities," *The Economist*, December 2, 2006, p. 74; "Anger Management in Brussels," *Petroleum Economist*, April 2006, pp. 1–3; R. Bream, "Liberalization of EU Market Accelerates Deal-making," *Financial Times*, February 28, 2007, p. 4; "Twists and Turns: Energy Liberalization in Europe," *The Economist*, December 8, 2007, p. 76; and "Better than Nothing?" *The Economist*, June 14, 2008, p. 80.

Case Discussion Questions

1. What do you think are the economic benefits of liberalizing the EU energy market? Who stands to gain the most from liberalization?
2. What are the implications of liberalization for energy producers in the EU? How will the environment they face change post-liberalization. What actions will they have to take?
3. Why is the de-integration of large energy companies seen as such an important part of any attempt to liberalize the EU energy market?
4. Why do you think progress toward the liberalization of the EU energy market has been fairly slow so far?



part 4

Global Money System

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Describe the functions of the foreign exchange market.
- 2 Understand what is meant by spot exchange rates.
- 3 Recognize the role that forward exchange rates play in insuring against foreign exchange risk.
- 4 Understand the different theories explaining how currency exchange rates are determined and their relative merits.
- 5 Identify the merits of different approaches toward exchange rate forecasting.
- 6 Compare and contrast the differences between translation, transaction, and economic exposure, and explain what managers can do to manage each type of exposure.

The Foreign Exchange Market

Billabong

opening case

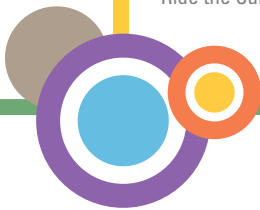
Billabong is a quintessential Australian company. The maker of “surf wear” from wet suits and board shorts to T-shirts and watches has a powerful brand name that is recognized by surfing enthusiasts around the globe. The company is a major exporter. Some 80 percent of its sales are generated outside of Australia through a network of 10,000 outlets in more than 100 countries. Not surprisingly given the history of surfing, the largest foreign market for Billabong is the United States, which accounts for about 50 percent of the company’s \$800 million in annual sales. As a result, Billabong’s fortunes are closely linked to the value of the Australian dollar against the U.S. dollar. When the Australian dollar falls against the U.S. dollar, Billabong’s products become less expensive in U.S. dollars, and this can drive sales forward. Conversely, if the Australian dollar rises in value, this can raise the price of Billabong’s products in terms of U.S. dollars, which impacts sales negatively. Billabong’s CEO has stated that every 1 cent movement in the U.S. dollar/Australian dollar exchange rate means a 0.6 percent change in profit for Billabong.

During the second half of 2008 it looked as if things were going Billabong’s way. The Australian dollar fell rapidly in value against the U.S. dollar. In June 2008 one Australian dollar was worth \$0.97. By October 2008 it was worth only \$0.60. The fall in the value of the Australian dollar was in part due to a fear among currency traders that as the world slipped into a recession, global demand for many of the raw materials produced in Australia would decline, exports would slump, and Australia’s trade balance would deteriorate. In anticipation of this, institutions sold Australian dollars, driving down its value on foreign exchange markets. For Billabong, however, this was something of a blessing. The cheaper Australian dollar would give it a pricing advantage and help to promote sales in the United States and elsewhere. When sales in U.S. dollars were translated back

into Australian dollars, their value increased as the Australian dollar fell. Anticipating this, in February 2009 Billabong's CEO affirmed that he expected the company to increase its profits by as much as 10 percent in 2009, despite the weak global retail environment.

Currency markets, however, can be difficult to predict, and sharp reversals do occur. Between March and November 2009 the Australian dollar surged in value, rising all the way back to \$0.94. The cause was twofold. First, there was a global sell-off of the American dollar as the full impact of the global financial crisis became apparent, and as the scale of debt in the United States became clearer. Second, despite a recession in the United States and Europe, the emerging economies of China and India continued to grow, and this helped to support demand for many of the basic commodities that Australia exports, which led to a strengthening of the Australian dollar. For Billabong, the sharp reversal was an embarrassment. The strong Australian dollar eradicated any pricing advantage Billabong might have enjoyed. Also, now the amount of Australian dollars that the company received for every sale made in U.S. dollars was declining. In February 2009 every \$1 earned in U.S. currency could be exchanged for 1.66 Australian dollars. By October 2009 every \$1 earned in U.S. currency could only be exchanged for 1.06 Australian dollars. In May 2009, with the Australian dollar rising rapidly, the CEO was forced to revise his previously bullish forecast for sales and earnings. Now he said, a combination of weaker than expected demand in the United States plus a strengthening Australian dollar would lead to a 10 percent decline in profits for 2009. ●

Sources: C. Marriott, "Caught in the Impact Zone," *Australian FX*, January 2010, pp. 11–12; R. Donkin, "Billabong Seeks \$290 Million, Slashes Forecast, Stores," *The Western Australian*, May 19, 2009; and "Billabong Ready to Ride the Currency Wave," *The Australian*, October 29, 2008, p. 40.



Introduction

Like many enterprises in the global economy, Billabong is impacted by changes in the value of currencies on the foreign exchange market. As detailed in the opening case, during late 2008 and early 2009 it looked as if the weak Australian dollar would help to boost Billabong's exports of surf wear to markets like the United States, and it issued bullish profit forecasts. By May 2009, an unanticipated rise in the value of the Australian dollar forced the company to revise its earnings forecasts for 2009 downward. As stated in the case, every 1 cent movement in the U.S. dollar/Australian dollar exchange rate means a 0.6 percent change in profit for Billabong. When the Australian dollar appreciates again the U.S. dollar, Billabong's products became more expensive in U.S. dollar terms, effectively putting the company at a price disadvantage in the United States, its major foreign market.

As at Billabong, what happens in the foreign exchange market can have a fundamental impact on the sales, profits, and strategy of an enterprise. Accordingly, it is very important for managers to understand the working of the foreign exchange market,

and what the impact of changes in currency exchange rates might be for their enterprise. With this in mind, the current chapter has three main objectives. The first is to explain how the foreign exchange market works. The second is to examine the forces that determine exchange rates, and to discuss the degree to which it is possible to predict future exchange rate movements. The third objective is to map the implications for international business of exchange rate movements. This chapter is the first of two that deal with the international monetary system and its relationship to international business. In the next chapter, we will explore the institutional structure of the international monetary system. The institutional structure is the context within which the foreign exchange market functions. As we shall see, changes in the institutional structure of the international monetary system can exert a profound influence on the development of foreign exchange markets.

The **foreign exchange market** is a market for converting the currency of one country into that of another country. An **exchange rate** is simply the rate at which one currency is converted into another. For example, Billabong uses the foreign exchange market to convert the dollars it earns from selling surf wear in the United States into Australian dollars. Without the foreign exchange market, international trade and international investment on the scale that we see today would be impossible; companies would have to resort to barter. The foreign exchange market is the lubricant that enables companies based in countries that use different currencies to trade with each other.

We know from earlier chapters that international trade and investment have their risks. Some of these risks exist because future exchange rates cannot be perfectly predicted. The rate at which one currency is converted into another can change over time. For example, at the start of 2001 one U.S. dollar bought 1.065 euros, but by the start of 2010, one U.S. dollar bought only 0.74 euro. The dollar had fallen sharply in value against the euro. This made American goods cheaper in Europe, boosting export sales. At the same time, it made European goods more expensive in the United States, which hurt the sales and profits of European companies that sold goods and services to the United States.

One function of the foreign exchange market is to provide some insurance against the risks that arise from such volatile changes in exchange rates, commonly referred to as foreign exchange risk. Although the foreign exchange market offers some insurance against foreign exchange risk, it cannot provide complete insurance. It is not unusual for international businesses to suffer losses because of unpredicted changes in exchange rates. Currency fluctuations can make seemingly profitable trade and investment deals unprofitable, and vice versa.

We begin this chapter by looking at the functions and the form of the foreign exchange market. This includes distinguishing among spot exchanges, forward exchanges, and currency swaps. Then we will consider the factors that determine exchange rates. We will also look at how foreign trade is conducted when a country's currency cannot be exchanged for other currencies; that is, when its currency is not convertible. The chapter closes with a discussion of these things in terms of their implications for business.

The Functions of the Foreign Exchange Market

The foreign exchange market serves two main functions. The first is to convert the currency of one country into the currency of another. The second is to provide some insurance against **foreign exchange risk**, by which we mean the adverse consequences of unpredictable changes in exchange rates.¹

Foreign Exchange Market
A market for converting the currency of one country into that of another country.

Exchange Rate
The rate at which one currency is converted into another.

LEARNING OBJECTIVE 1
Describe the functions of the foreign exchange market.

Foreign Exchange Risk
The risk that changes in exchange rates will hurt the profitability of a business deal.

CURRENCY CONVERSION Each country has a currency in which the prices of goods and services are quoted. In the United States, it is the dollar (\$); in Great Britain, the pound (£); in France, Germany, and other members of the euro zone it is the euro (€); in Japan, the yen (¥); and so on. In general, within the borders of a particular country, one must use the national currency. A U.S. tourist cannot walk into a store in Edinburgh, Scotland, and use U.S. dollars to buy a bottle of Scotch whisky. Dollars are not recognized as legal tender in Scotland; the tourist must use British pounds. Fortunately, the tourist can go to a bank and exchange her dollars for pounds. Then she can buy the whisky.

When a tourist changes one currency into another, she is participating in the foreign exchange market. The exchange rate is the rate at which the market converts one currency into another. For example, an exchange rate of $\text{€}1 = \$1.30$ specifies that one euro buys \$1.30 U.S. dollars. The exchange rate allows us to compare the relative prices of goods and services in different countries. Our U.S. tourist wishing to buy a bottle of Scotch whisky in Edinburgh may find that she must pay £30 for the bottle, knowing that the same bottle costs \$45 in the United States. Is this a good deal? Imagine the current pound/dollar exchange rate is $\text{£}1.00 = \$2.00$ (i.e., one British pound buys \$2.00). Our intrepid tourist takes out her calculator and converts £30 into dollars. (The calculation is 30×2). She finds that the bottle of Scotch costs the equivalent of \$60. She is surprised that a bottle of Scotch whisky could cost less in the United States than in Scotland (alcohol is taxed heavily in Great Britain).

Tourists are minor participants in the foreign exchange market; companies engaged in international trade and investment are major ones. International businesses have four main uses of foreign exchange markets. First, the payments a company receives for its exports, the income it receives from foreign investments, or the income it receives from licensing agreements with foreign firms may be in foreign currencies. To use those funds in its home country, the company must convert them to its home country's currency. Consider the Scotch distillery that exports its whisky to the United States. The distillery is paid in dollars, but since those dollars cannot be spent in Great Britain, they must be converted into British pounds. Similarly, Billabong sells its surfing products in the United States for dollars; it must convert the U.S. dollars it receives into Australian dollars to use them in Australia.

Second, international businesses use foreign exchange markets when they must pay a foreign company for its products or services in its country's currency. For example, Dell buys many of the components for its computers from Malaysian firms. The Malaysian companies must be paid in Malaysia's currency, the ringgit, so Dell must convert money from dollars into ringgit to pay them.

Third, international businesses also use foreign exchange markets when they have spare cash that they wish to invest for short terms in money markets. For example, consider a U.S. company that has \$10 million it wants to invest for three months. The best interest rate it can earn on these funds in the United States may be 4 percent. Investing in a South Korean money market account, however, may earn 12 percent. Thus, the company may change its \$10 million into Korean won and invest it in South Korea. Note, however, that the rate of return it earns on this investment depends not only on the Korean interest rate, but also on the changes in the value of the Korean won against the dollar in the intervening period.



Another Perspective

How Foreign Exchange Challenges Business Travel Ethics

In preparation for a trip to Japan, you exchange U.S. dollars for yen in late May, just before you leave. For \$1,000, your bank gives you ¥104,000. During your time in Osaka, the dollar weakens against the yen, to ¥99.5 to the dollar. Meanwhile, you enjoyed Japanese hospitality and spent only ¥10,000. Back home, you take your remaining ¥94,000 to the bank to convert back to dollars. How much have you spent on your trip?

Currency speculation is another use of foreign exchange markets. **Currency speculation** typically involves the short-term movement of funds from one currency to another in the hopes of profiting from shifts in exchange rates. Consider again a U.S. company with \$10 million to invest for three months. Suppose the company suspects that the U.S. dollar is overvalued against the Japanese yen. That is, the company expects the value of the dollar to depreciate (fall) against that of the yen. Imagine the current dollar/yen exchange rate is $\$1 = ¥120$. The company exchanges its \$10 million into yen, receiving ¥1.2 billion ($\$10 \text{ million} \times 120 = ¥1.2 \text{ billion}$). Over the next three months, the value of the dollar depreciates against the yen until $\$1 = ¥100$. Now the company exchanges its ¥1.2 billion back into dollars and finds that it has \$12 million. The company has made a \$2 million profit on currency speculation in three months on an initial investment of \$10 million! In general, however, companies should beware, for speculation by definition is a very risky business. The company cannot know for sure what will happen to exchange rates. While a speculator may profit handsomely if his speculation about future currency movements turns out to be correct, he can also lose vast amounts of money if it turns out to be wrong.

A kind of speculation that has become more common in recent years is known as the **carry trade**. The carry trade involves borrowing in one currency where interest rates are low, and then using the proceeds to invest in another currency where interest rates are high. For example, if the interest rate on borrowings in Japan is 1 percent, but the interest rate on deposits in American banks is 6 percent, it can make sense to borrow in Japanese yen, then convert the money into U.S. dollars and deposit it in an American bank. The trader can make a 5 percent margin by doing so, minus the transaction costs associated with changing one currency into another. The speculative element of this trade is that its success is based upon a belief that there will be no adverse movement in exchange rates (or interest rates for that matter) that will make the trade unprofitable. However, if the yen were to rapidly increase in value against the dollar, then it would take more U.S. dollars to repay the original loan, and the trade could fast become unprofitable. The dollar-yen carry trade was actually very significant during the mid-2000s, peaking at over \$1 trillion in 2007, when some 30 percent of trade on the Tokyo foreign exchange market was related to the carry trade.² This carry trade declined in importance during 2008–09 precisely because the Japanese yen was increasing in value against the dollar, making the trade riskier (in addition, interest rate differentials were falling as U.S. rates came down, making the trade less profitable even if exchange rates were stable).

INSURING AGAINST FOREIGN EXCHANGE RISK A second function of the foreign exchange market is to provide insurance against foreign exchange risk, which is the possibility that unpredicted changes in future exchange rates will have adverse consequences for the firm. When a firm insures itself against foreign exchange risk, we say that it is engaging in **hedging**. To explain how the market performs this function, we must first distinguish among spot exchange rates, forward exchange rates, and currency swaps.

Spot Exchange Rates When two parties agree to exchange currency and execute the deal immediately, the transaction is referred to as a spot exchange. Exchange rates governing such “on the spot” trades are referred to as spot exchange rates. The **spot exchange rate** is the rate at which a foreign exchange dealer converts one currency into another currency on a particular day. Thus, when our U.S. tourist in Edinburgh goes to a bank to convert her dollars into pounds, the exchange rate is the spot rate for that day.

Currency Speculation

Involves the short-term movement of funds from one currency to another in the hopes of profiting from shifts in exchange rates.

Carry Trade

Involves borrowing in one currency where interest rates are low, and then using the proceeds to invest in another currency where interest rates are high.

Hedging

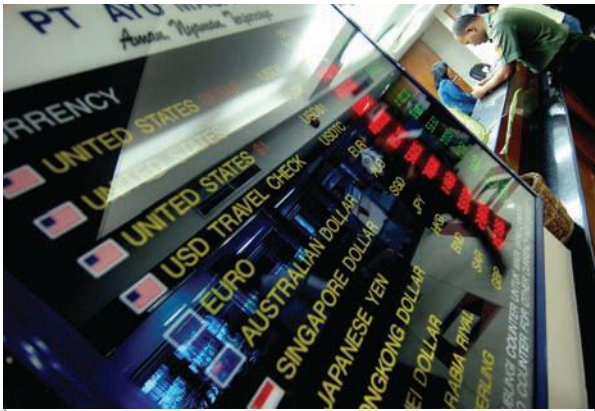
The process of insuring one's business against foreign exchange risk by using forward exchanges or currency swaps.

LEARNING OBJECTIVE 2

Understand what is meant by spot exchange rates.

Spot Exchange Rate

The exchange rate at which a foreign exchange dealer will convert one currency into another currency on a particular day.



Using insurance to protect against forward exchange rates helps companies hedge against financial risk.

Spot exchange rates are reported on a real-time basis on many financial Web sites. Table 9.1 shows the exchange rates for a selection of currencies traded in the New York foreign exchange market as of 1:11 p.m. February 18, 2009. An exchange rate can be quoted in two ways: as the amount of foreign currency one U.S. dollar will buy, or as the value of a dollar for one unit of foreign currency. Thus, one U.S. dollar bought €0.7954 on February 18, 2009, and one euro bought \$1.2572 U.S. dollars.

Spot rates change continually, often on a minute-by-minute basis (although the magnitude of changes over such short periods is usually small). The value of a currency is determined by the interaction between the demand and supply of that currency relative to the demand and supply of other currencies.

For example, if lots of people want U.S. dollars and dollars are in short supply, and few people want British pounds and pounds are in plentiful supply, the spot exchange rate for converting dollars into pounds will change. The dollar is likely to appreciate against the pound (or the pound will depreciate against the dollar). Imagine the spot exchange rate is £1 = \$2.00 when the market opens. As the day progresses, dealers demand more dollars and fewer pounds. By the end of the day, the spot exchange rate might be £1 = \$1.98. Each pound now buys fewer dollars than at the start of the day. The dollar has appreciated, and the pound has depreciated.

LEARNING OBJECTIVE 3

Recognize the role that forward exchange rates play in insuring against foreign exchange risk.

Forward Exchange Rates Changes in spot exchange rates can be problematic for an international business. For example, a U.S. company that imports laptop computers from Japan knows that in 30 days it must pay yen to a Japanese supplier when a shipment arrives. The company will pay the Japanese supplier ¥200,000 for each laptop computer, and the current dollar/yen spot exchange rate is \$1 = ¥120. At this rate, each computer costs the importer \$1,667 (i.e., $1,667 = 200,000/120$). The importer

Major Currency Cross Rates

Currency Last Trade	U.S. \$ N/A	¥en 1:22pm ET	Euro 1:22pm ET	Can \$ 1:22pm ET	U.K. £ 1:22pm ET	AU \$ 1:20pm ET	Swiss Franc 1:22pm ET
1 U.S. \$	= 1	92.3550	0.7954	1.2641	0.7034	1.5736	1.1736
1 ¥en	= 0.0108	1	0.0086	0.0137	0.0076	0.0170	0.0127
1 Euro	= 1.2572	116.114	1	1.5893	0.8843	1.9784	1.4755
1 Can \$	= 0.7911	73.0599	0.6292	1	0.5564	1.2448	0.9284
1 U.K. £	= 1.4217	131.290	1.1308	1.7971	1	2.2371	1.6685
1 AU \$	= 0.6355	58.6903	0.5055	0.8033	0.4470	1	0.7458
1 Swiss Franc	= 0.8521	78.6938	0.6777	1.0771	0.5994	1.3408	1

table 9.1

Value of the U.S. Dollar against other Currencies, February 18, 2009

Source: Yahoo! Finance.

knows she can sell the computers the day they arrive for \$2,000 each, which yields a gross profit of \$333 on each computer ($\$2,000 - \$1,667$). However, the importer will not have the funds to pay the Japanese supplier until the computers have been sold. If over the next 30 days the dollar unexpectedly depreciates against the yen, say, to $\$1 = ¥95$, the importer will still have to pay the Japanese company ¥200,000 per computer, but in dollar terms that would be equivalent to \$2,105 per computer, which is more than she can sell the computers for. A depreciation in the value of the dollar against the yen from $\$1 = ¥120$ to $\$1 = ¥95$ would transform a profitable deal into an unprofitable one.

To *insure* or *hedge* against this risk, the U.S. importer might want to engage in a forward exchange. A **forward exchange** occurs when two parties agree to exchange currency and execute the deal at some specific date in the future. Exchange rates governing such future transactions are referred to as **forward exchange rates**. For most major currencies, forward exchange rates are quoted for 30 days, 90 days, and 180 days into the future. In some cases, it is possible to get forward exchange rates for several years into the future. Returning to our computer importer example, let us assume the 30-day forward exchange rate for converting dollars into yen is $\$1 = ¥110$. The importer enters into a 30-day forward exchange transaction with a foreign exchange dealer at this rate and is guaranteed that she will have to pay no more than \$1,818 for each computer ($1,818 = 200,000/110$). This guarantees her a profit of \$182 per computer ($\$2,000 - \$1,818$). She also insures herself against the possibility that an unanticipated change in the dollar/yen exchange rate will turn a profitable deal into an unprofitable one.

In this example, the spot exchange rate ($\$1 = ¥120$) and the 30-day forward rate ($\$1 = ¥110$) differ. Such differences are normal; they reflect the expectations of the foreign exchange market about future currency movements. In our example, the fact that \$1 bought more yen with a spot exchange than with a 30-day forward exchange indicates foreign exchange dealers expected the dollar to depreciate against the yen in the next 30 days. When this occurs, we say the dollar is selling at a discount on the 30-day forward market (i.e., it is worth less than on the spot market). Of course, the opposite can also occur. If the 30-day forward exchange rate were $\$1 = ¥130$, for example, \$1 would buy more yen with a forward exchange than with a spot exchange. In such a case, we say the dollar is selling at a premium on the 30-day forward market. This reflects the foreign exchange dealers' expectations that the dollar will appreciate against the yen over the next 30 days.

In sum, when a firm enters into a forward exchange contract, it is taking out insurance against the possibility that future exchange rate movements will make a transaction unprofitable by the time that transaction has been executed. Although many firms routinely enter into forward exchange contracts to hedge their foreign exchange risk, there are some spectacular examples of what happens when firms don't take out this insurance. An example is given in the accompanying Management Focus, which explains how a failure to fully insure against foreign exchange risk cost Volkswagen dearly.

Currency Swaps The discussion of spot and forward exchange rates might lead you to conclude that the option to buy forward is very important to companies engaged in international trade—and you would be right. By April 2007, the latest date for which information is available, forward instruments accounted for some 69 percent of all foreign exchange transactions, while spot exchanges accounted for 31 percent.³ However, the vast majority of these forward exchanges were not forward exchanges of the type we have been discussing, but rather a more sophisticated instrument known as currency swaps.

Forward Exchange

When two parties agree to exchange currency and execute the deal at some specific date in the future.

Forward Exchange Rate

The exchange rate governing forward exchange transactions.



Volkswagen's Hedging Strategy

In January 2004, Volkswagen, Europe's largest car maker, reported a 95 percent drop in 2003 fourth-quarter profits, which slumped from €1.05 billion to a mere €50 million. For all of 2003, Volkswagen's operating profit fell by 50 percent from the record levels attained in 2002. Although the profit slump had multiple causes, two factors were the focus of much attention—the sharp rise in the value of the euro against the dollar during 2003, and Volkswagen's decision to only hedge 30 percent of its foreign currency exposure, as opposed to the 70 percent it had traditionally hedged. In total, currency losses due to the dollar's rise are estimated to have reduced Volkswagen's operating profits by some €1.2 billion (\$1.5 billion).

The rise in the value of the euro during 2003 took many companies by surprise. Since its introduction January 1, 1999, when it became the currency unit of 12 members of the European Union, the euro had recorded a volatile trading history against the U.S. dollar. In early 1999 the exchange rate stood at $€1 = \$1.17$, but by October 2000 it had slumped to $€1 = \$0.83$. Although it recovered, reaching parity of $€1 = \$1.00$ in late 2002, few analysts predicted a rapid rise in the value of the euro against the dollar during 2003. As so often happens in the foreign exchange markets, the experts were wrong; by late 2003 the exchange rate stood at $€1 = \$1.25$.

For Volkswagen, which made cars in Germany and exported them to the United States, the fall in the value of the dollar against the euro during 2003 was devastating. To understand what happened, consider a Volkswagen Jetta built in Germany for export to the United States. The Jetta costs €14,000 to make in Germany and ship to a dealer in the United States, where it sells for \$15,000. With the exchange rate standing at around $€1 = \$1$, the \$15,000 earned from the sale of a Jetta in the United States could be converted into €15,000, giving Volkswagen a profit of €1,000 on every Jetta sold. But if the exchange rate changes during the

year, ending up at $€1 = \$1.25$ as it did during 2003, each dollar of revenue will now buy only €0.80 ($€1/\$1.25 = €0.80$), and Volkswagen is squeezed. At an exchange rate of $€1 = \$1.25$, the \$15,000 Volkswagen gets for the Jetta is now worth only €12,000 when converted back into euros, meaning the company will lose €2,000 on every Jetta sold (when the exchange rate is $€1 = \$1.25$, $\$15,000/1.25 = €12,000$).

Volkswagen could have insured against this adverse movement in exchange rates by entering the foreign exchange market in late 2002 and buying a *forward contract* for dollars at an exchange rate of around $\$1 = €1$ (a *forward contract* gives the holder the right to exchange one currency for another at some point in the future at a predetermined exchange rate). Called *hedging*, the financial strategy of buying forward guarantees that at some future point, such as 180 days, Volkswagen would have been able to exchange the dollars it got from selling Jettas in the United States into euros at $\$1 = €1$, *irrespective of what the actual exchange rate was at that time*. In 2003 such a strategy would have been good for Volkswagen. However, hedging is not without its costs. For one thing, if the euro had declined in value against the dollar, instead of appreciating as it did, Volkswagen would have made even more profit per car in euros by not hedging (a dollar at the end of 2003 would have bought more euros than a dollar at the end of 2002). For another thing, hedging is expensive since foreign exchange dealers will charge a high commission for selling currency forward. Volkswagen decided to hedge just 30 percent of its anticipated U.S. sales in 2003 though forward contracts, rather than the 70 percent it had historically hedged. The decision cost the company over a €1 billion. For 2004, the company announced that it would revert back to hedging 70 percent of its foreign currency exposure.

Sources: Mark Landler, "As Exchange Rates Wwning, Car Makers Try to Duck," *The New York Times*, January 17, 2004, pp. B1, B4; N. Boudette, "Volkswagen Posts 95% Drop in Net," *The Wall Street Journal*, February 19, 2004, p. A3; and "Volkswagen's Financial Mechanic," *Corporate Finance*, June 2003, p. 1.

Currency Swap
Simultaneous purchase
and sale of a given
amount of foreign
exchange for two
different value dates.

A **currency swap** is the simultaneous purchase and sale of a given amount of foreign exchange for two different value dates. Swaps are transacted between international businesses and their banks, between banks, and between governments when it is desirable to move out of one currency into another for a limited period without incurring foreign exchange risk. A common kind of swap is spot against forward. Consider a company such as Apple Computer. Apple assembles laptop computers in the United States, but the screens are made in Japan. Apple also sells some of the finished laptops in Japan. So, like many companies, Apple both buys from and sells to Japan. Imagine Apple needs to change \$1 million into yen to pay its supplier of laptop screens today. Apple knows that in 90 days it will be paid ¥120 million by the Japanese importer that

buys its finished laptops. It will want to convert these yen into dollars for use in the United States. Let us say today's spot exchange rate is $\$1 = ¥120$ and the 90-day forward exchange rate is $\$1 = ¥110$. Apple sells \$1 million to its bank in return for ¥120 million. Now Apple can pay its Japanese supplier. At the same time, Apple enters into a 90-day forward exchange deal with its bank for converting ¥120 million into dollars. Thus, in 90 days Apple will receive \$1.09 million ($¥120 \text{ million} / 110 = \1.09 million). Since the yen is trading at a premium on the 90-day forward market, Apple ends up with more dollars than it started with (although the opposite could also occur). The swap deal is just like a conventional forward deal in one important respect: It enables Apple to insure itself against foreign exchange risk. By engaging in a swap, Apple knows today that the ¥120 million payment it will receive in 90 days will yield \$1.09 million.



Another Perspective

Key into Exchange Rate Language

The language used to describe exchange rates can be confusing, even though the ideas themselves are simple. Here's why: Any given observation describes a changing relationship (the movement in the currencies) that itself describes two relationships (the exchange rates for both currencies). The important thing to remember is that an exchange rate is described in terms of other exchange rates.

The language we use to describe these moving phenomena works in a similar, dual way: The euro gains against the dollar, so the euro is strengthening, or becoming dearer, from a dollar perspective. Meanwhile, the same observation indicates its mirror image, that the dollar is weakening, becoming cheaper against the euro, from a euro perspective.

The Nature of the Foreign Exchange Market

The foreign exchange market is not located in any one place. It is a global network of banks, brokers, and foreign exchange dealers connected by electronic communications systems. When companies wish to convert currencies, they typically go through their own banks rather than entering the market directly. The foreign exchange market has been growing at a rapid pace, reflecting a general growth in the volume of cross-border trade and investment (see Chapter 1). In March 1986, the average total value of global foreign exchange trading was about \$200 billion per day. According to the tri-annual survey by the Bank of International Settlements, by April 1995, it was more than \$1,200 billion per day, by April 2004 it reached \$1.8 trillion per day, and by April 2007 it had surged to \$3.21 trillion per day.⁴ The most important trading centers are London (34 percent of activity), New York (16 percent of activity), and Zurich, Tokyo, and Singapore (all with around 6 percent of activity).⁵ Major secondary trading centers include Frankfurt, Paris, Hong Kong, and Sydney.

London's dominance in the foreign exchange market is due to both history and geography. As the capital of the world's first major industrial trading nation, London had become the world's largest center for international banking by the end of the nineteenth century, a position it has retained. Today London's central position between Tokyo and Singapore to the east and New York to the west has made it the critical link between the East Asian and New York markets. Due to the particular differences in time zones, London opens soon after Tokyo closes for the night and is still open for the first few hours of trading in New York.⁶

Two features of the foreign exchange market are of particular note. The first is that the market never sleeps. Tokyo, London, and New York are all shut for only 3 hours out of every 24. During these three



Even though the British pound has declined in its importance as a vehicle currency, London remains the key location for global foreign exchange.

Arbitrage

The purchase of securities in one market for immediate resale in another to profit from a price discrepancy.

hours, trading continues in a number of minor centers, particularly San Francisco and Sydney, Australia. The second feature of the market is the integration of the various trading centers. High-speed computer linkages between trading centers around the globe have effectively created a single market. The integration of financial centers implies there can be no significant difference in exchange rates quoted in the trading centers. For example, if the yen/dollar exchange rate quoted in London at 3 p.m. is $¥120 = \$1$, the yen/dollar exchange rate quoted in New York at the same time (10 a.m. New York time) will be identical. If the New York yen/dollar exchange rate were $¥125 = \$1$, a dealer could make a profit through **arbitrage**, buying a currency low and selling it high. For example, if the prices differed in London and New York as given, a dealer in New York could take \$1 million and use that to purchase ¥125 million. She could then immediately sell the ¥125 million for dollars in London, where the transaction would yield \$1.046666 million, allowing the trader to book a profit of \$46,666 on the transaction. If all dealers tried to cash in on the opportunity, however, the demand for yen in New York would rise, resulting in an appreciation of the yen against the dollar such that the price differential between New York and London would quickly disappear. Because foreign exchange dealers are always watching their computer screens for arbitrage opportunities, the few that arise tend to be small, and they disappear in minutes.

Another feature of the foreign exchange market is the important role played by the U.S. dollar. Although a foreign exchange transaction can involve any two currencies, most transactions involve dollars on one side. This is true even when a dealer wants to sell a nondollar currency and buy another. A dealer wishing to sell Korean won for Brazilian real, for example, will usually sell the won for dollars and then use the dollars to buy real. Although this may seem a roundabout way of doing things, it is actually cheaper than trying to find a holder of real who wants to buy won. Because the volume of international transactions involving dollars is so great, it is not hard to find dealers who wish to trade dollars for won or real.

Due to its central role in so many foreign exchange deals, the dollar is a vehicle currency. In 2007, 86 percent of all foreign exchange transactions involved dollars on one side of the transaction. After the dollar, the most important vehicle currencies were the euro (37 percent), the Japanese yen (16.5 percent), and the British pound (15 percent)—reflecting the importance of these trading entities in the world economy. The euro has replaced the German mark as the world's second most important vehicle currency. The British pound used to be second in importance to the dollar as a vehicle currency, but its importance has diminished in recent years. Despite this, London has retained its leading position in the global foreign exchange market.

Economic Theories of Exchange Rate Determination

LEARNING OBJECTIVE 4

Understand the different theories explaining how currency exchange rates are determined and their relative merits.

At the most basic level, exchange rates are determined by the demand and supply of one currency relative to the demand and supply of another. For example, if the demand for dollars outstrips the supply of them and if the supply of Japanese yen is greater than the demand for them, the dollar/yen exchange rate will change. The dollar will appreciate against the yen (or the yen will depreciate against the dollar). However, while differences in relative demand and supply explain the determination of exchange rates, they do so only in a superficial sense. This simple explanation does not tell us what factors underlie the demand for and supply of a currency. Nor does it tell us when the demand for dollars will exceed the supply (and vice versa) or when the supply of Japanese yen will exceed demand for them (and vice versa). Neither

does it tell us under what conditions a currency is in demand or under what conditions it is not demanded. In this section, we will review economic theory's answers to these questions. This will give us a deeper understanding of how exchange rates are determined.

If we understand how exchange rates are determined, we may be able to forecast exchange rate movements. Because future exchange rate movements influence export opportunities, the profitability of international trade and investment deals, and the price competitiveness of foreign imports, this is valuable information for an international business. Unfortunately, there is no simple explanation. The forces that determine exchange rates are complex, and no theoretical consensus exists, even among academic economists who study the phenomenon every day. Nonetheless, most economic theories of exchange rate movements seem to agree that three factors have an important impact on future exchange rate movements in a country's currency: the country's price inflation, its interest rate, and market psychology.⁷

PRICES AND EXCHANGE RATES To understand how prices are related to exchange rate movements, we first need to discuss an economic proposition known as the law of one price. Then we will discuss the theory of purchasing power parity (PPP), which links changes in the exchange rate between two countries' currencies to changes in the countries' price levels.

The Law of One Price The **law of one price** states that in competitive markets free of transportation costs and barriers to trade (such as tariffs), identical products sold in different countries must sell for the same price when their price is expressed in terms of the same currency.⁸ For example, if the exchange rate between the British pound and the dollar is £1 = \$2.00, a jacket that retails for \$80 in New York should sell for £40 in London (since $\$80/2.00 = £40$). Consider what would happen if the jacket cost £30 in London (\$60 in U.S. currency). At this price, it would pay a trader to buy jackets in London and sell them in New York (an example of *arbitrage*). The company initially could make a profit of \$20 on each jacket by purchasing it for £30 (\$60) in London and selling it for \$80 in New York (we are assuming away transportation costs and trade barriers). However, the increased demand for jackets in London would raise their price in London, and the increased supply of jackets in New York would lower their price there. This would continue until prices were equalized. Thus, prices might equalize when the jacket cost £35 (\$70) in London and \$70 in New York (assuming no change in the exchange rate of £1 = \$2.00).

Law of One Price

In competitive markets free of transportation costs and barriers to trade, identical products sold in different countries must sell for the same price when their price is expressed in terms of the same currency.

Purchasing Power Parity If the law of one price were true for all goods and services, the purchasing power parity (PPP) exchange rate could be found from any individual set of prices. By comparing the prices of identical products in different currencies, it would be possible to determine the “real” or PPP exchange rate that would exist if markets were efficient. (An **efficient market** has no impediments to the free flow of goods and services, such as trade barriers, and prices reflect all available public information.)

A less extreme version of the PPP theory states that given relatively efficient markets—that is, markets in which few impediments to international trade exist—the price of a “basket of goods” should be roughly equivalent in each country. To express the PPP theory in symbols, let P\$ be the U.S. dollar price of a basket of particular goods and P¥ be the price of the same basket of goods in Japanese yen. The PPP theory predicts that the dollar/yen exchange rate, E\$/¥, should be equivalent to:

$$E_{\$/¥} = P_{\$}/P_{¥}$$

Efficient Market

A market which has no impediments to the free flow of goods and services, such as trade barriers, and prices reflect all available public information.



Another Perspective

The Law of One Price and the Internet

Presently, the law of one price applies to Internet buying that crosses national borders. Internet research provides accurate pricing information across markets. Many American consumers are trying to invoke the law of one price in the U.S. pharmaceutical market. They see that prices for prescription drugs are lower in Canada, and despite U.S. law prohibiting the importation of foreign drugs, they are having their prescriptions filled in Canada. If this trend continues, the law of one price suggests that U.S. drug prices will fall.

comparing a country's actual exchange rate with the one predicted by the PPP theorem based on relative prices of Big Macs is a test on whether a currency is undervalued or not. This is not a totally serious exercise, as *The Economist* admits, but it does provide us with a useful illustration of the PPP theorem.

Relative currency values according to the Big Mac index for January 6, 2010, are reproduced in Table 9.2. To calculate the index *The Economist* converts the price of a Big Mac in a country into dollars at current exchange rates and divides that by the average price of a Big Mac in America (which was \$3.58). According to the PPP theorem, the prices should be the same. If they are not, it implies that the currency is either overvalued against the dollar or undervalued. For example, the average price of a Big Mac in the euro area was \$4.84 at the euro/dollar exchange rate prevailing in early 2010. Dividing this by the average price of a Big Mac in the United States gives 1.35 (i.e., $4.84/3.58$), which suggests that the euro was overvalued by 35 percent against the U.S. dollar.

The next step in the PPP theory is to argue that the exchange rate will change if relative prices change. For example, imagine there is no price inflation in the United States, while prices in Japan are increasing by 10 percent a year. At the beginning of the year, a basket of goods costs \$200 in the United States and ¥20,000 in Japan, so the dollar/yen exchange rate, according to PPP theory, should be $\$1 = ¥100$. At the end of the year, the

Thus, if a basket of goods costs \$200 in the United States and ¥20,000 in Japan, PPP theory predicts that the dollar/yen exchange rate should be $\$200/¥20,000$ or \$0.01 per Japanese yen (i.e., $\$1 = ¥100$).

Every year, the newsmagazine *The Economist* publishes its own version of the PPP theorem, which it refers to as the "Big Mac Index." *The Economist* has selected McDonald's Big Mac as a proxy for a "basket of goods" because it is produced according to more or less the same recipe in about 120 countries. The Big Mac PPP is the exchange rate that would have hamburgers costing the same in each country. According to *The Economist*, com-

paring a country's actual exchange rate with the one predicted by the PPP theorem based on relative prices of Big Macs is a test on whether a currency is undervalued or not. This is not a totally serious exercise, as *The Economist* admits, but it does provide us with a useful illustration of the PPP theorem.

Relative currency values according to the Big Mac index for January 6, 2010, are reproduced in Table 9.2. To calculate the index *The Economist* converts the price of a Big Mac in a country into dollars at current exchange rates and divides that by the average price of a Big Mac in America (which was \$3.58). According to the PPP theorem, the prices should be the same. If they are not, it implies that the currency is either overvalued against the dollar or undervalued. For example, the average price of a Big Mac in the euro area was \$4.84 at the euro/dollar exchange rate prevailing in early 2010. Dividing this by the average price of a Big Mac in the United States gives 1.35 (i.e., $4.84/3.58$), which suggests that the euro was overvalued by 35 percent against the U.S. dollar.

The next step in the PPP theory is to argue that the exchange rate will change if relative prices change. For example, imagine there is no price inflation in the United States, while prices in Japan are increasing by 10 percent a year. At the beginning of the year, a basket of goods costs \$200 in the United States and ¥20,000 in Japan, so the dollar/yen exchange rate, according to PPP theory, should be $\$1 = ¥100$. At the end of the year, the basket of goods still costs \$200 in the United States, but it costs ¥22,000 in Japan. PPP theory predicts that the exchange rate should change as a result. More precisely, by the end of the year:

$$E_{\$/¥} = \$200/¥22,000$$

Thus, $¥1 = \$0.0091$ (or $\$1 = ¥110$). Because of 10 percent price inflation, the Japanese yen has depreciated by 10 percent against the dollar. One dollar will buy 10 percent more yen at the end of the year than at the beginning.

Money Supply and Price Inflation In essence, PPP theory predicts that changes in relative prices will result in a change in exchange rates. Theoretically, a country in which price inflation is running wild should expect to see its currency depreciate against that of countries in which inflation rates are lower. If we can predict what a country's



Another Perspective

Will China Revalue the Yuan?

Since 2008, China has pegged its currency, the yuan, to the dollar. In recent months, however, the United States has renewed calls for China to revalue the yuan, saying it is artificially weak and responsible for the huge U.S. trade deficit with China.

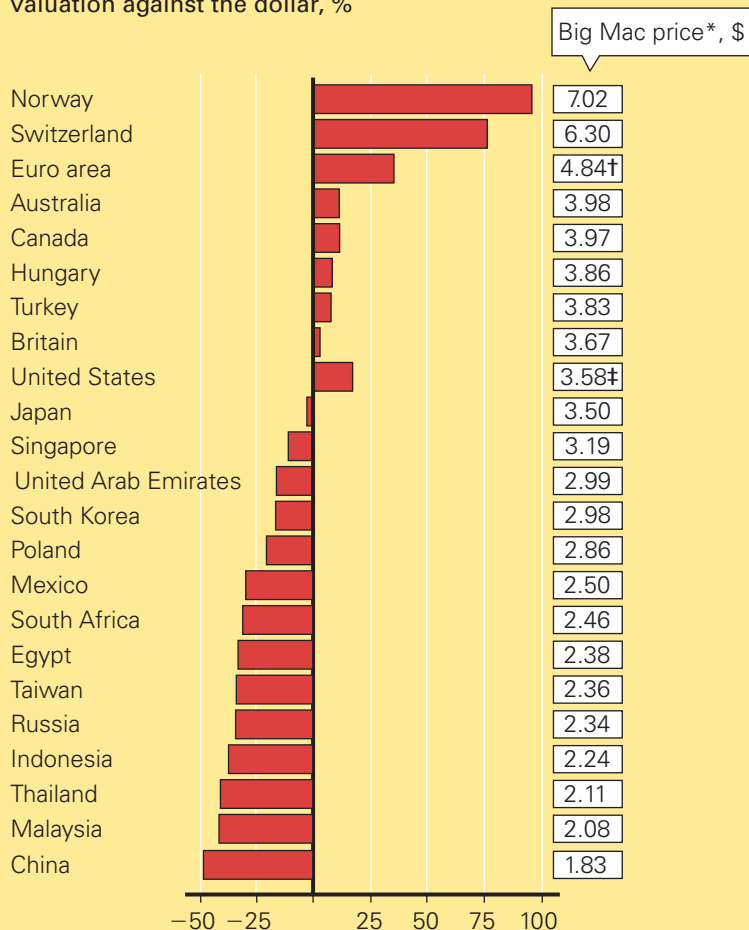
Industry observers say the undervalued currency of an economy the size of China's creates a tenuous situation for all of its trading partners. So far, China has resisted revaluing the yuan, claiming the advantage bodes well for Chinese exports. According to *The Economist*'s Big Mac index, the yuan is running 49 percent below the benchmark. ("Exchanging Blows," *The Economist*, March 17, 2010, www.economist.com; "Is a New Era Dawning for China's Currency Policy?" *Capital Spectator*, March 7, 2010, www.capitalspectator.com)

The Big Mac Index, January 6, 2010

Source: *The Economist*, January 6, 2010, http://www.economist.com/daily/chartgallery/displaystory.cfm?story_id=15210330.

Big Mac index

Local currency under (–)/over (+)
valuation against the dollar, %



*At market exchange rate (January 5th)

†Weighted average of member countries

‡Average of four cities

Source: *The Economist* using McDonald's price data

future inflation rate is likely to be, we can also predict how the value of its currency relative to other currencies—its exchange rate—is likely to change. The growth rate of a country's money supply determines its likely future inflation rate.⁹ Thus, in theory at least, we can use information about the growth in money supply to forecast exchange rate movements.

Inflation is a monetary phenomenon. It occurs when the quantity of money in circulation rises faster than the stock of goods and services; that is, when the money supply increases faster than output increases. Imagine what would happen if everyone in the country was suddenly given \$10,000 by the government. Many people would rush out to spend their extra money on those things they had always wanted—new cars, new furniture, better clothes, and so on. There would be a surge in demand for goods and services. Car dealers, department stores, and other providers of goods and services



Another Perspective

The Starbucks Index

To test the Big Mac index, which applies the PPP theory using the price of a Big Mac in various markets to determine the equilibrium value of the foreign currency, *The Economist* established a Starbucks index in 2004. Like the Big Mac, a cup of Starbucks coffee can be found in many foreign markets and can be seen as a proxy for a basket of goods. The results of the Starbucks index followed the Big Mac index in most markets, except in Asia, where the former indicated that the dollar was at parity with the Chinese yuan; the Big Mac index suggested that the yuan was 56 percent undervalued. Neither of these consumer items is a good proxy for a basket of goods, but comparing their relative prices with exchange rates is an interesting and playful approach to quickly grasping how under- or overvalued the foreign currency is against the dollar.

would respond to this upsurge in demand by raising prices. The result would be price inflation.

A government increasing the money supply is analogous to giving people more money. An increase in the money supply makes it easier for banks to borrow from the government and for individuals and companies to borrow from banks. The resulting increase in credit causes increases in demand for goods and services. Unless the output of goods and services is growing at a rate similar to that of the money supply, the result will be inflation. This relationship has been observed time after time in country after country.

So now we have a connection between the growth in a country's money supply, price inflation, and exchange rate movements. Put simply, *when the growth in a country's money supply is faster than the growth in its output, price inflation is fueled.* The PPP theory tells us that a country with a high inflation rate will see depreciation in its currency

exchange rate. In one of the clearest historical examples, in the mid-1980s, Bolivia experienced hyperinflation—an explosive and seemingly uncontrollable price inflation in which money loses value very rapidly. Table 9.3 presents data on Bolivia's money supply, inflation rate, and its peso's exchange rate with the U.S. dollar during the period of hyperinflation. The exchange rate is actually the “black market” exchange rate, as the Bolivian government prohibited converting the peso to other currencies during the period. The data show that the growth in money supply, the rate of price inflation, and the depreciation of the peso against the dollar all moved in step with each other. This is just what PPP theory and monetary economics predict. Between April 1984 and July 1985, Bolivia's money supply increased by 17,433 percent, prices increased by 22,908 percent, and the value of the peso against the dollar fell by 24,662 percent! In October 1985, the Bolivian government instituted a dramatic stabilization plan—which included the introduction of a new currency and tight control of the money supply—and by 1987 the country's annual inflation rate was down to 16 percent.¹⁰

Another way of looking at the same phenomenon is that an increase in a country's money supply, which increases the amount of currency available, changes the relative demand and supply conditions in the foreign exchange market. If the U.S. money supply is growing more rapidly than U.S. output, dollars will be relatively more plentiful than the currencies of countries where monetary growth is closer to output growth. As a result of this relative increase in the supply of dollars, the dollar will depreciate on the foreign exchange market against the currencies of countries with slower monetary growth.

Government policy determines whether the rate of growth in a country's money supply is greater than the rate of growth in output. A government can increase the money supply simply by telling the country's central bank to issue more money. Governments tend to do this to finance public expenditure (building roads, paying government workers, paying for defense, etc.). A government could finance public expenditure by raising taxes, but since nobody likes paying more taxes and since politicians do not like to be unpopular, they have a natural preference for expanding the money supply. Unfortunately, there is no magic money tree. The inevitable result of excessive growth in money supply is price inflation. However, this has not stopped governments around

**Macroeconomic Data
for Bolivia, April 1984 to
October 1985**

Source: Juan-Antino Morales, "Inflation Stabilization in Bolivia," in *Inflation Stabilization: The Experience of Israel, Argentina, Brazil, Bolivia, and Mexico*, ed. Michael Bruno et al. (Cambridge, MA: MIT Press, 1988).

Month	Money Supply (billions of pesos)	Price Level Relative to 1982 (average = 1)	Exchange Rate (pesos per dollar)
1984			
April	270	21.1	3,576
May	330	31.1	3,512
June	440	32.3	3,342
July	599	34.0	3,570
August	718	39.1	7,038
September	889	53.7	13,685
October	1,194	85.5	15,205
November	1,495	112.4	18,469
December	3,296	180.9	24,515
1985			
January	4,630	305.3	73,016
February	6,455	863.3	141,101
March	9,089	1,078.6	128,137
April	12,885	1,205.7	167,428
May	21,309	1,635.7	272,375
June	27,778	2,919.1	481,756
July	47,341	4,854.6	885,476
August	74,306	8,081.0	1,182,300
September	103,272	12,647.6	1,087,440
October	132,550	12,411.8	1,120,210

the world from expanding the money supply, with predictable results. If an international business is attempting to predict future movements in the value of a country's currency on the foreign exchange market, it should examine that country's policy toward monetary growth. If the government seems committed to controlling the rate of growth in money supply, the country's future inflation rate may be low (even if the current rate is high) and its currency should not depreciate too much on the foreign exchange market. If the government seems to lack the political will to control the rate of growth in money supply, the future inflation rate may be high, which is likely to cause its currency to depreciate. Historically, many Latin American governments have fallen into this latter category, including Argentina, Bolivia, and Brazil. More recently, many of the newly democratic states of Eastern Europe made the same mistake.

Empirical Tests of PPP Theory PPP theory predicts that exchange rates are determined by relative prices, and that changes in relative prices will result in a change in exchange rates. A country in which price inflation is running wild should expect to see its currency depreciate against that of countries with lower inflation rates. This is intuitively appealing, but is it true in practice? There are several good examples of the

connection between a country's price inflation and exchange rate position (such as Bolivia). However, extensive empirical testing of PPP theory has yielded mixed results.¹¹ While PPP theory seems to yield relatively accurate predictions in the long run, it does not appear to be a strong predictor of short-run movements in exchange rates covering time spans of five years or less.¹² In addition, the theory seems to best predict exchange rate changes for countries with high rates of inflation and underdeveloped capital markets. The theory is less useful for predicting short-term exchange rate movements between the currencies of advanced industrialized nations that have relatively small differentials in inflation rates.

The failure to find a strong link between relative inflation rates and exchange rate movements has been referred to as the purchasing power parity puzzle. Several factors may explain the failure of PPP theory to predict exchange rates more accurately.¹³ PPP theory assumes away transportation costs and barriers to trade. In practice, these factors are significant and they tend to create significant price differentials between countries. Transportation costs are certainly not trivial for many goods. Moreover, as we saw in Chapter 6, governments routinely intervene in international trade, creating tariff and nontariff barriers to cross-border trade. Barriers to trade limit the ability of traders to use arbitrage to equalize prices for the same product in different countries, which is required for the law of one price to hold. Government intervention in cross-border trade, by violating the assumption of efficient markets, weakens the link between relative price changes and changes in exchange rates predicted by PPP theory.

In addition, the PPP theory may not hold if many national markets are dominated by a handful of multinational enterprises that have sufficient market power to be able to exercise some influence over prices, control distribution channels, and differentiate their product offerings between nations.¹⁴ In fact, this situation seems to prevail in a number of industries. In the detergent industry, two companies, Unilever and Procter & Gamble, dominate the market in nation after nation. In heavy earthmoving equipment, Caterpillar Inc. and Komatsu are global market leaders. In the market for semiconductor equipment, Applied Materials has a commanding market share lead in almost every important national market. Microsoft dominates the market for personal computer operating systems and applications systems around the world, and so on. In such cases, dominant enterprises may be able to exercise a degree of pricing power, setting different prices in different markets to reflect varying demand conditions. This is referred to as price discrimination. For price discrimination to work, arbitrage must be limited. According to this argument, enterprises with some market power may be able to control distribution channels and therefore limit the unauthorized resale (arbitrage) of products purchased in another national market. They may also be able to limit resale (arbitrage) by differentiating otherwise identical products among nations along some line, such as design or packaging.

For example, even though the version of Microsoft Office sold in China may be less expensive than the version sold in the United States, the use of arbitrage to equalize prices may be limited because few Americans would want a version that was based on Chinese characters. The design differentiation between Microsoft Office for China and for the United States means that the law of one price would not work for Microsoft Office, even if transportation costs were trivial and tariff barriers between the United States and China did not exist. If the inability to practice arbitrage were widespread enough, it would break the connection between changes in relative prices and exchange rates predicted by the PPP theorem and help explain the limited empirical support for this theory.

Another factor of some importance is that governments also intervene in the foreign exchange market in attempting to influence the value of their currencies. We will

look at why and how they do this in Chapter 10. For now, the important thing to note is that governments regularly intervene in the foreign exchange market, and this further weakens the link between price changes and changes in exchange rates. One more factor explaining the failure of PPP theory to predict short-term movements in foreign exchange rates is the impact of investor psychology and other factors on currency purchasing decisions and exchange rate movements. We will discuss this issue in more detail later in this chapter.

INTEREST RATES AND EXCHANGE RATES Economic theory tells us that interest rates reflect expectations about likely future inflation rates. In countries where inflation is expected to be high, interest rates also will be high, because investors want compensation for the decline in the value of their money. This relationship was first formalized by economist Irvin Fisher and is referred to as the Fisher effect. The **Fisher effect** states that a country's "nominal" interest rate (i) is the sum of the required "real" rate of interest (r) and the expected rate of inflation over the period for which the funds are to be lent (I). More formally,

$$i = r + I$$

For example, if the real rate of interest in a country is 5 percent and annual inflation is expected to be 10 percent, the nominal interest rate will be 15 percent. As predicted by the Fisher effect, a strong relationship seems to exist between inflation rates and interest rates.¹⁵

We can take this one step further and consider how it applies in a world of many countries and unrestricted capital flows. When investors are free to transfer capital between countries, real interest rates will be the same in every country. If differences in real interest rates did emerge between countries, arbitrage would soon equalize them. For example, if the real interest rate in Japan was 10 percent and only 6 percent in the United States, it would pay investors to borrow money in the United States and invest it in Japan. The resulting increase in the demand for money in the United States would raise the real interest rate there, while the increase in the supply of foreign money in Japan would lower the real interest rate there. This would continue until the two sets of real interest rates were equalized.

It follows from the Fisher effect that if the real interest rate is the same worldwide, any difference in interest rates between countries reflects differing expectations about inflation rates. Thus, if the expected rate of inflation in the United States is greater than that in Japan, U.S. nominal interest rates will be greater than Japanese nominal interest rates.

Since we know from PPP theory that there is a link (in theory at least) between inflation and exchange rates, and since interest rates reflect expectations about inflation, it follows that there must also be a link between interest rates and exchange rates. This link is known as the international Fisher effect (IFE). The **international Fisher effect** states that for any two countries, the spot exchange rate should change in an equal amount but in the opposite direction to the difference in nominal interest rates between the two countries. Stated more formally, the change in the spot exchange rate between the United States and Japan, for example, can be modeled as follows:

$$[(S_1 - S_2)/S_2] \times 100 = i_{\$} - i_{¥}$$

where $i_{\$}$ and $i_{¥}$ are the respective nominal interest rates in the United States and Japan, S_1 is the spot exchange rate at the beginning of the period, and S_2 is the spot exchange rate at the end of the period. If the U.S. nominal interest rate is higher than Japan's, reflecting greater expected inflation rates, the value of the dollar against the yen should fall by that interest rate differential in the future. So if the interest rate in the

Fisher Effect

Nominal interest rates (i) in each country equal the required "real" rate of interest (r) and the expected rate of inflation over the period for which the funds are to be lent (I); that is, $i = r + I$.

International Fisher Effect

For any two countries, the spot exchange rate should change in an equal amount but in the opposite direction to the difference in nominal interest rates between the two countries.



George Soros, whose Quantum Fund has been fantastically successful in managing hedge funds, has been criticized by world leaders for being able to cause huge changes in currency markets by his actions.

United States is 10 percent and in Japan it is 6 percent, we would expect the value of the dollar to depreciate by 4 percent against the Japanese yen.

Do interest rate differentials help predict future currency movements? The evidence is mixed; as in the case of PPP theory, in the long run, there seems to be a relationship between interest rate differentials and subsequent changes in spot exchange rates. However, considerable short-run deviations occur. Like PPP, the international Fisher effect is not a good predictor of short-run changes in spot exchange rates.¹⁶

INVESTOR PSYCHOLOGY AND BANDWAGON EFFECTS

Empirical evidence suggests that neither PPP theory nor the international Fisher effect are particularly good at explaining short-term movements in exchange rates. One reason may be the impact of investor psychology on short-run exchange rate movements. Evidence accumulated over the past decade reveals that various psychological factors play an important role in determining the expectations of market traders as to likely future exchange rates.¹⁷ In turn, expectations have a tendency to become self-fulfilling prophecies.

A famous example of this mechanism occurred in September 1992 when the famous international financier George Soros made a huge bet against the British pound. Soros borrowed billions of pounds, using the assets of his investment funds as collateral, and immediately sold those pounds for German deutsche marks (this was before the advent of the euro). This technique, known as short selling, can earn the speculator enormous profits if he can subsequently buy back the pounds he sold at a much better exchange rate, and then use those pounds, purchased cheaply, to repay his loan. By selling pounds and buying deutsche marks, Soros helped to start pushing down the value of the pound on the foreign exchange markets. More importantly, when Soros started shorting the British pound, many foreign exchange traders, knowing Soros's reputation, jumped on the bandwagon and did likewise. This triggered a classic **bandwagon effect** with traders moving as a herd in the same direction at the same time. As the bandwagon effect gained momentum, with more traders selling British pounds and purchasing deutsche marks in expectation of a decline in the pound, their expectations became a self-fulfilling prophecy. Massive selling forced down the value of the pound against the deutsche mark. In other words, the pound declined in value not so much because of any major shift in macroeconomic fundamentals, but because investors followed a bet placed by a major speculator, George Soros.

According to a number of studies, investor psychology and bandwagon effects play a major role in determining short-run exchange rate movements.¹⁸ However, these effects can be hard to predict. Investor psychology can be influenced by political factors and by microeconomic events, such as the investment decisions of individual firms, many of which are only loosely linked to macroeconomic fundamentals, such as relative inflation rates. Also, bandwagon effects can be both triggered and exacerbated by the idiosyncratic behavior of politicians. Something like this seems to have occurred in Southeast Asia during 1997 when, one after another, the currencies of Thailand, Malaysia, South Korea, and Indonesia lost between 50 percent and 70 percent of their value against the U.S. dollar in a few months. For a detailed look at what occurred in South Korea, see the accompanying Country Focus. The collapse in the value of the Korean currency did not occur because South Korea had a higher inflation rate than the United States. It occurred because of an excessive buildup of dollar-denominated debt among South Korean firms. By mid-1997 it was clear that these

Bandwagon Effect

When traders move like a herd, all in the same direction and at the same time, in response to each others' perceived actions.



Country FOCUS

Anatomy of a Currency Crisis

In early 1997, South Korea could look back with pride on a 30-year “economic miracle” that had raised the country from the ranks of the poor and given it the world’s 11th-largest economy. By the end of 1997, the Korean currency, the won, had lost a staggering 67 percent of its value against the U.S. dollar, the South Korean economy lay in tatters, and the International Monetary Fund was overseeing a \$55 billion rescue package. This sudden turn of events had its roots in investments made by South Korea’s large industrial conglomerates, or *chaebol*, during the 1990s, often at the bequest of politicians. In 1993, Kim Young-Sam, a populist politician, became president of South Korea. Mr. Kim took office during a mild recession and promised to boost economic growth by encouraging investment in export-oriented industries. He urged the *chaebol* to invest in new factories. South Korea enjoyed an investment-led economic boom in 1994–1995, but at a cost. The *chaebol*, always reliant on heavy borrowing, built up massive debts that were equivalent, on average, to four times their equity.

As the volume of investments ballooned during the 1990s, the quality of many of these investments declined significantly. The investments often were made on the basis of unrealistic projections about future demand conditions. This resulted in significant excess capacity and falling prices. An example is investments made by South Korean *chaebol* in semiconductor factories. Investments in such facilities surged in 1994 and 1995 when a temporary global shortage of dynamic random access memory chips (DRAMs) led to sharp price increases for this product. However, supply shortages had disappeared by 1996 and excess capacity was beginning to make itself felt, just as the South Koreans started to bring new DRAM factories on stream. The results were predictable; prices for DRAMs plunged and the earnings of South Korean DRAM manufacturers fell by 90 percent, which meant it was difficult for them to make scheduled payments on the debt they had acquired to build the extra capacity. The risk of corporate bankruptcy increased significantly, and not just in the semiconductor industry. South Korean companies were also investing heavily in a wide range of other industries, including automobiles and steel.

Matters were complicated further because much of the borrowing had been in U.S. dollars, as opposed to Korean won. This had seemed like a smart move at the time. The dollar/won exchange rate had been stable at around \$1 = won 850. Interest rates on dollar borrowings were two to three percentage points lower than rates on borrowings in Korean won. Much of this borrowing was in the form of

short-term, dollar-denominated debt that had to be paid back to the lending institution within one year. While the borrowing strategy seemed to make sense, it involved risk. If the won were to depreciate against the dollar, the size of the debt burden that South Korean companies would have to service would increase when measured in the local currency. Currency depreciation would raise borrowing costs, depress corporate earnings, and increase the risk of bankruptcy. This is exactly what happened.

By mid-1997, foreign investors had become alarmed at the rising debt levels of South Korean companies, particularly given the emergence of excess capacity and plunging prices in several areas where the companies had made huge investments, including semiconductors, automobiles, and steel. Given increasing speculation that many South Korean companies would not be able to service their debt payments, foreign investors began to withdraw their money from the Korean stock and bond markets. In the process, they sold Korean won and purchased U.S. dollars. The selling of won accelerated in mid-1997 when two of the smaller *chaebol* filed for bankruptcy, citing their inability to meet scheduled debt payments. The increased supply of won and the increased demand for U.S. dollars pushed down the price of won in dollar terms from around won 840 = \$1 to won 900 = \$1.

At this point, the South Korean central bank stepped into the foreign exchange market to try to keep the exchange rate above won 1,000 = \$1. It used dollars that it held in reserve to purchase won. The idea was to try to push up the price of the won in dollar terms and restore investor confidence in the stability of the exchange rate. This action, however, did not address the underlying debt problem faced by South Korean companies. Against a backdrop of more corporate bankruptcies in South Korea, and the government’s stated intentions to take some troubled companies into state ownership, Standard & Poor’s, the U.S. credit rating agency, downgraded South Korea’s sovereign debt. This caused the Korean stock market to plunge 5.5 percent, and the Korean won to fall to won 930 = \$1. According to S&P, “The downgrade of . . . ratings reflects the escalating cost to the government of supporting the country’s ailing corporate and financial sectors.”

The S&P downgrade triggered a sharp sale of the Korean won. In an attempt to protect the won against what was fast becoming a classic bandwagon effect, the South Korean central bank raised short-term interest rates to over 12 percent, more than double the inflation rate. The bank also stepped up its intervention in the currency exchange markets, selling dollars and purchasing won in an attempt to keep the exchange rate above won 1,000 = \$1.

(continued)

The main effect of this action, however, was to rapidly deplete South Korea's foreign exchange reserves. These stood at \$30 billion on November 1, but fell to only \$15 billion two weeks later. With its foreign exchange reserves almost exhausted, the South Korean central bank gave up its defense of the won November 17. Immediately, the price of won in dollars plunged to around won 1,500 = \$1, effectively increasing by 60 to 70 percent the amount of won heavily indebted Korean companies had to pay to meet scheduled payments on their dollar-denominated

debt. These losses, due to adverse changes in foreign exchange rates, depressed the profits of many firms. South Korean firms suffered foreign exchange losses of more than \$15 billion in 1997.

Sources: J. Burton and G. Baker, "The Country That Invested Its Way into Trouble," *Financial Times*, January 15, 1998, p. 8; J. Burton, "South Korea's Credit Rating Is Lowered," *Financial Times*, October 25, 1997, p. 3; J. Burton, "Currency Losses Hit Samsung Electronics," *Financial Times*, March 20, 1998, p. 24; and "Korean Firms' Foreign Exchange Losses Exceed US \$15 Billion," *Business Korea*, February 1998, p. 55.

companies were having trouble servicing this debt. Foreign investors, fearing a wave of corporate bankruptcies, took their money out of the country, exchanging won for U.S. dollars. As this began to depress the exchange rate, currency traders jumped on the bandwagon and speculated against the won (selling it short), and it was this that produced a collapse in the value of the won.

SUMMARY OF EXCHANGE RATE THEORIES Relative monetary growth, relative inflation rates, and nominal interest rate differentials are all moderately good predictors of long-run changes in exchange rates. They are poor predictors of short-run changes in exchange rates, however, perhaps because of the impact of psychological factors, investor expectations, and bandwagon effects on short-term currency movements. This information is useful for an international business. Insofar as the long-term profitability of foreign investments, export opportunities, and the price competitiveness of foreign imports are all influenced by long-term movements in exchange rates, international businesses would be advised to pay attention to countries' differing monetary growth, inflation, and interest rates. International businesses that engage in foreign exchange transactions on a day-to-day basis could benefit by knowing some predictors of short-term foreign exchange rate movements. Unfortunately, short-term exchange rate movements are difficult to predict.

Exchange Rate Forecasting

LEARNING OBJECTIVE 5

Identify the merits of different approaches toward exchange rate forecasting.

A company's need to predict future exchange rate variations raises the issue of whether it is worthwhile for the company to invest in exchange rate forecasting services to aid decision making. Two schools of thought address this issue. The efficient market school argues that forward exchange rates do the best possible job of forecasting future spot exchange rates, and, therefore, investing in forecasting services would be a waste of money. The other school of thought, the inefficient market school, argues that companies can improve the foreign exchange market's estimate of future exchange rates (as contained in the forward rate) by investing in forecasting services. In other words, this school of thought does not believe the forward exchange rates are the best possible predictors of future spot exchange rates.

THE EFFICIENT MARKET SCHOOL Forward exchange rates represent market participants' collective predictions of likely spot exchange rates at specified future dates. If forward exchange rates are the best possible predictor of future spot rates, it would make no sense for companies to spend additional money trying to forecast short-run exchange rate movements. Many economists believe the foreign

exchange market is efficient at setting forward rates.¹⁹ As mentioned earlier, an efficient market is one in which prices reflect all available public information. (If forward rates reflect all available information about likely future changes in exchange rates, a company cannot beat the market by investing in forecasting services.)

If the foreign exchange market is efficient, forward exchange rates should be unbiased predictors of future spot rates. This does not mean the predictions will be accurate in any specific situation. It means inaccuracies will not be consistently above or below future spot rates; they will be random. Many empirical tests have addressed the efficient market hypothesis. Although most of the early work seems to confirm the hypothesis (suggesting that companies should not waste their money on forecasting services) some recent studies have challenged it.²⁰ There is some evidence that forward rates are not unbiased predictors of future spot rates, and that more accurate predictions of future spot rates can be calculated from publicly available information.²¹

THE INEFFICIENT MARKET SCHOOL Citing evidence against the efficient market hypothesis, some economists believe the foreign exchange market is inefficient. An **inefficient market** is one in which prices do not reflect all available information. In an inefficient market, forward exchange rates will not be the best possible predictors of future spot exchange rates.

If this is true, it may be worthwhile for international businesses to invest in forecasting services (as many do). The belief is that professional exchange rate forecasts might provide better predictions of future spot rates than forward exchange rates do. However, the track record of professional forecasting services is not that good.²² For example, forecasting services did not predict the 1997 currency crisis that swept through Southeast Asia, nor did they predict the rise in the value of the dollar that occurred during late 2008, a period when the United States fell into a deep financial crisis that some thought would lead to a decline in the *value* of the dollar (it appears that the dollar rose because it was seen as a relatively safe currency in a time when many nations were experiencing economic trouble).

APPROACHES TO FORECASTING Assuming the inefficient market school is correct that the foreign exchange market's estimate of future spot rates can be improved, on what basis should forecasts be prepared? Here again, there are two schools of thought. One adheres to fundamental analysis, while the other uses technical analysis.

Fundamental Analysis **Fundamental analysis** draws on economic theory to construct sophisticated econometric models for predicting exchange rate movements. The variables contained in these models typically include those we have discussed, such as relative money supply growth rates, inflation rates, and interest rates. In addition, they may include variables related to balance-of-payments positions.

Running a deficit on a balance-of-payments current account (a country is importing more goods and services than it is exporting) creates pressures that may result in the depreciation of the country's currency on the foreign exchange market.²³ Consider what might happen if the United States was running a persistent current account balance-of-payments deficit (as in fact, it has been). Since the United States would be importing more than it was exporting, people in other countries would be increasing their holdings of U.S. dollars. If these people were willing to hold their dollars, the dollar's exchange rate would not be influenced. However, if these people converted their dollars into other currencies, the supply of dollars in the foreign exchange market would increase (as would demand for the other currencies). This shift in demand

Inefficient Market

One in which prices do not reflect all available information.

Fundamental Analysis

Draws on economic theory to construct sophisticated econometric models for predicting exchange rate movements.

and supply would create pressures that could lead to the depreciation of the dollar against other currencies.

This argument hinges on whether people in other countries are willing to hold dollars. This depends on such factors as U.S. interest rates, the return on holding other dollar-denominated assets such as stocks in U.S. companies, and, most importantly, inflation rates. So, in a sense, the balance-of-payments situation is not a fundamental predictor of future exchange rate movements. For example, between 1998 and 2001, the U.S. dollar appreciated against most major currencies despite a growing balance-of-payments deficit. Relatively high real interest rates in the United States, coupled with low inflation and a booming U.S. stock market that attracted inward investment from foreign capital, made the dollar very attractive to foreigners, so they did not convert their dollars into other currencies. On the contrary, they converted other currencies into dollars to invest in U.S. financial assets, such as bonds and stocks, because they believed they could earn a high return by doing so. Capital flows into the United States fueled by foreigners who wanted to buy U.S. stocks and bonds kept the dollar strong despite the current account deficit. But what makes financial assets such as stocks and bonds attractive? The answer is prevailing interest rates and inflation rates, both of which affect underlying economic growth and the real return to holding U.S. financial assets. Given this, we are back to the argument that the fundamental determinants of exchange rates are monetary growth, inflation rates, and interest rates.

Technical Analysis

Uses price and volume data to determine past trends, which are expected to continue into the future.

Technical Analysis Technical analysis uses price and volume data to determine past trends, which are expected to continue into the future. This approach does not rely on a consideration of economic fundamentals. Technical analysis is based on the premise that there are analyzable market trends and waves and that previous trends and waves can be used to predict future trends and waves. Since there is no theoretical rationale for this assumption of predictability, many economists compare technical analysis to fortune-telling. Despite this skepticism, technical analysis has gained favor in recent years.²⁴

Freely Convertible Currency

A country's currency is freely convertible when the government of that country allows both residents and nonresidents to purchase unlimited amounts of a foreign currency with it.

Currency Convertibility

Until this point we have invalidly assumed that the currencies of various countries are freely convertible into other currencies. Due to government restrictions, a significant number of currencies are not freely convertible into other currencies. A country's currency is said to be **freely convertible** when the country's government allows both residents and nonresidents to purchase unlimited amounts of a foreign currency with it. A currency is said to be **externally convertible** when only nonresidents may convert it into a foreign currency without any limitations. A currency is **nonconvertible** when neither residents nor nonresidents are allowed to convert it into a foreign currency.

Externally Convertible Currency

Nonresidents can convert their holdings of domestic currency into foreign currency, but the ability of residents to convert the currency is limited in some way.

Free convertibility is not universal. Many countries place some restrictions on their residents' ability to convert the domestic currency into a foreign currency (a policy of external convertibility). Restrictions range from the relatively minor (such as restricting the amount of foreign currency they may take with them out of the country on trips) to the major (such as restricting domestic businesses' ability to take foreign currency out of the country). External convertibility restrictions can limit domestic companies' ability to invest abroad, but they present few problems for foreign companies wishing to do business in that country. For example, even if the Japanese government tightly controlled the ability of its residents to convert the yen into U.S. dollars, all U.S. businesses with deposits in Japanese banks may at any time convert all their yen into dollars and take them out of the country. Thus, a U.S. company with a subsidiary

Nonconvertible Currency

A currency is not convertible when both residents and nonresidents are prohibited from converting their holdings of that currency into another currency.



To deal with nonconvertibility problems, companies will barter instead. Venezuela traded iron ore for Caterpillar construction equipment. Caterpillar sold the iron ore to Romania for farm products, which it then sold on international markets for dollars.

in Japan is assured that it will be able to convert the profits from its Japanese operation into dollars and take them out of the country.

Serious problems arise, however, under a policy of nonconvertibility. This was the practice of the former Soviet Union, and it continued to be the practice in Russia for several years after the collapse of the Soviet Union. When strictly applied, nonconvertibility means that although a U.S. company doing business in a country such as Russia may be able to generate significant ruble profits, it may not convert those rubles into dollars and take them out of the country. Obviously this is not desirable for international business.

Governments limit convertibility to preserve their foreign exchange reserves. A country needs an adequate supply of these reserves to service its international debt commitments and to purchase imports. Governments typically impose convertibility restrictions on their currency when they fear that free convertibility will lead to a run on their foreign exchange reserves. This occurs when residents and nonresidents rush to convert their holdings of domestic currency into a foreign currency—a phenomenon generally referred to as **capital flight**. Capital flight is most likely to occur when the value of the domestic currency is depreciating rapidly because of hyperinflation, or when a country's economic prospects are shaky in other respects. Under such circumstances, both residents and nonresidents tend to believe that their money is more likely to hold its value if it is converted into a foreign currency and invested abroad. Not only will a run on foreign exchange reserves limit the country's ability to service its international debt and pay for imports, but it will also lead to a precipitous depreciation in the exchange rate as residents and nonresidents unload their holdings of domestic currency on the foreign exchange markets (thereby increasing the market supply of the country's currency). Governments fear that the rise in import prices

Capital Flight
Residents convert domestic currency into a foreign currency.

Countertrade
The trade of goods and services for other goods and services.

resulting from currency depreciation will lead to further increases in inflation. This fear provides another rationale for limiting convertibility.

Companies can deal with the nonconvertibility problem by engaging in countertrade. **Countertrade** refers to a range of barter-like agreements by which goods and services can be traded for other goods and services. Countertrade can make sense when a country's currency is nonconvertible. For example, consider the deal that General Electric struck with the Romanian government when that country's currency was nonconvertible. When General Electric won a contract for a \$150 million generator project in Romania, it agreed to take payment in the form of Romanian goods that could be sold for \$150 million on international markets. In a similar case, the Venezuelan government negotiated a contract with Caterpillar under which Venezuela would trade 350,000 tons of iron ore for Caterpillar heavy construction equipment. Caterpillar subsequently traded the iron ore to Romania in exchange for Romanian farm products, which it then sold on international markets for dollars.²⁵ Similarly, in a 2003 deal the government of Indonesia entered into a countertrade with Libya under which Libya agreed to purchase \$540 million in Indonesian goods, including textiles, tea, coffee, electronics, plastics, and auto parts, in exchange for 50,000 barrels per day of Libyan crude oil.²⁶

How important is countertrade? Twenty years ago, a large number of nonconvertible currencies existed in the world, and countertrade was quite significant. However, in recent years many governments have made their currencies freely convertible, and the percentage of world trade that involves countertrade is probably significantly below 10 percent.²⁷



Focus on Managerial Implications

This chapter contains a number of clear implications for business. First, it is critical that international businesses understand the influence of exchange rates on the profitability of trade and investment deals. Adverse changes in exchange rates can make apparently profitable deals unprofitable. As noted, the risk introduced into international business transactions by changes in exchange rates is referred to as foreign exchange risk. Foreign exchange risk is usually divided into three main categories: transaction exposure, translation exposure, and economic exposure.

Transaction Exposure

Transaction exposure is the extent to which the income from individual transactions is affected by fluctuations in foreign exchange values. Such exposure includes obligations for the purchase or sale of goods and services at previously agreed prices and the borrowing or lending of funds in foreign currencies. For example, suppose in 2004 an American airline agreed to purchase 10 Airbus 330 aircraft for €120 million each for a total price of €1.20 billion, with delivery scheduled for 2005 and payment due then. When the contract was signed in 2001 the dollar/euro exchange rate stood at \$1 = €1.10 so the American airline anticipated paying \$1.1 billion for the 10 aircraft when they were delivered ($\text{€}1.2 \text{ billion} / 1.1 = \1.09 billion). However, imagine that the value of the dollar depreciates against the euro over the intervening period, so that one dollar buys only €0.80 in 2008 when payment is due ($\$1 = \text{€}0.80$). Now the total cost in U.S. dollars is \$1.5 billion ($\text{€}1.2 \text{ billion} / 0.80 = \1.5 billion), an increase of \$0.41 billion! The transaction exposure here is \$0.41 billion, which is the money lost due to an adverse movement in exchange rates between the time when the deal was signed and when the aircraft were paid for.

LEARNING OBJECTIVE 6

Compare and contrast the differences between translation, transaction, and economic exposure, and explain what managers can do to manage each type of exposure.

Transaction Exposure

Extent to which income from individual transactions is affected by fluctuations in foreign exchange values.

Translation Exposure

Translation exposure is the impact of currency exchange rate changes on the reported financial statements of a company. Translation exposure is concerned with the present measurement of past events. The resulting accounting gains or losses are said to be unrealized—they are “paper” gains and losses—but they are still important. Consider a U.S. firm with a subsidiary in Mexico. If the value of the Mexican peso depreciates significantly against the dollar this would substantially reduce the dollar value of the Mexican subsidiary’s equity. In turn, this would reduce the total dollar value of the firm’s equity reported in its consolidated balance sheet. This would raise the apparent leverage of the firm (its debt ratio), which could increase the firm’s cost of borrowing and potentially limit its access to the capital market. Similarly, if an American firm has a subsidiary in the European Union, and if the value of the euro depreciates rapidly against that of the dollar over a year, this will reduce the dollar value of the euro profit made by the European subsidiary, resulting in negative translation exposure. In fact, many U.S. firms suffered from significant negative translation exposure in Europe during 2000, precisely because the euro did depreciate rapidly against the dollar. In 2002–2007, the euro rose in value against the dollar. This positive translation exposure boosted the dollar profits of American multinationals with significant operations in Europe.

Translation Exposure

The extent to which the reported consolidated results and balance sheets of a corporation are affected by fluctuations in foreign exchange values.

Economic Exposure

Economic exposure is the extent to which a firm’s future international earning power is affected by changes in exchange rates. Economic exposure is concerned with the long-run effect of changes in exchange rates on future prices, sales, and costs. This is distinct from transaction exposure, which is concerned with the effect of exchange rate changes on individual transactions, most of which are short-term affairs that will be executed within a few weeks or months. Consider the effect of wide swings in the value of the dollar on many U.S. firms’ international competitiveness. The rapid rise in the value of the dollar on the foreign exchange market in the 1990s hurt the price competitiveness of many U.S. producers in world markets. U.S. manufacturers that relied heavily on exports (such as Caterpillar) saw their export volume and world market share decline. The reverse phenomenon occurred in 2000–2009, when the dollar declined against most major currencies. The fall in the value of the dollar helped increase the price competitiveness of U.S. manufacturers in world markets.

Economic Exposure

The extent to which a firm’s future international earning power is affected by changes in exchange rates.

Reducing Translation and Transaction Exposure

A number of tactics can help firms minimize their transaction and translation exposure. These tactics primarily protect short-term cash flows from adverse changes in exchange rates. We have already discussed two of these tactics at length in the chapter, entering into forward exchange rate contracts and buying swaps. In addition to buying forward and using swaps, firms can minimize their foreign exchange exposure through leading and lagging payables and receivables—that is, paying suppliers and collecting payment from customers early or late depending on expected exchange rate movements. A **lead strategy** involves attempting to collect foreign currency receivables (payments from customers) early when a foreign currency is expected to depreciate and paying foreign currency payables (to suppliers) before they are due when a currency is expected to appreciate. A **lag strategy** involves delaying collection of foreign currency receivables if that currency is expected to appreciate and delaying payables if the currency is expected to depreciate. Leading and lagging involves accelerating payments from weak-currency to strong-currency countries and delaying inflows from strong-currency to weak-currency countries.

Lead Strategy

Attempting to collect foreign currency receivables early when a foreign currency is expected to depreciate and paying foreign currency payables before they are due when a currency is expected to appreciate.

Lag Strategy

Delaying collection of foreign currency receivables if that currency is expected to appreciate and delaying payables if the currency is expected to depreciate.



Management FOCUS

Dealing with the Rising Euro

Udo Pfeiffer, the CEO of SMS Elotherm, a German manufacturer of machine tools to engineer crankshafts for cars, signed a deal in late November 2004, to supply the U.S. operations of DaimlerChrysler with \$1.5 million worth of machines. The machines would be manufactured in Germany and exported to the United States. When the deal was signed, Pfeiffer calculated that at the agreed price, the machines would yield a profit of €30,000 each. Within three days that profit had declined by €8,000! The dollar had slid precipitously against the euro. SMS would be paid in dollars by DaimlerChrysler, but when translated back into euros, the price had declined. Since the company's costs were in euros, the declining revenues when expressed in euros were squeezing profit margins.

With the exchange rate standing at $\text{€}1 = \$1.33$ in early December 2004, Pfeiffer was deeply worried. He knew that if the dollar declined further to around $\text{€}1 = \$1.50$, SMS would be losing money on its sales to America. He could try to raise the dollar price of his products to compensate for the fall in the value of the dollar, but he knew that was unlikely to work. The market for machine tools was very competitive, and

manufacturers were constantly pressuring machine tool companies to lower prices, not raise them.

Another small German supplier to U.S. automobile companies, Keiper, was faring somewhat better. In 2001 Keiper, which manufactures metal frames for automobile seats, opened a plant in London, Ontario, to supply the U.S. operations of DaimlerChrysler. At the time the investment was made, the exchange rate was $\text{€}1 = \$1$. Management at Keiper had agonized over whether the investment made sense. Some in the company felt that it was better to continue exporting from Germany. Others argued that Keiper would benefit from being close to a major customer. Now with the euro appreciating every day, it looked like a smart move. Keiper had a real hedge against the rising value of the euro. But the advantages of being based in Canada were tempered by two things; first, the U.S. dollar had also depreciated against the Canadian dollar, although not by as much as its depreciation against the euro. Second, Keiper was still importing parts from Germany, and the euro had also appreciated against the Canadian dollar, raising the costs at Keiper's Ontario plant.

Source: Adapted from M. Landler, "Dollar's Fall Drains Profit of European Small Business," *The New York Times*, December 2, 2004, p. C1.

Lead and lag strategies can be difficult to implement, however. The firm must be in a position to exercise some control over payment terms. Firms do not always have this kind of bargaining power, particularly when they are dealing with important customers who are in a position to dictate payment terms. Also, because lead and lag strategies can put pressure on a weak currency, many governments limit leads and lags. For example, some countries set 180 days as a limit for receiving payments for exports or making payments for imports.

Reducing Economic Exposure

Reducing economic exposure requires strategic choices that go beyond the realm of financial management. The key to reducing economic exposure is to distribute the firm's productive assets to various locations so the firm's long-term financial well-being is not severely affected by adverse changes in exchange rates. This is a strategy that firms both large and small sometimes pursue. For example, fearing that the euro will continue to strengthen against the U.S. dollar, some European firms who do significant business in the United States have set up local production facilities in that market to ensure that a rising euro does not put them at a competitive disadvantage relative to their local rivals. Similarly, Toyota has production plants distributed around the world in part to make sure that a rising Yen does not price Toyota cars out of local markets. Caterpillar has also pursued this strategy, setting up factories around the world that can act as a hedge against the possibility that a strong dollar will price Caterpillar's exports out of foreign markets. In 2008 and 2009, this real hedge proved to be very useful. The accompanying Management Focus discusses how two German firms tried to reduce economic exposure.

Other Steps for Managing Foreign Exchange Risk

The firm needs to develop a mechanism for ensuring it maintains an appropriate mix of tactics and strategies for minimizing its foreign exchange exposure. Although there is no universal agreement as to the components of this mechanism, a number of common themes stand out.²⁸ First, central control of exposure is needed to protect resources efficiently and ensure that each subunit adopts the correct mix of tactics and strategies. Many companies have set up in-house foreign exchange centers. Although such centers may not be able to execute all foreign exchange deals—particularly in large, complex multinationals where myriad transactions may be pursued simultaneously—they should at least set guidelines for the firm’s subsidiaries to follow.

Second, firms should distinguish between, on one hand, transaction and translation exposure and, on the other, economic exposure. Many companies seem to focus on reducing their transaction and translation exposure and pay scant attention to economic exposure, which may have more profound long-term implications.²⁹ Firms need to develop strategies for dealing with economic exposure. For example, Black & Decker, the maker of power tools, has a strategy for actively managing its economic risk. The key to Black & Decker’s strategy is flexible sourcing. In response to foreign exchange movements, Black & Decker can move production from one location to another to offer the most competitive pricing. Black & Decker manufactures in more than a dozen locations around the world—in Europe, Australia, Brazil, Mexico, and Japan. More than 50 percent of the company’s productive assets are based outside North America. Although each of Black & Decker’s factories focuses on one or two products to achieve economies of scale, there is considerable overlap. On average, the company runs its factories at no more than 80 percent capacity, so most are able to switch rapidly from producing one product to producing another or to add a product. This allows a factory’s production to be changed in response to foreign exchange movements. For example, if the dollar depreciates against other currencies, the amount of imports into the United States from overseas subsidiaries can be reduced and the amount of exports from U.S. subsidiaries to other locations can be increased.³⁰

Third, the need to forecast future exchange rate movements cannot be overstated, though, as we saw earlier in the chapter, this is a tricky business. No model comes close to perfectly predicting future movements in foreign exchange rates. The best that can be said is that in the short run, forward exchange rates provide the best predictors of exchange rate movements, and in the long run, fundamental economic factors—particularly relative inflation rates—should be watched because they influence exchange rate movements. Some firms attempt to forecast exchange rate movements in-house; others rely on outside forecasters. However, all such forecasts are imperfect attempts to predict the future.

Fourth, firms need to establish good reporting systems so the central finance function (or in-house foreign exchange center) can regularly monitor the firm’s exposure positions. Such reporting systems should enable the firm to identify any exposed accounts, the exposed position by currency of each account, and the time periods covered.

Finally, on the basis of the information it receives from exchange rate forecasts and its own regular reporting systems, the firm should produce monthly foreign exchange exposure reports. These reports should identify how cash flows and balance sheet elements might be affected by forecasted changes in exchange rates. The reports can then be used by management as a basis for adopting tactics and strategies to hedge against undue foreign exchange risks.

Surprisingly, some of the largest and most sophisticated firms don’t take such precautionary steps, exposing themselves to very large foreign exchange risks. Thus as we have seen in this chapter, Volkswagen suffered significant losses during the early 2000s due to a failure to hedge its foreign exchange exposure.

Key Terms

foreign exchange market, p. 313	arbitrage, p. 320	externally convertible currency, p. 332
exchange rate, p. 313	law of one price, p. 321	nonconvertible currency, p. 332
foreign exchange risk, p. 313	efficient market, p. 321	capital flight, p. 333
currency speculation, p. 315	Fisher effect, p. 327	countertrade, p. 334
carry trade, p. 315	international Fisher effect, p. 327	transaction exposure, p. 334
hedging, p. 315	bandwagon effect, p. 328	translation exposure, p. 335
spot exchange rate, p. 315	inefficient market, p. 331	economic exposure, p. 335
forward exchange, p. 317	fundamental analysis, p. 331	lead strategy, p. 335
forward exchange rate, p. 317	technical analysis, p. 332	lag strategy, p. 335
currency swap, p. 318	freely convertible currency, p. 332	

Summary

This chapter explained how the foreign exchange market works, examined the forces that determine exchange rates, and then discussed the implications of these factors for international business. Given that changes in exchange rates can dramatically alter the profitability of foreign trade and investment deals, this is an area of major interest to international business. The chapter made the following points:

1. One function of the foreign exchange market is to convert the currency of one country into the currency of another. A second function of the foreign exchange market is to provide insurance against foreign exchange risk.
2. The spot exchange rate is the exchange rate at which a dealer converts one currency into another currency on a particular day.
3. Foreign exchange risk can be reduced by using forward exchange rates. A forward exchange rate is an exchange rate governing future transactions. Foreign exchange risk can also be reduced by engaging in currency swaps. A swap is the simultaneous purchase and sale of a given amount of foreign exchange for two different value dates.
4. The law of one price holds that in competitive markets that are free of transportation costs and barriers to trade, identical products sold in different countries must sell for the same price when their price is expressed in the same currency.
5. Purchasing power parity (PPP) theory states the price of a basket of particular goods should be roughly equivalent in each country. PPP theory predicts that the exchange rate will change if relative prices change.
6. The rate of change in countries' relative prices depends on their relative inflation rates. A country's inflation rate seems to be a function of the growth in its money supply.
7. The PPP theory of exchange rate changes yields relatively accurate predictions of long-term trends in exchange rates, but not of short-term movements. The failure of PPP theory to predict exchange rate changes more accurately may be due to transportation costs, barriers to trade and investment, and the impact of psychological factors such as bandwagon effects on market movements and short-run exchange rates.
8. Interest rates reflect expectations about inflation. In countries where inflation is expected to be high, interest rates also will be high.
9. The international Fisher effect states that for any two countries, the spot exchange rate should change in an equal amount but in the opposite direction to the difference in nominal interest rates.
10. The most common approach to exchange rate forecasting is fundamental analysis. This relies on variables such as money supply growth, inflation rates, nominal interest rates, and balance-of-payments positions to predict future changes in exchange rates.
11. In many countries, the ability of residents and nonresidents to convert local currency into a

foreign currency is restricted by government policy. A government restricts the convertibility of its currency to protect the country's foreign exchange reserves and to halt any capital flight.

12. Problematic for international business is a policy of nonconvertibility, which prohibits residents and nonresidents from exchanging local currency for foreign currency. Nonconvertibility makes it very difficult to engage in international trade and investment in the country. One way of coping with the nonconvertibility problem is to engage in countertrade—to trade goods and services for other goods and services.
13. The three types of exposure to foreign exchange risk are transaction exposure, translation exposure, and economic exposure.
14. Tactics that insure against transaction and translation exposure include buying forward, using currency swaps, leading and lagging payables and receivables, manipulating transfer prices, using local debt financing, accelerating dividend payments, and adjusting capital budgeting to reflect foreign exchange exposure.
15. Reducing a firm's economic exposure requires strategic choices about how the firm's productive assets are distributed around the globe.
16. To manage foreign exchange exposure effectively, the firm must exercise centralized oversight over its foreign exchange hedging activities, recognize the difference between transaction exposure and economic exposure, forecast future exchange rate movements, establish good reporting systems within the firm to monitor exposure positions, and produce regular foreign exchange exposure reports that can be used as a basis for action.

Critical Thinking and Discussion Questions

1. The interest rate on South Korean government securities with one-year maturity is 4 percent, and the expected inflation rate for the coming year is 2 percent. The interest rate on U.S. government securities with one-year maturity is 7 percent, and the expected rate of inflation is 5 percent. The current spot exchange rate for Korean won is $\$1 = \text{W}1,200$. Forecast the spot exchange rate one year from today. Explain the logic of your answer.
2. Two countries, Great Britain and the United States, produce just one good: beef. Suppose the price of beef in the United States is \$2.80 per pound and in Britain it is £3.70 per pound.
 - a. According to PPP theory, what should the dollar/pound spot exchange rate be?
 - b. Suppose the price of beef is expected to rise to \$3.10 in the United States and to £4.65 in Britain. What should the one-year forward dollar/pound exchange rate be?
 - c. Given your answers to parts *a* and *b*, and given that the current interest rate in the United States is 10 percent, what would you expect the current interest rate to be in Britain?
3. Reread the Management Focus "Volkswagen's Hedging Strategy," then answer the following questions:
 - a. Why do you think management at Volkswagen decided to hedge only 30 percent of its foreign currency exposure in 2003? What would have happened if it had hedged 70 percent?
 - b. Why do you think the value of the U.S. dollar declined against that of the euro in 2003?
 - c. Apart from hedging through the foreign exchange market, what else can Volkswagen do to reduce its exposure to future declines in the value of the U.S. dollar against the euro?
4. You manufacture wine goblets. In mid-June you receive an order for 10,000 goblets from Japan. Payment of ¥400,000 is due in mid-December. You expect the yen to rise from its present rate of $\$1 = \text{¥}130$ to $\$1 = \text{¥}100$ by December. You can borrow yen at 6 percent a year. What should you do?
5. You are the CFO of a U.S. firm whose wholly owned subsidiary in Mexico manufactures component parts for your U.S. assembly operations. The subsidiary has been financed by bank borrowings in the United States. One of your analysts told you that the Mexican peso is expected to depreciate by 30 percent against the dollar on the foreign exchange markets over the next year. What actions, if any, should you take?

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

1. You are assigned the duty of ensuring the availability of 100 million Japanese yen for a payment scheduled for tomorrow. Your company possesses only U.S. dollars, so you must identify a Web site that provides *real-time exchange rates* and find the spot exchange rate for Japanese yen. How many dollars do you have to spend to acquire the amount of yen required?
2. Your company imports olive oil from Italy to sell in the United States. As expected, the exchange

rate has changed from the previous year has impacted your bottom line. In preparing an annual report for your company, you would like to include a one-year *currency chart* showing the monthly movement of the U.S. dollar versus the euro. Download the relevant data indicating the exchange rate between these two currencies once per month for the past year. Then, analyze the data and describe the pattern you see. Over the past year, has the dollar gained or lost ground versus the euro?



Caterpillar Tractor

closing case

Caterpillar Tractor has long been one of America's major exporters. The company sells its construction equipment, mining equipment, and engines to some 200 countries worldwide. As a leading exporter, Caterpillar's fate has often been tied to the value of the U.S. dollar. In the 1980s, the U.S. dollar was strong against the Japanese yen. This gave Komatsu, Japan's premier manufacturer of heavy construction equipment, a pricing advantage against Caterpillar. Undercutting Caterpillar's prices by as much as 30 percent, Komatsu grabbed market share in the United States and other markets. For Caterpillar, it was a difficult time. At one point the company was losing a million dollars a day and battling a hostile labor union that was opposed to job restructuring designed to make the company more competitive. The company seemed to be yet another example of a declining business in America's rust belt.

Fast forward to the mid-2000s, and Caterpillar was thriving. Much had changed over the previous two decades. Caterpillar had reached deals with its unions and invested in state-of-the-art manufacturing facilities. Its productivity, once abysmal, was now among the best in the industry. Sales, exports, and profits were all rising. There was a worldwide boom in spending on infrastructure, and Caterpillar was reaping the gains, producing record amounts of equipment. Moreover, the U.S. dollar, which for years had been strong,

weakened significantly during the mid-2000s. This reduced the price of Caterpillar's exports, when translated into many foreign currencies, and helped the company to keep its prices down in foreign markets. At this point, Caterpillar was exporting over half of the output of its key U.S. factories in Peoria, Illinois.

Then in 2008, the dollar started to strengthen again. Even though the American economy was stumbling deep into a financial crisis that would usher in a steep economic recession, foreigners invested strongly in U.S. assets, particularly Treasury bills. Their demand for dollars to purchase these assets pushed up the value of the dollar on the foreign exchange markets. The hunger of foreigners for dollars was based on a belief that even though things were bad in America, they were probably going to be even worse in many other developed economies, and the U.S. government at least would not default on its bonds, making U.S. Treasury bills a safe haven in an economic storm.

Analysts fretted that the stronger dollar would impact negatively on Caterpillar's financial performance, since the prices of its exports were now rising when converted into many foreign currencies. The reality, however, was somewhat different. As 2008 progressed, the strong dollar started to negatively impact Caterpillar's revenues, but it had a *favorable* effect on Caterpillar's costs! What had changed over the

past two decades is that Caterpillar had dramatically expanded its network of foreign manufacturing operations. While still a major exporter, some 102 of its 237 manufacturing facilities were now located outside of North America, many in countries such as China, India, and Brazil that were expanding their infrastructure spending. Although the revenues generated by these operations in local currency, *when translated back into dollars*, declined as the dollar strengthened, the costs of these operations also fell, since their costs were also priced in local currencies, which reduced the impact on profit margins. Although Caterpillar's export revenues from the United States started to fall, as one would expect, because the company now sourced many of its inputs from foreign producers, the price it paid for those inputs also fell, which again moderated the impact of the strong dollar on earnings. This is not to say that a strong dollar does not have an effect, it does, but through its globalization strategy Caterpillar has

been able to reduce the impact of fluctuations in the value of the dollar on its profits.

Sources: J. B. Kelleher, "U.S. Exporters Can Win from the Strong Dollar," *International Herald Tribune*, May 9, 2008, p. 15; "Caterpillar's Comeback," *The Economist*, June 20, 1998, pp. 7–8; and A. Taylor, "Caterpillar," *Fortune*, July 20, 2007, pp. 48–54.

Case Discussion Questions

1. In the 1980s a stronger dollar hurt Caterpillar's competitive position, but in 2008 a stronger dollar did not seem to have the same effect. What had changed?
2. How did Caterpillar use strategy as a "real hedge" to reduce its exposure to foreign exchange risk? What is the downside of its approach?
3. Explain the difference between transaction exposure and translation exposure using the material in the Caterpillar case to illustrate your answer.



part 4 Global Money System

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Describe the historical development of the modern global monetary system.
- 2 Explain the role played by the World Bank and the IMF in the international monetary system.
- 3 Compare and contrast the differences between a fixed and a floating exchange rate system.
- 4 Identify exchange rate regimes that are used in the world today and why countries adopt different exchange rate regimes.
- 5 Understand the debate surrounding the role of the IMF in the management of financial crises.
- 6 Explain the implications of the global monetary system for currency management and business strategy.

The International Monetary System

Economic Turmoil in Latvia

opening case

Latvia, a country of 2.5 million people, is one of the three Baltic states that gained independence after the collapse of the Soviet Union. Over the past decade, the economic story in Latvia has been one of rapid economic growth powered by a vibrant private sector. The country joined the European Union in 2004 and pegged its currency, the *lat*, to the value of the euro. The eventual goal for Latvia was to adopt the euro. To maintain parity against the euro, Latvia used a variation of a system known as a currency board, where local currency in circulation is backed, unit for unit, by reserves of foreign currency, which in Latvia's case was primarily the euro.

From 2006 onward, repeated warnings indicated the Latvian economy might be overheating. Increasingly, inflows of foreign money into Latvian banks, particularly from Russia, sustained an economic boom. The banks were using these funds to finance aggressive lending, including lending to an increasingly frothy property market, with prices being bid up by borrowers who could get access to cheap credit. Critics urged the government to rein in the lending by raising interest rates, but to no avail. What the government failed to do, the market ultimately did anyway.

The boom started to unravel in 2008 as a global economic crisis that began with overvaluation in the U.S. property market rolled around the world. For Latvia, the trouble began when the nation's largest private bank, Parex, revealed it was in financial distress. Hurt by rising defaults on the risky loans it had made, Parex sought government help. The government stepped in, initially injecting 200 million lats (about \$390 million) into the bank. This did not solve the problems for Parex. With depositors rapidly withdrawing money, the government was forced to nationalize the institution. Far from halting the crisis, this seemed to deepen it as individuals and institutions started to change their lat into euros and U.S. dollars. Currency speculators also joined the fray by selling lats short, betting that the government would have to devalue the currency.

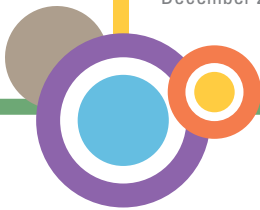
This put enormous pressure on the Latvian currency, forcing the country's central banks to enter the foreign exchange markets, buying lats in an attempt to maintain the currency peg against the euro. In less than two months, the bank went through over a fifth of its total foreign exchange reserves, but the money continued to flow out of the country.

One solution to the crisis would have been to devalue the lat against the euro. However, this would have created additional problems. Many Latvians had borrowed in euros. If the lat were depreciated against the euro, the cost of servicing their loans in local currency would have jumped by an amount equal to the depreciation, causing immediate economic hardship for local borrowers.

In December 2008, the Latvian government asked for help from both the European Union and the International Monetary Fund. The IMF put together an international rescue package, which totaled some 7.5 billion euros in loans from the IMF, the European Union, neighboring Sweden and Finland, and the World Bank. These funds were to be used to protect the value of the lat against the euro. Sweden and Finland contributed 1.8 billion euros to the fund, largely because Swedish and Finnish banks had large stakes in Latvian banks, and the concern was that problems in Latvia could damage the banking systems of these two countries.

As part of the conditions for the loan, the IMF required significant change in economic policy from the Latvian government, including interest rate increases, wage cuts, sharp cutbacks in government spending, and tax increases. There was no question that these policies would push Latvia into a deep recession. The belief of the IMF, however, is that they are necessary to restore confidence in both the country's banking system and in the ability of the government to maintain the peg of the lat to the euro. Once that has been achieved, so the argument goes, conditions will improve and the country will start to grow again. Some Latvians reacted to the deal by rioting in the streets of Riga, the capital. Forty people were hurt, including 14 police officers, and 106 arrests were made, suggesting that the road ahead will be a bumpy one. ●

Sources: "To the Barricades," *The Economist*, January 24, 2009, pp. 56–57; "Baltic Brink," *The Economist*, December 20, 2008, pp. 78–79; and R. Anderson, "Latvia to Receive 7.5 Billion in Aid," *Financial Times*, December 20, 2008, p. 4.



Introduction

International Monetary System
Institutional arrangements countries adopt to govern exchange rates.

What happened in Latvia in late 2008 goes to the heart of the subject matter covered in this chapter. Here we look at the international monetary system, and its role in determining exchange rates. The **international monetary system** refers to the institutional arrangements that govern exchange rates. In Chapter 9 we assumed the foreign exchange market was the primary institution for determining exchange rates, and the impersonal market forces of demand and supply determined the relative value of any

two currencies (i.e., their exchange rate). Furthermore, we explained that the demand and supply of currencies is influenced by their respective countries' relative inflation rates and interest rates. When the foreign exchange market determines the relative value of a currency, we say that the country is adhering to a **floating exchange rate** regime. Four of the world's major trading currencies—the U.S. dollar, the European Union's euro, the Japanese yen, and the British pound—are all free to float against each other. Thus, their exchange rates are determined by market forces and fluctuate against each other day to day, if not minute to minute. However, the exchange rates of many currencies are not determined by the free play of market forces; other institutional arrangements are adopted.

Many of the world's developing nations peg their currencies, primarily to the dollar or the euro. A **pegged exchange rate** means the value of the currency is fixed relative to a reference currency, such as the U.S. dollar, and then the exchange rate between that currency and other currencies is determined by the reference currency exchange rate. Latvia, for example, has pegged its exchange rate to the euro (see the opening case). Similarly, many of the states around the Gulf of Arabia have long pegged their currencies to the dollar.

Other countries, while not adopting a formal pegged rate, try to hold the value of their currency within some range against an important reference currency such as the U.S. dollar, or a “basket” of currencies. This is often referred to as a **dirty float**. It is a float because in theory, the value of the currency is determined by market forces, but it is a *dirty float* (as opposed to a clean float) because the central bank of a country will intervene in the foreign exchange market to try to maintain the value of its currency if it depreciates too rapidly against an important reference currency. This has been the policy adopted by the Chinese since July 2005. The value of the Chinese currency, the yuan, has been linked to a basket of other currencies, including the dollar, yen, and euro, and it is allowed to vary in value against individual currencies, but only within tight limits. As discussed in Chapter 5, some believe that the Chinese are deliberately holding down the value of their currency to promote exports.

Still other countries have operated with a **fixed exchange rate**, in which the values of a set of currencies are fixed against each other at some mutually agreed on exchange rate. Before the introduction of the euro in 2000, several member states of the European Union operated with fixed exchange rates within the context of the **European Monetary System (EMS)**. For a quarter of a century after World War II, the world's major industrial nations participated in a fixed exchange rate system. Although this system collapsed in 1973, some still argue that the world should attempt to reestablish it.

In this chapter, we will explain how the international monetary system works and point out its implications for international business. To understand how the system works, we must review its evolution. We will begin with a discussion of the gold standard and its breakup during the 1930s. Then we will discuss the 1944 Bretton Woods conference. This established the basic framework for the post–World War II international monetary system. The Bretton Woods system called for fixed exchange rates against the U.S. dollar. Under this fixed exchange rate system, the value of most currencies in terms of U.S. dollars was fixed for long periods and allowed to change only under a specific set of circumstances. The Bretton Woods conference also created two major international institutions that play a role in the international monetary system—the International Monetary Fund (IMF) and the World Bank. The IMF was given the task of maintaining order in the international monetary system; the World Bank's role was to promote development.

Today, both these institutions continue to play major roles in the world economy and in the international monetary system. In 1997 and 1998, for example, the IMF helped

Floating Exchange Rate

A system under which the exchange rate for converting one currency into another is continuously adjusted depending on the laws of supply and demand.

Pegged Exchange Rate

Currency value is fixed relative to a reference currency.

Dirty Float

A system under which a country's currency is nominally allowed to float freely against other currencies, but in which the government will intervene, buying and selling currency, if it believes that the currency has deviated too far from its fair value.

Fixed Exchange Rate

A system under which the exchange rate for converting one currency into another is fixed.

European Monetary System (EMS)

A system to regulate fixed exchange rates before the introduction of the euro.

several Asian countries deal with the dramatic decline in the value of their currencies that occurred during the Asian financial crisis that started in 1997. The IMF was also actively involved in helping Latvia manage its financial crisis in 2008 and 2009 (see the opening case). In 2010 the IMF had programs in 68 countries, the majority in the developing world, and had some \$175 billion in loans to nations.¹ At times of financial crisis, such as that which unfolded in 2008 and 2009, these loan amounts can spike much higher. The role of the IMF and to a lesser extent the World Bank and the appropriateness of their policies for many developing nations has been vigorously debated. Several prominent critics claim that in some cases, IMF policies make things worse, not better (some have argued this may be occurring in Latvia, where very restrictive policies have ushered in a deep recession). The debate over the role of the IMF took on new urgency given the institution's extensive involvement in the economies of developing countries during the late 1990s and early 2000s. Accordingly, we shall discuss the issue in some depth.

The Bretton Woods system of fixed exchange rates collapsed in 1973. Since then, the world has operated with a mixed system in which some currencies are allowed to float freely, but many are either managed by government intervention or pegged to another currency. We will explain the reasons for the failure of the Bretton Woods system as well as the nature of the present system. We will also discuss how pegged exchange rate systems work. More than three decades after the breakdown of the Bretton Woods system, the debate continues over what kind of exchange rate regime is best for the world. Some economists advocate a system in which major currencies are allowed to float against each other. Others argue for a return to a fixed exchange rate regime similar to the one established at Bretton Woods. This debate is intense and important, and we will examine the arguments of both sides.

Finally, we will discuss the implications of all this material for international business. We will see how the exchange rate policy adopted by a government can have an important impact on the outlook for business operations in a given country. We will also look at how the policies adopted by the IMF can have an impact on the economic outlook for a country and, accordingly, on the costs and benefits of doing business in that country.

The Gold Standard

LEARNING OBJECTIVE 1

Describe the historical development of the modern global monetary system.

The gold standard had its origin in the use of gold coins as a medium of exchange, unit of account, and store of value—a practice that dates to ancient times. When international trade was limited in volume, payment for goods purchased from another country was typically made in gold or silver. However, as the volume of international trade expanded in the wake of the Industrial Revolution, a more convenient means of financing international trade was needed. Shipping large quantities of gold and silver around the world to finance international trade seemed impractical. The solution adopted was to arrange for payment in paper currency and for governments to agree to convert the paper currency into gold on demand at a fixed rate.

MECHANICS OF THE GOLD STANDARD Pegging currencies to gold and guaranteeing convertibility is known as the **gold standard**. By 1880, most of the world's major trading nations, including Great Britain, Germany, Japan, and the United States, had adopted the gold standard. Given a common gold standard, the value of any currency in units of any other currency (the exchange rate) was easy to determine.

For example, under the gold standard, one U.S. dollar was defined as equivalent to 23.22 grains of “fine” (pure) gold. Thus, one could, in theory, demand that the U.S. government convert that one dollar into 23.22 grains of gold. Since there are

Gold Standard

The practice of pegging currencies to gold and guaranteeing convertibility.

480 grains in an ounce, one ounce of gold cost \$20.67 (480/23.22). The amount of a currency needed to purchase one ounce of gold was referred to as the **gold par value**. The British pound was valued at 113 grains of fine gold. In other words, one ounce of gold cost £4.25 (480/113). From the gold par values of pounds and dollars, we can calculate what the exchange rate was for converting pounds into dollars; it was $\text{£}1 = \$4.87$ (i.e., $\$20.67/\text{£}4.25$).

Gold Par Value

The amount of currency needed to purchase one ounce of gold.

STRENGTH OF THE GOLD STANDARD The great strength claimed for the gold standard was that it contained a powerful mechanism for achieving balance-of-trade equilibrium by all countries.² A country is said to be in **balance-of-trade equilibrium** when the income its residents earn from exports is equal to the money its residents pay to other countries for imports (the current account of its balance of payments is in balance). Suppose there are only two countries in the world, Japan and the United States. Imagine Japan's trade balance is in surplus because it exports more to the United States than it imports from the United States. Japanese exporters are paid in U.S. dollars, which they exchange for Japanese yen at a Japanese bank. The Japanese bank submits the dollars to the U.S. government and demands payment of gold in return. (This is a simplification of what would occur, but it will make our point.)

Balance-of-Trade Equilibrium

Reached when the income a country's residents earn from exports equals the money residents pay for imports.

Under the gold standard, when Japan has a trade surplus, there will be a net flow of gold from the United States to Japan. These gold flows automatically reduce the U.S. money supply and swell Japan's money supply. As we saw in Chapter 9, there is a close connection between money supply growth and price inflation. An increase in money supply will raise prices in Japan, while a decrease in the U.S. money supply will push U.S. prices downward. The rise in the price of Japanese goods will decrease demand for these goods, while the fall in the price of U.S. goods will increase demand for these goods. Thus, Japan will start to buy more from the United States, and the United States will buy less from Japan, until a balance-of-trade equilibrium is achieved.

This adjustment mechanism seems so simple and attractive that even today, almost 70 years after the final collapse of the gold standard, some people believe the world should return to a gold standard.

THE PERIOD BETWEEN THE WARS: 1918–1939 The gold standard worked reasonably well from the 1870s until the start of World War I in 1914, when it was abandoned. During the war, several governments financed part of their massive military expenditures by printing money. This resulted in inflation, and by the war's end in 1918, price levels were higher everywhere. The United States returned to the gold standard in 1919, Great Britain in 1925, and France in 1928.

Great Britain returned to the gold standard by pegging the pound to gold at the pre-war gold parity level of £4.25 per ounce, despite substantial inflation between 1914 and 1925. This priced British goods out of foreign markets, which pushed the country into a deep depression. When foreign holders of pounds lost confidence in Great Britain's commitment to maintaining its currency's value, they began converting their holdings of pounds into gold. The British government saw that it could not satisfy the demand for gold without seriously depleting its gold reserves, so it suspended convertibility in 1931.

The United States followed suit and left the gold standard in 1933 but returned to it in 1934, raising the dollar price of gold from \$20.67 per ounce to \$35 per ounce. Since more dollars were needed to buy an ounce of gold than before, the implication was that the dollar was worth less. This effectively amounted to a devaluation of the dollar relative to other currencies. Thus, before the devaluation, the pound/dollar exchange rate was $\text{£}1 = \$4.87$, but after the devaluation it was $\text{£}1 = \$8.24$. By reducing the price of U.S. exports and increasing the price of imports, the government was trying to create employment in the United States by boosting output (the U.S. government was basically

using the exchange rate as an instrument of trade policy—something it now accuses China of doing). However, a number of other countries adopted a similar tactic, and in the cycle of competitive devaluations that soon emerged, no country could win.

The net result was the shattering of any remaining confidence in the system. With countries devaluing their currencies at will, one could no longer be certain how much gold a currency could buy. Instead of holding onto another country's currency, people often tried to change it into gold immediately, lest the country devalue its currency in the intervening period. This put pressure on the gold reserves of various countries, forcing them to suspend gold convertibility. By the start of World War II in 1939, the gold standard was dead.

The Bretton Woods System

LEARNING OBJECTIVE 2

Explain the role played by the World Bank and the IMF in the international monetary system.

In 1944, at the height of World War II, representatives from 44 countries met at Bretton Woods, New Hampshire, to design a new international monetary system. With the collapse of the gold standard and the Great Depression of the 1930s fresh in their minds, these statesmen were determined to build an enduring economic order that would facilitate postwar economic growth. There was consensus that fixed exchange rates were desirable. In addition, the conference participants wanted to avoid the senseless competitive devaluations of the 1930s, and they recognized that the gold standard would not assure this. The major problem with the gold standard as previously constituted was that no multinational institution could stop countries from engaging in competitive devaluations.

The agreement reached at Bretton Woods established two multinational institutions—the International Monetary Fund (IMF) and the World Bank. The task of the IMF would be to maintain order in the international monetary system and that of the World Bank would be to promote general economic development. The Bretton Woods agreement also called for a system of fixed exchange rates that would be policed by the IMF. Under the agreement, all countries were to fix the value of their currency in terms of gold but were not required to exchange their currencies for gold. Only the dollar remained convertible into gold—at a price of \$35 per ounce. Each country decided



In 1944, at the height of World War II, representatives from 44 countries met at Bretton Woods, New Hampshire, to design a new international monetary system. Pictured here is Henry Morgenthau, then secretary of the Treasury, addressing the opening meeting of the conference where the IMF and the World Bank were established.

what it wanted its exchange rate to be vis-à-vis the dollar and then calculated the gold par value of the currency based on that selected dollar exchange rate. All participating countries agreed to try to maintain the value of their currencies within 1 percent of the par value by buying or selling currencies (or gold) as needed. For example, if foreign exchange dealers were selling more of a country's currency than demanded, that country's government would intervene in the foreign exchange markets, buying its currency in an attempt to increase demand and maintain its gold par value.

Another aspect of the Bretton Woods agreement was a commitment not to use devaluation as a weapon of competitive trade policy. However, if a currency became too weak to defend, a devaluation of up to 10 percent would be allowed without any formal approval by the IMF. Larger devaluations required IMF approval.

THE ROLE OF THE IMF The IMF Articles of Agreement were heavily influenced by the worldwide financial collapse, competitive devaluations, trade wars, high unemployment, hyperinflation in Germany and elsewhere, and general economic disintegration that occurred between the two world wars. The aim of the Bretton Woods agreement, of which the IMF was the main custodian, was to try to avoid a repetition of that chaos through a combination of discipline and flexibility.

Discipline A fixed exchange rate regime imposes discipline in two ways. First, the need to maintain a fixed exchange rate puts a brake on competitive devaluations and brings stability to the world trade environment. Second, a fixed exchange rate regime imposes monetary discipline on countries, thereby curtailing price inflation. For example, consider what would happen under a fixed exchange rate regime if Great Britain rapidly increased its money supply by printing pounds. As explained in Chapter 9, the increase in money supply would lead to price inflation. Given fixed exchange rates, inflation would make British goods uncompetitive in world markets, while the prices of imports would become more attractive in Great Britain. The result would be a widening trade deficit in Great Britain, with the country importing more than it exports. To correct this trade imbalance under a fixed exchange rate regime, Great Britain would be required to restrict the rate of growth in its money supply to bring price inflation back under control. Thus, fixed exchange rates are seen as a mechanism for controlling inflation and imposing economic discipline on countries.

Flexibility Although monetary discipline was a central objective of the Bretton Woods agreement, it was recognized that a rigid policy of fixed exchange rates would be too inflexible. It would probably break down just as the gold standard had. In some cases, a country's attempts to reduce its money supply growth and correct a persistent balance-of-payments deficit could force the country into recession and create high unemployment. The architects of the Bretton Woods agreement wanted to avoid high unemployment, so they built limited flexibility into the system. Two major features of the IMF Articles of Agreement fostered this flexibility: IMF lending facilities and adjustable parities.

The IMF stood ready to lend foreign currencies to members to tide them over during short periods of balance-of-payments deficits, when a rapid tightening of monetary or fiscal policy would hurt domestic employment. A pool of gold and currencies contributed by IMF members provided the resources for these lending operations. A persistent balance-of-payments deficit can lead to a depletion of a country's reserves of foreign currency, forcing it to devalue its currency. By providing deficit-laden countries with short-term foreign currency loans, IMF funds would buy time for countries to bring down their inflation rates and reduce their balance-of-payments deficits. The belief was that such loans would reduce pressures for devaluation and allow for a more orderly and less painful adjustment.

Countries were to be allowed to borrow a limited amount from the IMF without adhering to any specific agreements. However, extensive drawings from IMF funds would require a country to agree to increasingly stringent IMF supervision of its macroeconomic policies. Heavy borrowers from the IMF must agree to monetary and fiscal conditions set down by the IMF, which typically included IMF-mandated targets on domestic money supply growth, exchange rate policy, tax policy, government spending, and so on.

The system of adjustable parities allowed for the devaluation of a country's currency by more than 10 percent if the IMF agreed that a country's balance of payments was in "fundamental disequilibrium." The term *fundamental disequilibrium* was not defined in the IMF's Articles of Agreement, but it was intended to apply to countries that had suffered permanent adverse shifts in the demand for their products. Without devaluation, such a country would experience high unemployment and a persistent trade deficit until the domestic price level had fallen far enough to restore a balance-of-payments equilibrium. The belief was that devaluation could help sidestep a painful adjustment process in such circumstances.

THE ROLE OF THE WORLD BANK The official name for the World Bank is the International Bank for Reconstruction and Development (IBRD). When the Bretton Woods participants established the World Bank, the need to reconstruct the war-torn economies of Europe was foremost in their minds. The bank's initial mission was to help finance the building of Europe's economy by providing low-interest loans. As it turned out, the World Bank was overshadowed in this role by the Marshall Plan, under which the United States lent money directly to European nations to help them rebuild. So the bank turned its attention to "development" and began lending money to Third World nations. In the 1950s, the bank concentrated on public-sector projects. Power stations, road building, and other transportation investments were much in favor. During the 1960s, the bank also began to lend heavily in support of agriculture, education, population control, and urban development.

The bank lends money under two schemes. Under the IBRD scheme, money is raised through bond sales in the international capital market. Borrowers pay what the bank calls a market rate of interest—the bank's cost of funds plus a margin for expenses. This "market" rate is lower than commercial banks' market rate. Under the IBRD scheme, the bank offers low-interest loans to risky customers whose credit rating is often poor, such as the governments of underdeveloped nations.

A second scheme is overseen by the International Development Association (IDA), an arm of the bank created in 1960. Resources to fund IDA loans are raised through subscriptions from wealthy members such as the United States, Japan, and Germany. IDA loans go only to the poorest countries. Borrowers have 50 years to repay at an interest rate of 1 percent a year. The world's poorest nations receive grants and no-interest loans.

The Collapse of the Fixed Exchange Rate System

LEARNING OBJECTIVE 1

Describe the historical development of the modern global monetary system.

The system of fixed exchange rates established at Bretton Woods worked well until the late 1960s, when it began to show signs of strain. The system finally collapsed in 1973, and since then we have had a managed-float system. To understand why the system collapsed, one must appreciate the special role of the U.S. dollar in the system. As the only currency that could be converted into gold, and as the currency that served as the reference point for all others, the dollar occupied a central place in the system. Any pressure on the dollar to devalue could wreak havoc with the system, and that is what occurred.

Most economists trace the breakup of the fixed exchange rate system to the U.S. macroeconomic policy package of 1965–1968.³ To finance both the Vietnam conflict and his welfare programs, President Lyndon Johnson backed an increase in U.S. government spending that was not financed by an increase in taxes. Instead, it was financed by an increase in the money supply, which led to a rise in price inflation from less than 4 percent in 1966 to close to 9 percent by 1968. At the same time, the rise in government spending had stimulated the economy. With more money in their pockets, people spent more—particularly on imports—and the U.S. trade balance began to deteriorate.

The increase in inflation and the worsening of the U.S. foreign trade position gave rise to speculation in the foreign exchange market that the dollar would be devalued. Things came to a head in the spring of 1971 when U.S. trade figures showed that for the first time since 1945, the United States was importing more than it was exporting. This set off massive purchases of German deutsche marks in the foreign exchange market by speculators who guessed that the mark would be revalued against the dollar. On a single day, May 4, 1971, the Bundesbank (Germany's central bank) had to buy \$1 billion to hold the dollar/deutsche mark exchange rate at its fixed exchange rate given the great demand for deutsche marks. On the morning of May 5, the Bundesbank purchased another \$1 billion during the first hour of foreign exchange trading! At that point, the Bundesbank faced the inevitable and allowed its currency to float.

In the weeks following the decision to float the deutsche mark, the foreign exchange market became increasingly convinced that the dollar would have to be devalued. However, devaluation of the dollar was no easy matter. Under the Bretton Woods provisions, any other country could change its exchange rates against all currencies simply by fixing its dollar rate at a new level. But as the key currency in the system, the dollar could be devalued only if all countries agreed to simultaneously revalue against the dollar. Many countries did not want this, because it would make their products more expensive relative to U.S. products.

To force the issue, President Nixon announced in August 1971 that the dollar was no longer convertible into gold. He also announced that a new 10 percent tax on imports would remain in effect until U.S. trading partners agreed to revalue their currencies against the dollar. This brought the trading partners to the bargaining table, and in December 1971 an agreement was reached to devalue the dollar by about 8 percent against foreign currencies. The import tax was then removed.

The problem was not solved, however. The U.S. balance-of-payments position continued to deteriorate throughout 1972, while the nation's money supply continued to expand at an inflationary rate. Speculation continued to grow that the dollar was still overvalued and that a second devaluation would be necessary. In anticipation, foreign exchange dealers began converting dollars to deutsche marks and other currencies. After a massive wave of speculation in February 1972, which culminated with European central banks spending \$3.6 billion on March 1 to try to prevent their currencies from appreciating against the dollar, the foreign exchange market was closed. When the foreign exchange market reopened March 19, the currencies of Japan and most European countries were floating against the dollar, although many developing countries continued to peg their currency to the dollar, and many do to this day. At that time, the switch to a



Another Perspective

United States off the Gold Standard

When President Nixon took the United States off the gold standard in 1971, his decision established the dollar as the standard against which other currencies would be measured. The U.S. gold reserves, which in 1945 had held 80 percent of all gold reserves worldwide, had been under serious pressure since France, under the leadership of Charles De Gaulle, had demanded to convert the French dollar reserves to gold in 1965, the first of many central bank requests. Nixon's decision set up the dollar to be the de facto standard of the new floating system, and it continues that way today.

floating system was viewed as a temporary response to unmanageable speculation in the foreign exchange market. But it is now nearly 40 years since the Bretton Woods system of fixed exchange rates collapsed, and the temporary solution looks permanent.

The Bretton Woods system had an Achilles' heel: The system could not work if its key currency, the U.S. dollar, was under speculative attack. The Bretton Woods system could work only as long as the U.S. inflation rate remained low and the United States did not run a balance-of-payments deficit. Once these things occurred, the system soon became strained to the breaking point.

The Floating Exchange Rate Regime

LEARNING OBJECTIVE 1

Describe the historical development of the modern global monetary system.

The floating exchange rate regime that followed the collapse of the fixed exchange rate system was formalized in January 1976 when IMF members met in Jamaica and agreed to the rules for the international monetary system that are in place today.

THE JAMAICA AGREEMENT The Jamaica meeting revised the IMF's Articles of Agreement to reflect the new reality of floating exchange rates. The main elements of the Jamaica agreement include the following:

- Floating rates were declared acceptable. IMF members were permitted to enter the foreign exchange market to even out "unwarranted" speculative fluctuations.
- Gold was abandoned as a reserve asset. The IMF returned its gold reserves to members at the current market price, placing the proceeds in a trust fund to help poor nations. IMF members were permitted to sell their own gold reserves at the market price.
- Total annual IMF quotas—the amount member countries contribute to the IMF—were increased to \$41 billion. (Since then they have been increased to \$300 billion while the membership of the IMF has been expanded to include 184 countries. In 2009, the IMF was seeking to increase its funding to help with the global financial crisis). Non-oil-exporting, less developed countries were given greater access to IMF funds.

EXCHANGE RATES SINCE 1973 Since March 1973, exchange rates have become much more volatile and less predictable than they were between 1945 and 1973.⁴ This volatility has been partly due to a number of unexpected shocks to the world monetary system, including:

- The oil crisis in 1971, when the Organization of Petroleum Exporting Countries (OPEC) quadrupled the price of oil. The harmful effect of this on the U.S. inflation rate and trade position resulted in a further decline in the value of the dollar.
- The loss of confidence in the dollar that followed a sharp rise in the U.S. inflation rate in 1977–1978.
- The oil crisis of 1979, when OPEC once again increased the price of oil dramatically—this time it was doubled.
- The unexpected rise in the dollar between 1980 and 1985, despite a deteriorating balance-of-payments picture.
- The rapid fall of the U.S. dollar against the Japanese yen and German deutsche mark between 1985 and 1987, and against the yen between 1993 and 1995.
- The partial collapse of the European Monetary System in 1992.
- The 1997 Asian currency crisis, when the Asian currencies of several countries, including South Korea, Indonesia, Malaysia, and Thailand, lost between 50 percent and 80 percent of their value against the U.S. dollar in a few months.
- The decline in the value of the U.S. dollar from 2001 to 2009.

10.1 figure

Major Currencies Dollar Index, 1973–2009

Source: Constructed by the author from Federal Reserve Board statistics at www.federalreserve.gov/releases/H10/summary/.

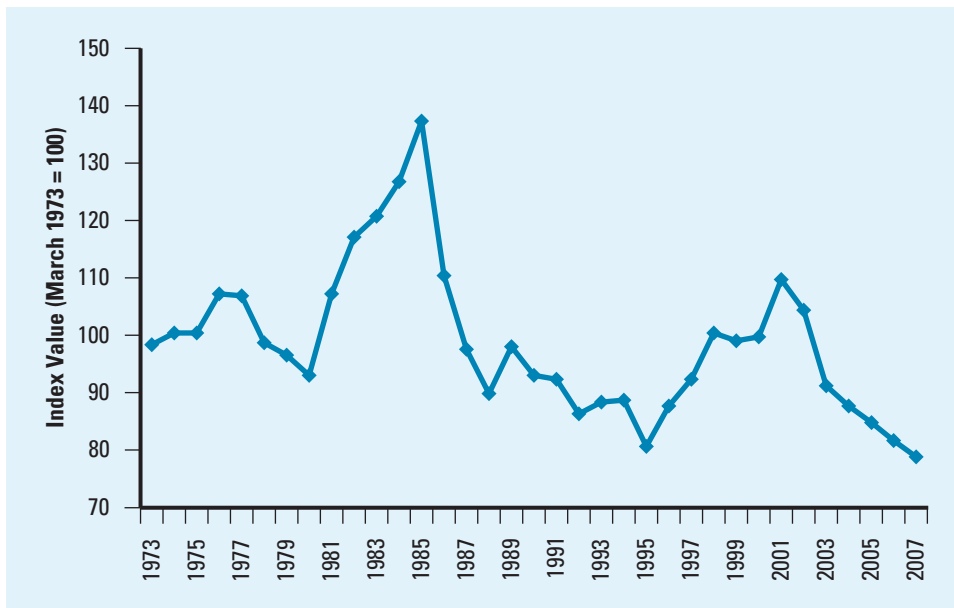


Figure 10.1 summarizes how the value of the U.S. dollar has fluctuated against an index of major trading currencies between 1973 and 2009. (The index, which was set equal to 100 in March 1973, is a weighted average of the foreign exchange values of the U.S. dollar against currencies that circulate widely outside the country of issue.) An interesting phenomenon in Figure 10.1 is the rapid rise in the value of the dollar between 1980 and 1985 and its subsequent fall between 1985 and 1988. A similar, though less pronounced, rise and fall in the value of the dollar occurred between 1995 and 2009. We will briefly discuss the rise and fall of the dollar during these periods, since this tells us something about how the international monetary system has operated in recent years.⁵

The rise in the value of the dollar between 1980 and 1985 occurred when the United States was running a large and growing trade deficit, importing substantially more than it exported. Conventional wisdom would suggest that the increased supply of dollars in the foreign exchange market as a result of the trade deficit should lead to a reduction in the value of the dollar, but as shown in Figure 10.1 it increased in value. Why?

A number of favorable factors overcame the unfavorable effect of a trade deficit. Strong economic growth in the United States attracted heavy inflows of capital from foreign investors seeking high returns on capital assets. High real interest rates attracted foreign investors seeking high returns on financial assets. At the same time, political turmoil in other parts of the world, along with relatively slow economic growth in the developed countries of Europe, helped create the view that the United States was a good place to invest. These inflows of capital increased the demand for dollars in the foreign exchange market, which pushed the value of the dollar upward against other currencies.

The fall in the value of the dollar between 1985 and 1988 was caused by a combination of government intervention and market forces. The rise in the dollar, which priced U.S. goods out of foreign markets and made imports relatively cheap, had contributed to a dismal trade picture. In 1985, the United States posted a record-high trade deficit of more than \$160 billion. This led to growth in demands for protectionism in the United States. In September 1985, the finance ministers and

central bank governors of the so-called Group of Five major industrial countries (Great Britain, France, Japan, Germany, and the United States) met at the Plaza Hotel in New York and reached what was later referred to as the Plaza Accord. They announced that it would be desirable for most major currencies to appreciate vis-à-vis the U.S. dollar and pledged to intervene in the foreign exchange markets, selling dollars, to encourage this objective. The dollar had already begun to weaken in the summer of 1985, and this announcement further accelerated the decline.

The dollar continued to decline until 1987. The governments of the Group of Five began to worry that the dollar might decline too far, so the finance ministers met in Paris in February 1987 and reached a new agreement known as the Louvre Accord. They agreed that exchange rates had been realigned sufficiently and pledged to support the stability of exchange rates around their current levels by intervening in the foreign exchange markets when necessary to buy and sell currency. Although the dollar continued to decline for a few months after the Louvre Accord, the rate of decline slowed, and by early 1988 the decline had ended.

Except for a brief speculative flurry around the time of the Persian Gulf War in 1991, the dollar was relatively stable for the first half of the 1990s. However, in the late 1990s the dollar again began to appreciate against most major currencies, including the euro after its introduction, even though the United States was still running a significant balance-of-payments deficit. Once again, the driving force for the appreciation in the value of the dollar was that foreigners continued to invest in U.S. financial assets, primarily stocks and bonds, and the inflow of money drove up the value of the dollar on foreign exchange markets. The inward investment was due to a belief that U.S. financial assets offered a favorable rate of return.

By 2002, however, foreigners had started to lose their appetite for U.S. stocks and bonds, and the inflow of money into the United States slowed. Instead of reinvesting dollars earned from exports to the United States in U.S. financial assets, they exchanged those dollars for other currencies, particularly euros, to invest them in non-dollar-denominated assets. One reason for this was the continued growth in the U.S. trade deficit, which hit a record \$767 billion in 2005 (by 2009 it had fallen to \$381 billion). Although the U.S. trade deficits had been hitting records for decades, this deficit was the largest ever when measured as a percentage of the country's GDP (7 percent of GDP in 2005).

The record deficit meant that ever more dollars were flowing out of the United States into foreign hands, and those foreigners were less inclined to reinvest those dollars in the United States at a rate required to keep the dollar stable. This growing reluctance of foreigners to invest in the United States was due to several factors. First, there was a slowdown in U.S. economic activity during 2001–2002, and a somewhat slow recovery thereafter, which made U.S. assets less attractive. Second, the U.S. government's budget deficit expanded rapidly after 2001, hitting a record \$318 billion in 2005 before falling back to \$158 billion in 2007, and then surging again to \$1.4 trillion in 2009 due to government stimulus plans and bailouts in the midst of a deep financial crisis. This led to fears that ultimately the budget deficit would be financed by an expansionary monetary policy that could lead to higher price inflation. Since inflation would reduce the value of



Another Perspective

Floating Dollars and OPEC

In the early 1970s, dollars became the currency for oil trades through an agreement between the United States and OPEC. This commitment of OPEC to dollar oil sales was made secretly by the United States and Saudi Arabia, first, and then the United States and other OPEC countries. The impact of petrodollars, as they are known, is huge. Petrodollars lead oil-producing countries to be likely to invest their dollar surpluses in the United States. In fact, OPEC dollar surpluses help to fund the U.S. trade deficit. Iraq, Iran, and Venezuela have at times initiated a push to move trading in oil to the euro, but so far OPEC has stayed with the dollar. (Peter Dale Scott, *Drugs, Oil, and War: The United States in Afghanistan, Colombia, and Indochina* [Lanham: MD: Rowman & Littlefield, 2003], pp. 41–42)



Country FOCUS

The U.S. Dollar, Oil Prices, and Recycling Petrodollars

Between 2004 and 2008 global oil prices surged. They peaked at over \$170 a barrel in 2008, up from about \$20 in 2001, before falling sharply back to the mid-\$30 range by early 2009. The rise in oil prices was due to a combination of greater than expected demand for oil, particularly from rapidly developing giants such as China and India; tight supplies; and perceived geopolitical risks in the Middle East, the world's largest oil-producing region.

The surge in oil prices was a windfall for oil-producing countries. Collectively they earned around \$700 billion in oil revenues in 2005, and well over \$1 trillion in 2007 and 2008, some 64 percent of which went to members of OPEC. Saudi Arabia, the world's largest oil producer, reaped a major share. Since oil is priced in U.S. dollars, the rise in oil prices has translated into a substantial increase in the dollar holdings of oil producers (the dollars earned from the sale of oil are often referred to as *petrodollars*). In essence, rising oil prices represent a net transfer of dollars from oil consumers in countries such as the United States to oil producers in Russia, Saudi Arabia, and Venezuela. What did they do with those dollars?

One option for producing countries was to spend their petrodollars on public-sector infrastructure, such as health services, education, roads, and telecommunications systems. Among other things, this could boost economic growth in those countries, and pull in foreign imports, which would help to balance the trade surpluses enjoyed by oil producers and support global economic growth. Spending did pick up in many oil-producing countries. However, according to the IMF, OPEC members spent only around 40 percent of their windfall profits from higher oil prices in 2002–2007 (an exception was Venezuela, where President

Hugo Chavez was on a spending spree). The last time oil prices increased sharply in 1979, oil producers significantly ramped up spending on infrastructure, only to find themselves saddled with excessive debt when oil prices collapsed a few years later. This time they were more cautious—an approach that now seems wise given the rapid collapse in oil prices during late 2008.

Another option was for oil producers to invest a good chunk of the dollars they earned from oil sales in dollar-denominated assets, such as U.S. bonds, stocks, and real estate. This did happen. OPEC members funneled dollars back into U.S. assets, mostly low-risk government bonds. The implication is that by recycling their petrodollars, oil producers helped to finance the large and growing current account deficit of the United States, enabling it to pay its large oil import bill.

A third possibility for oil producers was to invest in non-dollar-denominated assets, including European and Japanese bonds and stocks. This too happened. Some OPEC investors have purchased not just small equity positions, but entire companies. In 2005, for example, Dubai International Capital purchased the Tussauds Group, a British theme-park firm, and DP World of Dubai purchased P&O, Britain's biggest port and ferries group. Despite examples such as these, between 2005 and 2008, the bulk of petrodollars appear to have been recycled into dollar-denominated assets. In part this was because U.S. interest rates increased throughout 2004–2007. However, if the flow of petrodollars should dry up, with oil-rich countries investing in other currencies, such as euro-denominated assets, the dollar could fall sharply.

Sources: "Recycling the Petrodollars; Oil Producers' Surpluses," *The Economist*, November 12, 2005, pp. 101–02; S. Johnson, "Dollar's Rise Aided by OPEC Holdings," *Financial Times*, December 5, 2005, p. 17; and "The Petrodollar Puzzle," *The Economist*, June 9, 2007, p. 86.

the dollar, foreigners decided to hedge against this risk by holding fewer dollar assets in their investment portfolios. Third, from 2003 onward U.S. government officials began to "talk down" the value of the dollar, in part because the administration believed that a cheaper dollar would increase exports and reduce imports, thereby improving the U.S. balance of trade position.⁶ Foreigners saw this as a signal that the U.S. government would not intervene in the foreign exchange markets to prop up the value of the dollar, which increased their reluctance to reinvest dollars earned from export sales in U.S. financial assets. As a result of these factors, demand for dollars weakened and the value of the dollar slid on the foreign exchange markets, hitting an index value of 80.19 in December 2004, the lowest value since the index began in 1973. Although the dollar strengthened a little in 2005 and 2006, many commentators believed that it would resume its fall if large holders of U.S. dollars, such as oilproducing states, decided to diversify their foreign exchange holdings (see the accompanying Country Focus). Indeed,

the dollar's fall resumed in 2007, and by February 2010 the dollar index against major currencies stood at 76.1, down from 102.5 in November 2002.

Interestingly, from mid-2008 through early 2009 the dollar staged a moderate rally against major currencies, despite the fact that the American economy was suffering from a serious financial crisis. The reason seems to be that despite America's problems, things were even worse in many other countries, and foreign investors saw the dollar has a safe haven and put their money in low-risk U.S. assets, particularly low-yielding U.S. government bonds. This rally faltered in mid-2009 as investors became worried about the level of U.S. indebtedness.

In sum, we see that in recent history the value of the dollar has been determined by both market forces and government intervention. Under a floating exchange rate regime, market forces have produced a volatile dollar exchange rate. Governments have sometimes responded by intervening in the market—buying and selling dollars—in an attempt to limit the market's volatility and to correct what they see as overvaluation (in 1985) or potential undervaluation (in 1987) of the dollar. In addition to direct intervention, the value of the dollar has frequently been influenced by statements from government officials. The dollar may not have declined by as much as it did in 2004, for example, had not U.S. government officials publicly ruled out any action to stop the decline. Paradoxically, a signal not to intervene can affect the market. The frequency of government intervention in the foreign exchange market explains why the current system is sometimes thought of as a **managed-float system** or a dirty-float system.

Managed-Float System

System under which some currencies are allowed to float freely, but the majority are either managed by government intervention or pegged to another currency.

LEARNING OBJECTIVE 3

Compare and contrast the differences between a fixed and a floating exchange rate system.

Fixed versus Floating Exchange Rates

The breakdown of the Bretton Woods system has not stopped the debate about the relative merits of fixed versus floating exchange rate regimes. Disappointment with the system of floating rates in recent years has led to renewed debate about the merits of fixed exchange rates. In this section, we review the arguments for fixed and floating exchange rate regimes.⁷ We will discuss the case for floating rates before discussing why many commentators are disappointed with the experience under floating exchange rates and yearn for a system of fixed rates.

THE CASE FOR FLOATING EXCHANGE RATES The case in support of floating exchange rates has two main elements: monetary policy autonomy and automatic trade balance adjustments.

Monetary Policy Autonomy It is argued that under a fixed system, a country's ability to expand or contract its money supply as it sees fit is limited by the need to maintain exchange rate parity. Monetary expansion can lead to inflation, which puts downward pressure on a fixed exchange rate (as predicted by the PPP theory; see Chapter 9). Similarly, monetary contraction requires high interest rates (to reduce the demand for money). Higher interest rates lead to an inflow of money from abroad, which puts upward pressure on a fixed exchange rate. Thus, to maintain exchange rate parity under a fixed system, countries were limited in their ability to use monetary policy to expand or contract their economies.

Advocates of a floating exchange rate regime argue that removal of the obligation to maintain exchange rate parity would restore monetary control to a government. If a government faced with unemployment wanted to increase its money supply to stimulate domestic demand and reduce unemployment, it could do so unencumbered by the need to maintain its exchange rate. While monetary expansion might

lead to inflation, this would lead to a depreciation in the country's currency. If PPP theory is correct, the resulting currency depreciation on the foreign exchange markets should offset the effects of inflation. Although under a floating exchange rate regime, domestic inflation would have an impact on the exchange rate, it should have no impact on businesses' international cost competitiveness due to exchange rate depreciation. The rise in domestic costs should be exactly offset by the fall in the value of the country's currency on the foreign exchange markets. Similarly, a government could use monetary policy to contract the economy without worrying about the need to maintain parity.

Trade Balance Adjustments Under the Bretton Woods system, if a country developed a permanent deficit in its balance of trade (importing more than it exported) that could not be corrected by domestic policy, this would require the IMF to agree to a currency devaluation. Critics of this system argue that the adjustment mechanism works much more smoothly under a floating exchange rate regime. They argue that if a country is running a trade deficit, the imbalance between the supply and demand of that country's currency in the foreign exchange markets (supply exceeding demand) will lead to depreciation in its exchange rate. In turn, by making its exports cheaper and its imports more expensive, an exchange rate depreciation should correct the trade deficit.

THE CASE FOR FIXED EXCHANGE RATES The case for fixed exchange rates rests on arguments about monetary discipline, speculation, uncertainty, and the lack of connection between the trade balance and exchange rates.

Monetary Discipline We have already discussed the nature of monetary discipline inherent in a fixed exchange rate system when we discussed the Bretton Woods system. The need to maintain a fixed exchange rate parity ensures that governments do not expand their money supplies at inflationary rates. While advocates of floating rates argue that each country should be allowed to choose its own inflation rate (the monetary autonomy argument), advocates of fixed rates argue that governments all too often give in to political pressures and expand the monetary supply far too rapidly, causing unacceptably high price inflation. A fixed exchange rate regime would ensure that this does not occur.

Speculation Critics of a floating exchange rate regime also argue that speculation can cause fluctuations in exchange rates. They point to the dollar's rapid rise and fall during the 1980s, which they claim had nothing to do with comparative inflation rates and the U.S. trade deficit, but everything to do with speculation. They argue that when foreign exchange dealers see a currency depreciating, they tend to sell the currency in the expectation of future depreciation regardless of the currency's longer-term prospects. As more traders jump on the bandwagon, the expectations of depreciation are realized. Such destabilizing speculation tends to accentuate the fluctuations around the exchange rate's long-run value. It can damage a country's economy by distorting export and import prices. Thus, advocates of a fixed exchange rate regime argue that such a system will limit the destabilizing effects of speculation.

Uncertainty Speculation also adds to the uncertainty surrounding future currency movements that characterizes floating exchange rate regimes. The unpredictability of exchange rate movements in the post-Bretton Woods era has made business planning

difficult, and it adds risk to exporting, importing, and foreign investment activities. Given a volatile exchange rate, international businesses do not know how to react to the changes—and often they do not react. Why change plans for exporting, importing, or foreign investment after a 6 percent fall in the dollar this month, when the dollar may rise 6 percent next month? This uncertainty, according to the critics, dampens the growth of international trade and investment. They argue that a fixed exchange rate, by eliminating such uncertainty, promotes the growth of international trade and investment. Advocates of a floating system reply that the forward exchange market insures against the risks associated with exchange rate fluctuations (see Chapter 9), so the adverse impact of uncertainty on the growth of international trade and investment has been overstated.

Trade Balance Adjustments Those in favor of floating exchange rates argue that floating rates help adjust trade imbalances. Critics question the closeness of the link between the exchange rate and the trade balance. They claim trade deficits are determined by the balance between savings and investment in a country, not by the external value of its currency.⁸ They argue that depreciation in a currency will lead to inflation (due to the resulting increase in import prices). This inflation will wipe out any apparent gains in cost competitiveness that arise from currency depreciation. In other words, a depreciating exchange rate will not boost exports and reduce imports, as advocates of floating rates claim; it will simply boost price inflation. In support of this argument, those who favor fixed rates point out that the 40 percent drop in the value of the dollar between 1985 and 1988 did not correct the U.S. trade deficit. In reply, advocates of a floating exchange rate regime argue that between 1985 and 1992, the U.S. trade deficit fell from more than \$160 billion to about \$70 billion, and they attribute this in part to the decline in the value of the dollar.

WHO IS RIGHT? Which side is right in the vigorous debate between those who favor a fixed exchange rate and those who favor a floating exchange rate? Economists cannot agree. Business, as a major player on the international trade and investment scene, has a large stake in the resolution of the debate. Would international business be better off under a fixed regime, or are flexible rates better? The evidence is not clear.

We do, however, know that a fixed exchange rate regime modeled along the lines of the Bretton Woods system will not work. Speculation ultimately broke the system, a phenomenon that advocates of fixed rate regimes claim is associated with floating exchange rates! Nevertheless, a different kind of fixed exchange rate system might be more enduring and might foster the stability that would facilitate more rapid growth in international trade and investment. In the next section, we look at potential models for such a system and the problems with such systems.

Exchange Rate Regimes in Practice

LEARNING OBJECTIVE 4

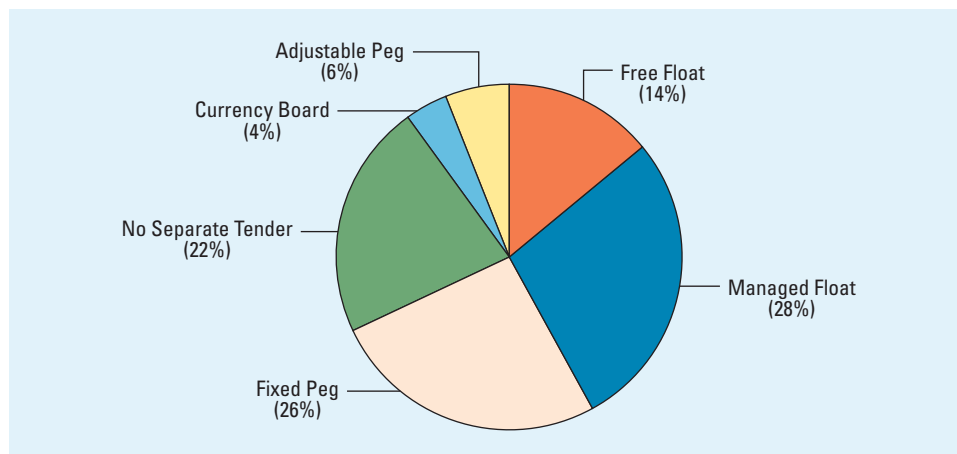
Identify the exchange rate regimes that are used in the world today and why countries adopt different exchange rate regimes.

Governments around the world pursue a number of different exchange rate policies. These range from a pure “free float” where the exchange rate is determined by market forces to a pegged system that has some aspects of the pre-1973 Bretton Woods system of fixed exchange rates. Figure 10.2 summarizes the exchange rate policies adopted by member states of the IMF. Some 14 percent of the IMF’s members allow their currency to float freely. Another 26 percent intervene in only a limited way (the so-called managed float). A further 28 percent of IMF members now have no separate

10.2 figure

Exchange Rate Policies, IMF Members, 2006

Source: Constructed by the author from IMF data.



legal tender of their own. These include the European Union countries that have adopted the euro, and effectively given up their own currencies, along with smaller states mostly in Africa or the Caribbean that have no domestic currency and have adopted a foreign currency as legal tender within their borders, typically the U.S. dollar or the euro. The remaining countries use more inflexible systems, including a fixed peg arrangement (26 percent) under which they peg their currencies to other currencies, such as the U.S. dollar or the euro, or to a basket of currencies. Other countries have adopted a system under which their exchange rate is allowed to fluctuate against other currencies within a target zone (an adjustable peg system). In this section, we will look more closely at the mechanics and implications of exchange rate regimes that rely on a currency peg or target zone.

PEGGED EXCHANGE RATES Under a pegged exchange rate regime, a country will peg the value of its currency to that of a major currency so that, for example, as the U.S. dollar rises in value, its own currency rises too. Pegged exchange rates are popular among many of the world's smaller nations. As with a full fixed exchange rate regime, the great virtue claimed for a pegged exchange rate is that it imposes monetary discipline on a country and leads to low inflation. For example, if Belize pegs the value of the Belizean dollar to that of the U.S. dollar so that $US\$1 = B\1.97 , then the Belizean government must make sure the inflation rate in Belize is similar to that in the United States. If the Belizean inflation rate is greater than the U.S. inflation rate, this will lead to pressure to devalue the Belizean dollar (i.e., to alter the peg). To maintain the peg, the Belizean government would be required to rein in inflation. Of course, for a pegged exchange rate to impose monetary discipline on a country, the country whose currency is chosen for the peg must also pursue sound monetary policy.

Evidence shows that adopting a pegged exchange rate regime moderates inflationary pressures in a country. An IMF study concluded that countries with pegged exchange rates had an average annual inflation rate of 8 percent, compared with 14 percent for intermediate regimes and 16 percent for floating regimes.⁹ However, many countries operate with only a nominal peg and in practice are willing to devalue their currency rather than pursue a tight monetary policy. It can be very difficult for a smaller country to maintain a peg against another currency if capital is flowing out of the country and foreign exchange traders are speculating against the currency. Something like this occurred in 1997 when a combination of adverse capital flows and currency speculation

forced several Asian countries, including Thailand and Malaysia, to abandon pegs against the U.S. dollar and let their currencies float freely. Malaysia and Thailand would not have been in this position had they dealt with a number of problems that began to arise in their economies during the 1990s, including excessive private-sector debt and expanding current account trade deficits.

CURRENCY BOARDS Hong Kong's experience during the 1997 Asian currency crisis added a new dimension to the debate over how to manage a pegged exchange rate. During late 1997 when other Asian currencies were collapsing, Hong Kong maintained the value of its currency against the U.S. dollar at about HK\$15 = \$7.80 despite several concerted speculative attacks. Hong Kong's currency board has been given credit for this success. A country that introduces a **currency board** commits itself to converting its domestic currency on demand into another currency at a fixed exchange rate. To make this commitment credible, the currency board holds reserves of foreign currency equal at the fixed exchange rate to at least 100 percent of the domestic currency issued. The system used in Hong Kong means its currency must be fully backed by the U.S. dollar at the specified exchange rate. This is still not a true fixed exchange rate regime, because the U.S. dollar, and by extension the Hong Kong dollar, floats against other currencies, but it has some features of a fixed exchange rate regime.

Under this arrangement, the currency board can issue additional domestic notes and coins only when there are foreign exchange reserves to back it. This limits the ability of the government to print money and, thereby, create inflationary pressures. Under a strict currency board system, interest rates adjust automatically. If investors want to switch out of domestic currency into, for example, U.S. dollars, the supply of domestic currency will shrink. This will cause interest rates to rise until it eventually becomes attractive for investors to hold the local currency again. In the case of Hong Kong, the interest rate on three-month deposits climbed as high as 20 percent in late 1997, as investors switched out of Hong Kong dollars and into U.S. dollars. The dollar peg held, however, and interest rates declined again.

Since its establishment in 1983, the Hong Kong currency board has weathered several storms, including the latest. This success persuaded several other countries in the developing world to consider a similar system. Argentina introduced a currency board in 1991 (but abandoned it in 2002) and Bulgaria, Estonia, and Lithuania have all gone down this road in recent years (seven IMF members have currency boards). Despite interest in the arrangement, however, critics are quick to point out that currency boards have their drawbacks.¹⁰ If local inflation rates remain higher than the inflation rate in the country to which the currency is pegged, the currencies of countries with currency boards can become uncompetitive and overvalued (this is what happened in the case of Argentina which had a currency board; see the closing case). Also, under a currency board system, government lacks the ability to set interest rates. Interest rates in Hong Kong, for example, are effectively set by the U.S. Federal Reserve. In addition, economic collapse in Argentina in 2001 and the subsequent decision to abandon its currency board dampened much of the enthusiasm for this mechanism of managing exchange rates.

Crisis Management by the IMF

Many observers initially believed that the collapse of the Bretton Woods system in 1973 would diminish the role of the IMF within the international monetary system. The IMF's original function was to provide a pool of money from which members could borrow, short term, to adjust their balance-of-payments position and maintain

Currency Board
Means of controlling a
country's currency.

LEARNING OBJECTIVE 5

Understand the debate surrounding the role of the IMF in the management of financial crises.

their exchange rate. Some believed the demand for short-term loans would be considerably diminished under a floating exchange rate regime. A trade deficit would presumably lead to a decline in a country's exchange rate, which would help reduce imports and boost exports. No temporary IMF adjustment loan would be needed. Consistent with this, after 1973, most industrialized countries tended to let the foreign exchange market determine exchange rates in response to demand and supply. No major industrial country has borrowed funds from the IMF since the mid-1970s, when Great Britain and Italy did. Since the early 1970s, the rapid development of global capital markets has allowed developed countries such as Great Britain and the United States to finance their deficits by borrowing private money, as opposed to drawing on IMF funds. Despite these developments, the activities of the IMF have expanded over the past 30 years. By 2010, the IMF had 186 members, 54 of which had some kind of IMF program in place. In 1997, the institution implemented its largest rescue packages until that date, committing more than \$110 billion in short-term loans to three troubled Asian countries—South Korea, Indonesia, and Thailand. This was followed by additional IMF rescue packages in Turkey, Russia, Argentina, and Brazil. IMF loans increased again in late 2008 as the global financial crisis took hold (see the opening case). In late 2008 and early 2009 the IMF made some \$50 billion in loans to troubled emerging economies such as Latvia. In April 2009, in response to the growing financial crisis, major IMF members agreed to triple the institution's resources from \$250 billion to \$750 billion, thereby giving the IMF the financial leverage to act aggressively in times of global financial crisis.

The IMF's activities have expanded because periodic financial crises have continued to hit many economies in the post-Bretton Woods era, particularly among the world's developing nations. The IMF has repeatedly lent money to nations experiencing financial crises, requesting in return that the governments enact certain macroeconomic policies. Critics of the IMF claim these policies have not always been as beneficial as the IMF might have hoped and in some cases may have made things worse. Following the IMF loans to several Asian economies, these criticisms reached new levels and a vigorous debate was waged as to the appropriate role of the IMF. In this section, we shall discuss some of the main challenges the IMF has had to deal with over the past quarter of a century and review the ongoing debate over the role of the IMF.

FINANCIAL CRISES IN THE POST-BRETTON WOODS ERA A number of broad types of financial crises have occurred over the past 30 years, many of which have required IMF involvement. A **currency crisis** occurs when a speculative attack on the exchange value of a currency results in a sharp depreciation in the value of the currency or forces authorities to expend large volumes of international currency reserves and sharply increase interest rates to defend the prevailing exchange rate. This is what happened in Brazil in 2002, and the IMF stepped in to help stabilize the value of the Brazilian currency on foreign exchange markets. A **banking crisis** refers to a loss of confidence in the banking system that leads to a run on banks, as individuals and companies withdraw their deposits. This is what happened



Another Perspective

IMF: All That Independent?

The International Monetary Fund (IMF) was formed to promote global monetary cooperation and economic growth. A special agency of the United Nations, it has its own charter and operates independently. The IMF works collaboratively with the United Nations and other international organizations, including the World Bank and the World Trade Organization. The IMF reports to its 186 member countries through its board of governors. U.S. Secretary of the Treasury Timothy F. Geithner is the U.S. member of the board, and Ben Bernanke, chairman of the U.S. Federal Reserve Board, is the alternate member. They control the U.S. share of the votes on the board of governors, 16.74 percent. (IMF Web site, www.imf.org, accessed March 26, 2010)

Currency Crisis

Occurs when a speculative attack on the exchange value of a currency results in a sharp depreciation in the value of the currency or forces authorities to expend large volumes of international currency reserves and sharply increase interest rates to defend the prevailing exchange rate.

Banking Crisis

A loss of confidence in the banking system that leads to a run on banks, as individuals and companies withdraw their deposits.

Foreign Debt Crisis

Situation in which a country cannot service its foreign debt obligations, whether private-sector or government debt.

in Latvia in 2008 (see the opening case). A **foreign debt crisis** is a situation in which a country cannot service its foreign debt obligations, whether private-sector or government debt.

These crises tend to have common underlying macroeconomic causes: high relative price inflation rates, a widening current account deficit, excessive expansion of domestic borrowing, and asset price inflation (such as sharp increases in stock and property prices).¹¹ At times, elements of currency, banking, and debt crises may be present simultaneously, as in the 1997 Asian crisis, the 2000–2002 Argentinean crisis and the 2008 crisis in Latvia.

To assess the frequency of financial crises, the IMF looked at the macroeconomic performance of a group of 53 countries from 1975 to 1997 (22 of these countries were developed nations, and 31 were developing countries).¹² The IMF found there had been 158 currency crises, including 55 episodes in which a country's currency declined by more than 25 percent. There were also 54 banking crises. The IMF's data suggest that developing nations were more than twice as likely to experience currency and banking crises as developed nations. It is not surprising, therefore, that most of the IMF's loan activities since the mid-1970s have been targeted toward developing nations.

Here we look at two crises that have been of particular significance in terms of IMF involvement since the early 1990s—the 1995 Mexican currency crisis and the 1997 Asian financial crisis. These crises were the result of excessive foreign borrowings, a weak or poorly regulated banking system, and high inflation rates. These factors came together to trigger simultaneous debt and currency crises. Checking the resulting crises required IMF involvement.

MEXICAN CURRENCY CRISIS OF 1995 The Mexican peso had been pegged to the dollar since the early 1980s when the International Monetary Fund made it a condition for lending money to the Mexican government to help bail the country out of a 1982 financial crisis. Under the IMF-brokered arrangement, the peso had been allowed to trade within a tolerance band of plus or minus 3 percent against the dollar. The band was also permitted to “crawl” down daily, allowing for an annual peso depreciation of about 4 percent against the dollar. The IMF believed that the need to maintain the exchange rate within a fairly narrow trading band would force the Mexican government to adopt stringent financial policies to limit the growth in the money supply and contain inflation.

Until the early 1990s, it looked as if the IMF policy had worked. However, the strains were beginning to show by 1994. Since the mid-1980s, Mexican producer prices had risen 45 percent more than prices in the United States, and yet there had not been a corresponding adjustment in the exchange rate. By late 1994, Mexico was running a \$17 billion trade deficit, which amounted to some 6 percent of the country's gross domestic product, and there had been an uncomfortably rapid expansion in public- and private-sector debt. Despite these strains, Mexican government officials had been stating publicly that they would support the peso's dollar peg at around $\$1 = 3.5$ pesos by adopting appropriate monetary policies and by intervening in the currency markets if necessary. Encouraged by such statements, \$64 billion of foreign investment money poured into Mexico between 1990 and 1994 as corporations and money managers sought to take advantage of the booming economy.

However, many currency traders concluded the peso would have to be devalued, and they began to dump pesos on the foreign exchange market. The government tried to hold the line by buying pesos and selling dollars, but it lacked the foreign currency reserves required to halt the speculative tide (Mexico's foreign exchange reserves fell

from \$6 billion at the beginning of 1994 to less than \$3.5 billion at the end of the year). In mid-December 1994, the Mexican government abruptly announced a devaluation. Immediately, much of the short-term investment money that had flowed into Mexican stocks and bonds over the previous year reversed its course, as foreign investors bailed out of peso-denominated financial assets. This exacerbated the sale of the peso and contributed to the rapid 40 percent drop in its value.

The IMF stepped in again, this time arm in arm with the U.S. government and the Bank for International Settlements. Together the three institutions pledged close to \$50 billion to help Mexico stabilize the peso and to redeem \$47 billion of public- and private-sector debt that was set to mature in 1995. Of this amount, \$20 billion came from the U.S. government and another \$18 billion came from the IMF (which made Mexico the largest recipient of IMF aid up to that point). Without the aid package, Mexico would probably have defaulted on its debt obligations, and the peso would have gone into free fall. As is normal in such cases, the IMF insisted on tight monetary policies and further cuts in public spending, both of which helped push the country into a deep recession. However, the recession was relatively short-lived, and by 1997 the country was once more on a growth path, had pared down its debt, and had paid back the \$20 billion borrowed from the U.S. government ahead of schedule.¹³

THE ASIAN CRISIS The financial crisis that erupted across Southeast Asia during the fall of 1997 emerged as the biggest challenge to date for the IMF. Holding the crisis in check required IMF loans to help the shattered economies of Indonesia, Thailand, and South Korea stabilize their currencies. In addition, although they did not request IMF loans, the economies of Japan, Malaysia, Singapore, and the Philippines were also hurt by the crisis.

The seeds of this crisis were sown during the previous decade when these countries were experiencing unprecedented economic growth. Although there were and remain important differences between the individual countries, a number of elements were common to most. Exports had long been the engine of economic growth in these countries. From 1990 to 1996, the value of exports from Malaysia had grown by 18 percent annually, Thai exports had grown by 16 percent per year, Singapore's by 15 percent, Hong Kong's by 14 percent, and those of South Korea and Indonesia by 12 percent annually.¹⁴

The nature of these exports had also shifted in recent years from basic materials and products such as textiles to complex and increasingly high-technology products, such as automobiles, semiconductors, and consumer electronics.

The Investment Boom The wealth created by export-led growth helped fuel an investment boom in commercial and residential property, industrial assets, and infrastructure. The value of commercial and residential real estate in cities such as Hong Kong and Bangkok started to soar. This fed a building boom the likes of which had never been seen in Asia. Heavy borrowing from banks financed much of this construction. As for industrial assets, the success of Asian exporters encouraged them to make bolder investments in industrial capacity. This was exemplified most clearly by South Korea's giant diversified conglomerates, or *chaebol*, many of which had ambitions to build a major position in the global automobile and semiconductor industries.

An added factor behind the investment boom in most Southeast Asian economies was the government. In many cases, the governments had embarked on huge infrastructure projects. In Malaysia, for example, a new government administrative center was being constructed in Putrajaya for M\$20 billion (U.S. \$8 billion at the

pre-July 1997 exchange rate), and the government was funding the development of a massive high-technology communications corridor and the huge Bakun dam, which at a cost of M\$13.6 billion was to be the most expensive power-generation plant in the country.¹⁵ Throughout the region, governments also encouraged private businesses to invest in certain sectors of the economy in accordance with “national goals” and “industrialization strategy.” In South Korea, long a country where the government played a proactive role in private-sector investments, President Kim Young-Sam urged the *chaebol* to invest in new factories as a way of boosting economic growth. South Korea enjoyed an investment-led economic boom in 1994–1995, but at a cost. The *chaebol*, always reliant on heavy borrowings, built up massive debts that were equivalent, on average, to four times their equity.¹⁶

In Indonesia, President Suharto had long supported investments in a network of an estimated 300 businesses owned by his family and friends in a system known as “crony capitalism.” Many of these businesses were granted lucrative monopolies by the president. For example, Suharto announced in 1995 that he had decided to manufacture a national car, built by a company owned by one of his sons, Hutomo Mandala Putra, in association with Kia Motors of South Korea. To support the venture, a consortium of Indonesian banks was “ordered” by the government to offer almost \$700 million in start-up loans to the company.¹⁷

By the mid-1990s, Southeast Asia was in the grips of an unprecedented investment boom, much of it financed with borrowed money. Between 1990 and 1995, gross domestic investment grew by 16.3 percent annually in Indonesia, 16 percent in Malaysia, 15.3 percent in Thailand, and 7.2 percent in South Korea. By comparison, investment grew by 4.1 percent annually over the same period in the United States and 0.8 percent in all high-income economies.¹⁸ And the rate of investment accelerated in 1996. In Malaysia, for example, spending on investment accounted for a remarkable 43 percent of GDP in 1996.¹⁹

Excess Capacity As the volume of investments ballooned during the 1990s, often at the bequest of national governments, the quality of many of these investments declined significantly. The investments often were made on the basis of unrealistic projections about future demand conditions. The result was significant excess capacity. For example, South Korean *chaebol* investments in semiconductor factories surged in 1994 and 1995 when a temporary global shortage of dynamic random access memory chips (DRAMs) led to sharp price increases for this product. However, supply shortages had disappeared by 1996 and excess capacity was beginning to make itself felt, just as the South Koreans started to bring new DRAM factories on stream. The results were predictable; prices for DRAMs plunged, and the earnings of South Korean DRAM manufacturers fell by 90 percent, which meant it was difficult for them to make scheduled payments on the debt they had taken on to build the extra capacity.²⁰

In another example, a building boom in Thailand resulted in excess capacity in residential and commercial property. By early 1997, an estimated 365,000 apartment units were unoccupied in Bangkok. With another 100,000 units scheduled to be completed in 1997, years of excess demand in the Thai property market had been replaced by excess supply. By one estimate, Bangkok’s building boom had produced enough excess space by 1997 to meet its residential and commercial needs for five years.²¹

The Debt Bomb By early 1997 what was happening in the South Korean semiconductor industry and the Bangkok property market was being played out elsewhere in the region. Massive investments in industrial assets and property had created

excess capacity and plunging prices, while leaving the companies that had made the investments groaning under huge debt burdens that they were now finding it difficult to service.

To make matters worse, much of the borrowing had been in U.S. dollars, as opposed to local currencies. This had originally seemed like a smart move. Throughout the region, local currencies were pegged to the dollar, and interest rates on dollar borrowings were generally lower than rates on borrowings in domestic currency. Thus, it often made economic sense to borrow in dollars if the option was available. However, if the governments could not maintain the dollar peg and their currencies started to depreciate against the dollar, this would increase the size of the debt burden when measured in the local currency. Currency depreciation would raise borrowing costs and could result in companies defaulting on their debt obligations.

Expanding Imports A final complicating factor was that by the mid-1990s, although exports were still expanding across the region, imports were too. The investments in infrastructure, industrial capacity, and commercial real estate were sucking in foreign goods at unprecedented rates. To build infrastructure, factories, and office buildings, Southeast Asian countries were purchasing capital equipment and materials from America, Europe, and Japan. Many Southeast Asian states saw the current accounts of their balance of payments shift strongly into the red during the mid-1990s. By 1995, Indonesia was running a current account deficit that was equivalent to 3.5 percent of its GDP, Malaysia's was 5.9 percent, and Thailand's was 8.1 percent.²² With deficits like these, it was increasingly difficult for the governments of these countries to maintain their currencies against the U.S. dollar. If that peg could not be held, the local currency value of dollar-denominated debt would increase, raising the specter of large-scale default on debt service payments. The scene was now set for a potentially rapid economic meltdown.

The Crisis The Asian meltdown began in mid-1997 in Thailand when it became clear that several key Thai financial institutions were on the verge of default. These institutions had been borrowing dollars from international banks at low interest rates and lending Thai baht at higher interest rates to local property developers. However, due to speculative over-building, these developers could not sell their commercial and residential property, forcing them to default on their debt obligations. In turn, the Thai financial institutions seemed increasingly likely to default on their dollar-denominated debt obligations to international banks. Sensing the beginning of the crisis, foreign investors fled the Thai stock market, selling their positions and converting them into U.S. dollars. The increased demand for dollars and increased supply of Thai baht, pushed down the dollar/Thai baht exchange rate, while the stock market plunged.

Seeing these developments, foreign exchange dealers and hedge funds started speculating against the baht, selling it short. For the previous 13 years, the Thai baht had been pegged to the U.S. dollar at an exchange rate of about \$1 = Bt25. The Thai government tried to defend the peg, but only succeeded in depleting its foreign exchange reserves. On July 2, 1997, the Thai government abandoned its defense and announced it would allow the baht



By 1997, years of excess demand in the Thai property market resulted in enough excess space to meet its residential and commercial needs for five years.

to float freely against the dollar. The baht started a slide that would bring the exchange rate down to \$1 = Bt55 by January 1998. As the baht declined, the Thai debt bomb exploded. The 55 percent decline in the value of the baht against the dollar doubled the amount of baht required to serve the dollar-denominated debt commitments taken on by Thai financial institutions and businesses. This increased the probability of corporate bankruptcies and further pushed down the battered Thai stock market. The Thailand Set stock market index ultimately declined from 787 in January 1997 to a low of 337 in December of that year, on top of a 45 percent decline in 1996.

On July 28, the Thai government called in the International Monetary Fund. With its foreign exchange reserves depleted, Thailand lacked the foreign currency needed to finance its international trade and service debt commitments and desperately needed the capital the IMF could provide. It also needed to restore international confidence in its currency and needed the credibility associated with gaining access to IMF funds. Without IMF loans, the baht likely would increase its free fall against the U.S. dollar and the whole country might go into default. The IMF agreed to provide the Thai government with \$17.2 billion in loans, but the conditions were restrictive.²³ The IMF required the Thai government to increase taxes, cut public spending, privatize several state-owned businesses, and raise interest rates—all steps designed to cool Thailand's overheated economy. The IMF also required Thailand to close illiquid financial institutions. In December 1997, the government shut 56 financial institutions, laying off 16,000 people and further deepening the recession that now gripped the country.

Following the devaluation of the Thai baht, wave after wave of speculation hit other Asian currencies. One after another in a period of weeks, the Malaysian ringgit, Indonesian rupiah, and the Singaporean dollar were all marked sharply lower. With its foreign exchange reserves down to \$28 billion, Malaysia let the ringgit float on July 14, 1997. Before the devaluation, the ringgit was trading at \$1 = 2.525 ringgit. Six months later it had declined to \$1 = 4.15 ringgit. Singapore followed on July 17, and the Singaporean dollar quickly dropped in value from \$1 = S\$1.495 before the devaluation to \$1 = S\$2.68 a few days later. Next up was Indonesia, whose rupiah was allowed to float August 14. For Indonesia, this was the beginning of a precipitous decline in the value of its currency, which was to fall from \$1 = 2,400 rupiah in August 1997 to \$1 = 10,000 rupiah on January 6, 1998, a loss of 76 percent.

With the exception of Singapore, whose economy is probably the most stable in the region, these devaluations were driven by factors similar to those behind the earlier devaluation of the Thai baht—a combination of excess investment; high borrowings, much of it in dollar-denominated debt; and a deteriorating balance-of-payments position. Although both Malaysia and Singapore were able to halt the slide in their currencies and stock markets without the help of the IMF, Indonesia was not. Indonesia was struggling with a private-sector, dollar-denominated debt of close to \$80 billion. With the rupiah sliding precipitously almost every day, the cost of servicing this debt was exploding, pushing more Indonesian companies into technical default.

On October 31, 1997, the IMF announced it had assembled a \$37 billion rescue deal for Indonesia in conjunction with the World Bank and the Asian Development Bank. In return, the Indonesian government agreed to close a number of troubled banks, reduce public spending, remove government subsidies on basic foodstuffs and energy, balance the budget, and unravel the crony capitalism that was so widespread in Indonesia. But the government of President Suharto appeared to backtrack several times on commitments made to the IMF. This precipitated further declines in the Indonesian currency and stock markets. Ultimately, Suharto removed costly government

subsidies, only to see the country dissolve into chaos as the populace took to the streets to protest the resulting price increases. This unleashed a chain of events that led to Suharto's removal from power in May 1998.

The final domino to fall was South Korea. During the 1990s, South Korean companies had built up huge debt loads as they invested heavily in new industrial capacity. Now they found they had too much industrial capacity and could not generate the income required to service their debt. South Korean banks and companies had also made the mistake of borrowing in dollars, much of it in the form of short-term loans that would come due within a year. Thus, when the Korean won started to decline in the fall of 1997 in sympathy with the problems elsewhere in Asia, South Korean companies saw their debt obligations balloon. Several large companies were forced to file for bankruptcy. This triggered a decline in the South Korean currency and stock market that was difficult to halt. The South Korean central bank tried to keep the dollar/won exchange rate above \$1 = W1,000 but found that this only depleted its foreign exchange reserves. On November 17, the South Korean central bank gave up the defense of the won, which quickly fell to \$1 = W1,500.

With its economy on the verge of collapse, the South Korean government on November 21 requested \$20 billion in standby loans from the IMF. As the negotiations progressed, it became apparent that South Korea was going to need far more than \$20 billion. Among other problems, the country's short-term foreign debt was found to be twice as large as previously thought at close to \$100 billion, while the country's foreign exchange reserves were down to less than \$6 billion. On December 3, 1997, the IMF and South Korean government reached a deal to lend \$55 billion to the country. The agreement with the IMF called for the South Koreans to open their economy and banking system to foreign investors. South Korea also pledged to restrain the *chaebol* by reducing their share of bank financing and requiring them to publish consolidated financial statements and undergo annual independent external audits. On trade liberalization, the IMF said South Korea would comply with its commitments to the World Trade Organization to eliminate trade-related subsidies and restrictive import licensing and would streamline its import certification procedures, all of which should open the South Korean economy to greater foreign competition.²⁴

EVALUATING THE IMF'S POLICY PRESCRIPTIONS By 2009, the IMF was committing loans to some 54 countries that were struggling with economic and currency crises. A detailed example of one such program is given in the accompanying Country Focus, which looks at IMF loans to Turkey. All IMF loan packages come with conditions attached. Until very recently, the IMF has insisted on a combination of tight macroeconomic policies, including cuts in public spending, higher interest rates, and tight monetary policy. It has also often pushed for the deregulation of sectors formerly protected from domestic and foreign competition, privatization of state-owned assets, and better financial reporting from the banking sector. These policies are designed to cool overheated economies by reining in inflation and reducing government spending and debt. Recently, this set of policy prescriptions has come in for tough criticisms from many observers, and the IMF itself has started to change its approach.²⁵

Inappropriate Policies One criticism is that the IMF's traditional policy prescriptions represent "one-size-fits-all" approach to macroeconomic policy that is inappropriate for many countries. In the case of the Asian crisis, critics argue that the tight macroeconomic policies imposed by the IMF are not well suited to countries that are suffering not from excessive government spending and inflation, but

from a private-sector debt crisis with deflationary undertones.²⁶ In South Korea, for example, the government had been running a budget surplus for years (it was 4 percent of South Korea's GDP in 1994–1996) and inflation was low at about 5 percent. South Korea had the second strongest financial position of any country in the Organization for Economic Cooperation and Development. Despite this, critics say, the IMF insisted on applying the same policies that it applies to countries suffering from high inflation. The IMF required South Korea to maintain an inflation rate of 5 percent. However, given the collapse in the value of its currency and the subsequent rise in price for imports such as oil, critics claimed inflationary pressures would inevitably increase in South Korea. So to hit a 5 percent inflation rate, the South Koreans would be forced to apply an unnecessarily tight monetary policy. Short-term interest rates in South Korea did jump from 12.5 percent to 21 percent immediately after the country signed its initial deal with the IMF. Increasing interest rates made it even more difficult for companies to service their already excessive short-term debt obligations, and critics used this as evidence to argue that the cure prescribed by the IMF may actually increase the probability of widespread corporate defaults, not reduce them.

At the time, the IMF rejected this criticism. According to the IMF, the central task was to rebuild confidence in the won. Once this was achieved, the won would recover from its oversold levels, reducing the size of South Korea's dollar-denominated debt burden when expressed in won, making it easier for companies to service their debt. The IMF also argued that by requiring South Korea to remove restrictions on foreign direct investment, foreign capital would flow into the country to take advantage of cheap assets. This, too, would increase demand for the Korean currency and help to improve the dollar/won exchange rate.

Korea did recover fairly quickly from the crisis, supporting the position of the IMF. While the economy contracted by 7 percent in 1998, by 2000 it had rebounded and grew at a 9 percent rate (measured by growth in GDP). Inflation, which peaked at 8 percent in 1998, fell to 2 percent by 2000, and unemployment fell from 7 percent to 4 percent over the same period. The won hit a low of \$1 = W1,812 in early 1998, but by 2000 was back to an exchange rate of around \$1 = W1,200, at which it seems to have stabilized.

Moral Hazard A second criticism of the IMF is that its rescue efforts are exacerbating a problem known to economists as moral hazard. **Moral hazard** arises when people behave recklessly because they know they will be saved if things go wrong. Critics point out that many Japanese and Western banks were far too willing to lend large amounts of capital to overleveraged Asian companies during the boom years of the 1990s. These critics argue that the banks should now be forced to pay the price for their rash lending policies, even if that means some banks must close.²⁷ Only by taking such drastic action, the argument goes, will banks learn the error of their ways and not engage in rash lending in the future. By providing support to these countries, the IMF is reducing the probability of debt default and in effect bailing out the banks whose loans gave rise to this situation.

This argument ignores two critical points. First, if some Japanese or Western banks with heavy exposure to the troubled Asian economies were forced to write off their loans due to widespread debt default, the impact would have been difficult to contain. The failure of large Japanese banks, for example, could have triggered a meltdown in the Japanese financial markets. That would almost inevitably lead to a serious decline in stock markets around the world, which was the very risk the IMF was trying to avoid by stepping in with financial support. Second, it is incorrect to imply that some banks have not had to pay the price for rash lending policies. The IMF has insisted on

Moral Hazard

Arises when people
behave recklessly
because they know they
will be saved if things
go wrong.

the closure of banks in South Korea, Thailand, and Indonesia. Foreign banks with short-term loans outstanding to South Korean enterprises have been forced by circumstances to reschedule those loans at interest rates that do not compensate for the extension of the loan maturity.

Lack of Accountability The final criticism of the IMF is that it has become too powerful for an institution that lacks any real mechanism for accountability.²⁸ The IMF has determined macroeconomic policies in those countries, yet according to critics such as noted economist Jeffrey Sachs, the IMF, with a staff of less than 1,000, lacks the expertise required to do a good job. Evidence of this, according to Sachs, can be found in the fact that the IMF was singing the praises of the Thai and South Korean governments only months before both countries lurched into crisis. Then the IMF put together a draconian program for South Korea without having deep knowledge of the country. Sachs' solution to this problem is to reform the IMF so it makes greater use of outside experts and its operations are open to greater outside scrutiny.

Observations As with many debates about international economics, it is not clear which side is correct about the appropriateness of IMF policies. There are cases where one can argue that IMF policies have been counterproductive, or only had limited success. For example, one might question the success of the IMF's involvement in Turkey given that the country has had to implement some 18 IMF programs since 1958 (see the accompanying Country Focus)! But the IMF can also point to some notable accomplishments, including its success in containing the Asian crisis, which could have rocked the global international monetary system to its core, and its actions in 2008 and 2009 to contain the global financial crisis, quickly stepping in to rescue countries such as Iceland and Latvia. Similarly, many observers give the IMF credit for its deft handling of politically difficult situations, such as the Mexican peso crisis, and for successfully promoting a free market philosophy.

Several years after the IMF's intervention, the economies of Asia and Mexico recovered. Certainly they all averted the kind of catastrophic implosion that might have occurred had the IMF not stepped in, and although some countries still faced considerable problems, it is not clear that the IMF should take much blame for this. The IMF cannot force countries to adopt the policies required to correct economic mismanagement. While a government may commit to taking corrective action in return for an IMF loan, internal political problems may make it difficult for a government to act on that commitment. In such cases, the IMF is caught between a rock and a hard place, for if it decided to withhold money, it might trigger financial collapse and the kind of contagion that it seeks to avoid.

Finally, it is notable that in recent years the IMF has started to change its policies. Specifically, in response to the global financial crisis of 2008–2009 the IMF began to urge countries to adopt policies that included fiscal stimulus and monetary easing—the direct opposite of what the fund traditionally advocated. Some economists in the fund are also now arguing that higher inflation rates might be a good thing, if the consequence is greater growth in aggregate demand, which would help to pull nations out of recessionary conditions. The IMF, in other words, is starting to display the very flexibility in policy responses that its critics claim it lacks. While the traditional policy of tight controls on fiscal policy and tight monetary policy targets might be appropriate for countries suffering from high inflation rates, the Asian economic crisis and the 2008–2009 global financial crisis were caused not by high inflation rates, but by excessive debt, and the IMF's “new approach” seems tailored to deal with this.²⁹



Country FOCUS

Turkey and the IMF

In May 2001, the International Monetary Fund (IMF) agreed to lend \$8 billion to Turkey to help the country stabilize its economy and halt a sharp slide in the value of its currency. This was the third time in two years that the international lending institution had put together a loan program for Turkey, and it was the 18th program since Turkey became a member of the IMF in 1958.

Many of Turkey's problems stemmed from a large and inefficient state sector and heavy subsidies to various private sectors of the economy such as agriculture. Although the Turkish government started to privatize state-owned companies in the late 1980s, the programs proceeded at a glacial pace, hamstrung by political opposition within Turkey. Instead of selling state-owned assets to private investors, successive governments increased support to unprofitable state-owned industries and raised the wage rates of state employees. Nor did the government cut subsidies to politically powerful private sectors of the economy, such as agriculture. To support state industries and finance subsidies, Turkey issued significant amounts of government debt. To limit the amount of debt, the government expanded the money supply to finance spending. The result was rampant inflation and high interest rates. During the 1990s, inflation averaged over 80 percent a year while real interest rates rose to more than 50 percent on a number of occasions. Despite this, the Turkish economy continued to grow at a healthy pace of 6 percent annually in real terms, a remarkable achievement given the high inflation rates and interest rates.

By the late 1990s the "Turkish miracle" of sustained growth in the face of high inflation and interest rates was running out of steam. Government debt had risen to 60 percent of gross domestic product, government borrowing was leaving little capital for private enterprises, and the cost of financing government debt was spiraling out of control. Rampant inflation was putting pressure on the Turkish currency, the lira, which at the time was pegged in value to a basket of other currencies. Realizing that it needed to reform its economy, the Turkish government sat down with the IMF in late 1999 to work out a recovery program, adopted in January 2000.

As with most IMF programs, the focus was on bringing down the inflation rate, stabilizing the value of the Turkish currency, and restructuring the economy to reduce government debt. The Turkish government committed itself to reducing government debt by taking a number of steps. These included an accelerated privatization program, using the proceeds to pay down debt; the reduction of agricultural subsidies; reform to make it more difficult for

people to qualify for public pension programs; and tax increases. The government also agreed to rein in the growth in the money supply to better control inflation. To limit the possibility of speculative attacks on the Turkish currency in the foreign exchange markets, the Turkish government and IMF announced that Turkey would peg the value of the lira against a basket of currencies and devalue the lira by a predetermined amount each month throughout 2000, bringing the total devaluation for the year to 25 percent. To ease the pain, the IMF agreed to provide the Turkish government with \$5 billion in loans that could be used to support the value of the lira.

Initially the program seemed to be working. Inflation fell to 35 percent in 2000, while the economy grew by 6 percent. By the end of 2000, however, the program was in trouble. Burdened with nonperforming loans, a number of Turkish banks faced default and had been taken into public ownership by the government. When a criminal fraud investigation uncovered evidence that several of these banks had been pressured by politicians into providing loans at below-market interest rates, foreign investors, worried that more banks might be involved, started to pull their money out of Turkey. This sent the Turkish stock market into a tailspin and put enormous pressure on the Turkish lira. The government raised Turkish overnight interbank lending rates to as high as 1,950 percent to try to stem the outflow of capital, but it was clear that Turkey alone could not halt the flow.

The IMF stepped once more into the breach, December 6, 2000, announcing a quickly arranged \$7.5 billion loan program for the country. In return for the loan, the IMF required the Turkish government to close 10 insolvent banks, speed up its privatization plans (which had once more stalled), and cap any pay increases for government workers. The IMF also reportedly urged the Turkish government to let its currency float freely in the foreign exchange markets, but the government refused, arguing that the result would be a rapid devaluation in the lira, which would raise import prices and fuel price inflation. The government insisted that reducing inflation should be its first priority.

This plan started to come apart in February 2001. A surge in inflation and a rapid slowdown in economic growth once more spooked foreign investors. Into this explosive mix waded Turkey's prime minister and president, who engaged in a highly public argument about economic policy and political corruption. This triggered a rapid outflow of capital. The government raised the overnight interbank lending rate to 7,500 percent to try to persuade foreigners to leave their money in the country, but to no avail. Realizing that it would be unable to keep the lira within its planned monthly devaluation range without raising interest rates to absurd levels or

(continued)

seriously depleting the country's foreign exchange reserves, on February 23, 2001, the Turkish government decided to let the lira float freely. The lira immediately dropped 50 percent in value against the U.S. dollar, but ended the day down some 28 percent.

Over the next two months, the Turkish economy continued to weaken as a global economic slowdown affected the nation. Inflation stayed high, and progress at reforming the country's economy remained bogged down by political considerations. By early April, the lira had fallen 40 percent against the dollar since February 23, and the country was teetering on the brink of an economic meltdown. For the third time in 18 months, the IMF stepped in, arranging for another \$8 billion in loans. Once more, the IMF insisted that the Turkish government accelerate privatization, close insolvent banks, deregulate its market, and cut government spending. Critics of the IMF, however, claimed this "austerity program" would only slow the Turkish economy and make matters worse, not better. These critics advocated a mix of sound monetary policy and tax cuts to boost Turkey's economic growth.

By 2007 significant progress had been made. Initially the Turkish government failed to fully comply with IMF

mandates on economic policy, causing the institution to hold back a scheduled \$1.6 billion in IMF loans until the government passed an "austerity budget," which it did reluctantly in March 2003 after months of public hand-wringing. Since then, things have improved. Inflation fell from a peak of 65 percent in December 2000 to about 8.2 percent for 2005 and 9 percent for 2007. Economic growth increased to a robust 9 percent in 2004, followed by 5.9 percent in 2005, 5.2 percent in 2006, and 4 percent in 2007. The pace of the privatization program has increased. The government also generated budget surpluses in 2003–2006.

Sources: P. Blustein, "Turkish Crisis Weakens the Case for Intervention," *Washington Post*, March 2, 2001, p. E1; H. Pope, "Can Turkey Finally Mend Its Economy?" *The Wall Street Journal*, May 22, 2001, p. A18; "Turkish Bath," *The Wall Street Journal*, February 23, 2001, p. A14; E. McBride, "Turkey—Fingers Crossed," *The Economist*, June 10, 2000, p. SS16–SS17; "Turkey and the IMF," *The Economist*, December 9, 2000, pp. 81–82; G. Chazan, "Turkey's Decision on Aid Is Sinking In," *The Wall Street Journal*, March 6, 2003, p. A11; S. Fittipaldi, "Markets Keep a Wary Eye on Ankara," *Global Finance*, October 2003, p. 88; "Plumper: Turkey," *The Economist*, December 18, 2004, p. 141; and "Turkey: Country Forecast Summary," *The Economist Intelligence Unit*, January 26, 2006.



Focus on Managerial Implications

The implications for international businesses of the material discussed in this chapter fall into three main areas: currency management, business strategy, and corporate–government relations.

Currency Management

An obvious implication with regard to currency management is that companies must recognize that the foreign exchange market does not work quite as depicted in Chapter 9. The current system is a mixed system in which a combination of government intervention and speculative activity can drive the foreign exchange market. Companies engaged in significant foreign exchange activities need to be aware of this and to adjust their foreign exchange transactions accordingly. For example, the currency management unit of Caterpillar claims it made millions of dollars in the hours following the announcement of the Plaza Accord by selling dollars and buying currencies that it expected to appreciate on the foreign exchange market following government intervention.

Under the present system, speculative buying and selling of currencies can create very volatile movements in exchange rates (as exhibited by the rise and fall of the dollar during the 1980s and the Asian currency crisis of the late 1990s). Contrary to the predictions of the purchasing power parity theory (see Chapter 9), exchange rate movements during the 1980s and 1990s often did not seem to be strongly influenced

LEARNING OBJECTIVES 6

Explain the implications of the global monetary system for currency management and business strategy.

by relative inflation rates. Insofar as volatile exchange rates increase foreign exchange risk, this is not good news for business. On the other hand, as we saw in Chapter 9, the foreign exchange market has developed a number of instruments, such as the forward market and swaps, that can help to insure against foreign exchange risk. Not surprisingly, use of these instruments has increased markedly since the breakdown of the Bretton Woods system in 1973.

Business Strategy

The volatility of the present global exchange rate regime presents a conundrum for international businesses. Exchange rate movements are difficult to predict, and yet their movement can have a major impact on a business's competitive position. For a detailed example, see the accompanying Management Focus on Airbus. Faced with uncertainty about the future value of currencies, firms can utilize the forward exchange market, which Airbus has done. However, the forward exchange market is far from perfect as a predictor of future exchange rates (see Chapter 9). It is also difficult if not impossible to get adequate insurance coverage for exchange rate changes that might occur several years in the future. The forward market tends to offer coverage for exchange rate changes a few months—not years—ahead. Given this, it makes sense to pursue strategies that will increase the company's strategic



Management FOCUS

Airbus and the Euro

Airbus had reason to celebrate in 2003; for the first time in the company's history it delivered more commercial jet aircraft than longtime rival Boeing. Airbus delivered 305 planes in 2003, compared to Boeing's 281. The celebration, however, was muted, for the strength of the euro against the U.S. dollar was casting a cloud over the company's future. Airbus, which is based in Toulouse, France, prices planes in dollars, just as Boeing has always done. But more than half of Airbus's costs are in euros. So as the dollar drops in value against the euro, and it dropped by over 50 percent between 2002 and the end of 2009, Airbus's costs rise in proportion to its revenue, squeezing profits in the process.

In the short run, the fall in the value of the dollar against the euro did not hurt Airbus. The company had fully hedged its dollar exposure until 2005 and mostly hedged for 2006. However, anticipating that the dollar will stay weak against the euro, Airbus has taken other steps to reduce its economic exposure to a strong European currency. Recognizing that raising prices is not an option given the strong competition from Boeing, Airbus has decided to focus on reducing its costs. As a step toward doing this, Airbus is giving U.S. suppliers a greater share of work on new aircraft models, such as the A380 super-jumbo and the A350. It is also shifting supply work on some of its older models

from European to American-based suppliers. This will increase the proportion of its costs that are in dollars, making profits less vulnerable to a rise in the value of the euro and reducing the costs of building an aircraft when they are converted back into euros.

In addition, Airbus is pushing its European-based suppliers to start pricing in U.S. dollars. Because the costs of many suppliers are in euros, the suppliers are finding that to comply with Airbus's wishes, they too have to move more work to the United States, or to countries whose currency is pegged to the U.S. dollar. Thus, one large French-based supplier, Zodiac, has announced that it was considering acquisitions in the United States. Not only is Airbus pushing suppliers to price components for commercial jet aircraft in dollars, but the company is also requiring suppliers to its A400M program, a military aircraft that will be sold to European governments and priced in euros, to price components in U.S. dollars. Beyond these steps, the CEO of EADS, Airbus's parent company, has publicly stated that it might be prepared to assemble aircraft in the United States if that helps to win important U.S. contracts.

Sources: D. Michaels, "Airbus Deliveries Top Boeing's; But Several Obstacles Remain," *The Wall Street Journal*, January 16, 2004, p. A9; J. L. Gerondeau, "Airbus Eyes U.S. Suppliers as Euro Gains," *Seattle Times*, February 21, 2004, p. C4; "Euro's Gains Create Worries in Europe," *HoustonChronicle.com*, January 13, 2004; and K. Done, "Soft Dollar and A380 Hitches Lead to EADS Losses," *Financial Times*, November 9, 2006, p. 32.

flexibility in the face of unpredictable exchange rate movements—that is, to pursue strategies that reduce the economic exposure of the firm (which we first discussed in Chapter 9).

Maintaining strategic flexibility can take the form of dispersing production to different locations around the globe as a real hedge against currency fluctuations (this seems to be what Airbus is now considering). Consider the case of Daimler-Benz, Germany's export-oriented automobile and aerospace company. In June 1995, the company stunned the German business community when it announced it expected to post a severe loss in 1995 of about \$720 million. The cause was Germany's strong currency, which had appreciated by 4 percent against a basket of major currencies since the beginning of 1995 and had risen by more than 30 percent against the U.S. dollar since late 1994. By mid-1995, the exchange rate against the dollar stood at $\$1 = \text{DM}1.38$. Daimler's management believed it could not make money with an exchange rate under $\$1 = \text{DM}1.60$. Daimler's senior managers concluded that the appreciation of the mark against the dollar was probably permanent, so they decided to move substantial production outside of Germany and increase purchasing of foreign components. The idea was to reduce the vulnerability of the company to future exchange rate movements. Even before it acquired Chrysler Corporation in 1998, the Mercedes-Benz division planned to produce 10 percent of its cars outside of Germany by 2000, mostly in the United States.³⁰ Similarly, the move by Japanese automobile companies to expand their productive capacity in the United States and Europe can be seen in the context of the increase in the value of the yen between 1985 and 1995, which raised the price of Japanese exports. For the Japanese companies, building production capacity overseas is a hedge against continued appreciation of the yen (as well as against trade barriers).

Another way of building strategic flexibility and reducing economic exposure involves contracting out manufacturing. This allows a company to shift suppliers from country to country in response to changes in relative costs brought about by exchange rate movements. However, this kind of strategy may work only for low-value-added manufacturing (e.g., textiles), in which the individual manufacturers have few if any firm-specific skills that contribute to the value of the product. It may be less appropriate for high-value-added manufacturing, in which firm-specific technology and skills add significant value to the product (e.g., the heavy equipment industry) and in which switching costs are correspondingly high. For high-value-added manufacturing, switching suppliers will lead to a reduction in the value that is added, which may offset any cost gains arising from exchange rate fluctuations.

The roles of the IMF and the World Bank in the present international monetary system also have implications for business strategy. Increasingly, the IMF has been acting as the macroeconomic police of the world economy, insisting that countries seeking significant borrowings adopt IMF-mandated macroeconomic policies. These policies typically include anti-inflationary monetary policies and reductions in government spending. In the short run, such policies usually result in a sharp contraction of demand. International businesses selling or producing in such countries need to be aware of this and plan accordingly. In the long run, the kind of policies imposed by the IMF can promote economic growth and an expansion of demand, which create opportunities for international business.

Corporate–Government Relations

As major players in the international trade and investment environment, businesses can influence government policy toward the international monetary system. For example, intense government lobbying by U.S. exporters helped convince the U.S. government that intervention in the foreign exchange market was necessary. With this in

mind, business can and should use its influence to promote an international monetary system that facilitates the growth of international trade and investment. Whether a fixed or floating regime is optimal is a subject for debate. However, exchange rate volatility such as the world experienced during the 1980s and 1990s creates an environment less conducive to international trade and investment than one with more stable exchange rates. Therefore, it would seem to be in the interests of international business to promote an international monetary system that minimizes volatile exchange rate movements, particularly when those movements are unrelated to long-run economic fundamentals.

Key Terms

international monetary system, p. 344

floating exchange rate, p. 345

pegged exchange rate, p. 345

dirty float, p. 345

fixed exchange rate, p. 345

European Monetary System (EMS), p. 345

gold standard, p. 346

gold par value, p. 347

balance-of-trade equilibrium, p. 347

managed-float system, p. 356

currency board, p. 360

currency crisis, p. 361

banking crisis, p. 361

foreign debt crisis, p. 362

moral hazard, p. 368

Summary

This chapter explained the workings of the international monetary system and pointed out its implications for international business. The chapter made the following points:

1. The gold standard is a monetary standard that pegs currencies to gold and guarantees convertibility to gold. It was thought that the gold standard contained an automatic mechanism that contributed to the simultaneous achievement of a balance-of-payments equilibrium by all countries. The gold standard broke down during the 1930s as countries engaged in competitive devaluations.
2. The Bretton Woods system of fixed exchange rates was established in 1944. The U.S. dollar was the central currency of this system; the value of every other currency was pegged to its value. Significant exchange rate devaluations were allowed only with the permission of the IMF. The role of the IMF was to maintain order in the international monetary system (a) to avoid a repetition of the competitive devaluations of the 1930s and (b) to control price inflation by imposing monetary discipline on countries.
3. The fixed exchange rate system collapsed in 1973, primarily due to speculative pressure on the dollar following a rise in U.S. inflation and a growing U.S. balance-of-trade deficit.
4. Since 1973 the world has operated with a floating exchange rate regime, and exchange rates have become more volatile and far less predictable. Volatile exchange rate movements have helped reopen the debate over the merits of fixed and floating systems.
5. The case for a floating exchange rate regime claims (a) such a system gives countries autonomy regarding their monetary policy and (b) floating exchange rates facilitate smooth adjustment of trade imbalances.
6. The case for a fixed exchange rate regime claims (a) the need to maintain a fixed exchange rate imposes monetary discipline on a country, (b) floating exchange rate regimes are vulnerable to speculative pressure, (c) the uncertainty that accompanies floating exchange rates dampens

the growth of international trade and investment, and (d) far from correcting trade imbalances, depreciating a currency on the foreign exchange market tends to cause price inflation.

7. In today's international monetary system, some countries have adopted floating exchange rates, some have pegged their currency to another currency such as the U.S. dollar, and some have pegged their currency to a basket of other currencies, allowing their currency to fluctuate within a zone around the basket.
8. In the post-Bretton Woods era, the IMF has continued to play an important role in helping countries navigate their way through financial crises by lending significant capital to embattled governments and by requiring them to adopt certain macroeconomic policies.
9. An important debate is occurring over the appropriateness of IMF-mandated macroeconomic policies. Critics charge that the IMF often imposes inappropriate conditions on developing nations that are the recipients of its loans.
10. The present managed-float system of exchange rate determination has increased the importance of currency management in international businesses.
11. The volatility of exchange rates under the present managed-float system creates both opportunities and threats. One way of responding to this volatility is for companies to build strategic flexibility and limit their economic exposure by dispersing production to different locations around the globe by contracting out manufacturing (in the case of low-value-added manufacturing) and other means.

Critical Thinking and Discussion Questions

1. Why did the gold standard collapse? Is there a case for returning to some type of gold standard? What is it?
2. What opportunities might current IMF lending policies to developing nations create for international businesses? What threats might they create?
3. Do you think the standard IMF policy prescriptions of tight monetary policy and reduced government spending are always appropriate for developing nations experiencing a currency crisis? How might the IMF change its approach? What would the implications be for international businesses?
4. Debate the relative merits of fixed and floating exchange rate regimes. From the perspective of an international business, what are the most important criteria in a choice between the systems? Which system is the more desirable for an international business?
5. Imagine that Canada, the United States, and Mexico decide to adopt a fixed exchange rate system. What would be the likely consequences of such a system for (a) international businesses and (b) the flow of trade and investment among the three countries?
6. Reread the Country Focus on the U.S. dollar, oil prices, and recycling petrodollars, then answer the following questions:
 - a. What will happen to the value of the U.S. dollar if oil producers decide to invest most of their earnings from oil sales in domestic infrastructure projects?
 - b. What factors determine the relative attractiveness of dollar-, euro-, and yen-denominated assets to oil producers flush with petrodollars? What might lead them to direct more funds toward non-dollar-denominated assets?
 - c. What will happen to the value of the U.S. dollar if OPEC members decide to invest more of their petrodollars toward non-dollar-denominated assets, such as euro-denominated stocks and bonds?
 - d. In addition to oil producers, China is also accumulating a large stock of dollars, currently estimated to total \$1.4 trillion. What would happen to the value of the dollar if China and oil-producing nations all shifted out of dollar-denominated assets at the same time? What would be the consequence for the U.S. economy?

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

1. While Latvia has been a member state of the European Union since 2004, it has not completed the third stage of the European Monetary Union and therefore still uses its own currency, the Latvian lats. Visit the site of the *Bank of Latvia* to get more information about the current monetary policy in Latvia. How is the value of lats determined? Why?
2. The International Capital Markets division of the International Monetary Fund (IMF) publishes the *Global Financial Stability Report*, a semiannual report that provides an assessment of global financial markets. Find the Global Financial Stability Map in the most recent report. Provide a description of the indicators used to construct the map and briefly summarize what the most current map illustrates in terms of changes in financial stability risks



closing case

Argentina's Monetary Crisis

In the 1990s Argentina was the darling of the international financial community. The country had fixed the exchange rate for the Argentinean peso to the U.S. dollar at \$1=1 peso. Maintaining the exchange rate had required Argentina to adopt strict anti-inflationary policies, which had succeeded in bringing down Argentina's historically high inflation rate and stimulated economic growth. By 2001, however, the economy was running into trouble. Global economic growth slowed and demand for many of the commodities that Argentina exported had fallen in tandem. Argentina's large neighbor and main trading partner, Brazil, was grappling with a financial crisis of its own and had devalued its currency against the dollar, and thus the peso, effectively pricing many Argentinean goods out of its market. To compound matters, the dollar had appreciated against most major currencies, taking the peso up with it, and making Argentinean goods more expensive in other international markets.

Starting in 1999, the Argentinean economy entered into a tailspin that was to take unemployment up to 25 percent by 2002. Anticipating that the country would have to devalue the peso against the dollar, corporations and individuals started to pull money out of pesos, placing their funds in dollar accounts. As people sold pesos, the Argentinean government used its foreign exchange reserves to buy them back in an effort to maintain the exchange rate at \$1= 1 peso. The government quickly ran down its reserves, and in 2000, the country negotiated a loan from the International Monetary Fund (IMF) to prop up its currency. In return for the loan, which

ultimately reached \$15 billion, the Argentinean government agreed to adopt a financial austerity program to balance its budget. However, conditions in the country continued to deteriorate, in no small part some critics claimed because the strict IMF policies made an already bad recession worse. By late 2001, with government tax revenues plunging as the economy contracted, the Argentinean government defaulted in its debt repayments, effectively rendering \$80 billion of government-issued bonds worthless. This created a massive crisis of confidence, which put further pressure on the peso. Throughout 2001 the Argentina government had been trying to support the value of the peso with the help of the loan from the International Monetary Fund, but it was becoming ever more difficult, and the debt default was the final nail in the coffin. In early 2002, the government bowed to the inevitable and decoupled the peso from the dollar, allowing it to float freely. It immediately fell to \$1 = 3.5 pesos.

The fall in the value of the peso helped to revive Argentinean commodity exports, which were now much cheaper for foreign buyers. A rebound in global economic growth after 2001 also helped, as did an economic recovery in neighboring Brazil. By 2003, the economy was once more on a growth path and unemployment was falling. In 2005 Argentina repaid its entire debt to the IMF. Commenting on the debt repayment, Argentinean President Nestor Kirchner criticized the IMF for promoting policies that "provoked poverty and pain on the Argentine people." While that view was popular in Argentina, some outside observers worried

that freed from IMF constraints, the Argentinean economy would return to its historic norm of loose monetary policy and high inflation.

Sources: Guillermo Nielsen, "Inside Argentina's Financial Crisis," *Euromoney*, March 2006, pp. 21–28; "Nestor Unbounded: The IMF and Argentina," *The Economist*, December 24, 2005, p. 12; and "Which Is the Victim? Argentina and the IMF," *The Economist*, March 6, 2004, pp. 82–83.

Case Discussion Questions

1. Why do you think Argentina adopted a fixed exchange rate policy in the 1990s?
2. To what extent did the fixed exchange rate policy contribute to Argentina's economic problems in 2000–2001? Would Argentina have been better off during this period with a floating exchange rate?
3. The IMF policy for Argentina included deep cuts in government spending and a sharp rise in interest rates? Why do you think the IMF thought these policies were necessary? What was the cost of these policies to Argentina? Was there another way of dealing with the crisis?
4. In late 2008 commodity prices again fell sharply. What do you think was the impact on Argentina? What would you expect to happen to the value of the Argentinean peso against major currencies? What actually happened?



part 5

Competing in a Global Marketplace

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Explain the concept of strategy.
- 2 Recognize how firms can profit by expanding globally.
- 3 Understand how pressures for cost reductions and pressures for local responsiveness influence strategic choice.
- 4 Identify the different strategies for competing globally and their pros and cons.
- 5 Explain the pros and cons of using strategic alliances to support global strategies.

The Strategy of International Business

Avon Products

opening case

Andrea Jung became CEO of Avon Products in 1999, and for six years the beauty products company, famous for its direct sales model, had revenues grow in excess of 10 percent annually. Profits tripled, making Jung a Wall Street favorite. Then in 2005, the success story started to turn ugly. Avon, which derives as much as 70 percent of its revenues from international markets, mostly in developing nations, suddenly began losing sales across the globe. A ban on direct sales had hurt its business in China (the Chinese government had accused companies that used a direct sales model of engaging in pyramid schemes and of creating “cults”). To compound matters, economic weakness in Eastern Europe, Russia, and Mexico, all drivers of Avon’s success, stalled growth there. The dramatic turn of events took investors by surprise. In May 2005 Jung had told investors that Avon would exceed Wall Street’s targets for the year. By September she was rapidly backpedaling and the stock fell 45 percent.

With her job on the line, Jung began to reevaluate Avon’s global strategy. Until this point, the company had expanded primarily by replicating its U.S. strategy and organization in other countries. When it entered a nation, it gave country managers considerable autonomy. All used the Avon brand and adopted the direct sales model that has been the company’s hallmark. The result was an army of 5 million Avon representatives around the world, all independent contractors, who sold the company’s skin care and makeup products. However, many country managers also set up their own local manufacturing operations and supply chains, were responsible for local marketing, and developed their own new products. In Jung’s words, “They were the king or queen of every decision.” The result was a lack of consistency in marketing strategy from nation to nation, extensive duplication of manufacturing operations and supply chains, and a profusion of new products, many of which were not profitable. In Mexico, for example,

the roster of products for sale had ballooned to 13,000. The company also had 15 layers of management, making accountability and communication problematic. There was also a distinct lack of data-driven analysis of new-product opportunities, with country managers often making decisions based on their intuition or gut feeling.

Jung's turnaround strategy involved several elements. To help transform Avon, she hired seasoned managers from well-known global consumer products companies such as Procter & Gamble and Unilever. She flattened the organization to improve communication, performance visibility, and accountability, reducing the number of management layers to just eight and laying off 30 percent of managers. Manufacturing was consolidated in a number of regional centers and supply chains were rationalized, eliminating duplication and reducing costs by over \$1 billion a year. Rigorous return on investment criteria were introduced to evaluate product profitability. As a consequence, 25 percent of Avon's products were discontinued. New-product decisions were centralized at Avon's headquarters. Jung also invested in centralized product development. The goal was to develop and introduce blockbuster new products that could be positioned as global brands. And Jung pushed the company to emphasize its value proposition in every national market, which could be characterized as high quality at a low price.

By 2007 this strategy was starting to yield dividends. The company's performance improved and growth resumed. It didn't hurt that Jung, a Chinese-American who speaks Mandarin, was instrumental in persuading Chinese authorities to rescind the ban on direct sales, allowing Avon to recruit 400,000 new representatives in China. Then the 2008–2009 global financial crisis hit. Jung's reaction: This was an opportunity for Avon to expand its business. In 2009, Avon ran ads around the world aimed at recruiting sales representatives. In the ads, female sales reps talked about working for Avon. "I can't get laid off, I can't get fired," is what one said. Phones started to ring off the hook, and Avon was quickly able to expand its global sales force. Jung also instituted an aggressive pricing strategy, while packaging was redesigned for a more elegant look at no additional cost. The idea was to emphasize the "value for money" the Avon's products represented. Well-known media stars were used in ads to help market the company's products, and Avon pushed its representatives to use online social networking sites as a medium to market themselves. The result: In the difficult years of 2008 and 2009, Avon gained global market share and its financial performance improved. In the fourth quarter of 2009, Avon's sales rose 13 percent to \$3.15 billion over a year earlier, while its profits expanded to \$269 million, up from \$232 million. ●

Sources: A. Chang, "Avon Ultimate Makeover Artist," *MarketWatch*, December 3, 2009; N. Byrnes, "Avon: More Than Cosmetic Change," *BusinessWeek*, March 3, 2007, pp. 62–63; and J. Hodson, "Avon 4Q Profit Jumps on Higher Overseas Sales," *The Wall Street Journal*, www.wallstreetjournal.com, February 4, 2010.



Introduction

Our primary concern thus far in this book has been with aspects of the larger environment in which international businesses compete. As we have described it in the preceding chapters, this environment has included the different political, economic, and cultural institutions found in nations, the international trade and investment framework, and the international monetary system. Now our focus shifts from the environment to the firm itself and, in particular, to the actions managers can take to compete more effectively as an international business. In this chapter, we look at how firms can increase their profitability by expanding their operations in foreign markets. We discuss the different strategies that firms pursue when competing internationally. We consider the pros and cons of these strategies. We discuss the various factors that affect a firm's choice of strategy. We also look at why firms often enter into strategic alliances with their global competitors, and we discuss the benefits, costs, and risks of strategic alliances.

Avon Products, profiled in the opening case, gives us a preview of some issues that we will explore in this chapter. Like many other companies, Avon moved into other countries because it saw huge growth opportunities there. It thought it could create value by transferring the Avon brand, products, and direct sales model, and giving country managers considerable autonomy to develop the local market. This worked for a long time, but by 2005 the company was running into significant headwinds. Avon's costs were too high, a result of extensive manufacturing duplication across national markets. It had too many products, many of which were not profitable, and there was a lack of consistency in marketing message and branding across nations. In response, CEO Andrea Jung changed the strategy of the company. The autonomy of local country managers was reduced. She consolidated manufacturing and reduced the product line by 25 percent, while emphasizing global brands and a global marketing strategy. This change in strategy helped Avon to take more than \$1 billion out of its cost structure while fueling an expansion in sales. As we shall see later in this chapter, many other companies have made a similar shift in the last two decades, moving from what can be characterized as a *localization strategy*, where local country managers have considerable autonomy over manufacturing and marketing, to a *global strategy*, where the corporate center exercises more control over manufacturing, marketing, and product development decisions. The tendency to make such a shift in many international businesses is a response to the globalization of markets, a phenomenon that we first discussed in Chapter 1. We shall discuss this process later in the chapter. To begin, however, we need to define exactly what we mean by strategy.

Strategy and The Firm

Before we discuss the strategies that managers in the multinational enterprise can pursue, we need to review some basic principles of strategy. A firm's **strategy** can be defined as the actions that managers take to attain the goals of the firm. For most firms, the preeminent goal is to maximize the value of the firm for its owners, its shareholders (subject to the very important constraint that this is done in a legal, ethical, and socially responsible manner—see Chapter 5 for details). To maximize the value of a firm, managers must pursue strategies that increase the *profitability* of the enterprise and its rate of *profit growth* over time (see Figure 11.1). **Profitability** can be measured in a number of ways, but for consistency, we shall define it as the rate of return that the firm makes on its invested capital (ROIC), which is calculated by dividing the net profits of the firm by

LEARNING OBJECTIVE 1

Explain the concept of strategy.

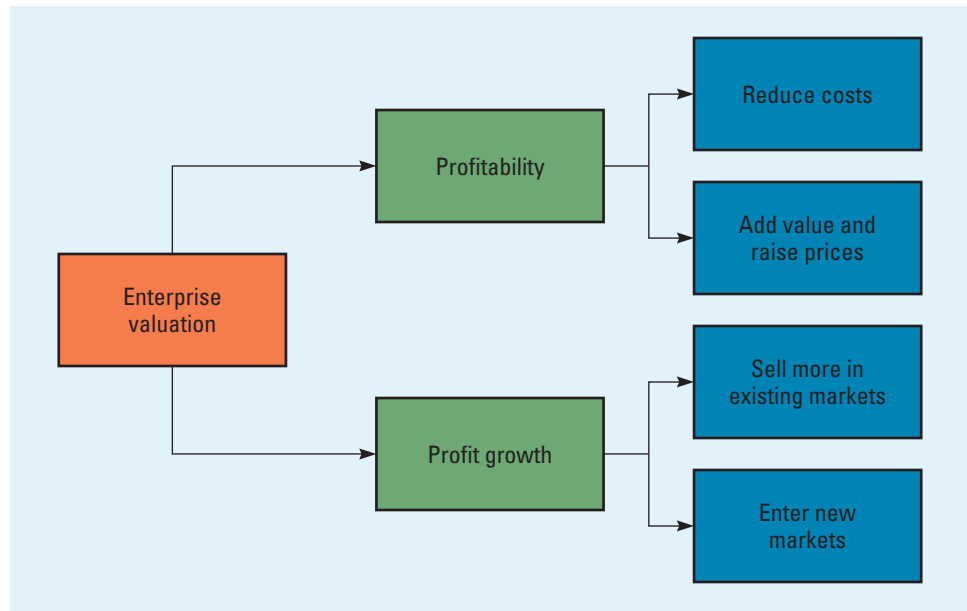
Strategy

Actions managers take to attain the firm's goals.

Profitability

A ratio or rate of return concept, calculated by dividing the net profits of the firm by total invested capital.

figure 11.1
Determinants of
Enterprise Value



Profit Growth
The percentage increase
in net profits over time.

total invested capital.¹ **Profit growth** is measured by the percentage increase in net profits over time. In general, higher profitability and a higher rate of profit growth will increase the value of an enterprise and thus the returns garnered by its owners, the shareholders.²

Managers can increase the profitability of the firm by pursuing strategies that lower costs or by pursuing strategies that add value to the firm's products, which enables the firm to raise prices. Managers can increase the rate at which the firm's profits grow over time by pursuing strategies to sell more products in existing markets or by pursuing strategies to enter new markets. As we shall see, expanding internationally can help managers boost the firm's profitability *and* increase the rate of profit growth over time.

VALUE CREATION The way to increase the profitability of a firm is to create more value. The amount of value a firm creates is measured by the difference between its costs of production and the value that consumers perceive in its products. In general, the more value customers place on a firm's products, the higher the price the firm can charge for those products. However, the price a firm charges for a good or service is typically less than the value placed on that good or service by the customer. This is because the customer captures some of that value in the form of what economists call a consumer surplus.³ The customer is able to do this because the firm is competing with other firms for the customer's business, so the firm must charge a lower price than it could were it a monopoly supplier. Also, it is normally impossible to segment the market to such a degree that the firm can charge each customer a price that reflects that individual's assessment of the value of a product, which economists refer to as a customer's reservation price. For these reasons, the price that gets charged tends to be less than the value placed on the product by many customers.



Another Perspective

Education as a Part of Your Value Chain

The concept of value chain can be used to examine the role your undergraduate education plays in your life plans. If you look closely at your personal development plans (education, internship, physical and emotional/spiritual fitness, extracurricular activities) and think about them in terms of primary and support activities, how does your choice of major fit into your personal development strategy? How do your choices of how you spend your time fit into your value chain? Do you ever spend time doing things that don't support the strategic goals of your personal value chain?

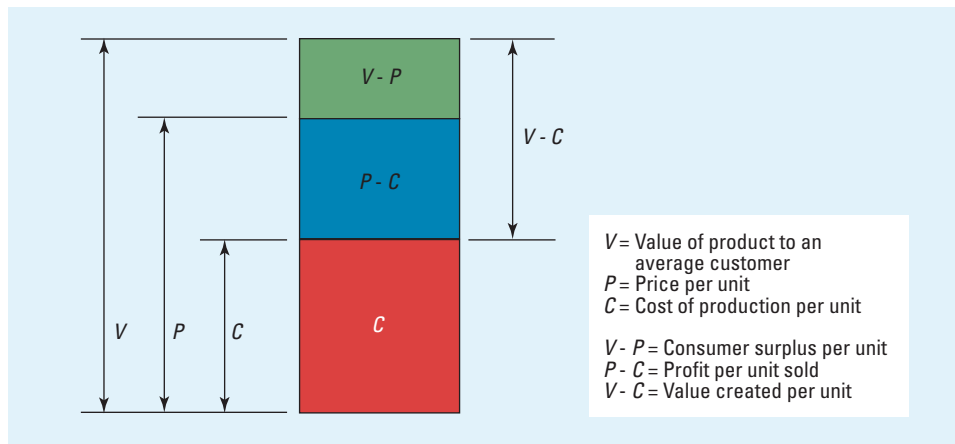


Figure 11.2 illustrates these concepts. The value of a product to an *average* consumer is V ; the average price that the firm can charge a consumer for that product given competitive pressures and its ability to segment the market is P ; and the average unit cost of producing that product is C (C comprises all relevant costs, including the firm's cost of capital). The firm's profit per unit sold (π) is equal to $P - C$, while the consumer surplus per unit is equal to $V - P$ (another way of thinking of the consumer surplus is as "value for the money"; the greater the consumer surplus, the greater the value for the money the consumer gets). The firm makes a profit so long as P is greater than C , and its profit will be greater the lower C is *relative* to P . The difference between V and P is in part determined by the intensity of competitive pressure in the marketplace; the lower the intensity of competitive pressure, the higher the price charged relative to V .⁴ In general, the higher the firm's profit per unit sold, the greater its profitability will be, all else being equal.

The firm's **value creation** is measured by the difference between V and C ($V - C$); a company creates value by converting inputs that cost C into a product on which consumers place a value of V . A company can create more value ($V - C$) either by lowering production costs, C , or by making the product more attractive through superior design, styling, functionality, features, reliability, after-sales service, and the like, so that consumers place a greater value on it (V increases) and, consequently, are willing to pay a higher price (P increases). This discussion suggests that *a firm has high profits when it creates more value for its customers and does so at a lower cost*. We refer to a strategy that focuses primarily on lowering production costs as a *low-cost strategy*. We refer to a strategy that focuses primarily on increasing the attractiveness of a product as a *differentiation strategy*.⁵ Coca-Cola primarily focuses on the differentiation side of this equation—it tried to differentiate itself from rivals by brand-building advertisements.

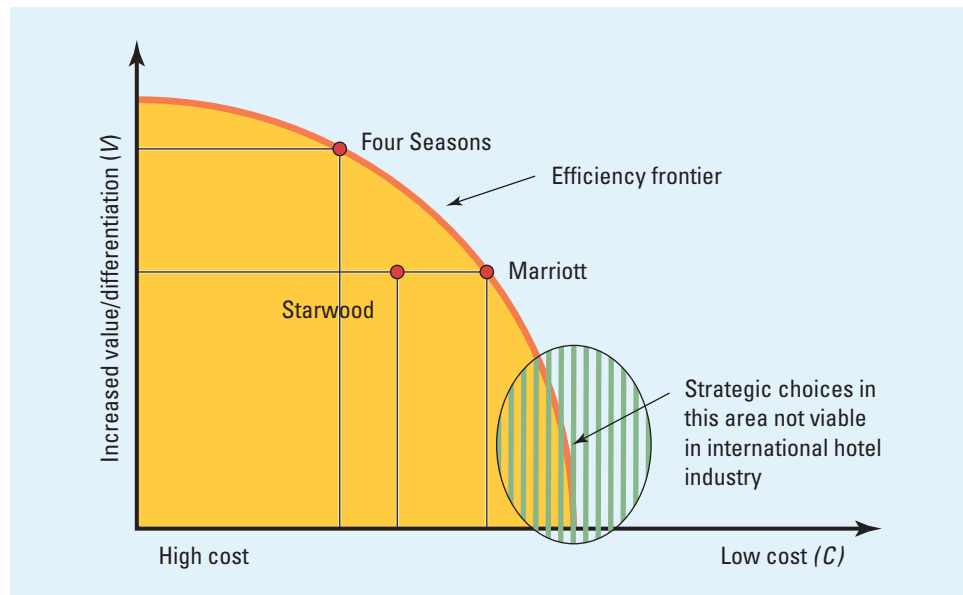
Michael Porter has argued that *low cost* and *differentiation* are two basic strategies for creating value and attaining a competitive advantage in an industry.⁶ According to Porter, superior profitability goes to those firms that can create superior value, and the way to create superior value is to drive down the cost structure of the business and/or differentiate the product in some way so that consumers value it more and are prepared to pay a premium price. Superior value creation relative to rivals does not necessarily require a firm to have the lowest cost structure in an industry, or to create the most valuable product in the eyes of consumers. However, it does require that the gap between value (V) and cost of production (C) be greater than the gap attained by competitors.

Value Creation

Performing activities that increase the value of goods or services to consumers.

figure 11.3

Strategic Choice in
the International
Hotel Industry



STRATEGIC POSITIONING Porter notes that it is important for a firm to be explicit about its choice of strategic emphasis with regard to value creation (differentiation) and low cost, and to configure its internal operations to support that strategic emphasis.⁷ Figure 11.3 illustrates his point. The convex curve in Figure 11.3 is what economists refer to as an efficiency frontier. The efficiency frontier shows all the different positions a firm can adopt with regard to adding value to the product (V) and lowering cost (C) assuming that its internal operations are configured efficiently to support a particular position (note that the horizontal axis in Figure 11.3 is reverse scaled—moving along the axis to the right implies lower costs). The efficiency frontier has a convex shape because of diminishing returns. Diminishing returns imply that when a firm already has significant value built into its product offering, increasing value by a relatively small amount requires significant additional costs. The converse also holds, when a firm already has a low-cost structure, it has to give up a lot of value in its product offering to get additional cost reductions.

Three hotel firms with a global presence that cater to international travelers are plotted on Figure 11.3—Four Seasons, Marriott International, and Starwood (Starwood owns the Sheraton and Westin chains). Four Seasons positions itself as a luxury chain and emphasizes the value of its product offering, which drives up its costs of operations. Marriott and Starwood are positioned more in the middle of the market. Both emphasize sufficient value to attract international business travelers, but are not luxury chains like Four Seasons. In Figure 11.3, Four Seasons and Marriott are shown to be on the efficiency frontier, indicating that their internal operations are well configured to their strategy and run efficiently. Starwood is inside the frontier, indicating that its operations are not running as efficiently as they might be, and that its costs are too high. This implies that Starwood is less profitable than Four Seasons and Marriott, and that its managers must take steps to improve the company's performance.

Porter emphasizes that it is very important for management to decide where the company wants to be positioned with regard to value (V) and cost (C), to configure operations accordingly, and to manage them efficiently to make sure the firm is operating on the efficiency frontier. However, not all positions on the efficiency frontier are viable. In the international hotel industry, for example, there might not be enough demand to support a chain that emphasizes very low cost and strips all the value out of

its product offering (see Figure 11.3). International travelers are relatively affluent and expect a degree of comfort (value) when they travel.

A central tenet of the basic strategy paradigm is that to maximize its profitability, a firm must do three things: (a) pick a position on the efficiency frontier that is viable in the sense that there is enough demand to support that choice; (b) configure its internal operations, such as manufacturing, marketing, logistics, information systems, human resources, and so on, so that they support that position; and (c) make sure the firm has the right organization structure in place to execute its strategy. *The strategy, operations, and organization of the firm must all be consistent with each other if it is to attain a competitive advantage and garner superior profitability.* By **operations** we mean the different value creation activities a firm undertakes, which we shall review next.

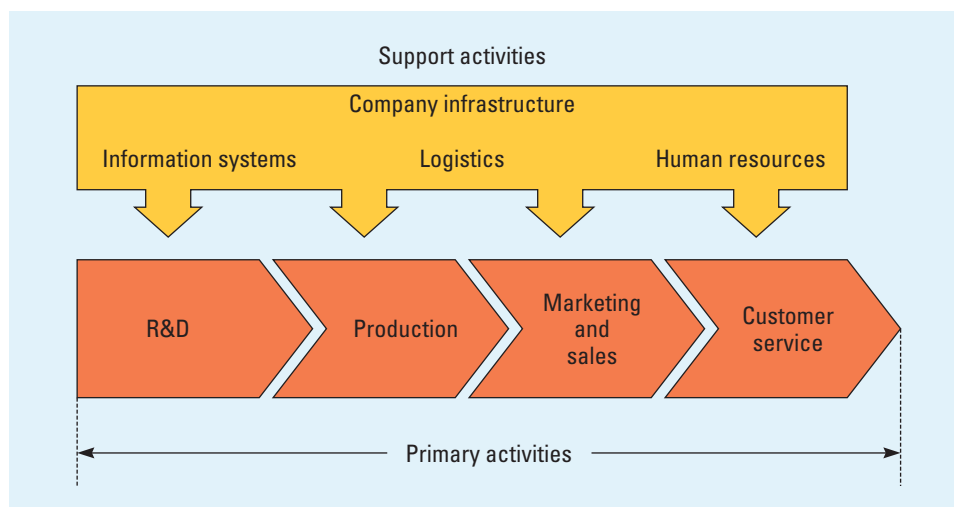
Operations

The various value creation activities a firm undertakes.

OPERATIONS: THE FIRM AS A VALUE CHAIN The operations of a firm can be thought of as a value chain composed of a series of distinct value creation activities including production, marketing and sales, materials management, R&D, human resources, information systems, and the firm infrastructure. We can categorize these value creation activities, or operations, as primary activities and support activities (see Figure 11.4).⁸ As noted above, if a firm is to implement its strategy efficiently, and position itself on the efficiency frontier shown in Figure 11.3, it must manage these activities effectively and in a manner that is consistent with its strategy.

Primary Activities Primary activities have to do with the design, creation, and delivery of the product; its marketing; and its support and after-sale service. Following normal practice, in the value chain illustrated in Figure 11.4, the primary activities are divided into four functions: research and development, production, marketing and sales, and customer service.

Research and development (R&D) is concerned with the design of products and production processes. Although we think of R&D as being associated with the design of physical products and production processes in manufacturing enterprises, many service companies also undertake R&D. For example, banks compete with each other by developing new financial products and new ways of delivering those products to customers. Online banking and smart debit cards are two examples of product development in the banking industry. Earlier examples of innovation in the banking industry included automated teller machines, credit cards, and debit cards. Through superior



11.4 figure

The Value Chain

product design, R&D can increase the functionality of products, which makes them more attractive to consumers (raising V). Alternatively, R&D may result in more efficient production processes, thereby cutting production costs (lowering C). Either way, the R&D function can create value.

Production is concerned with the creation of a good or service. For physical products, when we talk about production we generally mean manufacturing. Thus, we can talk about the production of an automobile. For services such as banking or health care, “production” typically occurs when the service is delivered to the customer (for example, when a bank originates a loan for a customer it is engaged in “production” of the loan). For a retailer such as Walmart, “production” is concerned with selecting the merchandise, stocking the store, and ringing up the sale at the cash register. For MTV, production is concerned with the creation, programming, and broadcasting of content, such as music videos and thematic shows. The production activity of a firm creates value by performing its activities efficiently so lower costs result (lower C) and/or by performing them in such a way that a higher-quality product is produced (which results in higher V).

The marketing and sales functions of a firm can help to create value in several ways. Through brand positioning and advertising, the marketing function can increase the value (V) that consumers perceive to be contained in a firm’s product. If these create a favorable impression of the firm’s product in the minds of consumers, they increase the price that can be charged for the firm’s product. For example, Ford has produced a high-value version of its Ford Expedition SUV. Sold as the Lincoln Navigator and priced around \$10,000 higher, the Navigator has the same body, engine, chassis, and design as the Expedition, but through skilled advertising and marketing, supported by some fairly minor features changes (e.g., more accessories and the addition of a Lincoln-style engine grille and nameplate), Ford has fostered the perception that the Navigator is a “luxury SUV.” This marketing strategy has increased the perceived value (V) of the Navigator relative to the Expedition, and enables Ford to charge a higher price (P) for the car.

Marketing and sales can also create value by discovering consumer needs and communicating them back to the R&D function of the company, which can then design products that better match those needs. For example, the allocation of research budgets at Pfizer, the world’s largest pharmaceutical company, is determined by the marketing function’s assessment of the potential market size associated with solving unmet medical needs. Thus, Pfizer is currently directing significant monies to R&D efforts aimed at finding treatments for Alzheimer’s disease, principally because marketing has identified the treatment of Alzheimer’s as a major unmet medical need in nations around the world where the population is aging.

The role of the enterprise’s service activity is to provide after-sale service and support. This function can create a perception of superior value (V) in the minds of consumers by solving customer problems and supporting customers after they have purchased the product. Caterpillar, the U.S.-based manufacturer of heavy earthmoving equipment, can get spare parts to any point in the world within 24 hours, thereby minimizing the amount of downtime its customers have to suffer if their Caterpillar equipment malfunctions. This is an extremely valuable capability in an industry where downtime is very expensive. It has helped to increase the value that customers associate with Caterpillar products and thus the price that Caterpillar can charge.

Support Activities The support activities of the value chain provide inputs that allow the primary activities to occur (see Figure 11.4). In terms of attaining a competitive advantage, support activities can be as important as, if not more important than, the “primary” activities of the firm. Consider information systems; these systems

refer to the electronic systems for managing inventory, tracking sales, pricing products, selling products, dealing with customer service inquiries, and so on. Information systems, when coupled with the communications features of the Internet, can alter the efficiency and effectiveness with which a firm manages its other value creation activities. Dell, for example, has used its information systems to attain a competitive advantage over rivals. When customers place an order for a Dell product over the firm's Web site, that information is immediately transmitted, via the Internet, to suppliers, who then configure their production schedules to produce and ship that product so that it arrives at the right assembly plant at the right time. These systems have reduced the amount of inventory that Dell holds at its factories to under two days, which is a major source of cost savings.

The logistics function controls the transmission of physical materials through the value chain, from procurement through production and into distribution. The efficiency with which this is carried out can significantly reduce cost (lower C), thereby creating more value. The combination of logistics systems and information systems is a particularly potent source of cost savings in many enterprise, such as Dell, where information systems tell Dell on a real-time basis where in its global logistics network parts are, when they will arrive at an assembly plant, and how production should be scheduled.

The human resource function can help create more value in a number of ways. It ensures that the company has the right mix of skilled people to perform its value creation activities effectively. The human resource function also ensures that people are adequately trained, motivated, and compensated to perform their value creation tasks. In a multinational enterprise, one of the things human resources can do to boost the competitive position of the firm is to take advantage of its transnational reach to identify, recruit, and develop a cadre of skilled managers, regardless of their nationality, who can be groomed to take on senior management positions. They can find the very best, wherever they are in the world. The senior management ranks of many multinationals are becoming increasingly diverse, as managers from a variety of national backgrounds have ascended to senior leadership positions. Japan's Sony, for example, is now headed not by a Japanese national, but by Howard Stringer, a Welshman.

The final support activity is the company infrastructure, or the context within which all the other value creation activities occur. The infrastructure includes the organizational structure, control systems, and culture of the firm. Because top management can exert considerable influence in shaping these aspects of a firm, top management should also be viewed as part of the firm's infrastructure. Through strong leadership, top management can consciously shape the infrastructure of a firm and through that the performance of all its value creation activities.

ORGANIZATION: THE IMPLEMENTATION OF STRATEGY The strategy of a firm is implemented through its organization. For a firm to have superior ROIC, its organization must support its strategy and operations. The term **organization architecture** can be used to refer to the totality of a firm's organization, including formal organizational structure, control systems and incentives, organizational culture, processes, and people.⁹ Figure 11.5 illustrates these different elements. By **organizational structure**, we mean three things: First, the formal division of the organization into subunits such as product divisions, national operations, and functions (most organizational charts display this aspect of structure); second, the location of decision-making responsibilities within that structure (e.g., centralized or decentralized); and third, the establishment of integrating mechanisms to coordinate the activities of subunits including cross functional teams and or pan-regional committees.

Organization Architecture

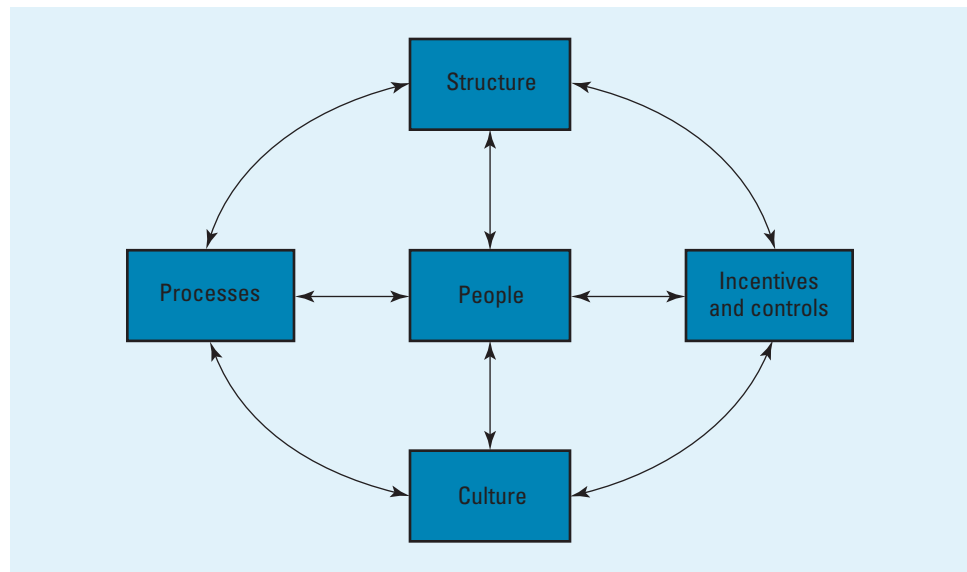
The totality of a firm's organization, including formal organizational structure, control systems and incentives, organizational culture, processes, and people.

Organizational Structure

The three-part structure of an organization, including its formal division into subunits such as product divisions, its location of decision-making responsibilities within that structure, and the establishment of integrating mechanisms to coordinate the activities of subunits.

figure 11.5

Organization Structure



Controls

The metrics used to measure the performance of subunits and make judgments about how well managers are running those subunits.

Incentives

The devices used to reward appropriate managerial behavior.

Processes

The manner in which decisions are made and work is performed within the organization.

Organizational Culture

The norms and value systems shared among an organization's employees.

People

The employees of an organization, its recruiting, compensation, and retention strategies, and the type of people who work at the organization.

Controls are the metrics used to measure the performance of subunits and make judgments about how well managers are running those subunits. **Incentives** are the devices used to reward appropriate managerial behavior. Incentives are very closely tied to performance metrics. For example, the incentives of a manager in charge of a national operating subsidiary might be linked to the performance of that company. Specifically, she might receive a bonus if her subsidiary exceeds its performance targets.

Processes are the manner in which decisions are made and work is performed within the organization. Examples are the processes for formulating strategy, for deciding how to allocate resources within a firm, or for evaluating the performance of managers and giving feedback. Processes are conceptually distinct from the location of decision-making responsibilities within an organization, although both involve decisions. While the CEO might have ultimate responsibility for deciding what the strategy of the firm should be (i.e., the decision-making responsibility is centralized), the process he or she uses to make that decision might include the solicitation of ideas and criticism from lower-level managers.

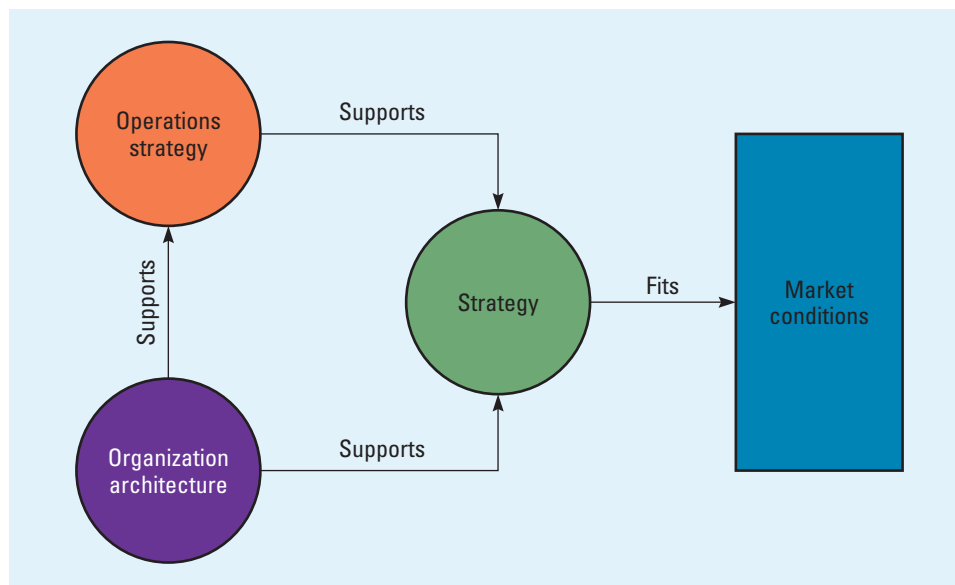
Organizational culture is the norms and value systems that are shared among the employees of an organization. Just as societies have cultures (see Chapter 3 for details), so do organizations. Organizations are societies of individuals who come together to perform collective tasks. They have their own distinctive patterns of culture and sub-culture.¹⁰ As we shall see, organizational culture can have a profound impact on how a firm performs. Finally, by **people** we mean not just the employees of the organization, but also the strategy used to recruit, compensate, and retain those individuals and the type of people that they are in terms of their skills, values, and orientation (discussed in depth in Chapter 16).

As illustrated by the arrows in Figure 11.5, the various components of an organization's architecture are not independent of each other: Each component shapes, and is shaped by, other components of architecture. An obvious example is the strategy regarding people. This can be used proactively to hire individuals whose internal values are consistent with those that the firm wishes to emphasize in its organization culture. Thus, the people component of architecture can be used to reinforce (or not) the prevailing culture of the organization.

If a firm is going to maximize its profitability, it must pay close attention to achieving internal consistency between the various components of its architecture, and the architecture must support the strategy and operations of the firm. For illustration, again consider Avon Products. To implement a more global strategy, CEO Andrea Jung found that she had to reduce the autonomy long enjoyed by local country managers and to centralize decisions with regard to manufacturing, product development and introduction, and marketing strategy. She also instituted a data-driven process for evaluating the return on investment earned by products. In other words, she had to change the structure and controls of Avon so that it matched the new strategy of the enterprise.

IN SUM: STRATEGIC FIT In sum, as we have repeatedly stressed, for a firm to attain superior performance and earn a high return on capital, its strategy (as captured by its desired strategic position on the efficiency frontier) must make sense given market conditions (there must be sufficient demand to support that strategic choice). The operations of the firm must be configured in a way that supports the strategy of the firm, and the organization architecture of the firm must match the operations and strategy of the firm. In other words, as illustrated in Figure 11.6, market conditions, strategy, operations, and organization must all be consistent with each other, or fit each other, for superior performance to be attained.

Of course, the issue is more complex than illustrated in Figure 11.6. For example, the firm can influence market conditions through its choice of strategy—it can create demand by leveraging core skills to create new market opportunities. In addition, shifts in market conditions caused by new technologies, government action such as deregulation, demographics, or social trends can mean that the strategy of the firm no longer fits the market. In such circumstances, the firm must change its strategy, operations, and organization to fit the new reality, which can be extraordinarily difficult. And last but by no means least, international expansion adds an additional layer of complexity to the strategic challenges facing the firm. We shall now consider this.



11.6 figure

Strategic Fit

Global Expansion, Profitability, and Profit Growth

LEARNING OBJECTIVE 2

Recognize how firms can profit by expanding globally.

Expanding globally allows firms to increase their profitability and rate of profit growth in ways not available to purely domestic enterprises.¹¹ Firms that operate internationally are able to:

1. Expand the market for their domestic product offerings by selling those products in international markets.
2. Realize location economies by dispersing individual value creation activities to those locations around the globe where they can be performed most efficiently and effectively.
3. Realize greater cost economies from experience effects by serving an expanded global market from a central location, thereby reducing the costs of value creation.
4. Earn a greater return by leveraging any valuable skills developed in foreign operations and transferring them to other entities within the firm's global network of operations.

As we will see, however, a firm's ability to increase its profitability and profit growth by pursuing these strategies is constrained by the need to customize its product offering, marketing strategy, and business strategy to differing national conditions; that is, by the imperative of localization.

EXPANDING THE MARKET: LEVERAGING PRODUCTS AND COMPETENCIES

A company can increase its growth rate by taking goods or services developed at home and selling them internationally. Almost all multinationals started out doing just this. For example, Procter & Gamble developed most of its best-selling products such as Pampers disposable diapers and Ivory soap in the United States, and subsequently then sold them around the world. Likewise, although Microsoft developed its software in the United States, from its earliest days the company has always focused on selling that software in international markets. Automobile companies such as Volkswagen and Toyota also grew by developing products at home and then selling them in international markets. The returns from such a strategy are likely to be greater if indigenous competitors in the nations a company enters lack comparable products. Thus, Toyota increased its profits by entering the large automobile markets of North America and Europe, offering products that were different from those offered by local rivals (Ford and GM) through their superior quality and reliability.

The success of many multinational companies that expand in this manner is based not just upon the goods or services that they sell in foreign nations, but also upon the core competencies that underlie the development, production, and marketing of those goods or services. The term **core competence** refers to skills within the firm that competitors cannot easily match or imitate.¹² These skills may exist in any of the firm's value creation activities—production, marketing, R&D, human resources, logistics, general management, and so on. Such skills are typically expressed in product offerings that other firms find difficult to match or imitate. Core competencies are the bedrock of a firm's competitive advantage. They enable a firm to reduce the costs of value creation and/or to create perceived value in such a way that premium pricing is possible. For example, Toyota has a core competence in the production of cars. It is able to produce high-quality, well-designed cars at a lower delivered cost than any other firm in the world. The competencies that enable Toyota to do this seem

Core Competence

A firm's skills that competitors cannot easily match or imitate.

to reside primarily in the firm's production and logistics functions.¹³ McDonald's has a core competence in managing fast-food operations (it seems to be one of the most skilled firms in the world in this industry); Procter & Gamble has a core competence in developing and marketing name brand consumer products (it is one of the most skilled firms in the world in this business); Starbucks has a core competence in the management of retail outlets selling high volumes of freshly brewed coffee-based drinks.

Since core competencies are by definition the source of a firm's competitive advantage, the successful global expansion by manufacturing companies such as Toyota and P&G was based not just on leveraging products and selling them in foreign markets, but also on the transfer of core competencies to foreign markets where indigenous competitors lacked them. The same can be said of companies engaged in the service sectors of an economy, such as financial institutions, retailers, restaurant chains, and hotels. Expanding the market for their services often means replicating their business model in foreign nations (albeit with some changes to account for local differences, which we will discuss in more detail soon). Starbucks, for example, is expanding rapidly outside of the United States by taking the basic business model it developed at home and using that as a blueprint for establishing international operations. Similarly, McDonald's is famous for its international expansion strategy, which has taken the company into more than 120 nations that collectively generate over half of the company's revenues.

LOCATION ECONOMIES We know from earlier chapters 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; South Korea in the production of semiconductors; and China in the production of apparel.¹⁴

For a firm that is trying to survive in a competitive global market, this implies that *trade barriers and transportation costs* permitting, the firm will benefit by basing each value creation activity it performs at that location where economic, political, and cultural conditions, including relative factor costs, are most conducive to the performance of that activity. Thus, if the best designers for a product live in France, a firm should base its design operations in France. If the most productive labor force for assembly operations is in Mexico, assembly operations should be based in Mexico. If the best marketers are in the United States, the marketing strategy should be formulated in the United States. And so on.

Firms that pursue such a strategy can realize what we refer to as **location economies**, which are the economies that arise from performing a value creation activity in the optimal location for that activity, wherever in the world that might be (transportation costs and trade barriers permitting). Locating a value creation activity in the optimal location for that activity can have one of two effects. *It can lower the costs of value creation and help the firm to achieve a low-cost position, and/or it can enable a firm to differentiate its product offering from those of competitors.* In terms of Figure 11.2, it can lower C and/or increase V (which in general supports higher pricing), both of which boost the profitability of the enterprise.

For an example of how this works in an international business, consider Clear Vision, a manufacturer and distributor of eyewear. Started in the 1980s by David Glassman, the

Location Economies

Cost advantages from performing a value creation activity in the optimal location for that activity.

firm now generates annual gross revenues of more than \$100 million. Not exactly small, but no corporate giant either, Clear Vision is a multinational firm with production facilities on three continents and customers around the world. Clear Vision began its move toward becoming a multinational in the 1980s. The strong dollar at that time made U.S.-based manufacturing very expensive. Low-priced imports were taking an ever-larger share of the U.S. eyewear market, and Clear Vision realized it could not survive unless it also began to import. Initially the firm bought from independent overseas manufacturers, primarily in Hong Kong. However, the firm became dissatisfied with these suppliers' product quality and delivery. As Clear Vision's volume of imports increased, Glassman decided the best way to guarantee quality and delivery was to set up Clear Vision's own manufacturing operation overseas. Accordingly, Clear Vision found a Chinese partner, and together they opened a manufacturing facility in Hong Kong, with Clear Vision being the majority shareholder.

The choice of the Hong Kong location was influenced by its combination of low labor costs, a skilled workforce, and tax breaks given by the Hong Kong government. The firm's objective at this point was to lower production costs by locating value creation activities at an appropriate location. After a few years, however, the increasing industrialization of Hong Kong and a growing labor shortage had pushed up wage rates to the extent that it was no longer a low-cost location. In response, Glassman and his Chinese partner moved part of their manufacturing to a plant in mainland China to take advantage of the lower wage rates there. Again, the goal was to lower production costs. The parts for eyewear frames manufactured at this plant are shipped to the Hong Kong factory for final assembly and then distributed to markets in North and South America. The Hong Kong factory now employs 80 people and the China plant between 300 and 400.

At the same time, Clear Vision was looking for opportunities to invest in foreign eyewear firms with reputations for fashionable design and high quality. Its objective was not to reduce production costs but to launch a line of high-quality differentiated, "designer" eyewear. Clear Vision did not have the design capability in-house to support such a line, but Glassman knew that certain foreign manufacturers did. As a result, Clear Vision invested in factories in Japan, France, and Italy, holding a minority shareholding in each case. These factories now supply eyewear for Clear Vision's Status Eye division, which markets high-priced designer eyewear.¹⁵

Thus, to deal with a threat from foreign competition, Clear Vision adopted a strategy intended to lower its cost structure (lower C): shifting its production from a high-cost location, the United States, to a low-cost location, first Hong Kong and later China. Then Clear Vision adopted a strategy intended to increase the perceived value of its product (increase V) so it could charge a premium price (P). Reasoning that premium pricing in eyewear depended on superior design, its strategy involved investing capital in French, Italian, and Japanese factories that had reputations for superior design. In sum, Clear Vision's strategies included some actions intended to reduce its costs of creating value and other actions intended to add perceived value to its product through differentiation. The overall goal was to increase the value created by Clear Vision and thus the profitability of the enterprise. To the extent that these strategies were successful, the firm should have attained a higher profit margin and greater profitability than if it had remained a U.S.-based manufacturer of eyewear.

Global Web
When different stages of the value chain are dispersed to those locations around the globe where value added is maximized or where costs of value creation are minimized.

Creating a Global Web Generalizing from the Clear Vision example, one result of this kind of thinking is the creation of a **global web** of value creation activities, with different stages of the value chain being dispersed to those locations around

the globe where perceived value is maximized or where the costs of value creation are minimized.¹⁶ Consider Lenovo's ThinkPad laptop computers (Lenovo is the Chinese computer company that purchased IBM's personal computer operations in 2005).¹⁷ This product is designed in the United States by engineers because Lenovo believes that the United States is the best location in the world to do the basic design work. The case, keyboard, and hard drive are made in Thailand; the display screen and memory in South Korea; the built-in wireless card in Malaysia; and the microprocessor in the United States. In each case, these components are manufactured and sourced from the optimal location given current factor costs. These components are then shipped to an assembly operation in Mexico, where the product is assembled before being shipped to the United States for final sale. Lenovo assembles the ThinkPad in Mexico because managers have calculated that due to low labor costs, the costs of assembly can be minimized there. The marketing and sales strategy for North America is developed by Lenovo personnel in the United States, primarily because managers believe that due to their knowledge of the local marketplace, U.S. personnel add more value to the product through their marketing efforts than personnel based elsewhere.

In theory, a firm that realizes location economies by dispersing each of its value creation activities to its optimal location should have a competitive advantage vis-à-vis a firm that bases all of its value creation activities at a single location. It should be able to better differentiate its product offering (thereby raising perceived value, V) and lower its cost structure (C) than its single-location competitor. In a world where competitive pressures are increasing, such a strategy may become an imperative for survival.

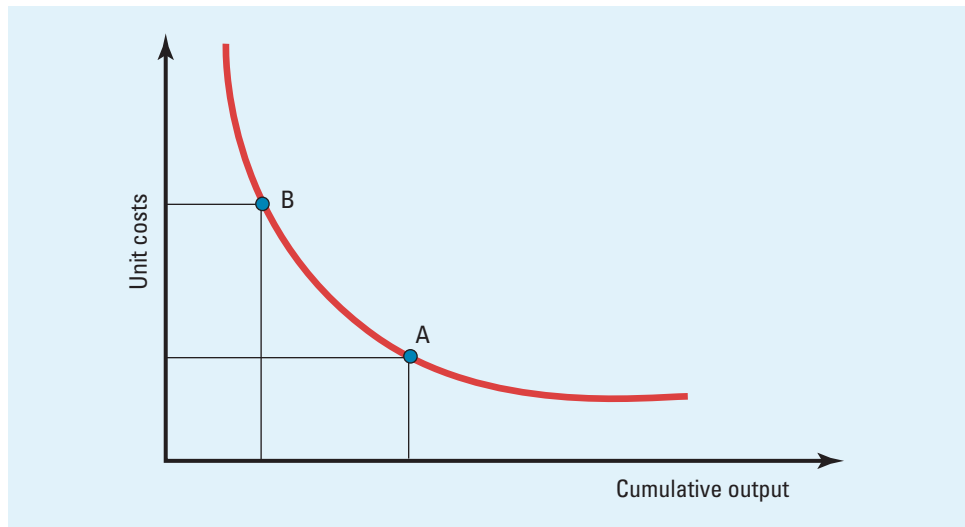
Some Caveats Introducing transportation costs and trade barriers complicates this picture. Due to favorable factor endowments, New Zealand may have a comparative advantage for automobile assembly operations, but high transportation costs would make it an uneconomical location from which to serve global markets. Another caveat concerns the importance of assessing political and economic risks when making location decisions. Even if a country looks very attractive as a production location when measured against all the standard criteria, if its government is unstable or totalitarian, the firm might be advised not to base production there. (Political risk is discussed in Chapter 2.) Similarly, if the government appears to be pursuing inappropriate economic policies that could lead to foreign exchange risk, that might be another reason for not basing production in that location, even if other factors look favorable.

EXPERIENCE EFFECTS The **experience curve** refers to systematic reductions in production costs that have been observed to occur over the life of a product.¹⁸ A number of studies have observed that a product's production costs decline by some quantity about each time *cumulative* output doubles. The relationship was first observed in the aircraft industry, where each time cumulative output of airframes was doubled, unit costs typically declined to 80 percent of their previous level.¹⁹ Thus, production cost for the fourth airframe would be 80 percent of production cost for the second airframe, the eighth airframe's production costs 80 percent of the fourth's, the sixteenth's 80 percent of the eighth's, and so on. Figure 11.7 illustrates this experience curve relationship between unit production costs and *cumulative* output (the relationship is for *cumulative* output over time, and *not* output in any one period, such as a year). Two things explain this: learning effects and economies of scale.

Experience Curve
Systematic production cost reductions that occur over the life of a product.

figure 11.7

The Experience Curve



Learning Effects

Cost savings from learning by doing.

Learning Effects Learning effects refer to cost savings that come from learning by doing. Labor, for example, learns by repetition how to carry out a task, such as assembling airframes, most efficiently. Labor productivity increases over time as individuals learn the most efficient ways to perform particular tasks. Equally important, in new production facilities, management typically learns how to manage the new operation more efficiently over time. Hence, production costs decline due to increasing labor productivity and management efficiency, which increases the firm's profitability.

Learning effects tend to be more significant when a technologically complex task is repeated, because there is more that can be learned about the task. Thus, learning effects will be more significant in an assembly process involving 1,000 complex steps than in one of only 100 simple steps. No matter how complex the task, however, learning effects typically disappear after a while. It has been suggested that they are important only during the start-up period of a new process and that they cease after two or three years.²⁰ Any decline in the experience curve after such a point is due to economies of scale.

Economies of Scale

Cost advantages associated with large-scale production.

Economies of Scale Economies of scale refer to the reductions in unit cost achieved by producing a large volume of a product. Attaining economies of scale lowers a firm's unit costs and increases its profitability. Economies of scale have a number of sources. One is the ability to spread fixed costs over a large volume.²¹ Fixed costs are the costs required to set up a production facility, develop a new product, and the like. They can be substantial. For example, the fixed cost of establishing a new production line to manufacture semiconductor chips now exceeds \$1 billion. Similarly, according to one estimate, developing a new drug and bringing it to market costs about \$800 million and takes about 12 years.²² The only way to recoup such high fixed costs may be to sell the product worldwide, which reduces average unit costs by spreading fixed costs over a larger volume. The more rapidly that cumulative sales volume is built up, the more rapidly fixed costs can be amortized over a large production volume, and the more rapidly unit costs will fall.

Second, a firm may not be able to attain an efficient scale of production unless it serves global markets. In the automobile industry, for example, an efficiently scaled

factory is one designed to produce about 200,000 units a year. Automobile firms would prefer to produce a single model from each factory since this eliminates the costs associated with switching production from one model to another. If domestic demand for a particular model is only 100,000 units a year, the inability to attain a 200,000-unit output will drive up average unit costs. By serving international markets as well, however, the firm may be able to push production volume up to 200,000 units a year, thereby reaping greater scale economies, lowering unit costs, and boosting profitability. By serving domestic and international markets from its production facilities a firm may be able to utilize those facilities more intensively. For example, if Intel sold microprocessors only in the United States, it may only be able to keep its factories open for one shift, five days a week. By serving international markets from the same factories, Intel can utilize its productive assets more intensively, which translates into higher capital productivity and greater profitability.

Finally, as global sales increase the size of the enterprise, so its bargaining power with suppliers increases, which may allow it to attain economies of scale in purchasing, bargaining down the cost of key inputs and boosting profitability that way. For example, Walmart has been able to use its enormous sales volume as a lever to bargain down the price it pays suppliers for merchandise sold through its stores.

Strategic Significance The strategic significance of the experience curve is clear. Moving down the experience curve allows a firm to reduce its cost of creating value (to lower C in Figure 11.2) and increase its profitability. The firm that moves down the experience curve most rapidly will have a cost advantage vis-à-vis its competitors. Firm A in Figure 11.7, because it is farther down the experience curve, has a clear cost advantage over firm B.

Many of the underlying sources of experience-based cost economies are plant based. This is true for most learning effects as well as for the economies of scale derived by spreading the fixed costs of building productive capacity over a large output, attaining an efficient scale of output, and utilizing a plant more intensively. Thus, one key to progressing downward on the experience curve as rapidly as possible is to increase the volume produced by a single plant as rapidly as possible. Because global markets are larger than domestic markets, a firm that serves a global market from a single location is likely to build accumulated volume more quickly than a firm that serves only its home market or that serves multiple markets from multiple production locations. Thus, serving a global market from a single location is consistent with moving down the experience curve and establishing a low-cost position. In addition, to get down the experience curve rapidly, a firm may need to price and market aggressively so demand will expand rapidly. It will also need to build sufficient production capacity for serving a global market. Also, the cost advantages of serving the world market from a single location will be even more significant if that location is the optimal one for performing the particular value creation activity.

Once a firm has established a low-cost position, it can act as a barrier to new competition. Specifically, an established firm that is well down the experience curve, such as firm A in Figure 11.7, can price so that it is still making a profit while new entrants, which are farther up the curve, are suffering losses.

The classic example of the successful pursuit of such a strategy concerns the Japanese consumer electronics company Matsushita. Along with Sony and Philips, Matsushita was in the race to develop a commercially viable videocassette recorder in the 1970s. Although Matsushita initially lagged behind Philips and Sony, it was able to get its VHS format accepted as the world standard and to reap enormous experience curve-based cost economies in the process. This cost advantage subsequently constituted a

formidable barrier to new competition. Matsushita's strategy was to build global volume as rapidly as possible. To ensure it could accommodate worldwide demand, the firm increased its production capacity 33-fold from 205,000 units in 1977 to 6.8 million units by 1984. By serving the world market from a single location in Japan, Matsushita was able to realize significant learning effects and economies of scale. These allowed Matsushita to drop its prices 50 percent within five years of selling its first VHS-format VCR. As a result, Matsushita was the world's major VCR producer by 1983, accounting for about 45 percent of world production and enjoying a significant cost advantage over its competitors. The next largest firm, Hitachi, accounted for only 11.1 percent of world production in 1983.²³ Today, firms such as Intel are the masters of this kind of strategy. The costs of building a state-of-the-art facility to manufacture microprocessors are so large (now in excess of \$2 billion) that to make this investment pay Intel *must* pursue experience curve effects, serving world markets from a limited number of plants to maximize the cost economies that derive from scale and learning effects.

LEVERAGING SUBSIDIARY SKILLS Implicit in our earlier discussion of core competencies is the idea that valuable skills are developed first at home and then transferred to foreign operations. However, for more mature multinationals that have already established a network of subsidiary operations in foreign markets, the development of valuable skills can just as well occur in foreign subsidiaries.²⁴ Skills can be created anywhere within a multinational's global network of operations, wherever people have the opportunity and incentive to try new ways of doing things. The creation of skills that help to lower the costs of production, or to enhance perceived value and support higher product pricing, is not the monopoly of the corporate center.

Leveraging the skills created within subsidiaries and applying them to other operations within the firm's global network may create value. McDonald's increasingly is finding that its foreign franchisees are a source of valuable new ideas. Faced with slow growth in France, its local franchisees experimented not only with the menu, but also with the layout and theme of restaurants. Gone are the ubiquitous golden arches, gone too are many of the utilitarian chairs and tables and other plastic features of the fast-food giant. Many McDonald's restaurants in France now have hardwood floors, exposed brick walls, and even armchairs. Half of the 930 or so outlets in France have been upgraded to a level that would make them unrecognizable to an American. The menu, too, was changed to include premier sandwiches, such as chicken on focaccia bread, priced some 30 percent higher than the average hamburger. The strategy worked. Following the change, increases in same-store sales rose from 1 percent annually to 3.4 percent. Impressed with the impact, McDonald's executives considered similar changes at other McDonald's restaurants in markets where same-store sales growth was sluggish, including the United States.²⁵

For the managers of the multinational enterprise, this phenomenon creates important new challenges. First, they must have the humility to recognize that valuable skills that lead to competencies can arise anywhere within the firm's global network, not just at the corporate center. Second, they must establish an incentive system that encourages local employees to acquire new skills. This is not as easy as it sounds. Creating new skills involves a degree of risk. Not all new skills add value. For every valuable idea created by a McDonald's subsidiary in a foreign country, there may be several failures. The management of the multinational must install incentives that encourage employees to take the necessary risks. The company must reward people for successes and not sanction them unnecessarily for taking risks that did not pan out. Third, managers must have a process for identifying when valuable new skills have been created

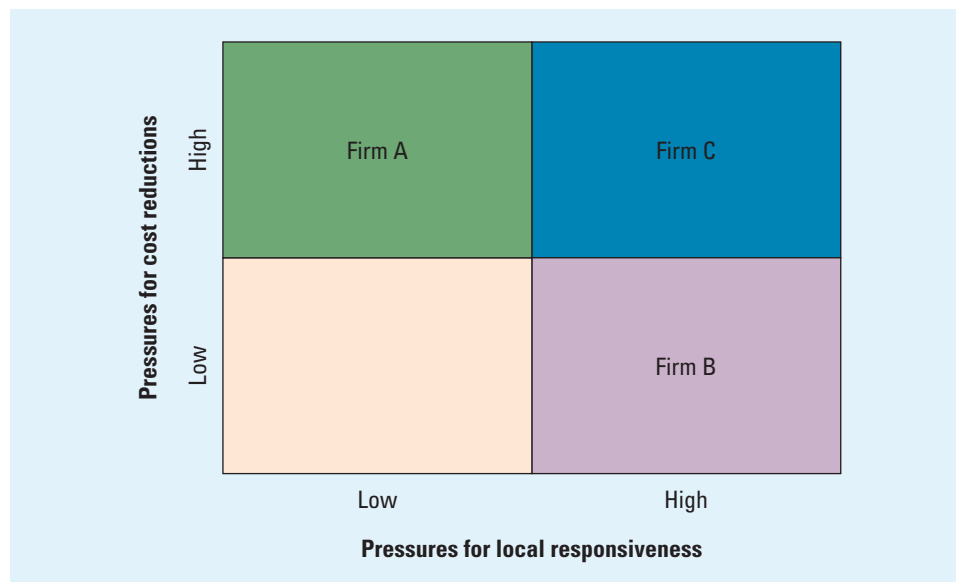
in a subsidiary. And finally, they need to act as facilitators, helping to transfer valuable skills within the firm.

PROFITABILITY AND PROFIT GROWTH SUMMARY We have seen how firms that expand globally can increase their profitability and profit growth by entering new markets where indigenous competitors lack similar competencies, by lowering costs and adding value to their product offering through the attainment of location economies, by exploiting experience curve effects, and by transferring valuable skills between their global network of subsidiaries. Strategies that increase profitability may also expand a firm's business, and thus enable it to attain a higher rate of profit growth. For example, by simultaneously realizing location economies and experience effects a firm may be able to produce a more highly valued product at a lower unit cost, thereby boosting profitability. The increase in the perceived value of the product may also attract more customers, thereby growing revenues and profits as well. Furthermore, rather than raising prices to reflect the higher perceived value of the product, the firm's managers may elect to hold prices low in order to increase global market share and attain greater scale economies (in other words, they may elect to offer consumers better "value for money"). Such a strategy could increase the firm's rate of profit growth even further, since consumers will be attracted by prices that are low relative to value. The strategy might also increase profitability if the scale economies that result from market share gains are substantial. In sum, managers need to keep in mind the complex relationship between profitability and profit growth when making strategic decisions about pricing.

Cost Pressures and Pressures for Local Responsiveness

Firms that compete in the global marketplace typically face two types of competitive pressures that affect their ability to realize location economies and experience effects, to leverage products and transfer competencies and skills within the enterprise. They face *pressures for cost reductions* and *pressures to be locally responsive* (see Figure 11.8).²⁶

LEARNING OBJECTIVE 3
Understand how pressures for cost reductions and pressures for local responsiveness influence strategic choice.



11.8 figure

Pressures for Cost Reductions and Local Responsiveness

These competitive pressures place conflicting demands on a firm. Responding to pressures for cost reductions requires that a firm try to minimize its unit costs. But responding to pressures to be locally responsive requires that a firm differentiate its product offering and marketing strategy from country to country in an effort to accommodate the diverse demands arising from national differences in consumer tastes and preferences, business practices, distribution channels, competitive conditions, and government policies. Because differentiation across countries can involve significant duplication and a lack of product standardization, it may raise costs.

While some enterprises, such as firm A in Figure 11.8, face high pressures for cost reductions and low pressures for local responsiveness, and others, such as firm B, face low pressures for cost reductions and high pressures for local responsiveness, many companies are in the position of firm C. They face high pressures for *both* cost reductions and local responsiveness. Dealing with these conflicting and contradictory pressures is a difficult strategic challenge, primarily because being locally responsive tends to raise costs.

PRESSURES FOR COST REDUCTIONS In competitive global markets, international businesses often face pressures for cost reductions. Responding to pressures for cost reduction requires a firm to try to lower the costs of value creation. A manufacturer, for example, might mass-produce a standardized product at the optimal location in the world, wherever that might be, to realize economies of scale, learning effects, and location economies. Alternatively, a firm might outsource certain functions to low-cost foreign suppliers in an attempt to reduce costs. Thus, many computer companies have outsourced their telephone-based customer service functions to India, where qualified technicians who speak English can be hired for a lower wage rate than in the United States. In the same manner, a retailer such as Walmart might push its suppliers (manufacturers) to do the same. (The pressure that Walmart has placed on its suppliers to reduce prices has been cited as a major cause of the trend among North American manufacturers to shift production to China.²⁷) A service business such as a bank might respond to cost pressures by moving some back-office functions, such as information processing, to developing nations where wage rates are lower.

Pressures for cost reduction can be particularly intense in industries producing commodity-type products where meaningful differentiation on nonprice factors is difficult and price is the main competitive weapon. This tends to be the case for products that serve universal needs. **Universal needs** exist when the tastes and preferences of consumers in different nations are similar if not identical. This is the case for conventional commodity products such as bulk chemicals, petroleum, steel, sugar, and the like. It also tends to be the case for many industrial and consumer products; for example, handheld calculators, semiconductor chips, personal computers, and liquid crystal display screens. Pressures for cost reductions are also intense in industries where major competitors are based in low-cost locations, where there is persistent excess capacity, and where consumers are powerful and face low switching costs. The liberalization of the world trade and investment environment in recent decades, by facilitating greater international competition, has generally increased cost pressures.²⁸

Universal Needs
Needs that are the same
all over the world, such
as steel, bulk chemicals,
and industrial
electronics.

PRESSURES FOR LOCAL RESPONSIVENESS Pressures for local responsiveness arise from national differences in consumer tastes and preferences, infrastructure, accepted business practices, and distribution channels, and from host-government demands. Responding to pressures to be locally responsive requires a

firm to differentiate its products and marketing strategy from country to country to accommodate these factors, all of which tends to raise the firm's cost structure.

Differences in Customer Tastes and Preferences Strong pressures for local responsiveness emerge when customer tastes and preferences differ significantly between countries, as they often do for deeply embedded historic or cultural reasons. In such cases, a multinational's products and marketing message have to be customized to appeal to the tastes and preferences of local customers. This typically creates pressure to delegate production and marketing responsibilities and functions to a firm's overseas subsidiaries.

For example, the automobile industry in the 1980s and early 1990s moved toward the creation of "world cars." The idea was that global companies such as General Motors, Ford, and Toyota would be able to sell the same basic vehicle the world over, sourcing it from centralized production locations. If successful, the strategy would have enabled automobile companies to reap significant gains from global scale economies. However, this strategy frequently ran aground upon the hard rocks of consumer reality. Consumers in different automobile markets seem to have different tastes and preferences, and demanded different types of vehicles. North American consumers show a strong demand for pickup trucks. This is particularly true in the South and West where many families have a pickup truck as a second or third car. But in European countries, pickup trucks are seen purely as utility vehicles and are purchased primarily by firms rather than individuals. As a consequence, the product mix and marketing message needs to be tailored to consider the different nature of demand in North America and Europe.

Some commentators have argued that customer demands for local customization are on the decline worldwide.²⁹ According to this argument, modern communications and transport technologies have created the conditions for a convergence of the tastes and preferences of consumers from different nations. The result is the emergence of enormous global markets for standardized consumer products. The worldwide acceptance of McDonald's hamburgers, Coca-Cola, Gap clothes, Nokia cell phones, and Sony PlayStations, all of which are sold globally as standardized products, are often cited as evidence of the increasing homogeneity of the global marketplace.

However, this argument seems somewhat naïve in many consumer goods markets. Significant differences in consumer tastes and preferences still exist across nations and cultures. Managers in international businesses do not yet have the luxury of being able to ignore these differences, and they may not for a long time to come. Even in a modern industry such as the cell phone business, important national differences in consumer usage patterns can be observed. Until recently, for example, Americans,



Another Perspective

Creating Local Value

Today, most global businesses maintain a social responsibility program that "gives back" to society, the industry, or the planet. Food industry giant Nestlé believes it can do the most good by creating local value that's also good for business—that is, determining the needs of the countries in which it operates, then focusing its efforts at the point where those needs intersect with the needs of shareholders. Using that premise, Nestlé identified water, rural development, and nutrition as areas of greatest impact. This strategy is reflected in Nestlé's commitment to increasing the nutritional value of its products while improving the taste. (Nestlé Web site, www.nestle.com, accessed April 3, 2010; Jess Halliday, "Nestle Explains Logic of Shareholder-Community Focus," *Food Navigator.com*, March 5, 2010, www.foodnavigator.com)



Americans in the South and West may use pickup trucks as a second or third car, but in Europe, pickups are seen purely as utility vehicles, which affects the marketing message being sent.



Local Responsiveness at MTV Networks

MTV Networks has become a symbol of globalization. Established in 1981, the U.S.-based music TV network has been expanding outside of its North American base since 1987 when it opened MTV Europe. Today MTV Networks figures that every second of every day over 2 million people are watching MTV around the world, the majority outside the United States. Despite its international success, MTV's global expansion got off to a weak start. In the 1980s, when the network's main programming fare was still music videos, it piped a single feed across Europe composed almost entirely of American programming with English-speaking veejays. Naively, the network's U.S. managers thought Europeans would flock to the American programming. But while viewers in Europe shared a common interest in a handful of global superstars, their tastes turned out to be surprisingly local. After losing share to local competitors, who focused more on local tastes, MTV changed its strategy in the 1990s. It broke its service into feeds aimed at national or regional markets. While MTV Networks exercises creative control over these different feeds, and while all the channels have the same familiar frenetic look and feel of

MTV in the United States, a significant share of the programming and content is now local.

Although a lot of programming ideas still originate in the United States, with staples such as "The Real World" having equivalents in different countries, an increasing share of programming is local in conception. In Italy, "MTV Kitchen" combines cooking with a music countdown. "Erotica" airs in Brazil and features a panel of youngsters discussing sex. The Indian channel produces 21 homegrown shows hosted by local veejays who speak "Hinglish," a city-bred breed of Hindi and English. And of course, each feed prominently features music videos by locally popular performers. This localization push reaped big benefits for MTV, allowing the network to capture viewers back from local imitators.

Sources: M. Gunther, "MTV's Passage to India," *Fortune*, August 9, 2004, pp. 117–122; B. Pulley and A. Tanzer, "Sumner's Gemstone," *Forbes*, February 21, 2000, pp. 107–11; K. Hoffman, "Youth TV's Old Hand Prepares for the Digital Challenge," *Financial Times*, February 18, 2000, p. 8; presentation by Sumner M. Redstone, chairman and CEO, Viacom Inc., delivered to Salomon Smith Barney 11th Annual Global Entertainment Media, Telecommunications Conference, Scottsdale, AZ, January 8, 2001; archived at www.viacom.com; and Viacom 10K Statement, 2005.

tended to think of cell phones primarily as devices for talking, and not as devices that can also send e-mails and browse the Web. Consequently, when selling to U.S. consumers, cell phone manufacturers focused more on slim good looks and less on advanced functions and features. This was in direct contrast to Asia and Europe, where text messaging and Web browsing were much more widely embraced by the early 2000s. A cultural issue seems to be at work here. People in Europe and Asia often have more time to browse the Web on their phones because they spend more time commuting on trains, while Americans tend to spend more time in cars, where their hands are occupied.³⁰ However, it is now clear that key technological innovations in the United States, and particularly the development of the iPhone by Apple, are changing this. For an example of a company that has discovered how important pressures for local responsiveness can still be, read the Management Focus on MTV Networks.

Differences in Infrastructure and Traditional Practices Pressures for local responsiveness arise from differences in infrastructure or traditional practices among countries, creating a need to customize products accordingly. Fulfilling this need may require the delegation of manufacturing and production functions to foreign subsidiaries. For example, in North America, consumer electrical systems are based on 110 volts, whereas in some European countries, 240-volt systems are standard. Thus, domestic electrical appliances have to be customized for this difference in infrastructure. Traditional practices also often vary across nations. For example, in Britain, people drive on the left-hand side of the road, creating a demand for right-hand-drive cars, whereas in France (and the rest of Europe), people drive on the right-hand side of the

road and therefore want left-hand-drive cars. Obviously, automobiles have to be customized to accommodate this difference in traditional practice.

Although many national differences in infrastructure are rooted in history, some are quite recent. For example, in the wireless telecommunications industry, different technical standards exist in different parts of the world. A technical standard known as GSM is common in Europe, and an alternative standard, CDMA, is more common in the United States and parts of Asia. Equipment designed for GSM will not work on a CDMA network, and vice versa. Thus, companies such as Nokia, Motorola, and Ericsson, which manufacture wireless handsets and infrastructure such as switches, need to customize their product offering according to the technical standard prevailing in a given country.

Differences in Distribution Channels A firm's marketing strategies may have to be responsive to differences in distribution channels among countries, which may necessitate the delegation of marketing functions to national subsidiaries. In the pharmaceutical industry, for example, the British and Japanese distribution systems are radically different from the U.S. system. British and Japanese doctors will not accept or respond favorably to a U.S.-style high-pressure sales force. Thus, pharmaceutical companies have to adopt different marketing practices in Britain and Japan compared with the United States—soft sell versus hard sell. Similarly, Poland, Brazil and Russia all have similar per capita income on a purchasing power parity basis, but there are big differences in distribution systems across the three countries. In Brazil, supermarkets account for 36 percent of food retailing, in Poland for 18 percent, and in Russia for less than 1 percent.³¹ These differences in channels require that companies adapt their own distribution and sales strategy.

Host Government Demands Economic and political demands imposed by host-country governments may require local responsiveness. For example, pharmaceutical companies are subject to local clinical testing, registration procedures, and pricing restrictions, all of which make it necessary that the manufacturing and marketing of a drug should meet local requirements. Because governments and government agencies control a significant proportion of the health care budget in most countries, they are in a powerful position to demand a high level of local responsiveness.

More generally, threats of protectionism, economic nationalism, and local content rules (which require that a certain percentage of a product should be manufactured locally) dictate that international businesses manufacture locally. For example, consider Bombardier, the Canadian-based manufacturer of railcars, aircraft, jet boats, and snowmobiles. Bombardier has 12 railcar factories across Europe. Critics of the company argue that the resulting duplication of manufacturing facilities leads to high costs and helps explain why Bombardier makes lower profit margins on its railcar operations than on its other business lines. In reply, managers at Bombardier argue that in Europe, informal rules with regard to local content favor people who use local workers. To sell railcars in Germany, they claim, you must manufacture in Germany. The same goes for Belgium, Austria, and France. To try to address its cost structure in Europe, Bombardier has centralized its engineering and purchasing functions, but it has no plans to centralize manufacturing.³²

Choosing a Strategy

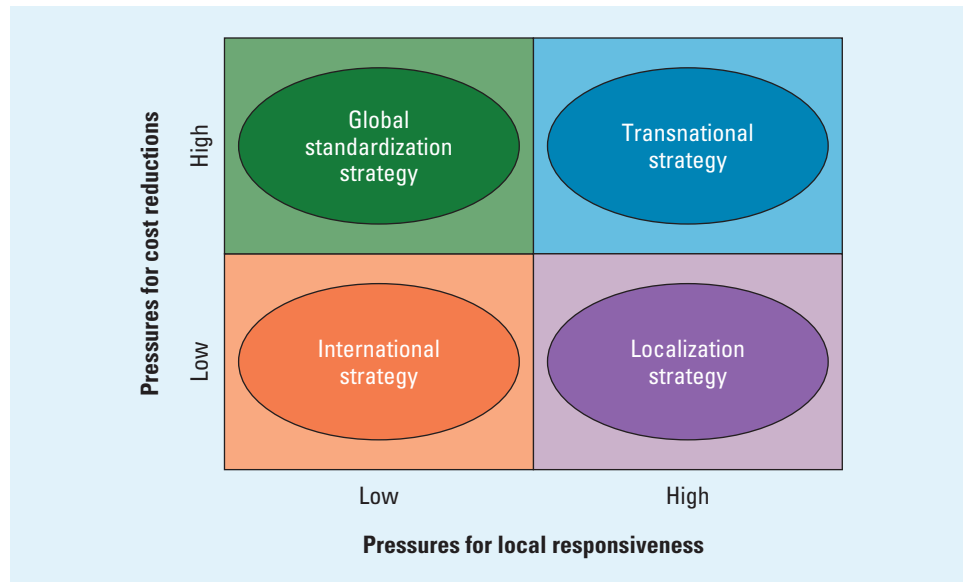
Pressures for local responsiveness imply that it may not be possible for a firm to realize the full benefits from economies of scale, learning effects, and location economies. It may not be possible to serve the global marketplace from a single low-cost location, producing a globally standardized product, and marketing it worldwide to attain the

LEARNING OBJECTIVE 4

Identify the different strategies for competing globally and their pros and cons.

figure 11.9

Four Basic Strategies



cost reductions associated with experience effects. The need to customize the product offering to local conditions may work against the implementation of such a strategy. For example, automobile firms have found that Japanese, American, and European consumers demand different kinds of cars, and this necessitates producing products that are customized for local markets. In response, firms such as Honda, Ford, and Toyota are pursuing a strategy of establishing top-to-bottom design and production facilities in each of these regions so that they can better serve local demands. Although such customization brings benefits, it also limits the ability of a firm to realize significant scale economies and location economies.

In addition, pressures for local responsiveness imply that it may not be possible to leverage skills and products associated with a firm's core competencies wholesale from one nation to another. Concessions often have to be made to local conditions. Despite being depicted as "poster boy" for the proliferation of standardized global products, even McDonald's has found that it has to customize its product offerings (i.e., its menu) to account for national differences in tastes and preferences.

How do differences in the strength of pressures for cost reductions versus those for local responsiveness affect the firm's choice of strategy? Firms typically choose among four main strategic postures when competing internationally. These can be characterized as a global standardization strategy, a localization strategy, a transnational strategy, and an international strategy.³³ The appropriateness of each strategy varies given the extent of pressures for cost reductions and local responsiveness. Figure 11.9 illustrates the conditions under which each of these strategies is most appropriate.

Global Standardization Strategy
A firm focuses on increasing profitability and profit growth by reaping the cost reductions that come from economies of scale, learning effects, and location economies.

GLOBAL STANDARDIZATION STRATEGY Firms that pursue a **global standardization strategy** focus on increasing profitability and profit growth by reaping the cost reductions that come from economies of scale, learning effects, and location economies; that is, their strategic goal is to pursue a low-cost strategy on a global scale. The production, marketing, and R&D activities of firms pursuing a global standardization strategy are concentrated in a few favorable locations. Firms pursuing a global standardization strategy try not to customize their product offering and marketing strategy to local conditions because customization involves shorter production runs



Management FOCUS

Vodafone in Japan

In 2002 Vodafone Group, based in the United Kingdom and the world's largest provider of wireless telephone service, made a big splash by paying \$14 billion to acquire J-Phone, the number three player in Japan's fast-growing market for wireless communications services. J-Phone was considered a hot property, having just launched Japan's first cell phones that were embedded with digital cameras, winning over large numbers of young people who wanted to send photos to their friends. Four years later, after losing market share to local competitors, Vodafone sold J-Phone and took an \$8.6 billion charge against earnings related to the sale. What went wrong?

According to analysts, Vodafone's mistake was to focus too much on building a global brand and not enough on local market conditions in Japan. In the early 2000s, Vodafone's vision was to offer consumers in different countries the same technology, so that they could take their phones with them when they traveled across international borders. The problem, however, was that Japan's most active cell phone users, many of them young people who don't regularly

travel abroad, care far less about this capability than about game playing and other features that are embedded in their cell phones.

Vodafone's emphasis on global services meant that it delayed its Japanese launch of 3G phones, which allow users to do things such as watch video clips and teleconference. The company, in line with its global branding ambitions, had decided to launch 3G cell phones that worked both inside and outside Japan. The delay was costly. Its Japanese competitors launched 3G phones a year ahead of Vodafone. Although these phones worked only in Japan, they rapidly gained share as consumers adopted these leading-edge devices. When Vodafone did finally introduce a 3G phone, design problems associated with making a phone that worked globally meant the supply of phones was limited, and the launch fizzled despite strong product reviews simply because consumers could not get the phones.

Sources: C. Bryan-Low, "Vodafone's Global Ambitions Got Hung Up in Japan," *The Wall Street Journal*, March 18, 2006, p. A1; and G. Parket, "Going Global Can Hit Snags Vodafone Finds," *The Wall Street Journal*, June 16, 2004, p. B1.

and the duplication of functions, which tends to raise costs. Instead, they prefer to market a standardized product worldwide so that they can reap the maximum benefits from economies of scale and learning effects. They also tend to use their cost advantage to support aggressive pricing in world markets.

This strategy makes most sense when there are strong pressures for cost reductions and demands for local responsiveness are minimal. Increasingly, these conditions prevail in many industrial goods industries, whose products often serve universal needs. In the semiconductor industry, for example, global standards have emerged, creating enormous demands for standardized global products. Accordingly, companies such as Intel, Texas Instruments, and Motorola all pursue a global standardization strategy. However, these conditions are not yet found in many consumer goods markets, where demands for local responsiveness remain high. The strategy is inappropriate when demands for local responsiveness are high. The experience of Vodafone, which is discussed in the accompanying Management Focus, illustrates what can happen when a global standardization strategy does not match market realities.

LOCALIZATION STRATEGY A **localization strategy** focuses on increasing profitability by customizing the firm's goods or services so that they provide a good match to tastes and preferences in different national markets. Localization is most appropriate when there are substantial differences across nations with regard to consumer tastes and preferences, and where cost pressures are not too intense. By customizing the product offering to local demands, the firm increases the value of that product in the local market. On the downside, because it involves some duplication of functions and smaller production runs, customization limits the ability of the firm to capture the cost reductions associated with mass-producing a standardized product for

Localization Strategy

Increasing profitability by customizing the firm's goods or services so that they provide a good match to tastes and preferences in different national markets.

global consumption. The strategy may make sense, however, if the added value associated with local customization supports higher pricing, which enables the firm to recoup its higher costs, or if it leads to substantially greater local demand, enabling the firm to reduce costs through the attainment of some scale economies in the local market.

At the same time, firms still have to keep an eye on costs. Firms pursuing a localization strategy still need to be efficient and, whenever possible, to capture some scale economies from their global reach. As noted earlier, many automobile companies have found that they have to customize some of their product offerings to local market demands—for example, producing large pickup trucks for U.S. consumers and small fuel-efficient cars for Europeans and Japanese. At the same time, these multinationals try to get some scale economies from their global volume by using common vehicle platforms and components across many different models, and manufacturing those platforms and components at efficiently scaled factories that are optimally located. By designing their products in this way, these companies have been able to localize their product offering, yet simultaneously capture some scale economies, learning effects, and location economies.

TRANSNATIONAL STRATEGY We have argued that a global standardization strategy makes most sense when cost pressures are intense and demands for local responsiveness limited. Conversely, a localization strategy makes most sense when demands for local responsiveness are high, but cost pressures are moderate or low. What happens, however, when the firm simultaneously faces both strong cost pressures and strong pressures for local responsiveness? How can managers balance the competing and inconsistent demands such divergent pressures place on the firm? According to some researchers, the answer is to pursue what has been called a transnational strategy.

Two of these researchers, Christopher Bartlett and Sumantra Ghoshal, argue that in today's global environment, competitive conditions are so intense that to survive, firms must do all they can to respond to pressures for cost reductions and local responsiveness. They must try to realize location economies and experience effects, to leverage products internationally, to transfer core competencies and skills within the company, and to simultaneously pay attention to pressures for local responsiveness.³⁴ Bartlett and Ghoshal note that in the modern multinational enterprise, core competencies and skills do not reside just in the home country but can develop in any of the firm's worldwide operations. Thus, they maintain that the flow of skills and product offerings should not be all one way, from home country to foreign subsidiary. Rather, the flow should also be from foreign subsidiary to home country and from foreign subsidiary to foreign subsidiary. Transnational enterprises, in other words, must also focus on leveraging subsidiary skills.

In essence, firms that pursue a **transnational strategy** are trying to simultaneously achieve low costs through location economies, economies of scale, and learning effects; differentiate their product offering across geographic markets to account for local differences; and foster a multidirectional flow of skills between different subsidiaries in the firm's global network of operations. As attractive as this may sound in theory, the strategy is not an easy one to pursue since it places conflicting demands on the company. Differentiating the product to respond to local demands in different geographic markets raises costs, which runs counter to the goal of reducing costs. Companies such as Ford and ABB (one of the

Transnational Strategy

Attempt to simultaneously achieve low costs through location economies, economies of scale, and learning effects while also differentiating product offering across geographic markets to account for local differences and fostering a multidirectional flow of skills between different subsidiaries in the firm's global network of operations.



IKEA, a worldwide retailer of home furnishings, is becoming more of a transnational company.

world's largest engineering conglomerates) have tried to embrace a transnational strategy and found it difficult to implement.

How best to implement a transnational strategy is one of the most complex questions that large multinationals are grappling with today. Few if any enterprises have perfected this strategic posture. But some clues as to the right approach can be derived from a number of companies. Consider the case of Caterpillar. The need to compete with low-cost competitors such as Komatsu of Japan forced Caterpillar to look for greater cost economies. However, variations in construction practices and government regulations across countries mean that Caterpillar also has to be responsive to local demands. Therefore, Caterpillar confronted significant pressures for cost reductions *and* for local responsiveness.

To deal with cost pressures, Caterpillar redesigned its products to use many identical components and invested in a few large-scale component manufacturing facilities, sited at favorable locations, to fill global demand and realize scale economies. At the same time, the company augments the centralized manufacturing of components with assembly plants in each of its major global markets. At these plants, Caterpillar adds local product features, tailoring the finished product to local needs. Thus, Caterpillar is able to realize many of the benefits of global manufacturing while reacting to pressures for local responsiveness by differentiating its product among national markets.³⁵ Caterpillar started to pursue this strategy in 1979 and by 1997 had succeeded in doubling output per employee, significantly reducing its overall cost structure in the process. Meanwhile, Komatsu and Hitachi, which are still wedded to a Japan-centric global strategy, have seen their cost advantages evaporate and have been steadily losing market share to Caterpillar.

Changing a firm's strategic posture to build an organization capable of supporting a transnational strategy is a complex and challenging task. Some would say it is too complex, because the strategy implementation problems of creating a viable organizational structure and control systems to manage this strategy are immense.

INTERNATIONAL STRATEGY Sometimes it is possible to identify multinational firms that find themselves in the fortunate position of being confronted with low cost pressures and low pressures for local responsiveness. Many of these enterprises have pursued an **international strategy**, taking products first produced for their domestic market and selling them internationally with only minimal local customization. The distinguishing feature of many such firms is that they are selling a product that serves universal needs, but they do not face significant competitors, and thus unlike firms pursuing a global standardization strategy, they are not confronted with pressures to reduce their cost structure. Xerox found itself in this position in the 1960s after its invention and commercialization of the photocopier. The technology underlying the photocopier was protected by strong patents, so for several years Xerox did not face competitors—it had a monopoly. The product serves universal needs, and it was highly valued in most developed nations. Thus, Xerox was able to sell the same basic product the world over, charging a relatively high price for that product. Since Xerox did not face direct competitors, it did not have to deal with strong pressures to minimize its cost structure.

Enterprises pursuing an international strategy have followed a similar developmental pattern as they expanded into foreign markets. They tend to centralize product development functions such as R&D at home. However, they also tend to establish manufacturing and marketing functions in each major country or geographic region in which they do business. The resulting duplication can raise costs, but this is less of an issue if the firm does not face strong pressures for cost reductions. Although they may undertake some local customization of product offering and marketing strategy, this tends to be rather limited in scope. Ultimately, in most firms that pursue an international strategy, the head office retains fairly tight control over marketing and product strategy.

International Strategy

Trying to create value by taking products first produced for the domestic market and selling them internationally with only minimal local customization.

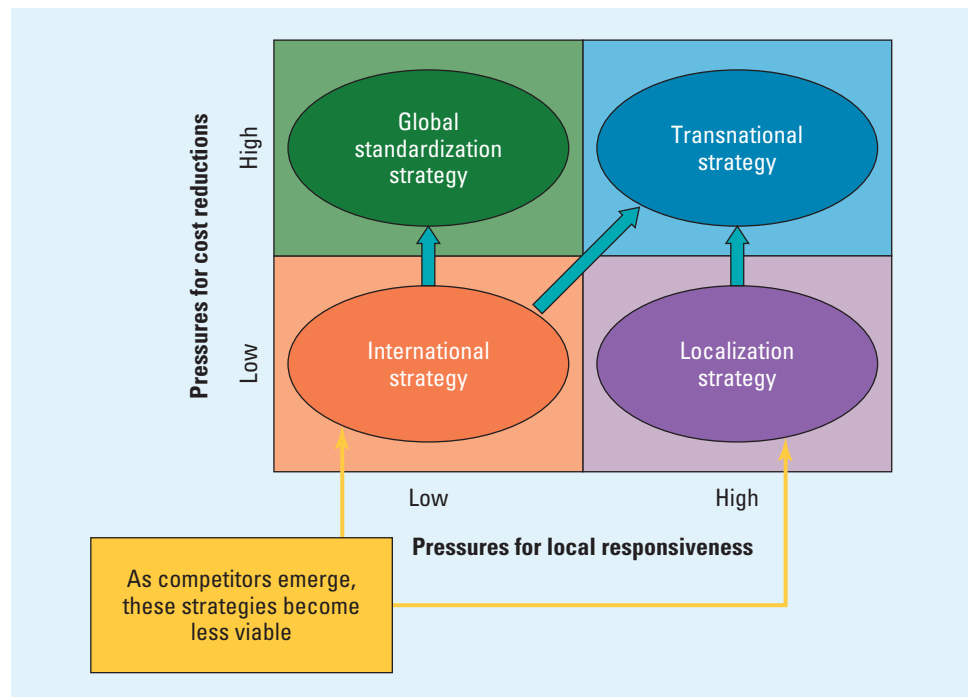
Other firms that have pursued this strategy include Procter & Gamble and Microsoft. Historically, Procter & Gamble developed innovative new products in Cincinnati and then transferred them wholesale to local markets (see the accompanying Management Focus). Similarly, the bulk of Microsoft's product development work takes place in Redmond, Washington, where the company is headquartered. Although some localization work is undertaken elsewhere, this is limited to producing foreign-language versions of popular Microsoft programs.

THE EVOLUTION OF STRATEGY The Achilles' heel of the international strategy is that over time, competitors inevitably emerge, and if managers do not take proactive steps to reduce their firm's cost structure, it will be rapidly outflanked by efficient global competitors. This is exactly what happened to Xerox. Japanese companies such as Canon ultimately invented their way around Xerox's patents, produced their own photocopiers in very efficient manufacturing plants, priced them below Xerox's products, and rapidly took global market share from Xerox. In the final analysis, Xerox's demise was not due to the emergence of competitors, for ultimately that was bound to occur, but due to its failure to proactively reduce its cost structure in advance of the emergence of efficient global competitors. The message in this story is that an international strategy may not be viable in the long term, and to survive, firms need to shift toward a global standardization strategy or a transnational strategy in advance of competitors (see Figure 11.10).

The same can be said about a localization strategy. Localization may give a firm a competitive edge, but if it is simultaneously facing aggressive competitors, the company will also have to reduce its cost structure, and the only way to do that may be to shift toward a transnational strategy. This is what Procter & Gamble has been doing (see the Management Focus). Thus, as competition intensifies, international and localization strategies tend to become less viable, and managers need to orientate their companies toward either a global standardization strategy or a transnational strategy.

figure 11.10

Changes in Strategy
over Time





Evolution of Strategy at Procter & Gamble

Founded in 1837, Cincinnati-based Procter & Gamble has long been one of the world's most international of companies. Today P&G is a global colossus in the consumer products business with annual sales in excess of \$50 billion, some 54 percent of which are generated outside of the United States. P&G sells more than 300 brands—including Ivory soap, Tide, Pampers, Iams pet food, Crisco, and Folgers—to consumers in 160 countries. Historically the strategy at P&G was well established. The company developed new products in Cincinnati and then relied on semi-autonomous foreign subsidiaries to manufacture, market, and distribute those products in different nations. In many cases, foreign subsidiaries had their own production facilities and tailored the packaging, brand name, and marketing message to local tastes and preferences. For years this strategy delivered a steady stream of new products and reliable growth in sales and profits. By the 1990s, however, profit growth at P&G was slowing.

The essence of the problem was simple: P&G's costs were too high because of extensive duplication of manufacturing, marketing, and administrative facilities in different national subsidiaries. The duplication of assets made sense in the world of the 1960s, when national markets were segmented from each other by barriers to cross-border trade. Products produced in Great Britain, for example, could not be sold economically in Germany due to high tariff duties levied on imports into Germany. By the 1980s, however, barriers to cross-border trade were falling rapidly worldwide and fragmented national markets were merging into larger regional or global markets. Also, the retailers through which P&G distributed its products were growing larger and more global, such as Walmart, Tesco from the United Kingdom, and Carrefour from France. These emerging global retailers were demanding price discounts from P&G.

In the 1990s P&G embarked on a major reorganization in an attempt to control its cost structure and recognize the

new reality of emerging global markets. The company shut down some 30 manufacturing plants around the globe, laid off 13,000 employees, and concentrated production in fewer plants that could better realize economies of scale and serve regional markets. It wasn't enough! Profit growth remained sluggish so in 1999 P&G launched its second reorganization of the decade. Named "Organization 2005," the goal was to transform P&G into a truly global company. The company tore up its old organization, which was based on countries and regions, and replaced it with one based on seven self-contained global business units, ranging from baby care to food products. Each business unit was given complete responsibility for generating profits from its products, and for manufacturing, marketing, and product development. Each business unit was told to rationalize production, concentrating it in fewer larger facilities; to try to build global brands wherever possible, thereby eliminating marketing differences between countries; and to accelerate the development and launch of new products. P&G announced that as a result of this initiative, it would close another 10 factories and lay off 15,000 employees, mostly in Europe where there was still extensive duplication of assets. The annual cost savings were estimated to be about \$800 million. P&G planned to use the savings to cut prices and increase marketing spending in an effort to gain market share, and thus further lower costs through the attainment of scale economies. This time the strategy seemed to be working. For most of the 2000s P&G reported strong growth in both sales and profits. Significantly, P&G's global competitors, such as Unilever, Kimberly-Clark, and Colgate-Palmolive, were struggling during the same time period.

Sources: J. Neff, "P&G Outpacing Unilever in Five-Year Battle," *Advertising Age*, November 3, 2003, pp. 1–3; G. Strauss, "Firm Restructuring into Truly Global Company," *USA Today*, September 10, 1999, p. B2; *Procter & Gamble 10K Report, 2005*; and M. Kolbasuk McGee, "P&G Jump-Starts Corporate Change," *Information Week*, November 1, 1999, pp. 30–34.

Strategic Alliances

Strategic alliances refer to cooperative agreements between potential or actual competitors. In this section, we are concerned specifically with strategic alliances between firms from different countries. Strategic alliances run the range from formal joint ventures, in which two or more firms have equity stakes (e.g., Fuji–Xerox), to short-term contractual agreements, in which two companies agree to cooperate on a particular task (such as developing a new product). Collaboration between competitors is fashionable; recent decades have seen an explosion in the number of strategic alliances.

LEARNING OBJECTIVE 5

Explain the pros and cons of using strategic alliances to support global strategies.

Strategic Alliances
Cooperative agreements between two or more firms.



Another Perspective

LG and Viking Form Strategic Alliance

Korea-based LG Electronics, a leader in consumer electronics, mobile phones, and appliances, formed a strategic alliance with Viking, a U.S.-based manufacturer of high-end kitchen ranges for restaurants and serious home cooks. Announced at an international trade show, the alliance will permit Viking to penetrate the Asia/Pacific markets and allow LG to broaden its current network of appliance dealers in the United States with Viking distributors. In addition, the two companies plan to collaborate on research and development, and take advantage of product cross-sourcing and joint procurement opportunities. ("LG Electronics, Viking Form Strategic Alliance," press release, January 21, 2010, www.lg.com)

THE ADVANTAGES OF STRATEGIC ALLIANCES

Firms ally themselves with actual or potential competitors for various strategic purposes.³⁶ First, strategic alliances may facilitate entry into a foreign market. For example, many firms feel that if they are to successfully enter the Chinese market, they need a local partner who understands business conditions, and who has good connections (or *guanxi*—see Chapter 3). Thus, in 2004 Warner Brothers entered into a joint venture with two Chinese partners to produce and distribute films in China. As a foreign film company, Warner found that if it wanted to produce films on its own for the Chinese market it had to go through a complex approval process for every film, and it had to farm out distribution to a local company, which made doing business in China very difficult. Due to the participation of Chinese firms, however, the joint-venture

films will go through a streamlined approval process, and the venture will be able to distribute any films it produces. Also, the joint venture will be able to produce films for Chinese TV, something that foreign firms are not allowed to do.³⁷

Strategic alliances also allow firms to share the fixed costs (and associated risks) of developing new products or processes. An alliance between Boeing and a number of Japanese companies to build Boeing's 787 commercial jetliner was motivated by Boeing's desire to share the estimated \$8 billion investment required to develop the aircraft. For another example of cost sharing, see the accompanying Management Focus, which discusses the strategic alliances between Cisco and Fujitsu.

Third, an alliance is a way to bring together complementary skills and assets that neither company could easily develop on its own.³⁸ In 2003, for example, Microsoft and Toshiba established an alliance aimed at developing embedded microprocessors (essentially tiny computers) that can perform a variety of entertainment functions in an automobile (e.g., run a back-seat DVD player or a wireless Internet connection). The processors run a version of Microsoft's Windows CE operating system. Microsoft brings its software engineering skills to the alliance and Toshiba its skills in developing microprocessors.³⁹ The alliance between Cisco and Fujitsu was also formed to share know-how (see the accompanying Management Focus).

Fourth, it can make sense to form an alliance that will help the firm establish technological standards for the industry that will benefit the firm. For example, in 1999 Palm Computer, the leading maker of personal digital assistants (PDAs), entered into an alliance with Sony under which Sony agreed to license and use Palm's operating system in Sony PDAs. The motivation for the alliance was in part to help establish Palm's operating system as the industry standard for PDAs, as opposed to a rival Windows-based operating system from Microsoft.⁴⁰

THE DISADVANTAGES OF STRATEGIC ALLIANCES

The advantages we have discussed can be very significant. Despite this, some commentators have criticized strategic alliances on the grounds that they give competitors a low-cost route to new technology and markets.⁴¹ For example, a few years ago some commentators argued that many strategic alliances between U.S. and Japanese firms were part of an implicit Japanese strategy to keep high-paying, high-value-added jobs in Japan while gaining the project engineering and production process skills that underlie the competitive success of many U.S. companies.⁴² They argued that Japanese success in the



Management FOCUS

Cisco and Fujitsu

In late 2004 Cisco Systems, the world's largest manufacturer of Internet routers, entered into an alliance with the Japanese computer, electronics, and telecommunications equipment firm Fujitsu. The stated purpose of the alliance was to jointly develop next-generation high-end routers for sale in Japan. Routers are the digital switches that sit at the heart of the Internet and direct traffic; they are, in effect, the traffic cops of the Internet. Although Cisco has long held the leading share in the market for routers (it pioneered the original router technology), it faces increasing competition from other firms such as Juniper Technologies and China's fast-growing Huawei Technologies. At the same time, demand in the market is shifting as more and more telecommunications companies adopt Internet-based telecommunications services. While Cisco has long had a strong global presence, management also believed the company needed to have better presence in Japan, which is shifting rapidly to second-generation high-speed Internet-based telecommunications networks.

By entering into an alliance with Fujitsu, Cisco believes it can achieve a number of goals. First, both firms can pool their R&D efforts, which will enable them to share complementary technology and develop products quicker, thereby gaining an advantage over competitors. Second, by combining Cisco's proprietary leading-edge router technology with Fujitsu's production expertise, the companies think

they can make more reliable products than those currently offered. Third, Fujitsu will give Cisco a stronger sales presence in Japan. Fujitsu has good links with Japan's telecommunications companies and a well-earned reputation for reliability. It will leverage these assets to sell the routers produced by the alliance, which will be co-branded as Fujitsu-Cisco products. Fourth, sales may be further enhanced by bundling the co-branded routers together with other telecommunications equipment that Fujitsu sells and by marketing an entire solution to customers. Fujitsu sells many telecommunications products but lacks a strong presence in routers. Cisco is strong in routers but lacks strong offerings elsewhere. The combination of the two company's products will enable Fujitsu to offer Japan's telecommunications companies "end-to-end" communications solutions. Since many companies prefer to purchase their equipment from a single provider, this should drive sales.

The alliance introduced its first products in May 2006. Both firms should benefit from the alliance. Development costs will be lower than if they did not cooperate. Cisco will grow its sales in Japan, and Fujitsu can use the co-branded routers to fill out its product line and sell more bundles of products to Japan's telecommunications companies.

Sources: "Fujitsu, Cisco Systems to Develop High-End Routers for Web Traffic," *Knight Ridder Tribune Business News*, December 6, 2004, p. 1; and "Fujitsu and Cisco Introduce New High Performance Routers for IP Next-Generation Networks," *JCN Newswire*, May 25, 2006.

machine tool and semiconductor industries was built on U.S. technology acquired through strategic alliances. And they argued that U.S. managers were aiding the Japanese by entering alliances that channel new inventions to Japan and provide a U.S. sales and distribution network for the resulting products. Although such deals may generate short-term profits, so the argument goes, in the long run the result is to "hollow out" U.S. firms, leaving them with no competitive advantage in the global marketplace.

These critics have a point; alliances have risks. Unless a firm is careful, it can give away more than it receives. But there are so many examples of apparently successful alliances between firms—including alliances between U.S. and Japanese firms—that their position seems extreme. It is difficult to see how the Microsoft-Toshiba alliance, the Boeing-Mitsubishi alliance for the 787, or the Fuji-Xerox alliance fit the critics' thesis. In these cases, both partners seem to have gained from the alliance. Why do some alliances benefit both firms while others benefit one firm and hurt the other? The next section provides an answer to this question.

MAKING ALLIANCES WORK The failure rate for international strategic alliances seems to be high. One study of 49 international strategic alliances found that two-thirds run into serious managerial and financial troubles within two years of their formation, and that although many of these problems are solved, 33 percent are

ultimately rated as failures by the parties involved.⁴³ The success of an alliance seems to be a function of three main factors: partner selection, alliance structure, and the manner in which the alliance is managed.

Partner Selection One key to making a strategic alliance work is to select the right ally. A good ally, or partner, has three characteristics. First, a good partner helps the firm achieve its strategic goals, whether they are market access, sharing the costs and risks of product development, or gaining access to critical core competencies. The partner must have capabilities that the firm lacks and that it values. Second, a good partner shares the firm's vision for the purpose of the alliance. If two firms approach an alliance with radically different agendas, the chances are great that the relationship will not be harmonious, will not flourish, and will end in divorce. Third, a good partner is unlikely to try to opportunistically exploit the alliance for its own ends; that is, to expropriate the firm's technological know-how while giving away little in return. In this respect, firms with reputations for "fair play" to maintain probably make the best allies. For example, companies such as General Electric are involved in so many strategic alliances that it would not pay the company to trample over individual alliance partners.⁴⁴ This would tarnish GE's reputation of being a good ally and would make it more difficult for GE to attract alliance partners. Because IBM attaches great importance to its alliances, it is unlikely to engage in the kind of opportunistic behavior that critics highlight. Similarly, their reputations make it less likely (but by no means impossible) that such Japanese firms as Sony, Toshiba, and Fuji, which have histories of alliances with non-Japanese firms, would opportunistically exploit an alliance partner.

To select a partner with these three characteristics, a firm needs to conduct comprehensive research on potential alliance candidates. To increase the probability of selecting a good partner, the firm should:

1. Collect as much pertinent, publicly available information on potential allies as possible.
2. Gather data from informed third parties. These include firms that have had alliances with the potential partners, investment bankers who have had dealings with them, and former employees.
3. Get to know the potential partner as well as possible before committing to an alliance. This should include face-to-face meetings between senior managers (and perhaps middle-level managers) to ensure that the chemistry is right.

Alliance Structure A partner having been selected, the alliance should be structured so that the firm's risks of giving too much away to the partner are reduced to an acceptable level. First, alliances can be designed to make it difficult (if not impossible) to transfer technology not meant to be transferred. The design, development, manufacture, and service of a product manufactured by an alliance can be structured so as to wall off sensitive technologies to prevent their leakage to the other participant. In a long-standing alliance between General Electric and Snecma to build commercial aircraft engines for single-aisle commercial jet aircraft, for example, GE reduced the risk of excess transfer by walling off certain sections of the production process. The modularization effectively cut off the transfer of what GE regarded as key competitive technology, while permitting Snecma access to final assembly. Formed in 1974, the alliance has been remarkably successful, and today it dominates the market for jet engines used on the Boeing 737 and Airbus 320.⁴⁵ Similarly, in the alliance between Boeing and the Japanese to build the 767, Boeing walled off research, design, and marketing functions considered central to its competitive position, while allowing the Japanese to share in production technology. Boeing also walled off new technologies not required for 767 production.⁴⁶

Second, contractual safeguards can be written into an alliance agreement to guard against the risk of opportunism by a partner. (Opportunism includes the theft of technology and/or markets.) For example, TRW, Inc., has three strategic alliances with large Japanese auto component suppliers to produce seat belts, engine valves, and steering gears for sale to Japanese-owned auto assembly plants in the United States. TRW has clauses in each of its alliance contracts that bar the Japanese firms from competing with TRW to supply U.S.-owned auto companies with component parts. By doing this, TRW protects itself against the possibility that the Japanese companies are entering into the alliances merely to gain access to the North American market to compete with TRW in its home market.

Third, both parties to an alliance can agree in advance to swap skills and technologies that the other covets, thereby ensuring a chance for equitable gain. Cross-licensing agreements are one way to achieve this goal. Fourth, the risk of opportunism by an alliance partner can be reduced if the firm extracts a significant credible commitment from its partner in advance. The long-term alliance between Xerox and Fuji to build photocopiers for the Asian market perhaps best illustrates this. Rather than enter into an informal agreement or a licensing arrangement (which Fuji Photo initially wanted), Xerox insisted that Fuji invest in a 50/50 joint venture to serve Japan and East Asia. This venture constituted such a significant investment in people, equipment, and facilities that Fuji Photo was committed from the outset to making the alliance work to earn a return on its investment. By agreeing to the joint venture, Fuji essentially made a credible commitment to the alliance. Given this, Xerox felt secure in transferring its photocopier technology to Fuji.⁴⁷

Managing the Alliance Once a partner has been selected and an appropriate alliance structure has been agreed on, the task facing the firm is to maximize its benefits from the alliance. As in all international business deals, an important factor is sensitivity to cultural differences (see Chapter 3). Many differences in management style are attributable to cultural differences, and managers need to make allowances for these in dealing with their partner. Beyond this, maximizing the benefits from an alliance seems to involve building trust between partners and learning from partners.⁴⁸

Managing an alliance successfully requires building interpersonal relationships between the firms' managers, or what is sometimes referred to as *relational capital*.⁴⁹ This is one lesson that can be drawn from a successful strategic alliance between Ford and Mazda. Ford and Mazda set up a framework of meetings within which their managers not only discuss matters pertaining to the alliance but also have time to get to know each other better. The belief is that the resulting friendships help build trust and facilitate harmonious relations between the two firms. Personal relationships also foster an informal management network between the firms. This network can then be used to help solve problems arising in more formal contexts (such as in joint committee meetings between personnel from the two firms).

Academics have argued that a major determinant of how much acquiring knowledge a company gains from an alliance is its ability to learn from its alliance partner.⁵⁰ For example, in a five-year study of 15 strategic alliances between major multinationals, Gary Hamel, Yves Doz, and C. K. Prahalad focused on a number of alliances between Japanese companies and Western (European or American) partners.⁵¹ In every case in which a Japanese company emerged from an alliance stronger than its Western partner, the Japanese company had made a greater effort to learn. Few Western companies studied seemed to want to learn from their Japanese partners. They tended to regard the alliance purely as a cost-sharing or risk-sharing device, rather than as an opportunity to learn how a potential competitor does business.

Consider the alliance between General Motors and Toyota constituted in 1985 to build the Chevrolet Nova. This alliance was structured as a formal joint venture, called New United Motor Manufacturing, Inc., and each party had a 50 percent equity stake. The venture owned an auto plant in Fremont, California. According to one Japanese manager, Toyota quickly achieved most of its objectives from the alliance: “We learned about U.S. supply and transportation. And we got the confidence to manage U.S. workers.”⁵² All that knowledge was then transferred to Georgetown, Kentucky, where Toyota opened its own plant in 1988. Possibly all GM got was a new product, the Chevrolet Nova. Some GM managers complained that the knowledge they gained through the alliance with Toyota has never been put to good use inside GM. They believe they should have been kept together as a team to educate GM’s engineers and workers about the Japanese system. Instead, they were dispersed to various GM subsidiaries.

To maximize the learning benefits of an alliance, a firm must try to learn from its partner and then apply the knowledge within its own organization. It has been suggested that all operating employees should be well briefed on the partner’s strengths and weaknesses and should understand how acquiring particular skills will bolster their firm’s competitive position. Hamel, Doz, and Prahalad note that this is already standard practice among Japanese companies. They made this observation:

We accompanied a Japanese development engineer on a tour through a partner’s factory. This engineer dutifully took notes on plant layout, the number of production stages, the rate at which the line was running, and the number of employees. He recorded all this despite the fact that he had no manufacturing responsibility in his own company, and that the alliance did not encompass joint manufacturing. Such dedication greatly enhances learning.⁵³

For such learning to be of value, it must be diffused throughout the organization (as was seemingly not the case at GM after the GM–Toyota joint venture). To achieve this, the managers involved in the alliance should educate their colleagues about the skills of the alliance partner.

Key Terms

strategy, p. 381	incentives, p. 388	learning effects, p. 394
profitability, p. 381	processes, p. 388	economies of scale, p. 394
profit growth, p. 382	organizational culture, p. 388	universal needs, p. 398
value creation, p. 383	people, p. 388	global standardization strategy, p. 402
operations, p. 385	core competence, p. 390	localization strategy, p. 403
organization architecture, p. 387	location economies, p. 391	transnational strategy, p. 404
organizational structure, p. 387	global web, p. 392	international strategy, p. 405
controls, p. 388	experience curve, p. 393	strategic alliances, p. 407

Summary

In this chapter we reviewed basic principles of strategy and the various ways in which firms can profit from global expansion, and we looked at the strategies firms that compete globally can adopt. The chapter made the following points:

1. A strategy can be defined as the actions that managers take to attain the goals of the firm. For most firms, the preeminent goal is to maximize shareholder value. Maximizing shareholder value requires firms to focus on

- increasing their profitability and the growth rate of profits over time.
2. International expansion may enable a firm to earn greater returns by transferring the product offerings derived from its core competencies to markets where indigenous competitors lack those product offerings and competencies.
 3. It may pay a firm to base each value creation activity it performs at that location where factor conditions are most conducive to the performance of that activity. We refer to this strategy as focusing on the attainment of location economies.
 4. By rapidly building sales volume for a standardized product, international expansion can assist a firm in moving down the experience curve by realizing learning effects and economies of scale.
 5. A multinational firm can create additional value by identifying valuable skills created within its foreign subsidiaries and leveraging those skills within its global network of operations.
 6. The best strategy for a firm to pursue often depends on a consideration of the pressures for cost reductions and for local responsiveness.
 7. Firms pursuing an international strategy transfer the products derived from core competencies to foreign markets, while undertaking some limited local customization.
 8. Firms pursuing a localization strategy customize their product offering, marketing strategy, and business strategy to national conditions.
 9. Firms pursuing a global standardization strategy focus on reaping the cost reductions that come from experience curve effects and location economies.
 10. Many industries are now so competitive that firms must adopt a transnational strategy. This involves a simultaneous focus on reducing costs, transferring skills and products, and boosting local responsiveness. Implementing such a strategy may not be easy.
 11. Strategic alliances are cooperative agreements between actual or potential competitors.
 12. The advantage of alliances are that they facilitate entry into foreign markets, enable partners to share the fixed costs and risks associated with new products and processes, facilitate the transfer of complementary skills between companies, and help firms establish technical standards.
 13. A 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.
 14. 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.
 15. Two keys to making alliances work seem to be building trust and informal communications networks between partners and taking proactive steps to learn from alliance partners.

Critical Discussion Questions

1. In a world of zero transportation costs, no trade barriers, and nontrivial differences between nations with regard to factor conditions, firms must expand internationally if they are to survive. Discuss.
2. Plot the position of the following firms on Figure 11.8: Procter & Gamble, IBM, Nokia, Coca-Cola, Dow Chemicals, US Steel, McDonald's. In each case justify your answer.
3. Reread the Management Focus, "Evolution of Strategy at Procter & Gamble," and then answer the following questions:
 - a. What strategy was Procter & Gamble pursuing when it first entered foreign markets in the period up until the 1980s?
 - b. Why do you think this strategy became less viable in the 1990s?
 - c. What strategy does P&G appear to be moving toward? What are the benefits of this strategy? What are the potential risks associated with it?
4. What do you see as the main organizational problems that are likely to be associated with implementation of a transnational strategy?
5. Reread the Management Focus, "Cisco and Fujitsu." What are the benefits to Cisco and Fujitsu, respectively, of the alliances? What are the risks to Cisco? How can Cisco mitigate those risks?

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

1. Several classifications and rankings of the world's largest companies are prepared by a variety of sources. Find one such *composite ranking* system and identify the criteria that are used in ranking the top global companies. Extract the list of the highest ranked 25 companies, paying particular attention to the home countries of the companies.
2. The top management of your company, a manufacturer and marketer of laptop computers,

has decided to pursue international expansion opportunities in Eastern Europe. To achieve economies of scale, management is aiming toward a strategy of minimum local adaptation. Focusing on an eastern European country of your choice, and using the “Countries” section of globalEDGE (select *Countries* at the main menu), prepare an executive summary that features those aspects of the product where standardization will simply not work and adaptation to local conditions will be essential.



closing case

The Evolving Strategy at IBM

IBM's CEO, Sam Palmisano, likes to talk about the evolution of global strategy at one of the world's largest computer enterprises. According to Palmisano, when IBM first started to expand internationally, it did so in the classic “international” pattern of many enterprises, undertaking most of its activities at home, and selling its products internationally through overseas sales offices. By the time Palmisano joined IBM in 1972, however, it had already moved away from this model, and was by then a classic “multinational” enterprise, with mini IBM's in major national markets around the world. This structure made sense for IBM in the 1970s, given that many markets were still segmented from each other by high barriers to cross-border trade and national differences in business practices often required considerable localization.

In recent decades, however, IBM has been moving away from this model and toward one that Palmisano characterizes as a “globally integrated enterprise.” In his words: “We are locating work and operations anywhere in the world based on economics, expertise, and the right business environment. We are integrating those operations horizontally and globally. We used to have separate supply chains in different markets. Now we have one supply chain, a global one. Our R&D has been global for many years, with research and software development carried out in labs around the world. But in our professional services businesses, where we used to think about our human capital—our people—in terms of countries, and regions, and business units, we now manage and deploy them as one global asset.”

Thus today's IBM locates its semiconductor R&D and manufacturing operation in upstate New York and Vermont, its global procurement center is in China, global services delivery is in India, while many of the services that support IBM's external and internal Web sites are in places such as Ireland and Brazil. The people at each of these centers are not focused on their national markets; they are leading integrated global operations.

This strategic shift was a response to three things; the globalization of the world economy; the global nature of many of IBM's customers, who were themselves shifting toward a global integration strategy; and the emergence of fierce competition from enterprises in emerging markets such as China and India. Take India as an example; in the 1990s a trio of Indian outsourcing firms, Tata Consulting Services, Infosys, and Wipro, started to take share away from IBM in its core information technology services business. The Indians enjoyed an advantage based on a large supply of highly educated but relative inexpensive engineering and managerial talent. IBM believed that to compete, it had to adopt the low-cost model being pioneered in India. So in 2004, it bought Daksh, an Indian firm that was a smaller version of India's big three information technology services firms. IBM has invested heavily in its Indian unit, building it into a large global business with leading market share that now competes effectively on cost and quality against its Indian rivals. While Palmisano notes that the original motivation for expanding in India was to gain access to low-cost labor, he now argues that the skill base in

India is just as important, if not more so. IBM can find a large supply of highly skilled people in India who can staff its global services operations and move seamlessly around the world. It doesn't hurt that most Indians have a good command of the English language, which has become the de facto language of business in much of the world.

Looking forward, Palmisano stresses that IBM is still fairly early in its journey to become a fully integrated global enterprise. The big thrust going forward will be on developing the human capital of the enterprise—helping to produce managers and engineers who see themselves as global professionals and global citizens, who are able to move effortlessly around the world and do business effectively in wide range of national contexts.

Sources: "The Empire Fights Back," *The Economist*, September 30, 2008, pp. 12–16; S. Palmisano, "The Globally Integrated Enterprise," *Vital Speeches of the Day*, October 2007, pp. 449–53; and S. Hamm, "IBM vs Tata: Which Is More American?" *BusinessWeek*, October 5, 2008, p. 28.

Case Discussion Questions

1. Palmisano states that in the 1970s and 1980s IBM was organized as a classic multinational enterprises. What does this mean? Why do you think IBM was organized that way? What were the advantages of this kind of strategic orientation?
2. By the 1990s the classic multinational strategic orientation was no longer working well for IBM. Why not?
3. What are the strategic advantages to IBM of its globally integrated enterprise strategy? What kind of organizational changes do you think had to be made at IBM to make this strategy a reality?
4. In terms of the strategic choice framework introduced in this chapter, what strategy do you think IBM is pursuing today?



上汽通用五菱
SGMW



part 5

Competing in a Global Marketplace

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Explain the three basic decisions that firms contemplating foreign expansion must make: which markets to enter, when to enter those markets, and on what scale.
- 2 Compare and contrast the different modes that firms use to enter foreign markets.
- 3 Identify the factors that influence a firm's choice of entry mode.
- 4 Recognize the pros and cons of acquisitions versus greenfield ventures as an entry strategy.

Entering Foreign Markets

General Motors in China

opening case

The late 2000s were not kind to General Motors. Hurt by a deep recession in the United States, and plunging vehicle sales, GM capped off a decade where it had progressively lost market share to foreign rivals such as Toyota by entering Chapter 11 bankruptcy. Between 1980, when it dominated the U.S. market, and 2009, when it entered bankruptcy protection, GM saw its U.S. market share slip from 44 percent to just 19 percent. The troubled company emerged from bankruptcy a few months later a smaller enterprise with fewer brands, and yet going forward some believe that the new GM could be a much more profitable enterprise. One major reason for this optimism was the success of its joint ventures in China.

GM entered China in 1997 with a \$1.6 billion investment to establish a joint venture with the state-owned Shanghai Automotive Industry Corp. (SAIC) to build Buick sedans. At the time, the Chinese market was tiny (less than 400,000 cars were sold in 1996), but GM was attracted by the enormous potential in a country of over 1 billion people that was experiencing rapid economic growth. GM forecast that by the late 2000s some 3 million cars a year might be sold in China. While it explicitly recognized that it had much to learn about the Chinese market, and would probably lose money for years to come, GM executives believed that it was crucial for them to establish a beachhead and to team with SAIC (one of the early leaders in China's emerging automobile industry) before its global rivals did. The decision to enter a joint venture was not a hard one. Not only did GM lack knowledge and connections in China, but also Chinese government regulations made it all but impossible for a foreign automaker to go it alone in the country.

While GM was not alone in investing in China—many of the world's major automobile companies entered into some kind of Chinese joint venture during this time period—it was among the largest investors. Only Volkswagen, whose management shared GM's view, made similar-sized investments. Other companies adopted a more cautious approach, investing smaller amounts and setting more limited goals.

By 2007 GM had expanded the range of its partnership with SAIC to include vehicles sold under the names of Chevrolet, Cadillac, and Wuling. The two companies had also established the Pan-Asian Technical Automotive center to design cars and components not just for China but also for other Asian markets. At this point it was already clear that both the Chinese market and the joint venture were exceeding GM's initial expectations. The venture was profitable, selling more than 900,000 cars and light trucks in 2007, an 18 percent increase over 2006 and placing it second only to Volkswagen in the market among foreign nameplates. Equally impressive, some 8 million cars and light trucks were sold in China in 2007, making China the second-largest car market in the world, ahead of Japan and behind the United States.

Much of the venture's success could be attributed to its strategy of designing vehicles explicitly for the Chinese market. For example, together with SAIC it produced a tiny minivan, the Wuling Sunshine. The van costs \$3,700, has a 0.8-liter engine, a top speed of 60 mph, and weighs less than 1,000 kilograms—a far cry from the heavy SUVs GM was known for in the United States. For China, the vehicle was perfect, and some 460,000 were sold in 2007, making it the best seller in the light-truck sector.

It is the future, however, that has people excited. In 2008 and 2009, while the U.S. and European automobile markets slumped, China's market registered strong growth. In 2009 some 13.8 million vehicles were sold in the country, surpassing the United States to become the largest automobile market in the world. GM and its local partners sold a record 1.8 million vehicles in 2009, a 67 percent increase over 2008. At this point, there were 40 cars for every 1,000 people in China, compared to 765 for every 1000 in the United States, suggesting that China could see rapid growth for years to come. ●

Sources: S. Schifferes, "Cracking China's Car Market," *BBC News*, May 17, 2007; N. Madden, "Led by Buick, Carmaker Learning Fine Points of Regional China Tastes," *Automotive News*, September 15, 2008, pp. 186–90; and "GM Posts Record Sales in China," *Toronto Star*, January 5, 2010, p. B4.



Introduction

This chapter is concerned with two closely related topics: (1) the decision of which foreign markets to enter, when to enter them, and on what scale; and (2) the choice of entry mode. Any firm contemplating foreign expansion must first struggle with the issue of which foreign markets to enter and the timing and scale of entry. The choice of which markets to enter should be driven by an assessment of relative long-run growth and profit potential.

The choice of mode for entering a foreign market is another major issue with which international businesses must wrestle. The various modes for serving foreign markets are exporting, licensing or franchising to host-country firms, establishing joint ventures with a host-country firm, setting up a new wholly owned subsidiary in a host

country to serve its market, or acquiring an established enterprise in the host nation to serve that market. Each of these options has advantages and disadvantages. The magnitude of the advantages and disadvantages associated with each entry mode is determined by a number of factors, including transport costs, trade barriers, political risks, economic risks, business risks, costs, and firm strategy. The optimal entry mode varies by situation, depending on these factors. Thus, whereas some firms may best serve a given market by exporting, other firms may better serve the market by setting up a new wholly owned subsidiary or by acquiring an established enterprise.

As discussed in the opening case, in 1997 GM decided to enter China on a significant scale. Its choice of entry mode, a joint venture with Shanghai Automotive Industry Corp., was dictated by circumstances at the time (Chinese government regulations made a joint venture the only practical alternative). GM was attracted to the market by the promise of rapid future growth. The growth exceeded GM's expectations, and the company reaped the rewards of making the right strategic choice under considerable uncertainty. Although GM as a whole did not fair well in the late 2000s (it had to seek bankruptcy protection in 2009), its success in China was the glittering jewel in an otherwise dismal picture, demonstrating just how important it can be for a company to get its foreign market entry strategy right.

Basic Entry Decisions

A firm contemplating foreign expansion must make three basic decisions: which markets to enter, when to enter those markets, and on what scale.¹

WHICH FOREIGN MARKETS? The world has more than 200 nation-states. They do not all hold the same profit potential for a firm contemplating foreign expansion. Ultimately, the choice must be based on an assessment of a nation's long-run profit potential. This potential is a function of several factors, many of which we have studied in earlier chapters. In Chapter 2, we looked in detail at the economic and political factors that influence the potential attractiveness of a foreign market. There we noted that the attractiveness of a country as a potential market for an international business depends on balancing the benefits, costs, and risks associated with doing business in that country.

Chapter 2 also noted that the long-run economic benefits of doing business in a country are a function of factors such as the size of the market (in terms of demographics), the present wealth (purchasing power) of consumers in that market, and the likely future wealth of consumers, which depends upon economic growth rates. While some markets are very large when measured by number of consumers (e.g., China, India, and Indonesia), one must also look at living standards and economic growth. On this basis, China and India, while relatively poor, are growing so rapidly that they are attractive targets for inward investment (hence GM's decision to invest in China in 1997; see the opening case). Alternatively, weak growth in Indonesia implies that this populous nation is a far less attractive target for inward investment. As we saw in Chapter 2, likely future economic growth rates appear to be a function of a free market system and a country's

LEARNING OBJECTIVE 1

Explain the three basic decisions that firms contemplating foreign expansion must make: which markets to enter, when to enter those markets, and on what scale.



Another Perspective

Thailand's Homebuilder Enters Foreign Markets

As a child in Thailand, Thongma Vjitpongpan helped his father sell soup to day laborers, balancing twin hampers on a shoulder pole and learning the first rule of good business: deliver quality at an affordable price. Today Thongma's business, Prukso Real Estate, uses mass-production techniques to build quality, affordable housing for low- and middle-income families. Prukso's process has been so successful—with recent annual revenues pegged at \$569 million—that the company intends to expand to other Asian countries where the need for low-cost housing is great. First on Prukso's list are India, Vietnam, and the Maldives, with China, Indonesia, and the Philippines to follow. (Brian Mertens, "Biggest Thai Home Builder Moving Abroad to Expand Company," *Forbes.com*, February 8, 2010, www.forbes.com)

capacity for growth (which may be greater in less developed nations). We also argued in Chapter 2 that the costs and risks associated with doing business in a foreign country are typically lower in economically advanced and politically stable democratic nations, and they are greater in less developed and politically unstable nations.

The discussion in Chapter 2 suggests that, other things being equal, the benefit–cost–risk trade-off is likely to be most favorable in politically stable developed and developing nations that have free market systems, and where there is not a dramatic upsurge in either inflation rates or private-sector debt. The trade-off is likely to be least favorable in politically unstable developing nations that operate with a mixed or command economy or in developing nations where speculative financial bubbles have led to excess borrowing (see Chapter 2 for further details).

Another important factor is the value an international business can create in a foreign market. This depends on the suitability of its product offering to that market and the nature of indigenous competition.² If the international business can offer a product that has not been widely available in that market and that satisfies an unmet need, the value of that product to consumers is likely to be much greater than if the international business simply offers the same type of product that indigenous competitors and other foreign entrants are already offering. Greater value translates into an ability to charge higher prices and/or to build sales volume more rapidly. By considering such factors, a firm can rank countries in terms of their attractiveness and long-run profit potential. Preference is then given to entering markets that rank highly. For example, Tesco, the large British grocery chain, has been aggressively expanding its foreign operations in recent years, primarily by focusing on emerging markets that lack strong indigenous competitors (see the accompanying Management Focus). Similarly, when GM entered China in 1997 the indigenous competitors were small and lacked technological know-how (see opening case).

Timing of Entry

Entry is early when a firm enters a foreign market before other foreign firms and late when a firm enters after other international businesses have established themselves.

First-Mover Advantages

Advantages accruing to the first to enter a market.

First-Mover Disadvantages

Disadvantages associated with entering a foreign market before other international businesses.

Pioneering Costs

Costs that an early entrant has to bear that a later entrant can avoid, such as the time and effort in learning the rules, failure due to ignorance, and the liability of being a foreigner.

TIMING OF ENTRY Once attractive markets have been identified, it is important to consider the **timing of entry**. We say that entry is early when an international business enters a foreign market before other foreign firms and late when it enters after other international businesses have already established themselves. The advantages frequently associated with entering a market early are commonly known as **first-mover advantages**.³ One first-mover advantage is the ability to preempt rivals and capture demand by establishing a strong brand name. This desire has driven the rapid expansion by Tesco into developing nations (see the Management Focus). A second advantage is the ability to build sales volume in that country and ride down the experience curve ahead of rivals, giving the early entrant a cost advantage over later entrants. One could argue that this factor motivated GM to enter the Chinese automobile market in 1997 when it was still tiny (it is now the world's largest; see the opening case). This cost advantage may enable the early entrant to cut prices below that of later entrants, thereby driving them out of the market. A third advantage is the ability of early entrants to create switching costs that tie customers into their products or services. Such switching costs make it difficult for later entrants to win business.

There can also be disadvantages associated with entering a foreign market before other international businesses. These are often referred to as **first-mover disadvantages**.⁴ These disadvantages may give rise to **pioneering costs**, costs that an early entrant has to bear that a later entrant can avoid. Pioneering costs arise when the business system in a foreign country is so different from that in a firm's home market that the enterprise has to devote considerable effort, time, and expense to learning the rules of the game. Pioneering costs include the costs of business failure if the firm, due to its ignorance of the foreign environment, makes major mistakes. A certain liability is associated with being a foreigner, and this liability is greater for foreign firms that



Tesco's International Growth Strategy

Tesco is the largest grocery retailer in the United Kingdom, with a 25 percent share of the local market. In its home market, the company's strengths are reputed to come from strong competencies in marketing and store site selection, logistics and inventory management, and its own label product offerings. By the early 1990s, these competencies had already given the company a leading position in the United Kingdom. The company was generating strong free cash flows, and senior management had to decide how to use that cash. One strategy they settled on was overseas expansion. As they looked at international markets, they soon concluded the best opportunities were not in established markets, such as those in North America and Western Europe, where strong local competitors already existed, but in the emerging markets of Eastern Europe and Asia where there were few capable competitors but strong underlying growth trends.

Tesco's first international foray was into Hungary in 1994, when it acquired an initial 51 percent stake in Global, a 43-store, state-owned grocery chain. By 2004, Tesco was the market leader in Hungary, with some 60 stores and a 14 percent market share. In 1995, Tesco acquired 31 stores in Poland from Stavia; a year later it added 13 stores purchased from Kmart in the Czech Republic and Slovakia; and the following year it entered the Republic of Ireland.

Tesco's Asian expansion began in 1998 in Thailand when it purchased 75 percent of Lotus, a local food retailer with 13 stores. Building on that base, Tesco had 64 stores in Thailand by 2004. In 1999, the company entered South Korea when it partnered with Samsung to develop a chain of hypermarkets. This was followed by entry into Taiwan in 2000, Malaysia in 2002, and China in 2004. The move into China came after three years of careful research and discussions with potential partners. Like many other Western companies, Tesco was attracted to the Chinese market by its large size and rapid growth. In the end, Tesco settled on a 50/50 joint venture with Hymall, a hypermarket chain that is controlled by Ting Hsin, a Taiwanese group, which had been operating in China for six years. Currently, Hymall has 25 stores in China, and it plans to open another 10 each year. Ting Hsin is a well-capitalized enterprise in its own right, and it will match Tesco's investments, reducing the risks Tesco faces in China.

As a result of these moves, by 2007 Tesco had more than 800 stores outside the United Kingdom, which generated £7.6 billion in annual revenues. In the United Kingdom, Tesco had some 1,900 stores, generating £30 billion. The

addition of international stores has helped to make Tesco the fourth-largest company in the global grocery market behind Walmart, Carrefour of France, and Ahold of Holland. Of the four, however, Tesco may be the most successful internationally. By 2005, all of its foreign ventures were making money.

In explaining the company's success, Tesco's managers have detailed a number of important factors. First, the company devotes considerable attention to transferring its core capabilities in retailing to its new ventures. At the same time, it does not send in an army of expatriate managers to run local operations, preferring to hire local managers and support them with a few operational experts from the United Kingdom. Second, the company believes that its partnering strategy in Asia has been a great asset. Tesco has teamed with good companies that have a deep understanding of the markets in which they are participating but that lack Tesco's financial strength and retailing capabilities. Consequently, both Tesco and its partners have brought useful assets to the venture, which have increased the probability of success. As the venture becomes established, Tesco has typically increased its ownership stake in its partner. Thus, under current plans, by 2011 Tesco will own 99 percent of Homeplus, its South Korean hypermarket chain. When the venture was established, Tesco owned 51 percent. Third, the company has focused on markets with good growth potential but that lack strong indigenous competitors, which provides Tesco with ripe ground for expansion.

In 2006, Tesco took its international expansion strategy to the next level when it announced it would enter the crowded U.S. grocery market with its Tesco Express concept. Currently running in five countries, Tesco Express stores are smaller, high-quality neighborhood grocery outlets that feature a large selection of prepared and healthy foods. Tesco will initially enter on the West Coast, investing some £250 million per year, with breakeven expected in the second year of operation. Although some question the wisdom of this move, others point out that in the United Kingdom Tesco has consistently outperformed the ASDA chain, which is owned by Walmart. Also, the Tesco Express format is not something found in the United States.

Sources: P. N. Child, "Taking Tesco Global," *The McKenzie Quarterly*, no. 3 (2002); H. Keers, "Global Tesco Sets Out Its Stall in China," *Daily Telegraph*, July 15, 2004, p. 31; K. Burgess, "Tesco Spends Pounds 140m on Chinese Partnership," *Financial Times*, July 15, 2004, p. 22; J. McTaggart, "Industry Awaits Tesco Invasion," *Progressive Grocer*, March 1, 2006, pp. 8–10; and Tesco's annual reports, archived at www.tesco.com.

enter a national market early.⁵ Research seems to confirm that the probability of survival increases if an international business enters a national market after several other foreign firms have already done so.⁶ The late entrant may benefit by observing and learning from the mistakes made by early entrants.

Pioneering costs also include the costs of promoting and establishing a product offering, including the costs of educating customers. These can be significant when the product being promoted is unfamiliar to local consumers. In contrast, later entrants may be able to ride on an early entrant's investments in learning and customer education by watching how the early entrant proceeded in the market, by avoiding costly mistakes made by the early entrant, and by exploiting the market potential created by the early entrant's investments in customer education. For example, KFC introduced the Chinese to American-style fast food, but a later entrant, McDonald's, has capitalized on the market in China.

An early entrant may be put at a severe disadvantage, relative to a later entrant, if regulations change in a way that diminishes the value of an early entrant's investments. This is a serious risk in many developing nations where the rules that govern business practices are still evolving. Early entrants can find themselves at a disadvantage if a subsequent change in regulations invalidates prior assumptions about the best business model for operating in that country.

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 and implies rapid entry. Consider the entry of the Dutch insurance company ING into the U.S. insurance market in 1999. ING had to spend several billion dollars to acquire its U.S. operations. Not all firms have the resources necessary to enter on a large scale, and even some large firms prefer to enter foreign markets on a small scale and then build slowly as they become more familiar with the market.

The consequences of entering on a significant scale—entering rapidly—are associated with the value of the resulting strategic commitments.⁷ A strategic commitment has a long-term impact and is difficult to reverse. Deciding to enter a foreign market on a significant scale is a major strategic commitment. Strategic commitments, such as rapid large-scale market entry, can have an important influence on the nature of competition in a market. For example, by entering the U.S. financial services market on a significant scale, ING signaled its commitment to the market. Such a move has several effects. On the positive side, it makes it easier for the company to attract customers and distributors (such as insurance agents). The scale of entry gives both customers and distributors reasons for believing that ING will remain in the market for the long run. The scale of entry may also give other foreign institutions considering entry into the United States pause; now they would have to compete not only against indigenous institutions in the United States, but also against an aggressive and successful European institution. On the negative side, by committing itself heavily to the United States, ING would have fewer resources available to support expansion in other desirable markets, such as Japan. The commitment to the United States limits the company's strategic flexibility.

As suggested by the ING example, significant strategic commitments are neither unambiguously good nor bad. Rather, they tend to change the competitive playing field and unleash a number of changes, some of which may be desirable and some of which will not be. It is important for a firm to think through the implications of large-scale entry into a market and act accordingly. Of particular relevance is trying to identify how actual and potential competitors might react to large-scale entry into a market. Also, the large-scale entrant is more likely than the small-scale entrant to be able to capture first-mover advantages associated with demand preemption, scale economies, and switching costs.

The value of the commitments that flow from rapid large-scale entry into a foreign market must be balanced against the resulting risks and lack of flexibility associated with significant commitments. But strategic inflexibility can also have value. A famous example from military history illustrates the value of inflexibility. When Hernán Cortés landed in Mexico, he ordered his men to burn all but one of his ships. Cortés reasoned that by eliminating their only method of retreat, his men had no choice but to fight hard to win against the Aztecs—and ultimately they did.⁸

Balanced against the value and risks of the commitments associated with large-scale entry are the benefits of a small-scale entry. Small-scale entry allows a firm to learn about a foreign market while limiting the firm's exposure to that market. Small-scale entry is a way to gather information about a foreign market before deciding whether to enter on a significant scale and how best to enter. By giving the firm time to collect information, small-scale entry reduces the risks associated with a subsequent large-scale entry. But the lack of commitment associated with small-scale entry may make it more difficult for the small-scale entrant to build market share and to capture first-mover or early-mover advantages. The risk-averse firm that enters a foreign market on a small scale may limit its potential losses, but it may also miss the chance to capture first-mover advantages.

MARKET ENTRY SUMMARY There are no “right” decisions here, just decisions that are associated with different levels of risk and reward. Entering a large developing nation such as China or India before most other international businesses in the firm's industry, and entering on a large scale, will be associated with high levels of risk. In such cases, the liability of being foreign is increased by the absence of prior foreign entrants whose experience can be a useful guide. At the same time, the potential long-term rewards associated with such a strategy are great. The early large-scale entrant into a major developing nation may be able to capture significant first-mover advantages that will bolster its long-run position in that market.⁹ This was what GM hoped to do when it entered China in 1997, and as of 2010 it seems as if GM has captured a significant first-mover, or at least early-mover, advantage (see the opening case). In contrast, entering developed nations such as Australia or Canada after other international businesses in the firm's industry, and entering on a small scale to first learn more about those markets, will be associated with much lower levels of risk. However, the potential long-term rewards are also likely to be lower because the firm is essentially forgoing the opportunity to capture first-mover advantages and because the lack of commitment signaled by small-scale entry may limit its future growth potential.

This section has been written largely from the perspective of a business based in a developed country considering entry into foreign markets. Christopher Bartlett and Sumantra Ghoshal have pointed out the ability that businesses based in developing nations have to enter foreign markets and become global players.¹⁰ Although such firms tend to be late entrants into foreign markets, and although their resources may be limited, Bartlett and Ghoshal argue that such late movers can still succeed against well-established global competitors by pursuing appropriate strategies. In particular, Bartlett and Ghoshal argue that companies based in developing nations should use the entry of foreign multinationals as an opportunity to learn from these competitors by benchmarking their operations and performance against them. Furthermore, they suggest the local company may be able to find ways to differentiate itself from a foreign multinational, for example, by focusing on market niches that the multinational ignores or is unable to serve effectively if it has a standardized global product offering. Having improved its performance through learning and differentiated its product offering, the firm from a developing nation may then be able to pursue its own international expansion strategy. Even though the firm may be a late entrant into many countries, by benchmarking and then differentiating itself from early movers in global markets, the firm from the developing nation



Management FOCUS

The Jollibee Phenomenon—A Philippine Multinational

Jollibee is one of the Philippines' phenomenal business success stories. Jollibee, which stands for "Jolly Bee," began operations in 1975 as a two-branch ice cream parlor. It later expanded its menu to include hot sandwiches and other meals. Encouraged by early success, Jollibee Foods Corporation was incorporated in 1978, with a network that had grown to seven outlets. In 1981, when Jollibee had 11 stores, McDonald's began to open stores in Manila. Many observers thought Jollibee would have difficulty competing against McDonald's. However, Jollibee saw this as an opportunity to learn from a very successful global competitor. Jollibee benchmarked its performance against that of McDonald's and started to adopt operational systems similar to those used at McDonald's to control its quality, cost, and service at the store level. This helped Jollibee to improve its performance.

As it came to better understand McDonald's business model, Jollibee began to look for a weakness in McDonald's global strategy. Jollibee executives concluded that McDonald's fare was too standardized for many locals, and that the local firm could gain share by tailoring its menu to local tastes. Jollibee's hamburgers were set apart by a secret mix of spices blended into the ground beef to make the burgers sweeter than those produced by McDonald's, appealing more to Philippine tastes. It also offered local fare including various rice dishes, pineapple burgers, and banana *langka* and peach mango pies for desserts. By pursuing

this strategy, Jollibee maintained a leadership position over the global giant. By 2006, Jollibee had over 540 stores in the Philippines, a market share of more than 60 percent, and revenues in excess of \$600 million. McDonald's, in contrast, had about 250 stores.

In the mid-1980s, Jollibee had gained enough confidence to expand internationally. Its initial ventures were into neighboring Asian countries such as Indonesia, where it pursued the strategy of localizing the menu to better match local tastes, thereby differentiating itself from McDonald's. In 1987, Jollibee entered the Middle East, where a large contingent of expatriate Filipino workers provided a ready-made market for the company. The strategy of focusing on expatriates worked so well that in the late 1990s Jollibee decided to enter another foreign market where there was a large Filipino population—the United States. Between 1999 and 2004, Jollibee opened eight stores in the United States, all in California. Even though many believe the U.S. fast-food market is saturated, the stores have performed well. While the initial clientele was strongly biased toward the expatriate Filipino community, where Jollibee's brand awareness is high, non-Filipinos increasingly are coming to the restaurant. In the San Francisco store, which has been open the longest, more than half the customers are now non-Filipino.

Recently Jollibee has focused its attentions on two international markets, mainland China and India. It has more than 100 stores in China, which operate under the Yonghe brand name (and serve Chinese style fast food). While it



Jollibee may be heading your way! Unlike many fast-food chains that have their roots within the United States, the Jollibee chain originated in the Philippines using McDonald's as a role model.

(continued)

does not yet have a presence in India, the company is reported to be considering its options for entering that nation and is reported to be considering acquiring an Indian fast-food chain, although as with so many enterprises, Jollibee has slowed its expansion strategy in the wake of the 2008–2009 global financial crisis. Jollibee has a bright future as a niche player in a market that has historically been dominated by U.S. multinationals.

Sources: Christopher Bartlett and Sumantra Ghoshal, "Going Global: Lessons from Late Movers," *Harvard Business Review*, March–April 2000, pp. 132–45; "Jollibee Battles Burger Giants in US Market," *Philippine Daily Inquirer*, July 13, 2000; M. Ballon, "Jollibee Struggling to Expand in U.S.," *Los Angeles Times*, September 16, 2002, p. C1; J. Hookway, "Burgers and Beer," *Far Eastern Economic Review*, December 2003, pp. 72–74; S. E. Lockyer, "Coming to America," *Nation's Restaurant News*, February 14, 2005, pp. 33–35; Erik de la Cruz, "Jollibee to Open 120 New Stores This Year, Plans India," *Inquirer Money*, July 5, 2006, www.business.inquirer.net; and www.jollibee.com.ph.

may still be able to build a strong international business presence. A good example of how this can work is given in the above Management Focus, which looks at how Jollibee, a Philippines-based fast-food chain, has started to build a global presence in a market dominated by U.S. multinationals such as McDonald's and KFC.

Entry Modes

Once a firm decides to enter a foreign market, the question arises as to the best mode of entry. Firms can use six different modes to enter foreign markets: exporting, turn-key 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.¹¹

EXPORTING Many manufacturing firms begin their global expansion as exporters and only later switch to another mode for serving a foreign market. We take a close look at the mechanics of exporting in the next chapter. Here we focus on the advantages and disadvantages of exporting as an entry mode.

Advantages **Exporting** has two distinct advantages. First, it avoids the often substantial costs of establishing manufacturing operations in the host country. Second, exporting may help a firm achieve experience curve and location economies (see Chapter 11). By manufacturing the product in a centralized location and exporting it to other national markets, the firm may realize substantial scale economies from its global sales volume. This is how Sony came to dominate the global TV market, how Matsushita came to dominate the VCR market, how many Japanese automakers made inroads into the U.S. market, and how South Korean firms such as Samsung gained market share in computer memory chips.

Disadvantages Exporting has a number of drawbacks. First, exporting from the firm's home base may not be appropriate if lower-cost locations for manufacturing the product can be found abroad (i.e., if the firm can realize location economies by moving production elsewhere). Thus, particularly for firms pursuing global or transnational strategies, it may be preferable to manufacture where the mix of factor conditions is most favorable from a value creation perspective and to export to the rest of the world from that location. This is not so much an argument against exporting as an argument against exporting from the firm's home country. Many U.S. electronics firms have moved some of their manufacturing to the Far East because of the availability of low-cost, highly skilled labor there. They then export from that location to the rest of the world, including the United States.

A second drawback to exporting is that high transport costs can make exporting uneconomical, particularly for bulk products. One way of getting around this is to

LEARNING OBJECTIVE 2

Compare and contrast the different modes that firms use to enter foreign markets.

Exporting

Sale of products produced in one country to residents of another country.



Another Perspective

Saudi Arabia to Export Phosphate

In an effort to curb its reliance on oil as the country's primary export commodity, the kingdom of Saudi Arabia has taken steps to develop and market a number of its other natural resources, including phosphate, gold, and bauxite, the main source of aluminum. Phosphate is important in the manufacture of many commercial fertilizers. As the world population continues to grow, the global food crisis deepens, leading economists to emphasize the need to optimize crop yields. Thus, fertilizer stands to become an important commodity. According to the Saudi Ports Authority, plans are under way to export phosphates from the port of Ras al-Zour. ("Saudi to Start Exporting Phosphates in Dec—Paper," *Reuters.com*, January 27, 2010, www.reuters.com)

manufacture bulk products regionally. This strategy enables the firm to realize some economies from large-scale production and at the same time to limit its transport costs. For example, many multinational chemical firms manufacture their products regionally, serving several countries from one facility.

Another drawback is that tariff barriers can make exporting uneconomical. Similarly, the threat of tariff barriers by the host-country government can make it very risky. A fourth drawback to exporting arises when a firm delegates its marketing, sales, and service in each country where it does business to another company. This is a common approach for manufacturing firms that are just beginning to expand internationally. The other company may be a local agent, or it may be another multinational with extensive international distribution operations. Local agents often carry the prod-

ucts of competing firms and so have divided loyalties. In such cases, the local agent may not do as good a job as the firm would if it managed its marketing itself. Similar problems can occur when another multinational takes on distribution.

The way around such problems is to set up wholly owned subsidiaries in foreign nations to handle local marketing, sales, and service. By doing this, the firm can exercise tight control over marketing and sales in the country while reaping the cost advantages of manufacturing the product in a single location, or a few choice locations.

Turnkey Project

A project in which a firm agrees to set up an operating plant for a foreign client and hand over the "key" when the plant is fully operational.

TURNKEY PROJECTS

Firms that specialize in the design, construction, and start-up of turnkey plants are common in some industries. In a **turnkey project**, the contractor agrees to handle every detail of the project for a foreign client, including the training of operating personnel. At completion of the contract, the foreign client is handed the "key" to a plant that is ready for full operation—hence, the term *turnkey*. This is a means of exporting process technology to other countries. Turnkey projects are most common in the chemical, pharmaceutical, petroleum refining, and metal refining industries, all of which use complex, expensive production technologies.

Advantages

The know-how required to assemble and run a technologically complex process, such as refining petroleum or steel, is a valuable asset. Turnkey projects are a way of earning great economic returns from that asset. The strategy is particularly useful where FDI is limited by host-government regulations. For example, the governments of many oil-rich countries have set out to build their own petroleum refining industries, so they restrict FDI in their oil and refining sectors. But because many of these countries lack petroleum-refining technology, they gain it by entering into turnkey projects with foreign firms that have the technology. Such deals are often attractive to the selling firm because without them, they would have no way to earn a return on their valuable know-how in that country. A turnkey strategy can also be less risky than conventional FDI. In a country with unstable political and economic environments, a longer-term investment might expose the firm to unacceptable political and/or economic risks (e.g., the risk of nationalization or of economic collapse).

Disadvantages

Three main drawbacks are associated with a turnkey strategy. First, the firm that enters into a turnkey deal will have no long-term interest in the foreign country. This can be a disadvantage if that country subsequently proves to be

a major market for the output of the process that has been exported. One way around this is to take a minority equity interest in the operation. Second, the firm that enters into a turnkey project with a foreign enterprise may inadvertently create a competitor. For example, many of the Western firms that sold oil-refining technology to firms in Saudi Arabia, Kuwait, and other Gulf states now find themselves competing with these firms in the world oil market. Third, if the firm's process technology is a source of competitive advantage, then selling this technology through a turnkey project is also selling competitive advantage to potential and/or actual competitors.

LICENSING A **licensing agreement** is an arrangement whereby a licensor grants the rights to intangible property to another entity (the licensee) for a specified period, and in return, the licensor receives a royalty fee from the licensee.¹² Intangible property includes patents, inventions, formulas, processes, designs, copyrights, and trademarks. For example, to enter the Japanese market, Xerox, inventor of the photocopier, established a joint venture with Fuji Photo that is known as Fuji-Xerox. Xerox then licensed its xerographic know-how to Fuji-Xerox. In return, Fuji-Xerox paid Xerox a royalty fee equal to 5 percent of the net sales revenue that Fuji-Xerox earned from the sales of photocopiers based on Xerox's patented know-how. In the Fuji-Xerox case, the license was originally granted for 10 years, and it has been renegotiated and extended several times since. The licensing agreement between Xerox and Fuji-Xerox also limited Fuji-Xerox's direct sales to the Asian Pacific region (although Fuji-Xerox does supply Xerox with photocopiers that are sold in North America under the Xerox label).¹³

Licensing

Occurs when a firm (the licensor) licenses the rights to produce its product, its production processes, or its brand name or trademark to another firm (the licensee); in return, the licensor collects a royalty fee from the licensee.

Advantages In the typical international licensing deal, the licensee puts up most of the capital necessary to get the overseas operation going. Thus, a primary advantage of licensing is that the firm does not have to bear the development costs and risks associated with opening a foreign market. Licensing is very attractive for firms lacking the capital to develop operations overseas. In addition, licensing can be attractive when a firm is unwilling to commit substantial financial resources to an unfamiliar or politically volatile foreign market. Licensing is also often used when a firm wishes to participate in a foreign market but is prohibited from doing so by barriers to investment. This was one of the original reasons for the formation of the Fuji-Xerox joint venture in 1962. Xerox wanted to participate in the Japanese market but was prohibited from setting up a wholly owned subsidiary by the Japanese government. So Xerox set up the joint venture with Fuji and then licensed its know-how to the joint venture.

Finally, licensing is frequently used when a firm possesses some intangible property that might have business applications, but it does not want to develop those applications itself. For example, Bell Laboratories at AT&I originally invented the transistor circuit in the 1950s, but AT&I decided it did not want to produce transistors, so it licensed the technology to a number of other companies, such as Texas Instruments. Similarly, Coca-Cola has licensed its famous trademark to clothing manufacturers, which have incorporated the design into clothing.

Disadvantages Licensing has three serious drawbacks. First, it does not give a firm the tight control over manufacturing, marketing, and strategy that is required for realizing experience curve and location economies. Licensing typically involves each licensee setting up its own production operations. This severely limits the firm's ability to realize experience curve and location economies by producing its product in a centralized location. When these economies are important, licensing may not be the best way to expand overseas.

Second, competing in a global market may require a firm to coordinate strategic moves across countries by using profits earned in one country to support competitive



At the completion of the contract, the foreign client is handed the “key” to a plant that is ready for full operation.

attacks in another. By its very nature, licensing limits a firm’s ability to do this. A licensee is unlikely to allow a multinational firm to use its profits (beyond those due in the form of royalty payments) to support a different licensee operating in another country.

A third problem with licensing is one that we encountered in Chapter 7 when we reviewed the economic theory of FDI. This is the risk associated with licensing technological know-how to foreign companies. Technological know-how constitutes the basis of many multinational firms’ competitive advantage. Most firms wish to maintain control over how their know-how is used, and a firm can quickly lose control over its technology by licensing it. Many firms have made the mistake of thinking they could maintain control over their know-how within the framework of a licensing agreement. RCA Corpora-

tion, for example, once licensed its color TV technology to Japanese firms including Matsushita and Sony. The Japanese firms quickly assimilated the technology, improved on it, and used it to enter the U.S. market, taking substantial market share away from RCA.

There are ways of reducing this risk. One way is by entering into a cross-licensing agreement with a foreign firm. Under a cross-licensing agreement, a firm might license some valuable intangible property to a foreign partner, but in addition to a royalty payment, the firm might also request that the foreign partner license some of its valuable know-how to the firm. Such agreements are believed to reduce the risks associated with licensing technological know-how, since the licensee realizes that if it violates the licensing contract (by using the knowledge obtained to compete directly with the licensor), the licensor can do the same to it. Cross-licensing agreements enable firms to hold each other hostage, which reduces the probability that they will behave opportunistically toward each other.¹⁴ Such cross-licensing agreements are increasingly common in high-technology industries. For example, the U.S. biotechnology firm Amgen licensed one of its key drugs, Nuprogene, to Kirin, the Japanese pharmaceutical company. The license gives Kirin the right to sell Nuprogene in Japan. In return, Amgen receives a royalty payment and, through a licensing agreement, gained the right to sell some of Kirin’s products in the United States.

Another way of reducing the risk associated with licensing is to follow the Fuji-Xerox model and link an agreement to license know-how with the formation of a joint venture in which the licensor and licensee take important equity stakes. Such an approach aligns the interests of licensor and licensee because both have a stake in ensuring that the venture is successful. Thus, the risk that Fuji Photo might appropriate Xerox’s technological know-how and then compete directly against Xerox in the global photocopier market was reduced by the establishment of a joint venture in which both Xerox and Fuji Photo had an important stake.

Franchising

A specialized form of licensing in which the franchiser sells intangible property to the franchisee and insists on rules to conduct the business.

FRANCHISING Franchising is similar to licensing, although franchising tends to involve longer-term commitments than licensing. **Franchising** is basically a specialized form of licensing in which the franchiser not only sells intangible property (normally a trademark) to the franchisee, but also insists that the franchisee agree to abide by strict rules as to how it does business. The franchiser will also often assist the franchisee to run the business on an ongoing basis. As with licensing, the franchiser typically receives a royalty payment, which amounts to some percentage of the franchisee’s

revenues. Whereas licensing is pursued primarily by manufacturing firms, franchising is employed primarily by service firms.¹⁵ McDonald's is a good example of a firm that has grown by using a franchising strategy. McDonald's strict rules as to how franchisees should operate a restaurant extend to control over the menu, cooking methods, staffing policies, and design and location. McDonald's also organizes the supply chain for its franchisees and provides management training and financial assistance.¹⁶

Advantages The advantages of franchising as an entry mode are very similar to those of licensing. The firm is relieved of many of the costs and risks of opening a foreign market on its own. Instead, the franchisee typically assumes those costs and risks. This creates a good incentive for the franchisee to build a profitable operation as quickly as possible. Thus, using a franchising strategy, a service firm can build a global presence quickly and at a relatively low cost and risk, as McDonald's has.

Disadvantages The disadvantages are less pronounced than in the case of licensing. Since franchising is often used by service companies, there is no reason to consider the need for coordination of manufacturing to achieve experience curve and location economies. But franchising may inhibit the firm's ability to take profits out of one country to support competitive attacks in another. A more significant disadvantage of franchising is quality control. The foundation of franchising arrangements is that the firm's brand name conveys a message to consumers about the quality of the firm's product. Thus, a business traveler checking in at a Four Seasons hotel in Hong Kong can reasonably expect the same quality of room, food, and service that she would receive in New York. The Four Seasons name is supposed to guarantee consistent product quality. This presents a problem in that foreign franchisees may not be as concerned about quality as they are supposed to be, and the result of poor quality can extend beyond lost sales in a particular foreign market to a decline in the firm's worldwide reputation. For example, if the business traveler has a bad experience at the Four Seasons in Hong Kong, she may never go to another Four Seasons hotel and may urge her colleagues to do likewise. The geographical distance of the firm from its foreign franchisees can make poor quality difficult to detect. In addition, the sheer numbers of franchisees—in the case of McDonald's, tens of thousands—can make quality control difficult. Due to these factors, quality problems may persist.

One way around this disadvantage is to set up a subsidiary in each country in which the firm expands. The subsidiary might be wholly owned by the company or a joint venture with a foreign company. The subsidiary assumes the rights and obligations to establish franchises throughout the particular country or region. McDonald's, for example, establishes a master franchisee in many countries. Typically, this master franchisee is a joint venture between McDonald's and a local firm. The proximity and the smaller number of franchises to oversee reduce the quality control challenge. In addition, because the subsidiary (or master franchisee) is at least partly owned by the firm, the firm can place its own managers in the subsidiary to help ensure that it is doing a good job of monitoring the franchises. This organizational arrangement has proven very satisfactory for McDonald's, KFC, and others.

JOINT VENTURES A **joint venture** entails establishing a firm that is jointly owned by two or more otherwise independent firms. Fuji-Xerox, for example, was set up as a joint venture between Xerox and Fuji Photo. Establishing a joint venture with a foreign firm has long been a popular mode for entering a new market. As we saw in the opening case, General Motors used a joint-venture strategy to enter the Chinese automobile market. The most typical joint venture is a 50/50 venture, in which each of the two parties holds a 50 percent ownership stake and contributes a team of managers

Joint Venture
Establishing a firm that is jointly owned by two or more otherwise independent firms.

to share operating control. This was the case with the Fuji–Xerox joint venture until 2001; it is now a 25/75 venture with Xerox holding 25 percent. The GM SAIC venture in China was a 50/50 venture until 2010, when it became a 51/49 venture, with SAIC holding the 51 percent stake. Some firms, however, have sought joint ventures in which they have a majority share and thus tighter control.¹⁷

Advantages Joint ventures have a number of advantages. First, a firm benefits from a local partner's knowledge of the host country's competitive conditions, culture, language, political systems, and business systems (this was one reason GM entered into a joint venture with SAIC in China; see the opening case). Thus, for many U.S. firms, joint ventures have involved the U.S. company providing technological know-how and products and the local partner providing the marketing expertise and the local knowledge necessary for competing in that country. Second, when the development costs and/or risks of opening a foreign market are high, a firm might gain by sharing these costs and or risks with a local partner. Third, in many countries, political considerations make joint ventures the only feasible entry mode (again, as was the case with GM's joint venture with SAIC). Research suggests joint ventures with local partners face a low risk of being subject to nationalization or other forms of adverse government interference.¹⁸ This appears to be because local equity partners, who may have some influence on host-government policy, have a vested interest in speaking out against nationalization or government interference.

Disadvantages Despite these advantages, joint ventures have major disadvantages. First, as with licensing, a firm that enters into a joint venture risks giving control of its technology to its partner. Thus, a proposed joint venture in 2002 between Boeing and Mitsubishi Heavy Industries to build a new wide-body jet (the 787), raised fears that Boeing might unwittingly give away its commercial airline technology to the Japanese. However, joint-venture agreements can be constructed to minimize this risk. One option is to hold majority ownership in the venture. This allows the dominant partner to exercise greater control over its technology. But it can be difficult to find a foreign partner willing to settle for minority ownership. Another option is to “wall off” from a partner technology that is central to the core competence of the firm, while sharing other technology.

A second disadvantage is that a joint venture does not give a firm the tight control over subsidiaries that it might need to realize experience curve or location economies. Nor does it give a firm the tight control over a foreign subsidiary that it might need for engaging in coordinated global attacks against its rivals. Consider the entry of Texas Instruments (TI) into the Japanese semiconductor market. When TI established semiconductor facilities in Japan, it did so for the dual purpose of checking Japanese manufacturers' market share and limiting their cash available for invading TI's global market. In other words, TI was engaging in global strategic coordination. To implement this strategy, TI's subsidiary in Japan had to be prepared to take instructions from corporate headquarters regarding competitive strategy. The strategy also required the Japanese subsidiary to run at a loss if necessary. Few if any potential joint-venture partners would have been willing to accept such conditions, since it would have necessitated a willingness to accept a negative return on investment. Indeed, many joint ventures establish a degree of autonomy that would make such direct control over strategic decisions all but impossible to establish.¹⁹ Thus, to implement this strategy, TI set up a wholly owned subsidiary in Japan.

A third disadvantage with joint ventures is that the shared ownership arrangement can lead to conflicts and battles for control between the investing firms if their goals and objectives change or if they take different views as to what the strategy should be.

This was apparently not a problem with the Fuji–Xerox joint venture. According to Yotaro Kobayashi, currently the chairman of Fuji–Xerox, a primary reason is that both Xerox and Fuji Photo adopted an arm’s-length relationship with Fuji–Xerox, giving the venture’s management considerable freedom to determine its own strategy.²⁰ However, much research indicates that conflicts of interest over strategy and goals often arise in joint ventures. These conflicts tend to be greater when the venture is between firms of different nationalities, and they often end in the dissolution of the venture.²¹ Such conflicts tend to be triggered by shifts in the relative bargaining power of venture partners. For example, in the case of ventures between a foreign firm and a local firm, as a foreign partner’s knowledge about local market conditions increases, it depends less on the expertise of a local partner. This increases the bargaining power of the foreign partner and ultimately leads to conflicts over control of the venture’s strategy and goals.²² Some firms have sought to limit such problems by entering into joint ventures in which one partner has a controlling interest.

WHOLLY OWNED SUBSIDIARIES In a **wholly owned subsidiary**, the firm owns 100 percent of the stock. Establishing a wholly owned subsidiary in a foreign market can be done two ways. The firm either can set up a new operation in that country, often referred to as a greenfield venture, or it can acquire an established firm in the host nation and use that firm to promote its products.²³ For example, ING’s strategy for entering the U.S. insurance market was to acquire established U.S. enterprises, rather than try to build an operation from the ground floor.

**Wholly Owned
Subsidiary**
A subsidiary in which the
firm owns 100 percent of
the stock.

Advantages There are several clear advantages of wholly owned subsidiaries. First, when a firm’s competitive advantage is based on technological competence, a wholly owned subsidiary will often be the preferred entry mode because it reduces the risk of losing control over that competence. (See Chapter 7 for more details.) Many high-tech firms prefer this entry mode for overseas expansion (e.g., firms in the semiconductor, electronics, and pharmaceutical industries). Second, a wholly owned subsidiary gives a firm tight control over operations in different countries. This is necessary for engaging in global strategic coordination (i.e., using profits from one country to support competitive attacks in another).

Third, a wholly owned subsidiary may be required if a firm is trying to realize location and experience curve economies (as firms pursuing global and transnational strategies try to do). As we saw in Chapter 11, when cost pressures are intense, it may pay a firm to configure its value chain in such a way that the value added at each stage is maximized. Thus, a national subsidiary may specialize in manufacturing only part of the product line or certain components of the end product, exchanging parts and products with other subsidiaries in the firm’s global system. Establishing such a global production system requires a high degree of control over the operations of each affiliate. The various operations must be prepared to accept centrally determined decisions as to how they will produce, how much they will produce, and how their output will be priced for transfer to the next operation. Because licensees or joint-venture partners are unlikely to accept such a subservient role, establishing wholly owned subsidiaries may be necessary. Finally, establishing a wholly owned subsidiary gives the firm a 100 percent share in the profits generated in a foreign market.

Disadvantages Establishing a wholly owned subsidiary is generally the most costly method of serving a foreign market from a capital investment standpoint. Firms doing this must bear the full capital costs and risks of setting up overseas operations. The risks associated with learning to do business in a new culture are less if the firm acquires an established host-country enterprise. However, acquisitions raise

additional problems, including those associated with trying to marry divergent corporate cultures. These problems may more than offset any benefits derived by acquiring an established operation. Because the choice between greenfield ventures and acquisitions is such an important one, we shall discuss it in more detail later in the chapter.

Selecting an Entry Mode

LEARNING OBJECTIVE 3

Identify the factors that influence a firm's choice of entry mode.

As the preceding discussion demonstrated, all the entry modes have advantages and disadvantages, as summarized in Table 12.1. Thus, trade-offs are inevitable when selecting an entry mode. For example, when considering entry into an unfamiliar country with a track record for discriminating against foreign-owned enterprises when awarding government contracts, a firm might favor a joint venture with a local enterprise. Its rationale might be that the local partner will help it establish operations in an unfamiliar environment and will help the company win government contracts. However, if the firm's core competence is based on proprietary technology, entering a joint venture might risk losing control of that technology to the joint-venture partner, in which case the strategy may seem unattractive. Despite the existence of such trade-offs, it is possible to make some generalizations about the optimal choice of entry mode.²⁴

table 12.1

Advantages and Disadvantages of Entry Modes

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

CORE COMPETENCIES AND ENTRY MODE We saw in Chapter 11 that firms often expand internationally to earn greater returns from their core competencies, transferring the skills and products derived from their core competencies to foreign markets where indigenous competitors lack those skills. The optimal entry mode for these firms depends to some degree on the nature of their core competencies. A distinction can be drawn between firms whose core competency is in technological know-how and those whose core competency is in management know-how.

Technological Know-How As was observed in Chapter 7, if a firm's competitive advantage (its core competence) is based on control over proprietary technological know-how, licensing and joint-venture arrangements should be avoided if possible to minimize the risk of losing control over that technology. Thus, if a high-tech firm sets up operations in a foreign country to profit from a core competency in technological know-how, it will probably do so through a wholly owned subsidiary. This rule should not be viewed as hard and fast, however. Sometimes a licensing or joint-venture arrangement can be structured to reduce the risk of licensees or joint-venture partners expropriating technological know-how. Another exception exists when a firm perceives its technological advantage to be only transitory, when it expects rapid imitation of its core technology by competitors. In such cases, the firm might want to license its technology as rapidly as possible to foreign firms to gain global acceptance for its technology before the imitation occurs.²⁵ Such a strategy has some advantages. By licensing its technology to competitors, the firm may deter them from developing their own, possibly superior, technology. Further, by licensing its technology, the firm may establish its technology as the dominant design in the industry (as Matsushita did with its VHS format for VCRs). This may ensure a steady stream of royalty payments. However, the attractions of licensing are frequently outweighed by the risks of losing control over technology and if this is a risk, licensing should be avoided.

Management Know-How The competitive advantage of many service firms is based on management know-how (e.g., McDonald's, Starbucks). For such firms, the risk of losing control over the management skills to franchisees or joint-venture partners is not that great. These firms' valuable asset is their brand name, and brand names are generally well protected by international laws pertaining to trademarks. Given this, many of the issues arising in the case of technological know-how are of less concern here. As a result, many service firms favor a combination of franchising and subsidiaries to control the franchises within particular countries or regions. The subsidiaries may be wholly owned or joint ventures, but most service firms have found that joint ventures with local partners work best for the controlling subsidiaries. A joint venture is often politically more acceptable and brings a degree of local knowledge to the subsidiary.

PRESSURES FOR COST REDUCTIONS AND ENTRY MODE The greater the pressures for cost reductions are, the more likely a firm will want to pursue some combination of exporting and wholly owned subsidiaries. By manufacturing in those locations where factor conditions are optimal and then exporting to the rest of the world, a firm may be able to realize substantial location and experience curve economies. The firm might then want to export the finished product to marketing subsidiaries based in various countries. These subsidiaries will typically be wholly owned and have the responsibility for overseeing distribution in their particular countries. Setting up wholly owned marketing subsidiaries is preferable to

joint-venture arrangements and to using foreign marketing agents because it gives the firm tight control that might be required for coordinating a globally dispersed value chain. It also gives the firm the ability to use the profits generated in one market to improve its competitive position in another market. In other words, firms pursuing global standardization or transnational strategies tend to prefer establishing wholly owned subsidiaries.

Greenfield Venture or Acquisition?

LEARNING OBJECTIVE 4

Recognize the pros and cons of acquisitions versus greenfield ventures as an entry strategy.

A firm can establish a wholly owned subsidiary in a country by building a subsidiary from the ground up, the so-called greenfield strategy, or by acquiring an enterprise in the target market.²⁶ The volume of cross-border acquisitions has been growing at a rapid rate for two decades. Over the past decade, between 40 and 80 percent of all FDI inflows have been in the form of mergers and acquisitions. In 2001, for example, mergers and acquisitions accounted for 80 percent of all FDI inflows. In 2004 the figure was 51 percent, or some \$381 billion. In 2008 the figure was 40 percent, or some \$673 billion.²⁷ The relative low figure recorded in 2008 reflects the impact of the global economic crisis, which depressed equity values worldwide and made cross-border mergers and acquisitions less attractive as an entry mode.

PROS AND CONS OF ACQUISITIONS Acquisitions have three major points in their favor. First, they are quick to execute. By acquiring an established enterprise, a firm can rapidly build its presence in the target foreign market. When the German automobile company Daimler-Benz decided it needed a bigger presence in the U.S. automobile market, it did not increase that presence by building new factories to serve the United States, a process that would have taken years. Instead, it acquired the number three U.S. automobile company, Chrysler, and merged the two operations to form DaimlerChrysler (Daimler spun off Chrysler into a private equity firm in 2007). When the Spanish telecommunications service provider Telefonica wanted to build a service presence in Latin America, it did so through a series of acquisitions, purchasing telecommunications companies in Brazil and Argentina. In these cases, the firms made acquisitions because they knew that was the quickest way to establish a sizable presence in the target market.

Second, in many cases firms make acquisitions to preempt their competitors. The need for preemption is particularly great in markets that are rapidly globalizing, such as telecommunications, where a combination of deregulation within nations and liberalization of regulations governing cross-border foreign direct investment has made it much easier for enterprises to enter foreign markets through acquisitions. Such markets may see concentrated waves of acquisitions as firms race each other to attain global scale. In the telecommunications industry, for example, regulatory changes triggered what can be called a feeding frenzy, with firms entering each other's markets via acquisitions to establish a global presence. These included the \$60 billion acquisition of Air Touch Communications in the United States by the British company Vodafone, which was the largest acquisition ever; the \$13 billion acquisition of One 2 One in Britain by the



Three pros to acquisitions, such as Vodafone's purchase of AirTouch, include a quick execution, preemption of the competition, and less risk than greenfield ventures.

German company Deutsche Telekom; and the \$6.4 billion acquisition of Excel Communications in the United States by Telelobe of Canada, all of which occurred in 1998 and 1999.²⁸ A similar wave of cross-border acquisitions occurred in the global automobile industry over the same time period, with Daimler acquiring Chrysler, Ford acquiring Volvo, and Renault acquiring Nissan.

Third, managers may believe acquisitions to be less risky than greenfield ventures. When a firm makes an acquisition, it buys a set of assets that are producing a known revenue and profit stream. In contrast, the revenue and profit stream from a greenfield venture is uncertain because it does not yet exist. When a firm makes an acquisition in a foreign market, it not only acquires a set of tangible assets, such as factories, logistics systems, customer service systems, and so on, but it also acquires valuable intangible assets including a local brand name and managers' knowledge of the business environment in that nation. Such knowledge can reduce the risk of mistakes caused by ignorance of the national culture.

Despite the arguments for making acquisitions, acquisitions often produce disappointing results.²⁹ For example, a study by Mercer Management Consulting looked at 150 acquisitions worth more than \$500 million each that were undertaken between January 1990 and July 1995.³⁰ The Mercer study concluded that 50 percent of these acquisitions eroded shareholder value, while another 33 percent created only marginal returns. Only 17 percent were judged to be successful. Similarly, a study by KPMG, an accounting and management consulting company, looked at 700 large acquisitions between 1996 and 1998. The study found that while some 30 percent of these actually created value for the acquiring company, 31 percent destroyed value, and the remainder had little impact.³¹ A similar study by McKenzie Co. estimated that some 70 percent of mergers and acquisitions failed to achieve expected revenue synergies.³² In a seminal study of the post-acquisition performance of acquired companies, David Ravenscraft and Mike Scherer concluded that on average the profits and market shares of acquired companies declined following acquisition.³³ They also noted that a smaller but substantial subset of those companies experienced traumatic difficulties, which ultimately led to their being sold by the acquiring company. Ravenscraft and Scherer's evidence suggests that many acquisitions destroy rather than create value. While most of this research has looked at domestic acquisitions, the findings probably also apply to cross-border acquisitions.³⁴

Why Do Acquisitions Fail? Acquisitions fail for several reasons. First, the acquiring firms often overpay for the assets of the acquired firm. The price of the target firm can get bid up if more than one firm is interested in its purchase, as is often the case. In addition, the management of the acquiring firm is often too optimistic about the value that can be created via an acquisition and is thus willing to pay a significant premium over a target firm's market capitalization. This is called the "hubris hypothesis" of why acquisitions fail. The hubris hypothesis postulates that top managers typically overestimate their ability to create value from an acquisition, primarily because rising to the top of a corporation has given them an exaggerated sense of their own capabilities.³⁵ For example, Daimler acquired Chrysler in 1998 for \$40 billion, a premium of 40 percent over the market value of Chrysler before the takeover bid. Daimler paid this much because it thought it could use Chrysler to help it grow market share in the United States. At the time, Daimler's management issued bold announcements about the "synergies" that would be created from combining the operations of the two companies. Executives believed they could attain greater scale economies from the global presence, take costs out of the German and U.S. operations, and boost the profitability of the combined entity. However, within a year of the acquisition, Daimler's German management was faced with a crisis at Chrysler,

which was suddenly losing money due to weak sales in the United States. In retrospect, Daimler's management had been far too optimistic about the potential for future demand in the U.S. auto market and about the opportunities for creating value from "synergies." Daimler acquired Chrysler at the end of a multiyear boom in U.S. auto sales and paid a large premium over Chrysler's market value just before demand slumped (and in 2007, in an admission of failure, Daimler sold its Chrysler unit to a private equity firm).³⁶

Second, many acquisitions fail because there is a clash between the cultures of the acquiring and acquired firm. After an acquisition, many acquired companies experience high management turnover, possibly because their employees do not like the acquiring company's way of doing things.³⁷ This happened at DaimlerChrysler; many senior managers left Chrysler in the first year after the merger. Apparently, Chrysler executives disliked the dominance in decision making by Daimler's German managers, while the Germans resented that Chrysler's American managers were paid two to three times as much as their German counterparts. These cultural differences created tensions, which ultimately exhibited themselves in high management turnover at Chrysler.³⁸ The loss of management talent and expertise can materially harm the performance of the acquired unit.³⁹ This may be particularly problematic in an international business, where management of the acquired unit may have valuable local knowledge that can be difficult to replace.

Third, many acquisitions fail because attempts to realize synergies by integrating the operations of the acquired and acquiring entities often run into roadblocks and take much longer than forecast. Differences in management philosophy and company culture can slow the integration of operations. Differences in national culture may exacerbate these problems. Bureaucratic haggling between managers also complicates the process. Again, this reportedly occurred at DaimlerChrysler, where grand plans to integrate the operations of the two companies were bogged down by endless committee meetings and by simple logistical considerations such as the six-hour time difference between Detroit and Germany. By the time an integration plan had been worked out, Chrysler was losing money, and Daimler's German managers suddenly had a crisis on their hands.

Finally, many acquisitions fail due to inadequate pre-acquisition screening.⁴⁰ Many firms decide to acquire other firms without thoroughly analyzing the potential benefits and costs. They often move with undue haste to execute the acquisition, perhaps because they fear another competitor may preempt them. After the acquisition, however, many acquiring firms discover that instead of buying a well-run business, they have purchased a troubled organization. This may be a particular problem in cross-border acquisitions because the acquiring firm may not fully understand the target firm's national culture and business system.

Reducing the Risks of Failure These problems can all be overcome if the firm is careful about its acquisition strategy.⁴¹ Screening of the foreign enterprise to be acquired, including a detailed auditing of operations, financial position, and management culture, can help to make sure the firm (1) does not pay too much for the acquired unit, (2) does not uncover any nasty surprises after the acquisition, and (3) acquires a firm whose organization culture is not antagonistic to that of the acquiring enterprise. It is also important for the acquirer to allay any concerns that management in the acquired enterprise might have. The objective should be to reduce unwanted management attrition after the acquisition. Finally, managers must move rapidly after an acquisition to put an integration plan in place and to act on that plan. Some people in both the acquiring and acquired units will try to slow or stop any integration efforts, particularly when losses of employment or management power

are involved, and managers should have a plan for dealing with such impediments before they arise.

PROS AND CONS OF GREENFIELD VENTURES The big advantage of establishing a greenfield venture in a foreign country is that it gives the firm a much greater ability to build the kind of subsidiary company that it wants. For example, it is much easier to build an organization culture from scratch than it is to change the culture of an acquired unit. Similarly, it is much easier to establish a set of operating routines in a new subsidiary than it is to convert the operating routines of an acquired unit. This is a very important advantage for many international businesses, where transferring products, competencies, skills, and know-how from the established operations of the firm to the new subsidiary are principal ways of creating value. For example, when Lincoln Electric, the U.S. manufacturer of arc welding equipment, first ventured overseas in the mid-1980s, it did so by acquisitions, purchasing arc welding equipment companies in Europe. However, Lincoln's competitive advantage in the United States was based on a strong organizational culture and a unique set of incentives that encouraged its employees to do everything possible to increase productivity. Lincoln found through bitter experience that it was almost impossible to transfer its organizational culture and incentives to acquired firms, which had their own distinct organizational cultures and incentives. As a result, the firm switched its entry strategy in the mid-1990s and began to enter foreign countries by establishing greenfield ventures, building operations from the ground up. While this strategy takes more time to execute, Lincoln has found that it yields greater long-run returns than the acquisition strategy.

Set against this significant advantage are the disadvantages of establishing a greenfield venture. Greenfield ventures are slower to establish. They are also risky. As with any new venture, a degree of uncertainty is associated with future revenue and profit prospects. However, if the firm has already been successful in other foreign markets and understands what it takes to do business in other countries, these risks may not be that great. For example, having already gained great knowledge about operating internationally, the risk to McDonald's of entering yet another country is probably not that great. Also, greenfield ventures are less risky than acquisitions in the sense that there is less potential for unpleasant surprises. A final disadvantage is the possibility of being preempted by more aggressive global competitors who enter via acquisitions and build a big market presence that limits the market potential for the greenfield venture.

MAKING A CHOICE The choice between acquisitions and greenfield ventures is not an easy one. Both modes have their advantages and disadvantages. In general, the choice will depend on the circumstances confronting the firm. If the firm is seeking to enter a market where there are already well-established incumbent enterprises, and where global competitors are also interested in establishing a presence, it may pay the firm to enter via an acquisition. In such circumstances, a greenfield venture may be too slow to establish a sizable presence. However, if the firm is going to make an



Another Perspective

Risks and Entering Foreign Markets

Business is all about risk, the right risks. Choosing which risks to accept and which to avoid is at the heart of management. These risks increase and become more interesting with entry into foreign markets. Scholar David Conklin discusses the idea of managing risk through planned uncertainty. By planned uncertainty he means an awareness of contingencies, with possible what-if scenarios developed in advance. The key idea here is that through an ongoing monitoring of the various risk areas, decision makers can have much of the data they may need to address a number of possible outcomes. Of course, we have to know what uncertainty to plan for, and we don't know what we don't know. Planning for everything is impossible, but what Conklin suggests is that planned uncertainty is a way of thinking. Given that we don't know the future, this way of thinking may be helpful in career development and other parts of our lives. Who ever said business wasn't like surfing?

acquisition, its management should be cognizant of the risks associated with acquisitions that were discussed earlier and consider these when determining which firms to purchase. It may be better to enter by the slower route of a greenfield venture than to make a bad acquisition.

If the firm is considering entering a country where there are no incumbent competitors to be acquired, then a greenfield venture may be the only mode. Even when incumbents exist, if the competitive advantage of the firm is based on the transfer of organizationally embedded competencies, skills, routines, and culture, it may still be preferable to enter via a greenfield venture. Things such as skills and organizational culture, which are based on significant knowledge that is difficult to articulate and codify, are much easier to embed in a new venture than they are in an acquired entity, where the firm may have to overcome the established routines and culture of the acquired firm. Thus, as our earlier examples suggest, firms such as McDonald's and Lincoln Electric prefer to enter foreign markets by establishing greenfield ventures.

Key Terms

timing of entry, p. 420

first-mover advantages, p. 420

first-mover disadvantages, p. 420

pioneering costs, p. 420

exporting, p. 425

turnkey project, p. 426

licensing, p. 427

franchising, p. 428

joint venture, p. 429

wholly owned

subsidiary, p. 431

Summary

The chapter made the following points:

1. Basic entry decisions include identifying which markets to enter, when to enter those markets, and on what scale.
2. The most attractive foreign markets tend to be found in politically stable developed and developing nations that have free market systems and where there is not a dramatic upsurge in either inflation rates or private-sector debt.
3. There are several advantages associated with entering a national market early, before other international businesses have established themselves. These advantages must be balanced against the pioneering costs that early entrants often have to bear, including the greater risk of business failure.
4. Large-scale entry into a national market constitutes a major strategic commitment that is likely to change the nature of competition in that market and limit the entrant's future strategic flexibility. Although making major strategic commitments can yield many benefits, there are also risks associated with such a strategy.
5. The six modes of entering a foreign market are exporting, creating turnkey projects, licensing, franchising, establishing joint ventures, and setting up a wholly owned subsidiary.
6. Exporting has the advantages of facilitating the realization of experience curve economies and of avoiding the costs of setting up manufacturing operations in another country. Disadvantages include high transport costs, trade barriers, and problems with local marketing agents.
7. Turnkey projects allow firms to export their process know-how to countries where FDI might be prohibited, thereby enabling the firm

to earn a greater return from this asset. The disadvantage is that the firm may inadvertently create efficient global competitors in the process.

8. The main advantage of licensing is that the licensee bears the costs and risks of opening a foreign market. Disadvantages include the risk of losing technological know-how to the licensee and a lack of tight control over licensees.
9. The main advantage of franchising is that the franchisee bears the costs and risks of opening a foreign market. Disadvantages center on problems of quality control of distant franchisees.
10. Joint ventures have the advantages of sharing the costs and risks of opening a foreign market and of gaining local knowledge and political influence. Disadvantages include the risk of losing control over technology and a lack of tight control.
11. The advantages of wholly owned subsidiaries include tight control over technological know-how. The main disadvantage is that the firm must bear all the costs and risks of opening a foreign market.
12. The optimal choice of entry mode depends on the firm's strategy. When technological know-how constitutes a firm's core competence, wholly owned subsidiaries are preferred, since they best control technology. When management know-how constitutes a firm's core competence, foreign franchises controlled by joint ventures seem to be optimal. When the firm is pursuing a global standardization or transnational strategy, the need for tight control over operations to realize location and experience curve economies suggests wholly owned subsidiaries are the best entry mode.
13. When establishing a wholly owned subsidiary in a country, a firm must decide whether to do so by a greenfield venture strategy or by acquiring an established enterprise in the target market.
14. Acquisitions are quick to execute, may enable a firm to preempt its global competitors, and involve buying a known revenue and profit stream. Acquisitions may fail when the acquiring firm overpays for the target, when the culture of the acquiring and acquired firms clash, when there is a high level of management attrition after the acquisition, and when there is a failure to integrate the operations of the acquiring and acquired firm.
15. The advantage of a greenfield venture in a foreign country is that it gives the firm a much greater ability to build the kind of subsidiary company that it wants. For example, it is much easier to build an organization culture from scratch than it is to change the culture of an acquired unit.

Critical Thinking and Discussion Questions

1. Review the Management Focus "Tesco's International Growth Strategy." Then answer the following questions:
 - a. Why did Tesco's initial international expansion strategy focus on developing nations?
 - b. How does Tesco create value in its international operations?
 - c. In Asia, Tesco has a long history of entering into joint-venture agreements with local partners. What are the benefits of doing this for Tesco? What are the risks? How are those risks mitigated?
 - d. In March 2006 Tesco announced it would enter the United States. This represents a departure from its historic strategy of focusing on developing nations. Why do you think Tesco made this decision? How is the U.S. market different from others Tesco has entered? What are the risks here? How do you think Tesco will do?
2. Licensing proprietary technology to foreign competitors is the best way to give up a firm's competitive advantage. Discuss.
3. Discuss how the need for control over foreign operations varies with firms' strategies and core competencies. What are the implications for the choice of entry mode?
4. A small Canadian firm that has developed 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 given below. The cost of investment in manufacturing facilities will be a major one for the Canadian firm, but it is not outside its reach. If these are the firm's only options, which one would you advise it to choose? Why?

- Manufacture the product at home and let foreign sales agents handle marketing.

- Manufacture the products at home and set up a wholly owned subsidiary in Europe to handle marketing.
- Enter into an alliance with a large European pharmaceutical firm. The product would be manufactured in Europe by the 50/50 joint venture and marketed by the European firm.

Research Task



<http://globalEDGE.msu.edu>

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

1. Entrepreneur magazine annually publishes a ranking of America's top 200 *franchisers* seeking international franchisees. Provide a list of the top 10 companies that pursue franchising as a mode of international expansion. Study one of these companies in detail and provide a description of its business model, its international expansion pattern, the qualifications it looks for in its franchisees, and the type of support and training it provides.
2. The U.S. Commercial Service prepares a series of reports titled the *Country Commercial Guide (CCG)* for each country of interest to U.S. investors. Utilize this guide to gather information on China. Imagine that your company is in agribusiness and is considering entering this country. Select the most appropriate entry method, supporting your decision with the information collected from the commercial guide.



closing case

General Electric's Joint Ventures

General Electric formerly entered a foreign market by either acquiring an established firm or establishing a greenfield subsidiary. Joint ventures with a local company were almost never considered. The prevailing philosophy was that without full control, the company didn't do the deal. However, times have changed. Since the early 2000s joint ventures have become one of the most powerful strategic tools in GE's arsenal. To enter the South Korean market, for example, GE Money, the retail lending arm of GE's financial services business, formed joint ventures with Hyundai to offer auto loans, mortgages, and credit cards. GE has a 43 percent stake in these ventures. Similarly, in Spain it has formed several joint ventures with local banks to provide consumer loans and credit cards to Spanish residents, and in Central America it has a joint venture with BAC-Credomatic, the largest bank in the region.

There are several reasons for the switch in strategy. For one thing, GE used to be able to buy its way into majority ownership in almost any business, but prices for acquisitions have been bid so high that GE is reluctant to acquire for fear

of overpaying. Better to form a joint venture, so the thinking goes, than risk paying too much for a company that turns out to have problems that are discovered only after the acquisition. Just as importantly, GE now sees joint ventures as a great way to dip its toe into foreign markets where it lacks local knowledge. Moreover, in certain nations, China being a case in point, economic, political, legal, and cultural considerations make joint ventures an easier option than either acquisitions or greenfield ventures. GE believes it can often benefit from the political contacts, local expertise, and business relationships that the local partner brings to the table, plus in certain sectors of the Chinese economy and some others, local laws prohibit other entry modes. GE also sees joint ventures as a good way to share the risk of building a business in a nation where it lacks local knowledge. Finally, under the leadership of CEO Jeffrey Immelt, GE has adopted aggressive growth goals, and it believes that entering via joint ventures into nations where it lacks a presence is the only way of attaining these goals. Fueled by its large number of joint

ventures, GE has rapidly expanded its international presence over the past decade. For the first time, in 2007 the company derived the majority of its revenue from foreign operations.

Of course, General Electric has done joint ventures in the past. For example, it has a long standing 50/50 joint venture with the French company Snecma to make engines for commercial jet aircraft, another with Fanuc of Japan to make controls for electrical equipment, and a third with Sea Containers of the United Kingdom, which has become one of the world's largest companies leasing shipping containers. But all of these ventures came about only after GE had explored other ways to gain access to particular markets or technology. Once the last option for GE, establishing joint ventures is now often the preferred entry strategy.

GE managers also note there is no shortage of partners willing to enter into a joint venture with the company. The company has a well-earned reputation for being a good partner. GE also is well known for its innovative management techniques and excellent management development programs. Many partners are happy to team up with GE to get access to this know-how. The knowledge flow goes both ways, with GE acquiring access to knowledge about local markets, and partners learning cutting-edge management techniques from GE that can be used to boost their own productivity.

Nevertheless, joint ventures are no panacea. GE's agreements normally give even the minority partner in a joint venture veto power over major strategic decisions, and control issues can scuttle some ventures. In January 2007, for example, GE announced it would enter into a venture with Britain's Smiths Group to make aerospace equipment. However, in September of the same year, GE ended talks aimed at establishing the venture, stating it could not reach an agreement

over the vision for the joint venture. GE has also found that as much as it would like majority ownership, or even a 50/50 split, sometimes it has to settle for a minority stake to gain access to a foreign market. In 2003, when GE entered into a joint venture with Hyundai Motor to offer auto loans, it did so as a minority partner even though it would have preferred a majority position. Hyundai had refused to cede control to GE.

Sources: C. H. Deutsch, "The Venturesome Giant," *The New York Times*, October 5, 2007, pp. C1, C8; "Odd Couple: Jet Engines," *The Economist*, May 5, 2007, p. 72; and "GE, BAC Joint Venture to Buy Banco Mercantil," *Financial Wire*, January 11, 2007, p. 1.

Case Discussion Questions

1. GE used to prefer acquisitions or greenfield ventures as an entry mode, rather than joint ventures. Why do you think this was the case?
2. Why do you think GE has come to favor joint ventures in recent years? Do you think the global economic crisis of 2008–2009 might have impact this preference in any way? If so, how?
3. What are the risks that GE must assume when it enters into a joint venture? Is there any way for GE to reduce these risks?
4. The case mentions that GE has a well-earned reputation for being a good partner. What are the likely benefits of this reputation to GE? If GE were to tarnish its reputation by, for example, opportunistically taking advantage of a partner, how might this impact the company going forward?
5. In addition to its reputation for being a good partner, what other assets do you think GE brings to the table that make it an attractive joint-venture partner?



part 5

Competing in a Global Marketplace

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Explain the promises and risks associated with exporting.
- 2 Identify the steps managers can take to improve their firm's export performance.
- 3 Identify information sources and government programs that exist to help exporters.
- 4 Recognize the basic steps involved in export financing.
- 5 Describe how countertrade can be used to facilitate exporting.

Exporting, Importing, and Countertrade

Vellus Products

opening case

Vellus Products was founded in 1991 in Columbus, Ohio, by Sharon Doherty to sell shampoo for pets. Doherty's original insight was that shampoos for people don't work well on pets because the skin of most animals is more sensitive than that of humans and becomes easily irritated. Because of her experience showing dogs, she knew that most existing pet shampoo left dog hair unmanageable and lacking the glamour needed for a dog show. Working with her nephew, who had a Ph.D. in chemistry, Doherty developed salon-type formulas specially suited to dogs (shampoo for horses was added later).

Doherty booked Vellus's first export sales in 1993 when a Taiwanese businessman, who had bought the shampoo in the United States, ordered \$25,000 worth of product, which he wanted to sell at dog shows in Taiwan. Before long, Doherty was getting calls from people around the world, most of whom heard about Vellus's products in dog shows, and a thriving export business was born.

As the volume of inquiries built up, Doherty realized she needed to gain a better understanding of foreign markets, export potential, and financing options, so she contacted the U.S. Department of Commerce's Commercial Service offices in Columbus. "As business has grown, I have gone from ordering country profiles to requesting customized exporting and financing strategies tailored to maximize export potential," she says. Today Vellus exports to 28 nations, although the bulk of the firm's international business operates through distributors in Sweden, Finland, Britain, France, Germany, Australia, New Zealand, Canada, and Iceland, where the products are marketed at pet shows and exhibitions. The company has registered its trademark in 15 European countries, and international sales account for more than half the firm's total. "I credit the Commercial Service for helping me to expand my exports, as it would have been much more difficult on my own," Doherty says.

Reflecting on her international success, Doherty has some advice for others who might want to go down the same road. First, she says, know whom you are dealing with. Relationships are important to successful exporting. Doherty says she gives advice and guidance to her distributors, sharing her knowledge and helping them to be successful. Second, having being duped by a man who falsely claimed he knew the pet market, she advocates doing background checks on potential business partners. "Gather as much information as you can," she says. "Don't make any assumptions; the wrong choice can cost your business valuable time and money." Third, Doherty believes it is important to learn the local culture. Vellus products are adapted to best suit different grooming techniques in different countries, something she believes has helped to make the company more successful. Finally, Doherty says, enjoy the ride! "I love exporting because it has enabled me to meet so many people from other cultures. Exporting has made me more broad-minded, and I have developed a great appreciation for other cultures and the way others live their lives." ●

Sources: U.S. Department of Commerce Web site, "Vellus Products Inc.," www.export.gov, accessed March 16, 2010; C. K. Cultice, "Best in Show: Vellus Products," *World Trade*, January 2007, pp. 70–73; and C. K. Cultice, "Lathering up World Markets," *Business America*, July 1997, p. 33.



Introduction

In the previous chapter, we reviewed exporting from a strategic perspective. We considered exporting as just one of a range of strategic options for profiting from international expansion. This chapter is more concerned with the nuts and bolts of exporting (and importing). Here we look at how to export. As the opening case makes clear, exporting is not just for large enterprises; many small entrepreneurial firms such as Vellus Products have benefited significantly from the money-making opportunities of exporting.

The volume of export activity in the world economy has increased as exporting has become easier. The gradual decline in trade barriers under the umbrella of GATT and now the WTO (see Chapter 6) along with regional economic agreements such as the European Union and the North American Free Trade Agreement (see Chapter 8) have significantly increased export opportunities. At the same time, modern communication and transportation technologies have alleviated the logistical problems associated with exporting. Firms are increasingly using the World Wide Web, toll-free phone numbers, and international air express services to reduce the costs of exporting. Consequently, it is no longer unusual to find small companies that are thriving as exporters.



Another Perspective

Autarky: Not in the Vocabulary of Globalization!

The word *autarky* refers to the belief that a country should be self-sufficient and avoid trade with other nations. Most economists regard autarky as an idealistic, but impractical, goal. Throughout history, countries have tried to achieve autarky, but soon discovered they could not produce the wide range of goods their population wants *and* make those goods available at competitive prices. In fact, those countries found themselves worse off economically than nations that engage in international trade. Word to the wise: Unless your country can efficiently produce everything it needs, it needs to trade. ("Economics A-Z," www.economist.com)

Nevertheless, exporting remains a challenge for many firms. Smaller enterprises can find the process intimidating. The firm wishing to export must identify foreign market opportunities, avoid a host of unanticipated problems that are often associated with doing business in a foreign market, familiarize itself with the mechanics of export and import financing, learn where to find financing and export credit insurance, and learn how it should deal with foreign exchange risk. The process can be made more problematic by currencies that are not freely convertible. Arranging payment for exports to countries with weak currencies can be a problem. This brings us to the topic of countertrade, by which payment for exports is received in goods and services rather than money. In this chapter, we will discuss all these issues with the exception of foreign exchange risk, which was covered in Chapter 10. We open the chapter by considering the promise and pitfalls of exporting.

The Promise and Pitfalls of Exporting

The great promise of exporting is that large revenue and profit opportunities are to be found in foreign markets for most firms in most industries. This was true for the company profiled in the opening case. The international market is normally so much larger than the firm's domestic market that exporting is nearly always a way to increase the company's revenue and profit base. By expanding the size of the market, exporting can enable a firm to achieve economies of scale, thereby lowering its unit costs. Firms that do not export often lose out on significant opportunities for growth and cost reduction.¹

Studies have shown that while many large firms tend to be proactive about seeking opportunities for profitable exporting, systematically scanning foreign markets to find ways to leverage their technology, products, and marketing skills in foreign countries, many medium-sized and small firms are very reactive.² Typically, such reactive firms do not even consider exporting until their domestic market is saturated and the emergence of excess productive capacity at home forces them to look for growth opportunities in foreign markets. Also, many small and medium-sized firms tend to wait for the world to come to them, rather than going out into the world to seek opportunities. Even when the world does come to them, they may not respond. An example is MMO Music Group, which makes sing-along tapes for karaoke machines. Foreign sales accounted for about 15 percent of MMO's revenues of \$8 million, but the firm's CEO admits that this figure would probably have been much higher had he paid attention to building international sales. Unanswered faxes and phone messages from Asia and Europe often piled up while he was trying to manage the burgeoning domestic side of the business. By the time MMO did turn its attention to foreign markets, other competitors had stepped into the breach and MMO found it tough going to build export volume.³

MMO's experience is common, and it suggests a need for firms to become more proactive about seeking export opportunities. One reason more firms are not proactive is that they are unfamiliar with foreign market opportunities; they simply do not know how big the opportunities actually are or where they might lie. Simple ignorance of the potential opportunities is a huge barrier to exporting.⁴ Also, many would-be exporters, particularly smaller firms, are often intimidated by the complexities and mechanics of exporting to countries where business practices, language, culture, legal systems, and currency are very different from the home market.⁵ This combination of unfamiliarity and intimidation probably explains why exporters still account for only a tiny percentage of U.S. firms, less than 5 percent of firms with fewer than 500 employees, according to the Small Business Administration.⁶

To make matters worse, many neophyte exporters run into significant problems when first trying to do business abroad, and this sours them on future exporting ventures. Common pitfalls include poor market analysis, a poor understanding of competitive

LEARNING OBJECTIVE 1

Explain the promises and risks associated with exporting.



FCX Systems' Success Story

Founded with the help of a \$20,000 loan from the Small Business Administration, FCX Systems is an exporting success story. FCX makes power converters for the aerospace industry. These devices convert common electric utility frequencies into the higher frequencies used in aircraft systems and are primarily used to provide power to aircraft while they are on the ground. Today the West Virginia enterprise generates over half of its \$20 million in annual sales from exports to more than 50 countries. FCX's prowess in opening foreign markets has earned the company several awards for export excellence, including a presidential award for achieving extraordinary growth in export sales.

FCX initially got into exporting because it found that foreigners were often more receptive to the company's products than potential American customers. According to Don Gallion, president of FCX, "In the overseas market, they were looking for a good technical product, preferably made in the U.S., but they weren't asking questions about 'How long have you been in business? Are you still going to be here tomorrow?' They were just anxious to get the product."

In 1989, soon after FCX's founding, the company signed on with an international distribution company to help with exporting, but Gallion became disillusioned with that company, and in 1994 FCX started to handle the exporting process on its own. At the time, exports represented 12 percent of sales, but by 1997 they had jumped to more than 50 percent of the total, where they have stayed since.

In explaining the company's export success, Gallion cites a number of factors. One was the extensive assistance that FCX has received over the years from a number of federal and state agencies, including the U.S. Department of Commerce and the Development Office of West Virginia.

These agencies demystified the process of exporting and provided good contacts for FCX. Finding a good local representative to help work through local regulations and customs is another critical factor, according to Gallion, who says, "A good rep will keep you out of trouble when it comes to customs and what you should and shouldn't do." Persistence is also very important, says Gallion, particularly when trying to break into markets where personal relationships are crucial, such as China.

China has been an interesting story for FCX. Recently the company has been booking \$2 million to \$3 million in sales to China, but it took years to get to this point. China had been on Gallion's radar screen since the early 1990s, primarily because of the country's rapid modernization and its plans to build or remodel some 179 airports between 1998 and 2008. This constituted a potentially large market for FCX, particularly compared with the United States where perhaps only three new airports would be built during the same period. Despite the scale of the opportunity, progress was very slow. The company had to identify airports and airline projects, government agencies, customers, and decision makers, as well as work through different languages—and make friends. According to Gallion, "Only after they consider you a friend will they buy a product. They believe a friend would never cheat you." To make friends in China, Gallion estimates he had to make more than 100 trips to China since the early 1990s, but now that the network has been established, it is starting to pay dividends.

Sources: J. Sparshott, "Businesses Must Export to Compete," *The Washington Times*, September 1, 2004, p. C8; "Entrepreneur of the Year 2001: Donald Gallion, FCX Systems," *The State Journal*, June 18, 2001, p. S10; and T. Pierro, "Exporting Powers Growth of FCX Systems," *The State Journal*, April 6, 1998, p. 1.

conditions in the foreign market, a failure to customize the product offering to the needs of foreign customers, lack of an effective distribution program, a poorly executed promotional campaign, and problems securing financing.⁷ Novice exporters tend to underestimate the time and expertise needed to cultivate business in foreign countries.⁸ Few realize the amount of management resources that have to be dedicated to this activity. Many foreign customers require face-to-face negotiations on their home turf. An exporter may have to spend months learning about a country's trade regulations, business practices, and more before a deal can be closed. The accompanying Management Focus, which documents the experience of FCX Systems in China, suggests that it may take years before foreigners are comfortable enough to purchase in significant quantities.

Exporters often face voluminous paperwork, complex formalities, and many potential delays and errors. According to a UN report on trade and development, a typical international trade transaction may involve 30 parties, 60 original documents, and

360 document copies, all of which have to be checked, transmitted, reentered into various information systems, processed, and filed. The United Nations has calculated that the time involved in preparing documentation, along with the costs of common errors in paperwork, often amounts to 10 percent of the final value of goods exported.⁹

Improving Export Performance

Inexperienced exporters have a number of ways to gain information about foreign market opportunities and avoid common pitfalls that tend to discourage and frustrate novice exporters.¹⁰ In this section, we look at information sources for exporters to increase their knowledge of foreign market opportunities, we consider the pros and cons of using export management companies (EMCs) to assist in the export process, and we review various exporting strategies that can increase the probability of successful exporting. We begin, however, with a look at how several nations try to help domestic firms export.

AN INTERNATIONAL COMPARISON One big impediment to exporting is the simple lack of knowledge of the opportunities available. Often there are many markets for a firm's product, but because they are in countries separated from the firm's home base by culture, language, distance, and time, the firm does not know of them. Identifying export opportunities is made even more complex because more than 200 countries with widely differing cultures compose the world of potential opportunities. Faced with such complexity and diversity, firms sometimes hesitate to seek export opportunities.

The way to overcome ignorance is to collect information. In Germany, one of the world's most successful exporting nations, trade associations, government agencies, and commercial banks gather information, helping small firms identify export opportunities. A similar function is provided by the Japanese Ministry of International Trade and Industry (MITI), which is always on the lookout for export opportunities. In addition, many Japanese firms are affiliated in some way with the *sogo shosha*, Japan's great trading houses. The *sogo shosha* have offices all over the world, and they proactively, continuously seek export opportunities for their affiliated companies large and small.¹¹

German and Japanese firms can draw on the large reservoirs of experience, skills, information, and other resources of their respective export-oriented institutions. Unlike their German and Japanese competitors, many U.S. firms are relatively blind when they seek export opportunities; they are information disadvantaged. In part, this reflects historical differences. Both Germany and Japan have long made their living as trading nations, whereas until recently the United States has been a relatively self-contained continental economy in which international trade played a minor role. This is changing; both imports and exports now play a greater role in the U.S. economy than they did 20 years ago. However, the United States has not yet evolved an institutional structure for promoting exports similar to that of either Germany or Japan.

INFORMATION SOURCES Despite institutional disadvantages, U.S. firms can increase their awareness of export opportunities. The most comprehensive source of information is the U.S. Department of Commerce and its

LEARNING OBJECTIVE 2

Identify the steps managers can take to improve their firm's export performance.

Sogo Shosha

Japan's great trading houses.

LEARNING OBJECTIVE 3

Identify information sources and government programs that exist to help exporters.



Another Perspective

Product Safety: An Exporting Pitfall

Manufacturers in China have experienced a string of recalls from products they exported in recent years. Among the unsafe items were toys containing lead paint; pet food contaminated with melamine; packaged dumplings found to have traces of insecticide; and high levels of toxic cadmium in children's jewelry. The U.S. Consumer Products Safety Commission and the Department of Housing and Urban Development advised homeowners in several states to replace certain types of Chinese-made drywall. Used widely by contractors after hurricanes swept through the South, the drywall has been linked to respiratory and electrical problems because of unsafe levels of hydrogen sulfide. (Javier C. Hernandez, "U.S. Urges Homeowners to Remove Chinese Drywall," *The New York Times*, April 2, 2010, www.nytimes.com)

EXPORT.GOV

Helping U.S. Companies Export

Register | Manage Your Account

Search Export.gov

Advanced Search

Home

About Us | Partner Agencies | Contact Us | FAQ | Non-U.S. Companies

Find Opportunities

By Industry

Market Research

Trade Events

Trade Leads

Find Solutions

International Sales-Marketing

International Finance

International Logistics

Licenses & Regulations

Trade Data & Analysis

Trade Problems

Contact Us

1-800-USA Trade

Find a Local U.S. Office

Find an Overseas Office

U.S. EXPORTS

customers ★ profits ★ success

What's New with the National Export Initiative (NEI)

The National Export Initiative (NEI) is an initiative to improve conditions that directly affect the private sector's ability to export. There is always something going on with the NEI. Here are a few highlights:

Historic Ex-Im Bank Loan Helps Centennial, Colorado Company Export to Saudi Arabia, Sustain 230 Jobs at Home

Are you looking to learn more about the Export-Import Bank and their programs to help you export? Attend their seminars and trade events to learn more.

Where Will Your Next Customer Come From? Look Around the World – Check out SBA's video, podcasts, and free courses that walk you through the export process

Learn more about exporting with the Basic Guide to Exporting Webinar Series

What's New in Exporting

Sign up for Export.gov email updates

Register for Boston Seminar: Leveraging Your Website to Increase International Sales

Register for Webinar: Census' Foreign Trade Regulations Webinar Series (Presented in Spanish)

Commercial News USA Offers Free French Translation

Export University: Educating Towards Export Excellence

Video and Audio Programs

Spotlights

Trade Mission to Iraq

Register by 7/19/10

Trade Mission to Saudi Arabia

Register by 9/15/10

Mandatory Screening of Cargo on Passenger Flights

CCSP

Global Insights: Roy Paulson

Exporting 101

Export Basics

Export Programs Guide

Watch Export Webinars

What are HS Codes

Find Tariffs and Taxes

I Want To

Promote My Products Overseas

Fill out a NAFTA Certificate

File a Trade Complaint

Protect my IPR

Get USG Advocacy

Prominent Markets

China

India

Africa

FTA Countries

Other Country Information

President Obama Visits Solyndra, Inc

Submit Feedback | Social Media | Privacy Policy | Disclaimer | USA.gov | Site Map | Download Adobe Reader

One of the biggest challenges for U.S. businesses trying to go global is finding the right information. The U.S. government provides assistance and links to other helpful sources on its www.export.gov Web site.

district offices all over the country (as noted in the opening case, Vellus Products used these services and credits them with the company's international successes). Within that department are two organizations dedicated to providing businesses with intelligence and assistance for attacking foreign markets: the International Trade Administration and the United States and Foreign Commercial Service.

These agencies provide the potential exporter with a "best prospects" list, which gives the names and addresses of potential distributors in foreign markets along with businesses they are in, the products they handle, and their contact person. In addition, the Department of Commerce has assembled a "comparison shopping service" for 14 countries that are major markets for U.S. exports. For a small fee, a firm can receive a customized market research survey on a product of its choice. This survey provides information on marketability, the competition, comparative prices, distribution channels, and names of potential sales representatives. Each study is conducted on-site by an officer of the Department of Commerce.

The Department of Commerce also organizes trade events that help potential exporters make foreign contacts and explore export opportunities. The department

448 Part Five Competing in a Global Marketplace



Management FOCUS

Exporting with a Little Government Help

Exporting can seem like a daunting prospect, but the reality is that in the United States, as in many other countries, many small enterprises have built profitable export businesses. For example, Landmark Systems of Virginia had virtually no domestic sales before it entered the European market. Landmark had developed a software program for IBM mainframe computers and located an independent distributor in Europe to represent its product. In the first year, 80 percent of sales were attributed to exporting. In the second year, sales jumped from \$100,000 to \$1.4 million—with 70 percent attributable to exports. Landmark is not alone; government data suggest that in the United States by 2007, nearly 97 percent of the 240,000 firms that exported were small or medium-sized businesses that employed fewer than 500 people. Their share of total U.S. exports grew steadily over the last decade and reached 29 percent by the mid-2000s.

To help jump-start the exporting process, many small companies have drawn on the expertise of government agencies, financial institutions, and export management companies. Consider the case of Novi, Inc., a California-based business. Company President Michael Stoff tells how he utilized the services of the U.S. Small Business Administration (SBA) Office of International Trade to start exporting: “When I began my business venture, Novi, Inc., I knew that my Tune-Tote (a stereo system for bicycles) had the potential to be successful in international markets. Although I had no prior experience in this area, I began researching and collecting information on international markets. I was willing to learn, and by targeting key sources for information and guidance, I was able to penetrate international markets in a short period of time. One vital source I used from the beginning was the SBA.

Through the SBA I was directed to a program that dealt specifically with business development—the Service Corps of Retired Executives (SCORE). I was assigned an adviser who had run his own import/export business for 30 years. The services of SCORE are provided on a continual basis and are free.

“As I began to pursue exporting, my first step was a thorough marketing evaluation. I targeted trade shows with a good presence of international buyers. I also went to DOC (Department of Commerce) for counseling and information about the rules and regulations of exporting. I advertised my product in ‘Commercial News USA,’ distributed through U.S. embassies to buyers worldwide. I utilized DOC’s World Traders Data Reports to get background information on potential foreign buyers. As a result, I received 60 to 70 inquiries about Tune-Tote from around the world. Once I completed my research and evaluation of potential buyers, I decided which ones would be most suitable to market my product internationally. Then I decided to grant exclusive distributorship. In order to effectively communicate with my international customers, I invested in a fax. I chose a U.S. bank to handle international transactions. The bank also provided guidance on methods of payment and how best to receive and transmit money. This is essential know-how for anyone wanting to be successful in foreign markets.”

In just one year of exporting, export sales at Novi topped \$1 million and increased 40 percent in the second year of operations. Today, Novi, Inc., is a large distributor of wireless intercom systems that exports to more than 10 countries.

Sources: Small Business Administration Office of International Trade, “Guide to Exporting,” www.sba.gov/oit/info/Guide-ToExporting/index.html; U.S. Department of Commerce, “A Profile of U.S. Exporting Companies, 2000–2001,” February 2003, report available at www.census.gov/foreign-trade/aip/index.html#profile; and *The 2007 National Exporting Strategy* (Washington, DC: U.S. International Trade Commission, 2007).

organizes exhibitions at international trade fairs, which are held regularly in major cities worldwide. The department also has a matchmaker program, in which department representatives accompany groups of U.S. businesspeople abroad to meet with qualified agents, distributors, and customers.

Another government organization, the Small Business Administration (SBA), can help potential exporters (see the accompanying Management Focus for examples of the SBA’s work). The SBA employs 76 district international trade officers and 10 regional international trade officers throughout the United States as well as a 10-person international trade staff in Washington, D.C. Through its Service Corps of Retired Executives (SCORE) program, the SBA also oversees some 850 volunteers with international trade experience to provide one-on-one counseling to active and new-to-export businesses.

The SBA also coordinates the Export Legal Assistance Network (ELAN), a nationwide group of international trade attorneys who provide free initial consultations to small businesses on export-related matters.

In addition to the Department of Commerce and SBA, nearly every state and many large cities maintain active trade commissions whose purpose is to promote exports. Most of these provide business counseling, information gathering, technical assistance, and financing. Unfortunately, many have fallen victim to budget cuts or to turf battles for political and financial support with other export agencies.

A number of private organizations are also beginning to provide more assistance to would-be exporters. Commercial banks and major accounting firms are more willing to assist small firms in starting export operations than they were a decade ago. In addition, large multinationals that have been successful in the global arena are typically willing to discuss opportunities overseas with the owners or managers of small firms.¹²

LEARNING OBJECTIVE 2

Identify the steps managers can take to improve their firm's export performance.

Export Management Company

Export specialists who act as the export marketing department for client firms.

UTILIZING EXPORT MANAGEMENT COMPANIES One way for first-time exporters to identify the opportunities associated with exporting and to avoid many of the associated pitfalls is to hire an **export management company (EMC)**. EMCs are export specialists who act as the export marketing department or international department for their client firms. EMCs normally accept two types of export assignments. They start exporting operations for a firm with the understanding that the firm will take over operations after they are well established. In another type, start-up services are performed with the understanding that the EMC will have continuing responsibility for selling the firm's products. Many EMCs specialize in serving firms in particular industries and in particular areas of the world. Thus, one EMC may specialize in selling agricultural products in the Asian market, while another may focus on exporting electronics products to Eastern Europe. MD International, for example, focuses on selling medical equipment to Latin America.

In theory, the advantage of EMCs is that they are experienced specialists who can help the neophyte exporter identify opportunities and avoid common pitfalls. A good EMC will have a network of contacts in potential markets, have multilingual employees, have a good knowledge of different business mores, and be fully conversant with the ins and outs of the exporting process and with local business regulations. However, the quality of EMCs varies.¹³ While some perform their functions very well, others appear to add little value to the exporting company. Therefore, an exporter should review carefully a number of EMCs and check references. One drawback of relying on EMCs is that the company can fail to develop its own exporting capabilities.

LEARNING OBJECTIVE 2

Identify the steps managers can take to improve their firm's export performance.

EXPORT STRATEGY In addition to using EMCs, a firm can reduce the risks associated with exporting if it is careful about its choice of export strategy.¹⁴ A few guidelines can help firms improve their odds of success. For example, one of the most successful exporting firms in the world, the Minnesota Mining and Manufacturing Co. (3M), has built its export success on three main principles—enter on a small scale to reduce risks, add additional product lines once the exporting operations start to become successful, and hire locals to promote the firm's products (3M's export strategy is profiled in the accompanying Management Focus). Another successful exporter, Red Spot Paint & Varnish, emphasizes the importance of cultivating personal relationships when trying to build an export business (see the Management Focus at the end of this section).



Management FOCUS

Export Strategy at 3M

The Minnesota Mining and Manufacturing Co. (3M), which makes more than 40,000 products including tape, sandpaper, medical products, and the ever-present Post-it Notes, is one of the world's great multinational operations. Today over 60 percent of the firm's revenues are generated outside the United States. Although the bulk of these revenues came from foreign-based operations, 3M remains a major exporter with over \$2 billion in exports. The company often uses its exports to establish an initial presence in a foreign market, only building foreign production facilities once sales volume rises to a level that justifies local production.

The export strategy is built around simple principles. One is known as "FIDO," which stands for First In (to a new market) Defeats Others. The essence of FIDO is to gain an advantage over other exporters by getting into a market first and learning about that country and how to sell there before others do. A second principle is "make a little, sell a little," which is the idea of entering on a small scale with a very modest investment and pushing one basic product, such as reflective sheeting for traffic signs in Russia or scouring pads in Hungary. Once 3M believes it has learned enough about the market to reduce the risk of failure to reasonable levels, it adds additional products.

A third principle at 3M is to hire local employees to sell the firm's products. The company normally sets up a local sales subsidiary to handle its export activities in a country. It then

staffs this subsidiary with local hires because it believes they are likely to have a much better idea of how to sell in their own country than American expatriates. Because of the implementation of this principle, less than 200 of 3M's 40,000-plus foreign employees are U.S. expatriates.

Another common practice at 3M is to formulate global strategic plans for the export and eventual overseas production of its products. Within the context of these plans, 3M gives local managers considerable autonomy to find the best way to sell the product within their country. Thus, when 3M first exported its Post-it Notes, it planned to "sample the daylights" out of the product, but it also told local managers to find the best way of doing this. Local managers hired office cleaning crews to pass out samples in Great Britain and Germany; in Italy, office products distributors were used to pass out free samples; while in Malaysia, local managers employed young women to go from office to office handing out samples of the product. In typical 3M fashion, when the volume of Post-it Notes was sufficient to justify it, exports from the United States were replaced by local production. Thus, after several years 3M found it worthwhile to set up production facilities in France to produce Post-it Notes for the European market.

Sources: R. L. Rose, "Success Abroad," *The Wall Street Journal*, March 29, 1991, p. A1; T. Eiben, "US Exporters Keep On Rolling," *Fortune*, June 14, 1994, pp. 128–31; 3M Company, *A Century on Innovation*, 3M, 2002; and 2005 10K form archived at 3M's Web site at www.mmm.com.

The probability of exporting successfully can be increased dramatically by taking a handful of simple strategic steps. First, particularly for the novice exporter, it helps to hire an EMC or at least an experienced export consultant to help identify opportunities and navigate the paperwork and regulations so often involved in exporting. Second, it often makes sense to initially focus on one market or a handful of markets. Learn what is required to succeed in those markets before moving on to other markets. The firm that enters many markets at once runs the risk of spreading its limited management resources too thin. The result of such a shotgun approach to exporting may be a failure to become established in any one market. Third, as with 3M, it often makes sense to enter a foreign market on a small scale to reduce the costs of any subsequent failure. Most importantly, entering on a small scale provides the time and opportunity to learn about the foreign country before making significant capital commitments to that market. Fourth, the exporter needs to recognize the time and managerial commitment involved in building export sales and should hire additional personnel to oversee this activity. Fifth, in many countries, it is important to devote a lot of attention to building strong and enduring relationships with local distributors and/or customers (see the Management Focus on Red Spot Paint for an example). Sixth, as 3M often does, it is important to hire local personnel to help the firm establish itself in a foreign market. Local people are likely to have a much greater sense of how to do business in a given



Management FOCUS

Red Spot Paint & Varnish

Established in 1903 and based in Evansville, Indiana, Red Spot Paint & Varnish Company is in many ways typical of the companies that can be found in the small towns of America's heartland. The closely held company, whose CEO, Charles Storms, is the great-grandson of the founder, has 500 employees and annual sales of close to \$90 million. The company's main product is paint for plastic components used in the automobile industry. Red Spot products are seen on automobile bumpers, wheel covers, grilles, headlights, instrument panels, door inserts, radio buttons, and other components. Unlike many other companies of a similar size and location, however, Red Spot has a thriving international business. International sales (which include exports and local production by licensees) now account for between 15 percent and 25 percent of revenue in any one year, and Red Spot does business in about 15 countries.

Red Spot has long had some international sales and once won an export award. To further its international business, Red Spot hired a Central Michigan University professor, Bryan Williams. Williams, who was hired because of his foreign-language skills (he speaks German, Japanese, and some Chinese), was the first employee at Red Spot whose exclusive focus was international marketing and sales. His first challenge was the lack of staff skilled in the business of exporting. He found that it was difficult to build an international business without in-house expertise in the basic mechanics of exporting. According to Williams, Red Spot needed people who understood the nuts and bolts of

exporting—letters of credit, payment terms, bills of lading, and so on. As might be expected for a business based in the heartland of America, no ready supply of such individuals was in the vicinity. It took Williams several years to solve this problem. Now Red Spot has a full-time staff of two who have been trained in the principles of exporting and international operations.

A second problem that Williams encountered was the clash between the quarter-to-quarter mentality that frequently pervades management practice in the United States and the long-term perspective that is often necessary to build a successful international business. Williams has found that building long-term personal relationships with potential foreign customers is often the key to getting business. When foreign customers visit Evansville, Williams often invites them home for dinner. His young children started calling one visitor from Hong Kong "Uncle." Even with such efforts, however, the business may not come quickly. Meeting with potential foreign customers yields no direct business 90 percent of the time, although Williams points out that it often yields benefits in terms of competitive information and relationship building. He has found that perseverance pays. For example, Williams and Storms called on a major German automobile parts manufacturer for seven years before finally landing some business from the company.

Sources: R. L. Rose and C. Quintanilla, "More Small U.S. Firms Take Up Exporting with Much Success," *The Wall Street Journal*, December 20, 1996, p. A1, A10; and interview with Bryan Williams of Red Spot Paint.

country than a manager from an exporting firm who has previously never set foot in that country. Seventh, several studies have suggested the firm needs to be proactive about seeking export opportunities.¹⁵ Armchair exporting does not work! The world will not normally beat a pathway to your door. Finally, it is important for the exporter to retain the option of local production. Once exports reach a sufficient volume to justify cost-efficient local production, the exporting firm should consider establishing production facilities in the foreign market. Such localization helps foster good relations with the foreign country and can lead to greater market acceptance. Exporting is often not an end in itself, but merely a step on the road toward establishment of foreign production (again, 3M provides an example of this philosophy).

LEARNING OBJECTIVE 4

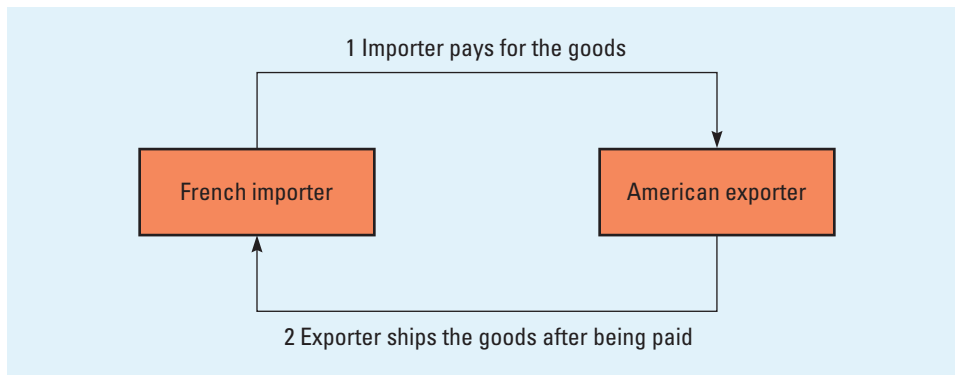
Recognize the basic steps involved in export financing.

Export and Import Financing

Mechanisms for financing exports and imports have evolved over the centuries in response to a problem that can be particularly acute in international trade: the lack of trust that exists when one must put faith in a stranger. In this section, we examine the financial devices that have evolved to cope with this problem in the context of international

13.1 figure

Preference of the U.S.
Exporter



trade: the letter of credit, the draft (or bill of exchange), and the bill of lading. Then we will trace the 14 steps of a typical export–import transaction.¹⁶

LACK OF TRUST Firms engaged in international trade have to trust someone they may have never seen, who lives in a different country, who speaks a different language, who abides by (or does not abide by) a different legal system, and who could be very difficult to track down if he or she defaults on an obligation. Consider a U.S. firm exporting to a distributor in France. The U.S. businessman might be concerned that if he ships the products to France before he receives payment from the French businesswoman, she might take delivery of the products and not pay him. Conversely, the French importer might worry that if she pays for the products before they are shipped, the U.S. firm might keep the money and never ship the products or might ship defective products. Neither party to the exchange completely trusts the other. This lack of trust is exacerbated by the distance between the two parties—in space, language, and culture—and by the problems of using an underdeveloped international legal system to enforce contractual obligations.

Due to the (quite reasonable) lack of trust between the two parties, each has his or her own preferences as to how the transaction should be configured. To make sure he is paid, the manager of the U.S. firm would prefer the French distributor to pay for the products before he ships them (see Figure 13.1). Alternatively, to ensure she receives the products, the French distributor would prefer not to pay for them until they arrive (see Figure 13.2). Thus, each party has a different set of preferences. Unless there is some way of establishing trust between the parties, the transaction might never occur.

13.2 figure

Preference of the
French Importer

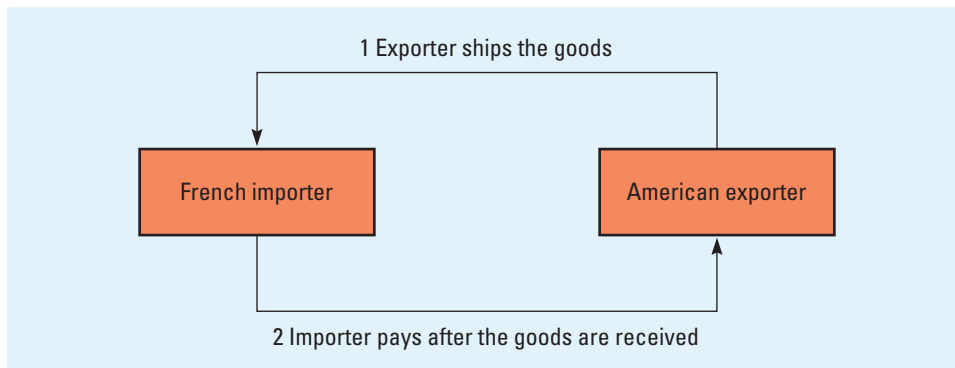
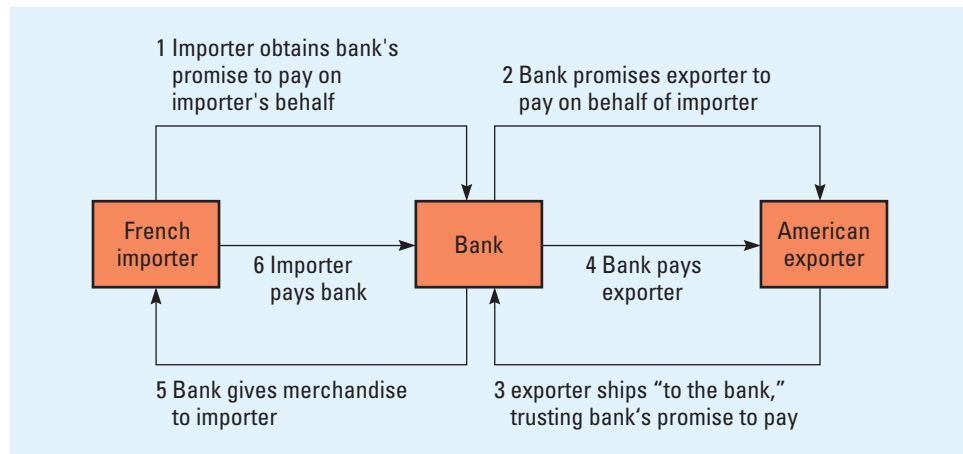


figure 13.3

The Use of a Third Party



The problem is solved by using a third party trusted by both—normally a reputable bank—to act as an intermediary. What happens can be summarized as follows (see Figure 13.3). First, the French importer obtains the bank’s promise to pay on her behalf, knowing the U.S. exporter will trust the bank. This promise is known as a letter of credit. Having seen the letter of credit, the U.S. exporter now ships the products to France. Title to the products is given to the bank in the form of a document called a bill of lading. In return, the U.S. exporter tells the bank to pay for the products, which the bank does. The document for requesting this payment is referred to as a draft. The bank, having paid for the products, now passes the title on to the French importer, whom the bank trusts. At that time or later, depending on their agreement, the importer reimburses the bank. In the remainder of this section, we examine how this system works in more detail.

LETTER OF CREDIT A letter of credit, abbreviated as L/C, stands at the center of international commercial transactions. Issued by a bank at the request of an importer, the **letter of credit** states that the bank will pay a specified sum of money to a beneficiary, normally the exporter, on presentation of particular, specified documents.

Consider again the example of the U.S. exporter and the French importer. The French importer applies to her local bank, say, the Bank of Paris, for the issuance of a letter of credit. The Bank of Paris then undertakes a credit check of the importer. If the Bank of Paris is satisfied with her creditworthiness, it will issue a letter of credit. However, the Bank of Paris might require a cash deposit or some other form of collateral from her. In addition, the Bank of Paris will charge the importer a fee for this service. Typically this amounts to between 0.5 percent and 2 percent of the value of the letter of credit, depending on the importer’s creditworthiness and the size of the transaction. (As a rule, the larger the transaction, the lower the percentage.)

Assume the Bank of Paris is satisfied with the French importer’s creditworthiness and agrees to issue a letter of credit. The letter states that the Bank of Paris will pay the U.S. exporter for the merchandise as long as it is shipped in accordance with specified instructions and conditions. At this point, the letter of credit becomes a financial contract between the Bank of Paris and the U.S. exporter. The Bank of Paris then sends the letter of credit to the U.S. exporter’s bank, say, the Bank of New York. The Bank of New York tells the exporter that it has received a letter of credit and that he

Letter of Credit

Issued by a bank, indicating that the bank will make payments under specific circumstances.

can ship the merchandise. After the exporter has shipped the merchandise, he draws a draft against the Bank of Paris in accordance with the terms of the letter of credit, attaches the required documents, and presents the draft to his own bank, the Bank of New York, for payment. The Bank of New York then forwards the letter of credit and associated documents to the Bank of Paris. If all of the terms and conditions contained in the letter of credit have been complied with, the Bank of Paris will honor the draft and will send payment to the Bank of New York. When the Bank of New York receives the funds, it will pay the U.S. exporter.

As for the Bank of Paris, once it has transferred the funds to the Bank of New York, it will collect payment from the French importer. Alternatively, the Bank of Paris may allow the importer some time to resell the merchandise before requiring payment. This is not unusual, particularly when the importer is a distributor and not the final consumer of the merchandise, since it helps the importer's cash flow. The Bank of Paris will treat such an extension of the payment period as a loan to the importer and will charge an appropriate rate of interest.

The great advantage of this system is that both the French importer and the U.S. exporter are likely to trust reputable banks, even if they do not trust each other. Once the U.S. exporter has seen a letter of credit, he knows that he is guaranteed payment and will ship the merchandise. Also, an exporter may find that having a letter of credit will facilitate obtaining preexport financing. For example, having seen the letter of credit, the Bank of New York might be willing to lend the exporter funds to process and prepare the merchandise for shipping to France. This loan may not have to be repaid until the exporter has received his payment for the merchandise. As for the French importer, she does not have to pay for the merchandise until the documents have arrived and unless all conditions stated in the letter of credit have been satisfied. The drawback for the importer is the fee she must pay the Bank of Paris for the letter of credit. In addition, since the letter of credit is a financial liability against her, it may reduce her ability to borrow funds for other purposes.

DRAFT A draft, sometimes referred to as a **bill of exchange**, is the instrument normally used in international commerce to effect payment. A **draft** is simply an order written by an exporter instructing an importer, or an importer's agent, to pay a specified amount of money at a specified time. In the example of the U.S. exporter and the French importer, the exporter writes a draft that instructs the Bank of Paris, the French importer's agent, to pay for the merchandise shipped to France. The person or business initiating the draft is known as the maker (in this case, the U.S. exporter). The party to whom the draft is presented is known as the drawee (in this case, the Bank of Paris).

International practice is to use drafts to settle trade transactions. This differs from domestic practice in which a seller usually ships merchandise on an open account, followed by a commercial invoice that specifies the amount due and the terms of payment. In domestic transactions, the buyer can often obtain possession of the merchandise without signing a formal document acknowledging his or her obligation to pay. In contrast, due to the lack of trust in international transactions, payment or a formal promise to pay is required before the buyer can obtain the merchandise.

Drafts fall into two categories, sight drafts and time drafts. A **sight draft** is payable on presentation to the drawee. A **time draft** allows for a delay in payment—normally 30, 60, 90, or 120 days. It is presented to the drawee, who signifies acceptance of it by writing or stamping a notice of acceptance on its face. Once accepted, the time draft becomes a promise to pay by the accepting party. When a time draft is drawn on and

Bill of Exchange

An order written by an exporter instructing an importer, or an importer's agent, to pay a specified amount of money at a specified time; also called a **draft**.

Draft

An order written by an exporter instructing an importer, or an importer's agent, to pay a specified amount of money at a specified time.

Sight Draft

A draft payable on presentation to the drawee.

Time Draft

A promise to pay by the accepting party at some future date.

accepted by a bank, it is called a banker's acceptance. When it is drawn on and accepted by a business firm, it is called a trade acceptance.

Time drafts are negotiable instruments; that is, once the draft is stamped with an acceptance, the maker can sell the draft to an investor at a discount from its face value. Imagine the agreement between the U.S. exporter and the French importer calls for the exporter to present the Bank of Paris (through the Bank of New York) with a time draft requiring payment 120 days after presentation. The Bank of Paris stamps the time draft with an acceptance. Imagine further that the draft is for \$100,000.

The exporter can either hold onto the accepted time draft and receive \$100,000 in 120 days or he can sell it to an investor, say, the Bank of New York, for a discount from the face value. If the prevailing discount rate is 7 percent, the exporter could receive \$97,700 by selling it immediately (7 percent per year discount rate for 120 days for \$100,000 equals \$2,300, and $\$100,000 - \$2,300 = \$97,700$). The Bank of New York would then collect the full \$100,000 from the Bank of Paris in 120 days. The exporter might sell the accepted time draft immediately if he needed the funds to finance merchandise in transit and/or to cover cash flow shortfalls.

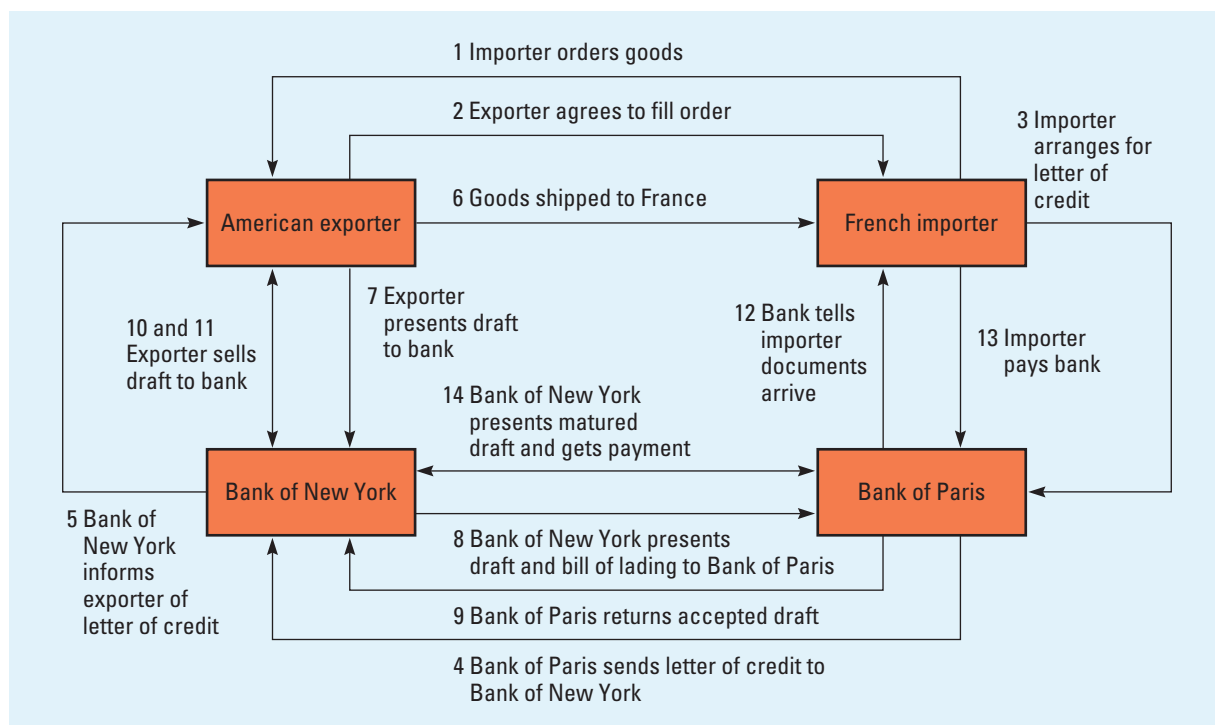
Bill of Lading

A document issued to the exporter by the common carrier transporting the merchandise; it serves as a receipt, a contract, and a document of title.

BILL OF LADING The third key document for financing international trade is the bill of lading. The **bill of lading** is issued to the exporter by the common carrier transporting the merchandise. It serves three purposes: it is a receipt, a contract, and a document of title. As a receipt, the bill of lading indicates that the carrier has received the merchandise described on the face of the document. As a contract, it specifies that the carrier is obligated to provide transportation service in return for a certain charge. As a document of title, it can be used to obtain payment or a written promise of payment before the merchandise is released to the importer. The bill of lading can also function as collateral against which funds may be advanced to the exporter by its local bank before or during shipment and before final payment by the importer.

A TYPICAL INTERNATIONAL TRADE TRANSACTION Now that we have reviewed the elements of an international trade transaction, let us see how the process works in a typical case, sticking with the example of the U.S. exporter and the French importer. The typical transaction involves 14 steps (see Figure 13.4).

1. The French importer places an order with the U.S. exporter and asks the American if he would be willing to ship under a letter of credit.
2. The U.S. exporter agrees to ship under a letter of credit and specifies relevant information such as prices and delivery terms.
3. The French importer applies to the Bank of Paris for a letter of credit to be issued in favor of the U.S. exporter for the merchandise the importer wishes to buy.
4. The Bank of Paris issues a letter of credit in the French importer's favor and sends it to the U.S. exporter's bank, the Bank of New York.
5. The Bank of New York advises the exporter of the opening of a letter of credit in his favor.
6. The U.S. exporter ships the goods to the French importer on a common carrier. An official of the carrier gives the exporter a bill of lading.
7. The U.S. exporter presents a 90-day time draft drawn on the Bank of Paris in accordance with its letter of credit and the bill of lading to the Bank of New York. The exporter endorses the bill of lading so title to the goods is transferred to the Bank of New York.



13.4 figure

A Typical International Trade Transaction

8. The Bank of New York sends the draft and bill of lading to the Bank of Paris. The Bank of Paris accepts the draft, taking possession of the documents and promising to pay the now-accepted draft in 90 days.
9. The Bank of Paris returns the accepted draft to the Bank of New York.
10. The Bank of New York tells the U.S. exporter that it has received the accepted bank draft, which is payable in 90 days.
11. The exporter sells the draft to the Bank of New York at a discount from its face value and receives the discounted cash value of the draft in return.
12. The Bank of Paris notifies the French importer of the arrival of the documents. She agrees to pay the Bank of Paris in 90 days. The Bank of Paris releases the documents so the importer can take possession of the shipment.
13. In 90 days, the Bank of Paris receives the importer's payment, so it has funds to pay the maturing draft.
14. In 90 days, the holder of the matured acceptance (in this case, the Bank of New York) presents it to the Bank of Paris for payment. The Bank of Paris pays.

Export Assistance

Prospective U.S. exporters can draw on two forms of government-backed assistance to help finance their export programs. They can get financing aid from the Export-Import Bank and export credit insurance from the Foreign Credit Insurance Association (similar programs are available in most countries).

LEARNING OBJECTIVE 3

Identify information sources and government programs that exist to help exporters.



The Export-Import Bank provides financing aid to companies, such as the example above, that require assistance with imports, exports, and the exchange of commodities.

Export-Import Bank

Agency of the U.S. government whose mission is to provide aid in financing and facilitate exports and imports; also referred to as the Ex-Im Bank.

EXPORT-IMPORT BANK The **Export-Import Bank**, often referred to as Ex-Im Bank, is an independent agency of the U.S. government. Its mission is to provide financing aid that will facilitate exports, imports, and the exchange of commodities between the United States and other countries. In 2010 its financing activities were expanded from \$4 billion to \$6 billion following a push by the Obama administration to try to create some 2 million new jobs through exports. Ex-Im Bank pursues its mission with various loan and loan-guarantee programs. The agency guarantees repayment of medium and long-term loans U.S. commercial banks make to foreign borrowers for purchasing U.S. exports. The bank guarantee makes the commercial banks more willing to lend cash to foreign enterprises.

Ex-Im Bank also has a direct lending operation under which it lends dollars to foreign borrowers for use in purchasing U.S. exports. In some cases, it grants loans that commercial banks would not if it sees a potential benefit to the United States in doing so. The foreign borrowers use the loans to pay U.S. suppliers and repay the loan to the agency with interest.

EXPORT CREDIT INSURANCE For reasons outlined earlier, exporters clearly prefer to get letters of credit from importers. However, sometimes an exporter who insists on a letter of credit will lose an order to one who does not require a letter of credit. Thus, when the importer is in a strong bargaining position and able to play competing suppliers against each other, an exporter may have to forgo a letter of credit.¹⁷ The lack of a letter of credit exposes the exporter to the risk that the foreign importer will default on payment. The exporter can insure against this possibility by buying export credit insurance. If the customer defaults, the insurance firm will cover a major portion of the loss.

In the United States, export credit insurance is provided by the Foreign Credit Insurance Association (FCIA), an association of private commercial institutions operating under the guidance of the Export-Import Bank. The FCIA provides coverage against commercial risks and political risks. Losses due to commercial risk result from

the buyer's insolvency or payment default. Political losses arise from actions of governments that are beyond the control of either buyer or seller.

Countertrade

Countertrade is an alternative means of structuring an international sale when conventional means of payment are difficult, costly, or nonexistent. We first encountered countertrade in Chapter 10 in our discussion of currency convertibility. A government may restrict the convertibility of its currency to preserve its foreign exchange reserves so they can be used to service international debt commitments and purchase crucial imports.¹⁸ This is problematic for exporters. Nonconvertibility implies that the exporter may not be paid in his or her home currency; and few exporters would desire payment in a currency that is not convertible. Countertrade is a common solution.¹⁹ **Countertrade** denotes a whole range of barterlike agreements; its principle is to trade goods and services for other goods and services when they cannot be traded for money. Some examples of countertrade are:

- An Italian company that manufactures power-generating equipment, ABB SAE Sadelmi SpA, was awarded a 720 million baht (\$17.7 million) contract by the Electricity Generating Authority of Thailand. The contract specified that the company had to accept 218 million baht (\$5.4 million) of Thai farm products as part of the payment.
- Saudi Arabia agreed to buy 10 747 jets from Boeing with payment in crude oil, discounted at 10 percent below posted world oil prices.
- General Electric won a contract for a \$150 million electric generator project in Romania by agreeing to market \$150 million of Romanian products in markets to which Romania did not have access.
- The Venezuelan government negotiated a contract with Caterpillar under which Venezuela would trade 350,000 tons of iron ore for Caterpillar earthmoving equipment.
- Albania offered such items as spring water, tomato juice, and chrome ore in exchange for a \$60 million fertilizer and methanol complex.
- Philip Morris ships cigarettes to Russia, for which it receives chemicals that can be used to make fertilizer. Philip Morris ships the chemicals to China, and in return, China ships glassware to North America for retail sale by Philip Morris.²⁰

LEARNING OBJECTIVE 5

Describe how countertrade can be used to facilitate exporting.

Countertrade

The trade of goods or services for other goods or services.

THE INCIDENCE OF COUNTERTRADE In the modern era, countertrade arose in the 1960s as a way for the Soviet Union and the Communist states of Eastern Europe, whose currencies were generally nonconvertible, to purchase imports. During the 1980s, the technique grew in popularity among many developing nations that lacked the foreign exchange reserves required to purchase necessary imports. Today, reflecting their own shortages of foreign exchange reserves, some successor states to the former Soviet Union and the Eastern European Communist nations periodically engage in countertrade to purchase their imports. Estimates of the percentage of world trade covered by some sort of countertrade agreement range from highs of 8 and 10 percent by value to lows of about 2 percent.²¹ The precise figure is unknown but it is probably at the low end of these estimates given the increasing liquidity of international financial markets and wider currency convertibility. However, a short-term spike in the volume of countertrade can follow periodic financial crisis. For example, countertrade activity increased notably after



Another Perspective

CARP Stimulates International Trade

Countertrade could soon be booming in Denmark as a result of a recent \$4 billion combat aircraft replacement program initiated by the Danish government. Under the terms of the program, Denmark intends to order 30 to 48 combat jets—a purchase that could prove to be a windfall for many of the country's defense contractors in terms of subcontracts and partnership opportunities. For example, U.S.-based Boeing Company, a leading contender for the contract to build those jets, has already expressed interest in fuel-cell products manufactured by Danish defense contractor Falck Schmidt Defence Systems (FSDS).

(Gerard O'Dwyer, "Looking for a Ride on F-35," *Defense News.com*, December 14, 2009, www.defensenews.com)

the Asian financial crisis of 1997. That crisis left many Asian nations with little hard currency to finance international trade. In the tight monetary regime that followed the crisis in 1997, many Asian firms found it very difficult to get access to export credits to finance their own international trade. Thus they turned to the only option available to them—countertrade.

Given that countertrade is a means of financing international trade, albeit a relatively minor one, prospective exporters may have to engage in this technique from time to time to gain access to certain international markets. The governments of developing nations sometimes insist on a certain amount of countertrade.²² For example, all foreign companies contracted by Thai state agencies for work costing more than 500 million baht (\$12.3 million) are required to accept at least 30 percent of their payment in Thai agricultural products. Between 1994

and mid-1998, foreign firms purchased 21 billion baht (\$517 million) in Thai goods under countertrade deals.²³

TYPES OF COUNTERTRADE With its roots in the simple trading of goods and services for other goods and services, countertrade has evolved into a diverse set of activities that can be categorized as five distinct types of trading arrangements: barter, counterpurchase, offset, switch trading, and compensation or buyback.²⁴ Many countertrade deals involve not just one arrangement, but elements of two or more.

Barter

The direct exchange of goods and/or services between two parties without a cash transaction.

Barter Barter is the direct exchange of goods and/or services between two parties without a cash transaction. Although barter is the simplest arrangement, it is not common. Its problems are twofold. First, if goods are not exchanged simultaneously, one party ends up financing the other for a period. Second, firms engaged in barter run the risk of having to accept goods they do not want, cannot use, or have difficulty reselling at a reasonable price. For these reasons, barter is viewed as the most restrictive countertrade arrangement. It is primarily used for one-time-only deals in transactions with trading partners who are not creditworthy or trustworthy.

Counterpurchase

A reciprocal buying agreement.

Counterpurchase Counterpurchase is a reciprocal buying agreement. It occurs when a firm agrees to purchase a certain amount of materials back from a country to which a sale is made. Suppose a U.S. firm sells some products to China. China pays the U.S. firm in dollars, but in exchange, the U.S. firm agrees to spend some of its proceeds from the sale on textiles produced by China. Thus, although China must draw on its foreign exchange reserves to pay the U.S. firm, it knows it will receive some of those dollars back because of the counterpurchase agreement. In one counterpurchase agreement, Rolls-Royce sold jet parts to Finland. As part of the deal, Rolls-Royce agreed to use some of the proceeds from the sale to purchase Finnish-manufactured TV sets that it would then sell in Great Britain.

Offset

A buying agreement similar to a counterpurchase, but the exporting country can then fulfill the agreement with any firm in the country to which the sale is being made.

Offset An offset is similar to a counterpurchase insofar as one party agrees to purchase goods and services with a specified percentage of the proceeds from the original sale. The difference is that this party can fulfill the obligation with any firm in the

country to which the sale is being made. From an exporter's perspective, this is more attractive than a straight counterpurchase agreement because it gives the exporter greater flexibility to choose the goods that it wishes to purchase.

Switch Trading The term **switch trading** refers to the use of a specialized third-party trading house in a countertrade arrangement. When a firm enters a counterpurchase or offset agreement with a country, it often ends up with what are called counterpurchase credits, which can be used to purchase goods from that country. Switch trading occurs when a third-party trading house buys the firm's counterpurchase credits and sells them to another firm that can better use them. For example, a U.S. firm concludes a counterpurchase agreement with Poland for which it receives some number of counterpurchase credits for purchasing Polish goods. The U.S. firm cannot use and does not want any Polish goods, however, so it sells the credits to a third-party trading house at a discount. The trading house finds a firm that can use the credits and sells them at a profit.

Switch Trading

The use of a specialized third-party trading house in a countertrade arrangement.

In one example of switch trading, Poland and Greece had a counterpurchase agreement that called for Poland to buy the same U.S.-dollar value of goods from Greece that it sold to Greece. However, Poland could not find enough Greek goods that it required, so it ended up with a dollar-denominated counterpurchase balance in Greece that it was unwilling to use. A switch trader bought the right to 250,000 counterpurchase dollars from Poland for \$225,000 and sold them to a European sultana (grape) merchant for \$235,000, who used them to purchase sultanas from Greece.

Compensation or Buybacks A **buyback** occurs when a firm builds a plant in a country—or supplies technology, equipment, training, or other services to the country—and agrees to take a certain percentage of the plant's output as partial payment for the contract. For example, Occidental Petroleum negotiated a deal with Russia under which Occidental would build several ammonia plants in Russia and as partial payment receive ammonia over a 20-year period.

Buyback

When a firm builds a plant in a country and agrees to take a certain percentage of the plant's output as partial payment for the contract.

THE PROS AND CONS OF COUNTERTRADE Countertrade's main attraction is that it can give a firm a way to finance an export deal when other means are not available. Given the problems that many developing nations have in raising the foreign exchange necessary to pay for imports, countertrade may be the only option available when doing business in these countries. Even when countertrade is not the only option for structuring an export transaction, many countries prefer countertrade to cash deals. Thus, if a firm is unwilling to enter a countertrade agreement, it may lose an export opportunity to a competitor that is willing to make a countertrade agreement.

In addition, a countertrade agreement may be required by the government of a country to which a firm is exporting goods or services. Boeing often has to agree to counterpurchase agreements to capture orders for its commercial jet aircraft. For example, in exchange for gaining an order from Air India, Boeing may be required to purchase certain component parts, such as aircraft doors, from an Indian company. Taking this one step further, Boeing can use its willingness to enter into a counterpurchase agreement as a way of winning orders in the face of intense competition from its global rival, Airbus. Thus, countertrade can become a strategic marketing weapon.

However, the drawbacks of countertrade agreements are substantial. Other things being equal, firms would normally prefer to be paid in hard currency. Countertrade

contracts may involve the exchange of unusable or poor-quality goods that the firm cannot dispose of profitably. For example, a few years ago, one U.S. firm got burned when 50 percent of the television sets it received in a countertrade agreement with Hungary were defective and could not be sold. In addition, even if the goods it receives are of high quality, the firm still needs to dispose of them profitably. To do this, countertrade requires the firm to invest in an in-house trading department dedicated to arranging and managing countertrade deals. This can be expensive and time-consuming.

Given these drawbacks, countertrade is most attractive to large, diverse multinational enterprises that can use their worldwide network of contacts to dispose of goods acquired in countertrading. The masters of countertrade are Japan's giant trading firms, the *sogo shosha*, which use their vast networks of affiliated companies to profitably dispose of goods acquired through countertrade agreements. The trading firm of Mitsui & Company, for example, has about 120 affiliated companies in almost every sector of the manufacturing and service industries. If one of Mitsui's affiliates receives goods in a countertrade agreement that it cannot consume, Mitsui & Company will normally be able to find another affiliate that can profitably use them. Firms affiliated with one of Japan's *sogo shosha* often have a competitive advantage in countries where countertrade agreements are preferred.

Western firms that are large, diverse, and have a global reach (e.g., General Electric, Philip Morris, and 3M) have similar profit advantages from countertrade agreements. Indeed, 3M has established its own trading company—3M Global Trading, Inc.—to develop and manage the company's international countertrade programs. Unless there is no alternative, small and medium-sized exporters should probably try to avoid countertrade deals because they lack the worldwide network of operations that may be required to profitably utilize or dispose of goods acquired through them.²⁵

Key Terms

<i>sogo shosha</i> , p. 447	sight draft, p. 455	barter, p. 460
export management company, p. 450	time draft, p. 455	counterpurchase, p. 460
letter of credit, p. 454	bill of lading, p. 456	offset, p. 460
bill of exchange, p. 455	Export-Import Bank, p. 458	switch trading, p. 461
draft, p. 455	countertrade, p. 459	buyback, p. 461

Summary

In this chapter, we examined the steps that firms must take to establish themselves as exporters. The chapter made the following points:

1. One big impediment to exporting is ignorance of foreign market opportunities.
2. Neophyte exporters often become discouraged or frustrated with the exporting process because they encounter many problems, delays, and pitfalls.
3. The way to overcome ignorance is to gather information. In the United States, a number of institutions, most important of which is the Department of Commerce, can help firms gather information in the matchmaking process.

- Export management companies can also help identify export opportunities.
4. Many of the pitfalls associated with exporting can be avoided if a company hires an experienced export management company, or export consultant, and if it adopts the appropriate export strategy.
 5. Firms engaged in international trade must do business with people they cannot trust and people who may be difficult to track down if they default on an obligation. Due to the lack of trust, each party to an international transaction has a different set of preferences regarding the configuration of the transaction.
 6. The problems arising from lack of trust between exporters and importers can be solved by using a third party that is trusted by both, normally a reputable bank.
 7. A letter of credit is issued by a bank at the request of an importer. It states that the bank promises to pay a beneficiary, normally the exporter, on presentation of documents specified in the letter.
 8. A draft is the instrument normally used in international commerce to effect payment. It is an order written by an exporter instructing an importer, or an importer's agent, to pay a specified amount of money at a specified time.
 9. Drafts are either sight drafts or time drafts. Time drafts are negotiable instruments.
 10. A bill of lading is issued to the exporter by the common carrier transporting the merchandise. It serves as a receipt, a contract, and a document of title.
 11. U.S. exporters can draw on two types of government-backed assistance to help finance their exports: loans from the Export-Import Bank and export credit insurance from the Foreign Credit Insurance Association.
 12. Countertrade includes a range of barterlike agreements. It is primarily used when a firm exports to a country whose currency is not freely convertible and may lack the foreign exchange reserves required to purchase the imports.
 13. The main attraction of countertrade is that it gives a firm a way to finance an export deal when other means are not available. A firm that insists on being paid in hard currency may be at a competitive disadvantage vis-à-vis one that is willing to engage in countertrade.
 14. The main disadvantage of countertrade is that the firm may receive unusable or poor-quality goods that cannot be disposed of profitably.

Critical Thinking and Discussion Questions

1. A firm based in Washington State wants to export a shipload of finished lumber to the Philippines. The would-be importer cannot get sufficient credit from domestic sources to pay for the shipment but insists that the finished lumber can quickly be resold in the Philippines for a profit. Outline the steps the exporter should take to effect this export to the Philippines.
2. You are the assistant to the CEO of a small textile firm that manufactures quality, premium-priced, stylish clothing. The CEO has decided to see what the opportunities are for exporting and has asked you for advice as to the steps the company should take. What advice would you give the CEO?
3. An alternative to using a letter of credit is export credit insurance. What are the advantages and disadvantages of using export credit insurance rather than a letter of credit for exporting (a) a luxury yacht from California to Canada, and (b) machine tools from New York to Ukraine?
4. How do you explain the use of countertrade? Under what scenarios might its use increase further by 2015? Under what scenarios might its use decline?
5. How might a company make strategic use of countertrade schemes as a marketing weapon to generate export revenues? What are the risks associated with pursuing such a strategy?

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

1. The Internet is rich with resources that provide guidance for companies wishing to expand their markets through exporting. GlobalEDGE provides links under a category called *Trade Tutorials*. Identify three sources listed by globalEDGE and provide a description of the services available for new exporters through each of these sources.
2. You work for a banking company that hopes to provide financial services in India. After searching a resource that enumerates the *import and export regulations* for a variety of countries, outline the most important foreign trade barriers your firm's managers must keep in mind while developing a strategy for entry into the Indian banking market.



MD International

closing case

Al Merritt founded MD International in 1987. A former salesman for a medical equipment company, Merritt saw an opportunity to act as an export intermediary for medical equipment manufacturers in the United States. He chose to focus on Latin America and the Caribbean, regions in which he had experience. Trade barriers were starting to fall throughout the region as Latin governments embraced a more liberal economic ideology, creating an opening for entrepreneurs such as Merritt. Local governments were also expanding their spending on health care, creating an opportunity that Merritt was poised to exploit.

Merritt located his company in south Florida to be close to his market. The company has grown to become the largest intermediary exporting medical devices to the region. Today the company sells the products of more than 30 medical manufacturers to some 600 regional distributors. While many medical equipment manufacturers don't sell directly to the region because of the sizable marketing costs, MD can afford to because it goes into those markets with a broad portfolio of products.

The company's success is in part due to its deep-rooted knowledge and understanding of the Latin American market. MD works very closely with teams of doctors, biomedical engineers, microbiologists, and marketing managers across Latin America to understand their needs, and what the company can do for them. The sale of products to customers is typically only the beginning of a relationship. MD

International also provides hands-on training to medical personnel in the use of devices and extensive after-sales service and support.

Along the way to becoming a successful exporter, MD International has leaned heavily upon export assistance programs established by the U.S. government. For example, in the early 2000s a shipment to Venezuela was held up by the country's customs service, demanding proof that the medical devices were not intended for military use. Within two days, staff at the U.S. Export Assistance Center in Miami arranged for the U.S. Embassy in Venezuela to have a letter written and delivered to customs, assuring that the products had no military applications, and the shipment was released. Merritt has also worked extensively with the Export-Import Bank to gain financing for its exports (the company needs to finance the inventory that it exports).

Despite these advantages, it has not all been easy going for MD International. Latin American economies have often been highly cyclical, and MD International has ridden those cycles with them. In 2001, for example, after several years of solid growth, an economic crisis in both Argentina and Brazil, coupled with a slowdown in Mexico, resulted in losses for the year and forced Merritt to layoff one-third of his staff and cut the pay of others, which included a 50 percent pay cut for himself. Things started to improve in 2002, and the weak dollar in the mid-2000s also helped to boost export sales. However, the global financial crisis of 2008

ushered in another tough period, although prior experience suggests that MD International can not only survive such downturns, but also come out stronger as weaker competitors fall by the wayside.

Sources: J. Bussey, "Where Have All the Exporters Gone?" *Miami Herald*, September 30, 2005, p. C1; M. Chandler, "Dade Firm Seeks to Remake Health Care," *Miami Herald*, June 15, 2000; and C. Cultice, "Exports with a Heart," U.S. Department of Commerce, export success stories, at www.export.gov.

Case Discussion Questions

1. How does an intermediary such as MD International create value for the manufacturers who use it to sell medical equipment in foreign markets? Why do they
2. Why did MD International focus on Latin America? What are the benefits of this regional approach? What are the potential drawbacks?
3. What would it take for MD International to start exporting to other regions such as Asia or Europe? Given this, would you advise Al Merritt to continue his regional focus going forward, or to add other regions?
4. How important has government assistance been to MD International? Do you think helping firms such as MD International represents good use of taxpayer money?

want to use MD International rather than export directly themselves?



part 5

Competing in a Global Marketplace

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Explain why production and logistics decisions are of central importance to many multinational businesses.
- 2 Explain how country differences, production technology, and product features all affect the choice of where to locate production activities.
- 3 Recognize how the role of foreign subsidiaries in production can be enhanced over time as they accumulate knowledge.
- 4 Identify the factors that influence a firm's decision of whether to source supplies from within the company or from foreign suppliers.
- 5 Describe what is required to efficiently coordinate a globally dispersed production system.

Global Production, Outsourcing, and Logistics

The Rise of the Indian Automobile Industry

opening case

India is well on its way to becoming a small-car manufacturing hub for some of the world's largest automobile companies. Between 2003 and 2008 automobile exports from India increased fivefold to about 250,000 cars a year. Despite a global economic slowdown, exports are predicted to increase, reaching half a million vehicles a year by 2012. The leading Indian exporter is the Korean company Hyundai, which committed early to the Indian market. Hyundai began production in India in 1998, when consumers were only purchasing 300,000 cars a year, despite the country's population of almost 1 billion people. Hyundai invested in a plant in the southern city of Chennai with the capacity to turn out 100,000 cheap small cars a year. It had to train most of the workers, often giving them two years of on-the-job training before hiring them full time. Soon Hyundai's early investments were paying off, as Indian's emerging middle class snapped up its cars. Still the company had excess capacity, so it turned its attention to exports.

By 2004, Hyundai was the country's largest automobile exporter, shipping 70,000 cars a year overseas. Things have only improved for Hyundai since then. By 2008 Hyundai was making 500,000 cars a year in India and exporting over a third of them. Its smallest car, the i10, is now produced only in India and shipped mainly to Europe. The company plans to expand its Indian manufacturing capacity to 650,000, and ship up to half of its output overseas. Hyundai is now considering selling its Indian-made cars in the United States as well as in Europe.

Hyundai's success has not gone unnoticed. Suzuki and Nissan have also been investing aggressively in Indian automobile factories. Suzuki exported about 50,000 cars from India in 2007 and hopes to increase that to 200,000 by 2010. Nissan also has big plans for India. It has invested some \$1.1 billion in a new factory close to Hyundai's in Chennai. Completed in 2010, the factory has the capacity to make some 400,000 cars a year, about half of

which will be exported. Ford, BMW, GM, and Toyota are also building, or planning to build, cars in India. A notable local competitor is Tata Motors, which launched a low-cost “people’s car,” priced at \$2,500, for the Indian market in 2009.

For all of these companies, India has several attractions. The rapidly developing country has a potentially large domestic market. Also, labor costs are low compared to many other nations. Nissan, for example, notes that wage rates in India will be one-tenth of those in its Japanese factories. Plus, as Hyundai has shown, productivity is high and Indian workers can produce quality automobiles. Hyundai’s executives claim that its Indian cars are of comparable quality to those produced in Korea. Nissan’s goal is to use the same highly efficient flexible manufacturing processes in India as it uses in Japan. Before it starts production, Nissan plans to send Indian workers to its Japanese factories for training on manufacturing processes and quality control.

India produces a large number of engineers every year, providing the professional skill base for designing cars and managing complex manufacturing facilities. Nissan intends to draw on this talent to design a low-cost small car to compete with Tata. According to Nissan executives, the great advantage of India’s engineers is that they are less likely to have the preconceptions of automobile engineers in developed nations, are more likely to “think outside of the box,” and thus may be better equipped to handle the challenges of designing an ultra-low-cost small car.

Establishing manufacturing facilities in India does have problems, however. Nissan executives note that basic infrastructure is still lacking, roads are poor, and often clogged with everything from taxis and motorbikes to bullocks and carts, making the Japanese practice of just-in-time delivery hard to implement. It is also proving challenging to find local parts suppliers that can attain the same high-quality standards as those Nissan follows elsewhere in the world. Nissan’s strategy has been to work with promising local companies, helping them to raise their standards. For example, under the guidance of engineers from Nissan, the Indian parts supplier Capro, which makes body panels, has built a new factory near Nissan’s Chennai facility, using the latest Japanese equipment. Workers there have also been trained in the Japanese practice of *kaizen*, or continuous process improvement.

While it is still early, observers see the potential for Chennai to develop into the Detroit of India, with a cluster of automobile companies and parts suppliers working in the region producing high-quality, low-cost small cars that will not only sell well in the rapidly expanding Indian market, but could also sell well worldwide.

Sources: E. Bellman, “India Cranks Out Small Cars for Export,” *The Wall Street Journal*, October 6, 2008, p. A1; N. Lakshman, “India’s Car Market Offers No Relief for Automakers,” *BusinessWeek Online*, December 23, 2008; and M. Fackler, “In India, a New Detroit,” *The New York Times*, June 26, 2008, pp. C1, C4.



Introduction

As trade barriers fall and global markets develop, many firms increasingly confront a set of interrelated issues. First, where in the world should production activities be located? Should they be concentrated in a single country, or should they be dispersed around the globe, matching the type of activity with country differences in factor costs, tariff barriers, political risks, and the like to minimize costs and maximize value added? Second, what should be the long-term strategic role of foreign production sites? Should the firm abandon a foreign site if factor costs change, moving production to another more favorable location, or is there value to maintaining an operation at a given location even if underlying economic conditions change? Third, should the firm own foreign production activities, or is it better to outsource those activities to independent vendors? Fourth, how should a globally dispersed supply chain be managed, and what is the role of Internet-based information technology in the management of global logistics? Fifth, should the firm manage global logistics itself, or should it outsource the management to enterprises that specialize in this activity?

The rise of the Indian automobile industry touches on some of these issues, since the industry is being driven by investment from foreign companies such as Hyundai and Nissan. These companies clearly see India, and particularly the region around the southern city of Chennai, as an emerging global center for the manufacture of low-cost small cars. In Nissan's view, for example, not only does India's own rapidly growing domestic market make local production attractive, but also the combination of low labor costs, high quality, good engineering talent, and the beginnings of a network of local suppliers makes Chennai a good global hub for designing, manufacturing, and then exporting low-cost small cars to other markets around the globe. From a strategic perspective, the goal of companies such as Nissan and Hyundai is to turn their Chennai factories into important components of their global manufacturing system.

Strategy, Production, and Logistics

In Chapter 11, we introduced the concept of the value chain and discussed a number of value creation activities, including production, marketing, logistics, R&D, human resources, and information systems. In this chapter, we will focus on two of these activities—**production** and **logistics**—and attempt to clarify how they might be performed internationally to (1) lower the costs of value creation and (2) add value by better serving customer needs. We will discuss the contributions of information technology to these activities, which has become particularly important in the era of the Internet. In later chapters, we will look at other value creation activities in this international context (marketing, R&D, and human resource management).

In Chapter 11, we defined *production* as “the activities involved in creating a product.” We used the term *production* to denote both service and manufacturing activities, since one can produce a service or produce a physical product. Although in this chapter we focus more on the production of physical goods, one should not forget that the term can also be applied to services. This has become more evident in recent years with the trend among U.S. firms to outsource the “production” of certain service activities to developing nations where labor costs are lower (for example, the trend among many U.S. companies to outsource customer care services to places such as India, where English is widely spoken and labor costs are much lower). Logistics is the activity that controls the transmission of physical materials through the value chain, from procurement through production and into distribution. Production and logistics are closely linked since a firm's ability to perform its production activities efficiently depends on a timely supply of high-quality material inputs, for which logistics is responsible.

LEARNING OBJECTIVE 1

Explain why production and logistics decisions are of central importance to many multinational businesses.

Production

Activities involved in creating a product.

Logistics

The procurement and physical transmission of material through the supply chain, from suppliers to customers.



Another Perspective

Careers in Supply Chain Management

With increased outsourcing and overseas production sites and customers, supply chain management is a growing field. The Council of Supply Chain Management Professionals (CSCMP), a professional association with more than 8,500 members worldwide, says the industry offers a promising outlook. What's more, potential employers are everywhere—manufacturers and distributors; government agencies; consulting firms; the transport industry; universities and colleges; service firms such as banks, hospitals, and hotels; and third-party logistics providers.

For more information about the organization and careers in this field, visit the CSCMP Web site at www.cscmp.org and its careers site, www.careersinsupplychain.org.

The production and logistics functions of an international firm have a number of important strategic objectives.¹ One is to lower costs. Dispersing production activities to various locations around the globe where each activity can be performed most efficiently can lower costs. Costs can also be cut by managing the global supply chain efficiently so as to better match supply and demand. Efficient supply chain management reduces the amount of inventory in the system and increases inventory turnover, which means the firm has to invest less working capital in inventory and is less likely to find excess inventory on hand that cannot be sold and has to be written off.

A second strategic objective shared by production and logistics is to increase product quality by eliminating defective products from both the supply chain and the manufacturing process.² (In this context, *quality* means *reliability*, implying that the

product has no defects and performs well.) The objectives of reducing costs and increasing quality are not independent of each other. As illustrated in Figure 14.1, the firm that improves its quality control will also reduce its costs of value creation. Improved quality control reduces costs by:

- Increasing productivity because time is not wasted producing poor-quality products that cannot be sold, leading to a direct reduction in unit costs.
- Lowering rework and scrap costs associated with defective products.
- Reducing the warranty costs and time associated with fixing defective products.

The effect is to lower the costs of value creation by reducing both production and after-sales service costs.

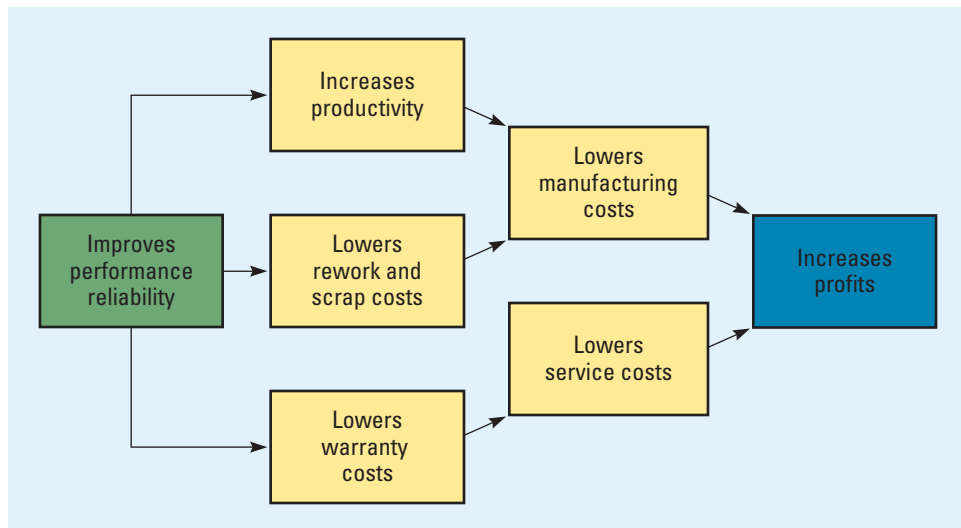
The principal tool that most managers now use to increase the reliability of their product offering is the Six Sigma quality improvement methodology. The Six Sigma methodology is a direct descendant of the **total quality management (TQM)** philosophy that was widely adopted, first by Japanese companies and then American companies

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.

figure 14.1

The Relationship between Quality and Costs



during the 1980s and early 1990s.³ The TQM philosophy was developed by a number of American consultants such as W. Edward Deming, Joseph Juran, and A. V. Feigenbaum.⁴ Deming identified a number of steps that should be part of any TQM program. He argued that management should embrace the philosophy that mistakes, defects, and poor-quality materials are not acceptable and should be eliminated. He suggested that the quality of supervision should be improved by allowing more time for supervisors to work with employees and by providing them with the tools they need to do the job. Deming recommended that management should create an environment in which employees will not fear reporting problems or recommending improvements. He believed that work standards should not only be defined as numbers or quotas, but should also include some notion of quality to promote the production of defect-free output. He argued that management has the responsibility to train employees in new skills to keep pace with changes in the workplace. In addition, he believed that achieving better quality requires the commitment of everyone in the company.

Six Sigma, the modern successor to TQM, is a statistically based philosophy that aims to reduce defects, boost productivity, eliminate waste, and cut costs throughout a company. Six Sigma programs have been adopted by several major corporations, such as Motorola, General Electric, and Allied Signal. Sigma comes from the Greek letter that statisticians use to represent a standard deviation from a mean, the higher the number of “sigmas” the smaller the number of errors. At six sigma, a production process would be 99.99966 percent accurate, creating just 3.4 defects per million units. While it is almost impossible for a company to achieve such perfection, Six Sigma quality is a goal that several strive toward. Increasingly, companies are adopting Six Sigma programs to try to boost their product quality and productivity.⁵

The growth of international standards has also focused greater attention on the importance of product quality. In Europe, for example, the European Union requires that the quality of a firm’s manufacturing processes and products be certified under a quality standard known as **ISO 9000** before the firm is allowed access to the EU marketplace. Although the ISO 9000 certification process has proved to be somewhat bureaucratic and costly for many firms, it does focus management attention on the need to improve the quality of products and processes.⁶

Six Sigma

Statistically based methodology for improving product quality.

ISO 9000

Certification process that requires certain quality standards must be met.



Motorola uses the Six Sigma philosophy, which aims to reduce defects, boost productivity, eliminate waste, and cut costs throughout the company.

In addition to the lowering of costs and the improvement of quality, two other objectives have particular importance in international businesses. First, production and logistics functions must be able to accommodate demands for local responsiveness. As we saw in Chapter 12, demands for local responsiveness arise from national differences in consumer tastes and preferences, infrastructure, distribution channels, and host-government demands. Demands for local responsiveness create pressures to decentralize production activities to the major national or regional markets in which the firm does business or to implement flexible manufacturing processes that enable the firm to customize the product coming out of a factory according to the market in which it is to be sold.

Second, production and logistics must be able to respond quickly to shifts in customer demand. In recent years, time-based competition has grown more important.⁷ When consumer demand is prone to large and unpredictable shifts, the firm that can adapt most quickly to these shifts will gain an advantage.⁸ As we shall see, both production and logistics play critical roles here.

Where to Produce

LEARNING OBJECTIVE 2

Explain how country differences, production technology, and product features all affect the choice of where to locate production activities.

An essential decision facing an international firm is where to locate its production activities to best minimize costs and improve product quality. For the firm contemplating international production, a number of factors must be considered. These factors can be grouped under three broad headings: country factors, technological factors, and product factors.⁹

COUNTRY FACTORS We reviewed country-specific factors in some detail earlier in the book. Political economy, culture, and relative factor costs differ from country to country. In Chapter 5, we saw that due to differences in factor costs, some countries have a comparative advantage for producing certain products. In Chapters 2 and 3, we saw how differences in political economy and national culture influence the benefits, costs, and risks of doing business in a country. Other things being equal, a firm should locate its various manufacturing activities where the economic, political, and cultural conditions, including relative factor costs, are conducive to the performance of those activities (for an example, see the accompanying Management Focus, which looks at the Philips NV investment in China). In Chapter 12, we referred to the benefits derived from such a strategy as location economies. We argued that one result of the strategy is the creation of a global web of value creation activities.

Also important in some industries is the presence of global concentrations of activities at certain locations. In Chapter 7, we discussed the role of location externalities in influencing foreign direct investment decisions. Externalities include the presence of an appropriately skilled labor pool and supporting industries.¹⁰ Such externalities can play an important role in deciding where to locate manufacturing activities. For example, because of a cluster of semiconductor manufacturing plants in Taiwan, a pool of labor with experience in the semiconductor business has developed. In addition, the plants have attracted a number of supporting industries, such as the manufacturers of semiconductor capital equipment and silicon, which have established facilities in Taiwan to be near their customers. This implies that there are real benefits to locating in Taiwan, as opposed to another location that lacks such externalities. Other things being equal, the externalities make Taiwan an attractive location for semiconductor manufacturing facilities.

Of course, other things are not equal. Differences in relative factor costs, political economy, culture, and location externalities are important, but other factors also loom large. Formal and informal trade barriers obviously influence location decisions (see Chapter 6), as do transportation costs and rules and regulations regarding foreign direct investment (see Chapter 7). For example, although relative factor costs may make a



Philips in China

The Dutch consumer electronics, lighting, semiconductor, and medical equipment conglomerate Philips NV has been operating factories in China since 1985 when the country first opened its markets to foreign investors. Then China was seen as the land of unlimited demand, and Philips, like many other Western companies, dreamed of Chinese consumers snapping up its products by the millions. But the company soon found out that one of the big reasons the company liked China—the low wage rates—also meant that few Chinese workers could afford to buy the products they were producing. Chinese wage rates are currently one-third of those in Mexico and Hungary, and 5 percent of those in the United States or Japan. So Philips hit on a new strategy; keep the factories in China but export most of the goods to the United States and elsewhere.

By the mid-2000s, Philips had invested over \$2.5 billion in China. The company now operates 25 wholly owned subsidiaries and joint ventures in China. Together they employ some 30,000 people. Philips exports nearly two-thirds of the \$7 billion in products that the factories produce every year. Philips accelerated its Chinese investment in anticipation of China's entry into the World Trade Organization. The company plans to move even more production to China in the future. In 2003, Philips announced it would phase out production of electronic razors in the Netherlands, lay off 2,000 Dutch employees, and move production to China by 2005. A week earlier, Philips had stated it would expand capacity at its semiconductor factories in China, while phasing out production in higher-cost locations elsewhere.

The attractions of China to Philips include low wage rates, an educated workforce, a robust Chinese economy, a stable exchange rate that is pegged to the U.S. dollar, a rapidly expanding industrial base that includes many other Western and Chinese companies that Philips uses as suppliers, and easier access to world markets given China's entry into the WTO. Philips has stated that ultimately its goal is to turn China into a global supply base from which the company's products will be exported around the world. By the mid-2000s more than 25 percent of everything Philips made worldwide came from China, and

executives say the figure is rising rapidly. Several products, such as CD and DVD players, are now made only in China. Philips is also starting to give its Chinese factories a greater role in product development. In the TV business, for example, basic development used to occur in Holland but was moved to Singapore in the early 1990s. Now Philips is transferring TV development work to a new R&D center in Suzhou near Shanghai. Similarly, basic product development work on LCD screens for cell phones was recently shifted to Shanghai.

Philips is hardly alone in this process. By the mid-2000s more than half of all exports from China came from foreign manufacturers or their joint ventures in China. China was the source of more than 80 percent of the DVD players sold worldwide, 50 percent of the cameras, 40 percent of all microwave ovens, 30 percent of the air conditioners, 25 percent of the washing machines, and 20 percent of all refrigerators.

Some observers worry that Philips and companies pursuing a similar strategy might be overdoing it. Too much dependence on China could be dangerous if political, economic, or other problems disrupt production and the company's ability to supply global markets. Some observers believe that it might be better if the manufacturing facilities of companies were more geographically diverse as a hedge against problems in China. The fears of the critics were given some substance in early 2003 when an outbreak of the pneumonia-like SARS (severe acute respiratory syndrome) virus in China resulted in the temporary shutdown of several plants operated by foreign companies and disrupted their global supply chains. Although Philips was not directly affected, it did restrict travel by its managers and engineers to its Chinese plants.

Sources: B. Einhorn, "Philips' Expanding Asia Connections," *BusinessWeek Online*, November 27, 2003; K. Leggett and P. Wonacott, "The World's Factory: A Surge in Exports from China Jolts the Global Industry," *The Wall Street Journal*, October 10, 2002, p. A1; "Philips NV: China Will Be Production Site for Electronic Razors," *The Wall Street Journal*, April 8, 2003, p. B12; "Philips Plans China Expansion," *The Wall Street Journal*, September 25, 2003, p. B13; M. Saunderson, "Eight out of 10 DVD Players Will Be Made in China," *Dealerscope*, July 2004, p. 28; and J. Blau, "Philips Tears Down Eindhoven R&D Fence," *Research Technology Management* 50, no. 6 (2007), pp. 9–11.

country look attractive as a location for performing a manufacturing activity, regulations prohibiting foreign direct investment may eliminate this option. Similarly, a consideration of factor costs might suggest that a firm should source production of a certain component from a particular country, but trade barriers could make this uneconomical.

Another country factor is expected future movements in its exchange rate (see Chapters 9 and 10). Adverse changes in exchange rates can quickly alter a country's attractiveness as a manufacturing base. Currency appreciation can transform a

low-cost location into a high-cost location. Many Japanese corporations had to grapple with this problem during the 1990s and early 2000s. The relatively low value of the yen on foreign exchange markets between 1950 and 1980 helped strengthen Japan's position as a low-cost location for manufacturing. Between 1980 and the mid-1990s, however, the yen's steady appreciation against the dollar increased the dollar cost of products exported from Japan, making Japan less attractive as a manufacturing location. In response, many Japanese firms moved their manufacturing offshore to lower-cost locations in East Asia.

TECHNOLOGICAL FACTORS The type of technology a firm uses to perform specific manufacturing activities can be pivotal in location decisions. For example, because of technological constraints, in some cases it is necessary to perform certain manufacturing activities in only one location and serve the world market from there. In other cases, the technology may make it feasible to perform an activity in multiple locations. Three characteristics of a manufacturing technology are of interest here: the level of fixed costs, the minimum efficient scale, and the flexibility of the technology.

Fixed Costs As we noted in Chapter 11, in some cases the fixed costs of setting up a production plant are so high that a firm must serve the world market from a single location or from a very few locations. For example, it now costs more than \$1 billion to set up a state-of-the-art plant to manufacture semiconductor chips. Given this, other things being equal, serving the world market from a single plant sited at a single (optimal) location can make sense.

Conversely, a relatively low level of fixed costs can make it economical to perform a particular activity in several locations at once. This allows the firm to better accommodate demands for local responsiveness. Manufacturing in multiple locations may also help the firm avoid becoming too dependent on one location. Being too dependent on one location is particularly risky in a world of floating exchange rates. Many firms disperse their manufacturing plants to different locations as a “real hedge” against potentially adverse moves in currencies.

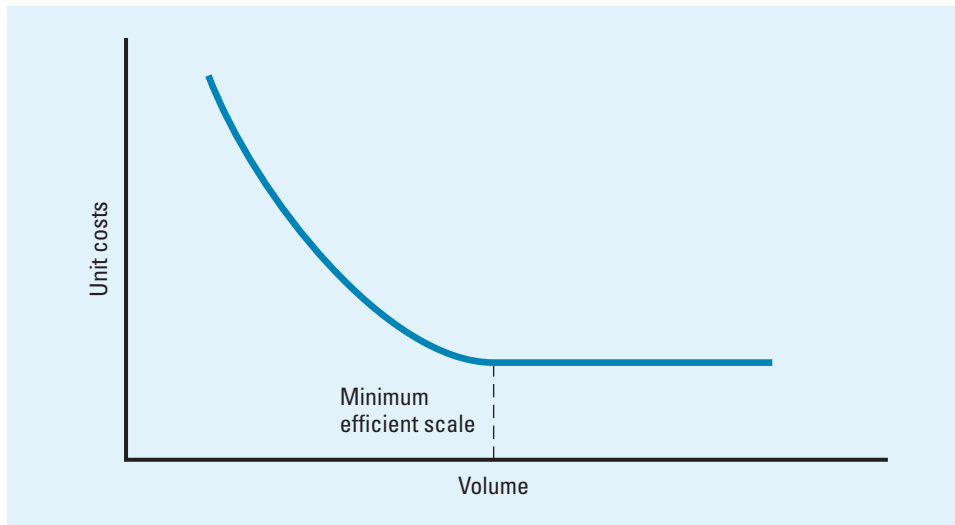
Minimum Efficient Scale The concept of economies of scale tells us that as plant output expands, unit costs decrease. The reasons include the greater utilization of capital equipment and the productivity gains that come with specialization of employees within the plant.¹¹ However, beyond a certain level of output, few additional scale economies are available. Thus, the “unit cost curve” declines with output until a certain output level is reached, at which point further increases in output realize little reduction in unit costs. The level of output at which most plant-level scale economies are exhausted is referred to as the **minimum efficient scale** of output. This is the scale of output a plant must operate to realize all major plant-level scale economies (see Figure 14.2).

The implications of this concept are as follows: The larger the minimum efficient scale of a plant relative to total global demand, the greater the argument for centralizing production in a single location or a limited number of locations. Alternatively, when the minimum efficient scale of production is low relative to global demand, it may be economical to manufacture a product at several locations. For example, the minimum efficient scale for a plant to manufacture personal computers is about 250,000 units a year, while the total global demand exceeds 35 million units a year. The low level of minimum efficient scale in relation to total global demand makes it economically feasible for a company such as Dell to manufacture PCs in six locations.

As in the case of low fixed costs, the advantages of a low minimum efficient scale include allowing the firm to accommodate demands for local responsiveness or to hedge against currency risk by manufacturing the same product in several locations.

**Minimum
Efficient Scale**
The level of output at
which most plant-level
scale economies are
exhausted.

A Typical Unit-Cost Curve



Flexible Manufacturing and Mass Customization Central to the concept of economies of scale is the idea that the best way to achieve high efficiency, and hence low unit costs, is through the mass production of a standardized output. The trade-off implicit in this idea is between unit costs and product variety. Producing greater product variety from a factory implies shorter production runs, which in turn implies an inability to realize economies of scale. That is, wide product variety makes it difficult for a company to increase its production efficiency and thus reduce its unit costs. According to this logic, the way to increase efficiency and drive down unit costs is to limit product variety and produce a standardized product in large volumes.

This view of production efficiency has been challenged by the rise of flexible manufacturing technologies. The term **flexible manufacturing technology**—or **lean production**, as it is often called—covers a range of manufacturing technologies designed to (1) reduce setup times for complex equipment, (2) increase the utilization of individual machines through better scheduling, and (3) improve quality control at all stages of the manufacturing process.¹² Flexible manufacturing technologies allow the company to produce a wider variety of end products at a unit cost that at one time could be achieved only through the mass production of a standardized output. Research suggests the adoption of flexible manufacturing technologies may actually increase efficiency and lower unit costs relative to what can be achieved by the mass production of a standardized output, while at the same time enabling the company to customize its product offering to a much greater extent than was once thought possible. The term **mass customization** has been coined to describe the ability of companies to use flexible manufacturing technology to reconcile two goals that were once thought to be incompatible—low cost and product customization.¹³ Flexible manufacturing technologies vary in their sophistication and complexity.

Flexible Manufacturing Technology (Lean Production)

Manufacturing technology designed to improve job scheduling, reduce setup time, and improve quality control.

Mass Customization

The production of a variety of end products at a unit cost that could once be achieved only through mass production of a standardized output.



Ford Motor Co. uses flexible manufacturing technology at its Louisville, Kentucky, assembly plant.

One of the most famous examples of a flexible manufacturing technology, Toyota's production system, has been credited with making Toyota the most efficient auto company in the world. (Despite Toyota's recent problems with sudden uncontrolled acceleration, the company continues to be an efficient producer of high-quality automobiles, according to J.D. Power and Associates, which produces an annual quality survey. Indeed, Toyota's Lexus models continue to top J.D. Power's quality rankings.)¹⁴ Toyota's flexible manufacturing system was developed by one of the company's engineers, Ohno Taiichi. After working at Toyota for five years and visiting Ford's U.S. plants, Ohno became convinced that the mass production philosophy for making cars was flawed. He saw numerous problems with mass production.

First, long production runs created massive inventories that had to be stored in large warehouses. This was expensive, both because of the cost of warehousing and because inventories tied up capital in unproductive uses. Second, if the initial machine settings were wrong, long production runs resulted in the production of a large number of defects (i.e., waste). Third, the mass production system was unable to accommodate consumer preferences for product diversity.

In response, Ohno looked for ways to make shorter production runs economical. He developed a number of techniques designed to reduce setup times for production equipment (a major source of fixed costs). By using a system of levers and pulleys, he reduced the time required to change dies on stamping equipment from a full day in 1950 to three minutes by 1971. This made small production runs economical, which allowed Toyota to respond better to consumer demands for product diversity. Small production runs also eliminated the need to hold large inventories, thereby reducing warehousing costs. Plus, small product runs and the lack of inventory meant that defective parts were produced only in small numbers and entered the assembly process immediately. This reduced waste and helped trace defects back to their source to fix the problem. In sum, these innovations enabled Toyota to produce a more diverse product range at a lower unit cost than was possible with conventional mass production.¹⁵

Flexible Machine Cells

Flexible manufacturing technology in which a grouping of various machine types, a common materials handler, and a centralized cell controller produce a family of products.

Flexible machine cells are another common flexible manufacturing technology. A flexible machine cell is a grouping of various types of machinery, a common materials handler, and a centralized cell controller (computer). Each cell normally contains four to six machines capable of performing a variety of operations. The typical cell is dedicated to the production of a family of parts or products. The settings on machines are computer controlled, which allows each cell to switch quickly between the production of different parts or products.

Improved capacity utilization and reductions in work in progress (that is, stockpiles of partly finished products) and in waste are major efficiency benefits of flexible machine cells. Improved capacity utilization arises from the reduction in setup times and from the computer-controlled coordination of production flow between machines, which eliminates bottlenecks. The tight coordination between machines also reduces work-in-progress inventory. Reductions in waste are due to the ability of computer-controlled machinery to identify ways to transform inputs into outputs while producing a minimum of unusable waste material. While freestanding machines might be in use 50 percent of the time, the same machines when grouped into a cell can be used more than 80 percent of the time and produce the same end product with half the waste. This increases efficiency and results in lower costs.

The effects of installing flexible manufacturing technology on a company's cost structure can be dramatic. Ford Motor Co. has been introducing flexible manufacturing technologies into its automotive plants around the world. These new technologies should allow Ford to produce multiple models from the same line and to switch production

from one model to another much more quickly than in the past, allowing Ford to take \$2 billion out of its cost structure.¹⁶

Besides improving efficiency and lowering costs, flexible manufacturing technologies also enable companies to customize products to the demands of small consumer groups—at a cost that at one time could be achieved only by mass-producing a standardized output. Thus, the technologies help a company achieve mass customization, which increases its customer responsiveness. Most important for international business, flexible manufacturing technologies can help a firm to customize products for different national markets. The importance of this advantage cannot be overstated. When flexible manufacturing technologies are available, a firm can manufacture products customized to various national markets at a single factory sited at the optimal location. And it can do this without absorbing a significant cost penalty. Thus, firms no longer need to establish manufacturing facilities in each major national market to provide products that satisfy specific consumer tastes and preferences, part of the rationale for a localization strategy (see Chapter 11).

Summary A number of technological factors support the economic arguments for concentrating production facilities in a few choice locations or even in a single location. Other things being equal, when fixed costs are substantial, the minimum efficient scale of production is high, and/or flexible manufacturing technologies are available, the arguments for concentrating production at a few choice locations are strong. This is true even when substantial differences in consumer tastes and preferences exist between national markets, because flexible manufacturing technologies allow the firm to customize products to national differences at a single facility. Alternatively, when fixed costs are low, the minimum efficient scale of production is low, and flexible manufacturing technologies are not available, the arguments for concentrating production at one or a few locations are not as compelling. In such cases, it may make more sense to manufacture in each major market in which the firm is active if this helps the firm better respond to local demands. This holds only if the increased local responsiveness more than offsets the cost disadvantages of not concentrating manufacturing. With the advent of flexible manufacturing technologies and mass customization, such a strategy is becoming less attractive. In sum, technological factors are making it feasible, and necessary, for firms to concentrate manufacturing facilities at optimal locations. Trade barriers and transportation costs are major brakes on this trend.

PRODUCT FACTORS Two product features affect location decisions. The first is the product's *value-to-weight* ratio because of its influence on transportation costs. Many electronic components and pharmaceuticals have high value-to-weight ratios; they are expensive and they do not weigh very much. Thus, even if they are shipped halfway around the world, their transportation costs account for a very small percentage of total costs. Given this, other things being equal, there is great pressure to produce these products in the optimal location and to serve the world market from there. The opposite holds for products with low value-to-weight ratios. Refined sugar, certain bulk chemicals, paint, and petroleum products all have low value-to-weight ratios; they are relatively inexpensive products that weigh a lot. Accordingly, when they are shipped long distances, transportation costs account for a large percentage of total costs. Thus, other things being equal, there is great pressure to make these products in multiple locations close to major markets to reduce transportation costs.

The other product feature that can influence location decisions is whether the product serves universal needs, needs that are the same all over the world. Examples include many industrial products (e.g., industrial electronics, steel, bulk chemicals) and

modern consumer products (e.g., handheld calculators, personal computers, video game consoles). Because there are few national differences in consumer taste and preference for such products, the need for local responsiveness is reduced. This increases the attractiveness of concentrating production at an optimal location.

LOCATING PRODUCTION FACILITIES There are two basic strategies for locating production facilities: concentrating them in a centralized location and serving the world market from there, or decentralizing them in various regional or national locations that are close to major markets. The appropriate strategic choice is determined by the various country-specific, technological, and product factors we have discussed in this section and are summarized in Table 14.1.

As can be seen, concentration of production makes most sense when:

- Differences between countries in factor costs, political economy, and culture have a substantial impact on the costs of manufacturing in various countries.
- Trade barriers are low.
- Externalities arising from the concentration of like enterprises favor certain locations.
- Important exchange rates are expected to remain relatively stable.
- The production technology has high fixed costs and high minimum efficient scale relative to global demand, or flexible manufacturing technology exists.
- The product's value-to-weight ratio is high.
- The product serves universal needs.

Alternatively, decentralization of production is appropriate when:

- Differences between countries in factor costs, political economy, and culture do not have a substantial impact on the costs of manufacturing in various countries.
- Trade barriers are high.

table 14.1
Location Strategy and
Production

	Concentrated Production Favored	Decentralized Production Favored
Country factors		
Difference in political economy	Substantial	Few
Difference in culture	Substantial	Few
Difference in factor costs	Substantial	Few
Trade barriers	Few	Substantial
Location externalities	Important in industry	Not important in industry
Exchange rates	Stable	Volatile
Technological factors		
Fixed costs	High	Low
Minimum efficient scale	High	Low
Flexible manufacturing technology	Available	Not available
Product factors		
Value-to-weight ratio	High	Low
Serves universal needs	Yes	No

- Location externalities are not important.
- Volatility in important exchange rates is expected.
- The production technology has low fixed costs and low minimum efficient scale, and flexible manufacturing technology is not available.
- The product's value-to-weight ratio is low.
- The product does not serve universal needs (that is, significant differences in consumer tastes and preferences exist between nations).

In practice, location decisions are seldom clear cut. For example, it is not unusual for differences in factor costs, technological factors, and product factors to point toward concentrated production while a combination of trade barriers and volatile exchange rates points toward decentralized production. This seems to be the case in the world automobile industry. Although the availability of flexible manufacturing and cars' relatively high value-to-weight ratios suggest concentrated manufacturing, the combination of formal and informal trade barriers and the uncertainties of the world's current floating exchange rate regime (see Chapter 10) have inhibited firms' ability to pursue this strategy. For these reasons, several automobile companies have established "top-to-bottom" manufacturing operations in three major regional markets: Asia, North America, and Western Europe.

The Strategic Role of Foreign Factories

Whatever the rationale behind establishing a foreign production facility, the strategic role of foreign factories can evolve over time.¹⁷ Initially, many foreign factories are established where labor costs are low. Their strategic role typically is to produce labor-intensive products at as low a cost as possible. For example, beginning in the 1970s, many U.S. firms in the computer and telecommunication equipment businesses established factories across Southeast Asia to manufacture electronic components, such as circuit boards and semiconductors, at the lowest possible cost. They located their factories in countries such as Malaysia, Thailand, and Singapore precisely because each of these countries offered an attractive combination of low labor costs, adequate infrastructure, and favorable tax and trade regime. Initially, the components produced by these factories were designed elsewhere and the final product was assembled elsewhere. Over time, however, the strategic role of some of these factories has expanded; they have become important centers for the design and final assembly of products for the global marketplace. For example, Hewlett-Packard's operation in Singapore was established as a low-cost location for the production of circuit boards, but the facility has become the center for the design and final assembly of portable ink-jet printers for the global marketplace (see the accompanying Management Focus). A similar process seems to be occurring at some of the factories that Philips has established in China (see the Management Focus on Philips) and may now be starting to happen in India with regard to the production of small cars (see the opening case).

Such upward migration in the strategic role of foreign factories arises because many foreign factories upgrade their own capabilities.¹⁸ This improvement comes from two sources. First, pressure from the center to improve a factory's cost structure and/or customize a product to the demands of consumers in a particular nation can start a chain of events that ultimately leads to development of additional capabilities at that factory. For example, to meet centrally mandated directions to drive down costs, engineers at HP's Singapore factory argued that they needed to redesign products so they could be manufactured at a lower cost. This led to the establishment of a design center in Singapore. As this design center proved its worth, HP executives realized the importance of co-locating design and manufacturing operations. They increasingly transferred more design

LEARNING OBJECTIVE 3

Recognize how the role of foreign subsidiaries in production can be enhanced over time as they accumulate knowledge.



Hewlett-Packard in Singapore

In the late 1960s, Hewlett-Packard was looking around Asia for a low-cost location to produce electronic components that were to be manufactured using labor-intensive processes. The company looked at several Asian locations and eventually settled on Singapore, opening its first factory there in 1970. Although Singapore did not have the lowest labor costs in the region, costs were low relative to North America. Plus, the Singapore location had several important benefits that could not be found at many other locations in Asia. The education level of the local workforce was high. English was widely spoken. The government of Singapore seemed stable and committed to economic development, and the city-state had one of the better infrastructures in the region, including good communication and transportation networks and a rapidly developing industrial and commercial base. HP also extracted favorable terms from the Singapore government with regard to taxes, tariffs, and subsidies.

At its start, the plant manufactured only basic components. The combination of low labor costs and a favorable tax regime helped to make this plant profitable early. In 1973, HP transferred the manufacture of one of its basic handheld calculators from the United States to Singapore. The objective was to reduce manufacturing costs, which the Singapore factory was quickly able to do. Increasingly confident in the capability of the Singapore factory to handle entire products, as opposed to just components, HP's management transferred other products to Singapore over the next few years including keyboards, solid-state displays, and integrated circuits. However, all these products were still designed, developed, and initially produced in the United States.

The plant's status shifted in the early 1980s when HP embarked on a worldwide campaign to boost product quality and reduce costs. HP transferred the production of its HP41C handheld calculator to Singapore. The managers at the Singapore plant were given the goal of substantially reducing manufacturing costs. They argued that this could

be achieved only if they were allowed to redesign the product so it could be manufactured at a lower overall cost. HP's central management agreed, and 20 engineers from the Singapore facility were transferred to the United States for one year to learn how to design application-specific integrated circuits. They then brought this expertise back to Singapore and set about redesigning the HP41C.

The results were a huge success. By redesigning the product, the Singapore engineers reduced manufacturing costs for the HP41C by 50 percent. Using this newly acquired capability for product design, the Singapore facility then set about redesigning other products it produced. HP's corporate managers were so impressed with the progress made at the factory that they transferred production of the entire calculator line to Singapore in 1983. This was followed by the partial transfer of ink-jet production to Singapore in 1984 and keyboard production in 1986. In all cases, the facility redesigned the products and often reduced unit manufacturing costs by more than 30 percent. The initial development and design of all these products, however, still occurred in the United States.

In the late 1980s and 1990s, the Singapore plant assumed added responsibilities, particularly in the ink-jet printer business. The factory was given the job of redesigning an HP ink-jet printer for the Japanese market. Although the initial product redesign was a market failure, the managers at Singapore pushed to be allowed to try again. They were given the job of redesigning HP's DeskJet 505 printer for the Japanese market. This time the redesigned product was a success, garnering significant sales in Japan. Emboldened by this success, the plant has continued to take on additional design responsibilities. Today, it is viewed as a "lead plant" within HP's global network, with primary responsibility not just for manufacturing, but also for the development and design of a family of small ink-jet printers targeted at the Asian market.

Sources: K. Ferdows, "Making the Most of Foreign Factories," *Harvard Business Review*, March–April 1997, pp. 73–88; and "Hewlett-Packard: Singapore," Harvard Business School Case No. 694–035.

responsibilities to the Singapore factory. In addition, the Singapore factory ultimately became the center for the design of products tailored to the needs of the Asian market. This made good strategic sense because it meant products were being designed by engineers who were close to the Asian market and probably had a good understanding of the needs of that market, as opposed to engineers located in the United States.

A second source of improvement in the capabilities of a foreign 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 past 20 years. Their communication and transportation infrastructures and the education level of the population have improved. While these countries once lacked the advanced infrastructure required to support sophisticated design, development, and manufacturing operations, this is often no longer the case. This has made it much easier for factories based in these nations to take on a greater strategic role.

Because of such developments, many international businesses are moving away from a system in which their foreign factories were viewed as nothing more than low-cost manufacturing facilities and toward one where foreign factories are viewed as globally dispersed centers of excellence.¹⁹ In this new model, foreign factories take the lead role for the design and manufacture of products to serve important national or regional markets or even the global market. The development of such dispersed centers of excellence is consistent with the concept of a transnational strategy, introduced in Chapter 12. A major aspect of a transnational strategy is a belief in **global learning**—the idea that valuable knowledge does not reside just in a firm's domestic operations; it may also be found in its foreign subsidiaries. Foreign factories that upgrade their capabilities over time are creating valuable knowledge that might benefit the whole corporation.

Managers of international businesses need to remember that foreign factories can improve their capabilities over time, and this can be of immense strategic benefit to the firm. Rather than viewing foreign factories simply as sweatshops where unskilled labor churns out low-cost goods, managers need to see them as potential centers of excellence and to encourage and foster attempts by local managers to upgrade the capabilities of their factories and, thereby, enhance their strategic standing within the corporation.

Such a process does imply that once a foreign factory has been established and valuable skills have been accumulated, it may not be wise to switch production to another location simply because some underlying variable, such as wage rates, has changed.²⁰ HP has kept its facility in Singapore, rather than switching production to a location where wage rates are now much lower, such as Vietnam, because it recognizes that the Singapore factory has accumulated valuable skills that more than make up for the higher wage rates. Thus, when reviewing the location of production facilities, the international manager must consider the valuable skills that may have been accumulated at various locations, and the impact of those skills on factors such as productivity and product design.

Global Learning

The flow of skills and product offerings from foreign subsidiary to home country and from foreign subsidiary and foreign subsidiary.

Outsourcing Production: Make-or-Buy Decisions

International businesses frequently face **make-or-buy decisions**, decisions about whether they should perform a certain value creation activity themselves or outsource it to another entity.²¹ Historically, most outsourcing decisions have involved the manufacture of physical products. Most manufacturing firms have done their own final assembly, but have had to decide whether to vertically integrate and manufacture their own component parts or outsource the production of such parts, purchasing them from independent suppliers. Such make-or-buy decisions are an important aspect of the strategy of many firms. In the automobile industry, for example, the typical car contains more than 10,000 components, so automobile firms constantly face make-or-buy decisions. Toyota produces less than 30 percent of the value of cars that roll off its assembly lines. The remaining 70 percent, mainly accounted for by component parts and complex subassemblies, comes from independent suppliers. In the athletic shoe industry, the make-or-buy issue has been taken to an extreme with companies such as Nike and Reebok having no involvement in manufacturing; all production has been outsourced, primarily to manufacturers based in low-wage countries.

LEARNING OBJECTIVE 4

Identify the factors that influence a firm's decision of whether to source supplies from within the company or from foreign suppliers.

Make-or-Buy Decisions

Whether a firm should make or buy component parts.



Nike relies on outsourcing to manufacture its products. The company has received worldwide criticism for turning its back on social responsibility for the sake of profit.

Specialized Asset

An asset designed to perform a specific task, whose value is significantly reduced in its next-best use.

movements, changes in relative factor costs, and the like. In this section, we examine the arguments for making products in-house and for buying them, and we consider the trade-offs involved in such a decision. Then we discuss strategic alliances as an alternative to producing all or part of a product within the company.

THE ADVANTAGES OF MAKE The arguments that support making all or part of a product in-house—vertical integration—are fourfold. Vertical integration

may be associated with lower costs, facilitate investments in highly specialized assets, protect proprietary product technology, and ease the scheduling of adjacent processes.

Lowering Costs It may pay a firm to continue manufacturing a product or component part in-house if the firm is more efficient at that production activity than any other enterprise.

Facilitating Specialized Investments Some times firms have to invest in specialized assets in order to do business with another enterprise.²³ A **specialized asset** is an asset whose value is contingent upon a particular relationship persisting. For example, imagine Ford of Europe has developed a new, high-performance, high-quality, and uniquely designed fuel-injection system. The increased fuel



Another Perspective

Outsourcing: A Strategy for the Future

Although many American workers take a negative view of outsourcing because it typically means a loss of jobs stateside, outsourcing can be a useful strategy for managing quality and controlling costs. In addition, some other perspectives add to the strategic role that outsourcing decisions play in today's business environment. For a developing country, outsourcing provides a way to "get into the game." For a global organization, outsourcing creates an opportunity to build a presence in a future market while it's still developing. Establishing an early presence may lead to first-mover advantages, creating brand loyalty in consumers and providing valuable market knowledge for the producer.

efficiency will help sell Ford cars. Ford must decide whether to make the system in-house or to contract out the manufacturing to an independent supplier. Manufacturing these uniquely designed systems requires investments in equipment that can be used only for this purpose; it cannot be used to make fuel injection systems for any other auto firm. Thus, investment in this equipment constitutes an investment in specialized assets. When, as in this situation, one firm must invest in specialized assets to supply another, mutual dependency is created. In such circumstances, each party might fear the other will abuse the relationship by seeking more favorable terms.

To appreciate this, let us first examine this situation from the perspective of an independent supplier who has been asked by Ford to make this investment. The supplier might reason that once it has made the investment, it will become dependent on Ford for business since Ford is the only possible customer for the output of this equipment. The supplier perceives this as putting Ford in a strong bargaining position and worries that once the specialized investment has been made, Ford might use this to squeeze down prices for the systems. Given this risk, the supplier declines to make the investment in specialized equipment.

Now take the position of Ford. Ford might reason that if it contracts out production of these systems to an independent supplier, it might become too dependent on that supplier for a vital input. Because specialized equipment is required to produce the fuel injection systems, Ford cannot easily switch its orders to other suppliers who lack that equipment. (It would face high switching costs.) Ford perceives this as increasing the bargaining power of the supplier and worries that the supplier might use its bargaining strength to demand higher prices.

Thus, the mutual dependency that outsourcing would create makes Ford nervous and scares away potential suppliers. The problem here is lack of trust. Neither party completely trusts the other to play fair. Consequently, Ford might reason that the only safe way to get the new fuel injection systems is to manufacture them itself. It may be unable to persuade any independent supplier to manufacture them. Thus, Ford decides to make rather than buy.

In general, we can predict that when substantial investments in specialized assets are required to manufacture a component, the firm will prefer to make the component internally rather than contract it out to a supplier. Substantial empirical evidence supports this prediction.²⁴

Protecting Proprietary Product Technology Proprietary product technology is unique to a firm. If it enables the firm to produce a product containing superior features, proprietary technology can give the firm a competitive advantage. The firm would not want competitors to get this technology. If the firm outsources the production of entire products or components containing proprietary technology, it runs the risk that those suppliers will expropriate the technology for their own use or that they will sell it to the firm's competitors. Thus, to maintain control over its technology, the firm might prefer to make such products or component parts in-house.

Improving Scheduling Another argument for producing all or part of a product in-house is that production cost savings result because it makes planning, coordination, and scheduling of adjacent processes easier.²⁵ This is particularly important in firms with just-in-time inventory systems (discussed later in the chapter). In the 1920s, for example, Ford profited from tight coordination and scheduling made possible by backward vertical integration into steel foundries, iron ore shipping, and mining. Deliveries at Ford's foundries on the Great Lakes were coordinated so well that ore was turned into engine blocks within 24 hours. This substantially reduced Ford's production costs by eliminating the need to hold excessive ore inventories.

For international businesses that source worldwide, scheduling problems can be exacerbated by the time and distance between the firm and its suppliers. This is true whether the firms use their own subunits as suppliers or use independent suppliers. However, ownership of upstream production facilities is not the issue here. By using information technology, firms can attain tight coordination between different stages in the production process.

THE ADVANTAGES OF BUY Buying component parts, or an entire product, from independent suppliers can give the firm greater flexibility, can help drive down the firm's cost structure, and may help the firm capture orders from international customers.

Strategic Flexibility The great advantage of buying component parts, or even an entire product, from independent suppliers is that the firm can maintain its flexibility, switching orders between suppliers as circumstances dictate. This is particularly important internationally, where changes in exchange rates and trade barriers can alter the attractiveness of supply sources. One year Hong Kong might offer the lowest cost for a particular component, and the next year, Mexico may. Many firms source the same products from suppliers based in two countries, primarily as a hedge against adverse movements in factor costs, exchange rates, and the like.

Sourcing products from independent suppliers can also be advantageous when the optimal location for manufacturing a product is beset by political risks. Under such circumstances, foreign direct investment to establish a component manufacturing operation in that country would expose the firm to political risks. The firm can avoid many of these risks by buying from an independent supplier in that country, thereby maintaining the flexibility to switch sourcing to another country if a war, revolution, or other political change alters that country's attractiveness as a supply source.

However, maintaining strategic flexibility has its downside. If a supplier perceives the firm will change suppliers in response to changes in exchange rates, trade barriers, or general political circumstances, that supplier might not be willing to make investments in specialized plants and equipment that would ultimately benefit the firm.

Lower Costs Although making a product or component part in-house—vertical integration—is often undertaken to lower costs, it may have the opposite effect. When this is the case, outsourcing may lower the firm's cost structure. Making all or part of a product in-house increases an organization's scope, and the resulting increase in organizational complexity can raise a firm's cost structure. There are three reasons for this.

First, the greater the number of subunits in an organization, the more problems coordinating and controlling those units. Coordinating and controlling subunits require top management to process large amounts of information about subunit activities. The greater the number of subunits, the more information top management must process and the harder it is to do well. Theoretically, when the firm becomes involved in too many activities, headquarters management will be unable to effectively control all of them, and the resulting inefficiencies will more than offset any advantages derived from vertical integration.²⁶ This can be particularly serious in an international business, where the problem of controlling subunits is exacerbated by distance and differences in time, language, and culture.

Second, the firm that vertically integrates into component part manufacture may find that because its internal suppliers have a captive customer in the firm, they lack an incentive to reduce costs. The fact that they do not have to compete for orders with other suppliers may result in high operating costs. The managers of the supply operation may be tempted to pass on cost increases to other parts of the firm in the form of higher transfer prices, rather than looking for ways to reduce those costs.

Third, vertically integrated firms have to determine appropriate prices for goods transferred to subunits within the firm. This is a challenge in any firm, but it is even more complex in international businesses. Different tax regimes, exchange rate movements, and headquarters' ignorance about local conditions all increase the complexity of transfer pricing decisions. This complexity enhances internal suppliers' ability to manipulate transfer prices to their advantage, passing cost increases downstream rather than looking for ways to reduce costs.

The firm that buys its components from independent suppliers can avoid all these problems and the associated costs. The firm that sources from independent suppliers has fewer subunits to control. The incentive problems that occur with internal suppliers do not arise when independent suppliers are used. Independent suppliers know they must continue to be efficient if they are to win business from the firm. Also, because independent suppliers' prices are set by market forces, the transfer pricing problem does not exist. In sum, the bureaucratic inefficiencies and resulting costs that can arise when firms vertically integrate backward and produce their own components are avoided by buying component parts from independent suppliers.

Offsets Another reason for outsourcing some manufacturing to independent suppliers based in other countries is that it may help the firm capture more orders from that country. Offsets are common in the commercial aerospace industry. For example, before Air India places a large order with Boeing, the Indian government might ask Boeing to push some subcontracting work toward Indian manufacturers. This is not unusual in international business. Representatives of the U.S. government have repeatedly urged Japanese automobile companies to purchase more component parts from U.S. suppliers to partially offset the large volume of automobile exports from Japan to the United States.

TRADE-OFFS Clearly there are trade-offs in make-or-buy decisions. The benefits of making all or part of a product in-house seem to be greatest when highly specialized assets are involved, when vertical integration is necessary for protecting proprietary technology, or when the firm is simply more efficient than external suppliers at performing a particular activity. When these conditions are not present, the risk of strategic inflexibility and organizational problems suggest it may be better to contract out some or all production to independent suppliers. Because issues of strategic flexibility and organizational control loom even larger for international businesses than purely domestic ones, an international business should be particularly wary of vertical integration into component part manufacture. In addition, some outsourcing in the form of offsets may help a firm gain larger orders in the future.

STRATEGIC ALLIANCES WITH SUPPLIERS Several international businesses have tried to reap some benefits of vertical integration without the associated organizational problems by entering strategic alliances with essential suppliers. For example, there was an alliance between Kodak and Canon, under which Canon built photocopiers for sale by Kodak; an alliance between Microsoft and Flextronics, under which Flextronics built the Xbox for Microsoft; and an alliance between Boeing and several Japanese companies to build its jet aircraft, including the 787. By these alliances, Kodak, Microsoft, and Boeing have committed themselves to long-term relationships with these suppliers, which have encouraged the suppliers to undertake specialized investments. Strategic alliances build trust between the firm and its suppliers. Trust is built when a firm makes a credible commitment to continue purchasing from a supplier on reasonable terms. For example, the firm may invest money in a supplier—perhaps by taking a minority shareholding—to signal its intention to build a productive, mutually beneficial long-term relationship.

This kind of arrangement between the firm and its parts suppliers was pioneered in Japan by large auto companies such as Toyota. Many Japanese automakers have cooperative relationships with their suppliers that go back decades. In these relationships, the auto companies and their suppliers collaborate on ways to increase value added by, for example, implementing just-in-time inventory systems or cooperating in the design of component parts to improve quality and reduce assembly costs. These relationships have been formalized when the auto firms acquired minority shareholdings in many of their essential suppliers to symbolize their desire for long-term cooperative relationships with them. At the same time, the relationship between the firm and each essential supplier remains market mediated and terminable if the supplier fails to perform. By pursuing such a strategy, the Japanese automakers capture many of the benefits of vertical integration, particularly those arising from investments in specialized assets, without suffering the organizational problems that come with formal vertical integration. The parts suppliers also benefit from these relationships because they grow with the firm they supply and share in its success.²⁷

The adoption of just-in-time inventory systems (JIT), computer-aided design (CAD), and computer-aided manufacturing (CAM) over the past two decades 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. To get a supplier to agree to adopt such systems, a firm must make a credible commitment to an enduring relationship with the supplier—it must build trust with the supplier. It can do this within the framework of a strategic alliance.

Alliances are not all good. Like formal vertical integration, a firm that enters long-term alliances may limit its strategic flexibility by the commitments it makes to its alliance partners. As we saw in Chapter 12 when we considered alliances between competitors, a firm that allies itself with another firm risks giving away key technological know-how to a potential competitor.

Managing a Global Supply Chain

LEARNING OBJECTIVE 5

Describe what is required to efficiently coordinate a globally dispersed production system.

Logistics encompasses the activities necessary to get materials from suppliers to a manufacturing facility, through the manufacturing process, and out through a distribution system to the end user.²⁸ In the international business, the logistics function manages the global supply chain. The twin objectives of logistics are to manage a firm's global supply chain at the lowest possible cost and in a way that best serves customer needs, thereby lowering the costs of value creation and helping the firm establish a competitive advantage through superior customer service.

The potential for reducing costs through more efficient logistics is enormous. For the typical manufacturing enterprise, material costs account for between 50 and 70 percent of revenues, depending on the industry. Even a small reduction in these costs can have a substantial impact on profitability. According to one estimate, for a firm with revenues of \$1 million, a return on investment rate of 5 percent, and materials costs that are 50 percent of sales revenues, a \$15,000 increase in total profits could be achieved either by increasing sales revenues 30 percent or by reducing materials costs by 3 percent.²⁹ In a saturated market, it would be much easier to reduce materials costs by 3 percent than to increase sales revenues by 30 percent.

Just-in-Time (JIT) Inventory

Logistics system designed to deliver parts to a production process as they are needed, not before.

THE ROLE OF JUST-IN-TIME INVENTORY Pioneered by Japanese firms during that country's remarkable economic transformation during the 1960s and 1970s, just-in-time inventory systems now play a major role in most manufacturing firms. The basic philosophy behind **just-in-time (JIT) inventory** systems is

to economize on inventory holding costs by having materials arrive at a manufacturing plant just in time to enter the production process and not before. The major cost saving comes from speeding up inventory turnover. This reduces inventory holding costs, such as warehousing and storage costs. It means the company can reduce the amount of working capital it needs to finance inventory, freeing capital for other uses and/or lowering the total capital requirements of the enterprise. Other things being equal, this will boost the company's profitability as measured by return on capital invested. It also means the company is less likely to have excess unsold inventory that it has to write off against earnings or price low to sell.

In addition to the cost benefits, JIT systems can also help firms improve product quality. Under a JIT system, parts enter the manufacturing process immediately; they are not warehoused. This allows defective inputs to be spotted right away. The problem can then be traced to the supply source and fixed before more defective parts are produced. Under a more traditional system, warehousing parts for weeks before they are used allows many defective parts to be produced before a problem is recognized.

The drawback of a JIT system is that it leaves a firm without a buffer stock of inventory. Although buffer stocks are expensive to store, they can help a firm respond quickly to increases in demand and tide a firm over shortages brought about by disruption among suppliers. Such a disruption occurred after the September 11, 2001, attacks on the World Trade Center, when the subsequent shutdown of international air travel and shipping left many firms that relied upon globally dispersed suppliers and tightly managed "just-in-time" supply chains without a buffer stock of inventory. A less pronounced but similar situation occurred again in April 2003 when the outbreak of pneumonia-like SARS (severe acute respiratory syndrome) virus in China resulted in the temporary shutdown of several plants operated by foreign companies and disrupted their global supply chains. Similarly, in late 2004, record imports into the United States left several major West Coast shipping ports clogged with too many ships from Asia that could not be unloaded fast enough, and disrupted the finely tuned supply chains of several major U.S. enterprises.³⁰

There are ways of reducing the risks associated with a global supply chain that operates on just-in-time principles. To reduce the risks associated with depending on one supplier for an important input, some firms source these inputs from several suppliers located in different countries. While this does not help in the case of an event with global ramifications, such as September 11, 2001, it does help manage country-specific supply disruptions, which are more common.

THE ROLE OF INFORMATION TECHNOLOGY AND THE INTERNET

Web-based information systems play a crucial role in modern materials management. By tracking component parts as they make their way across the globe toward an assembly plant, information systems enable a firm to optimize its production scheduling according to when components are expected to arrive. By locating component parts in the supply chain precisely, good information systems allow the firm to accelerate



Another Perspective

Logistics in the Service Sector: Global Account Management

Like manufacturers, professional service firms have also been learning how to better manage their delivery on a global basis. For example, some global accounting firms are dealing with other global firms in a new way, using one supplier for all their accounting-related needs around the world. The traditional approach involved the development of market-specific relationships, so the same multinational client would have 5 to 20 individual accounting relationships, one in each major market for each company division. Under a global account management approach, one relationship has a global span—and one contract. Such logistics allow for more effective relationship management, a better sense of what the client needs, more product extension opportunities, and better pricing and economies.

production when needed by pulling key components out of the regular supply chain and having them flown to the manufacturing plant.

Firms now typically use electronic data interchange (EDI) via the Internet to coordinate the flow of materials into manufacturing, through manufacturing, and out to customers. Sometimes customers also are integrated into the system. These electronic links are then used to place orders with suppliers, to register parts leaving a supplier, to track them as they travel toward a manufacturing plant, and to register their arrival. Suppliers typically use an EDI link to send invoices to the purchasing firm. One consequence of an EDI system is that suppliers, shippers, and the purchasing firm can communicate with each other with no time delay, which increases the flexibility and responsiveness of the whole global supply system. A second consequence is that much of the paperwork between suppliers, shippers, and the purchasing firm is eliminated. Good EDI systems can help a firm decentralize materials management decisions to the plant level by giving corporate-level managers the information they need for coordinating and controlling decentralized materials management groups.

Before the emergence of the Internet as a major communication medium, firms and their suppliers normally had to purchase expensive proprietary software solutions to implement EDI systems. The ubiquity of the Internet and the availability of Web-based applications have made most of these proprietary solutions obsolete. Less expensive Web-based systems that are much easier to install and manage now dominate the market for global supply chain management software. These Web-based systems have transformed the management of globally dispersed supply chains, allowing even small firms to achieve a much better balance between supply and demand, thereby reducing the inventory in their systems and reaping the associated economic benefits. With many firms now using these systems, those that do not will find themselves at a competitive disadvantage.

Key Terms

production, p. 469	minimum efficient scale, p. 474	make-or-buy decisions, p. 481
logistics, p. 469	flexible manufacturing technology (lean production), p. 475	specialized asset, p. 482
total quality management (TQM), p. 470	mass customization, p. 475	just-in-time
Six Sigma, p. 471	flexible machine cells, p. 476	inventory, p. 486
ISO 9000, p. 471	global learning, p. 481	

Summary

This chapter explained how efficient production and logistics functions can improve an international business's competitive position by lowering the costs of value creation and by performing value creation activities in such ways that customer service is enhanced and value added is maximized. We looked closely at three issues central to international production and logistics: where to produce, what to make and what to buy, and how to coordinate a globally dispersed manufacturing and

supply system. The chapter made the following points:

1. The choice of an optimal production location must consider country factors, technological factors, and product factors.
2. Country factors include the influence of factor costs, political economy, and national culture on production costs, along with the presence of location externalities.

3. Technological factors include the fixed costs of setting up production facilities, the minimum efficient scale of production, and the availability of flexible manufacturing technologies that allow for mass customization.
4. Product factors include the value-to-weight ratio of the product and whether the product serves universal needs.
5. Location strategies either concentrate or decentralize manufacturing. The choice should be made in light of country, technological, and product factors. All location decisions involve trade-offs.
6. Foreign factories can improve their capabilities over time, and this can be of immense strategic benefit to the firm. Managers need to view foreign factories as potential centers of excellence and to encourage and foster attempts by local managers to upgrade factory capabilities.
7. An essential issue in many international businesses is determining which component parts should be manufactured in-house and which should be outsourced to independent suppliers.
8. Making components in-house facilitates investments in specialized assets and helps the firm protect its proprietary technology. It may improve scheduling between adjacent stages in the value chain, also. In-house production also makes sense if the firm is an efficient, low-cost producer of a technology.
9. Buying components from independent suppliers facilitates strategic flexibility and helps the firm avoid the organizational problems associated with extensive vertical integration. Outsourcing might also be employed as part of an “offset” policy, which is designed to win more orders for the firm from a country by pushing some subcontracting work to that country.
10. Several firms have tried to attain the benefits of vertical integration and avoid its associated organizational problems by entering long-term strategic alliances with essential suppliers.
11. Although alliances with suppliers can give a firm the benefits of vertical integration without dispensing entirely with the benefits of a market relationship, alliances have drawbacks. The firm that enters a strategic alliance may find its strategic flexibility limited by commitments to alliance partners.
12. Logistics encompasses all the activities that move materials to a production facility, through the production process, and out through a distribution system to the end user. The logistics function is complicated in an international business by distance, time, exchange rates, custom barriers, and other things.
13. Just-in-time systems generate major cost savings from reducing warehousing and inventory holding costs and from reducing the need to write off excess inventory. In addition, JIT systems help the firm spot defective parts and remove them from the manufacturing process quickly, thereby improving product quality.
14. Information technology, particularly Internet-based electronic data interchange, plays a major role in materials management. EDI facilitates the tracking of inputs, allows the firm to optimize its production schedule, lets the firm and its suppliers communicate in real time, and eliminates the flow of paperwork between a firm and its suppliers.

Critical Thinking and Discussion Questions

1. An electronics firm is considering how best to supply the world market for microprocessors used in consumer and industrial electronic products. A manufacturing plant costs about \$500 million to construct and requires a highly skilled workforce. The total value of the world market for this product over the next 10 years is estimated to be between \$10 billion and \$15 billion. The tariffs prevailing in this industry are currently low. Should the firm adopt a concentrated or decentralized manufacturing strategy? What kind of location(s) should the firm favor for its plant(s)?
2. A chemical firm is considering how best to supply the world market for sulfuric acid. A manufacturing plant costs about \$20 million to

construct and requires a moderately skilled workforce. The total value of the world market for this product over the next 10 years is estimated to be between \$20 billion and \$30 billion. The tariffs prevailing in this industry are moderate. Should the firm favor concentrated manufacturing or decentralized manufacturing? What kind of location(s) should the firm seek for its plant(s)?

3. A firm must decide whether to make a component part in-house or to contract it out to an independent supplier. Manufacturing the part requires a nonrecoverable investment in specialized assets. The most efficient suppliers are located in countries with currencies that many foreign exchange analysts expect to appreciate substantially over the next decade. What are the pros and cons of (a) manufacturing

the component in-house and (b) outsourcing manufacturing to an independent supplier? Which option would you recommend? Why?

4. Reread the Management Focus on Philips in China then answer the following questions:
 - a. What are the benefits to Philips of shifting so much of its global production to China?
 - b. What are the risks associated with a heavy concentration of manufacturing assets in China?
 - c. What strategies might Philips adopt to maximize the benefits and mitigate the risks associated with moving so much product?
5. Explain how an efficient logistics function can help an international business compete more effectively in the global marketplace.

Research Task



<http://globalEDGE.msu.edu>

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

1. You work for a company whose manufacturing operations require a highly skilled labor force. Some executives have recently decided to open a production plant in Europe to serve that market because the high cost of transporting the products from your U.S. plant are making your company's products less attractive for consumers. Using the *Chartbook of International Labor Comparisons*, compare the attractiveness of

producing in Spain, Italy, and Portugal based both on labor market indicators and on competitiveness indicators for manufacturing. Prepare an executive summary recommending where your company should produce.

2. The International Association of Outsourcing Professionals (IAOP) ranks the world's best *global outsourcing* service providers. What are the criteria used to rank companies? Identify the 10 best companies. What are the key strengths for each company? Do you notice any trends in the information you have gathered?



Building the Boeing 787

closing case

Boeing's newest commercial jet aircraft, the wide-bodied 787 jet, is a bold bet on the future of both airline travel and plane making. Designed to fly long-haul point-to-point routes, the 250-seat 787 is made largely out of composite materials, such as carbon fibers, rather than traditional materials such as aluminum. Some 80 percent of the 787 by volume is composite materials, making the plane 20 percent lighter than a traditional aircraft of the same size, which translates into a big

saving in jet fuel consumption and costs. The 787 is also packed full of other design innovations, including larger windows, greater headroom, and state-of-the-art electronics on the flight deck and in the passenger compartment.

To reduce the risks associated with this technological gamble, Boeing outsourced an unprecedented 70 percent of the content of the 787 to other manufacturers, most of them based in other nations. In contrast, 50 percent of the Boeing 777 was

outsourced, 30 percent of the 767, and only 5 percent of the 707. The idea was that in return for a share of the work, partners would contribute toward the estimated \$8 billion in development costs for the 787. In addition, by outsourcing, Boeing believed it could tap into the expertise of the most efficient producers, wherever they might be located, thereby driving down the costs of making the plane. Furthermore, Boeing believed that outsourcing some work to foreign countries would help it garner sales in those countries. Boeing's role in the entire process was to design the plane, market and sell it, and undertake final assembly in its Everett plant in Washington State. Boeing also believed that by outsourcing the design of so many components, it could cut the time to develop this aircraft to four years from the six that is normal in the industry.

Some 17 partners in 10 countries were selected to produce major parts of the aircraft. The rear fuselage was to be made by Vought Aircraft Industries in South Carolina, Alenia Aeronautica of Italy was to make the middle fuselage sections and horizontal tailpieces. Three Japanese companies, Fuji, Kawasaki, and Mitsubishi, were to produce the planes wing. The nose section was to be made by Toronto-based Onex Corporation. All of these bulky pieces were to be shipped to Everett for final assembly aboard a fleet of three modified Boeing 747 freighters call "Dreamlifters."

Until late 2007, the strategy seemed to be working remarkably well. Boeing had booked orders for more than 770 aircraft, worth more than \$100 billion, making the 787 the most successful aircraft launch in the history of commercial aviation. But behind the scenes, cracks were appearing in Boeing's globally dispersed supply chain. In mid-2007, Boeing admitted the 787 might be a few months late due to problems with the supply of special fasteners for the fuselage. As it turned out, the problems were much more serious. By early 2008 Boeing was admitting to a delay of up to 12 months in the delivery of the first 787, an additional \$2 billion in development costs, and was facing the possibility of having to pay millions in penalty clause payments for late delivery to its leading customers.

The core issue was that several key partners had not been able to meet Boeing's delivery schedules. To make composite parts, for example, Italy's Alenia had to build a new factory, but the site that it chose was a 300-year-old olive grove, and it faced months of haggling with local authorities and had to agree to replant the trees elsewhere before it could break ground. To compound problems, its first fuselage sections delivered to Boeing did not meet the required quality standards. Then when parts did arrive at Everett, Boeing

found that many components had not been installed in the fuselages (as required), and that assembly instructions were available only in Italian. Other problems arose because several partners themselves outsourced mission critical design work to other enterprises. Vought, for example, outsourced the design and building of floor pieces for which it was responsible to an Israeli company. In turn, the Israeli company had trouble meeting Boeing's exacting quality standards. However, because it was reporting to Vought, not Boeing, executives at Boeing did not learn of this until it had already become a serious bottleneck. Upon learning of the issue, Boeing rapidly dispatched engineers to Israel to work with the company, but by now several months had been lost. Boeing also subsequently acquired Vought in 2009, bringing the supplier in-house.

Despite all of these issues, Boeing remains committed to its outsourcing program.

However, the company has learned that if it is going to outsource work to foreign suppliers, much closer management oversight and coordination is required. The company has also indicated that as valuable as outsourcing can be, it probably went too far with the 787. Going forward, Boeing has signaled that it will not outsource key components that are seen as a source of Boeing's competitive advantage (wings, in particular, are often mentioned as a component that may not be outsourced for future aircraft models).

Sources: J. L. Lunsford, "Jet Blues," *The Wall Street Journal*, December 7, 2007, p. A1; J. Gapper, "A Clever Way to Build a Boeing," *Financial Times*, July 9, 2007, p. 11; J. Teresko, "The Boeing 787: A Matter of Materials," *Industry Week*, December 2007, pp. 34–39; and P. Sanders, "Boeing Takes Control of Plants," *The Wall Street Journal*, December 23, 2009, p. B2.

Case Discussion Questions

1. What are the benefits to Boeing of outsourcing so much work on the 787 to foreign suppliers? What are the potential risks? Do the benefits outweigh the risks?
2. In 2007 and 2008 Boeing ran into several publicized issues with regard to its management of a globally dispersed supply chain? What are the causes of these problems? What can a company such as Boeing do to make sure such problems do not occur in the future?
3. Some critics have claimed that by outsourcing so much work, Boeing has been exporting American jobs overseas. Is this criticism fair? How should the company respond to such criticisms?



part 5

Competing in a Global Marketplace

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Explain why it might make sense to vary the attributes of a product from country to country.
- 2 Recognize why and how a firm's distribution strategy might vary among countries.
- 3 Identify why and how advertising and promotional strategies might vary among countries.
- 4 Explain why and how a firm's pricing strategy might vary among countries.
- 5 Describe how the globalization of the world economy is affecting new-product development within the international business firm.

Global Marketing and R&D

Ford's Marketing Goes Global

opening case

In recent years globalization has become a major thrust at Ford, the most successful of America's troubled automobile companies. The company has been pushing aggressively toward development of global vehicles—models that share the same components, look the same, and are positioned the same way wherever they are sold. By 2015 all Ford vehicles competing in global segments should be common in North America, Europe, and Asia. They include the Fiesta and Focus small cars, Fusion and Mondeo midsize cars, and commercial vans.

To support this "One Ford" vision, Ford consolidated its national and regional product development activities into one organization in 2006 and charged it with creating global models. In the process, the company cut costs by hundreds of millions of dollars by eliminating overlap. Global purchasing operations were consolidated in 2008, again for large cost savings both from eliminating duplication and from the pricing power associated with purchasing components on a large scale. Then 2009 held a turn for marketing with the creation of a global marketing, sales and service organization to integrate and drive a more consistent and compelling connection with customers around the world.

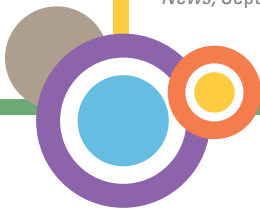
In the past, Ford's marketing departments in different countries had the authority to create their own programs, and often did so in a vacuum without coordinating with marketers in other countries. The result was not only high costs from extensive duplication of everything from TV commercials and photos sessions to public relations events, but also a lack of consistency in marketing message and public relations strategy. Now Ford is insisting that marketing managers from different countries and regions communicate with each other before developing a marketing strategy for a vehicle.

The goal is not to have an identical marketing strategy for each country, but to have greater commonalities and synergies—to learn from each other, leveraging good ideas while reducing the duplication of effort. Thus, for example, instead of hiring different photographers to shoot different pictures of the same car in different countries, Ford will use one photographer to shoot pictures for the entire world.

The launch of the 2011 Ford Focus is the first example of this execution. Marketers from around the world have cooperated in developing a marketing strategy. The car went on sale in China and Europe in the fall of 2009, and in the United States in 2010. Ten years ago, Ford used up to 15 advertising campaigns for individual countries when it launched the Focus globally and a number of different ad agencies. This time it used fewer than 10 campaigns, and they look much more like each other, sharing common themes. The same agency is coordinating and developing messages worldwide. The idea is to develop core messages that work in all markets, and then to tweak those messages to account for differences in local culture. While Ford does recognize that country differences are still important, what it does not want to do is use totally different messages. Rather, it is trying to develop a common set of marketing tools that can be used in different ways in different countries.

For illustration, marketers in the United States watched how the Chinese “seeded” the new Ford Focus by giving it to early “influencers” who then wrote about it on social network Web sites. In China, where traditional advertising is still not well developed, Internet-based social media campaigns can (and did) spark interest. The marketers then decided to adopt a similar viral marketing strategy in the United States. The result was the “Fiesta Movement,” a Web-centric exercise in viral marketing revolving around 100 “agents” who were given early versions of the 2011 Focus and required to blog about it. ●

Sources: B. G. Hoffman, “Ford Fuses Global Marketing Efforts,” *Detroit News*, September 9, 2009, p. A9; L. C. Geist, “Ford Tests Global Focus with Launch of Focus,” *Automotive News*, December 28, 2009, p. 14; “Ford Strengthens Global Marketing Function as Next Step in Implementing ‘One Ford’ Vision,” *PR Newswire*, January 27, 2009; and B. G. Hoffman, “Ford Heiress Leads Automaker’s Global Marketing Push,” *Detroit News*, September 9, 2009, p. A9.



Introduction

In the previous chapter, we looked at the roles of global production and logistics in an international business. In this chapter, we continue our focus on specific business functions by examining the roles of marketing and research and development (R&D) in an international business. We focus on how marketing and R&D can be performed so they will reduce the costs of value creation and add value by better serving customer needs.

In Chapter 12 we spoke of the tension existing in most international businesses between the needs to reduce costs and at the same time to respond to local conditions, which tends to raise costs. This tension continues to be a persistent theme in this chapter. A global marketing strategy that views the world’s consumers as similar in their tastes and preferences is consistent with the mass production of a standardized output. By mass-producing a standardized output, whether it be soap or semiconductor

chips, the firm can realize substantial unit cost reductions from experience curve and other economies of scale. However, ignoring country differences in consumer tastes and preferences can lead to failure. Thus, an international business's marketing function needs to determine when product standardization is appropriate and when it is not, and to adjust the marketing strategy accordingly. Even if product standardization is appropriate, the way in which a product is positioned in a market and the promotions and messages used to sell that product may still have to be customized so that they resonate with local consumers.

As described in the opening case, Ford is dealing with just these issues. In 2006 the company consolidated its different national and regional product development activities into one organization, and in 2009 it did the same with marketing. The goal has been to create “One Ford”—a company that develops and sells the same cars to the same market segments worldwide. A driving force behind the One Ford vision has been the idea to reduce costs. At the same time, Ford does recognize that differences across countries in tastes and preferences, and in culture, are still significant. Accordingly, while it seeks to develop common marketing themes that are used worldwide for new models, such as the 2011 Ford Focus, local markets have retained the authority to “tweak” those themes, and the ways in which they are presented, so that they are attuned to local conditions.

We consider marketing and R&D within the same chapter because of their close relationship. A critical aspect of the marketing function is identifying gaps in the market so that the firm can develop new products to fill those gaps. Developing new products requires R&D—thus, the linkage between marketing and R&D. A firm should develop new products with market needs in mind, and only marketing can define those needs for R&D personnel. Also, only marketing can tell R&D whether to produce globally standardized or locally customized products. Research has long maintained that a major contributor to the success of new-product introductions is a close relationship between marketing and R&D.¹

In this chapter, we begin by reviewing the debate on the globalization of markets. Then we discuss the issue of market segmentation. Next we look at four elements that constitute a firm's marketing mix: product attributes, distribution strategy, communication strategy, and pricing strategy. The **marketing mix** is the set of choices the firm offers to its targeted markets. Many firms vary their marketing mix from country to country, depending on differences in national culture, economic development, product standards, distribution channels, and so on.

The chapter closes with a look at new-product development in an international business and at the implications of this for the organization of the firm's R&D function.

Marketing Mix
Choices about product attributes, distribution strategy, communication strategy, and pricing strategy that a firm offers its targeted markets.

The Globalization of Markets and Brands

In a now-classic *Harvard Business Review* article, the late Theodore Levitt wrote lyrically about the globalization of world markets. Levitt's arguments have become something of a lightning rod in the debate about the extent of globalization. According to Levitt,

A powerful force drives the world toward a converging commonalty, and that force is technology. It has proletarianized communication, transport, and travel. The result is a new commercial reality—the emergence of global markets for standardized consumer products on a previously unimagined scale of magnitude.

Gone are accustomed differences in national or regional preferences. The globalization of markets is at hand. With that, the multinational commercial world nears its end, and so does the multinational corporation. The multinational

corporation operates in a number of countries and adjusts its products and practices to each—at high relative costs. The global corporation operates with resolute consistency—at low relative cost—as if the entire world were a single entity; it sells the same thing in the same way everywhere.

Commercially, nothing confirms this as much as the success of McDonald's from the Champs Élysées to the Ginza, of Coca-Cola in Bahrain and Pepsi-Cola in Moscow, and of rock music, Greek salad, Hollywood movies, Revlon cosmetics, Sony television, and Levi's jeans everywhere.

Ancient differences in national tastes or modes of doing business disappear. The commonality of preference leads inescapably to the standardization of products, manufacturing, and the institutions of trade and commerce.²

This is eloquent and evocative writing, but is Levitt correct? The rise of global media phenomenon from CNN to MTV, and the ability of such media to help shape a global culture, would seem to lend weight to Levitt's argument. If Levitt is correct, his argument has major implications for the marketing strategies pursued by international business. However, many academics feel that Levitt overstates his case.³ Although Levitt may have a point when it comes to many basic industrial products, such as steel, bulk chemicals, and semiconductor chips, globalization in the sense used by Levitt seems to be the exception rather than the rule in many consumer goods markets and industrial markets. Even a firm such as McDonald's, which Levitt holds up as the archetypal example of a consumer products firm that sells a standardized product worldwide, modifies its menu from country to country in light of local consumer preferences. In the Middle East, for example, McDonald's sells the McArabia, a chicken sandwich on Arabian style bread, and in France, the Croque McDo, a hot ham and cheese sandwich.⁴

On the other hand, Levitt is probably correct to assert that modern transportation and communications technologies are facilitating a convergence of certain tastes and preferences among consumers in the more advanced countries of the world, and this has become even more prevalent since he wrote. The popularity of sushi in Los Angeles, hamburgers in Tokyo, hip-hop music, and global media phenomena such as MTV all support this contention. In the long run, such technological

forces may lead to the evolution of a global culture. At present, however, the continuing persistence of cultural and economic differences between nations acts as a brake on any trend toward the standardization of consumer tastes and preferences across nations. Indeed, that may never occur. Some writers have argued that the rise of global culture doesn't mean that consumers share the same tastes and preferences.⁵ Rather, people in different nations, often with conflicting viewpoints, are increasingly participating in a shared "global" conversation, drawing upon shared symbols that include global brands from Nike and Dove to Coca-Cola and Sony. But the way in which these brands are perceived, promoted, and used still varies from country to country, depending upon local differences in tastes and preferences. Furthermore, trade barriers and differences in product and technical standards also constrain a firm's ability to sell a standardized product to a



Another Perspective

Aloft Adds Key Global Markets

Global hospitality leader Starwood Hotels & Resorts, with 1,000 properties in 100 countries, continues to find ways to segment the hotel market. The latest brand to join its family is Aloft, designed to shake up the "buttoned-down" hotel industry. Aloft was created for the young, hip guest who appreciates high style at an affordable price. Guests enjoy Aloft's urban feel and open design, and such amenities as wireless check-in. Opening in 2008 with 40 hotels in U.S. cities as well as in Abu Dhabi and Beijing, Aloft has since added properties in Bangkok and Brussels as well as three Indian cities: Chennai, Bangalore, and Coimbatore. (www.starwoodhotels.com, accessed April 14, 2010; "Aloft Hotels Eyes Global Expansion in 2010: Openings Include Brussels, Bangalore—and Brooklyn," *Hospitality.net*, March 18, 2010, www.hospitalitynet.org)

global market using a standardized marketing strategy. We discuss the sources of these differences in subsequent sections when we look at how products must be altered from country to country. In short, Levitt's globally standardized markets seem a long way off in many industries.

Market Segmentation

Market segmentation refers to identifying distinct groups of consumers whose purchasing behavior differs from others in important ways. Markets can be segmented in numerous ways: by geography, demography (sex, age, income, race, education level, etc.), sociocultural factors (social class, values, religion, lifestyle choices), and psychological factors (personality). Because different segments exhibit different patterns of purchasing behavior, firms often adjust their marketing mix from segment to segment. Thus, the precise design of a product, the pricing strategy, the distribution channels used, and the choice of communication strategy may all be varied from segment to segment. The goal is to optimize the fit between the purchasing behavior of consumers in a given segment and the marketing mix, thereby maximizing sales to that segment. Automobile companies, for example, use a different marketing mix to sell cars to different socioeconomic segments. Thus, Toyota uses its Lexus division to sell high-priced luxury cars to high-income consumers, while selling its entry-level models, such as the Toyota Corolla, to lower-income consumers. Similarly, personal computer manufacturers will offer different computer models, embodying different combinations of product attributes and price points, precisely to appeal to consumers from different market segments (e.g., business users and home users).

When managers in an international business consider market segmentation in foreign countries, they need to be cognizant of two main issues: the differences between countries in the structure of market segments and the existence of segments that transcend national borders. The structure of market segments may differ significantly from country to country. An important market segment in a foreign country may have no parallel in the firm's home country, and vice versa. The firm may have to

Market

Segmentation

Identifying groups of consumers whose purchasing behavior differs from others in important ways.



Youth around the world have responded to Quiksilver, a company whose products range from clothing to wet suits. Quiksilver uses similar marketing tactics regardless of where stores are located because the popularity of surfing and winter sports transcends international boundaries.



Marketing to Black Brazil

Brazil is home to the largest black population outside of Nigeria. Nearly half of the 160 million people in Brazil are of African or mixed-race origin. Despite this, until recently businesses have made little effort to target this numerically large segment. Part of the reason is rooted in economics. Black Brazilians have historically been poorer than Brazilians of European origin and thus have not received the same attention as whites. But after a decade of relatively strong economic performance in Brazil, an emerging black middle class is beginning to command the attention of consumer product companies. To take advantage of this, companies such as Unilever have introduced a range of skin care products and cosmetics aimed at black Brazilians, and Brazil's largest toy company recently introduced a black Barbie-like doll, Susi Olodum, sales of which quickly caught up with sales of a similar white doll.

But there is more to the issue than simple economics. Unlike the United States, where a protracted history of racial discrimination gave birth to the civil rights movement, fostered black awareness, and produced an identifiable subculture in U.S. society, the history of blacks in Brazil has been very different. Although Brazil did not abolish slavery until 1888, racism in Brazil has historically been much subtler than in the United States. Brazil has never excluded blacks from voting or had a tradition of segregating the races. Historically, too, the government encouraged intermarriage between whites and blacks in

order to "bleach" society. Partly due to this more benign history, Brazil has not had a black rights movement similar to that in the United States, and racial self-identification is much weaker. Surveys routinely find that African-Brazilian consumers decline to categorize themselves as either black or white; instead they choose one of dozens of skin tones and see themselves as being part of a culture that transcends race.

This subtler racial dynamic has important implications for market segmentation and tailoring the marketing mix in Brazil. Unilever had to face this issue when launching a Vaseline Intensive Care lotion for black consumers in Brazil. The company learned in focus groups that for the product to resonate with nonwhite women, its promotions had to feature women of different skin tones, excluding neither whites nor blacks. The campaign Unilever devised features three women with different skin shades at a fitness center. The bottle says the lotion is for "tan and black skin," a description that could include many white women considering that much of the population lives near the beach. Unilever learned that the segment exists, but it is more difficult to define and requires more subtle marketing messages than the African-American segment in the United States or middle-class segments in Africa.

Sources: M. Jordan, "Marketers Discover Black Brazil," *The Wall Street Journal*, November 24, 2000, pp. A11, A14. Copyright 2000 by Dow Jones & Co. Inc. Reproduced with permission from Dow Jones & Co. Inc. in the format textbook by the Copyright Clearance Center.

develop a unique marketing mix to appeal to the purchasing behavior of a certain segment in a given country. An example of such a market segment is given in the accompanying Management Focus, which looks at the African-Brazilian market segment in Brazil, which as you will see is very different from the African-American segment in the United States. In another example, a research project identified a segment of consumers in China in the 50-to-60 age range that has few parallels in other countries.⁶ Members of this group came of age during China's Cultural Revolution in the late 1960s and early 1970s, and their experiences shaped their value. They tend to be highly sensitive to price and respond negatively to new products and most forms of marketing. Thus, firms doing business in China may need to customize their marketing mix to address the unique values and purchasing behavior of the group. The existence of such a segment constrains the ability of firms to standardize their global marketing strategy.

In contrast, the existence of market segments that transcend national borders clearly enhances the ability of an international business to view the global marketplace as a single entity and pursue a global strategy, selling a standardized product worldwide and using the same basic marketing mix to help position and sell that product in a variety of national markets. For a segment to transcend national borders, consumers

in that segment must have some compelling similarities along important dimensions—such as age, values, lifestyle choices—and those similarities must translate into similar purchasing behavior. Although such segments clearly exist in certain industrial markets, they are somewhat rarer in consumer markets. One emerging global segment that is attracting the attention of international marketers of consumer goods is the so-called global youth segment. Global media are paving the way for a global youth segment. Evidence that such a segment exists comes from a study of the cultural attitudes and purchasing behavior of more than 6,500 teenagers in 26 countries.⁷ The findings suggest that teens around the world are increasingly living parallel lives that share many common values. It follows that they are likely to purchase the same kind of consumer goods and for the same reasons.

Product Attributes

A product can be viewed as a bundle of attributes.⁸ For example, the attributes that make up a car include power, design, quality, performance, fuel consumption, and comfort; the attributes of a hamburger include taste, texture, and size; a hotel's attributes include atmosphere, quality, comfort, and service. Products sell well when their attributes match consumer needs (and when their prices are appropriate). BMW cars sell well to people who have high needs for luxury, quality, and performance, precisely because BMW builds those attributes into its cars. If consumer needs were the same the world over, a firm could simply sell the same product worldwide. However, consumer needs vary from country to country, depending on culture and the level of economic development. A firm's ability to sell the same product worldwide is further constrained by countries' differing product standards. In this section, we review each of these issues and discuss how they influence product attributes.

LEARNING OBJECTIVE 1
Explain why it might make sense to vary the attributes of a product from country to country.

CULTURAL DIFFERENCES We discussed countries' cultural differences in Chapter 3. Countries differ along a whole range of dimensions, including social structure, language, religion, and education. These differences have important implications for marketing strategy. For example, hamburgers do not sell well in Islamic countries, where the consumption of ham is forbidden by Islamic law. The most important aspect of cultural differences is probably the impact of tradition. Tradition is particularly important in foodstuffs and beverages. For example, reflecting differences in traditional eating habits, the Findus frozen food division of Nestlé, the Swiss food giant, markets fish cakes and fish fingers in Great Britain, but beef bourguignon and coq au vin in France and vitello con funghi and braviola in Italy. In addition to its normal range of products, Coca-Cola in Japan markets Georgia, a cold coffee in a can, and Aquarius, a tonic drink, both of which appeal to traditional Japanese tastes.

For historical and idiosyncratic reasons, a range of other cultural differences exist between countries. For example, scent preferences differ from one country to another. SC Johnson, a manufacturer of waxes and polishes, encountered resistance to its lemon-scented Pledge furniture polish among older consumers in Japan. Careful market research revealed that the polish smelled similar to a latrine disinfectant used widely in Japan. Sales rose sharply after the scent was adjusted.⁹ In another example, Cheetos, the bright orange and cheesy-tasting snack from



Coca-Cola markets Georgia, a cold coffee in a can, in Japan.

PepsiCo's Frito-Lay unit, do not have a cheese taste in China. Chinese consumers generally do not like the taste of cheese because it has never been part of traditional cuisine and because many Chinese are lactose-intolerant.¹⁰

There is some evidence of the trends Levitt talked about. Tastes and preferences are becoming more cosmopolitan. Coffee is gaining ground against tea in Japan and Great Britain, while American-style frozen dinners have become popular in Europe (with some fine-tuning to local tastes). Taking advantage of these trends, Nestlé has found that it can market its instant coffee, spaghetti bolognese, and Lean Cuisine frozen dinners in essentially the same manner in both North America and Western Europe. However, there is no market for Lean Cuisine dinners in most of the rest of the world, and there may not be for years or decades. Although some cultural convergence has occurred, particularly among the advanced industrial nations of North America and Western Europe, Levitt's global culture characterized by standardized tastes and preferences is still a long way off.

ECONOMIC DEVELOPMENT Just as important as differences in culture are differences in the level of economic development. We discussed the extent of country differences in economic development in Chapter 2. Consumer behavior is influenced by the level of economic development of a country. Firms based in highly developed countries such as the United States tend to build a lot of extra performance attributes into their products. These extra attributes are not usually demanded by consumers in less developed nations, where the preference is for more basic products. Thus, cars sold in less developed nations typically lack many of the features found in developed nations, such as air-conditioning, power steering, power windows, radios, and cassette players. For most consumer durables, product reliability may be a more important attribute in less developed nations, where such a purchase may account for a major proportion of a consumer's income, than it is in advanced nations.

Contrary to Levitt's suggestions, consumers in the most developed countries are often not willing to sacrifice their preferred attributes for lower prices. Consumers in the most advanced countries often shun globally standardized products that have been developed with the lowest common denominator in mind. They are willing to pay more for products that have additional features and attributes customized to their tastes and preferences. For example, demand for top-of-the-line four-wheel-drive sport utility vehicles, such as Chrysler's Jeep, Ford's Explorer, and Toyota's Land Cruiser, has been largely restricted to the United States. This is due to a combination of factors, including the high-income level of U.S. consumers, the country's vast distances, the relatively low cost of gasoline, and the culturally grounded "outdoor" theme of American life.

PRODUCT AND TECHNICAL STANDARDS Even with the forces that are creating some convergence of consumer tastes and preferences among advanced, industrialized nations, Levitt's vision of global markets may still be a long way off because of national differences in product and technological standards.

Differing government-mandated product standards can rule out mass production and marketing of a standardized product. Differences in technical standards also constrain the globalization of markets. Some of these differences result from idiosyncratic decisions made long ago, rather than from government actions, but their long-term effects are profound. For example, DVD equipment manufactured for sale in the United States will not play DVDs recorded on equipment manufactured for sale in Great Britain, Germany, and France (and vice versa). Different technical standards for television signal frequency emerged in the 1950s that require television and video equipment to be customized to prevailing standards. RCA stumbled in the 1970s when

it failed to account for this in its marketing of TVs in Asia. Although several Asian countries adopted the U.S. standard, Singapore, Hong Kong, and Malaysia adopted the British standard. People who bought RCA TVs in those countries could receive a picture but no sound!¹¹

Distribution Strategy

A critical element of a firm's marketing mix is its distribution strategy: the means it chooses for delivering the product to the consumer. The way the product is delivered is determined by the firm's entry strategy, discussed in Chapter 12. In this section, we examine a typical distribution system, discuss how its structure varies between countries, and look at how appropriate distribution strategies vary from country to country.

Figure 15.1 illustrates a typical distribution system consisting of a channel that includes a wholesale distributor and a retailer. If the firm manufactures its product in the particular country, it can sell directly to the consumer, to the retailer, or to the wholesaler. The same options are available to a firm that manufactures outside the country. Plus, this firm may decide to sell to an import agent, which then deals with the wholesale distributor, the retailer, or the consumer. Later in the chapter we will consider the factors that determine the firm's choice of channel.

DIFFERENCES BETWEEN COUNTRIES The four main differences between distribution systems are retail concentration, channel length, channel exclusivity, and channel quality.

Retail Concentration In some countries, the retail system is very concentrated, but it is fragmented in others. In a **concentrated retail system**, a few retailers supply most of the market. A **fragmented retail system** is one in which there are many retailers, no one of which has a major share of the market. Many of the differences in concentration are rooted in history and tradition. In the United States, the importance of the automobile and the relative youth of many urban areas have resulted in a retail

LEARNING OBJECTIVE 2

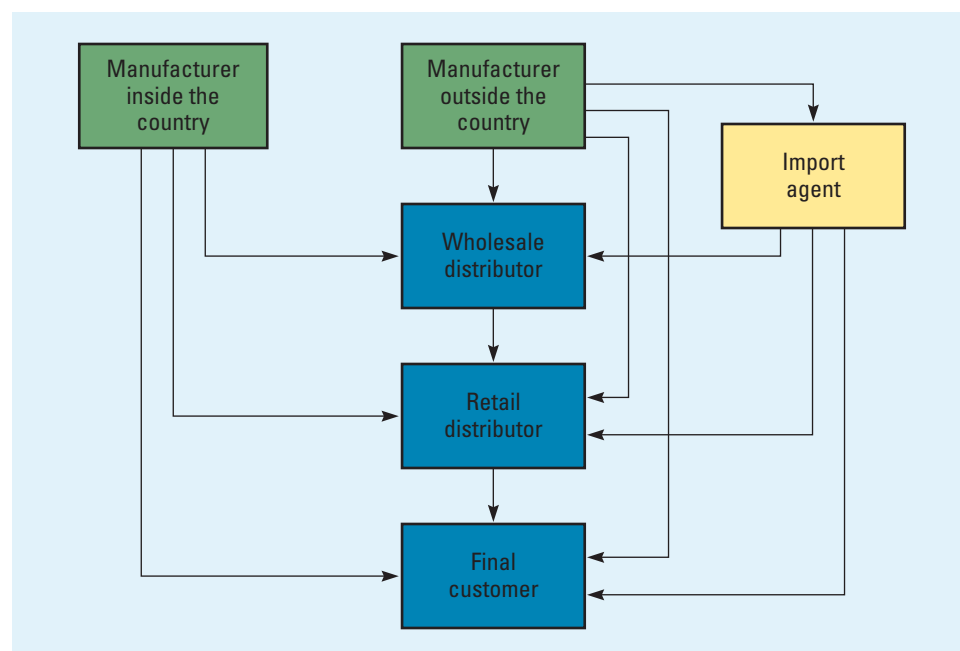
Recognize why and how a firm's distribution strategy might vary among countries.

Concentrated Retail System

A few retailers supply most of the market.

Fragmented Retail System

Many retailers supply a market with no one having a major share.



15.1 figure

A Typical Distribution System

system centered on large stores or shopping malls to which people can drive. This has facilitated system concentration. Japan, with a much greater population density and a large number of urban centers that grew up before the automobile, has a more fragmented retail system, with many small stores serving local neighborhoods and to which people frequently walk. In addition, the Japanese legal system protects small retailers. Small retailers can try to block the establishment of a large retail outlet by petitioning their local government.

Developed countries tend toward greater retail concentration. Three factors that contribute to this are the increases in car ownership, number of households with refrigerators and freezers, and number of two-income households. All these factors have changed shopping habits and facilitated the growth of large retail establishments sited away from traditional shopping areas. The last decade has seen consolidation in the global retail industry, with companies such as Walmart and Carrefour attempting to become global retailers by acquiring retailers in different countries. This has increased retail concentration.

In contrast, retail systems are very fragmented in many developing countries, which can make for interesting distribution challenges. In rural China, large areas of the country can be reached only by traveling rutted dirt roads. In India, Unilever has to sell to retailers in 600,000 rural villages, many of which cannot be accessed via paved roads, which means products can reach their destination only by bullock, bicycle, or cart. In neighboring Nepal, the terrain is so rugged that even bicycles and carts are not practical, and businesses rely on yak trains and the human back to deliver products to thousands of small retailers.

Channel Length

The number of intermediaries that a product has to go through before it reaches the final consumer.

Channel Length **Channel length** refers to the number of intermediaries between the producer (or manufacturer) and the consumer. If the producer sells directly to the consumer, the channel is very short. If the producer sells through an import agent, a wholesaler, and a retailer, a long channel exists. The choice of a short or long channel is in part a strategic decision for the producing firm. However, some countries have longer distribution channels than others. The most important determinant of channel length is the degree to which the retail system is fragmented. Fragmented retail systems tend to promote the growth of wholesalers to serve retailers, which lengthens channels.

The more fragmented the retail system, the more expensive it is for a firm to make contact with each individual retailer. Imagine a firm that sells toothpaste in a country where there are more than a million small retailers, as in rural India and China. To sell directly to the retailers, the firm would have to build a huge sales force. This would be very expensive, particularly since each sales call would yield a very small order. But suppose a few hundred wholesalers in the country supply retailers not only with toothpaste but also with all other personal care and household products. Because these wholesalers carry a wide range of products, they get bigger orders with each sales call, making it worthwhile for them to deal directly with the retailers. Accordingly, it makes economic sense for the firm to sell to the wholesalers and the wholesalers to deal with the retailers.

Because of such factors, countries with fragmented retail systems also tend to have long channels of distribution, sometimes with multiple layers. The classic example is Japan, where there are often two or three layers of wholesalers between the firm and retail outlets. In countries such as Great Britain, Germany, and the United States where the retail system is far more concentrated, channels are much shorter. When the retail sector is very concentrated, it makes sense for the firm to deal directly with retailers, cutting out wholesalers. A relatively small sales force is required to deal with a concentrated retail sector, and the orders generated from

each sales call can be large. Such circumstances tend to prevail in the United States, where large food companies may sell directly to supermarkets rather than going through wholesale distributors.

The rapid development of the Internet in recent years has helped to shorten channel length. For example, the Seattle-based outdoor equipment retailer REI sells its products in Japan via a Japanese-language Web site, thereby eliminating the need for a retail presence on the ground in Japan, which obviously shortens the channel length between REI and its customers. However, there are definite drawbacks with such a strategy. In the case of REI, consumers cannot receive the same level of advice over the Web as in physical retail stores, where salespeople can help customers choose the right gear for their needs. So although REI benefits from a short channel in Japan, it may lose significant sales due to the lack of point-of-sale service.

Another factor that is shortening channel length in some countries is the entry of large discount superstores, such as Carrefour, Walmart, and Tesco. The business model of these retailers is in part based upon the idea that in an attempt to lower prices, they cut out wholesalers and instead deal directly with manufacturers. Thus, when Walmart entered Mexico, its policy of dealing directly with manufacturers, instead of buying merchandise through wholesalers, helped to shorten distribution channels in that nation. Similarly, Japan's historically long distribution channels are now being shortened by the rise of large retailers, some of them foreign owned, such as Toys "R" Us, and some of them indigenous enterprises that are imitating the American model, all of which are progressively cutting out wholesalers and dealing directly with manufacturers.

Channel Exclusivity An **exclusive distribution channel** is one that is difficult for outsiders to access. For example, it is often difficult for a new firm to get access to shelf space in supermarkets. This occurs because retailers tend to prefer to carry the products of established manufacturers of foodstuffs with national reputations rather than gamble on the products of unknown firms. The exclusivity of a distribution system varies between countries. Japan's system is often held up as an example of a very exclusive system. In Japan, relationships between manufacturers, wholesalers, and retailers often go back decades. Many of these relationships are based on the understanding that distributors will not carry the products of competing firms. In return, the distributors are guaranteed an attractive markup by the manufacturer. As many U.S. and European manufacturers have learned, the close ties that result from this arrangement can make access to the Japanese market difficult. However, it is possible to break into the Japanese market with a new consumer product. Procter & Gamble did during the 1990s with its Joy brand of dish soap. P&G was able to overcome a tradition of exclusivity for two reasons. First, after a decade of lackluster economic performance, Japan is changing. In their search for profits, retailers are far more willing than they have been historically to violate the old norms of exclusivity. Second, P&G has been in Japan long enough and has a broad enough portfolio of consumer products to give it considerable leverage with distributors, enabling it to push new products out through the distribution channel.

Exclusive Distribution Channel

A channel that outsiders find difficult to access.

Channel Quality **Channel quality** refers to the expertise, competencies, and skills of established retailers in a nation, and their ability to sell and support the products of international businesses. Although the quality of retailers is good in most developed nations, in emerging markets and less developed nations from Russia to Indonesia, channel quality is variable at best. The lack of a high-quality channel may impede market entry, particularly in the case of new or sophisticated products that require significant point-of-sale assistance and after-sales services and support. When channel quality

Channel Quality

The expertise, competencies, and skills of established retailers in a nation, and their ability to sell and support the products of international businesses.

is poor, an international business may have to devote considerable attention to upgrading the channel, for example, by providing extensive education and support to existing retailers, and in extreme cases, by establishing its own channel. Thus, after pioneering its Apple retail store concept in the United States, Apple is opening retail stores in several nations, such as the United Kingdom, to provide point-of-sales education, service, and support for its popular iPod and computer products. Apple believes that this strategy will help it to gain market share in these nations.

CHOOSING A DISTRIBUTION STRATEGY A choice of distribution strategy determines which channel the firm will use to reach potential consumers. Should the firm try to sell directly to the consumer or should it go through retailers; should it go through a wholesaler; should it use an import agent; or should it invest in establishing its own channel? The optimal strategy is determined by the relative costs and benefits of each alternative, which vary from country to country, depending on the four factors we have just discussed: retail concentration, channel length, channel exclusivity, and channel quality.

Because each intermediary in a channel adds its own markup to the products, there is generally a critical link between channel length, the final selling price, and the firm's profit margin. The longer a channel, the greater is the aggregate markup, and the higher the price that consumers are charged for the final product. To ensure that prices do not get too high as a result of markups by multiple intermediaries, a firm might be forced to operate with lower profit margins. Thus, if price is an important competitive weapon, and if the firm does not want to see its profit margins squeezed, other things being equal, the firm would prefer to use a shorter channel.

However, the benefits of using a longer channel may outweigh these drawbacks. As we have seen, one benefit of a longer channel is that it cuts selling costs when the retail sector is very fragmented. Thus, it makes sense for an international business to use longer channels in countries where the retail sector is fragmented and shorter channels in countries where the retail sector is concentrated. Another benefit of using a longer channel is market access—the ability to enter an exclusive channel. Import agents may have long-term relationships with wholesalers, retailers, or important consumers and thus be better able to win orders and get access to a distribution system. Similarly, wholesalers may have long-standing relationships with retailers and be better able to persuade them to carry the firm's product than the firm itself would.

Import agents are not limited to independent trading houses; any firm with a strong local reputation could serve as well. For example, to break down channel exclusivity and gain greater access to the Japanese market, Apple Computer signed distribution agreements with five large Japanese firms, including business equipment giant Brother Industries, stationery leader Kokuyo, Mitsubishi, Sharp, and Minolta. These firms use their own long-established distribution relationships with consumers, retailers, and wholesalers to push Apple computers through the Japanese distribution system. As a result, Apple's share of the Japanese market increased from less than 1 percent to 13 percent in the four years following the signing of the agreements.¹²

If such an arrangement is not possible, the firm might want to consider other, less traditional alternatives to gaining market access. Frustrated by channel exclusivity in Japan, some foreign manufacturers of consumer goods have attempted to sell directly to Japanese consumers using direct mail and catalogs. REI had trouble persuading Japanese wholesalers and retailers to carry its products, so it began a direct-mail campaign and then a Web-based strategy to enter Japan that is proving successful.

Finally, if channel quality is poor, a firm should consider what steps it could take to upgrade the quality of the channel, including establishing its own distribution channel.

Communication Strategy

Another critical element in the marketing mix is communicating the attributes of the product to prospective customers. A number of communication channels are available to a firm, including direct selling, sales promotion, direct marketing, and advertising. A firm's communication strategy is partly defined by its choice of channel. Some firms rely primarily on direct selling, others on point-of-sale promotions or direct marketing, and others on mass advertising; still others use several channels simultaneously to communicate their message to prospective customers. In this section, we will look first at the barriers to international communication. Then we will survey the various factors that determine which communication strategy is most appropriate in a particular country. After that we discuss global advertising.

LEARNING OBJECTIVE 3

Identify why and how advertising and promotional strategies might vary among countries.

BARRIERS TO INTERNATIONAL COMMUNICATION International communication occurs whenever a firm uses a marketing message to sell its products in another country. The effectiveness of a firm's international communication can be jeopardized by three potentially critical variables: cultural barriers, source effects, and noise levels.

Cultural Barriers Cultural barriers can make it difficult to communicate messages across cultures. We discussed some sources and consequences of cultural differences between nations in Chapter 3 and in the previous section of this chapter. Because of cultural differences, a message that means one thing in one country may mean something quite different in another. For example, when Procter & Gamble first promoted its Camay soap in Japan it ran into unexpected trouble. In a TV commercial, a Japanese man walked into the bathroom while his wife was bathing. The woman began telling her husband all about her new soap, but the husband, stroking her shoulder, hinted that suds were not on his mind. This ad had been popular in Europe, but it flopped in Japan because it is considered bad manners there for a man to intrude on his wife.¹³

Benetton, the Italian clothing manufacturer and retailer, is another firm that has run into cultural problems with its advertising. The company launched a worldwide



Clothing retailer Benetton has become famous for advertising that has been deemed offensive or inappropriate in some countries.

advertising campaign with the theme “United Colors of Benetton” that had won awards in France. One of its ads featured a black woman breast-feeding a white baby, and another one showed a black man and a white man handcuffed together. Benetton was surprised when the ads were attacked by U.S. civil rights groups for promoting white racial domination. Benetton withdrew its ads and fired its advertising agency, Eldorado of France.

The best way for a firm to overcome cultural barriers is to develop cross-cultural literacy (see Chapter 3). In addition, it should use local input, such as a local advertising agency, in developing its marketing message. If the firm uses direct selling rather than advertising to communicate its message, it should develop a local sales force whenever possible. Cultural differences limit a firm’s ability to use the same marketing message and selling approach worldwide. What works well in one country may be offensive in another.

Source Effects

When the receiver of the message evaluates the message based on the status or image of the sender.

Source and Country of Origin Effects **Source effects** occur when the receiver of the message (the potential consumer in this case) evaluates the message on the basis of status or image of the sender. Source effects can be damaging for an international business when potential consumers in a target country have a bias against foreign firms. For example, a wave of “Japan bashing” swept the United States in the early 1990s. Worried that U.S. consumers might view its products negatively, Honda responded by creating ads that emphasized the U.S. content of its cars to show how “American” the company had become.

Many international businesses try to counter negative source effects by deemphasizing their foreign origins. When the French antiglobalization protestor Jose Bove was hailed as a hero by some in France for razing a partly built McDonald’s in 1999, the French franchisee of McDonald’s responded with an ad depicting a fat, ignorant American who could not understand why McDonald’s France used locally produced

food that wasn’t genetically modified. The edgy ad worked, and McDonald’s French operations are now among the most robust in the company’s global network.¹⁴ Similarly, when British Petroleum acquired Mobil Oil’s extensive network of U.S. gas stations, it changed its name to BP, diverting attention away from the fact that one of the biggest operators of gas stations in the United States is a British firm.

A subset of source effects is referred to as **country of origin effects**, or the extent to which the place of manufacturing influences product evaluations. Research suggests that the consumer may use country of origin as a cue when evaluating a product, particularly if he or she lacks more detailed knowledge of the product. For example, one study found that Japanese consumers tended to rate Japanese products more favorably than U.S. products across multiple dimensions, even when independent analysis showed that they were actually inferior.¹⁵ When a negative country of origin effect exists, an international business may have to work hard to counteract this effect by, for example, using promotional messages that stress the positive performance attributes of its product. Thus, the South Korean automobile company Hyundai tried to overcome negative perceptions about the quality of its vehicle in the United States

Country of Origin Effects

The extent to which the place of manufacturing influences product evaluations.



Another Perspective

The Complexity of Language and Symbols

Consider the complexity of interpreting colors, symbols, and numbers internationally:

White is a symbol of mourning in the Far East but happiness and purity in the United States.

Purple is associated with death in many Latin American countries.

Blue signals femininity in Holland but masculinity in Sweden and the United States.

Red is unlucky or negative in Chad, Germany, and Nigeria but positive in Argentina, Denmark, and Romania. Brides wear red in China.

Yellow flowers are a sign of death in Mexico, infidelity in France, and loyalty in the United States.

The number 7 is unlucky in Ghana, Kenya, and Singapore but lucky in India, Morocco, Nigeria, and the United States.

An owl connotes wisdom in the United States but bad luck in India.

A deer suggests speed and grace in the United States but homosexuality in Brazil.

(J. Cohen, “The Search for Universal Symbols,” *Journal of International Consumer Marketing* 3–4 [1996], pp. 187–210)

by running advertisements that favorably compare the company's cars to more prestigious brands.

Source effects and country of origin effects are not always negative. French wine, Italian clothes, and German luxury cars benefit from nearly universal positive source effects. In such cases, it may pay a firm to emphasize its foreign origins. In Japan, for example, there is strong demand for high-quality foreign goods, particularly those from Europe. It has become chic to carry a Gucci handbag, sport a Rolex watch, drink expensive French wine, and drive a BMW.

Noise Levels Noise tends to reduce the probability of effective communication. **Noise** refers to the amount of other messages competing for a potential consumer's attention, and this too varies across countries. In highly developed countries such as the United States, noise is extremely high. Fewer firms vie for the attention of prospective customers in developing countries, thus the noise level is lower.

Noise

The amount of other messages competing for a potential consumer's attention.

PUSH VERSUS PULL STRATEGIES The main decision with regard to communications strategy is the choice between a push strategy and a pull strategy. A **push strategy** emphasizes personal selling rather than mass media advertising in the promotional mix. Although effective as a promotional tool, personal selling requires intensive use of a sales force and is relatively costly. A **pull strategy** depends more on mass media advertising to communicate the marketing message to potential consumers.

Push Strategy

A marketing strategy emphasizing personal selling rather than mass media advertising.

Although some firms employ only a pull strategy and others only a push strategy, still other firms combine direct selling with mass advertising to maximize communication effectiveness. Factors that determine the relative attractiveness of push and pull strategies include product type relative to consumer sophistication, channel length, and media availability.

Pull Strategy

A marketing strategy emphasizing mass media advertising as opposed to personal selling.

Product Type and Consumer Sophistication Firms in consumer goods industries that are trying to sell to a large segment of the market generally favor a pull strategy. Mass communication has cost advantages for such firms, thus they rarely use direct selling. Exceptions can be found in poorer nations with low literacy levels, where direct selling may be the only way to reach consumers (see the Management Focus on Unilever). Firms that sell industrial products or other complex products favor a push strategy. Direct selling allows the firm to educate potential consumers about the features of the product. This may not be necessary in advanced nations where a complex product has been in use for some time, where the product's attributes are well understood, where consumers are sophisticated, and where high-quality channels exist that can provide point-of-sale assistance. However, customer education may be important when consumers have less sophistication toward the product, which can be the case in developing nations or in advanced nations when a new complex product is being introduced, or where high-quality channels are absent or scarce.

Channel Length The longer the distribution channel, the more intermediaries there are that must be persuaded to carry the product for it to reach the consumer. This can lead to inertia in the channel, which can make entry difficult. Using direct selling to push a product through many layers of a distribution channel can be expensive. In such circumstances, a firm may try to pull its product through the channels by using mass advertising to create consumer demand—once demand is created, intermediaries will feel obliged to carry the product.

In Japan, products often pass through two, three, or even four wholesalers before they reach the final retail outlet. This can make it difficult for foreign firms to break into the Japanese market. Not only must the foreign firm persuade a Japanese retailer to carry its product, but it may also have to persuade every intermediary in the chain to carry the



Unilever—Selling to India's Poor

One of the world's largest and oldest consumer products companies, Unilever has long had a substantial presence in many of the world's poorer nations, such as India. Outside of major urban areas, low income, unsophisticated consumers, illiteracy, fragmented retail distribution systems, and the lack of paved roads have made for difficult marketing challenges. Despite this, Unilever has built a significant presence among impoverished rural populations by adopting innovative selling strategies.

Take India as an example. The country's large rural population is dispersed among some 600,000 villages, more than 500,000 of which cannot be reached by a motor vehicle. Some 91 percent of the rural population lives in villages of fewer than 2,000 people, and of necessity, rural retail stores are very small and carry limited stock. The population is desperately poor, making perhaps a dollar a day, and two-thirds of that income is spent on food, leaving about 30 cents a day for other items. Literacy levels are low, and TVs are rare, making traditional media ineffective. Despite these drawbacks, Hindustan Lever, Unilever's Indian subsidiary, has made a concerted effort to reach the rural poor. Although the revenues generated from rural sales are small, Unilever hopes that as the country develops and income levels rise, the population will continue to purchase the Unilever brands that they are familiar with, giving the company a long-term competitive advantage.

To contact rural consumers, Hindustan Lever tries to establish a physical presence wherever people frequently gather in numbers. This means ensuring that advertisements are seen in places where people congregate and

make purchases, such as at village wells and weekly rural markets, and where they consume products, such as at riverbanks where people gather to wash their clothes using (the company hopes) Unilever soap. It is not uncommon to see the villages well plastered with advertisements for Unilever products. The company also takes part in weekly rural events, such as market day, at which farm produce is sold and family provisions purchased. Hindustan Lever salesmen will visit these gatherings, display their products, explain how they work, give away some free samples, make a few sales, and seed the market for future demand.

The backbone of Hindustan Lever's selling effort, however, is a rural distribution network that encompasses 100 factories, 7,500 distributors, and an estimated 3 million retail stores, many of which are little more than a hole in a wall or a stall at a market. The total stock of Unilever products in these stores may be no more than a few sachets of shampoo and half a dozen bars of soap. A depot in each of India's states feeds products to major wholesalers, which then sell directly to retailers in thousands of small towns and villages that can be reached by motor vehicles. If access via motor vehicles is not possible, the major wholesalers sell to smaller second-tier wholesalers, which then handle distribution to India's 500,000 inaccessible rural villages, reaching them by bicycle, bullock, cart, or baskets carried on a human back.

Sources: K. Merchant, "Striving for Success—One Sachet at a Time," *Financial Times*, December 11, 2000, p. 14; M. Turner, "Bicycle Brigade Takes Unilever to the People," *Financial Times*, August 17, 2000, p. 8; "Brands Thinking Positively," *Brand Strategy*, December 2003, pp. 28–29; and "The Legacy That Got Left on the Shelf," *The Economist*, February 2, 2008, pp. 77–79.

product. Mass advertising may be one way to break down channel resistance in such circumstances. However, in countries such as India, which has a very long distribution channel to serve its massive rural population, mass advertising may not work because of low literacy levels, in which case, the firm may need to fall back on direct selling or rely on the good will of distributors (see the Management Focus on Unilever).

Media Availability A pull strategy relies on access to advertising media. In the United States, a large number of media are available, including print media (newspapers and magazines), broadcasting media (television and radio), and the Internet. The rise of cable television in the United States has facilitated extremely focused advertising (e.g., MTV for teens and young adults, Lifetime for women, ESPN for sports enthusiasts). The same is true of the Internet, with different Web sites attracting different kinds of users, and companies such as Google transforming the ability of companies to do targeted advertising. While this level of media sophistication is now found in many other developed countries, it is still not universal. Even many advanced nations have far fewer electronic media available for advertising than the United States. In Scandinavia, for example, no commercial television or radio stations existed until recently; all

electronic media were state owned and carried no commercials, although this has now changed with the advent of satellite television deregulation. In many developing nations, the situation is even more restrictive because mass media of all types are typically more limited. A firm's ability to use a pull strategy is limited in some countries by media availability. In such circumstances, a push strategy is more attractive. For example, Unilever uses a push strategy to sell consumer products in rural India, where few mass media are available (see the accompanying Management Focus).

Media availability is limited by law in some cases. Few countries allow advertisements for tobacco and alcohol products on television and radio, though they are usually permitted in print media. When the leading Japanese whiskey distiller, Suntory, entered the U.S. market, it had to do so without television, its preferred medium. The firm spends about \$50 million annually on television advertising in Japan. Similarly, while advertising pharmaceutical products directly to consumers is allowed in the United States, it is prohibited in many other advanced nations. In such cases, pharmaceutical firms must rely heavily upon advertising and direct-sales efforts focused explicitly at doctors in order to get their products prescribed.

The Push–Pull Mix The optimal mix between push and pull strategies depends on product type and consumer sophistication, channel length, and media sophistication. Push strategies tend to be emphasized

- For industrial products or complex new products.
- When distribution channels are short.
- When few print or electronic media are available.

Pull strategies tend to be emphasized

- For consumer goods.
- When distribution channels are long.
- When sufficient print and electronic media are available to carry the marketing message.

GLOBAL ADVERTISING In recent years, largely inspired by the work of visionaries such as Theodore Levitt, there has been much discussion about the pros and cons of standardizing advertising worldwide.¹⁶ One of the most successful standardized campaigns in history was Philip Morris's promotion of Marlboro cigarettes. The campaign was instituted in the 1950s, when the brand was repositioned, to assure smokers that the flavor would be unchanged by the addition of a filter. The campaign theme of "Come to where the flavor is: Come to Marlboro country" was a worldwide success. Marlboro built on this when it introduced "the Marlboro man," a rugged cowboy smoking his Marlboro while riding his horse through the great outdoors. This ad proved successful in almost every major market around the world, and it helped propel Marlboro to the top of the world market.

For Standardized Advertising The support for global advertising is threefold. First, it has significant economic advantages. Standardized advertising lowers the costs of value creation by spreading the fixed costs of developing the advertisements over many countries. For example, Coca-Cola's advertising agency, McCann-Erickson, claims to have saved Coca-Cola \$90 million over 20 years by using certain elements of its campaigns globally.

Second, there is the concern that creative talent is scarce and so one large effort to develop a campaign will produce better results than 40 or 50 smaller efforts. A third justification for a standardized approach is that many brand names are global. With the substantial amount of international travel today and the considerable overlap in



National regulations may prevent the use of standardized advertising. For example, Kellogg's tag line "Kellogg's makes their cornflakes the best they have ever been" could not be used in Germany because of a prohibition against competitive claims.

media across national borders, many international firms want to project a single brand image to avoid confusion caused by local campaigns. This is particularly important in regions such as Western Europe, where travel across borders is almost as common as travel across state lines in the United States.

Against Standardized Advertising There are two main arguments against globally standardized advertising. First, as we have seen repeatedly in this chapter and in Chapter 3, cultural differences between nations are such that a message that works in one nation can fail miserably in another. Cultural diversity makes it extremely difficult to develop a single advertising theme that is effective worldwide. Messages directed at the culture of a given country may be more effective than global messages.

Second, advertising regulations may block implementation of standardized advertising. For example, Kellogg could not use a television commercial it produced in Great Britain to promote its cornflakes in many other European countries. A reference to the iron and vitamin content of its cornflakes was not permissible in the Netherlands, where claims relating to health and medical benefits are outlawed. A child wearing a Kellogg T-shirt had to be edited out of the commercial before it could be used in France, because French law forbids the use of children in product endorsements. The key line "Kellogg's makes their cornflakes the best they have ever been" was disallowed in Germany because of a prohibition against competitive claims.¹⁷ Similarly, American Express ran afoul of regulatory authorities in Germany when it launched a promotional scheme that had proved successful in other countries. The scheme advertised the offer of "bonus points" every time American Express cardholders used their cards. According to the advertisements, these bonus points could be used toward air travel with three airlines and hotel accommodations. American Express was charged with breaking Germany's competition law, which prevents an offer of free gifts in connection with the sale of goods, and the firm had to withdraw the advertisements at considerable cost.¹⁸

Dealing with Country Differences Some firms are experimenting with capturing some benefits of global standardization while recognizing differences in countries' cultural and legal environments. A firm may select some features to include in all its advertising campaigns and localize other features. By doing so, it may be able to save on some costs and build international brand recognition and yet customize its advertisements to different cultures.

Nokia, the Finnish cell phone manufacture, has been trying to do this. Historically, Nokia had used a different advertising campaign in different markets. In the mid-2000s, however, the company launched a global advertising campaign that used the slogan "1001 reasons to have a Nokia imaging phone." Nokia did this to reduce advertising costs and capture some economies of scale. In addition, in an increasingly integrated world, the company believes that there is value in trying to establish a consistent global brand image. At the same time, Nokia is tweaking the advertisements for different cultures. The campaign uses actors from the region where the ad runs to reflect the local population, though they will say the same lines. Local settings are also modified when showcasing the phones by, for example, using a marketplace when advertising in Italy or a bazaar when advertising in the Middle East.¹⁹ Another example of this process is given in the accompanying Management Focus feature, which looks at how Unilever built a global brand for its Dove products, while still tweaking the message to take local sensibilities into account.



Dove's Global "Real Beauty" Campaign

In 2003, Dove was not a beauty brand; it was a bar of soap that was positioned and sold differently in different markets. Unilever, the company that marketed Dove, was a storied consumer product multinational with global reach, a strong position in fast-growing developing nations, and a reputation for customizing products to conditions prevailing in local markets. In India, for example, women often oil their hair before washing it, so Western shampoos that do not remove the oil have not sold well. Unilever reformulated its shampoo for India, and was rewarded with market leadership. But sometimes Unilever went too far. It used different formulations for shampoo in Hong Kong and mainland China, for example, even though hair and washing habits were very similar in both markets. Unilever would also often vary the packaging and marketing message in similar products, even for its most commoditized products. The company tended to exaggerate complexity, and by 2003 its financial performance was suffering.

Six years later Unilever's financial performance has improved, in no small part because it has shifted toward a more global emphasis, and the Dove brand has led the way. The Dove story dates to 2003 when the global brand director, Sylvia Lagnado, who was based in New York, decided to move the positioning of Dove from one based on the product to one of an entire beauty brand. The basic message: The brand should stand for the real beauty of all women. Dove's mission was to make women feel more beautiful every day by widening the stereotypical definition of beauty and inspiring them to take care of themselves.

But how was this mission to be executed? Following a series of workshops held around the globe that asked brand managers and advertising agency partners to find ways to communicate an inclusive definition of beauty, the Canadian brand manager asked 67 female photographers to submit work that best reflected real beauty. The photographs are stunning portraits not of models, but of women from all walks of life that come in all shapes, sizes, and ages. It led to a coffee table book and traveling exhibition, called the Dove Photo Tour, which garnered a lot of positive press in Canada. Sylvia Lagnado realized that the Canadians were on to something. About the same time, the German office of Unilever's advertising agency, Ogilvy & Mather Worldwide, came up with a concept for communicating "real beauty" based on photographs showing ordinary women in their underwear, instead of skinny models. The original German advertisements quickly made their

way to the United Kingdom, where a London newspaper article stated the campaign is not advertising; it's politics. Sylvia Lagnado was not surprised by this. She had commissioned research showing that only 2 percent of women worldwide considered themselves beautiful, and that half thought their weight was too high.

In 2004, the Dove Campaign for Real Beauty was launched globally. This was a radical shift for Unilever and the Dove brand, which until then had left marketing in the hands of local brand managers. Nevertheless, the Real Beauty campaign was tweaked to take local sensibilities into account. For example, it was deemed better not to show women touching each other in America, while in Latin America tactile women did not shock anybody, so touching was seen as OK.

In Canada, the campaign opened with billboard "tick box" advertisements on real women in their underwear that invited people to call a toll-free number and vote on provocative tickers, such as "Fat/Fabulous?" The votes were tallied and displayed in real time on the billboards. This created a huge buzz, and the technique was quickly adopted in other markets, such as the United States. As the campaign gained traction and a positive groundswell of media attention occurred (in the United States, for example, the Dove Women were invited to appear on the *Opera Winfrey* TV show). Unilever extended the Dove product line to include skin creams, shampoos, and shower gels. In 2005, the campaign was followed by the launch of the Dove "self-esteem fund," a worldwide campaign to persuade girls and young women to embrace a more positive image of themselves. Unilever also made an online video, loaded onto YouTube, called "Onslaught," which was critical of the beauty industry and ended with the slogan, "Talk to your daughter before the beauty industry does." Another video, "Evolution," showed how the face of a girl could be changed, partly through computer graphics, to create an image of beauty. The video ended with the tag line, "No wonder our perception of beauty is distorted." Made for very little money, the YouTube videos created a viral buzz that helped to transform Dove into one of Unilever's leading brands. By its use of such techniques, the campaign for Real Beauty has become a model for how to revitalize and build a new global brand.

Sources: "The Legacy That Got Left on the Shelf," *The Economist*, February 2, 2008, pp. 77–79; R. Rothenberg, "Dove Effort Gives Package-Goods Marketers Lessons for the Future," *Advertising Age*, March 5, 2007, p. 18; J. Neff, "A Real Beauty: Dove's Viral Makes Big Splash for No Cash," *Advertising Age*, October 30, 2006, pp. 1–2; and K. Mazurkewich, "Dove Story: You Know the Name, and Some of the Story," *Strategy*, January 2007, pp. 37–39.

Pricing Strategy

LEARNING OBJECTIVE 4

Explain why and how a firm's pricing strategy might vary among countries.

International pricing strategy is an important component of the overall international marketing mix.²⁰ In this section, we look at three aspects of international pricing strategy. First, we examine the case for pursuing price discrimination, charging different prices for the same product in different countries. Second, we look at what might be called strategic pricing. Third, we review some regulatory factors, such as government-mandated price controls and antidumping regulations, that limit a firm's ability to charge the prices it would prefer in a country.

PRICE DISCRIMINATION Price discrimination exists whenever consumers in different countries are charged different prices for the same product, or for slightly different variations of the product.²¹ Price discrimination involves charging whatever the market will bear; in a competitive market, prices may have to be lower than in a market where the firm has a monopoly. Price discrimination can help a company maximize its profits. It makes economic sense to charge different prices in different countries.

Two conditions are necessary for profitable price discrimination. First, the firm must be able to keep its national markets separate. If it cannot do this, individuals or businesses may undercut its attempt at price discrimination by engaging in arbitrage. Arbitrage occurs when an individual or business capitalizes on a price differential for a firm's product between two countries by purchasing the product in the country where prices are lower and reselling it in the country where prices are higher. For example, many automobile firms have long practiced price discrimination in Europe. A Ford Escort once cost \$2,000 more in Germany than it did in Belgium. This policy broke down when car dealers bought Escorts in Belgium and drove them to Germany, where they sold them at a profit for slightly less than Ford was selling Escorts in Germany. To protect the market share of its German auto dealers, Ford had to bring its German prices into line with those being charged in Belgium. Ford could not keep these markets separate.

However, Ford still practices price discrimination between Great Britain and Belgium. A Ford car can cost up to \$3,000 more in Great Britain than in Belgium. In this case, arbitrage has not been able to equalize the price, because right-hand-drive cars are sold in Great Britain and left-hand-drive cars in the rest of Europe. Because there is no market for left-hand-drive cars in Great Britain, Ford has been able to keep the markets separate.

The second necessary condition for profitable price discrimination is different price elasticities of demand in different countries. The **price elasticity of demand** is a measure of the responsiveness of demand for a product to change in price. Demand is said to be **elastic** when a small change in price produces a large change in demand; it is said to be **inelastic** when a large change in price produces only a small change in demand. Figure 15.2 illustrates elastic and inelastic demand curves. Generally, a firm can charge a higher price in a country where demand is inelastic.

The elasticity of demand for a product in a given country is determined by a number of factors, of which income level and competitive conditions are the two most important. Price elasticity tends to be greater in countries with low income levels. Consumers with limited incomes tend to be very price conscious; they have less to spend, so they look much more closely at price. Thus, price elasticities for products such as personal computers is greater in countries such as India, where a PC is still a luxury item, than in the United States, where it is now considered a necessity. The same is true of the software that resides on those PCs; thus, to sell more software in India, Microsoft has had to introduce into that market low-priced versions of its products, such as Windows Starter Edition.

In general, the more competitors there are, the greater consumers' bargaining power will be and the more likely consumers will be to buy from the firm that charges the lowest

Price Elasticity of Demand

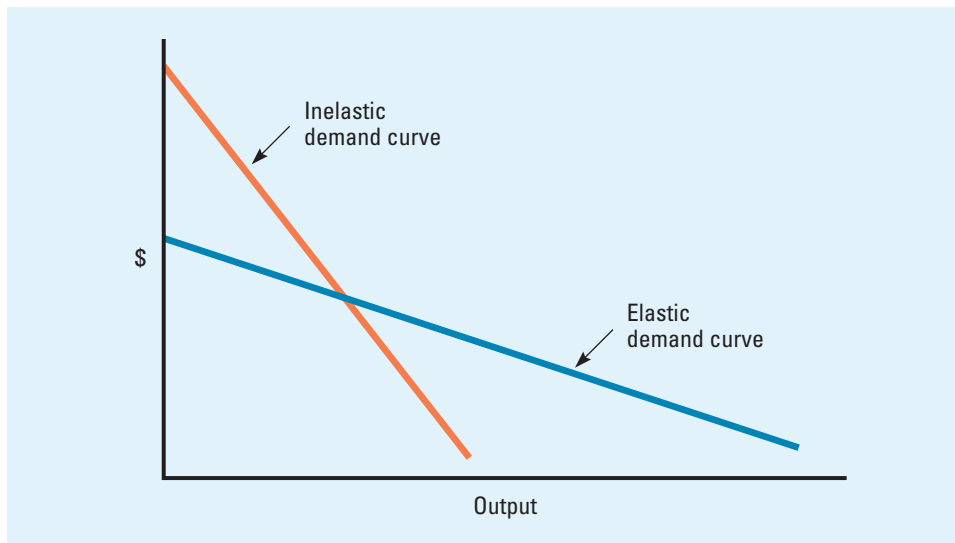
A measure of how responsive demand for a product is to changes in price.

Elastic

When a small change in price produces a large change in demand.

Inelastic

When a large change in price produces only a small change in demand.



price. Thus, many competitors cause high elasticity of demand. In such circumstances, if a firm raises its prices above those of its competitors, consumers will switch to the competitors' products. The opposite is true when a firm faces few competitors. When competitors are limited, consumers' bargaining power is weaker and price is less important as a competitive weapon. Thus, a firm may charge a higher price for its product in a country where competition is limited than in one where competition is intense.

STRATEGIC PRICING The concept of **strategic pricing** has three aspects, which we will refer to as predatory pricing, multipoint pricing, and experience curve pricing. Both predatory pricing and experience curve pricing may violate antidumping regulations. After we review predatory and experience curve pricing, we will look at antidumping rules and other regulatory policies.

Strategic Pricing
Pricing aimed at giving a company a competitive advantage over its rivals.

Predatory Pricing **Predatory pricing** is the use of price as a competitive weapon to drive weaker competitors out of a national market. Once the competitors have left the market, the firm can raise prices and enjoy high profits. For such a pricing strategy to work, the firm must normally have a profitable position in another national market, which it can use to subsidize aggressive pricing in the market it is trying to monopolize. Historically, many Japanese firms were accused of pursuing such a policy. The argument ran like this: Because the Japanese market was protected from foreign competition by high informal trade barriers, Japanese firms could charge high prices and earn high profits at home. They then used these profits to subsidize aggressive pricing overseas, with the goal of driving competitors out of those markets. Once this had occurred, so it is claimed, the Japanese firms then raised prices. Matsushita was accused of using this strategy to enter the U.S. TV market. As one of the major TV producers in Japan, Matsushita earned high profits at home. It then used these profits to subsidize the losses it made in the United States during its early years there, when it priced low to increase its market penetration. Ultimately, Matsushita became the world's largest manufacturer of TVs.²²

Predatory Pricing
Reducing prices below fair market value as a competitive weapon to drive weaker competitors out of the market ("fair" being cost plus some reasonable profit margin).

Multipoint Pricing Strategy Multipoint pricing becomes an issue when two or more international businesses compete against each other in two or more national markets. For example, multipoint pricing was an issue for Kodak and Fuji Photo because the companies long competed against each other around the world in the market for

Multipoint Pricing

Occurs when a pricing strategy in one market may have an impact on a rival's pricing strategy in another market.

silver halide film.²³ **Multipoint pricing** refers to the fact a firm's pricing strategy in one market may have an impact on its rivals' pricing strategy in another market. Aggressive pricing in one market may elicit a competitive response from a rival in another market. For example, Fuji launched an aggressive competitive attack against Kodak in the U.S. company's home market in January 1997, cutting prices on multiple-roll packs of 35mm film by as much as 50 percent.²⁴ This price cutting resulted in a 28 percent increase in shipments of Fuji color film during the first six months of 1997, while Kodak's shipments dropped by 11 percent. This attack created a dilemma for Kodak; the company did not want to start price discounting in its largest and most profitable market. Kodak's response was to aggressively cut prices in Fuji's largest market, Japan. This strategic response recognized the interdependence between Kodak and Fuji and the fact that they compete against each other in many different nations. Fuji responded to Kodak's counterattack by pulling back from its aggressive stance in the United States.

The Kodak story illustrates an important aspect of multipoint pricing: Aggressive pricing in one market may elicit a response from rivals in another market. The firm needs to consider how its global rivals will respond to changes in its pricing strategy before making those changes. A second aspect of multipoint pricing arises when two or more global companies focus on particular national markets and launch vigorous price wars in those markets in an attempt to gain market dominance. In the Brazil market for disposable diapers, two U.S. companies, Kimberly-Clark Corp. and Procter & Gamble, entered a price war as each struggled to establish dominance in the market.²⁵ As a result, over three years the cost of disposable diapers fell from \$1 per diaper to 33 cents per diaper, while several other competitors, including indigenous Brazilian firms, were driven out of the market. Kimberly-Clark and Procter & Gamble are engaged in a global struggle for market share and dominance, and Brazil is one of their battlegrounds. Both companies can afford to engage in this behavior, even though it reduces their profits in Brazil, because they have profitable operations elsewhere in the world that can subsidize these losses.

Pricing decisions around the world need to be centrally monitored. It is tempting to delegate full responsibility for pricing decisions to the managers of various national subsidiaries, thereby reaping the benefits of decentralization. However, because pricing strategy in one part of the world can elicit a competitive response in another, central management needs to at least monitor and approve pricing decisions in a given national market, and local managers need to recognize that their actions can affect competitive conditions in other countries.

Experience Curve Pricing We first encountered the experience curve in Chapter 12. As a firm builds its accumulated production volume over time, unit costs fall due to experience effects. Learning effects and economies of scale underlie the experience curve. Price comes into the picture because aggressive pricing (along with aggressive promotion and advertising) can build accumulated sales volume rapidly and thus move production down the experience curve. Firms further down the experience curve have a cost advantage vis-à-vis those further up the curve.

Many firms pursuing an **experience curve pricing** strategy on an international scale will price low worldwide in attempting to build global sales volume as rapidly as possible, even if this means taking large losses initially. Such a firm believes that in several years, when it has moved down the experience curve, it will be making substantial profits and have a cost advantage over its less-aggressive competitors.

REGULATORY INFLUENCES ON PRICES The ability to engage in either price discrimination or strategic pricing may be limited by national or international regulations. Most important, a firm's freedom to set its own prices is constrained by antidumping regulations and competition policy.

Experience Curve Pricing

Aggressive pricing designed to increase volume and help the firm realize experience curve economies.

Antidumping Regulations Both predatory pricing and experience curve pricing can run afoul of antidumping regulations. Dumping occurs whenever a firm sells a product for a price that is less than the cost of producing it. Most regulations, however, define dumping more vaguely. For example, a country is allowed to bring antidumping actions against an importer under Article 6 of GATT as long as two criteria are met: sales at “less than fair value” and “material injury to a domestic industry.” The problem with this terminology is that it does not indicate what value is considered fair. The ambiguity has led some to argue that selling abroad at prices below those in the country of origin, as opposed to below cost, is dumping.

Such logic led the Bush administration to place a 20 percent duty on imports of foreign steel in 2001. Foreign manufacturers protested that they were not selling below cost. Admitting that their prices were lower in the United States than some other countries, they argued that this simply reflected the intensely competitive nature of the U.S. market (i.e., different price elasticities).

Antidumping rules set a floor under export prices and limit firms’ ability to pursue strategic pricing. The rather vague terminology used in most antidumping actions suggests that a firm’s ability to engage in price discrimination also may be challenged under antidumping legislation.

Competition Policy Most developed nations have regulations designed to promote competition and to restrict monopoly practices. These regulations can be used to limit the prices a firm can charge in a given country. For example, at one time the Swiss pharmaceutical manufacturer Hoffmann-LaRoche had a monopoly on the supply of Valium and Librium tranquilizers. The company was investigated by the British Monopolies and Mergers Commission, which is responsible for promoting fair competition in Great Britain. The commission found that Hoffmann-LaRoche was overcharging for its tranquilizers and ordered the company to reduce its prices 35 to 40 percent. Hoffmann-LaRoche maintained unsuccessfully that it was merely engaging in price discrimination. Similar actions were later brought against Hoffmann-LaRoche by the German cartel office and by the Dutch and Danish governments.²⁶

Configuring the Marketing Mix

A firm might vary aspects of its marketing mix from country to country to take into account local differences in culture, economic conditions, competitive conditions, product and technical standards, distribution systems, government regulations, and the like. Such differences may require variation in product attributes, distribution strategy, communications strategy, and pricing strategy. The cumulative effect of these factors makes it rare for a firm to adopt the same marketing mix worldwide. A detailed example is given in the accompanying Management Focus, which looks at how Levi Strauss now varies its marketing mix from country to country. This is a particularly interesting example because Theodore Levitt held up Levi Strauss as an example of global standardization, but as the Management Focus makes clear, the opposite now seems to be the case.

The financial services industry is often thought of as one in which global standardization of the marketing mix is the norm. However, while a financial services company such as American Express may sell the same basic charge card service worldwide, utilize the same basic fee structure for that product, and adopt the same basic global advertising message (“don’t leave home without it”), differences in national regulations still mean that it has to vary aspects of its communications strategy from country to country (as pointed out earlier, the promotional strategy it had developed in the United States was illegal in Germany). Similarly, while McDonald’s is often thought of as the quintessential



Levi Strauss Goes Local

It's been a tough few years for Levi Strauss, the iconic manufacturer of blue jeans. The company, whose 501 jeans became the global symbol of the baby boom generation and were sold in more than 100 countries, saw its sales drop from a peak of \$7.1 billion in 1996 to just \$4.0 billion in 2004. Fashion trends had moved on, its critics charged, and Levi Strauss, hamstrung by high costs and a stagnant product line, was looking more faded than a well-worn pair of 501s. Perhaps so, but 2005–2009 brought signs that a turnaround was in progress. Sales increased, and after a string of losses the company started to register profits again.

There were three parts to this turnaround. First, there were cost reductions at home. Levi Strauss closed its last remaining American factories and moved production offshore where jeans could be produced more cheaply. Second, the company broadened its product line, introducing the Levi's Signature brand that could be sold through lower-priced outlets in markets that were more competitive, including the core American market where Walmart had driven down prices. Third, in the late 1990s the company decided to give more responsibility to national managers, allowing them to better tailor the product offering and marketing mix to local conditions. Before this, Levi Strauss had basically sold the same product worldwide, often using the same advertising message. The old strategy was designed to enable the company to realize economies of scale in production and advertising, but it wasn't working.

Under the new strategy, variations between national markets have become more pronounced. Jeans have been tailored to different body types. In Asia, shorter leg lengths are common, whereas in South Africa, more room is needed for the backside of women's jeans, so Levi Strauss has customized the product offering to account for these physical differences. Then there are sociocultural differences: In Japan, tight-fitting black jeans are popular; in Islamic

countries, women are discouraged from wearing tight-fitting jeans, so Levi's offerings in countries like Turkey are roomier. Climate also has an effect on product design. In Northern Europe, standard-weight denim jeans are sold, whereas in hotter countries lighter denim is used, along with brighter colors that are not washed out by the tropical sun.

Levi's ads, which used to be global, have also been tailored to regional differences. In Europe, the ads now talk about the cool fit. In Asia, they talk about the rebirth of an original. In the United States, the ads show real people who are themselves originals: ranchers, surfers, great musicians. There are also differences in distribution channels and pricing strategy. In the fiercely competitive American market, prices are as low as \$25 and Levi's are sold through mass-market discount retailers, such as Walmart. In India, strong sales growth is being driven by Levi's low-priced Signature brand. In Spain, jeans are seen as higher fashion items and are being sold for \$50 in higher-quality outlets. In the United Kingdom, too, prices for 501s are much higher than in the United States, reflecting a more benign competitive environment.

This marketing mix variation seems to be reaping dividends; although demand in the United States and Europe remains sluggish, growth in many other countries is strong. Turkey, South Korea, and South Africa all recorded growth rates in excess of 20 percent a year following the introduction of this strategy in 2005. Looking forward, Levi Strauss expects 60 percent of its growth to come from emerging markets.

Sources: "How Levi Strauss Rekindled the Allure of Brand America," *World Trade*, March 2005, p. 28; "Levi Strauss Walks with a Swagger into New Markets," *Africa News*, March 17, 2005; "Levi's Adaptable Standards," *Strategic Direction*, June 2005, pp. 14–16; A. Benady, "Levi's Looks to the Bottom Line," *Financial Times*, February 15, 2005, p. 14, and R. A. Smith, "At Levi Strauss Dockers Are In," *The Wall Street Journal*, February 14, 2007, p. A14.

example of a firm that sells the same basic standardized product worldwide, in reality it varies one important aspect of its marketing mix—its menu—from country to country. McDonald's also varies its distribution strategy. In Canada and the United States, most McDonald's are located in areas that are easily accessible by car, whereas in more densely populated and less automobile-reliant societies of the world, such as Japan and Great Britain, location decisions are driven by the accessibility of a restaurant to pedestrian traffic. Because countries typically still differ along one or more of the dimensions discussed above, some customization of the marketing mix is normal.

However, there are often significant opportunities for standardization along one or more elements of the marketing mix.²⁷ Firms may find that it is possible and desirable to standardize their global advertising message or core product attributes to realize

substantial cost economies. They may find it desirable to customize their distribution and pricing strategy to take advantage of local differences. In reality, the “customization versus standardization” debate is not an all or nothing issue; it frequently makes sense to standardize some aspects of the marketing mix and customize others, depending on conditions in various national marketplaces.

New-Product Development

Firms that successfully develop and market new products can earn enormous returns. Examples include DuPont, which has produced a steady stream of successful innovations such as cellophane, nylon, Freon, and Teflon (nonstick pans); Sony, whose successes include the Walkman, the compact disk, the PlayStation, the Blu-ray high-definition DVD player; Pfizer, the drug company that during the 1990s produced several major new drugs, including Viagra; 3M, which has applied its core competency in tapes and adhesives to developing a wide range of new products; Intel, which has consistently managed to lead in the development of innovative microprocessors to run personal computers; and Cisco Systems, which developed the routers that sit at the hubs of Internet connections, directing the flow of digital traffic.

In today's world, competition is as much about technological innovation as anything else. The pace of technological change has accelerated since the Industrial Revolution in the eighteenth century, and it continues to do so today. The result has been a dramatic shortening of product life cycles. Technological innovation is both creative and destructive.²⁸ An innovation can make established products obsolete overnight. But an innovation can also make a host of new products possible. Witness recent changes in the electronics industry. For 40 years before the early 1950s, vacuum tubes were a major component in radios and then in record players and early computers. The advent of transistors destroyed the market for vacuum tubes, but at the same time it created new opportunities connected with transistors. Transistors took up far less space than vacuum tubes, creating a trend toward miniaturization that continues today. The transistor held its position as the major component in the electronics industry for just a decade. Microprocessors were developed in the 1970s, and the market for transistors declined rapidly. The microprocessor created yet another set of new-product opportunities: handheld calculators (which destroyed the market for slide rules), compact disk players (which destroyed the market for analog record players), personal computers (which destroyed the market for typewriters), cell phones (which may ultimately replace landline phones), to name a few.

This “creative destruction” unleashed by technological change makes it critical that a firm stay on the leading edge of technology, lest it lose out to a competitor's innovations. As we explain in the next subsection, this not only creates a need for the firm to invest in R&D, but it also requires the firm to establish R&D activities at those locations where expertise is concentrated. As we shall see, leading-edge technology on its own is not enough to guarantee a firm's survival. The firm must also apply that technology to developing products that satisfy consumer needs, and it must design the product so that it can be manufactured in a cost-effective manner. To do that, the firm needs to build close links between R&D, marketing, and manufacturing.

LEARNING OBJECTIVE 5

Describe how the globalization of the world economy is affecting new-product development within the international business firm.



Another Perspective

New-Product Development—on a Budget

Innovation rises to new heights when companies introduce a product that's truly affordable. Consider the Nano, built by Tata Motors of India and, with the almost unbelievable sticker price of \$2,500, dubbed “the world's cheapest car.” Tata's introduction of the fuel-efficient, low-emission four-passenger vehicle made car ownership—for the first time—a possibility for millions of Indian families.

For physicians practicing in rural India, GE Healthcare created an ultra-portable electrocardiograph machine. The product's success motivated GE to adapt the design and offer a similar device to U.S. doctors for about \$1,000—a fraction of the cost of the traditional machine. (Mark Foster, “New, Improved, and Super Low-Cost,” *BusinessWeek*, April 9, 2010, www.businessweek.com)

This is difficult enough for the domestic firm, but it is even more problematic for the international business competing in an industry where consumer tastes and preferences differ from country to country.²⁹ With all of this in mind, we move on to examine locating R&D activities and building links between R&D, marketing, and manufacturing.

THE LOCATION OF R&D Ideas for new products are stimulated by the interactions of scientific research, demand conditions, and competitive conditions. Other things being equal, the rate of new-product development seems to be greater in countries where

- More money is spent on basic and applied research and development.
- Underlying demand is strong.
- Consumers are affluent.
- Competition is intense.³⁰

Basic and applied research and development discovers new technologies and then commercializes them. Strong demand and affluent consumers create a potential market for new products. Intense competition between firms stimulates innovation as the firms try to beat their competitors and reap potentially enormous first-mover advantages that result from successful innovation.

For most of the post-World War II period, the country that ranked highest on these criteria was the United States. The United States devoted a greater proportion of its gross domestic product to R&D than any other country did. Its scientific establishment was the largest and most active in the world. U.S. consumers were the most affluent, the market was large, and competition among U.S. firms was brisk. Due to these factors, the United States was the market where most new products were developed and introduced. Accordingly, it was the best location for R&D activities; it was where the action was.

Over the past 20 years, things have been changing quickly. The U.S. monopoly on new-product development has weakened considerably. Although U.S. firms are still at the leading edge of many new technologies, Asian and European firms are also strong players, with companies such as Sony, Sharp, Samsung, Ericsson, Nokia, and Philips NV driving product innovation in their respective industries. In addition, both Japan and the European Union are large, affluent markets, and the wealth gap between them and the United States is closing.

As a result, it is often no longer appropriate to consider the United States as the lead market. In video games, for example, Japan is often the lead market, with companies such as Sony and Nintendo introducing their latest video game players in Japan some six months before they introduce them in the United States. In wireless telecommunications, Europe is generally reckoned to be ahead of the United States. Some of the most advanced applications of wireless telecommunications services are being pioneered not in the United States but in Finland, where more than 90 percent of the population has wireless telephones, compared with 65 percent of the U.S. population. However, it is questionable whether any developed nation can be considered the lead market. To succeed in today's high-technology industries, it is often necessary to simultaneously introduce new products in all major industrialized markets. When Intel introduces a new microprocessor, for example, it does not first introduce it in the United States and then roll it out in Europe a year later. It introduces it simultaneously around the world.

Because leading-edge research is now carried out in many locations around the world, the argument for centralizing R&D activity in the United States is now much weaker than it was two decades ago. (It used to be argued that centralized R&D eliminated duplication.) Much leading-edge research is now occurring in Japan and Europe. Dispersing R&D activities to those locations allows a firm to stay close to the center of leading-edge activity to gather scientific and competitive information and to draw on local scientific

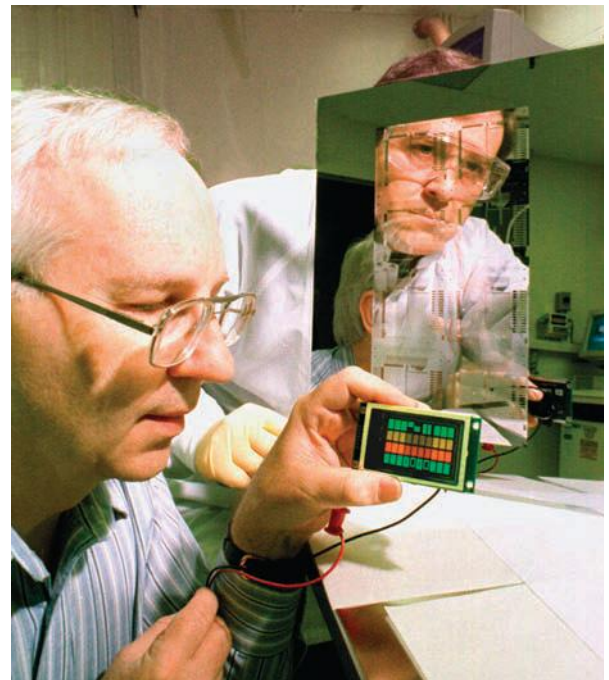
resources.³¹ This may result in some duplication of R&D activities, but the cost disadvantages of duplication are outweighed by the advantages of dispersion.

For example, to expose themselves to the research and new-product development work being done in Japan, many U.S. firms have set up satellite R&D centers in Japan. Kodak's R&D center in Japan employs about 200 people. The company hired about 100 Japanese researchers and directed the lab to concentrate on electronic imaging technology. U.S. firms that have established R&D facilities in Japan include Corning, Texas Instruments, IBM, Digital Equipment, Procter & Gamble, Upjohn, Pfizer, DuPont, Monsanto, and Microsoft.³² The National Science Foundation (NSF) has documented a sharp increase in the proportion of total R&D spending by U.S. firms that is now done abroad.³³ For example, Motorola now has 14 dedicated R&D facilities located in seven countries, and Bristol-Myers Squibb has 12 facilities in six countries. At the same time, to internationalize their own research and gain access to U.S. talent, many European and Japanese firms are investing in U.S.-based research facilities, according to the NSF.

INTEGRATING R&D, MARKETING, AND PRODUCTION Although a firm that is successful at developing new products may earn enormous returns, new-product development has a high failure rate. One study of product development in 16 companies in the chemical, drug, petroleum, and electronics industries suggested that only about 20 percent of R&D projects result in commercially successful products or processes.³⁴ Another in-depth case study of product development in three companies (one in chemicals and two in drugs) reported that about 60 percent of R&D projects reached technical completion, 30 percent were commercialized, and only 12 percent earned an economic profit that exceeded the company's cost of capital.³⁵ Along the same lines, another study concluded that one in nine major R&D projects, or about 11 percent, produced commercially successful products.³⁶ In sum, the evidence suggests that only 10 to 20 percent of major R&D projects give rise to commercially successful products. Well-publicized product failures include Apple Computer's Newton personal digital assistant, Sony's Betamax format in the video player and recorder market, and Sega's Dreamcast videogame console.

The reasons for such high failure rates are various and include development of a technology for which demand is limited, failure to adequately commercialize promising technology, and inability to manufacture a new product cost effectively. Firms can reduce the probability of making such mistakes by insisting on tight cross-functional coordination and integration between three core functions involved in the development of new products: R&D, marketing, and production.³⁷ Tight cross-functional integration between R&D, production, and marketing can help a company to ensure that

1. Product development projects are driven by customer needs.
2. New products are designed for ease of manufacture.
3. Development costs are kept in check.
4. Time to market is minimized.



Companies such as Eastman Kodak Co. have R&D centers in both the United States and Japan to stay on the cutting edge of trends in their industries. Here, in a joint research venture with Sanyo Electronics of Japan, Kodak researchers inspect a glass substrate used in the development of next-generation flat-panel displays that enable brighter, thinner, more power-efficient displays for cellular phones, personal data assistants, and computer terminals.

Close integration between R&D and marketing is required to ensure that product development projects are driven by the needs of customers. A company's customers can be a primary source of new-product ideas. Identification of customer needs, particularly unmet needs, can set the context within which successful product innovation occurs. As the point of contact with customers, the marketing function of a company can provide valuable information in this regard. Integration of R&D and marketing is crucial if a new product is to be properly commercialized. Without integration of R&D and marketing, a company runs the risk of developing products for which there is little or no demand.

Integration between R&D and production can help a company design products with manufacturing requirements in mind. Designing for manufacturing can lower costs and increase product quality. Integrating R&D and production can also help lower development costs and speed products to market. If a new product is not designed with manufacturing capabilities in mind, it may prove too difficult to build. Then the product will have to be redesigned, and both overall development costs and the time it takes to bring the product to market may increase significantly. Making design changes during product planning could increase overall development costs by 50 percent and add 25 percent to the time it takes to bring the product to market.³⁸ Many quantum product innovations require new processes to manufacture them, which makes it all the more important to achieve close integration between R&D and production. Minimizing time to market and development costs may require the simultaneous development of new products and new processes.³⁹

CROSS-FUNCTIONAL TEAMS One way to achieve cross-functional integration is to establish cross-functional product development teams composed of representatives from R&D, marketing, and production. Because these functions may be located in different countries, the team will sometimes have a multinational membership. The objective of a team should be to take a product development project from the initial concept development to market introduction. A number of attributes seem to be important for a product development team to function effectively and meet all its development milestones.⁴⁰

First, the team should be led by a “heavyweight” project manager who has high status within the organization and who has the power and authority required to get the financial and human resources the team needs to succeed. The leader should be dedicated primarily, if not entirely, to the project. He or she should be someone who believes in the project (a champion) and who is skilled at integrating the perspectives of different functions and at helping personnel from different functions and countries work together for a common goal. The leader should also be able to act as an advocate of the team to senior management.

Second, the team should be composed of at least one member from each key function. The team members should have a number of attributes, including an ability to contribute functional expertise, high standing within their function, a willingness to share responsibility for team results, and an ability to put functional and national advocacy aside. It is generally preferable if core team members are 100 percent dedicated to the project for its duration. This assures their focus on the project, not on the ongoing work of their function.

Third, the team members should physically be in one location if possible to create a sense of camaraderie and to facilitate communication. This presents problems if the team members are drawn from facilities in different nations. One solution is to transfer key individuals to one location for the duration of a product development project. Fourth, the team should have a clear plan and clear goals, particularly with regard to critical development milestones and development budgets. The team should have incentives to attain those goals, such as receiving pay bonuses when major development milestones are hit.

Fifth, each team needs to develop its own processes for communication and conflict resolution. For example, one product development team at Quantum Corporation, a California-based manufacturer of disk drives for personal computers, instituted a rule that all major decisions would be made and conflicts resolved at meetings that were held every Monday afternoon. This simple rule helped the team meet its development goals. In this case, it was also common for team members to fly in from Japan, where the product was to be manufactured, to the U.S. development center for the Monday meetings.⁴¹

BUILDING GLOBAL R&D CAPABILITIES The need to integrate R&D and marketing to adequately commercialize new technologies poses special problems in the international business because commercialization may require different versions of a new product to be produced for various countries.⁴² To do this, the firm must build close links between its R&D centers and its various country operations. A similar argument applies to the need to integrate R&D and production, particularly in those international businesses that have dispersed production activities to different locations around the globe in consideration of relative factor costs and the like.

Integrating R&D, marketing, and production in an international business may require R&D centers in North America, Asia, and Europe that are linked by formal and informal integrating mechanisms with marketing operations in each country in their regions and with the various manufacturing facilities. In addition, the international business may have to establish cross-functional teams whose members are dispersed around the globe. This complex endeavor requires the company to utilize formal and informal integrating mechanisms to knit its far-flung operations together so they can produce new products in an effective and timely manner.

While there is no one best model for allocating product development responsibilities to various centers, one solution adopted by many international businesses involves establishing a global network of R&D centers. Within this model, fundamental research is undertaken at basic research centers around the globe. These centers are normally located in regions or cities where valuable scientific knowledge is being created and where there is a pool of skilled research talent (e.g., Silicon Valley in the United States, Cambridge in England, Kobe in Japan, Singapore). These centers are the innovation engines of the firm. Their job is to develop the basic technologies that become new products.

These technologies are picked up by R&D units attached to global product divisions and are used to generate new products to serve the global marketplace. At this level, commercialization of the technology and design for manufacturing are emphasized. If further customization is needed so the product appeals to the tastes and preferences of consumers in individual markets, such redesign work will be done by an R&D group based in a subsidiary in that country or at a regional center that customizes products for several countries in the region.

Hewlett-Packard has four basic research centers located in Palo Alto, California; Bristol, England; Haifa, Israel; and Tokyo, Japan.⁴³ These labs are the seedbed for technologies that ultimately become new products and businesses. They are the company's innovation engines. The Palo Alto center, for example, pioneered HP's thermal ink-jet technology. The products are developed by R&D centers associated with HP's global product divisions. Thus, the Consumer Products Group, which has its worldwide headquarters in San Diego, California, designs, develops, and manufactures a range of imaging products using HP-pioneered thermal ink-jet technology. Subsidiaries might then customize the product so that it best matches the needs of important national markets. HP's subsidiary in Singapore, for example, is responsible for the design and production of thermal ink-jet printers for Japan and other Asian markets. This subsidiary takes products originally developed in San Diego and redesigns them for the

Asian market. In addition, the Singapore subsidiary has taken the lead from San Diego in the design and development of certain portable thermal ink-jet printers. HP delegated this responsibility to Singapore because this subsidiary has acquired important competencies in the design and production of thermal ink-jet products, so it has become the best place in the world to undertake this activity.

Microsoft offers a similar example. The company has basic research sites in Redmond, Washington (its headquarters); Silicon Valley, California; Cambridge, England; Tokyo, Japan; Beijing, China; and Bangalore, India. Staff at these research sites work on the fundamental problems that underlie the design of future products. For example, a group at Redmond is working on natural language recognition software, while another works on artificial intelligence. These research centers don't produce new products; rather, they produce the technology that is used to enhance existing products or help produce new products. The products are produced by dedicated product groups (e.g., desktop operating systems, applications). Customization of the products to match the needs of local markets is sometimes carried out at local subsidiaries. Thus, the Chinese subsidiary will do some basic customization of programs such as Microsoft Office, adding Chinese characters and customizing the interface, and the R&D group in India has helped to develop products for that market.

Key Terms

marketing mix, p. 495	source effects, p. 506	inelastic, p. 512
market segmentation, p. 497	country of origin effects, p. 506	strategic pricing, p. 513
concentrated retail system, p. 501	noise, p. 507	predatory pricing, p. 513
fragmented retail system, p. 501	push strategy, p. 507	multipoint pricing, p. 514
channel length, p. 502	pull strategy, p. 507	experience curve
exclusive distribution channel, p. 503	price elasticity of demand, p. 512	pricing, p. 514
channel quality, p. 503	elastic, p. 512	

Summary

This chapter discussed the marketing and R&D functions in international business. A persistent theme of the chapter is the tension that exists between the need to reduce costs and the need to be responsive to local conditions, which raises costs. The chapter made these major points:

1. Theodore Levitt argued that due to the advent of modern communications and transport technologies, consumer tastes and preferences are becoming global, which is creating global markets for standardized consumer products. However, this position is regarded as extreme by many commentators, who argue that substantial differences still exist between countries.
2. Market segmentation refers to the process of identifying distinct groups of consumers whose purchasing behavior differs from each other in important ways. Managers in an international business need to be aware of two main issues relating to segmentation: the extent to which there are differences between countries in the structure of market segments, and the existence of segments that transcend national borders.
3. A product can be viewed as a bundle of attributes. Product attributes need to be varied from country to country to satisfy different consumer tastes and preferences.
4. Country differences in consumer tastes and preferences are due to differences in culture and economic development. In addition, differences in product and technical standards

- may require the firm to customize product attributes from country to country.
5. A distribution strategy decision is an attempt to define the optimal channel for delivering a product to the consumer.
 6. Significant country differences exist in distribution systems. In some countries, the retail system is concentrated; in others, it is fragmented. In some countries, channel length is short; in others, it is long. Access to distribution channels is difficult to achieve in some countries, and the quality of the channel may be poor.
 7. A critical element in the marketing mix is communication strategy, which defines the process the firm will use in communicating the attributes of its product to prospective customers.
 8. Barriers to international communication include cultural differences, source effects, and noise levels.
 9. A communication strategy is either a push strategy or a pull strategy. A push strategy emphasizes personal selling, and a pull strategy emphasizes mass media advertising. Whether a push strategy or a pull strategy is optimal depends on the type of product, consumer sophistication, channel length, and media availability.
 10. A globally standardized advertising campaign, which uses the same marketing message all over the world, has economic advantages, but it fails to account for differences in culture and advertising regulations.
 11. Price discrimination exists when consumers in different countries are charged different prices for the same product. Price discrimination can help a firm maximize its profits. For price discrimination to be effective, the national markets must be separate and their price elasticities of demand must differ.
 12. Predatory pricing is the use of profit gained in one market to support aggressive pricing in another market to drive competitors out of that market.
 13. Multipoint pricing refers to the fact that a firm's pricing strategy in one market may affect rivals' pricing strategies in another market. Aggressive pricing in one market may elicit a competitive response from a rival in another market that is important to the firm.
 14. Experience curve pricing is the use of aggressive pricing to build accumulated volume as rapidly as possible to quickly move the firm down the experience curve.
 15. New-product development is a high-risk, potentially high-return activity. To build a competency in new-product development, an international business must do two things: disperse R&D activities to those countries where new products are being pioneered, and integrate R&D with marketing and manufacturing.
 16. Achieving tight integration among R&D, marketing, and manufacturing requires the use of cross-functional teams.

Critical Thinking and Discussion Questions

1. Imagine you are the marketing manager for a U.S. manufacturer of disposable diapers. Your firm is considering entering the Brazilian market. Your CEO believes the advertising message that has been effective in the United States will suffice in Brazil. Outline some possible objections to this. Your CEO also believes that the pricing decisions in Brazil can be delegated to local managers. Why might she be wrong?
2. Within 20 years, we will have seen the emergence of enormous global markets for standardized consumer products. Do you agree with this statement? Justify your answer.
3. You are the marketing manager of a food products company that is considering entering the Indian market. The retail system in India tends to be very fragmented. Also, retailers and wholesalers tend to have long-term ties with Indian food companies, which makes access to distribution channels difficult. What distribution strategy would you advise the company to pursue? Why?
4. Price discrimination is indistinguishable from dumping. Discuss the accuracy of this statement.
5. You work for a company that designs and manufactures personal computers. Your company's R&D center is in North Dakota.

The computers are manufactured under contract in Taiwan. Marketing strategy is delegated to the heads of three regional groups: a North American group (based in Chicago), a European group (based in Paris), and an Asian group (based in Singapore). Each regional group develops the marketing approach within its region. In order of importance, the largest markets for your products are North America, Germany, Great Britain, China, and Australia. Your company is experiencing problems in its product development and commercialization process. Products are late to market, the manufacturing quality is poor, costs are higher than projected, and market acceptance of new products is less than hoped for. What might be the source of these problems? How would you fix them?

6. Reread the Management Focus, “Levi Strauss Goes Local,” and then answer the following questions:

- a. What marketing strategy was Levi Strauss using until the early 2000s? Why did this strategy appear to work for decades? Why was it not working by the 2000s?
- b. How would you characterize Levi Strauss’s current strategy? What elements of the marketing mix are now changed from nation to nation?
- c. What are the benefits of the company’s new marketing strategy? Is there a downside?
- d. What does the Levi Strauss story tell you about the “globalization of markets”?

Research Task



<http://globalEDGE.msu.edu>

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

1. You are the marketing manager for a diversified food and beverage company. Preliminary market research indicates that Chile holds significant opportunities for your products. Using an analysis of the food and beverage industry in Chile used by *Australian suppliers*, prepare a short report identifying the factors that must be considered when formulating the marketing strategy for this country.
2. A. T. Kearney publishes an annual study to help retailers prioritize their global development strategies by ranking the retail expansion attractiveness of emerging countries based on a set of criteria. Find the latest version of this *Global Retail Development Index*. What criteria are used to identify the attractiveness of the retail environment in emerging countries? Are there any countries in the top 10 that surprise you? Why (or, why not)?



Microsoft in India

closing case

Microsoft made its name by building two monopolies, its Windows operating system and its Office suite of personal productivity software, that are used the world over. Windows, for example, runs on about 94 percent of the world’s personal computers. Despite its global dominance, however, Microsoft has found it difficult to get traction in many developing nations. India is a case in point. Although the country has a well-educated middle class, and although India is home to some of the world’s most successful information technology outsourcing companies, the vast majority of Indians do not

have access to a personal computer. India has only 25 PCs per thousand people compared to 997 per thousand in the United States. The main reason for this is cost! Most Indians are simply too poor to afford a PC. Also, Microsoft’s Windows franchise faces two major competitors in India: pirated versions of Windows, and the free open source product Linux, which can be found on many servers and also is making its way onto desktop PCs in India.

Dealing with these issues has forced Microsoft to rethink its global strategy of one-size fits all. In many ways, India has

become a test case for Microsoft's efforts to customize its offerings to the realities of emerging markets. To help develop local offerings, Microsoft invested heavily in an Indian R&D center in Hyderabad, which today employs 1,500 people and is the company's largest software development center outside the United States.

To protect its Windows franchise against lower-cost competitors (pirates and Linux), Microsoft developed a special version of Windows, Windows XP Starter Edition. This sells for less than half the price of Windows XP, which is itself cheaper than its recent operating systems, Windows Vista and Windows 7. Windows XP Starter Edition has limited functionality—it can run only three programs at once and is not configured for computer networking—but the low price is more appealing in the Indian market. Starter Edition comes in 10 local Indian languages, plus Hindi and English, significantly broadening its appeal.

Instead of selling packaged software, which is too expensive for many small businesses, Microsoft is selling monthly online access to some of its other offerings, such as Office and SQL Server (Microsoft's database product), for a low subscription fee. The programs are hosted on Microsoft servers. Not only does this strategy help Microsoft gain incremental sales that would not otherwise occur, but it also is proving to be an effective response to pirates, who cannot offer a similar service. Ironically, this strategy may ultimately be one that is favored in developed markets, such as the United States, where competitors such as Google are already starting to gain traction with similar online offerings.

Other innovative offerings in India include a product called multipoint, which allows users to attach several computer mice to a single machine. The product is for use in schools and was developed after Microsoft observed very few Indians schools had one PC per student, and that students often lined up three or four deep behind a machine. Microsoft is developing simple educational programs that multiple students can interact with at the same time by clicking on icons. For example, children can play a game where they hear a word and then compete to identify the text on the screen that matches the sound.

More generally, Microsoft has observed that in India many people are using cell phones to perform basic functions that in other countries would be done using personal computers. The PC is still too expensive to be used by many small Indian businesses (20 people or less) that account for half of India's manufacturing. Cell phones are cheaper, they are mobile, and they are easy to use. To address this market, Microsoft is experimenting with a number of approaches. The company has created text-messaging services for farmers and manufacturers, enabling them to check prices, inventory levels, orders, and so on via their cell phones. For example, in 2008 it rolled out a project in Tirupur, a textile manufacturing center, enabling small manufacturers with cell phones to track progress with orders over the Web via text messages. All the back-end server hardware and maintenance is outsourced to a local firm, while Microsoft charges users a monthly fee for the service. By pioneering locally customized services such as these, Microsoft hopes to grow its share of the Indian software market.

Sources: M. Bahree, "Knitters without Windows," *Forbes*, September 29, 2008, pp. 74–77; A. Vance, "Microsoft Goes Far Afield to Study Emerging Markets," *The New York Times*, October 27, 2008, p. B8; and J. Greene, "Now Microsoft Wagers on India," *BusinessWeek Online*, December 8, 2005.

Case Discussion Questions

1. Why does Microsoft's traditional strategy of "one size fits all" not work well in emerging markets such as India? What is different about these markets? How do customers differ both in their characteristics, and in the way they use technology?
2. What steps did Microsoft have to take to develop products that are customized to Indian consumers?
3. How does Microsoft vary the marketing mix of its existing product offerings to gain traction with Indian customers? What else has Microsoft done to make headway in India?
4. What general lessons can be derived from Microsoft's experience in India?

AstraZeneca

part 5

Competing in a Global Marketplace

LEARNING OBJECTIVES

After you have read this chapter you should be able to:

- 1 Summarize the strategic role of human resource management in international business firms.
- 2 Identify the pros and cons of different approaches to staffing policy in international business firms.
- 3 Explain why managers may fail to thrive in foreign postings.
- 4 Recognize how management development and training programs can increase the value of human capital in international business firms.
- 5 Explain how and why performance appraisal systems might vary across nations.
- 6 Explain how and why compensation systems might vary across nations.
- 7 Understand how organized labor can influence strategic choices in international business firms.

Global Human Resource Management

AstraZeneca International

opening case

AstraZeneca is one of the world's largest pharmaceutical companies. Headquartered in London, the company has 65,000 employees, 51 percent of whom are in Europe, 32 percent in the Americas, and 17 percent in Asia, Africa, and Australia. The company is active in more than 100 nations and has sales in excess of \$31 billion. A key strategic imperative for this multinational is to build a talented global workforce, led by managers who have a global perspective, are comfortable moving around the world, interacting with people from other cultures, and doing business in different nations. It is not easy.

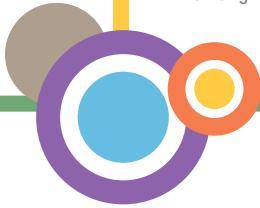
To help build international bench strength, the company will move managers to another country for up to three years. Such assignments are not cheap; the company estimates that it can cost two to four times an employee's annual salary to cover expenses. Expenses can include a child's school tuition, tax equalization, cultural training, and subsidized housing. Because of this expense, AstraZeneca focuses its international assignments only on its most promising employees—those who are scheduled for advancement and leadership positions within the company. In every case, the human resource staff will assess whether the investment in a person is worth making. Simply posting an employee to a foreign country is not enough. To get promoted, employees must also learn to work in international teams and to manage across borders. If employees are judged to lack the capability to do this, they will not get a foreign posting. If they fail to do this effectively when on the posting, their advancement prospects will be reduced.

To ease the transition to another country, AstraZeneca offers employees and their spouses help with moving, locating schools for children, learning a language, and understanding cultural differences. The company also

offers repatriation training for employees coming home after extended postings abroad. It does this because experience has shown that many expatriates and their families have problems readjusting to their old life after extended time in a different culture.

Another problem that the human resource function at AstraZeneca has to grapple with is how to raise the talent base of employees in emerging markets where AstraZeneca has been making big investments in recent years. For example, until recently, China offered very little professional management education (this is now changing rapidly). In 2003 AstraZeneca had some 1,000 employees in China. Today it has over 3,500. The company has been trying to raise the skill level of key Chinese employees as fast as possible, sending key managerial talent abroad to get exposure to other cultures and to acculturate them into the way in which AstraZeneca does business. It wants them to understand what it is like to be part of a global business. All expatriates have a host-country line manager assigned to them, as well as a home-country line manager who monitors their progress. The majority of them return to China where the most successful are targeted for future leadership positions within the Chinese subsidiary. The most talented, however, may go beyond this, and ultimately move into senior management positions at the corporate level. ●

Sources: S. Stern, "AstraZeneca's Long March to China," *Daily Telegraph*, September 7, 2006, p. 3; J. M. Von Bergen, "More U.S. Workers Getting Global Assignments," *Tribune News Service*, August 12, 2008; and T. Mohn, "The Long Trip Home," *The New York Times*, March 10, 2009, p. B6.



Introduction

This chapter continues our survey of specific functions within an international business by looking at international human resource management (HRM). **Human resource management** refers to the activities an organization carries out to use its human resources effectively.¹ These activities include determining the firm's human resource strategy, staffing, performance evaluation, management development, compensation, and labor relations. None of these activities is performed in a vacuum; all are related to the strategy of the firm. As we will see, HRM has an important strategic component.² Through its influence on the character, development, quality, and productivity of the firm's human resources, the HRM function can help the firm achieve its primary strategic goals of reducing the costs of value creation and adding value by better serving customer.

Irrespective of the desire of managers in many multinationals to build a truly global enterprise with a global workforce, the reality is that HRM practices still have to be modified to national context. The strategic role of HRM is complex enough in a purely domestic firm, but it is more complex in an international business, where staffing, management development, performance evaluation, and compensation activities

Human Resource Management
Activities an organization conducts to use its human resources effectively.

are complicated by profound differences between countries in labor markets, culture, legal systems, economic systems, and the like (see Chapters 2 and 3). For example,

- Compensation practices may vary from country to country, depending on prevailing management customs.
- Labor laws may prohibit union organization in one country and mandate it in another.
- Equal employment legislation may be strongly pursued in one country and not in another.

If it is to build a cadre of managers capable of managing a multinational enterprise, the HRM function must deal with a host of issues. It must decide how to staff key management posts in the company, how to develop managers so that they are familiar with the nuances of doing business in different countries, how to compensate people in different nations, and how to evaluate the performance of managers based in different countries. HRM must also deal with a host of issues related to expatriate managers. (An **expatriate manager** is a citizen of one country who is working abroad in one of the firm's subsidiaries.) It must decide when to use expatriates, determine whom to send on expatriate postings, be clear about why they are doing it, compensate expatriates appropriately, and make sure that they are adequately debriefed and reoriented once they return home. Take AstraZeneca as an example (see the opening case). This major pharmaceutical firm is trying to become a truly global enterprise. An important component of this is identifying future leaders of the company, and exposing them to the challenges of doing business in different nations, and working in multinational teams, through job transfers.

In this chapter, we will look closely at the role of HRM in an international business. We begin by briefly discussing the strategic role of HRM. Then we turn our attention to four major tasks of the HRM function: staffing policy, management training and development, performance appraisal, and compensation policy. We will point out the strategic implications of each of these tasks. The chapter closes with a look at international labor relations and the relationship between the firm's management of labor relations and its overall strategy.

The Strategic Role of International HRM

A large and expanding body of academic research suggests that a strong fit between human resources practices and strategy is required for high profitability.³ You will recall from Chapter 11 that superior performance requires not only the right strategy, but the strategy must also be supported by the right organization architecture. Strategy is implemented through organization. As shown in Figure 16.1 (which is based on Figure 11.5), people are the linchpin of a firm's organization architecture. For a firm to outperform its rivals in the global market place, it must have the right people in the right postings. Those people must be trained appropriately so that they have the skill sets required to perform their jobs effectively, and so that they behave in a manner that is congruent with the desired culture of the firm. Their compensation packages must create incentives for them to take actions that are consistent with the strategy of the



Another Perspective

The Philippines' Best Export? People

Of all the many products that come from the Philippines, arguably their best is . . . their people. Nine million native Filipinos—nearly one-tenth of the country's population—work overseas. In a recent year their production totaled nearly \$16 billion: roughly 11 percent of the nation's economy and up more than 5 percent from the previous year. Expatriate Filipinos work in great numbers in such countries as Macau, Taiwan, and the United Arab Emirates. And despite the recent global economic downturn, fewer workers than expected returned to their native home because of job loss. Instead, as the recession continued, they found employment in other sectors. ("People, the Philippines' Best Export," *The Economist*, February 9, 2010, <http://www.economist.com>)

Expatriate Manager

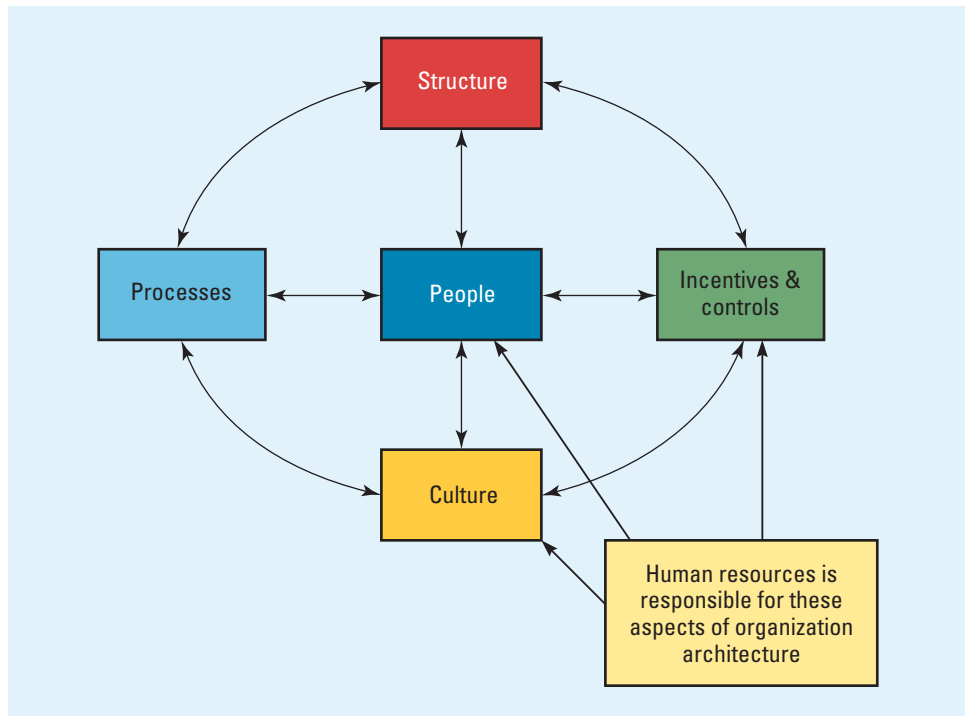
A national of one country appointed to a management position in another country.

LEARNING OBJECTIVE 1

Summarize the strategic role of human resource management in international business firms.

figure 16.1

The Role of Human Resources in Shaping Organization Architecture



firm, and the performance appraisal systems the firm uses must measure the behavior that the firm wants to encourage.

As indicated in Figure 16.1, the HRM function, through its staffing, training, compensation, and performance appraisal activities, has a critical impact upon the people, culture, incentive, and control system elements of firm's organization architecture (performance appraisal systems are part of the control systems in an enterprise). Thus, HRM professionals have a critically important strategic role. It is incumbent upon them to shape these elements of a firm's organization architecture in a manner that is consistent with the strategy of the enterprise, so that the firm can effectively implement its strategy.

In short, superior human resource management can be a sustained source of high productivity and competitive advantage in the global economy. At the same time, research suggests that many international businesses have room for improving the effectiveness of their HRM function. In one study of competitiveness among 326 large multinationals, the authors found that human resource management was one of the weakest capabilities in most firms, suggesting that improving the effectiveness of international HRM practices might have substantial performance benefits.⁴

In Chapter 11, we examined four strategies pursued by international businesses: localization strategy, international strategy, global standardization strategy, and transnational strategy. Firms that emphasize localization try to create value by emphasizing local responsiveness; international firms, by transferring products and competencies overseas; global firms, by realizing experience curve and location economies; and transnational firms, by doing all these things simultaneously. In this chapter, we will see that success also requires HRM policies to be congruent with the firm's strategy. For example, a transnational strategy imposes different requirements for staffing, management development, and compensation practices than a localization strategy. Firms pursuing a transnational strategy need to build a strong corporate culture and an informal management network for transmitting information and knowledge within

the organization (this is one of the things that AstraZeneca is trying to do through managerial transfers; see the opening case). Through its employee selection, management development, performance appraisal, and compensation policies, the HRM function can help develop these things. Thus, as we have noted, HRM has a critical role to play in implementing strategy. In each section that follows, we will review the strategic role of HRM in some detail.

Staffing Policy

Staffing policy is concerned with the selection of employees for particular jobs. At one level, this involves selecting individuals who have the skills required to do particular jobs. At another level, staffing policy can be a tool for developing and promoting the desired corporate culture of the firm.⁵ 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 U.S. operation or a foreign operation. The belief is that if employees are predisposed toward the organization's norms and value systems by their personality type, the firm will be able to attain higher performance.

TYPES OF STAFFING POLICY Research has identified three types of staffing policies in international businesses: the ethnocentric approach, the polycentric approach, and the geocentric approach.⁶ We will review each policy and link it to the strategy pursued by the firm. The most attractive staffing policy is probably the geocentric approach, although there are several impediments to adopting it.

The Ethnocentric Approach An **ethnocentric staffing policy** is one in which all key management positions are filled by parent-country nationals. This practice was widespread at one time. Firms such as Procter & Gamble, Philips NV, and Matsushita (now called Panasonic) originally followed it. In the Dutch firm Philips, for example, all important positions in most foreign subsidiaries were at one time held by Dutch nationals, who were referred to by their non-Dutch colleagues as the Dutch Mafia. Historically in many Japanese and South Korean firms, such as Toyota, Matsushita, and Samsung, key positions in international operations have often been held by home-country nationals. According to the Japanese Overseas Enterprise Association, only 29 percent of foreign subsidiaries of Japanese companies had presidents who were not Japanese. In contrast, 66 percent of the Japanese subsidiaries of foreign companies had Japanese presidents.⁷

Firms pursue an ethnocentric staffing policy for three reasons. First, the firm may believe the host country lacks qualified individuals to fill senior management positions. This argument is heard most often when the firm has operations in less developed countries. Second, the firm may see an ethnocentric staffing policy as the best way to maintain a unified corporate culture. Many Japanese firms, for example, have traditionally preferred their foreign operations to be headed by expatriate Japanese managers because these managers will have been socialized into the firm's culture while employed in Japan.⁸ Procter & Gamble until fairly recently preferred to staff important management positions in its foreign subsidiaries with U.S. nationals who had been socialized into P&G's corporate culture by years of employment in its U.S. operations. Such reasoning tends to predominate when a firm places a high value on its corporate culture.

LEARNING OBJECTIVE 2

Identify the pros and cons of different approaches to staffing policy in international business firms.

Staffing Policy

Strategy concerned with selecting employees for particular jobs.

Corporate Culture

An organization's norms and value systems.

Ethnocentric Staffing Policy

A staffing approach within the MNE in which all key management positions are filled by parent-country nationals.

Third, if the firm is trying to create value by transferring core competencies to a foreign operation, as firms pursuing an international strategy are, it may believe that the best way to do this is to transfer parent-country nationals who have knowledge of that competency to the foreign operation. Imagine what might occur if a firm tried to transfer a core competency in marketing to a foreign subsidiary without a corresponding transfer of home-country marketing management personnel. The transfer would probably fail to produce the anticipated benefits because the knowledge underlying a core competency cannot easily be articulated and written down. Such knowledge often has a significant tacit dimension; it is acquired through experience. Just like the great tennis player who cannot instruct others how to become great tennis players simply by writing a handbook, the firm that has a core competency in marketing, or anything else, cannot just write a handbook that tells a foreign subsidiary how to build the firm's core competency anew in a foreign setting. It must also transfer management personnel to the foreign operation to show foreign managers how to become good marketers, for example. The need to transfer managers overseas arises because the knowledge that underlies the firm's core competency resides in the heads of its domestic managers and was acquired through years of experience, not by reading a handbook. Thus, if a firm is to transfer a core competency to a foreign subsidiary, it must also transfer the appropriate managers.

Despite this rationale for pursuing an ethnocentric staffing policy, the policy is now on the wane in most international businesses for two reasons. First, an ethnocentric staffing policy limits advancement opportunities for host-country nationals. This can lead to resentment, lower productivity, and increased turnover among that group. Resentment can be greater still if, as often occurs, expatriate managers are paid significantly more than home-country nationals.

Second, an ethnocentric policy can lead to *cultural myopia*, the firm's failure to understand host-country cultural differences that require different approaches to marketing and management. The adaptation of expatriate managers can take a long time, during which they may make major mistakes. For example, expatriate managers may fail to appreciate how product attributes, distribution strategy, communications strategy, and pricing strategy should be adapted to host-country conditions. The result may be costly blunders. They may also make decisions that are ethically suspect simply because they do not understand the culture in which they are managing.⁹ In one highly publicized case in the United States, Mitsubishi Motors was sued by the federal Equal Employment Opportunity Commission for tolerating extensive and systematic sexual harassment in a plant in Illinois. The plant's top management, all Japanese expatriates, denied the charges. The Japanese managers may have failed to realize that behavior that would be viewed as acceptable in Japan was not acceptable in the United States.¹⁰

Polycentric Staffing Policy

An MNE staffing policy in which host-country nationals are recruited to manage subsidiaries in their own country, while parent-country nationals occupy key positions at corporate headquarters.

The Polycentric Approach A **polycentric staffing policy** requires host-country nationals to be recruited to manage subsidiaries, while parent-country nationals occupy key positions at corporate headquarters. In many respects, a polycentric approach is a response to the shortcomings of an ethnocentric approach. One advantage of adopting a polycentric approach is that the firm is less likely to suffer from cultural myopia. Host-country managers are unlikely to make the mistakes arising from cultural misunderstandings to which expatriate managers are vulnerable. A second advantage is that a polycentric approach may be less expensive to implement, reducing the costs of value creation. Expatriate managers can be expensive to maintain.

A polycentric approach also has its drawbacks. Host-country nationals have limited opportunities to gain experience outside their own country and thus cannot progress beyond senior positions in their own subsidiary. As in the case of an ethnocentric policy,

this may cause resentment. Perhaps the major drawback with a polycentric approach, however, is the gap that can form between host-country managers and parent-country managers. Language barriers, national loyalties, and a range of cultural differences may isolate the corporate headquarters staff from the various foreign subsidiaries. The lack of management transfers from home to host countries, and vice versa, can exacerbate this isolation and lead to a lack of integration between corporate headquarters and foreign subsidiaries. The result can be a “federation” of largely independent national units with only nominal links to the corporate headquarters. Within such a federation, the coordination required to transfer core competencies or to pursue experience curve and location economies may be difficult to achieve. Thus, although a polycentric approach may be effective for firms pursuing a localization strategy, it is inappropriate for other strategies.

The federation that may result from a polycentric approach can also be a force for inertia within the firm. After decades of pursuing a polycentric staffing policy, food and detergents giant Unilever found that shifting from a strategic posture that emphasized localization to a transnational posture was very difficult. Unilever’s foreign subsidiaries had evolved into quasi-autonomous operations, each with its own strong national identity. These “little kingdoms” objected strenuously to corporate headquarters’ attempts to limit their autonomy and to rationalize global manufacturing.¹¹

The Geocentric Approach A **geocentric staffing policy** seeks the best people for key jobs throughout the organization, regardless of nationality. This is the staffing policy that has been adopted by AstraZeneca (see the opening case). This policy has a number of advantages. First, it enables the firm to make the best use of its human resources. Second, and perhaps more important, a geocentric policy enables the firm to build a cadre of international executives who feel at home working in a number of cultures. Creation of such a cadre may be a critical first step toward building a strong unifying corporate culture and an informal management network, both of which are required for global standardization and transnational strategies.¹² Firms pursuing a geocentric staffing policy may be better able to create value from the pursuit of experience curve and location economies and from the multidirectional transfer of core competencies than firms pursuing other staffing policies. In addition, the multinational composition of the management team that results from geocentric staffing tends to reduce cultural myopia and to enhance local responsiveness.

In sum, other things being equal, a geocentric staffing policy seems the most attractive. Recent years have seen a sharp shift toward the adoption of a geocentric staffing policy by many multinationals. For example, India’s Tata Group, now a \$20 billion global conglomerate, runs several of its companies with American and British executives. Japan’s Sony Corporation broke 60 years of tradition in 2005 when it installed its first non-Japanese chairman and CEO, Howard Stringer, a former CBS president and U.S. citizen who was born and raised in Wales. American companies increasingly draw their managerial talent from overseas. One study found that by the mid-2000s, 24 percent of the managers among the top 100 to 250 people in U.S. companies were from outside the United States. For European companies the average is 40 percent.¹³

However, a number of problems limit the firm’s ability to pursue a geocentric policy. Many countries want foreign subsidiaries to employ their citizens. To achieve this goal, they use immigration laws to require the employment of host-country nationals if they are available in adequate numbers and have the necessary skills. Most countries, including the United States, require firms to provide extensive documentation if they wish to hire a foreign national instead of a local national. This documentation can be time consuming, expensive, and at times futile. A geocentric staffing policy also can be

Geocentric Staffing Policy

A staffing policy under which the firm seeks the best people for key jobs throughout the company, regardless of nationality.



Another Perspective

Women in International Assignments

Would you send a woman expatriate to Saudi Arabia, Kuwait, Japan, or Korea? How are Western women expatriates doing in foreign cultures that have traditionally limited women's public roles? Women sent to these countries have met with substantial success. Their key challenge is to get the assignments! Once in place, women expatriates are successful. This is in part because once in the culture, women expatriates are seen first as expatriates who fall outside the local role for women. In addition, "expat" women also have salience in their new environment—they are noticed—and this can be a distinct business advantage. Locals often take pride in developing business relationships with women expatriates because by doing so they can suggest that the foreign stereotype of their culture is superficial and incomplete.

expensive to implement. Training and relocation costs increase when transferring managers from country to country. The company may also need a compensation structure with a standardized international base pay level higher than national levels in many countries. In addition, the higher pay enjoyed by managers placed on an international fast track may be a source of resentment within a firm.

Summary The advantages and disadvantages of the three approaches to staffing policy are summarized in Table 16.1. Broadly speaking, an ethnocentric approach is compatible with an international strategy, a polycentric approach is compatible with a localization strategy, and a geocentric approach is compatible with both global standardization and transnational strategies. (See Chapter 11 for details of the strategies.)

While the staffing policies described here are well known and widely used among both practitioners and scholars of international businesses, some critics have claimed that the typology is too simplistic and that it obscures the internal differentiation of management practices within international businesses. The critics claim that within some international businesses, staffing policies vary significantly from national subsidiary to national subsidiary; while some are managed on an ethnocentric basis, others are managed in a polycentric or geocentric manner.¹⁴ Other critics note that the staffing policy adopted by a firm is primarily driven by its geographic scope, as opposed to its strategic orientation. Firms that have a broad geographic scope are the most likely to have a geocentric mind-set.¹⁵

table 16.1

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

EXPATRIATE MANAGERS Two of the three staffing policies we have discussed—the ethnocentric and the geocentric—rely on extensive use of expatriate managers. As defined earlier, expatriates are citizens of one country who are working in another country. Sometimes the term *inpatriates* is used to identify a subset of expatriates who are citizens of a foreign country working in the home country of their multinational employer.¹⁶ Thus, a citizen of Japan who moves to the United States to work at Microsoft would be classified as an inpatriate. 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.¹⁷ Here we briefly review the evidence on expatriate failure before discussing a number of ways to minimize the failure rate.

LEARNING OBJECTIVE 3

Explain why managers may fail to thrive in foreign postings.

Expatriate Failure

The premature of an expatriate manager to the home country.

Expatriate Failure Rates Expatriate failure represents a failure of the firm's selection policies to identify individuals who will not thrive abroad.¹⁸ The consequences include premature return from a foreign posting and high resignation rates, with expatriates leaving their company at about twice the rate of domestic managers.¹⁹ 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.²⁰ Although detailed data are not available for most nationalities, one suspects that high expatriate failure is a universal problem. Some 28 percent of British expatriates, for example, are estimated to fail in their overseas postings.²¹ The costs of expatriate failure are high. One estimate is that the average cost per failure to the parent firm can be as high as three times the expatriate's annual domestic salary plus the cost of relocation (which is affected by currency exchange rates and location of assignment). Estimates of the costs of each failure run between \$250,000 and \$1 million.²² In addition, approximately 30 to 50 percent of American expatriates, whose average annual compensation package runs to \$250,000, stay at their international assignments but are considered ineffective or marginally effective by their firms.²³ In a seminal study, R. L. Tung surveyed a number of U.S., European, and Japanese multinationals.²⁴ Her results, summarized in Table 16.2, show that 76 percent of U.S. multinationals experienced

Recall Rate Percent	Percent of Companies
U.S. multinationals	
20–40%	7%
10–20	69
<10	24
European multinationals	
11–15%	3%
6–10	38
<5	59
Japanese multinationals	
11–19%	14%
6–10	10
<5	76

16.2 table

Expatriate Failure Rates

Source: Data from R. L. Tung, "Selection and Training Procedures of U.S., European, and Japanese Multinationals," pp. 51–71. Copyright © by The Regents of the University of California. Reprinted from the *California Management Review*, Vol. 1.25, No. 1, by permission from The Regents.

expatriate failure rates of 10 percent or more, and 7 percent experienced a failure rate of more than 20 percent. Tung's work also suggests that U.S.-based multinationals experience a much higher expatriate failure rate than either European or Japanese multinationals.

Tung asked her sample of multinational managers to indicate reasons for expatriate failure. For U.S. multinationals, the reasons, in order of importance, were

1. Inability of spouse to adjust.
2. Manager's inability to adjust.
3. Other family problems.
4. Manager's personal or emotional maturity.
5. Inability to cope with larger overseas responsibilities.

Managers of European firms gave only one reason consistently to explain expatriate failure: the inability of the manager's spouse to adjust to a new environment. For the Japanese firms, the reasons for failure were

1. Inability to cope with larger overseas responsibilities.
2. Difficulties with new environment.
3. Personal or emotional problems.
4. Lack of technical competence.
5. Inability of spouse to adjust.

The most striking difference between these lists is that "inability of spouse to adjust" was the top reason for expatriate failure among U.S. and European multinationals but only the number five reason among Japanese multinationals. Tung comments that this difference is not surprising, given the role and status to which Japanese society traditionally relegates the wife and the fact that most of the Japanese expatriate managers in the study were men.

Since Tung's study, a number of other studies have consistently confirmed that the inability of a spouse to adjust, the inability of the manager to adjust, or other family problems remain major reasons for continuing high levels of expatriate failure.²⁵ One study by International Orientation Resources, an HRM consulting firm, found that 60 percent of expatriate failures occur due to these three reasons.²⁶ Another study found that the most common reason for assignment failure is lack of partner (spouse) satisfaction, which was listed by 27 percent of respondents.²⁷ The inability of expatriate managers to adjust to foreign postings seems to be caused by a lack of cultural skills on the part of the manager being transferred. According to one HRM consulting firm, this is because the expatriate selection process at many firms is fundamentally flawed. "Expatriate assignments rarely fail because the person cannot accommodate to the technical demands of the job. Typically, the expatriate selections are made by line managers based on technical competence. They fail because of family and personal issues and lack of cultural skills that haven't been part of the selection process."²⁸

The failure of spouses to adjust to a foreign posting seems to be related to a number of factors. Often spouses find themselves in a foreign country without the familiar network of family and friends. Language differences make it difficult for them to make new friends. While this may not be a problem for the manager, who can make friends at work, it can be difficult for the spouse, who might feel trapped at home. The problem is often exacerbated by immigration regulations prohibiting the spouse from taking employment. With the recent rise of two-career families in many developed nations, this issue has become much more important. One survey found that 69 percent of expatriates are married, with spouses accompanying them 77 percent of the time. Of those spouses, 49 percent were employed before an assignment and only



Managing Expatriates at Royal Dutch/Shell

Royal Dutch/Shell is a global petroleum company with joint headquarters in both London and The Hague in the Netherlands. The company employs more than 100,000 people, approximately 5,500 of whom are at any one time living and working as expatriates. The expatriates at Shell are a diverse group, made up of over 70 nationalities and located in more than 100 countries. Shell, as a global corporation, has long recognized that the international mobility of its workforce is essential to its success. By the 1990s, however, Shell was finding it harder to recruit key personnel for foreign postings. To discover why, the company interviewed more than 200 expatriate employees and their spouses to determine their biggest concerns. The data were then used to construct a survey that was sent to 17,000 current and former expatriate employees, expatriates' spouses, and employees who had declined international assignments.

The survey registered a phenomenal 70 percent response rate, clearly indicating that many employees thought this was an important issue. According to the survey, five issues had the greatest impact on the willingness of an employee to accept an international assignment. In order of importance, these were (1) separation from children during their secondary education (the children of British and Dutch expatriates were often sent to boarding schools in their home countries while their parents worked abroad), (2) harm done to a spouse's career and employment, (3) failure to recognize and involve a spouse in the relocation decision, (4) failure to provide adequate information and assistance regarding relocation, and (5) health issues. The underlying message was that the family is the basic unit of expatriation, not the individual, and Shell needed to do more to recognize this.

To deal with these issues, Shell implemented a number of programs designed to address some of these problems. To help with the education of children, Shell built elementary schools for Shell employees where there was a heavy concentration of expatriates. As for secondary school education, it worked with local schools, often providing grants, to help them upgrade their educational offerings. It also offered an education supplement to help expatriates send their children to private schools in the host country.

Helping spouses with their careers is a more vexing problem. According to the survey data, half of the spouses accompanying Shell staff on assignment were employed until the transfer. When expatriated, only 12 percent were able to secure employment, while a further 33 percent wished to be employed. Shell set up a spouse employment center to address the problem. The center provides career counseling and assistance in locating employment opportunities both during and immediately after an international assignment. The company also agreed to reimburse up to 80 percent of the costs of vocational training, further education, or re-accreditation, up to \$4,400 per assignment.

Shell also set up a global information and advice network known as "The Outpost" to provide support for families contemplating a foreign posting. The Outpost has its headquarters in The Hague and now runs 40 information centers in more than 30 countries. The center recommends schools and medical facilities and provides housing advice and up-to-date information on employment, study, self-employment, and volunteer work.

Sources: E. Smockum, "Don't Forget the Trailing Spouse," *Financial Times*, May 6, 1998, p. 22; V. Frazee, "Tearing Down Roadblocks," *Workforce* 77, no. 2 (1998), pp. 50–54; C. Sievers, "Expatriate Management," *HR Focus* 75, no. 3 (1998), pp. 75–76; and J. Barbian, "Return to Sender," *Training*, January 2002, pp. 40–43.

11 percent were employed during an assignment.²⁹ Research suggests that a main reason managers now turn down international assignments is concern over the impact such an assignment might have on their spouse's career.³⁰ The accompanying Management Focus examines how one large multinational company, Royal Dutch/Shell, has tried to come to grips with this issue.

Expatriate Selection One way to reduce expatriate failure rates is by improving selection procedures to screen out inappropriate candidates. In a review of the research on this issue, Mendenhall and Oddou state that a major problem in many firms is that HRM managers tend to equate domestic performance with overseas performance potential.³¹ Domestic performance and overseas performance potential are *not* the same thing. An executive who performs well in a domestic setting may not be able to adapt to managing in a different cultural setting. From their review of the

research, Mendenhall and Oddou identified four dimensions that seem to predict success in a foreign posting: self-orientation, others-orientation, perceptual ability, and cultural toughness.

1. *Self-orientation.* The attributes of this dimension strengthen the expatriate's self-esteem, self-confidence, and mental well-being. Expatriates with high self-esteem, self-confidence, and mental well-being were more likely to succeed in foreign postings. Mendenhall and Oddou concluded that such individuals were able to adapt their interests in food, sport, and music; had interests outside of work that could be pursued (e.g., hobbies); and were technically competent.
2. *Others-orientation.* The attributes of this dimension enhance the expatriate's ability to interact effectively with host-country nationals. The more effectively the expatriate interacts with host-country nationals, the more likely he or she is to succeed. Two factors seem to be particularly important here: relationship development and willingness to communicate. Relationship development refers to the ability to develop long-lasting friendships with host-country nationals. Willingness to communicate refers to the expatriate's willingness to use the host-country language. Although language fluency helps, an expatriate need not be fluent to show willingness to communicate. Making the effort to use the language is what is important. Such gestures tend to be rewarded with greater cooperation by host-country nationals.
3. *Perceptual ability.* This is the ability to understand why people of other countries behave the way they do; that is, the ability to empathize. This dimension seems critical for managing host-country nationals. Expatriate managers who lack this ability tend to treat foreign nationals as if they were home-country nationals. As a result, they may experience significant management problems and considerable frustration. As one expatriate executive from Hewlett-Packard observed, "It took me six months to accept the fact that my staff meetings would start 30 minutes late, and that it would bother no one but me." According to Mendenhall and Oddou, well-adjusted expatriates tend to be nonjudgmental and nonevaluative in interpreting the behavior of host-country nationals and willing to be flexible in their management style, adjusting it as cultural conditions warrant.
4. *Cultural toughness.* This dimension refers to the relationship between the country of assignment and how well an expatriate adjusts to a particular posting. Some countries are much tougher postings than others because their cultures are more unfamiliar and uncomfortable. For example, many Americans regard Great Britain as a relatively easy foreign posting, and for good reason—the two cultures have much in common. But many Americans find postings in non-Western cultures, such as India, Southeast Asia, and the Middle East, to be much tougher.³² The reasons are many, including poor health care and housing standards, inhospitable climate, lack of Western entertainment, and language difficulties. Also, many cultures are extremely male-dominated and may be particularly difficult postings for female Western managers.

THE GLOBAL MIND-SET Some researchers suggest that a global mind-set, one characterized by cognitive complexity and a cosmopolitan outlook, is the fundamental attribute of a global manager. Such managers can deal with high levels of complexity and ambiguity and are open to the world. How do you develop these attributes? Often they are gained in early life, from a family that is bicultural, lives in foreign countries, or learns foreign languages as a regular part of family life.

Mendenhall and Oddou note that standard psychological tests can be used to assess the first three of these dimensions, whereas a comparison of cultures can give managers

a feeling for the fourth dimension. They contend that these four dimensions, in addition to domestic performance, should be considered when selecting a manager for foreign posting. However, practice does not often conform to Mendenhall and Oddou's recommendations. Tung's research, for example, showed that only 5 percent of the firms in her sample used formal procedures and psychological tests to assess the personality traits and relational abilities of potential expatriates.³³ Research by International Orientation Resources suggests that when selecting employees for foreign assignments, only 10 percent of the 50 Fortune 500 firms they surveyed tested for important psychological traits such as cultural sensitivity, interpersonal skills, adaptability, and flexibility. Instead, 90 percent of the time employees were selected on the basis of their technical expertise, not their cross-cultural fluency.³⁴

Mendenhall and Oddou do not address the problem of expatriate failure due to a spouse's inability to adjust. According to a number of other researchers, a review of the family situation should be part of the expatriate selection process (see the Management Focus on Royal Dutch/Shell for an example).³⁵ A survey by Windam International, another international HRM consulting firm, found that spouses were included in preselection interviews for foreign postings only 21 percent of the time, and that only half of them received any cross-cultural training. The rise of dual-career families has added an additional and difficult dimension to this long-standing problem.³⁶ Increasingly, spouses wonder why they should have to sacrifice their own career to further that of their partner.³⁷

Training and Management Development

Selection is just the first step in matching a manager with a job. The next step is training the manager to do the specific job. For example, an intensive training program might be used to give expatriate managers the skills required for success in a foreign posting. However, management development is a much broader concept. It is intended to develop the manager's skills over his or her career with the firm. Thus, as part of a management development program, a manager might be sent on several foreign postings over a number of years to build his or her cross-cultural sensitivity and experience. At the same time, along with other managers in the firm, the person might attend management education programs at regular intervals. The thinking behind job transfers is that broad international experience will enhance the management and leadership skills of executives. Research suggests this may be the case.³⁸

Historically, most international businesses have been more concerned with training than with management development. Plus, they tended to focus their training efforts on preparing home-country nationals for foreign postings. Recently, however, the shift toward greater global competition and the rise of transnational firms have changed this. It is increasingly common for firms to provide general management development programs in addition to training for particular posts. In many international businesses, the explicit purpose of these management development programs is strategic. Management development is seen as a tool to help the firm achieve its strategic goals, not only by giving managers the required skill set, but also by helping to reinforce the desired culture of the firm and by facilitating the

LEARNING OBJECTIVE 4

Recognize how management development and training programs can increase the value of human capital in international business firms.



International businesses, such as Caterpillar, are increasingly providing general management development programs in addition to training for particular foreign postings.

creation of an informal network for sharing knowledge within the multinational enterprise.

With this distinction between training and management development in mind, we first examine the types of training managers receive for foreign postings. Then we discuss the connection between management development and strategy in the international business.

TRAINING FOR EXPATRIATE MANAGERS Earlier in the chapter we saw that the two most common reasons for expatriate failure were the inability of a manager's spouse to adjust to a foreign environment and the manager's own inability to adjust to a foreign environment. Training can help the manager and spouse cope with both these problems. Cultural training, language training, and practical training all seem to reduce expatriate failure. We discuss each of these kinds of training here.³⁹ Despite the usefulness of these kinds of training, evidence suggests that many managers receive no training before they are sent on foreign postings. One study found that only about 30 percent of managers sent on one- to five-year expatriate assignments received training before their departure.⁴⁰

Cultural Training Cultural training seeks to foster an appreciation for the host country's culture. The belief is that understanding a host country's culture will help the manager empathize with the culture, which will enhance his or her effectiveness in dealing with host-country nationals. It has been suggested that expatriates should receive training in the host country's culture, history, politics, economy, religion, and social and business practices.⁴¹ If possible, it is also advisable to arrange for a familiarization trip to the host country before the formal transfer, as this seems to ease culture shock. Given the problems related to spouse adaptation, it is important that the spouse, and perhaps the whole family, be included in cultural training programs.

Language Training English is the language of world business; it is quite possible to conduct business all over the world using only English. Notwithstanding the prevalence of English, however, an exclusive reliance on English diminishes an expatriate manager's ability to interact with host-country nationals. As noted earlier, a willingness to communicate in the language of the host country, even if the expatriate is far from fluent, can help build rapport with local employees and improve the manager's effectiveness. Despite this, one study of 74 executives of U.S. multinationals found that only 23 believed knowledge of foreign languages was necessary for conducting business abroad.⁴² Those firms that did offer foreign language training for expatriates believed it improved their employees' effectiveness and enabled them to relate more easily to a foreign culture, which fostered a better image of the firm in the host country.

Practical Training Practical training is aimed at helping the expatriate manager and family ease themselves into day-to-day life in the host country. The sooner a routine is established, the better are the prospects that the expatriate and his or her family will adapt successfully. One critical need is for a support network of friends for the expatriate. Where an expatriate community exists, firms often devote considerable effort to ensuring the new expatriate family is quickly integrated into that group. The expatriate community can be a useful source of support and information and can be invaluable in helping the family adapt to a foreign culture.

REPATRIATION OF EXPATRIATES A largely overlooked but critically important issue in the training and development of expatriate managers is to prepare them for reentry into their home-country organization.⁴³ Repatriation should be seen as the final link in an integrated, circular process that connects good selection and cross-cultural training of expatriate managers with completion of their term abroad and reintegration into their national organization. However, instead of having employees come home to share their knowledge and encourage other high-performing managers to take the same international career track, expatriates too often face a different scenario.⁴⁴

Often when they return home after a stint abroad—where they have typically been autonomous, well compensated, and celebrated as a big fish in a little pond—they face an organization that doesn’t know what they have done for the past few years, doesn’t know how to use their new knowledge, and doesn’t particularly care. In the worst cases, reentering employees have to scrounge for jobs, or firms will create standby positions that don’t use the expatriate’s skills and capabilities and fail to make the most of the business investment the firm has made in that individual.

Research illustrates the extent of this problem. According to one study of repatriated employees, 60 to 70 percent didn’t know what their position would be when they returned home. Also, 60 percent said their organizations were vague about repatriation, about their new roles, and about their future career progression within the company; 77 percent of those surveyed took jobs at a lower level in their home organization than in their international assignments.⁴⁵ Not surprising, 15 percent of returning expatriates leave their firms within a year of arriving home, and 40 percent leave within three years.⁴⁶

The key to solving this problem is good human resource planning. Just as the HRM function needs to develop good selection and training programs for its expatriates, it also needs to develop good programs for reintegrating expatriates back into work life within their home-country organization, for preparing them for changes in their physical and professional landscape, and for utilizing the knowledge they acquired while abroad. For an example of the kind of program that might be used, see the accompanying Management Focus that looks at the repatriation program developed by Monsanto.

MANAGEMENT DEVELOPMENT AND STRATEGY Management development programs are designed to increase the overall skill levels of managers through a mix of ongoing management education and rotations of managers through a number of jobs within the firm to give them varied experiences. They are attempts to improve the overall productivity and quality of the firm’s management resources.

International businesses increasingly are using management development as a strategic tool. This is particularly true in firms pursuing a transnational strategy, as increasing numbers are. Such firms need a strong unifying corporate culture and informal management networks to assist in coordination and control. In addition, transnational firm managers need to be able to detect pressures for local responsiveness, and that requires them to understand the culture of a host country.

Management development programs help build a unifying corporate culture by socializing new managers into the norms and value systems of the firm. In-house company training programs and intense interaction during off-site training can foster *esprit de corps*—shared experiences, informal networks, perhaps a company language or jargon—as well as develop technical competencies. These training events often include songs, picnics, and sporting events that promote feelings of togetherness. These rites of integration may include “initiation rites” wherein personal culture is stripped,



Monsanto's Repatriation Program

Monsanto is a global provider of agricultural products with 10,000 employees. At any one time, the company will have 100 mid- and higher-level managers on extended postings abroad. Two-thirds of these are Americans posted overseas; the remainder are foreign nationals employed in the United States. At Monsanto, managing expatriates and their repatriation begins with a rigorous selection process and intensive cross-cultural training, both for the managers and for their families. As at many other global companies, the idea is to build an internationally minded cadre of highly capable managers who will lead the organization in the future.

One of the strongest features of this program is that employees and their sending and receiving managers, or sponsors, develop an agreement about how this assignment will fit into the firm's business objectives. The focus is on why employees are going abroad to do the job and what their contribution to Monsanto will be when they return. Sponsoring managers are expected to be explicit about the kind of job opportunities the expatriates will have once they return home.

Once they arrive back in their home country, expatriate managers meet with cross-cultural trainers during debriefing sessions. They are also given the opportunity to showcase their experiences to their peers, subordinates, and superiors in special information exchanges.

However, Monsanto's repatriation program focuses on more than just business; it also attends to the family's reentry. Monsanto has found that difficulties with repatriation

often have more to do with personal and family-related issues than with work-related issues. But the personal matters obviously affect an employee's on-the-job performance, so it is important for the company to pay attention to such issues.

This is why Monsanto offers returning employees an opportunity to work through personal difficulties. About three months after they return home, expatriates meet for three hours at work with several colleagues of their choice. The debriefing session is a conversation aided by a trained facilitator who has an outline to help the expatriate cover all the important aspects of the repatriation. The debriefing allows the employee to share important experiences and to enlighten managers, colleagues, and friends about his or her expertise so others within the organization can use some of the global knowledge. According to one participant, "It sounds silly, but it's such a hectic time in the family's life, you don't have time to sit down and take stock of what's happening. You're going through the move, transitioning to a new job, a new house, and the children may be going to a new school. This is a kind of oasis; a time to talk and put your feelings on the table." Apparently it works; since the program was introduced, the attrition rate among returning expatriates has dropped sharply.

Sources: C. M. Solomon, "Repatriation: Up, Down, or Out?" *Personnel Journal*, January 1995, pp. 28–34; and J. Schaefer, E. Hannibal, and J. O'Neill, "How Strategy, Culture and Improved Service Delivery Reshape Monsanto's International Assignment Program," *Journal of Organizational Excellence* 22, no. 3 (2003), pp. 35–40.

company uniforms are donned (e.g., T-shirts bearing the company logo), and humiliation is inflicted (e.g., a pie in the face). All these activities aim to strengthen a manager's identification with the company.⁴⁷

Bringing managers together in one location for extended periods and rotating them through different jobs in several countries helps the firm build an informal management network. Such a network can then be used as a conduit for exchanging valuable performance-enhancing knowledge within the organization.⁴⁸ Consider the Swedish telecommunications company L. M. Ericsson. Interunit cooperation is extremely important at Ericsson, particularly for transferring know-how and core competencies from the parent to foreign subsidiaries, from foreign subsidiaries to the parent, and between foreign subsidiaries. To facilitate cooperation, Ericsson transfers large numbers of people back and forth between headquarters and subsidiaries. Ericsson sends a team of 50 to 100 engineers and managers from one unit to another for a year or two. This establishes a network of interpersonal contacts. This policy is effective for both solidifying a common culture in the company and coordinating the company's globally dispersed operations.⁴⁹

Performance Appraisal

Performance appraisal systems are used to evaluate the performance of managers against some criteria that the firm judges to be important for the implementation of strategy and the attainment of a competitive advantage. A firm's performance appraisal systems are an important element of its control systems, which is a central component of organization architecture (see Figure 16.1). A particularly thorny issue in many international businesses is how best to evaluate the performance of expatriate managers.⁵⁰ In this section, we look at this issue and consider some guidelines for appraising expatriate performance.

LEARNING OBJECTIVE 5

Explain how and why performance appraisal systems might vary across nations.

PERFORMANCE APPRAISAL PROBLEMS Unintentional bias makes it difficult to evaluate the performance of expatriate managers objectively. In many cases, two groups evaluate the performance of expatriate managers—host-nation managers and home-office managers—and both are subject to bias. The host-nation managers may be biased by their own cultural frame of reference and expectations. For example, Oddou and Mendenhall report the case of a U.S. manager who introduced participative decision making while working in an Indian subsidiary.⁵¹ The manager subsequently received a negative evaluation from host-country managers because in India, the strong social stratification means managers are seen as experts who should not have to ask subordinates for help. The local employees apparently viewed the U.S. manager's attempt at participatory management as an indication that he was incompetent and did not know his job.

Home-country managers' appraisals may be biased by distance and by their own lack of experience working abroad. Home-office managers are often not aware of what is going on in a foreign operation. Accordingly, they tend to rely on hard data in evaluating an expatriate's performance, such as the subunit's productivity, profitability, or market share. Such criteria may reflect factors outside the expatriate manager's control (e.g., adverse changes in exchange rates, economic downturns). Also, hard data do not take into account many less-visible soft variables that are also important, such as an expatriate's ability to develop cross-cultural awareness and to work productively with local managers. Due to such biases, many expatriate managers believe that headquarters management evaluates them unfairly and does not fully appreciate the value of their skills and experience. This could be one reason many expatriates believe a foreign posting does not benefit their careers. In one study of personnel managers in U.S. multinationals, 56 percent of the managers surveyed stated that a foreign assignment is either detrimental or immaterial to one's career.⁵²

GUIDELINES FOR PERFORMANCE APPRAISAL Several things can reduce bias in the performance appraisal process.⁵³ First, most expatriates appear to believe more weight should be given to an on-site manager's appraisal than to an off-site manager's appraisal. Due to proximity, an on-site manager is more likely to evaluate the soft variables that are important aspects of an expatriate's performance. The evaluation may be especially valid when the on-site manager is of the same nationality as the expatriate, since cultural bias should be alleviated. In practice, home-office managers often write performance evaluations after receiving input from on-site managers. When this is the case, most experts recommend that a former expatriate who served in the same location should be involved in the appraisal to help reduce bias. Finally, when the policy is for foreign on-site managers to write performance evaluations, home-office managers should be consulted before an on-site manager completes a formal termination evaluation. This gives the home-office manager the opportunity to balance what could be a very hostile evaluation based on a cultural misunderstanding.

LEARNING OBJECTIVE 6

Explain how and why compensation systems might vary across nations.

Compensation

Two issues are raised in every discussion of compensation practices in an international business. One is how compensation should be adjusted to reflect national differences in economic circumstances and compensation practices. The other issue is how expatriate managers should be paid. From a strategic perspective, the important point is that whatever compensation system is used, it should reward managers for taking actions that are consistent with the strategy of the enterprise.

NATIONAL DIFFERENCES IN COMPENSATION Substantial differences exist in the compensation of executives at the same level in various countries. Table 16.3 summarizes the results of a survey undertaken by Towers Perrin. Among other things, this survey looked at average compensation for top human resource executives across 26 countries in the 2005–06 period for companies with annual sales of around

table 16.3

Compensation in 26 Countries for Top Human Resource Executives

Source: Towers Perrin, *Towers Perrin Worldwide Total Remuneration Study, 2005–2006*, www.towersperrin.com.

Country	HR Executive Average Total Compensation
Argentina	\$212,879
Australia	293,782
Belgium	446,624
Brazil	356,733
Canada	307,053
China (Hong Kong)	268,158
China (Shanghai)	85,393
France	384,904
Germany	456,665
India	146,384
Italy	432,569
Japan	278,697
Malaysia	140,587
Mexico	382,334
Netherlands	287,247
Poland	120,410
Singapore	230,281
South Africa	371,781
South Korea	182,716
Spain	305,519
Sweden	302,473
Switzerland	447,563
Taiwan	158,146
United Kingdom	494,519
United States	525,923
Venezuela	225,317

\$500 million.⁵⁴ The figures include both base compensation and performance-related pay bonuses, but they do not include stock options. As can be seen, wide variations exist across countries. The average compensation for top HR executives in the United States was \$525,923, compared with \$278,697 in Japan and \$158,146 in Taiwan. According to Towers Perrin, similar pay differences can be seen across other job categories, including the CEO and CFO positions. These figures underestimate the true differential because many U.S. executives earn considerable sums of money from stock option grants.

National differences in compensation raise a perplexing question for an international business: Should the firm pay executives in different countries according to the prevailing standards in each country, or should it equalize pay on a global basis? The problem does not arise in firms pursuing ethnocentric or polycentric staffing policies. In ethnocentric firms, the issue can be reduced to that of how much home-country expatriates should be paid (which we will consider later). As for polycentric firms, the lack of managers' mobility among national operations implies that pay can and should be kept country-specific. There would seem to be no point in paying executives in Great Britain the same as U.S. executives if they never work side by side.

However, this problem is very real in firms with geocentric staffing policies. A geocentric staffing policy is consistent with a transnational strategy. One aspect of this policy is the need for a cadre of international managers that may include many different nationalities. Should all members of such a cadre be paid the same salary and the same incentive pay? For a U.S.-based firm, this would mean raising the compensation of foreign nationals to U.S. levels, which could be expensive. If the firm does not equalize pay, it could cause considerable resentment among foreign nationals who are members of the international cadre and work with U.S. nationals. If a firm is serious about building an international cadre, it may have to pay its international executives the same basic salary irrespective of their country of origin or assignment. Currently, however, this practice is not widespread.

Over the past 10 years many firms have moved toward a compensation structure based on consistent global standards, with employees being evaluated by the same grading system and having access to the same bonus pay and benefits structure irrespective of where they work. Some 85 percent of the companies in a recent survey by Mercer Management Consulting have stated that they now have a global compensation strategy.⁵⁵ McDonald's, which is featured in the accompanying Management Focus, is one such enterprise. Another survey found that two thirds of multinationals now exercise central control over the benefit plans offered in different nations.⁵⁶ However, except for a relative small cadre of internationally mobile executives, base pay in most firms is set with regard to local market conditions.

EXPATRIATE PAY The most common approach to expatriate pay is the balance sheet approach. According to Organizational Resources Consulting, some 80 percent of the 781 companies it surveyed used this approach.⁵⁷ This approach equalizes purchasing power across countries so employees can enjoy the same living standard in their foreign posting that they enjoyed at home. In addition, the approach provides financial incentives to offset qualitative differences between assignment locations.⁵⁸ Figure 16.2 shows a typical balance sheet. Note that home-country outlays for the employee are designated as income taxes, housing expenses, expenditures for goods and services (food, clothing, entertainment, etc.), and reserves (savings, pension contributions, etc.). The balance sheet approach attempts to provide expatriates with the same standard of living in their host countries as they enjoy at home plus a financial inducement (i.e., premium, incentive) for accepting an overseas assignment.

The components of the typical expatriate compensation package are a base salary, a foreign service premium, allowances of various types, tax differentials, and benefits. We



Management FOCUS

Global Compensation Practices at McDonald's

With more than 400,000 managers and senior staff employees in 118 countries around the world, by the early 2000s McDonald's had to develop a consistent global compensation and performance appraisal strategy. In 2003, McDonald's launched an initiative that was designed to do just that. After months of consultation with managers all over the world, in 2004 the company began to roll out its new global compensation program.

One important element of this program calls for the corporate head office to provide local-country managers with a menu of business principles to focus on in the coming year. These principles include areas such as customer service, marketing, and restaurant re-imaging. Each country manager then picks three to five areas that they need to focus on for success in their local market. For example, if France is introducing a new menu item, it might create business targets around that for the year. Human resource managers then submit their business cases and targets to senior executives at the headquarters for approval. At the

end of the year, the country's annual incentive pool is based on how the region met its targets, as well as on the business unit's operating income. A portion of individual employees' annual bonus is based on that mix.

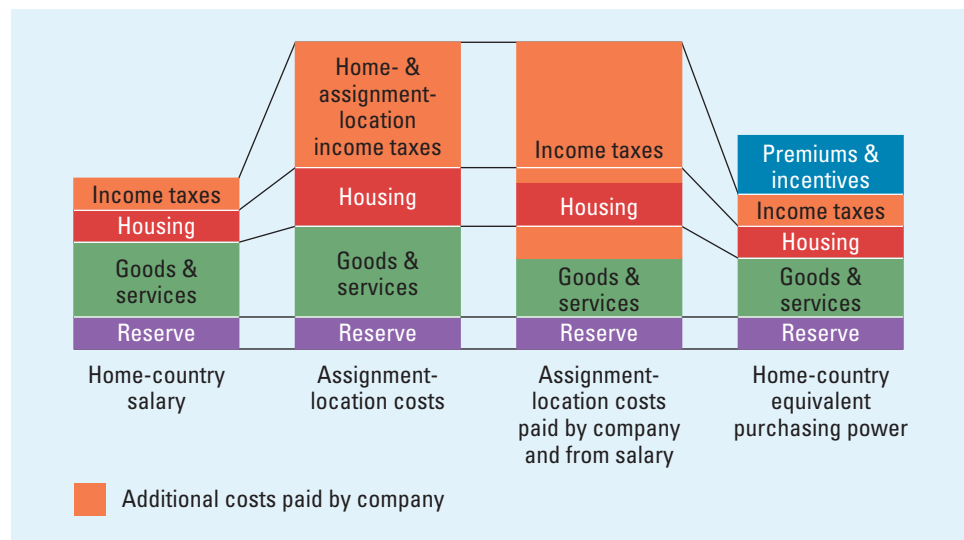
The other portion of employees' annual incentives is based on individual performance. McDonald's has always had a performance rating system, but in 2004 the company introduced global guidelines that suggest that 20 percent of employees receive the highest rating, 70 percent the middle, and 10 percent the bottom. By providing guidelines rather than forced ranking, McDonald's hopes to encourage differentiation of performance while allowing for some local flexibility nuances. By providing principles and guidance, and yet allowing local managers to customize their compensation programs to meet local market demands, McDonald's also claims that it has seen a reduction in turnover. The company's own internal surveys suggest that more employees now believe that their compensation is fair and reflects local market conditions.

Source: J. Marquez, "McDonald's Rewards Program Leaves Some Room for Local Flavor," *Workforce Management*, April 10, 2006, p. 26.

shall briefly review each of these components.⁵⁹ An expatriate's total compensation package may amount to three times what he or she would cost the firm in a home-country posting. Because of the high cost of expatriates, many firms have reduced their use of them in recent years. However, a firm's ability to reduce its use of expatriates may be limited, particularly if it is pursuing an ethnocentric or geocentric staffing policy.

figure 16.2

The Balance Sheet Approach to Expatriate Pay



Base Salary An expatriate's base salary is normally in the same range as the base salary for a similar position in the home country. The base salary is normally paid in either the home-country currency or in the local currency.

Foreign Service Premium A foreign service premium is extra pay the expatriate receives for working outside his or her country of origin. It is offered as an inducement to accept foreign postings. It compensates the expatriate for having to live in an unfamiliar country isolated from family and friends, having to deal with a new culture and language, and having to adapt to new work habits and practices. Many firms pay foreign service premiums as a percentage of base salary, ranging from 10 to 30 percent after tax, with 16 percent being the average premium.⁶⁰

Allowances Four types of allowances are often included in an expatriate's compensation package: hardship allowances, housing allowances, cost-of-living allowances, and education allowances. A hardship allowance is paid when the expatriate is being sent to a difficult location, usually defined as one where such basic amenities as health care, schools, and retail stores are grossly deficient by the standards of the expatriate's home country. A housing allowance is normally given to ensure that the expatriate can afford the same quality of housing in the foreign country as at home. In locations where housing is expensive (e.g., London, Tokyo), this allowance can be substantial—as much as 10 to 30 percent of the expatriate's total compensation package. A cost-of-living allowance ensures that the expatriate will enjoy the same standard of living in the foreign posting as at home. An education allowance ensures that an expatriate's children receive adequate schooling (by home-country standards). Host-country public schools are sometimes not suitable for an expatriate's children, in which case they must attend a private school.

Taxation Unless a host country has a reciprocal tax treaty with the expatriate's home country, the expatriate may have to pay income tax to both the home- and host-country governments. When a reciprocal tax treaty is not in force, the firm typically pays the expatriate's income tax in the host country. In addition, firms normally make up the difference when a higher income tax rate in a host country reduces an expatriate's take-home pay.

Benefits Many firms also ensure that their expatriates receive the same level of medical and pension benefits abroad that they received at home. This can be costly for the firm, since many benefits that are tax deductible for the firm in the home country (e.g., medical and pension benefits) may not be deductible out of the country.

International Labor Relations

The HRM function of an international business is typically responsible for international labor relations. From a strategic perspective, the key issue in international labor relations is the degree to which organized labor can limit the choices of an international business. A firm's ability to integrate and consolidate its global operations to realize experience



Another Perspective

Expat Resources on the Web

Not so many years ago, business professionals whose companies sent them overseas to work had few outside resources to help them become acclimated to their new status as expatriates. Today, however, a wealth of information is available online.

A simple keyword search for “expatriate” on a search engine yields an almost endless supply of links: newspapers and magazines published exclusively for expats; Web sites catering to expatriates in specific regions or countries; general information sites offering insiders' guides to different countries and their finance, culture, and health care systems; not to mention blogs and chat rooms, forums and groups. The expatriate boom has even fueled an industry offering a broad array of services for expats, from mail forwarding to tax preparation to health and life insurance.

LEARNING OBJECTIVE 7

Understand how organized labor can influence strategic choices in international business firms.

curve and location economies can be limited by organized labor, constraining the pursuit of a transnational or global standardization strategy. Prahalad and Doz cite the example of General Motors, which gained peace with labor unions by agreeing not to integrate and consolidate operations in the most efficient manner.⁶¹ General Motors made substantial investments in Germany—matching its new investments in Austria and Spain—at the demand of the German metalworkers' unions.

One task of the HRM function is to foster harmony and minimize conflict between the firm and organized labor. With this in mind, this section is divided into three parts. First, we review organized labor's concerns about multinational enterprises. Second, we look at how organized labor has tried to deal with these concerns. And third, we look at how international businesses manage their labor relations to minimize labor disputes.

THE CONCERNS OF ORGANIZED LABOR Labor unions generally try to get better pay, greater job security, and better working conditions for their members through collective bargaining with management. Unions' bargaining power is derived largely from their ability to threaten to disrupt production, either by a strike or some other form of work protest (e.g., refusing to work overtime). This threat is credible, however, only insofar as management has no alternative but to employ union labor.

A principal concern of domestic unions about multinational firms is that the company can counter its bargaining power with the power to move production to another country. Ford, for example, clearly threatened British unions with a plan to move manufacturing to Continental Europe unless British workers abandoned work rules that limited productivity, showed restraint in negotiating for wage increases, and curtailed strikes and other work disruptions.⁶²

Another concern of organized labor is that an international business will keep highly skilled tasks in its home country and farm out only low-skilled tasks to foreign plants. Such a practice makes it relatively easy for an international business to switch production from one location to another as economic conditions warrant. Consequently, the bargaining power of organized labor is once more reduced.

A final union concern arises when an international business attempts to import employment practices and contractual agreements from its home country. When these practices are alien to the host country, organized labor fears the change will reduce its influence and power. This concern has surfaced in response to Japanese multinationals that have been trying to export their style of labor relations to other countries. For example, much to the annoyance of the United Auto Workers (UAW), many Japanese auto plants in the United States are not unionized. As a result, union influence in the auto industry is declining.

THE STRATEGY OF ORGANIZED LABOR Organized labor has responded to the increased bargaining power of multinational corporations by taking three actions: (1) trying to establish international labor organizations, (2) lobbying for national legislation to restrict multinationals, and (3) trying to achieve international regulations on multinationals through such organizations as the United Nations. These efforts have not been very successful.

In the 1960s, organized labor began to establish international trade secretariats (ITSs) to provide worldwide links for national unions in particular industries. The long-term goal was to be able to bargain transnationally with multinational firms. Organized labor believed that by coordinating union action across countries through an ITS, it could counter the power of a multinational corporation by threatening to disrupt production on an international scale. For example, Ford's threat to move production from Great Britain to other European locations would not have been credible if the unions in various European countries had united to oppose it.



The International Labor Organization was set up to seek the promotion of social justice and internationally recognize human and labor rights. Photo © International Labor Organization

However, the ITSs have had virtually no real success. Although national unions may want to cooperate, they also compete with each other to attract investment from international businesses, and hence jobs for their members. For example, in attempting to gain new jobs for their members, national unions in the auto industry often court auto firms that are seeking locations for new plants. One reason Nissan chose to build its European production facilities in Great Britain rather than Spain was that the British unions agreed to greater concessions than the Spanish unions did. As a result of such competition between national unions, cooperation is difficult to establish.

A further impediment to cooperation has been the wide variation in union structure. Trade unions developed independently in each country. As a result, the structure and ideology of unions tend to vary significantly from country to country, as does the nature of collective bargaining. For example, in Great Britain, France, and Italy, many unions are controlled by left-wing socialists, who view collective bargaining through the lens of “class conflict.” In contrast, most union leaders in Germany, the Netherlands, Scandinavia, and Switzerland are far more moderate politically. The ideological gap between union leaders in different countries has made cooperation difficult. Divergent ideologies are reflected in radically different views about the role of a union in society and the stance unions should take toward multinationals.

Organized labor has also met with only limited success in its efforts to get national and international bodies to regulate multinationals. Such international organizations as the International Labor Organization (ILO) and the Organization for Economic Cooperation and Development (OECD) have adopted codes of conduct for multinational firms to follow in labor relations. However, these guidelines are not as far-reaching as many unions would like. They also do not provide any enforcement mechanisms. Many researchers report that such guidelines are of only limited effectiveness.⁶³

APPROACHES TO LABOR RELATIONS International businesses differ markedly in their approaches to international labor relations. The main difference is the degree to which labor relations activities are centralized or decentralized. Historically, most international businesses have decentralized international labor relations

activities to their foreign subsidiaries because labor laws, union power, and the nature of collective bargaining varied so much from country to country. It made sense to decentralize the labor relations function to local managers. The belief was that there was no way central management could effectively handle the complexity of simultaneously managing labor relations in a number of different environments.

Although this logic still holds, there is now a trend toward greater centralized control. This trend reflects international firms' attempts to rationalize their global operations. The general rise in competitive pressure in industry after industry has made it more important for firms to control their costs. Because labor costs account for such a large percentage of total costs, many firms are now using the threat to move production to another country in their negotiations with unions to change work rules and limit wage increases (as Ford did in Europe). Because such a move would involve major new investments and plant closures, this bargaining tactic requires the input of headquarters management. Thus, the level of centralized input into labor relations is increasing.

In addition, the realization is growing that the way work is organized within a plant can be a major source of competitive advantage. Much of the competitive advantage of Japanese automakers, for example, has been attributed to the use of self-managing teams, job rotation, cross-training, and the like in their Japanese plants.⁶⁴ To replicate their domestic performance in foreign plants, the Japanese firms have tried to replicate their work practices there. This often brings them into direct conflict with traditional work practices in those countries, as sanctioned by the local labor unions, so the Japanese firms have often made their foreign investments contingent on the local union accepting a radical change in work practices. To achieve this, the headquarters of many Japanese firms bargains directly with local unions to get union agreement to changes in work rules before committing to an investment. For example, before Nissan decided to invest in northern England, it got a commitment from British unions to agree to a change in traditional work practices. By its very nature, pursuing such a strategy requires centralized control over the labor relations function.

Key Terms

human resource management, p. 528
expatriate manager, p. 529
staffing policy, p. 531

corporate culture, p. 531
ethnocentric staffing policy, p. 531
polycentric staffing policy, p. 532

geocentric staffing policy, p. 533
expatriate failure, p. 535

Summary

This chapter focused on human resource management in international businesses. HRM activities include human resource strategy, staffing, performance evaluation, management development, compensation, and labor relations. None of these activities is performed in a vacuum; all must be appropriate to the firm's strategy. The chapter made the following points:

1. Firm success requires HRM policies to be congruent with the firm's strategy and with its formal and informal structure and controls.
2. Staffing policy is concerned with selecting employees who have the skills required to perform particular jobs. Staffing policy can be a tool for developing and promoting a corporate culture.
3. An ethnocentric approach to staffing policy fills all key management positions in an international business with parent-country nationals. The policy is congruent with an

international strategy. A drawback is that ethnocentric staffing can result in cultural myopia.

4. A polycentric staffing policy uses host-country nationals to manage foreign subsidiaries and parent-country nationals for the key positions at corporate headquarters. This approach can minimize the dangers of cultural myopia, but it can create a gap between home- and host-country operations. The policy is best suited to a localization strategy.
5. A geocentric staffing policy seeks the best people for key jobs throughout the organization, regardless of their nationality. This approach is consistent with building a strong unifying culture and informal management network and is well suited to both global standardization and transnational strategies. Immigration policies of national governments may limit a firm's ability to pursue this policy.
6. A prominent issue in the international staffing literature is expatriate failure, defined as the premature return of an expatriate manager to his or her home country. The costs of expatriate failure can be substantial.
7. Expatriate failure can be reduced by selection procedures that screen out inappropriate candidates. The most successful expatriates seem to be those who have high self-esteem and self-confidence, can get along well with others, are willing to attempt to communicate in a foreign language, and can empathize with people of other cultures.
8. Training can lower the probability of expatriate failure. It should include cultural training, language training, and practical training, and it should be provided to both the expatriate manager and the spouse.
9. Management development programs attempt to increase the overall skill levels of managers through a mix of ongoing management education and rotation of managers through different jobs within the firm to give them varied experiences. Management development is often used as a strategic tool to build a strong unifying culture and informal management network, both of which support transnational and global standardization strategies.
10. It can be difficult to evaluate the performance of expatriate managers objectively because of unintentional bias. A firm can take a number of steps to reduce this bias.
11. Country differences in compensation practices raise a difficult question for an international business: Should the firm pay executives in different countries according to the standards in each country or equalize pay on a global basis?
12. The most common approach to expatriate pay is the balance sheet approach. This approach aims to equalize purchasing power so employees can enjoy the same living standard in their foreign posting that they had at home.
13. A key issue in international labor relations is the degree to which organized labor can limit the choices available to an international business. A firm's ability to pursue a transnational or global standardization strategy can be significantly constrained by the actions of labor unions.
14. A principal concern of organized labor is that the multinational can counter union bargaining power with threats to move production to another country.
15. Organized labor has tried to counter the bargaining power of multinationals by forming international labor organizations. In general, these efforts have not been effective.

Critical Thinking and Discussion Questions

1. What are the main advantages and disadvantages of the ethnocentric, polycentric, and geocentric approaches to staffing policy? When is each approach appropriate?
2. Research suggests that many expatriate employees encounter problems that limit both their effectiveness in a foreign posting and their contribution to the company when they return home. What are the main causes and consequences of these problems, and how might a firm reduce the occurrence of such problems?
3. What is the link between an international business's strategy and its human resource management policies, particularly with regard

- to the use of expatriate employees and their pay scale?
4. In what ways can organized labor constrain the strategic choices of an international business? How can an international business limit these constraints?

5. Reread the Management Focus on McDonald's global compensation practices. How does McDonald's approach help the company to take local differences into account when reviewing the performance of different country managers and awarding bonus pay?

Research Task



<http://globalEDGE.msu.edu>

Use the globalEDGE Resource Desk (<http://globalEDGE.msu.edu/resourcedesk/>) to complete the following exercises:

1. The U.S. Department of State prepares quarterly reports for *living costs abroad* to compensate civilian employees working for the U.S. government at various posts worldwide. Using the most current report, identify the posts that are regarded as having a high cost of living as well as those that are perceived as risky (those
2. You work in the human resources department at the headquarters of a multinational corporation. Your company is about to send several American managers to New Zealand as expatriates. Utilize resources available on the globalEDGE Web site regarding *working internationally* to examine the income tax rates in New Zealand.



Lenovo

closing case

In late 2004 IBM announced it was getting out of the personal computer business and would sell its entire PC operations to Lenovo, the fast-growing Chinese manufacturer of personal computers, for \$1.75 billion. The acquisition turned Lenovo into the world's third-largest PC firm. It also raised many questions about how a Chinese enterprise with little global exposure would manage the assets of an American firm that had 2,400 employees in the United States, 4,000 in foreign manufacturing facilities, and 3,600 sales and distribution centers in over 60 countries around the world.

Lenovo moved quickly to reassure employees that it was committed to building a truly global enterprise with a global workforce. Less than 24 hours after the two companies announced the acquisition, the human resources department at IBM's PC division released a 59-point question-and-answer memo to all employees informing them that they would become employees of Lenovo, that their compensation and benefits would remain identical or fully comparable to their IBM package, and that they would not be asked to relocate. The memo also made it clear that employees could accept employment at Lenovo or leave, with no separation pay. IBM

would not consider them for a transfer within IBM or recruit or hire the new Lenovo employees for two years.

What really surprised many observers, however, was the composition of the top management team at the new Lenovo and the location of its global headquarters. Top executives at Lenovo were smart enough to realize that the acquisition would have little value if IBM's managers, engineers, and salespeople left the company, so they moved Lenovo's global headquarters to New York! Plus, the former head of IBM's PC division, Stephen Ward, was appointed CEO of Lenovo, while Yang Yuanqing, the former CEO of Lenovo, became chairman, and Lenovo's Mary Ma became CFO. The 30-member top management team was split down the middle—half Chinese, half American—and boasted more women than men. English was declared the company's new business language. The goal, according to Yang, was to transform Lenovo into a truly global corporation with a global workforce that is capable of going head-to-head with Dell in the battle for dominance in the global PC business. The choice of Ward for CEO, for example, was based on the presumption that none of the Chinese executives had the experience and capabilities required

to manage a truly global enterprise. For Lenovo, when deciding who should hold management positions, the national origin of the candidate is not an issue. Rather, the decision focuses upon whether the person has the skills and capabilities required for working in a global enterprise. Lenovo is committed to hiring the very best people, wherever they might come from.

Commenting on the acquisition, Bill Matson, a former IBM executive who became senior vice president of human resources at Lenovo, noted the company would use the same set of principles to guide workforce management in all locations. He noted, "You have to establish the broad principles of how you want to manage your business, but then you have to be very astute about how those principles are applied in every local market so that you remain responsive to the needs of people in different environments."

Sources: D. Barboza, "An Unknown Giant Flexes Its Muscles," *The New York Times*, December 4, 2004, pp. B1, B3; D. Roberts and L. Lee, "East Meets West," *BusinessWeek*, May 9, 2005, pp. 1–4; C. Forelle, "How IBM's Ward Will Lead China's Largest PC Company," *The Wall Street Journal*, April 21, 2005, p. B1; and F. Hansen, "International Business Machine," *Workforce Management*, July 2005, pp. 36–44.

Case Discussion Questions

1. What is the staffing policy that Lenovo is pursuing?
2. What strategy do you think the company is pursuing?
Does its staffing policy match its strategy?
3. What are the strengths of Lenovo's staffing policy? Can you see any potential weaknesses, or problems, that the company might encounter as a result of this policy?
4. If Lenovo is to become a truly global enterprise, what should the HRM function do to enable the company to attain this goal?



glossary

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.

Ad valorem tariff A tariff levied as a proportion of the value of an imported good.

Administrative trade policies Administrative policies, typically adopted by government bureaucracies, that can be used to restrict imports or boost exports.

Andean Pact A 1969 agreement between Bolivia, Chile, Ecuador, Colombia, and Peru to establish a customs union.

Antidumping policies Policies designed to punish foreign firms that engage in dumping and thus protect domestic producers from unfair foreign competition.

Arbitrage The purchase of securities in one market for immediate resale in another to profit from a price discrepancy.

Asia-Pacific Economic Cooperation (APEC) Made up of 21 member states whose goal is to increase multilateral cooperation in view of the economic rise of the Pacific nations.

Association of Southeast Asian Nations (ASEAN) An attempt to establish a free trade area between Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam.

Balance-of-payments accounts National accounts that track both payments to and receipts from foreigners.

Balance-of-trade equilibrium Reached when the income a country's residents earn from exports equals the money residents pay for imports.

Bandwagon effect When traders move like a herd, all in the same direction and at the same time, in response to each others' perceived actions.

Banking crisis A loss of confidence in the banking system that leads to a run on banks, as individuals and companies withdraw their deposits.

Barter The direct exchange of goods or services between two parties without a cash transaction.

Bill of exchange An order written by an exporter instructing an importer, or an importer's agent, to pay a specified amount of money at a specified time.

Bill of lading A document issued to an exporter by a common carrier transporting merchandise; it serves as a receipt, a contract, and a document of title.

Bretton Woods A 1944 conference in which representatives of 40 countries met to design a new international monetary system.

Business ethics Accepted principles of right or wrong governing the conduct of businesspeople.

Buyback When a firm builds a plant in a country and agrees to take a certain percentage of the plant's output as partial payment of the contract.

Capital account Records onetime changes in the stock of assets.

Capital flight Residents convert domestic currency into a foreign currency.

Caribbean Single Market and Economy (CSME) Unites six CARICOM members in agreeing to lower trade barriers and harmonize macroeconomic and monetary policies.

CARICOM An association of English-speaking Caribbean states that are attempting to establish a customs union.

Carry trade Involves borrowing in one currency where interest rates are low, and then using the proceeds to invest in another currency where interest rates are high.

Caste system A system of social stratification in which social position is determined by the family into which a person is born, and change in that position is usually not possible during an individual's lifetime.

Central America Free Trade Agreement (CAFTA) The agreement of the member states of the Central American Common Market joined by the Dominican Republic to trade freely with the United States.

Central American Common Market A trade pact between Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua, which began in the early 1960s but collapsed in 1969 due to war.

Channel length The number of intermediaries that a product has to go through before it reaches the final consumer.

Channel quality The expertise, competencies, and skills of established retailers in a nation, and their ability to sell and support the products of international businesses.

Civil law system A system of law based on a very detailed set of written laws and codes.

Class consciousness A tendency for individuals to perceive themselves in terms of their class background.

Class system A system of social stratification in which social status is determined by the family into which a person is born and by subsequent socioeconomic achievements; mobility between classes is possible.

Code of ethics A business's formal statement of ethical priorities.

Collectivism A political system that emphasizes collective goals as opposed to individual goals.

Command economy An economic system where the allocation of resources, including determination of what goods and services should be produced, and in what quantity, is planned by the government.

Common law A system of law based on tradition, precedent, and custom; when law courts interpret common law, they do so with regard to these characteristics.

Common market A group of countries committed to (1) removing all barriers to the free flow of goods, services, and factors of production between each other and (2) the pursuit of a common external trade policy.

Communist totalitarianism A version of collectivism advocating that socialism can be achieved only through a totalitarian dictatorship.

Communists Those who believe socialism can be achieved only through revolution and totalitarian dictatorship.

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

Concentrated retail system A few retailers supply most of the market.

Confucian dynamism Theory that Confucian teachings affect attitudes toward time, persistence, ordering by status, protection of face, respect for tradition, and reciprocation of gifts and favors. The units of resources required to produce a good are assumed to remain constant no matter where one is on a country's production possibility frontier.

Contract A document that specifies the conditions under which an exchange is to occur and details the rights and obligations of the parties involved.

Contract law The body of law that governs contract enforcement.

Controls The metrics used to measure the performance of subunits and make judgments about how well managers are running those subunits.

Convention on Combating Bribery of Foreign Public Officials in International Business Transactions The convention obliges member states to make the bribery of foreign public officials a criminal offense.

Copyright Exclusive legal rights of authors, composers, playwrights, artists, and publishers to publish and dispose of their work as they see fit.

Core competence Firm skills that competitors cannot easily match or imitate.

Corporate culture Organization's norms and value systems.

Council of the European Union The ultimate decision-making body in the EU.

Counterpurchase A reciprocal buying agreement.

Countertrade The trade of goods and services for other goods and services.

Countervailing duties Antidumping duties.

Country of origin effects The extent to which the place of manufacturing influences product evaluations.

Court of Justice Supreme appeals court for EU law.

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

Cross-licensing agreement An arrangement in which a company licenses valuable intangible property to a foreign partner and receives a license for the partner's valuable knowledge; reduces risk of licensing.

Cultural relativism The belief that ethics are culturally determined and that firms should adopt the ethics of the cultures in which they operate.

Culture A system of values and norms that are shared among a group of people and that when taken together constitute a design for living.

Currency board Means of controlling a country's currency.

Currency crisis Occurs when a speculative attack on the exchange value of a currency results in a sharp depreciation in the value of the currency or forces authorities to expend large volumes of international currency reserves and sharply increase interest rates to defend the prevailing exchange rate.

Currency speculation Involves short-term movement of funds from one currency to another in hopes of profiting from shifts in exchange rates.

Currency swap Simultaneous purchase and sale of a given amount of foreign exchange for two different value dates.

Current account In the balance of payments, records transactions involving the export or import of goods and services.

Current account deficit Occurs when a country imports more good, services, and income than it exports.

Current account surplus Occurs when a country exports more goods, services, and income than it imports.

Customs union A group of countries committed to (1) removing all barriers to the free flow of goods and services between each other and (2) the pursuit of a common external trade policy.

D'Amato Act Act passed in 1996, similar to the Helms-Burton Act, aimed at Libya and Iran.

Democracy Political system in which government is by the people, exercised either directly or through elected representatives.

Deregulation Removal of government restrictions concerning the conduct of a business.

Dirty float A system under which a country's currency is nominally allowed to float freely against other currencies, but in which the government will intervene, buying and selling currency, if it believes that the currency has deviated too far from its fair value.

Draft See **Bill of exchange**.

Dumping Selling goods in a foreign market for less than their cost of production or below their "fair" market value.

Eclectic paradigm Argument that combining location-specific assets or resource endowments and the firm's own unique assets often requires FDI; it requires the firm to establish production facilities where those foreign assets or resource endowments are located.

Economic exposure The extent to which a firm's future international earning power is affected by changes in exchange rates.

Economic risk The likelihood that events, including economic mismanagement, will cause drastic changes in a country's business environment that adversely affect the profit and other goals of a particular business enterprise.

Economic union A group of countries committed to (1) the removal of all barriers to the free flow of goods, services, and factors of production between each other; (2) the adoption of a common currency; (3) the harmonization of tax rates; and (4) the pursuit of a common external trade policy.

Economies of scale Cost advantages associated with large-scale production.

Elastic When a small change in price produces a large change in demand.

Entrepreneurs Those who first commercialize innovations.

Ethical dilemma A situation in which there is no ethically acceptable solution.

Ethical strategy A course of action that does not violate a company's business ethics.

Ethical system A set of moral principles, or values, that are used to guide and shape behavior.

Ethics officer An individual hired by a company to be responsible for making sure that all employees are trained to be ethically aware, that ethical considerations enter the decision-making process, and that employees follow the company's code of ethics.

Ethnocentric staffing policy A staffing approach within the MNE in which all key management positions are filled by parent-country nationals.

Ethnocentrism Behavior that is based on the belief in the superiority of one's own ethnic group or culture; often shows disregard or contempt for the culture of other countries.

European Commission Body responsible for proposing EU legislation, implementing it, and monitoring compliance.

European Council The ultimate controlling authority within the EU.

European Free Trade Association (EFTA) A free trade association including Norway, Iceland, Liechtenstein, and Switzerland.

European Monetary System (EMS) A system to regulate fixed exchange rates before the introduction of the euro.

European Parliament Elected EU body that consults on issues proposed by European Commission.

European Union (EU) An economic group of 27 European nations; established as a customs union, it is moving toward economic union; formerly the European Community.

Exchange rate The rate at which one currency is converted into another.

Exclusive distribution channel A channel that outsiders find difficult to access.

Expatriate failure The premature return of an expatriate manager to the home country.

Expatriate manager A national of one country appointed to a management position in another country.

Experience curve Systematic production cost reductions that occur over the life of a product.

Experience curve pricing Aggressive pricing designed to increase volume and help the firm realize experience curve economies.

Export management company Export specialists who act as an export marketing department for client firms.

Export-Import Bank Agency of the U.S. government whose mission is to provide aid in financing and

facilitate exports and imports; also referred to as the Ex-Im Bank.

Exporting Sale of products produced in one country to residents of another country.

External stakeholders Individuals or groups that have some claim on a firm such as customers, suppliers, and unions.

Externalities Knowledge spillovers.

Externally convertible currency Nonresidents can convert their holdings of domestic currency into foreign currency, but the ability of residents to convert the currency is limited in some way.

Factor endowments The extent to which a country is endowed with resources such as land, labor, and capital.

Factors of production Inputs into the productive process of a firm, including labor, management, land, capital, and technological know-how.

Financial account Records transactions that involve the purchase or sale of assets.

First-mover advantages Advantages accruing to the first to enter a market.

First-mover disadvantages Disadvantages associated with entering a foreign market before other international businesses.

Fisher effect Nominal interest rates (i) in each country equal the required real rate of interest (r) and the expected rate of inflation over the period of time for which the funds are to be lent (I); that is, $i = r + I$.

Fixed exchange rate A system under which the exchange rate for converting one currency into another is fixed.

Flexible machine cells Flexible manufacturing technology in which a grouping of various machine types, a common materials handler, and a centralized cell controller produce a family of products.

Flexible manufacturing technology (lean production) Manufacturing technology designed to improve job scheduling, reduce setup time, and improve quality control.

Floating exchange rate A system under which the exchange rate for converting one currency into another is continuously adjusted depending on the laws of supply and demand.

Flow of foreign direct investment The amount of foreign direct investment undertaken over a given time period (normally one year).

Folkways Routine conventions of everyday life.

Foreign Corrupt Practices Act U.S. law regulating behavior regarding the conduct of international business in the taking of bribes and other unethical actions.

Foreign debt crisis Situation in which a country cannot service its foreign debt obligations, whether private-sector or government debt.

Foreign direct investment (FDI) Direct investment in business operations in a foreign country.

Foreign exchange market A market for converting the currency of one country into that of another country.

Foreign exchange risk The risk that changes in exchange rates will hurt the profitability of a business deal.

Forward exchange When two parties agree to exchange currency and execute a deal at some specific date in the future.

Forward exchange rate The exchange rate governing forward exchange transactions.

Fragmented retail system Many retailers supply a market with no one having a major share.

Franchising A specialized form of licensing in which the franchiser sells intangible property to the franchisee and insists on rules to conduct the business.

Free trade The absence of government barriers to the free flow of goods and services between countries.

Free trade area A group of countries committed to removing all barriers to the free flow of goods and services between each other, but pursuing independent external trade policies.

Freely convertible currency A country's currency is freely convertible when the government of that country allows both residents and nonresidents to purchase unlimited amounts of foreign currency with the domestic currency.

Fundamental analysis Draws on economic theory to construct sophisticated econometric models for predicting exchange rate movements.

Fundamental rights of stakeholders Basic rights of stakeholders, such as the right to information about products and working conditions, that should be considered when business decisions are made.

General Agreement on Tariffs and Trade (GATT) International treaty that committed signatories to lowering barriers to the free flow of goods across national borders and led to the WTO.

Geocentric staffing policy A staffing policy under which the firm seeks the best people for key jobs throughout the company, regardless of nationality.

Global learning The flow of skills and product offerings from foreign subsidiary to home country and from foreign subsidiary to foreign subsidiary.

Global Standardization Strategy A firm focuses on increasing profitability and profit growth by reaping the cost reductions that come from economies of scale, learning effects, and location economies

Global web When different stages of value chain are dispersed to those locations around the globe where value added is maximized or where costs of value creation are minimized.

Globalization Trend away from distinct national economic units and toward one huge global market.

Globalization of markets Moving away from an economic system in which national markets are distinct entities, isolated by trade barriers and barriers of distance, time, and culture, and toward a system in which national markets are merging into one global market.

Globalization of production Trend by individual firms to disperse parts of their productive processes to different locations around the globe to take advantage of differences in cost and quality of factors of production.

Gold par value The amount of currency needed to purchase one ounce of gold.

Gold standard The practice of pegging currencies to gold and guaranteeing convertibility.

Greenfield investment Establishing a new operation in a foreign country.

Gross fixed capital formation Summarizes the total amount of capital invested in factories, stores, office buildings, and the like.

Gross national income (GNI) The yardstick for measuring economic activity of a country, this measures the total annual income of a nation's residents.

Group An association of two or more individuals who have a shared sense of identity and who interact with each other in structured ways on the basis of a common set of expectations about each other's behavior.

Hedging The process of insuring one's business against foreign exchange risk by using forward exchanges or currency swaps.

Helms-Burton Act Act passed in 1996 that allowed Americans to sue foreign firms that use Cuban property confiscated from them after the 1959 revolution.

Human Development Index (HDI) An attempt by the UN to assess the impact of a number of factors on the quality of human life in a country.

Human resource management Activities an organization conducts to use its human resources effectively.

Import quota A direct restriction on the quantity of a good that can be imported into a country.

Incentives The devices used to reward appropriate managerial behavior.

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

Individualism versus collectivism Theory focusing on the relationship between the individual and his or her

fellows; in individualistic societies, the ties between individuals are loose and individual achievement is highly valued; in societies where collectivism is emphasized, ties between individuals are tight, people are born into collectives, such as extended families, and everyone is supposed to look after the interests of his or her collective.

Inefficient market One in which prices do not reflect all available information.

Inelastic When a large change in price produces only a small change in demand.

Infant industry argument New industries in developing countries must be temporarily protected from international competition to help them reach a position where they can compete on world markets with the firms of developed nations.

Inflows of FDI Flow of foreign direct investment into a country.

Innovation Development of new products, processes, organizations, management practices, and strategies.

Intellectual property Products of the mind, ideas (e.g., books, music, computer software, designs, technological know-how); intellectual property can be protected by patents, copyrights, and trademarks.

Internal stakeholders People who work for or own the business such as employees, directors, and stockholders.

Internalization theory The argument that firms prefer FDI over licensing in order to retain control over know-how, manufacturing, marketing, and strategy or because some firm capabilities are not amenable to licensing.

International business Any firm that engages in international trade or investment.

International Fisher effect For any two countries, the spot exchange rate should change in an equal amount but in the opposite direction to the difference in nominal interest rates between countries.

International Monetary Fund (IMF) International institution set up to maintain order in the international monetary system.

International monetary system Institutional arrangements countries adopt to govern exchange rates.

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

International trade Occurs when a firm exports goods or services to consumers in another country.

ISO 9000 Certification process that requires certain quality standards must be met.

Joint venture Establishing a firm that is jointly owned by two or more otherwise independent firms.

Just distribution A distribution of goods and services that is considered fair and equitable.

Justice theories Ethical approaches that focus on the attainment of a just distribution of economic goods and services.

Just-in-time (JIT) inventory Logistics systems designed to deliver parts to a production process as they are needed, not before.

Kantian ethics The belief that people should be treated as ends and never as means to the ends of others.

Lag strategy Delaying the collection of foreign currency receivables if that currency is expected to appreciate, and delaying payables if that currency is expected to depreciate.

Late-mover disadvantages Handicaps experienced by being a late entrant in a market.

Law of one price In competitive markets free of transportation costs and barriers to trade, identical products sold in different countries must sell for the same price when their price is expressed in the same currency.

Lead strategy Attempting to collect foreign currency receivables early when a foreign currency is expected to depreciate and paying foreign currency payables before they are due when a currency is expected to appreciate.

Lean production Flexible manufacturing technologies pioneered at Toyota and now used in much of the automobile industry.

Learning effects Cost savings from learning by doing.

Legal risk The likelihood that a trading partner will opportunistically break a contract or expropriate intellectual property rights.

Legal system System of rules that regulate behavior and the processes by which the laws of a country are enforced and through which redress of grievances is obtained.

Letter of credit Issued by a bank, indicating that the bank will make payments under specific circumstances.

Licensing Occurs when a firm (the licensor) licenses the right to produce its product, its production processes, or its brand name or trademark to another firm (the licensee); in return for giving the licensee these rights, the licensor collects a royalty fee on every unit the licensee sells.

Licensing agreement Arrangement in which a licensor grants the rights to intangible property to the licensee for a specified period and receives a royalty fee in return.

Local content requirement A requirement that some specific fraction of a good be produced domestically.

Localization strategy Increasing profitability by customizing the firm's goods and services so that they provide a good match to tastes and preferences in different national markets.

Location economies Cost advantages from performing a value creation activity at the optimal location for that activity.

Location-specific advantages Advantages that arise from using resource endowments or assets that are tied to a particular foreign location and that a firm finds valuable to combine with its own unique assets (such as the firm's technological, marketing, or management know-how).

Logistics The procurement and physical transmission of material through the supply chain, from suppliers to customers.

Maastricht Treaty Treaty agreed to in 1991, but not ratified until January 1, 1994, that committed the 12 member states of the European Community to adopt a common currency.

Make-or-buy decisions Whether a firm should make or buy component parts.

Managed-float system System under which some currencies are allowed to float freely, but the majority are either managed by government intervention or pegged to another currency.

Market economy An economic system in which the interaction of supply and demand determines the quantity in which goods and services are produced.

Market segmentation Identifying groups of consumers whose purchasing behavior differs from others in important ways.

Marketing mix Choices about product attributes, distribution strategy, communication strategy, and pricing strategy that a firm offers its targeted markets.

Masculinity versus femininity Theory of the relationship between gender and work roles. In masculine cultures, sex roles are sharply differentiated and traditional "masculine values" such as achievement and the effective exercise of power determine cultural ideals; in feminine cultures, sex roles are less sharply distinguished, and little differentiation is made between men and women in the same job.

Mass customization The production of a variety of end products at a unit cost that could once be achieved only through mass production of a standardized output.

Mercantilism An economic philosophy advocating that countries should simultaneously encourage exports and discourage imports.

Mercosur Pact between Argentina, Brazil, Paraguay, and Uruguay to establish a free trade area.

Minimum efficient scale The level of output at which most plant-level scale economies are exhausted.

Mixed economy Certain sectors of the economy are left to private ownership and free market mechanisms, while other sectors have significant government ownership and government planning.

Moore's law The power of microprocessor technology doubles and its costs of production fall in half every 18 months.

Moral hazard Arises when people behave recklessly because they know they will be saved if things go wrong.

Moral imagination Standing in the shoes of a stakeholder and asking how a proposed decision will affect that stakeholder.

Mores Norms seen as central to the functioning of a society and to its social life.

Multinational enterprise (MNE) A firm that owns business operations in more than one country.

Multipoint competition Arises when two or more enterprises encounter each other in different regional markets, national markets, or industries.

Multipoint pricing Occurs when a pricing strategy in one market may have an impact on a rival's pricing strategy in another market.

Naive immoralism The belief that if a manager of a multinational sees that firm from other nations are not following ethical norms in a host nation, that manager should not either.

New Trade Theory Theory that sometimes countries specialize in the production and export of particular products not because of underlying differences in factor endowments, but because in certain industries the world market can support only a limited number of firms.

Noblesse oblige A French term referring to the honorable and benevolent behavior required of persons of noble birth.

Noise The amount of other messages competing for a potential consumer's attention.

Nonconvertible currency A currency is not convertible when both residents and nonresidents are prohibited from converting their holdings of that currency into another currency.

Norms Social rules and guidelines that prescribe appropriate behavior in particular situations.

North American Free Trade Agreement (NAFTA) Free trade area between Canada, Mexico, and the United States.

Offset A buying agreement similar to counterpurchase, but the exporting country can then fulfill the agreement with any firm in the country to which the sale is being made.

Offshore production FDI undertaken to serve the home market.

Oligopoly An industry composed of a limited number of large firms.

Operations The various value creation activities a firm undertakes.

Optimal currency area One where similarities between the economic structure of countries make it feasible to adopt a single currency.

Organization architecture The totality of a firm's organization, including formal organizational structure, control systems and incentives, organizational culture, processes, and people.

Organization culture The values and norms shared among an organization's employees.

Organizational structure The three-part structure of an organization, including its formal division into subunits such as product divisions, its location of decision-making responsibilities within that structure, and the establishment of integrating mechanisms to coordinate the activities of all subunits.

Outflows of FDI Flow of foreign direct investment out of a country.

Paris Convention for the Protection of Industrial Property International agreement to protect intellectual property.

Patent Grants the inventor of a new product or process exclusive rights to the manufacture, use, or sale of that invention.

Pegged exchange rate Currency value is fixed relative to a reference currency.

People The employees of an organization, its recruiting, compensation, and retention strategies, and the type of people who work at the organization.

Personal ethics The generally accepted principles of right and wrong governing the conduct of individuals.

Pioneering costs Costs an early entrant bears that later entrants avoid, such as the time and effort in learning the rules, failure due to ignorance, and the liability of being a foreigner.

Political economy The political, economic, and legal systems of a country.

Political risk The likelihood that political forces will cause drastic changes in a country's business environment that will adversely affect the profit and other goals of a particular business enterprise.

Political system System of government in a nation.

Political union A central political apparatus that coordinates economic, social, and foreign policy.

Polycentric staffing policy A staffing policy in an MNE in which host-country nationals are recruited to manage subsidiaries in their own country, while parent-country nationals occupy key positions at corporate headquarters.

Power distance Theory of how a society deals with the fact that people are unequal in physical and intellectual

capabilities. High power distance cultures are found in countries that let inequalities grow over time into inequalities of power and wealth; low power distance cultures are found in societies that try to play down such inequalities as much as possible.

Predatory pricing Reducing prices below fair market value as a competitive weapon to drive weaker competitors out of the market (“fair” being cost plus some reasonable profit margin).

Price elasticity of demand A measure of how responsive demand for a product is to changes in price.

Private action The theft, piracy, blackmail, and the like by private individuals or groups.

Privatization The sale of state-owned enterprises to private investors.

Processes The manner in which decisions are made and work is performed within any organization.

Product liability Involves holding a firm and its officers responsible when a product causes injury, death, or damage.

Product safety laws Set certain safety standards to which a product must adhere.

Production Activities involved in creating a product.

Production possibility frontier (PPF) The various output possibilities a country can produce from its resource pool.

Profit growth The percentage increase in net profits over time.

Profitability A ratio or rate of return concept.

Property rights Bundle of legal rights over the use to which a resource is put and over the use made of any income that may be derived from that resource.

Public action The extortion of income or resources of property holders by public officials, such as politicians and government bureaucrats.

Pull strategy A marketing strategy emphasizing mass media advertising as opposed to personal selling.

Purchasing power parity (PPP) An adjustment in gross domestic product per capita to reflect differences in the cost of living.

Push strategy A marketing strategy emphasizing personal selling rather than mass media advertising.

Quota rent Extra profit producers make when supply is artificially limited by an import quota.

Regional economic integration Agreements among countries in a geographic region to reduce and ultimately remove tariff and nontariff barriers to the free flow of goods, services, and factors of production between each other.

Relatively efficient market One in which few impediments to international trade and investment exist.

Religion A system of shared beliefs and rituals concerned with the realm of the sacred.

Representative democracy A political system in which citizens periodically elect individuals to represent them in government.

Righteous moralism The belief that a multinational’s home-country standards of ethics are the appropriate ones for companies to follow in foreign countries.

Rights theories A 20th-century theory that recognizes that human beings have fundamental rights and privileges that transcend national boundaries and cultures.

Right-wing totalitarianism A political system in which political power is monopolized by a party, group, or individual that generally permits individual economic freedom but restricts individual political freedom, including free speech, often on the grounds that it would lead to the rise of communism.

Sight draft A draft payable on presentation to the drawee.

Single European Act A 1987 act, adopted by members of the European Community, that committed member countries to establishing an economic union.

Six Sigma Statistically based methodology for improving product quality.

Smoot-Hawley Act Enacted in 1930 by the U.S. Congress, this tariff erected a wall of barriers against imports into the United States.

Social democrats Those committed to achieving socialism by democratic means.

Sogo Shosha Japan’s great trading houses.

Social mobility The extent to which individuals can move out of the social strata into which they are born.

Social responsibility The idea that businesspeople should consider the social consequences of economic actions when making business decisions.

Social strata Hierarchical social categories often based on family background, occupation, and income.

Social structure The basic social organization of a society.

Socialism A political philosophy advocating substantial public involvement, through government ownership, in the means of production and distribution.

Society Group of people who share a common set of values and norms.

Source effects When the receiver of the message evaluates the message based on the status or image of the sender.

Specialized asset An asset designed to perform a specific task, whose value is significantly reduced in its next-best use.

Specific tariff Tariff levied as a fixed charge for each unit of good imported.

Spot exchange rate The exchange rate at which a foreign exchange dealer will convert one currency into another that particular day.

Staffing policy Strategy concerned with selecting employees for particular jobs.

Stakeholders The individuals or groups that have an interest, stake, or claim in the actions and overall performance of a company.

Stock of foreign direct investment The total accumulated value of foreign-owned assets at a given time.

Strategic alliances Cooperative agreements between two or more firms.

Strategic commitment A decision that has a long-term impact and is difficult to reverse, such as entering a foreign market on a large scale.

Strategic pricing Pricing aimed at giving a company a competitive advantage over its rivals.

Strategic trade policy Government policy aimed at improving the competitive position of a domestic industry or domestic firm in the world market.

Strategy Actions managers take to attain the firm's goals.

Subsidy Government financial assistance to a domestic producer.

Sullivan principles A twofold approach to doing business in apartheid South Africa, comprising passive resistance to apartheid laws and attempts to influence the abolition of apartheid laws.

Switch trading The use of a specialized third-party trading house in a countertrade arrangement.

Tariff A tax levied on imports.

Tariff rate quota The process of applying a lower tariff rate to imports within the import quota than those over the quota.

Technical analysis Uses price and volume data to determine past trends, which are expected to continue into the future.

Theocratic law system A system of law based on religious teachings.

Theocratic totalitarianism A political system in which political power is monopolized by a party, group, or individual that governs according to religious principles.

Time draft A promise to pay by the accepting party at some future date.

Timing of entry Entry is early when a firm enters a foreign market before other foreign firms and late when a firm enters after other international businesses have established themselves.

Total quality management (TQM) Management philosophy that takes as its central focus the need to improve the quality of a company's products and services.

Totalitarianism Form of government in which one person or political party exercises absolute control over all spheres of human life and opposing political parties are prohibited.

Trade creation Trade created due to regional economic integration; occurs when high-cost domestic producers are replaced by low-cost foreign producers in a free trade area.

Trade diversion Trade diverted due to regional economic integration; occurs when low-cost foreign suppliers outside a free trade area are replaced by higher-cost foreign suppliers in a free trade area.

Trademark Designs and names, often officially registered, by which merchants or manufacturers designate and differentiate their products.

Transaction exposure The extent to which income from individual transactions is affected by fluctuations in foreign exchange values.

Translation exposure The extent to which the reported consolidated results and balance sheets of a corporation are affected by fluctuations in foreign exchange values.

Transnational strategy Attempt to simultaneously achieve low costs through location economies, economies of scale, and learning effects while also differentiating product offerings across geographic markets to account for local differences and fostering multidirectional flows of skills between different subsidiaries in the firm's global network of operations.

Treaty of Lisbon Treaty signed in 2007 that made the European Parliament the co-equal legislator for almost all European laws and also created the position of the president of the European Council.

Treaty of Rome The 1957 treaty that established the European Community.

Tribal totalitarianism A political system in which a party, group, or individual that represents the interests of a particular tribe (ethnic group) monopolizes political power.

Turnkey project A project in which a firm agrees to set up an operating plant for a foreign client and hand over the "key" when the plant is fully operational.

Uncertainty avoidance Extent to which cultures socialize members to accept ambiguous situations and to tolerate uncertainty.

United Nations An international organization made up of 191 countries headquartered in New York City, formed in 1945 to promote peace, security, and cooperation.

United Nations Convention on Contracts for the International Sale of Goods (CIGS) A set of rules governing certain aspects of the making and performance of commercial contracts between sellers and buyers who have their places of businesses in different nations.

Universal Declaration of Human Rights A United Nations document that lays down the basic principles of human rights that should be adhered to.

Universal needs Needs that are the same all over the world, such as steel, bulk chemicals, and industrial electronics.

Utilitarian approaches to ethics These hold that the moral worth of actions or practices is determined by their consequences.

Value creation Performing activities that increase the value of goods or services to consumers.

Values Abstract ideas about what a society believes to be good, right, and desirable.

Voluntary export restraint (VER) A quota on trade imposed from the exporting country's side, instead of the importer's; usually imposed at the request of the importing country's government.

Wholly owned subsidiary A subsidiary in which the firm owns 100 percent of the stock.

World Bank International institution set up to promote general economic development in the world's poorer nations.

World Intellectual Property Organization An international organization whose members sign treaties to agree to protect intellectual property.

World Trade Organization (WTO) The organization that succeeded the General Agreement on Tariffs and Trade (GATT) as a result of the successful completion of the Uruguay Round of GATT negotiations.

Zero-sum game A situation in which an economic gain by one country results in an economic loss by another.



endnotes

Chapter 1

1. Trade statistics from World Trade Organization, "Trade to Expand by 9.5% in 2010 after a Dismal 2009," WTO press release, March 26, 2010. Foreign exchange statistics from Bank for International Settlements, www.bis.org/index.htm.
2. Thomas L. Friedman, *The World Is Flat* (New York: Farrar, Straus and Giroux, 2005).
3. Ibid.
4. T. Levitt, "The Globalization of Markets," *Harvard Business Review*, May–June 1983, pp. 92–102.
5. U.S. Department of Commerce, "A Profile of U.S. Exporting Companies, 2000–2001," February 2003; report available at www.census.gov/foreign-trade/aip/index.html#profile.
6. Ibid.
7. C. M. Draffen, "Going Global: Export Market Proves Profitable for Region's Small Businesses," *Newsday*, March 19, 2001, p. C18.
8. B. Benoit and R. Milne, "Germany's Best Kept Secret, How Its Exporters Are Betting the World," *Financial Times*, May 19, 2006, p. 11.
9. See F. T. Knickerbocker, *Oligopolistic Reaction and Multinational Enterprise* (Boston: Harvard Business School Press, 1973); and R. E. Caves, "Japanese Investment in the U.S.: Lessons for the Economic Analysis of Foreign Investment," *The World Economy* 16 (1993), pp. 279–300.
10. I. Metthee, "Playing a Large Part," *Seattle Post-Intelligencer*, April 9, 1994, p. 13.
11. D. Pritchard, "Are Federal Tax Laws and State Subsidies for Boeing 7E7 Selling America Short?" *Aviation Week*, April 12, 2004, pp. 74–75.
12. "Operating Profit," *The Economist*, August 16, 2008, pp. 74–76.
13. R. B. Reich, *The Work of Nations* (New York: A.A. Knopf, 1991).
14. United Nations, "The UN in Brief," www.un.org/Overview/brief.html.
15. J. A. Frankel, "Globalization of the Economy," *National Bureau of Economic Research Working Paper Series*, working paper no. 7858, 2000.
16. J. Bhagwati, *Protectionism* (Cambridge, MA: MIT Press, 1989).
17. F. Williams, "Trade Round Like This May Never Be Seen Again," *Financial Times*, April 15, 1994, p. 8.
18. W. Vieth, "Major Concessions Lead to Success for WTO Talks," *Los Angeles Times*, November 14, 2001, p. A1; and "Seeds Sown for Future Growth," *The Economist*, November 17, 2001, pp. 65–66.
19. Ibid.
20. World Trade Organization, *International Trade Trends and Statistics, 2009* (Geneva: WTO, 2009).
21. World Trade Organization, "Trade to Expand by 9.5% in 2010 after a Dismal 2009."
22. United Nations, *World Investment Report, 2009* (New York: United Nations, 2009); and "Global FFDI Flows continue to slide in 2009," UN Conference on Trade and Development press release, September 17, 2009.
23. World Trade Organization, *International Trade Trends and Statistics, 2008* (Geneva: WTO, 2008); and United Nations, *World Investment Report, 2008* (New York: United Nations, 2008).
24. United Nations, *World Investment Report, 2009*.
25. Moore's law is named after Intel founder Gordon Moore.
26. Frankel, "Globalization of the Economy."
27. J. G. Fernald and V. Greenfield, "The Fall and Rise of the Global Economy," *Chicago Fed Letters*, April 2001, pp. 1–4.
28. Data compiled from various sources and listed at www.internetworldstats.com/stats.htm.
29. From www.census.gov/mrts/www/ecommm.html, accessed May 15, 2009.
30. For a counterpoint, see "Geography and the Net: Putting It in Its Place," *The Economist*, August 11, 2001, pp. 18–20.

31. Frankel, "Globalization of the Economy."
32. Data from Bureau of Transportation Statistics, 2001.
33. Fernald and Greenfield, "The Fall and Rise of the Global Economy."
34. Data located at www.bts.gov/publications/us_international_trade_and_freight_transportation_trends/2003/index.html.
35. N. Hood and J. Young, *The Economics of the Multinational Enterprise* (New York: Longman, 1973).
36. United Nations, *World Investment Report*, 2009.
37. Ibid.
38. Ibid.
39. S. Chetty, "Explosive International Growth and Problems of Success among Small and Medium Sized Firms," *International Small Business Journal*, February 2003, pp. 5–28.
40. R. A. Mosbacher, "Opening Up Export Doors for Smaller Firms," *Seattle Times*, July 24, 1991, p. A7.
41. "Small Companies Learn How to Sell to the Japanese," *Seattle Times*, March 19, 1992.
42. Holstein, "Why Johann Can Export, but Johnny Can't."
43. N. Buckley and A. Ostrovsky, "Back to Business—How Putin's Allies Are Turning Russia into a Corporate State," *Financial Times*, June 19, 2006, p. 11.
44. J. E. Stiglitz, *Globalization and Its Discontents* (New York: W. W. Norton, 2003); J. Bhagwati, *In Defense of Globalization* (New York: Oxford University Press, 2004); and Friedman, *The World Is Flat*.
45. See, for example, Ravi Batra, *The Myth of Free Trade* (New York: Touchstone Books, 1993); William Greider, *One World, Ready or Not: The Manic Logic of Global Capitalism* (New York: Simon and Schuster, 1997); and D. Radrik, *Has Globalization Gone Too Far?* (Washington, DC: Institution for International Economics, 1997).
46. James Goldsmith, "The Winners and the Losers," in *The Case against the Global Economy*, eds. J. Mander and E. Goldsmith (San Francisco: Sierra Club, 1996); and Lou Dobbs, *Exporting America* (New York: Time Warner Books, 2004).
47. For an excellent summary, see "The Globalization of Labor," in *World Economic Outlook 2007* (Washington, DC: International Monetary Fund, April 2007), chap. 5. Also see R. Freeman, "Labor Market Imbalances," Harvard University Working Paper, www.bos.frb.org/economic/conf/conf51/papers/freeman.pdf, accessed June 14, 2007.
48. D. L. Bartlett and J. B. Steele, "America: Who Stole the Dream," *Philadelphia Inquirer*, September 9, 1996.
49. For example, see Paul Krugman, *Pop Internationalism* (Cambridge, MA: MIT Press, 1996).
50. For example, see B. Milanovic and L. Squire, "Does Tariff Liberalization Increase Wage Inequality?" *National Bureau of Economic Research Working Paper Series*, working paper no. 11046, January 2005; and B. Milanovic, "Can We Discern the Effect of Globalization on Income Distribution?" *World Bank Economic Review* 19 (2005), pp. 21–44. Also see the summary in "The Globalization of Labor."
51. Jared Bernstein, Elizabeth C. McNichol, Lawrence Mishel, and Robert Zahradnik, "Pulling Apart: A State by State Analysis of Income Trends," *Economic Policy Institute*, January 2000.
52. See "The Globalization of Labor."
53. M. Forster and M. Pearson, "Income Distribution and Poverty in the OECD Area," *OECD Economic Studies* 34 (2002).
54. Bernstein et al., "Pulling Apart."
55. See "The Globalization of Labor."
56. See Krugman, *Pop Internationalism*; and D. Belman and T. M. Lee, "International Trade and the Performance of U.S. Labor Markets," in *U.S. Trade Policy and Global Growth*, ed. R. A. Blecker (New York: Economic Policy Institute, 1996).
57. Freeman, "Labor Market Imbalances."
58. E. Goldsmith, "Global Trade and the Environment," in *The Case against the Global Economy*, eds. J. Mander and E. Goldsmith (San Francisco: Sierra Club, 1996).
59. P. Choate, *Jobs at Risk: Vulnerable U.S. Industries and Jobs under NAFTA* (Washington, DC: Manufacturing Policy Project, 1993).
60. Ibid.
61. B. Lomborg, *The Skeptical Environmentalist* (Cambridge: Cambridge University Press, 2001).
62. H. Nordstrom and S. Vaughan, *Trade and the Environment, World Trade Organization Special Studies No. 4* (Geneva: WTO, 1999).
63. Figures are from "Freedom's Journey: A Survey of the 20th Century. Our Durable Planet," *The Economist*, September 11, 1999, p. 30.
64. For an exhaustive review of the empirical literature, see B. R. Copeland and M. Scott Taylor, "Trade, Growth and the Environment," *Journal of Economic Literature*, March 2004, pp. 7–77.
65. G. M. Grossman and A. B. Krueger, "Economic Growth and the Environment," *Quarterly Journal of Economics* 110 (1995), pp. 353–78.
66. Krugman, *Pop Internationalism*.

67. R. Kuttner, "Managed Trade and Economic Sovereignty," in *U.S. Trade Policy and Global Growth*, ed. R. A. Blecker (New York: Economic Policy Institute, 1996).
68. Ralph Nader and Lori Wallach, "GATT, NAFTA, and the Subversion of the Democratic Process," in *U.S. Trade Policy and Global Growth*, ed. R. A. Blecker (New York: Economic Policy Institute, 1996), pp. 93–94.
69. Lant Pritchett, "Divergence, Big Time," *Journal of Economic Perspectives* 11, no. 3 (Summer 1997), pp. 3–18.
70. Ibid.
71. W. Easterly, "How Did Heavily Indebted Poor Countries Become Heavily Indebted?" *World Development*, October 2002, pp. 1677–96; and J. Sachs, *The End of Poverty* (New York: Penguin Books, 2006).
72. See D. Ben-David, H. Nordstrom, and L. A. Winters, *Trade, Income Disparity and Poverty. World Trade Organization Special Studies No. 5* (Geneva: WTO, 1999).
73. William Easterly, "Debt Relief," *Foreign Policy*, November–December 2001, pp. 20–26.
74. Jeffrey Sachs, "Sachs on Development: Helping the World's Poorest," *The Economist*, August 14, 1999, pp. 17–20.
75. World Trade Organization, *Annual Report 2003* (Geneva: WTO, 2004).
7. For a detailed but accessible elaboration of this argument, see Friedman and Friedman, *Free to Choose*. Also see P. M. Romer, "The Origins of Endogenous Growth," *Journal of Economic Perspectives* 8, no. 1 (1994), pp. 2–32.
8. T. W. Lippman, *Understanding Islam* (New York: Meridian Books, 1995).
9. "Islam's Interest," *The Economist*, January 18, 1992, pp. 33–34.
10. M. El Qorchi, "Islamic Finance Gears Up," *Finance and Development*, December 2005, pp. 46–50; and S. Timewell, "Islamic Finance—Virtual Concept to Critical Mass," *The Banker*, March, 2008, pp. 10–16.
11. This information can be found on the UN's Treaty Web site at <http://untreaty.un.org/ENGLISH/bible/englishinternetbible/partI/chapterX/treaty17.asp>.
12. International Court of Arbitration, www.iccwbo.org/index_court.asp.
13. D. North, *Institutions, Institutional Change, and Economic Performance* (Cambridge: Cambridge University Press, 1991).
14. "China's Next Revolution," *The Economist*, March 10, 2007, p. 9.
15. P. Klebnikov, "Russia's Robber Barons," *Forbes*, November 21, 1994, pp. 74–84; C. Mellow, "Russia: Making Cash from Chaos," *Fortune*, April 17, 1995, pp. 145–51; and "Mr Tatum Checks Out," *The Economist*, November 9, 1996, p. 78.
16. K. van Wolferen, *The Enigma of Japanese Power* (New York: Vintage Books, 1990), pp. 100–5.
17. P. Bardhan, "Corruption and Development: A Review of the Issues," *Journal of Economic Literature*, September 1997, pp. 1320–46.
18. K. M. Murphy, A. Shleifer, and R. Vishny, "Why Is Rent Seeking So Costly to Growth?" *American Economic Review* 83, no. 2 (1993), pp. 409–14.
19. Transparency International, "Global Corruption Report, 2009," www.transparency.org, 2009.
20. www.transparency.org.
21. J. Coolidge and S. Rose Ackerman, "High Level Rent Seeking and Corruption in African Regimes," World Bank policy research working paper no. 1780, June 1997; Murphy et al., "Why Is Rent Seeking So Costly to Growth?"; M. Habib and L. Zurawicki, "Corruption and Foreign Direct Investment," *Journal of International Business Studies* 33 (2002), pp. 291–307; J. E. Anderson and D. Marcouiller, "Insecurity and the Pattern of International Trade," *Review of Economics and Statistics* 84 (2002), pp. 342–52; T. S. Aidt, "Economic Analysis of Corruption: A Survey," *The Economic Journal* 113 (November 2003), pp. 632–53;

Chapter 2

1. Although as we shall see, there is not a strict one-to-one correspondence between political systems and economic systems. A. O. Hirschman, "The On-and-Off Again Connection between Political and Economic Progress," *American Economic Review* 84, no. 2 (1994), pp. 343–48.
2. For a discussion of the roots of collectivism and individualism, see H. W. Spiegel, *The Growth of Economic Thought* (Durham, NC: Duke University Press, 1991). A discussion of collectivism and individualism can be found in M. Friedman and R. Friedman, *Free to Choose* (London: Penguin Books, 1980).
3. For a classic summary of the tenets of Marxism details, see A. Giddens, *Capitalism and Modern Social Theory* (Cambridge: Cambridge University Press, 1971).
4. J. S. Mill, *On Liberty* (London: Longman's, 1865), p. 6.
5. A. Smith, *The Wealth of Nations, Vol. 1* (London: Penguin Books), p. 325.
6. R. Wesson, *Modern Government—Democracy and Authoritarianism*, 2nd ed. (Englewood Cliffs, NJ: Prentice Hall, 1990).

- and D. A. Houston, "Can Corruption Ever Improve an Economy?" *Cato Institute* 27 (2007), pp. 325–43.
22. Details can be found at [www.oecd.org/EN/home/0, EN-home-31-nodirectorate-no-nono-31,00.html](http://www.oecd.org/EN/home/0,EN-home-31-nodirectorate-no-nono-31,00.html).
 23. Dale Stackhouse and Kenneth Ungar, "The Foreign Corrupt Practices Act: Bribery, Corruption, Record Keeping and More," *Indiana Lawyer*, April 21, 1993.
 24. For an interesting discussion of strategies for dealing with the low cost of copying and distributing digital information, see the chapter on rights management in C. Shapiro and H. R. Varian, *Information Rules* (Boston: Harvard Business School Press, 1999). Also see Charles W. L. Hill, "Digital Piracy," *Asian Pacific Journal of Management*, 2007.
 25. Douglass North has argued that the correct specification of intellectual property rights is one factor that lowers the cost of doing business and, thereby, stimulates economic growth and development. See North, *Institutions, Institutional Change, and Economic Performance*.
 26. International Federation of the Phonographic Industry, *The Commercial Music Industry Global Piracy Report, 2005*, www.ifpi.org.
 27. Business Software Alliance, "Sixth Annual BSA and IDC Global Software Piracy Study," May 2009, www.bsa.org, accessed April 5, 2010.
 28. Ibid.
 29. "Trade Tripwires," *The Economist*, August 27, 1994, p. 61.
 30. World Bank, "World Development Indicators Online, 2010."
 31. A. Sen, *Development as Freedom* (New York: Alfred A. Knopf, 1999).
 32. G. M. Grossman and E. Helpman, "Endogenous Innovation in the Theory of Growth," *Journal of Economic Perspectives* 8, no. 1 (1994), pp. 23–44; and Romer, "The Origins of Endogenous Growth."
 33. W. W. Lewis, *The Power of Productivity* (Chicago: University of Chicago Press, 2004).
 34. F. A. Hayek, *The Fatal Conceit: Errors of Socialism* (Chicago: University of Chicago Press, 1989).
 35. James Gwartney, Robert Lawson, and Walter Block, *Economic Freedom of the World: 1975–1995* (London: Institute of Economic Affairs, 1996).
 36. North, *Institutions, Institutional Change, and Economic Performance*. See also Murphy et al., "Why Is Rent Seeking So Costly to Growth?"; and K. E. Maskus, "Intellectual Property Rights in the Global Economy," *Institute for International Economics*, 2000.
 37. Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000).
 38. Hirschman, "The On-and-Off Again Connection between Political and Economic Progress"; and A. Przeworski and F. Limongi, "Political Regimes and Economic Growth," *Journal of Economic Perspectives* 7, no. 3 (1993), pp. 51–59.
 39. Ibid.
 40. For details of this argument, see M. Olson, "Dictatorship, Democracy, and Development," *American Political Science Review*, September 1993.
 41. For example, see Jarad Diamond's Pulitzer Prize-winning book, *Guns, Germs, and Steel* (New York: W. W. Norton, 1997). Also see J. Sachs, "Nature, Nurture and Growth," *The Economist*, June 14, 1997, pp. 19–22; and J. Sachs, *The End of Poverty* (New York: Penguin Books, 2005).
 42. Sachs, "Nature, Nurture and Growth."
 43. "What Can the Rest of the World Learn from the Classrooms of Asia?" *The Economist*, September 21, 1996, p. 24.
 44. J. Fagerberg, "Technology and International Differences in Growth Rates," *Journal of Economic Literature* 32 (September 1994), pp. 1147–75.
 45. See The Freedom House Survey Team, "Freedom in the World: 2010" and associated materials, www.freedomhouse.org.
 46. "Russia Downgraded to Not Free," Freedom House press release, December 20, 2004, www.freedomhouse.org.
 47. Freedom House, "Democracies Century: A Survey of Political Change in the Twentieth Century, 1999," www.freedomhouse.org.
 48. L. Conners, "Freedom to Connect," *Wired*, August 1997, pp. 105–6.
 49. F. Fukuyama, "The End of History," *The National Interest* 16 (Summer 1989), p. 18.
 50. S. P. Huntington, *The Clash of Civilizations and the Remaking of World Order* (New York: Simon & Schuster, 1996).
 51. Ibid., p. 116.
 52. United States Department of State, "Country Reports on Terrorism, 2008," archived at www.state.gov/s/ct/rls/crt/2007/103716.htm, accessed April 5, 2010.
 53. United States National Counterterrorism Center, "Reports on Incidents of Terrorism, 2005," April 11, 2006.
 54. S. Fisher, R. Sahay, and C. A. Vegh, "Stabilization and the Growth in Transition Economies: the Early

- Experience,” *Journal of Economic Perspectives* 10 (Spring 1996), pp. 45–66.
55. M. Miles et al., *2010 Index of Economic Freedom* (Washington, DC: Heritage Foundation, 2010).
 56. International Monetary Fund, *World Economic Outlook: Focus on Transition Economies* (Geneva: IMF, October 2000).
 57. J. C. Brada, “Privatization Is Transition—Is It?” *Journal of Economic Perspectives*, Spring 1996, pp. 67–86.
 58. See S. Zahra et al., “Privatization and Entrepreneurial Transformation,” *Academy of Management Review* 3, no. 25 (2000), pp. 509–24.
 59. N. Brune, G. Garrett, and B. Kogut, “The International Monetary Fund and the Global Spread of Privatization,” *IMF Staff Papers* 51, no. 2 (2003), pp. 195–219.
 60. Fischer et al., “Stabilization and the Growth in Transition Economies.”
 61. J. Sachs, C. Zinnes, and Y. Eilat, “The Gains from Privatization in Transition Economies: Is Change of Ownership Enough?” CAER discussion paper no. 63 (Cambridge, MA: Harvard Institute for International Development, 2000).
 62. J. Nellis, “Time to Rethink Privatization in Transition Economies?” *Finance and Development* 36, no. 2 (1999), pp. 16–19.
 63. M. S. Borish and M. Noel, “Private Sector Development in the Visegrad Countries,” *World Bank*, March 1997.
 64. “Caught between Right and Left, Town and Country,” *The Economist*, March 10, 2007, pp. 23–24.
 65. For a discussion of first-mover advantages, see M. Liberman and D. Montgomery, “First-Mover Advantages,” *Strategic Management Journal* 9 (Summer Special Issue, 1988), pp. 41–58.
 66. S. H. Robock, “Political Risk: Identification and Assessment,” *Columbia Journal of World Business*, July–August 1971, pp. 6–20.
 5. Geert Hofstede, *Culture’s Consequences: International Differences in Work-Related Values* (Beverly Hills, CA: Sage Publications, 1984), p. 21.
 6. J. Z. Namenwirth and R. B. Weber, *Dynamics of Culture* (Boston: Allen & Unwin, 1987), p. 8.
 7. R. Mead, *International Management: Cross-Cultural Dimensions* (Oxford: Blackwell Business, 1994), p. 7.
 8. Edward T. Hall and M. R. Hall, *Understanding Cultural Differences* (Yarmouth, ME: Intercultural Press, 1990).
 9. Edward T. Hall and M. R. Hall, *Hidden Differences: Doing Business with the Japanese* (New York: Doubleday, 1987).
 10. “Iraq: Down but Not Out,” *The Economist*, April 8, 1995, pp. 21–23.
 11. S. P. Huntington, *The Clash of Civilizations* (New York: Simon & Schuster, 1996).
 12. M. Thompson, R. Ellis, and A. Wildavsky, *Cultural Theory* (Boulder, CO: Westview Press, 1990).
 13. M. Douglas, *In the Active Voice* (London: Routledge, 1982), pp. 183–254.
 14. M. L. Dertouzos, R. K. Lester, and R. M. Solow, *Made in America* (Cambridge, MA: MIT Press, 1989).
 15. C. Nakane, *Japanese Society* (Berkeley: University of California Press, 1970).
 16. Ibid.
 17. For details, see M. Aoki, *Information, Incentives, and Bargaining in the Japanese Economy* (Cambridge: Cambridge University Press, 1988); and Dertouzos et al., *Made in America*.
 18. E. Luce, *The Strange Rise of Modern India* (Boston: Little Brown, 2006); and D. Pick and K. Dayaram, “Modernity and Tradition in the Global Era: The Re-invention of Caste in India,” *International Journal of Sociology and Social Policy* 26, no. 7/8 (2006), pp. 284–301.
 19. For an excellent historical treatment of the evolution of the English class system, see E. P. Thompson, *The Making of the English Working Class* (London: Vintage Books, 1966). See also R. Miliband, *The State in Capitalist Society* (New York: Basic Books, 1969), especially Chapter 2. For more recent studies of class in British societies, see Stephen Brook, *Class: Knowing Your Place in Modern Britain* (London: Victor Gollancz, 1997); A. Adonis and S. Pollard, *A Class Act: The Myth of Britain’s Classless Society* (London: Hamish Hamilton, 1997); and J. Gerteis and M. Savage, “The Salience of Class in Britain and America: A Comparative Analysis,” *British Journal of Sociology*, June 1998.
 20. Adonis and Pollard, *A Class Act*.

Chapter 3

1. Mary Yoko Brannen, “When Mickey Loses Face: Re-contextualization, Semantic Fit, and the Semiotics of Foreignness,” *Academy of Management Review* 29, no. 4 (2004), pp. 593–616.
2. See R. Dore, *Taking Japan Seriously* (Stanford, CA: Stanford University Press, 1987).
3. Data come from J. Monger, “International Comparison of Labor Disputes in 2004,” *Labor Market Trends*, April 2006, pp. 117–28.
4. E. B. Tylor, *Primitive Culture* (London: Murray, 1871).

21. Y. Bian, "Chinese Social Stratification and Social Mobility," *Annual Review of Sociology* 28 (2002), pp. 91–117.
22. N. Goodman, *An Introduction to Sociology* (New York: HarperCollins, 1991).
23. R. J. Barro and R. McCleary, "Religion and Economic Growth across Countries," *American Sociological Review*, October 2003, pp. 760–82.
24. M. Weber, *The Protestant Ethic and the Spirit of Capitalism* (New York: Charles Scribner's Sons, 1958, original 1904–1905). For an excellent review of Weber's work, see A. Giddens, *Capitalism and Modern Social Theory* (Cambridge: Cambridge University Press, 1971).
25. Weber, *The Protestant Ethic and the Spirit of Capitalism*, p. 35.
26. A. S. Thomas and S. L. Mueller, "The Case for Comparative Entrepreneurship," *Journal of International Business Studies* 31, no. 2 (2000), pp. 287–302; and S. A. Shane, "Why Do Some Societies Invent More than Others?" *Journal of Business Venturing* 7 (1992), pp. 29–46.
27. See S. M. Abbasi, K. W. Hollman, and J. H. Murrey, "Islamic Economics: Foundations and Practices," *International Journal of Social Economics* 16, no. 5 (1990), pp. 5–17; and R. H. Dekmejian, *Islam in Revolution: Fundamentalism in the Arab World* (Syracuse, NY: Syracuse University Press, 1995).
28. T. W. Lippman, *Understanding Islam* (New York: Meridian Books, 1995).
29. Dekmejian, *Islam in Revolution*.
30. M. K. Nydell, *Understanding Arabs* (Yarmouth, ME: Intercultural Press, 1987).
31. Lippman, *Understanding Islam*.
32. The material in this section is based largely on Abbasi et al., "Islamic Economics."
33. "Islamic Finance: Calling the Faithful," *The Economist*, December 9, 2006, pp. 77–78; and "Savings and Souls," *The Economist*, September 6, 2008, pp. 81–83.
34. "Forced Devotion," *The Economist*, February 17, 2001, pp. 76–77.
35. For details of Weber's work and views, see Giddens, *Capitalism and Modern Social Theory*.
36. See, for example, the views expressed in "A Survey of India: The Tiger Steps Out," *The Economist*, January 21, 1995.
37. See R. Dore, *Taking Japan Seriously*; and C. W. L. Hill, "Transaction Cost Economizing as a Source of Comparative Advantage: The Case of Japan," *Organization Science* 6 (1995).
38. C. C. Chen, Y. R. Chen, and K. Xin, "Guanxi Practices and Trust in Management," *Organization Science* 15, no. 2 (March–April 2004), pp. 200–10.
39. See Aoki, *Information, Incentives, and Bargaining*; and J. P. Womack, D. T. Jones, and D. Roos, *The Machine That Changed the World* (New York: Rawson Associates, 1990).
40. For examples of this line of thinking, see M. W. Peng and P. S. Heath, "The Growth of the Firm in Planned Economies in Transition," *Academy of Management Review* 21 (1996), pp. 492–528; M. W. Peng, *Business Strategies in Transition Economies* (Thousand Oaks, CA: Sage, 2000); and M. W. Peng and Y. Luo, "Managerial Ties and Firm Performance in a Transition Economy," *Academy of Management Journal*, June 2000, pp. 486–501.
41. This hypothesis dates back to two anthropologists, Edward Sapir and Benjamin Lee Whorf. See E. Sapir, "The Status of Linguistics as a Science," *Language* 5 (1929), pp. 207–14; and B. L. Whorf, *Language, Thought, and Reality* (Cambridge, MA: MIT Press, 1956).
42. The tendency has been documented empirically. See A. Annett, "Social Fractionalization, Political Instability, and the Size of Government," *IMF Staff Papers* 48 (2001), pp. 561–92.
43. D. A. Ricks, *Big Business Blunders: Mistakes in Multinational Marketing* (Homewood, IL: Dow Jones-Irwin, 1983).
44. Goodman, *An Introduction to Sociology*.
45. M. E. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990).
46. *Ibid.*, pp. 395–97.
47. G. Hofstede, "The Cultural Relativity of Organizational Practices and Theories," *Journal of International Business Studies*, Fall 1983, pp. 75–89; and G. Hofstede, *Cultures and Organizations: Software of the Mind* (New York: McGraw-Hill, 1997).
48. For a more detailed critique, see R. Mead, *International Management: Cross-Cultural Dimensions* (Oxford: Blackwell, 1994), pp. 73–75.
49. For example, see W. J. Bigoness and G. L. Blakely, "A Cross-National Study of Managerial Values," *Journal of International Business Studies*, December 1996, p. 739; D. H. Ralston, D. H. Holt, R. H. Terpstra, and Y. Kai-Cheng, "The Impact of National Culture and Economic Ideology on Managerial Work Values," *Journal of International Business Studies* 28, no. 1 (1997), pp. 177–208; P. B. Smith, M. F. Peterson, and Z. Ming Wang, "The Manager as a Mediator of Alternative Meanings," *Journal of International Business Studies* 27, no. 1 (1996), pp. 115–37; and L. Tang and P. E. Koves, "A Framework to Update Hofstede's

- Cultural Value Indices,” *Journal of International Business Studies* 39 (2008), pp. 1045–63.
50. G. Hofstede and M. H. Bond, “The Confucius Connection,” *Organizational Dynamics* 16, no. 4 (1988), pp. 5–12; and G. Hofstede, *Culture’s Consequences: Comparing Values, Behaviors, Institutions and Organizations across Nations* (Thousand Oaks, CA: Sage, 2001).
 51. R. S. Yeh and J. J. Lawrence, “Individualism and Confucian Dynamism,” *Journal of International Business Studies* 26, no. 3 (1995), pp. 655–66.
 52. For evidence of this, see R. Inglehart, “Globalization and Postmodern Values,” *The Washington Quarterly*, Winter 2000, pp. 215–28.
 53. Mead, *International Management*, chap. 17.
 54. “Free, Young, and Japanese,” *The Economist*, December 21, 1991.
 55. Namenwirth and Weber, *Dynamics of Culture*; and Inglehart, “Globalization and Postmodern Values.”
 56. G. Hofstede, “National Cultures in Four Dimensions,” *International Studies of Management and Organization* 13, no. 1, pp. 46–74; and Tang and Koves, “A Framework to Update Hofstede’s Cultural Value Indices.”
 57. See Inglehart, “Globalization and Postmodern-Values.” For updates, go to <http://wvs.isr.umich.edu/index.html>.
 58. Hofstede, “National Cultures in Four Dimensions.”
 59. Hall and Hall, *Understanding Cultural Differences*.
 60. See Aoki, *Information, Incentives, and Bargaining*; Dertouzos et al., *Made in America*; and Porter, *The Competitive Advantage of Nations*, pp. 395–97.
 61. For empirical work supporting such a view, see Annett, “Social Fractionalization, Political Instability, and the Size of Government.”
- Chapter 4**
1. S. Greenhouse, “Nike Shoe Plant in Vietnam Is Called Unsafe for Workers,” *The New York Times*, November 8, 1997; and V. Dobnik, “Chinese Workers Abused Making Nikes, Reeboks,” *Seattle Times*, September 21, 1997, p. A4.
 2. Thomas Donaldson, “Values in Tension: Ethics Away from Home,” *Harvard Business Review*, September–October 1996.
 3. Robert Kinloch Massie, *Loosing the Bonds: The United States and South Africa in the Apartheid Years* (New York: Doubleday, 1997).
 4. Not everyone agrees that the divestment trend had much influence on the South African economy. For a counterview see Siew Hong Teoh, Ivo Welch, and C. Paul Wazzan, “The Effect of Socially Activist Investing on the Financial Markets: Evidence from South Africa,” *The Journal of Business* 72, no. 1 (January 1999), pp. 35–60.
 5. Andy Rowell, “Trouble Flares in the Delta of Death; Shell Has Polluted More Than Ken Saro Wiwa’s Oroniland in Nigeria,” *The Guardian*, November 8, 1995, p. 6.
 6. H. Hamilton, “Shell’s New World Wide View,” *Washington Post*, August 2, 1998, p. H1.
 7. Rowell, “Trouble Flares in the Delta of Death.”
 8. Peter Singer, *One World: The Ethics of Globalization*. (New Haven, CT: Yale University Press, 2002).
 9. Garrett Hardin, “The Tragedy of the Commons,” *Science* 162, no. 1 (1968), pp. 1243–48.
 10. For a summary of the evidence see S. Solomon, D. Qin, M. Manning, Z. Chen, M. Marquis, K. B. Avery, M. Tignor, and H. L. Miller, eds., *Contribution of Working Group I to the Fourth Assessment Report of the Intergovernmental Panel on Climate Change* (Cambridge: Cambridge University Press, 2007).
 11. J. Everett, D. Neu, and A. S. Rahaman, “The Global Fight Against Corruption,” *Journal of Business Ethics* 65 (2006), pp. 1–18.
 12. Richard T. De George, *Competing with Integrity in International Business* (Oxford: Oxford University Press, 1993).
 13. Details can be found at www.oecd.org/EN/home/0,,EN-home-31-nodirectorate-no-nono-31,00.html.
 14. Bardhan Pranab, “Corruption and Development,” *Journal of Economic Literature* 36 (September 1997), pp. 1320–46.
 15. A. Shleifer and R. W. Vishny, “Corruption,” *Quarterly Journal of Economics*, no. 108 (1993), pp. 599–617; and I. Ehrlich and F. Lui, “Bureaucratic Corruption and Endogenous Economic Growth,” *Journal of Political Economy* 107 (December 1999), pp. 270–92.
 16. P. Mauro, “Corruption and Growth,” *Quarterly Journal of Economics*, no. 110 (1995), pp. 681–712.
 17. Detailed at [www.iit.edu/departments/csep/PublicWWW/codes/coe/Bus_Conduct_Dow_Corning\(1996\).html](http://www.iit.edu/departments/csep/PublicWWW/codes/coe/Bus_Conduct_Dow_Corning(1996).html).
 18. S. A. Waddock and S. B. Graves, “The Corporate Social Performance-Financial Performance Link,” *Strategic Management Journal* 8 (1997), pp. 303–19.
 19. Daniel Litvin, *Empires of Profit* (New York: Texere, 2003).
 20. Details can be found at BP’s Web site, www.bp.com.
 21. This is known as the “when in Rome perspective.” Donaldson, “Values in Tension: Ethics Away from Home.”

22. De George, *Competing with Integrity in International Business*.
23. For a discussion of the ethics of using child labor, see J. Isern, "Bittersweet Chocolate: The Legacy of Child Labor in Cocoa Production in Cote d'Ivoire," *Journal of Applied Management and Entrepreneurship* 11 (2006), pp. 115–32.
24. Saul W. Gellerman, "Why Good Managers Make Bad Ethical Choices," in *Ethics in Practice: Managing the Moral Corporation*, ed. Kenneth R. Andrews (Cambridge, MA: Harvard Business School Press, 1989).
25. David Messick and Max H. Bazerman, "Ethical Leadership and the Psychology of Decision Making," *Sloan Management Review* 37 (Winter 1996), pp. 9–20.
26. Robert Bryce, *Pipe Dreams: Greed, Ego and the Death of Enron* (New York: Public Affairs, 2002).
27. Milton Friedman, "The Social Responsibility of Business Is to Increase Profits," *The New York Times Magazine*, September 13, 1970. Reprinted in Tom L. Beauchamp and Norman E. Bowie, *Ethical Theory and Business*, 7th ed. (Upper Saddle River, NJ: Prentice Hall, 2001).
28. Friedman, "The Social Responsibility of Business Is to Increase Profits," p. 55.
29. For example, see Donaldson, "Values in Tension: Ethics Away from Home." See also Norman Bowie, "Relativism and the Moral Obligations of Multination Corporations," in Beauchamp and Bowie, *Ethical Theory and Business*.
30. For example, see De George, *Competing with Integrity in International Business*.
31. Details can be found at www.bp.com/sectiongenericarticle.do?categoryId=79&contentId=2002369#2014689.
32. This example is often repeated in the literature on international business ethics. It was first outlined by Arthur Kelly in "Case Study—Italian Style Mores." Printed in Thomas Donaldson and Patricia Werhane, *Ethical Issues in Business* (Englewood Cliffs, NJ: Prentice Hall, 1979).
33. See Beauchamp and Bowie, *Ethical Theory and Business*.
34. Thomas Donaldson, *The Ethics of International Business* (Oxford: Oxford University Press, 1989).
35. Found at www.un.org/Overview/rights.html.
36. Donaldson, *The Ethics of International Business*.
37. See Chapter 10 in Beauchamp and Bowie, *Ethical Theory and Business*.
38. John Rawls, *A Theory of Justice*, rev. ed. (Cambridge, MA: Belknap Press, 1999).
39. Found on Unilever's Web site at www.unilever.com/company/ourprinciples/.
40. Joseph Bower and Jay Dial, "Jack Welch: General Electric's Revolutionary," Harvard Business School Case, Case #9-394-065, April 1994.
41. For example, see R. Edward Freeman and Daniel Gilbert, *Corporate Strategy and the Search for Ethics* (Englewood Cliffs, NJ: Prentice Hall, 1988); Thomas Jones, "Ethical Decision Making by Individuals in Organizations," *Academy of Management Review* 16 (1991), pp. 366–95; and J. R. Rest, *Moral Development: Advances in Research and Theory* (New York: Praeger, 1986).
42. Ibid.
43. See E. Freeman, *Strategic Management: A Stakeholder Approach* (Boston: Pitman Press, 1984); C. W. L. Hill and T. M. Jones, "Stakeholder-Agency Theory," *Journal of Management Studies* 29 (1992), pp. 131–54; and J. G. March and H. A. Simon, *Organizations* (New York: John Wiley & Sons, Inc., 1958).
44. Hill and Jones, "Stakeholder-Agency Theory," and March and Simon, *Organizations*.
45. De George, *Competing with Integrity in International Business*.
46. The code can be accessed at United Technologies Web site, www.utc.com/profile/ethics/index.htm.
47. Colin Grant, "Whistle Blowers: Saints of Secular Culture," *Journal of Business Ethics*, September 2002, pp. 391–400.
48. Found on Unilever's Web site, www.unilever.com/company/ourprinciples/.

Chapter 5

1. H. W. Spiegel, *The Growth of Economic Thought* (Durham, NC: Duke University Press, 1991).
2. M. Solis, "The Politics of Self-Restraint: FDI Subsidies and Japanese Mercantilism," *The World Economy* 26 (February 2003), pp. 153–70.
3. S. Hollander, *The Economics of David Ricardo* (Buffalo: The University of Toronto Press, 1979).
4. D. Ricardo, *The Principles of Political Economy and Taxation* (Homewood, IL: Irwin, 1967, first published in 1817).
5. For example, R. Dornbusch, S. Fischer, and P. Samuelson, "Comparative Advantage: Trade and Payments in a Ricardian Model with a Continuum of Goods," *American Economic Review* 67 (December 1977), pp. 823–39.
6. B. Balassa, "An Empirical Demonstration of Classic Comparative Cost Theory," *Review of Economics and Statistics*, 1963, pp. 231–38.
7. See P. R. Krugman, "Is Free Trade Passé?" *Journal of Economic Perspectives* 1 (Fall 1987), pp. 131–44.

8. P. Samuelson, "Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting Globalization," *Journal of Economic Perspectives* 18, no. 3 (Summer 2004), pp. 135–46.
9. P. Samuelson, "The Gains from International Trade Once Again," *Economic Journal* 72 (1962), pp. 820–29.
10. S. Lohr, "An Elder Challenges Outsourcing's Orthodoxy," *The New York Times*, September 9, 2004, p. C1.
11. Samuelson, "Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting Globalization," p. 143.
12. See A. Dixit and G. Grossman, "Samuelson Says Nothing About Trade Policy," Princeton University, 2004, accessed from <http://www.princeton.edu/~dixitak/home/>.
13. J. Bhagwati, A. Panagariya, and T. N. Sirinivasan, "The Muddles over Outsourcing," *Journal of Economic Perspectives* 18, no. 4 (Fall 2004), pp. 93–114.
14. For example, J. D. Sachs and A. Warner, "Economic Reform and the Process of Global Integration," *Brookings Papers on Economic Activity*, 1995, pp. 1–96; J. A. Frankel and D. Romer, "Does Trade Cause Growth?" *American Economic Review* 89, no. 3 (June 1999), pp. 379–99; and D. Dollar and A. Kraay, "Trade, Growth and Poverty," Working Paper, Development Research Group, World Bank, June 2001. Also, for an accessible discussion of the relationship between free trade and economic growth, see T. Taylor, "The Truth about Globalization," *Public Interest*, Spring 2002, pp. 24–44; and D. Acemoglu, S. Johnson, and J. Robinson, "The Rise of Europe: Atlantic Trade, Institutional Change and Economic Growth," *American Economic Review* 95, no. 3 (2005), pp. 547–79.
15. Sachs and Warner, "Economic Reform and the Process of Global Integration."
16. *Ibid.*, pp. 35–36.
17. R. Wacziarg and K. H. Welch, "Trade Liberalization and Growth: New Evidence," *National Bureau of Economic Research Working Paper Series*, working paper no. 10152, December 2003.
18. Frankel and Romer, "Does Trade Cause Growth?"
19. A recent skeptical review of the empirical work on the relationship between trade and growth questions these results. See Francisco Rodriguez and Dani Rodrik, "Trade Policy and Economic Growth: A Skeptics Guide to the Cross-National Evidence," *National Bureau of Economic Research*, working paper no. 7081, April 1999. Even these authors, however, cannot find any evidence that trade hurts economic growth or income levels.
20. B. Ohlin, *Interregional and International Trade* (Cambridge: Harvard University Press, 1933). For a summary, see R. W. Jones and J. P. Neary, "The Positive Theory of International Trade," in *Handbook of International Economics*, eds. R. W. Jones and P. B. Kenen (Amsterdam: North Holland, 1984).
21. W. Leontief, "Domestic Production and Foreign Trade: The American Capital Position Re-Examined," *Proceedings of the American Philosophical Society* 97 (1953), pp. 331–49.
22. R. M. Stern and K. Maskus, "Determinants of the Structure of U.S. Foreign Trade," *Journal of International Economics* 11 (1981), pp. 207–44.
23. See H. P. Bowen, E. E. Leamer, and L. Sveikayskas, "Multicountry, Multifactor Tests of the Factor Abundance Theory," *American Economic Review* 77 (1987), pp. 791–809.
24. D. Trefler, "The Case of the Missing Trade and Other Mysteries," *American Economic Review* 85 (December 1995), pp. 1029–46.
25. D. R. Davis and D. E. Weinstein, "An Account of Global Factor Trade," *American Economic Review*, December 2001, pp. 1423–52.
26. R. Vernon, "International Investments and International Trade in the Product Life Cycle," *Quarterly Journal of Economics*, May 1966, pp. 190–207; and R. Vernon and L. T. Wells, *The Economic Environment of International Business*, 4th ed. (Englewood Cliffs, NJ: Prentice Hall, 1986).
27. For a good summary of this literature, see E. Helpman and P. Krugman, *Market Structure and Foreign Trade: Increasing Returns, Imperfect Competition, and the International Economy* (Boston: MIT Press, 1985). Also see P. Krugman, "Does The New Trade Theory Require a New Trade Policy?" *World Economy* 15, no. 4 (1992), pp. 423–41.
28. M. B. Lieberman and D. B. Montgomery, "First-Mover Advantages," *Strategic Management Journal* 9 (Summer 1988), pp. 41–58; and W. T. Robinson and Sungwook Min, "Is the First to Market the First to Fail?" *Journal of Marketing Research* 29 (2002), pp. 120–28.
29. J. R. Tybout, "Plant and Firm Level Evidence on New Trade Theories," *National Bureau of Economic Research Working Paper Series*, working paper no. 8418, August 2001 (paper available at <http://www.nber.org>); and S. Deraniyagala and B. Fine, "New Trade Theory Versus Old Trade Policy: A Continuing Enigma," *Cambridge Journal of Economics* 25 (November 2001), pp. 809–25.
30. A. D. Chandler, *Scale and Scope* (New York: Free Press, 1990).
31. Krugman, "Does the New Trade Theory Require a New Trade Policy?"

32. M. E. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990). For a good review of this book, see R. M. Grant, "Porter's Competitive Advantage of Nations: An Assessment," *Strategic Management Journal* 12 (1991), pp. 535–48.
33. B. Kogut, ed., *Country Competitiveness: Technology and the Organizing of Work* (New York: Oxford University Press, 1993).
34. Porter, *The Competitive Advantage of Nations*, p. 121.
35. Lieberman and Montgomery, "First-Mover Advantages." See also Robinson and Min, "Is the First to Market the First to Fail?"; W. Boulding and M. Christen, "First Mover Disadvantage," *Harvard Business Review*, October 2001, pp. 20–21; and R. Agarwal and M. Gort, "First Mover Advantage and the Speed of Competitive Entry," *Journal of Law and Economics* 44 (2001), pp. 131–59.
36. C. A. Hamilton, "Building Better Machine Tools," *Journal of Commerce*, October 30, 1991, p. 8; and "Manufacturing Trouble," *The Economist*, October 12, 1991, p. 71.
37. J. W. Peters, "U.S. Trade Deficit Grew to Another Record in 06," *The New York Times*, February 14, 2007, p. 1.
38. P. Krugman, *The Age of Diminished Expectations* (Cambridge, MA: MIT Press, 1990).
39. D. Griswold, "Are Trade Deficits a Drag on U.S. Economic Growth," *Free Trade Bulletin*, March 12, 2007, Cato Institute; and O. Blanchard, "Current Account Deficits in Rich Countries," *NBER Working Paper Series*, working paper no. 12925, February 2007.
40. S. Edwards, "The U.S. Current Account Deficit: Gradual Correction or Abrupt Adjustment?" *NBER Working Paper Series*, working paper no. 12154, April 2006.
- Market," *The Economist; Survey of Agriculture and Technology*, March 25, 2000, pp. 8–10.
6. K. Anderson, W. Martin, and D. van der Mensbrugghe, "Distortions to World Trade: Impact on Agricultural Markets and Farm Incomes," *Review of Agricultural Economics* 28 (Summer 2006), pp. 168–94.
7. R. W. Crandall, *Regulating the Automobile* (Washington, DC: Brookings Institution, 1986).
8. Krugman and Obstfeld, *International Economics*.
9. G. Hufbauer and Z. A. Elliott, *Measuring the Costs of Protectionism in the United States* (Washington, DC: Institute for International Economics, 1993).
10. Bhagwati, *Protectionism*; and "Japan to Curb VCR Exports," *The New York Times*, November 21, 1983, p. D5.
11. Alan Goldstein, "Sematech Members Facing Dues Increase; 30% Jump to Make Up for Loss of Federal Funding," *Dallas Morning News*, July 27, 1996, p. 2F.
12. N. Dunne and R. Waters, "U.S. Waves a Big Stick at Chinese Pirates," *Financial Times*, January 6, 1995, p. 4.
13. B. Tomson, "U.S. Beef Heads Back to China," *Barron's*, December 26, 2005, p. M16.
14. Bill Lambrecht, "Monsanto Softens Its Stance on Labeling in Europe," *St. Louis Post-Dispatch*, March 15, 1998, p. E1.
15. Peter S. Jordan, "Country Sanctions and the International Business Community," *American Society of International Law Proceedings of the Annual Meeting* 20, no. 9 (1997), pp. 333–42.
16. "Waiting for China; Human Rights and International Trade," *Commonwealth*, March 11, 1994; and "China: The Cost of Putting Business First," *Human Rights Watch*, July 1996.
17. For a comprehensive review of the evidence, see B. R. Copeland and M. Scott Taylor, "Trade, Growth and the Environment," *Journal of Economic Literature* 42 (March 2004), pp. 7–71.
18. For accessible summaries of the issues, see T. Flannery, *The Weather Makers* (New York: Grove Press, 2005); and J. Houghton, *Global Warming: The Complete Briefing* (Cambridge: Cambridge University Press, 1994).
19. S. Solomon et al., eds., *Contribution of Working Group I to the Fourth Assessment Report of the Intergovernmental Panel on Climate Change, 2007* (Cambridge: Cambridge University Press, 2007).
20. Ibid.
21. Copeland and Taylor, "Trade, Growth and the Environment."
22. "Brazil's Auto Industry Struggles to Boost Global Competitiveness," *Journal of Commerce*, October 10, 1991, p. 6A.

Chapter 6

1. For a detailed welfare analysis of the effect of a tariff, see P. R. Krugman and M. Obstfeld, *International Economics: Theory and Policy* (New York: HarperCollins, 2000), chap. 8.
2. Y. Sazanami, S. Urata, and H. Kawai, *Measuring the Costs of Protection in Japan* (Washington, DC: Institute for International Economics, 1994).
3. J. Bhagwati, *Protectionism* (Cambridge, MA: MIT Press, 1988); and "Costs of Protection," *Journal of Commerce*, September 25, 1991, p. 8A.
4. World Trade Organization, *World Trade Report 2006* (Geneva: WTO, 2006).
5. The study was undertaken by Kym Anderson of the University of Adelaide. See "A Not So Perfect

23. For reviews, see J. A. Brander, "Rationales for Strategic Trade and Industrial Policy," in *Strategic Trade Policy and the New International Economics*, ed. P. R. Krugman (Cambridge, MA: MIT Press, 1986); P. R. Krugman, "Is Free Trade Passé?" *Journal of Economic Perspectives* 1 (1987), pp. 131–44; and P. R. Krugman, "Does the New Trade Theory Require a New Trade Policy?" *World Economy* 15, no. 4 (1992), pp. 423–41.
24. "Airbus and Boeing: The Jumbo War," *The Economist*, June 15, 1991, pp. 65–66.
25. For details see Krugman, "Is Free Trade Passé?"; and Brander, "Rationales for Strategic Trade and Industrial Policy."
26. Krugman, "Is Free Trade Passé?"
27. This dilemma is a variant of the famous prisoner's dilemma, which has become a classic metaphor for the difficulty of achieving cooperation between self-interested and mutually suspicious entities. For a good general introduction, see A. Dixit and B. Nalebuff, *Thinking Strategically: The Competitive Edge in Business, Politics, and Everyday Life* (New York: W. W. Norton & Co., 1991).
28. Note that the Smoot-Hawley Act did not cause the Great Depression. However, the beggar-thy-neighbor trade policies that it ushered in certainly made things worse. See Bhagwati, *Protectionism*.
29. Ibid.
30. World Bank, *World Development Report* (New York: Oxford University Press, 1987).
31. World Trade Organization, *World Trade Report, 2008* (Geneva: WTO, 2008).
32. Frances Williams, "WTO—New Name Heralds New Powers," *Financial Times*, December 16, 1993, p. 5; and Frances Williams, "Gatt's Successor to Be Given Real Clout," *Financial Times*, April 4, 1994, p. 6.
33. W. J. Davey, "The WTO Dispute Settlement System: The First Ten Years," *Journal of International Economic Law*, March 2005, pp. 17–28.
34. Information provided on WTO Web site, www.wto.org/english/tratop_e/dispu_e/dispu_status_e.htm.
35. Frances Williams, "Telecoms: World Pact Set to Slash Costs of Calls," *Financial Times*, February 17, 1997.
36. G. De Jonquieres, "Happy End to a Cliff Hanger," *Financial Times*, December 15, 1997, p. 15.
37. Jim Carlton, "Greens Target WTO Plan for Lumber," *The Wall Street Journal*, November 24, 1999, p. A2.
38. Kari Huus, "WTO Summit Leaves Only Discontent," MSNBC, December 3, 1999, www.msnbc.com.
39. Data at www.wto.org/english/tratop_e/adp_e/adp_e.htm.
40. *Annual Report by the Director General 2003* (Geneva: World Trade Organization, 2003).
41. Ibid.
42. Ibid.
43. Anderson, Martin, and van der Mensbrugghe, "Distortions to World Trade: Impact on Agricultural Markets and Farm Incomes."
44. World Trade Organization, *Annual Report 2002* (Geneva: WTO, 2002).
45. A. Tanzer, "Pill Factory to the World," *Forbes*, December 10, 2001, pp. 70–72.
46. S. C. Bradford, P. L. E. Grieco, and G. C. Hufbauer, "The Payoff to America from Global Integration," in *The United States and the World Economy: Foreign Policy for the Next Decade*, ed. C. F. Bergsten (Washington, DC: Institute for International Economics, 2005).
47. World Bank, *Global Economic Prospects 2005* (Washington, DC: World Bank, 2005).
48. "Doha Development Agenda," *OECD Observer*, September 2006, pp. 64–67.
49. W. Vieth, "Major Concessions Lead to Success for WTO Talks," *Los Angeles Times*, November 14, 2001, p. A1; and "Seeds Sown for Future Growth," *The Economist*, November 17, 2001, pp. 65–66.
50. "The WTO under Fire—The Doha Round," *The Economist*, September 20, 2003, pp. 30–32.
51. "Punitive Tariffs Are Approved on Imports of Japanese Steel," *The New York Times*, June 12, 1999, p. A3.

Chapter 7

1. United Nations, *World Investment Report, 2009* (New York and Geneva: United Nations, 2009).
2. Ibid.; and "Global FFDI Flows Continue to Slide in 2009," UN Conference on Trade and Development press release, September 17, 2009.
3. World Trade Organization, *International Trade Statistics, 2008* (Geneva: WTO, 2008); and United Nations, *World Investment Report, 2008* (New York and Geneva: United Nations, 2008).
4. United Nations, *World Investment Report, 2009*.
5. Ibid.
6. Ibid.
7. Ibid.
8. Ibid.
9. Ibid.
10. Ibid.
11. Ibid.

12. See D. J. Ravenscraft and F. M. Scherer, *Mergers, Sell-offs and Economic Efficiency* (Washington, DC: The Brookings Institution, 1987); and A. Seth, K. P. Song, and R. R. Pettit, "Value Creation and Destruction in Cross-Border Acquisitions," *Strategic Management Journal* 23 (2002), pp. 921–40.
13. For example, see S. H. Hymer, *The International Operations of National Firms: A Study of Direct Foreign Investment* (Cambridge, MA: MIT Press, 1976); A. M. Rugman, *Inside the Multinationals: The Economics of Internal Markets* (New York: Columbia University Press, 1981); D. J. Teece, "Multinational Enterprise, Internal Governance, and Industrial Organization," *American Economic Review* 75 (May 1983), pp. 233–38; C. W. L. Hill and W. C. Kim, "Searching for a Dynamic Theory of the Multinational Enterprise: A Transaction Cost Model," *Strategic Management Journal* 9 (special issue, 1988), pp. 93–104; A. Verbeke, "The Evolutionary View of the MNE and the Future of Internalization Theory," *Journal of International Business Studies* 34 (2003), pp. 498–501; and J. H. Dunning, "Some Antecedents of Internalization Theory," *Journal of International Business Studies* 34 (2003), pp. 108–28.
14. J. P. Womack, D. T. Jones, and D. Roos, *The Machine that Changed the World* (New York: Rawson Associates, 1990).
15. The argument is most often associated with F. T. Knickerbocker, *Oligopolistic Reaction and Multinational Enterprise* (Boston: Harvard Business School Press, 1973).
16. The studies are summarized in R. E. Caves, *Multinational Enterprise and Economic Analysis*, 2nd ed. (Cambridge, UK: Cambridge University Press, 1996).
17. See R. E. Caves, "Japanese Investment in the US: Lessons for the Economic Analysis of Foreign Investment," *The World Economy* 16 (1993), pp. 279–300; B. Kogut and S. J. Chang, "Technological Capabilities and Japanese Direct Investment in the United States," *Review of Economics and Statistics* 73 (1991), pp. 401–43; and J. Anand and B. Kogut, "Technological Capabilities of Countries, Firm Rivalry, and Foreign Direct Investment," *Journal of International Business Studies*, 1997, pp. 445–65.
18. K. Ito and E. L. Rose, "Foreign Direct Investment Location Strategies in the Tire Industry," *Journal of International Business Studies* 33 (2002), pp. 593–602.
19. H. Haveman and L. Nonnemaker, "Competition in Multiple Geographical Markets," *Administrative Science Quarterly* 45 (2000), pp. 232–67; and L. Fuentelsaz and J. Gomez, "Multipoint Competition, Strategic Similarity and Entry into Geographic Markets," *Strategic Management Journal* 27 (2006), pp. 447–57.
20. For the use of Vernon's theory to explain Japanese direct investment in the United States and Europe, see S. Thomsen, "Japanese Direct Investment in the European Community," *The World Economy* 16 (1993), pp. 301–15. Also see Z. Gao and C. Tisdell, "Foreign Investment and Asia, Particularly China's Rise in the Television Industry: The International Product Life Cycle Reconsidered," *Journal of Asia-Pacific Business* 6, no. 3 (2005), pp. 37–50.
21. J. H. Dunning, *Explaining International Production* (London: Unwin Hyman, 1988).
22. P. Krugman, "Increasing Returns and Economic Geography," *Journal of Political Economy* 99, no. 3 (1991), pp. 483–99.
23. J. M. Shaver and F. Flyer, "Agglomeration Economies, Firm Heterogeneity, and Foreign Direct Investment in the United States," *Strategic Management Journal* 21 (2000), pp. 1175–93.
24. J. H. Dunning and R. Narula, "Transpacific Foreign Direct Investment and the Investment Development Path," *South Carolina Essays in International Business*, May 1995.
25. W. Shan and J. Song, "Foreign Direct Investment and the Sourcing of Technological Advantage: Evidence from the Biotechnology Industry," *Journal of International Business Studies* 28, no. 2 (1997), pp. 267–84.
26. For some additional evidence, see L. E. Brouthers, K. D. Brouthers, and S. Warner, "Is Dunning's Eclectic Framework Descriptive or Normative?" *Journal of International Business Studies* 30 (1999), pp. 831–44.
27. For elaboration, see S. Hood and S. Young, *The Economics of the Multinational Enterprise* (London: Longman, 1979); and P. M. Sweezy and H. Magdoff, "The Dynamics of U.S. Capitalism," *Monthly Review Press*, 1972.
28. C. Forelle and G. Hitt, "IBM Discusses Security Measure in Lenovo Deal," *The Wall Street Journal*, February 25, 2005, p. A2.
29. For an example of this policy as practiced in China, see L. G. Branstetter and R. C. Freenstra, "Trade and Foreign Direct Investment in China: A Political Economy Approach," *Journal of International Economics* 58 (December 2002), pp. 335–58.
30. M. Itoh and K. Kiyono, "Foreign Trade and Direct Investment," in *Industrial Policy of Japan*, ed. R. Komiya, M. Okuno, and K. Suzumura (Tokyo: Academic Press, 1988).
31. R. E. Lipsey, "Home and Host Country Effects of FDI," *National Bureau of Economic Research Working Paper Series*, working paper no. 9293, October 2002; and X. Li and X. Liu, "Foreign Direct Investment and Economic Growth," *World Development* 33 (March 2005), pp. 393–413.

32. X. J. Zhan and T. Ozawa, *Business Restructuring in Asia: Cross Border M&As in Crisis Affected Countries* (Copenhagen: Copenhagen Business School, 2000); I. Costa, S. Robles, and R. de Queiroz, "Foreign Direct Investment and Technological Capabilities," *Research Policy* 31 (2002), pp. 1431–43; B. Potterie and F. Lichtenberg, "Does Foreign Direct Investment Transfer Technology across Borders?" *Review of Economics and Statistics* 83 (2001), pp. 490–97; and K. Saggi, "Trade, Foreign Direct Investment and International Technology Transfer," *World Bank Research Observer* 17 (2002), pp. 191–235.
33. K. M. Moden, "Foreign Acquisitions of Swedish Companies: Effects on R&D and Productivity," Stockholm: Research Institute of International Economics, 1998, mimeo.
34. "Foreign Friends," *The Economist*, January 8, 2000, pp. 71–72.
35. A. Jack, "French Go into Overdrive to Win Investors," *Financial Times*, December 10, 1997, p. 6.
36. "Foreign Friends."
37. G. Hunya and K. Kalotay, *Privatization and Foreign Direct Investment in Eastern and Central Europe* (Geneva: UNCTAD, 2001).
38. United Nations, *World Investment Report, 2002* (New York and Geneva: United Nations, 2002).
39. R. Ram and K. H. Zang, "Foreign Direct Investment and Economic Growth," *Economic Development and Cultural Change* 51 (2002), pp. 205–25.
40. United Nations, *World Investment Report, 1998* (New York and Geneva: United Nations, 1997).
41. United Nations, *World Investment Report, 2000* (New York and Geneva: United Nations, 2000).
42. R. B. Reich, *The Work of Nations: Preparing Ourselves for the 21st Century* (New York: Alfred A. Knopf, 1991).
43. This idea has been articulated, although not quite in this form, by C. A. Bartlett and S. Ghoshal, *Managing across Borders: The Transnational Solution* (Boston: Harvard Business School Press, 1989).
44. P. Magnusson, "The Mexico Pact: Worth the Price?" *BusinessWeek*, May 27, 1991, pp. 32–35.
45. C. Johnston, "Political Risk Insurance," in *Assessing Corporate Political Risk*, ed. D. M. Raddock (Totowa, NJ: Rowan & Littlefield, 1986).
46. M. Tolchin and S. Tolchin, *Buying into America: How Foreign Money Is Changing the Face of Our Nation* (New York: Times Books, 1988).
47. S. Rai, "India to Ease Limits on Foreign Ownership of Media and Tea," *The New York Times*, June 26, 2002, p. W1.
48. L. D. Qiu and Z. Tao, "Export, Foreign Direct Investment and Local Content Requirements," *Journal of Development Economics* 66 (October 2001), pp. 101–25.
49. United Nations, *World Investment Report, 2003* (New York and Geneva: United Nations, 2003).
50. See R. E. Caves, *Multinational Enterprise and Economic Analysis* (Cambridge, UK: Cambridge University Press, 1982).
51. For a good general introduction to negotiation strategy, see M. H. Bazerman and M. A. Neale, *Negotiating Rationally* (New York: Free Press, 1992); A. Dixit and B. Nalebuff, *Thinking Strategically: The Competitive Edge in Business, Politics, and Everyday Life* (New York: W. W. Norton, 1991); and H. Raiffa, *The Art and Science of Negotiation* (Cambridge, MA: Harvard University Press, 1982).

Chapter 8

1. Information taken from World Trade Organization Web site and current as of February 2010, www.wto.org.
2. Ibid.
3. The Andean Pact has been through a number of changes since its inception. The latest version was established in 1991. See "Free-Trade Free for All," *The Economist*, January 4, 1991, p. 63.
4. D. Swann, *The Economics of the Common Market*, 6th ed. (London: Penguin Books, 1990).
5. See J. Bhagwati, "Regionalism and Multilateralism: An Overview," Columbia University Discussion Paper 603, Department of Economics, Columbia University, New York; A. de la Torre and M. Kelly, "Regional Trade Arrangements," Occasional Paper 93, Washington, DC: International Monetary Fund, March 1992; J. Bhagwati, "Fast Track to Nowhere," *The Economist*, October 18, 1997, pp. 21–24; Jagdish Bhagwati, *Free Trade Today* (Princeton and Oxford: Princeton University Press, 2002); and B. K. Gordon, "A High Risk Trade Policy," *Foreign Affairs* 82 no. 4 (July/August 2003), pp. 105–15.
6. N. Colchester and D. Buchan, *Europower: The Essential Guide to Europe's Economic Transformation in 1992* (London: The Economist Books, 1990), and Swann, *Economics of the Common Market*.
7. A. S. Posen, "Fleeting Equality, The Relative Size of the EU and US Economies in 2020," The Brookings Institution, September 2004.
8. Swann, *Economics of the Common Market*; Colchester and Buchan, *Europower: The Essential Guide to Europe's Economic Transformation in 1992*; "The European Union: A Survey," *The Economist*, October 22, 1994;

- “The European Community: A Survey,” *The Economist*, July 3, 1993; and the European Union Web site at <http://europa.eu.int>.
9. E. J. Morgan, “A Decade of EC Merger Control,” *International Journal of Economics and Business*, November 2001, pp. 451–73.
10. “The European Community: A Survey.”
11. Tony Barber, “The Lisbon Reform Treaty,” *FT.com*, December 13, 2007.
12. “One Europe, One Economy,” *The Economist*, November 30, 1991, pp. 53–54; and “Market Failure: A Survey of Business in Europe,” *The Economist*, June 8, 1991, pp. 6–10.
13. Alan Riley, “The Single Market Ten Years On,” *European Policy Analyst*, December 2002, pp. 65–72.
14. See C. Wyploze, “EMU: Why and How It Might Happen,” *Journal of Economic Perspectives* 11 (1997), pp. 3–22; and M. Feldstein, “The Political Economy of the European Economic and Monetary Union,” *Journal of Economic Perspectives* 11 (1997), pp. 23–42.
15. “One Europe, One Economy”; and Feldstein, “The Political Economy of the European Economic and Monetary Union.”
16. Feldstein, “The Political Economy of the European Economic and Monetary Union.”
17. “Time for Europhoria?” *The Economist*, January 4, 2003, p. 58.
18. “The Passing of the Buck?” *The Economist*, December 4, 2004, pp. 78–80.
19. Details regarding conditions of membership and the progression of enlargement negotiations can be found at <http://europa.eu.int/comm/enlargement/index.htm>.
20. “What Is NAFTA?” *Financial Times*, November 17, 1993, p. 6; and S. Garland, “Sweet Victory,” *Business-Week*, November 29, 1993, pp. 30–31.
21. “NAFTA: The Showdown,” *The Economist*, November 13, 1993, pp. 23–36.
22. N. C. Lustog, “NAFTA: Setting the Record Straight,” *The World Economy*, 1997, pp. 605–14; and G. C. Hufbauer and J. J. Scott, *NAFTA Revisited: Achievements and Challenges* (Washington, DC: Institute for International Economics, 2005).
23. W. Thorbecke and C. Eigen-Zucchi, “Did NAFTA Cause a Giant Sucking Sound?” *Journal of Labor Research*, Fall 2002, pp. 647–58; G. Gagne, “North American Free Trade, Canada, and U.S. Trade Remedies: An Assessment after Ten Years,” *The World Economy*, 2000, pp. 77–91; Hufbauer and Schott, *NAFTA Revisited*; and J. Romalis, “NAFTA’s and CUSTA’s Impact on International Trade,” *Review of Economics and Statistics* 98, no. 3 (2007), pp. 416–35.
24. All trade figures from U.S. Department of Commerce Trade Stat Express Web site at <http://tse.export.gov/>.
25. J. Cavanagh et al., “Happy Ever NAFTA?” *Foreign Policy*, September–October 2002, pp. 58–65.
26. “The Business of the American Hemisphere,” *The Economist*, August 24, 1991, pp. 37–38.
27. “NAFTA Is Not Alone,” *The Economist*, June 18, 1994, pp. 47–48.
28. “Murky Mercosur,” *The Economist*, July 26, 1997, pp. 66–67.
29. See M. Philips, “South American Trade Pact under Fire,” *The Wall Street Journal*, October 23, 1996, p. A2; A. J. Yeats, *Does Mercosur’s Trade Performance Justify Concerns about the Global Welfare-Reducing Effects of Free Trade Arrangements? Yes!* (Washington, DC: World Bank, 1996); and D. M. Leipziger et al., “Mercosur: Integration and Industrial Policy,” *The World Economy*, 1997, pp. 585–604.
30. “Another Blow to Mercosur,” *The Economist*, March 31, 2001, pp. 33–34.
31. “Lula Lays Out Mercosur Rescue Mission,” *Latin America Newsletters*, February 4, 2003, p. 7.
32. “A Free Trade Tug of War,” *The Economist*, December 11, 2004, p. 54.
33. “CARICOM Single Market Begins,” *EIU Views*, February 3, 2006.
34. M. Esterl, “Free Trade Area of the Americas Stalls,” *The Economist*, January 19, 2005, p. 1.
35. M. Moffett and J. D. McKinnon, “Failed Summit Casts Shadow on Global Trade Talks,” *The Wall Street Journal*, November 7, 2005, p. A1.
36. “Every Man for Himself: Trade in Asia,” *The Economist*, November 2, 2002, pp. 43–44.
37. L. Gooch, “Asian Free-Trade Zone Raises Hopes,” *The New York Times*, January 1st, 2010, p. B3.
38. “Aimless in Seattle,” *The Economist*, November 13, 1993, pp. 35–36.
39. G. de Jonquieres, “APEC Grapples with Market Turmoil,” *Financial Times*, November 21, 1997, p. 6; and G. Baker, “Clinton Team Wins Most of the APEC Tricks,” *Financial Times*, November 27, 1997, p. 5.
40. M. Turner, “Trio Revives East African Union,” *Financial Times*, January 16, 2001, p. 4.
41. P. Davis, “A European Campaign: Local Companies Rush for a Share of EC Market While Barriers Are Down,” *Minneapolis-St. Paul City Business*, January 8, 1990, p. 1.
42. “The Business of Europe,” *The Economist*, December 7, 1991, pp. 63–64.

43. T. Horwitz, "Europe's Borders Fade," *The Wall Street Journal*, May 18, 1993, pp. A1, A12; "A Singular Market," *The Economist*, October 22, 1994, pp. 10–16; and "Something Dodgy in Europe's Single Market," *The Economist*, May 21, 1994, pp. 69–70.
44. E. G. Friberg, "1992: Moves Europeans Are Making," *Harvard Business Review*, May–June 1989, pp. 85–89.

Chapter 9

1. For a good general introduction to the foreign exchange market, see R. Weisweiler, *How the Foreign Exchange Market Works* (New York: New York Institute of Finance, 1990). A detailed description of the economics of foreign exchange markets can be found in P. R. Krugman and M. Obstfeld, *International Economics: Theory and Policy* (New York: HarperCollins, 1994).
2. "The Domino Effect," *The Economist*, July 5, 2008, p. 85.
3. Bank for International Settlements, *Tri-annual Central Bank Survey of Foreign Exchange and Derivatives Market Activity*, April 2007 (Basle, Switzerland: BIS, December 2007).
4. Ibid.
5. Ibid.
6. M. Dickson, "Capital Gain: How London Is Thriving as it Takes on the Global Competition," *Financial Times*, March 27, 2006, p. 11.
7. For a comprehensive review, see M. Taylor, "The Economics of Exchange Rates," *Journal of Economic Literature* 33 (1995), pp. 13–47.
8. Krugman and Obstfeld, *International Economics: Theory and Policy*.
9. M. Friedman, *Studies in the Quantity Theory of Money* (Chicago: University of Chicago Press, 1956). For an accessible explanation, see M. Friedman and R. Friedman, *Free to Choose* (London: Penguin Books, 1979), chap. 9.
10. Juan-Antino Morales, "Inflation Stabilization in Bolivia," in *Inflation Stabilization: The Experience of Israel, Argentina, Brazil, Bolivia, and Mexico*, ed. Michael Bruno et al. (Cambridge, MA: MIT Press, 1988); and The Economist, *World Book of Vital Statistics* (New York: Random House, 1990).
11. For reviews and recent articles see, H. J. Edison, J. E. Gagnon, and W. R. Melick, "Understanding the Empirical Literature on Purchasing Power Parity," *Journal of International Money and Finance* 16 (February 1997), pp. 1–18; J. R. Edison, "Multi-Country Evidence on the Behavior of Purchasing Power Parity under the Current Float," *Journal of International Money and Finance* 16 (February 1997), pp. 19–36; K. Rogoff, "The Purchasing Power Parity Puzzle," *Journal of Economic Literature* 34 (1996), pp. 647–68; D. R. Rapach and M. E. Wohar, "Testing the Monetary Model of Exchange Rate Determination: New Evidence from a Century of Data," *Journal of International Economics*, December 2002, pp. 359–85; and M. P. Taylor, "Purchasing Power Parity," *Review of International Economics*, August 2003, pp. 436–456.
12. M. Obstfeld and K. Rogoff, "The Six Major Puzzles in International Economics," *National Bureau of Economic Research Working Paper Series*, working paper no. 7777, July 2000.
13. Ibid.
14. See M. Devereux and C. Engel, "Monetary Policy in the Open Economy Revisited: Price Setting and Exchange Rate Flexibility," *National Bureau of Economic Research Working Paper Series*, working paper no. 7665, April 2000. Also P. Krugman, "Pricing to Market When the Exchange Rate Changes," in *Real Financial Economics*, ed. S. Arndt and J. Richardson (Cambridge, MA: MIT Press, 1987).
15. For a summary of the evidence, see the survey by Taylor, "The Economics of Exchange Rates."
16. R. E. Cumby and M. Obstfeld, "A Note on Exchange Rate Expectations and Nominal Interest Differentials: A Test of the Fisher Hypothesis," *Journal of Finance*, June 1981, pp. 697–703; and L. Coppock and M. Poitras, "Evaluating the Fisher Effect in Long Term Cross Country Averages," *International Review of Economics and Finance* 9 (2000), pp. 181–203.
17. Taylor, "The Economics of Exchange Rates." See also R. K. Lyons, *The Microstructure Approach to Exchange Rates* (Cambridge, MA: MIT Press, 2002).
18. See H. L. Allen and M. P. Taylor, "Charts, Noise, and Fundamentals in the Foreign Exchange Market," *Economic Journal* 100 (1990), pp. 49–59; and T. Ito, "Foreign Exchange Rate Expectations: Micro Survey Data," *American Economic Review* 80 (1990), pp. 434–49.
19. For example, see E. Fama, "Forward Rates as Predictors of Future Spot Rates," *Journal of Financial Economics*, October 1976, pp. 361–77.
20. L. Kilian and M. P. Taylor, "Why Is It so Difficult to Beat the Random Walk Forecast of Exchange Rates?" *Journal of International Economics* 20 (May 2003), pp. 85–103; and R. M. Levich, "The Efficiency of Markets for Foreign Exchange," in *International Finance*, ed. G. D. Gay and R. W. Kold (Richmond, VA: Robert F. Dane, Inc., 1983).
21. J. Williamson, *The Exchange Rate System* (Washington, DC: Institute for International Economics, 1983); and R. H. Clarida, L. Sarno, M. P. Taylor, and G. Valente, "The Out of Sample Success of Term

- Structure Models as Exchange Rate Predictors,” *Journal of International Economics* 60 (May 2003), pp. 61–84.
22. Kilian and Taylor, “Why Is It So Difficult to Beat the Random Walk Forecast of Exchange Rates.”
 23. Rogoff, “The Purchasing Power Parity Puzzle.”
 24. C. Engel and J. D. Hamilton, “Long Swings in the Dollar: Are They in the Data and Do Markets Know It?” *American Economic Review*, September 1990, pp. 689–713.
 25. J. R. Carter and J. Gagne, “The Do’s and Don’ts of International Countertrade,” *Sloan Management Review*, Spring 1988, pp. 31–37.
 26. “Where There Is a Will,” *Trade Finance*, October 2003, pp. 1–2.
 27. D. S. Levine, “Got a Spare Destroyer Lying Around?” *World Trade* 10 (June 1997), pp. 34–35; and Dan West, “Countertrade,” *Business Credit*, April 2001, pp. 64–67.
 28. For details on how various firms manage their foreign exchange exposure, see the articles contained in the special foreign exchange issue of *Business International Money Report*, December 18, 1989, pp. 401–12.
 29. Ibid.
 30. S. Arterian, “How Black & Decker Defines Exposure,” *Business International Money Report*, December 18, 1989, pp. 404, 405, 409.
- Chapter 10**
1. Updates can be found at the IMF Web site: www.imf.org.
 2. The argument goes back to 18th century philosopher David Hume. See D. Hume, “On the Balance of Trade,” reprinted in *The Gold Standard in Theory and in History*, ed. B. Eichengreen (London: Methuen, 1985).
 3. R. Solomon, *The International Monetary System, 1945–1981* (New York: Harper & Row, 1982).
 4. International Monetary Fund, *World Economic Outlook, 2005* (Washington, DC: IMF, May 2005).
 5. For an extended discussion of the dollar exchange rate in the 1980s, see B. D. Pauls, “US Exchange Rate Policy: Bretton Woods to the Present,” *Federal Reserve Bulletin*, November 1990, pp. 891–908.
 6. R. Miller, “Why the Dollar Is Giving Way,” *Business-Week*, December 6, 2004, pp. 36–37.
 7. For a feel for the issues contained in this debate, see P. Krugman, *Has the Adjustment Process Worked?* (Washington, DC: Institute for International Economics, 1991); “Time to Tether Currencies,” *The Economist*, January 6, 1990, pp. 15–16; P. R. Krugman and M. Obstfeld, *International Economics: Theory and Policy* (New York: HarperCollins, 1994); J. Shelton, *Money Meltdown* (New York: Free Press, 1994); and S. Edwards, “Exchange Rates and the Political Economy of Macroeconomic Discipline,” *American Economic Review* 86, no. 2 (May 1996), pp. 159–63.
 8. The argument is made by several prominent economists, particularly Stanford’s Robert McKinnon. See R. McKinnon, “An International Standard for Monetary Stabilization,” *Policy Analyses in International Economics* 8 (1984). The details of this argument are beyond the scope of this book. For a relatively accessible exposition, see P. Krugman, *The Age of Diminished Expectations* (Cambridge, MA: MIT Press, 1990).
 9. A. R. Ghosh, J. D. Ostry, A. M. Gulde, and H.C. Wolf, “Does the Exchange Rate Regime Matter for Inflation and Growth?” *IMF Economic Issues* No. 2, 1997.
 10. “The ABC of Currency Boards,” *The Economist*, November 1, 1997, p. 80.
 11. International Monetary Fund, *World Economic Outlook, 1998* (Washington, DC: IMF, 1998).
 12. Ibid.
 13. See P. Carroll and C. Torres, “Mexico Unveils Program of Harsh Fiscal Medicine,” *The Wall Street Journal*, March 10, 1995, pp. A1, A6; and “Putting Mexico Together Again,” *The Economist*, February 4, 1995, p. 65.
 14. World Trade Organization, *Annual Report, 1997*, vol. II, table III, p. 69.
 15. J. Ridding and J. Kynge, “Complacency Gives Way to Contagion,” *Financial Times*, January 13, 1998, p. 8.
 16. J. Burton and G. Baker, “The Country That Invested Its Way into Trouble,” *Financial Times*, January 15, 1998, p. 8.
 17. P. Shenon, “The Suharto Billions,” *The New York Times*, January 16, 1998, p. 1.
 18. World Bank, *1997 World Development Report* (Oxford: Oxford University Press, 1998), Table 11.
 19. Ridding and Kynge, “Complacency Gives Way to Contagion.”
 20. Burton and Baker, “The Country That Invested Its Way into Trouble.”
 21. “Bitter Pill for the Thais,” *Straits Times*, July 5, 1997, p. 46.
 22. World Bank, *1997 World Development Report*, Table 2.
 23. International Monetary Fund, press release no. 97/37, August 20, 1997.
 24. T. S. Shorrocks, “Korea Starts Overhaul; IMF Aid Hits \$60 Billion,” *Journal of Commerce*, December 8, 1997, p. 3A.

25. See J. Sachs, "Economic Transition and Exchange Rate Regime," *American Economic Review* 86, no. 92 (May 1996), pp. 147–52; and J. Sachs, "Power unto Itself," *Financial Times*, December 11, 1997, p. 11.
26. Sachs, "Power unto Itself."
27. Martin Wolf, "Same Old IMF Medicine," *Financial Times*, December 9, 1997, p. 12.
28. Sachs, "Power unto Itself."
29. "New Fund, Old Fundamentals," *The Economist*, May 2, 2009, p. 78.
30. P. Gumbel and B. Coleman, "Daimler Warns of Severe '95 Loss Due to Strong Mark," *The New York Times*, June 29, 1995, pp. 1, 10; and M. Wolf, "Daimler-Benz Announces Major Losses," *Financial Times*, June 29, 1995, p. 1.

Chapter 11

1. More formally, $ROIC = \text{Net profit after tax} / \text{Capital}$, where capital includes the sum of the firm's equity and debt. This way of calculating profitability is highly correlated with return on assets.
2. T. Copeland, T. Koller, and J. Murrin, *Valuation: Measuring and Managing the Value of Companies* (New York: John Wiley & Sons, Inc., 2000).
3. The concept of consumer surplus is an important one in economics. For a more detailed exposition, see D. Besanko, D. Dranove, and M. Shanley, *Economics of Strategy* (New York: John Wiley & Sons, Inc., 1996).
4. However, $P = V$ only in the special case where the company has a perfect monopoly, and where it can charge each customer a unique price that reflects the value of the product to that customer (i.e., where perfect price discrimination is possible). More generally, except in the limiting case of perfect price discrimination, even a monopolist will see most consumers capture some of the value of a product in the form of a consumer surplus.
5. This point is central to the work of Michael Porter, *Competitive Advantage* (New York: Free Press, 1985). See also chap. 4 in P. Ghemawat, *Commitment: The Dynamic of Strategy* (New York: Free Press, 1991).
6. M. E. Porter, *Competitive Strategy* (New York: Free Press, 1980).
7. M. E. Porter, "What Is Strategy?" *Harvard Business Review*, On-point Enhanced Edition article, February 1, 2000.
8. Porter, *Competitive Advantage*.
9. D. Naidler, M. Gerstein, and R. Shaw, *Organization Architecture* (San Francisco: Jossey-Bass, 1992).
10. G. Morgan, *Images of Organization* (Beverly Hills, CA: Sage Publications, 1986).
11. Empirical evidence does seem to indicate that, on average, international expansion is linked to greater firm profitability. For some recent examples, see M. A. Hitt, R. E. Hoskisson, and H. Kim, "International Diversification, Effects on Innovation and Firm Performance," *Academy of Management Journal* 40, no. 4 (1997), pp. 767–98; and S. Tallman and J. Li, "Effects of International Diversity and Product Diversity on the Performance of Multinational Firms," *Academy of Management Journal* 39, no. 1 (1996), pp. 179–96.
12. This concept has been popularized by G. Hamel and C. K. Prahalad, *Competing for the Future* (Boston: Harvard Business School Press, 1994). The concept is grounded in the resource-based view of the firm; for a summary, see J. B. Barney, "Firm Resources and Sustained Competitive Advantage," *Journal of Management* 17 (1991), pp. 99–120; and K. R. Conner, "A Historical Comparison of Resource-Based Theory and Five Schools of Thought within Industrial Organization Economics: Do We Have a New Theory of the Firm?" *Journal of Management* 17 (1991), pp. 121–54.
13. J. P. Womack, D. T. Jones, and D. Roos, *The Machine That Changed the World* (New York: Rawson Associates, 1990).
14. M. E. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990).
15. Example is based on C. S. Trager, "Enter the Mini-Multinational," *Northeast International Business*, March 1989, pp. 13–14.
16. See R. B. Reich, *The Work of Nations* (New York: Alfred A. Knopf, 1991); and P. J. Buckley and N. Hashai, "A Global System View of Firm Boundaries," *Journal of International Business Studies*, January 2004, pp. 33–50.
17. D. Barboza, "An Unknown Giant Flexes Its Muscles," *The New York Times*, December 4, 2004, pp. B1, B3.
18. G. Hall and S. Howell, "The Experience Curve from an Economist's Perspective," *Strategic Management Journal* 6 (1985), pp. 197–212.
19. A. A. Alchian, "Reliability of Progress Curves in Airframe Production," *Econometrica* 31 (1963), pp. 697–93.
20. Hall and Howell, "The Experience Curve from an Economist's Perspective."
21. For a full discussion of the source of scale economies, see D. Besanko, D. Dranove, and M. Shanley, *Economics of Strategy* (New York: John Wiley & Sons, Inc., 1996).
22. This estimate was provided by the Pharmaceutical Manufacturers Association.
23. "Matsushita Electrical Industrial in 1987," in *Transnational Management*, eds. C. A. Bartlett and S. Ghoshal (Homewood, IL: Richard D. Irwin, 1992).

24. See J. Birkinshaw and N. Hood, "Multinational Subsidiary Evolution: Capability and Charter Change in Foreign Owned Subsidiary Companies," *Academy of Management Review* 23 (October 1998), pp. 773–95; A. K. Gupta and V. J. Govindarajan, "Knowledge Flows within Multinational Corporations," *Strategic Management Journal* 21 (2000), pp. 473–96; V. J. Govindarajan and A. K. Gupta, *The Quest for Global Dominance* (San Francisco: Jossey Bass, 2001); T. S. Frost, J. M. Birkinshaw, and P. C. Ensign, "Centers of Excellence in Multinational Corporations," *Strategic Management Journal* 23 (2002), pp. 997–1018; and U. Andersson, M. Forsgren, and U. Holm, "The Strategic Impact of External Networks," *Strategic Management Journal* 23 (2002), pp. 979–96.
25. S. Leung, "Armchairs, TVs and Espresso: Is It McDonald's?" *The Wall Street Journal*, August 30, 2002, pp. A1, A6.
26. C. K. Prahalad and Yves L. Doz, *The Multinational Mission: Balancing Local Demands and Global Vision* (New York: Free Press, 1987). Also see J. Birkinshaw, A. Morrison, and J. Hulland, "Structural and Competitive Determinants of a Global Integration Strategy," *Strategic Management Journal* 16 (1995), pp. 637–55; and P. Ghemawat, *Redefining Global Strategy* (Boston: Harvard Business School Press, 2007).
27. J. E. Garten, "Wal-Mart Gives Globalization a Bad Name," *BusinessWeek*, March 8, 2004, p. 24.
28. Prahalad and Doz, *The Multinational Mission: Balancing Local Demands and Global Vision*. Prahalad and Doz actually talk about local responsiveness rather than local customization.
29. T. Levitt, "The Globalization of Markets," *Harvard Business Review*, May–June 1983, pp. 92–102.
30. K. Belson, "In U.S., Cell Phone Users Are Often All Talk," *The New York Times*, December 13, 2004, pp. C1, C4.
31. W. W. Lewis, *The Power of Productivity* (Chicago: University of Chicago Press, 2004).
32. C. J. Chipello, "Local Presence Is Key to European Deals," *The Wall Street Journal*, June 30, 1998, p. A15.
33. Bartlett and Ghoshal, *Managing across Borders*.
34. Ibid. Pankaj Ghemawat makes a similar argument, although he does not use the term *transnational*. See Ghemawat, *Redefining Global Strategy*.
35. T. Hout, M. E. Porter, and E. Rudden, "How Global Companies Win Out," *Harvard Business Review*, September–October 1982, pp. 98–108.
36. See K. Ohmae, "The Global Logic of Strategic Alliances," *Harvard Business Review*, March–April 1989, pp. 143–54; G. Hamel, Y. L. Doz, and C. K. Prahalad, "Collaborate with Your Competitors and Win!" *Harvard Business Review*, January–February 1989, pp. 133–39; W. Burgers, C. W. L. Hill, and W. C. Kim, "Alliances in the Global Auto Industry," *Strategic Management Journal* 14 (1993), pp. 419–32; and P. Kale, H. Singh, H. Perlmutter, "Learning and Protection of Proprietary Assets in Strategic Alliances: Building Relational Capital," *Strategic Management Journal* 21 (2000), pp. 217–37.
37. L. T. Chang, "China Eases Foreign Film Rules," *The Wall Street Journal*, October 15, 2004, p. B2.
38. B. L. Simonin, "Transfer of Marketing Knowhow in International Strategic Alliances," *Journal of International Business Studies*, 1999, pp. 463–91, and J. W. Spencer, "Firms' Knowledge Sharing Strategies in the Global Innovation System," *Strategic Management Journal* 24 (2003), pp. 217–33.
39. C. Souza, "Microsoft Teams with MIPS, Toshiba," *EBN*, February 10, 2003, p. 4.
40. M. Frankel, "Now Sony Is Giving Palm a Hand," *BusinessWeek*, November 29, 2000, p. 50.
41. Kale, Singh, and Perlmutter, "Learning and Protection of Proprietary Assets."
42. R. B. Reich and E. D. Mankin, "Joint Ventures with Japan Give Away Our Future," *Harvard Business Review*, March–April 1986, pp. 78–90.
43. J. Bleeke and D. Ernst, "The Way to Win in Cross-Border Alliances," *Harvard Business Review*, November–December 1991, pp. 127–35.
44. C. H. Deutsch, "The Venturesome Giant," *The New York Times*, October 5, 2007, pp. C1, C8.
45. "Odd Couple," *The Economist*, May 5, 2007, pp. 79–80.
46. W. Roehl and J. F. Truitt, "Stormy Open Marriages Are Better," *Columbia Journal of World Business*, Summer 1987, pp. 87–95.
47. K. McQuade and B. Gomes-Casseres, "Xerox and Fuji-Xerox," *Harvard Business Review*, February 15, 1991.
48. See T. Khanna, R. Gulati, and N. Nohria, "The Dynamics of Learning Alliances: Competition, Cooperation, and Relative Scope," *Strategic Management Journal* 19 (1998), pp. 193–210; and Kale, Singh, Perlmutter, "Learning and Protection of Proprietary Assets."
49. Kale, Singh, Perlmutter, "Learning and Protection of Proprietary Assets in Strategic Alliances."
50. Hamel, Doz, and Prahalad, "Collaborate with Competitors"; Khanna, Gulati, and Nohria, "The Dynamics of Learning Alliances: Competition, Cooperation, and Relative Scope"; and E. W. K. Tang, "Acquiring Knowledge by Foreign Partners from International Joint Ventures in a Transition Economy: Learning by

Doing and Learning Myopia,” *Strategic Management Journal* 23 (2002), pp. 835–54.

51. Hamel, Doz, and Prahalad, “Collaborate with Competitors.”
52. B. Wysocki, “Cross-Border Alliances Become Favorite Way to Crack New Markets,” *The Wall Street Journal*, March 4, 1990, p. A1.
53. Hamel, Doz, and Prahalad, “Collaborate with Competitors,” p. 138.

Chapter 12

1. For interesting empirical studies that deal with the issues of timing and resource commitments, see T. Isobe, S. Makino, and D. B. Montgomery, “Resource Commitment, Entry Timing, and Market Performance of Foreign Direct Investments in Emerging Economies,” *Academy of Management Journal* 43, no. 3 (2000), pp. 468–84, and Y. Pan and P. S. K. Chi, “Financial Performance and Survival of Multinational Corporations in China,” *Strategic Management Journal* 20, no. 4 (1999), pp. 359–74. A complementary theoretical perspective on this issue can be found in V. Govindarjan and A. K. Gupta, *The Quest for Global Dominance* (San Francisco: Jossey-Bass, 2001). Also see F. Vermeulen and H. Barkeme, “Pace, Rhythm and Scope: Process Dependence in Building a Profitable Multinational Corporation,” *Strategic Management Journal* 23 (2002), pp. 637–54.
2. This can be reconceptualized as the resource base of the entrant, relative to indigenous competitors. For work that focuses on this issue, see W. C. Bogner, H. Thomas, and J. McGee, “A Longitudinal Study of the Competitive Positions and Entry Paths of European Firms in the U.S. Pharmaceutical Market,” *Strategic Management Journal* 17 (1996), pp. 85–107; D. Collis, “A Resource-Based Analysis of Global Competition,” *Strategic Management Journal* 12 (1991), pp. 49–68; and S. Tallman, “Strategic Management Models and Resource-Based Strategies among MNEs in a Host Market,” *Strategic Management Journal* 12 (1991), pp. 69–82.
3. For a discussion of first-mover advantages, see M. Lieberman and D. Montgomery, “First-Mover Advantages,” *Strategic Management Journal* 9 (Summer Special Issue, 1988), pp. 41–58.
4. J. M. Shaver, W. Mitchell, and B. Yeung, “The Effect of Own Firm and Other Firm Experience on Foreign Direct Investment Survival in the United States, 1987–92,” *Strategic Management Journal* 18 (1997), pp. 811–24.
5. S. Zaheer and E. Mosakowski, “The Dynamics of the Liability of Foreignness: A Global Study of Survival in the Financial Services Industry,” *Strategic Management Journal* 18 (1997), pp. 439–64.
6. Shaver, Mitchell, and Yeung, “The Effect of Own Firm and Other Firm Experience on Foreign Direct Investment Survival in the United States.”
7. P. Ghemawat, *Commitment: The Dynamics of Strategy* (New York: Free Press, 1991).
8. R. Luecke, *Scuttle Your Ships before Advancing* (Oxford: Oxford University Press, 1994).
9. Isobe, Makino, and Montgomery, “Resource Commitment, Entry Timing, and Market Performance”; Pan and Chi, “Financial Performance and Survival of Multinational Corporations in China”; and Govindarjan and Gupta, *The Quest for Global Dominance*.
10. Christopher Bartlett and Sumantra Ghoshal, “Going Global: Lessons from Late Movers,” *Harvard Business Review*, March–April 2000, pp. 132–45.
11. This section draws on numerous studies, including: C. W. L. Hill, P. Hwang, and W. C. Kim, “An Eclectic Theory of the Choice of International Entry Mode,” *Strategic Management Journal* 11 (1990), pp. 117–28; C. W. L. Hill and W. C. Kim, “Searching for a Dynamic Theory of the Multinational Enterprise: A Transaction Cost Model,” *Strategic Management Journal* 9 (Special Issue on Strategy Content, 1988), pp. 93–104; E. Anderson and H. Gatignon, “Modes of Foreign Entry: A Transaction Cost Analysis and Propositions,” *Journal of International Business Studies* 17 (1986), pp. 1–26; F. R. Root, *Entry Strategies for International Markets* (Lexington, MA: D. C. Heath, 1980); A. Madhok, “Cost, Value and Foreign Market Entry: The Transaction and the Firm,” *Strategic Management Journal* 18 (1997), pp. 39–61; K. D. Brouthers and L. B. Brouthers, “Acquisition or Greenfield Start-Up?” *Strategic Management Journal* 21, no. 1 (2000), pp. 89–97; X. Martin and R. Salmon, “Knowledge Transfer Capacity and Its Implications for the Theory of the Multinational Enterprise,” *Journal of International Business Studies*, July 2003, p. 356; and A. Verbeke, “The Evolutionary View of the MNE and the Future of Internalization Theory,” *Journal of International Business Studies*, November 2003, pp. 498–515.
12. For a general discussion of licensing, see F. J. Contractor, “The Role of Licensing in International Strategy,” *Columbia Journal of World Business*, Winter 1982, pp. 73–83.
13. See E. Terazono and C. Lorenz, “An Angry Young Warrior,” *Financial Times*, September 19, 1994, p. 11; and K. McQuade and B. Gomes-Casseres, “Xerox and Fuji-Xerox,” Harvard Business School Case No. 9-391-156.
14. O. E. Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985).

15. J. H. Dunning and M. McQueen, "The Eclectic Theory of International Production: A Case Study of the International Hotel Industry," *Managerial and Decision Economics* 2 (1981), pp. 197–210.
16. Andrew E. Serwer, "McDonald's Conquers the World," *Fortune*, October 17, 1994, pp. 103–16.
17. For an excellent review of the basic theoretical literature of joint ventures, see B. Kogut, "Joint Ventures: Theoretical and Empirical Perspectives," *Strategic Management Journal* 9 (1988), pp. 319–32. More recent studies include T. Chi, "Option to Acquire or Divest a Joint Venture," *Strategic Management Journal* 21, no. 6 (2000), pp. 665–88; H. Merchant and D. Schendel, "How Do International Joint Ventures Create Shareholder Value?" *Strategic Management Journal* 21, no. 7 (2000), pp. 723–37; H. K. Steensma and M. A. Lyles, "Explaining IJV Survival in a Transitional Economy through Social Exchange and Knowledge Based Perspectives," *Strategic Management Journal* 21, no. 8 (2000), pp. 831–51; and J. F. Hennart and M. Zeng, "Cross Cultural Differences and Joint Venture Longevity," *Journal of International Business Studies*, December 2002, pp. 699–717.
18. D. G. Bradley, "Managing against Expropriation," *Harvard Business Review*, July–August 1977, pp. 78–90.
19. J. A. Robins, S. Tallman, and K. Fladmoe-Lindquist, "Autonomy and Dependence of International Cooperative Ventures," *Strategic Management Journal*, October 2002, pp. 881–902.
20. Speech given by Tony Kobayashi at the University of Washington Business School, October 1992.
21. A. C. Inkpen and P. W. Beamish, "Knowledge, Bargaining Power, and the Instability of International Joint Ventures," *Academy of Management Review* 22 (1997), pp. 177–202; and S. H. Park and G. R. Ungson, "The Effect of National Culture, Organizational Complementarity, and Economic Motivation on Joint Venture Dissolution," *Academy of Management Journal* 40 (1997), pp. 279–307.
22. Inkpen and Beamish, "Knowledge, Bargaining Power, and the Instability of International Joint Ventures."
23. See Brouthers and Brouthers, "Acquisition or Greenfield Start-up?"; and J. F. Hennart and Y. R. Park, "Greenfield versus Acquisition: The Strategy of Japanese Investors in the United States," *Management Science*, 1993, pp. 1054–70.
24. This section draws on Hill, Hwang, and Kim, "An Eclectic Theory of the Choice of International Entry Mode."
25. C. W. L. Hill, "Strategies for Exploiting Technological Innovations: When and When Not to License," *Organization Science* 3 (1992), pp. 428–41.
26. See Brouthers and Brouthers, "Acquisition or Greenfield Start-Up?"; and J. Anand and A. Delios, "Absolute and Relative Resources as Determinants of International Acquisitions," *Strategic Management Journal*, February 2002, pp. 119–34.
27. United Nations, *World Investment Report, 2009* (New York and Geneva: United Nations, 2009).
28. Ibid.
29. For evidence on acquisitions and performance, see R. E. Caves, "Mergers, Takeovers, and Economic Efficiency," *International Journal of Industrial Organization* 7 (1989), pp. 151–74; M. C. Jensen and R. S. Ruback, "The Market for Corporate Control: The Scientific Evidence," *Journal of Financial Economics* 11 (1983), pp. 5–50; R. Roll, "Empirical Evidence on Takeover Activity and Shareholder Wealth," in *Knights, Raiders and Targets*, ed. J. C. Coffee, L. Lowenstein, and S. Rose (Oxford: Oxford University Press, 1989); A. Schleifer and R. W. Vishny, "Takeovers in the 60s and 80s: Evidence and Implications," *Strategic Management Journal* 12 (Winter 1991 Special Issue), pp. 51–60; T. H. Brush, "Predicted Changes in Operational Synergy and Post-Acquisition Performance of Acquired Businesses," *Strategic Management Journal* 17 (1996), pp. 1–24; and A. Seth, K. P. Song, and R. R. Pettit, "Value Creation and Destruction in Cross-Border Acquisitions," *Strategic Management Journal* 23 (October 2002), pp. 921–40.
30. J. Warner, J. Templeman, and R. Horn, "The Case against Mergers," *BusinessWeek*, October 30, 1995, pp. 122–34.
31. "Few Takeovers Pay Off for Big Buyers," *Investors Business Daily*, May 25, 2001, p. 1.
32. S. A. Christofferson, R. S. McNish, and D. L. Sias, "Where Mergers Go Wrong," *The McKinsey Quarterly* 2 (2004), pp. 92–110.
33. D. J. Ravenscraft and F. M. Scherer, *Mergers, Selloffs, and Economic Efficiency* (Washington, DC: Brookings Institution, 1987).
34. See P. Ghemawat and F. Ghadar, "The Dubious Logic of Global Mega-mergers," *Harvard Business Review*, July–August 2000, pp. 65–72.
35. R. Roll, "The Hubris Hypothesis of Corporate Takeovers," *Journal of Business* 59 (1986), pp. 197–216.
36. "Marital Problems," *The Economist*, October 14, 2000.
37. See J. P. Walsh, "Top Management Turnover Following Mergers and Acquisitions," *Strategic Management Journal* 9 (1988), pp. 173–83.
38. B. Vlasic and B. A. Stertz, *Taken for a Ride: How Daimler-Benz Drove Off with Chrysler* (New York: HarperCollins, 2000).

39. See A. A. Cannella and D. C. Hambrick, "Executive Departure and Acquisition Performance," *Strategic Management Journal* 14 (1993), pp. 137–52.
40. P. Haspeslagh and D. Jemison, *Managing Acquisitions* (New York: Free Press, 1991).
41. Ibid.

Chapter 13

1. R. A. Pope, "Why Small Firms Export: Another Look," *Journal of Small Business Management* 40 (2002), pp. 17–26.
2. S. T. Cavusgil, "Global Dimensions of Marketing," in *Marketing*, ed. P. E. Murphy and B. M. Enis (Glenview, IL: Scott, Foresman, 1985), pp. 577–99.
3. S. M. Mehta, "Enterprise: Small Companies Look to Cultivate Foreign Business," *The Wall Street Journal*, July 7, 1994, p. B2.
4. P. A. Julien and C. Ramagelaha, "Competitive Strategy and Performance of Exporting SMEs," *Entrepreneurship Theory and Practice* 27, no. 3 (March 2003), pp. 227–94.
5. W. J. Burpitt and D. A. Rondinelli, "Small Firms' Motivations for Exporting: To Earn and Learn?" *Journal of Small Business Management*, October 2000, pp. 1–14; and J. D. Mittelstaedt, G. N. Harben, and W. A. Ward, "How Small Is Too Small?" *Journal of Small Business Management* 41 (2003), pp. 68–85.
6. Small Business Administration, "The State of Small Business 1999–2000: Report to the President," 2001 (accessed at www.sba.gov/advo/stats/stateofsb99_00.pdf); and D. Ransom, "Obama's Math: More Exports Equals More Jobs," *The Wall Street Journal*, February 5, 2010.
7. A. O. Ogbuehi and T. A. Longfellow, "Perceptions of U.S. Manufacturing Companies Concerning Exporting," *Journal of Small Business Management*, October 1994, pp. 37–59; and U.S. Small Business Administration, "Guide to Exporting," www.sba.gov/oit/info/Guide-toExporting/index.html.
8. R. W. Haigh, "Thinking of Exporting?" *Columbia Journal of World Business* 29 (December 1994), pp. 66–86.
9. F. Williams, "The Quest for More Efficient Commerce," *Financial Times*, October 13, 1994, p. 7.
10. See Burpitt and Rondinelli, "Small Firms' Motivations for Exporting"; and C. S. Katsikeas, L. C. Leonidou, and N. A. Morgan, "Firm Level Export Performance Assessment," *Academy of Marketing Science* 28 (2000), pp. 493–511.
11. M. Y. Yoshino and T. B. Lifson, *The Invisible Link* (Cambridge, MA: MIT Press, 1986).
12. L. W. Tuller, *Going Global* (Homewood, IL: Business One-Irwin, 1991).
13. Haigh, "Thinking of Exporting?"
14. M. A. Raymond, J. Kim, and A. T. Shao, "Export Strategy and Performance," *Journal of Global Marketing* 15 (2001), pp. 5–29; and P. S. Aulakh, M. Kotabe, and H. Teegen, "Export Strategies and Performance of Firms from Emerging Economies," *Academy of Management Journal* 43 (2000), pp. 342–61.
15. J. Francis and C. Collins-Dodd, "The Impact of Firms' Export Orientation on the Export Performance of High-Tech Small and Medium Sized Enterprises," *Journal of International Marketing* 8, no. 3 (2000), pp. 84–103.
16. J. Koch, "Integration of U.S. Small Businesses into the Export Trade Sector Using Available Financial Tools and Resources," *Business Credit* 109, no. 10 (2007), pp. 64–68.
17. For a review of the conditions under which a buyer has power over a supplier, see M. E. Porter, *Competitive Strategy* (New York: Free Press, 1980).
18. *Exchange Agreements and Exchange Restrictions* (Washington, DC: International Monetary Fund, 1989).
19. It's also sometimes argued that countertrade is a way of reducing the risks inherent in a traditional money-for-goods transaction, particularly with entities from emerging economies. See C. J. Choi, S. H. Lee, and J. B. Kim, "A Note of Countertrade: Contractual Uncertainty and Transactional Governance in Emerging Economies," *Journal of International Business Studies* 30, no. 1 (1999), pp. 189–202.
20. J. R. Carter and J. Gagne, "The Do's and Don'ts of International Countertrade," *Sloan Management Review*, Spring 1988, pp. 31–37; and W. Maneerungsee, "Countertrade: Farm Goods Swapped for Italian Electricity," *Bangkok Post*, July 23, 1998.
21. Estimate from the American Countertrade Association at www.countertrade.org/index.htm. See also D. West, "Countertrade," *Business Credit* 104, no. 4 (2001), pp. 64–67; and B. Meyer, "The Original Meaning of Trade Meets the Future of Barter," *World Trade* 13 (January 2000), pp. 46–50.
22. Carter and Gagne, "The Do's and Don'ts of International Countertrade."
23. Maneerungsee, "Countertrade: Farm Goods Swapped for Italian Electricity."
24. For details, see Carter and Gagne, "The Do's and Don'ts of International Countertrade"; J. F. Hennart, "Some Empirical Dimensions of Countertrade," *Journal of International Business Studies*, 1990, pp. 240–60; and West, "Countertrade."

25. D. J. Lecraw, "The Management of Counter-trade: Factors Influencing Success," *Journal of International Business Studies*, Spring 1989, pp. 41–59.

Chapter 14

1. B. C. Arntzen, G. G. Brown, T. P. Harrison, and L. L. Trafton, "Global Supply Chain Management at Digital Equipment Corporation," *Interfaces* 25 (1995), pp. 69–93; and Diana Farrell, "Beyond Offshoring," *Harvard Business Review*, December 2004, pp. 1–8.
2. D. A. Garvin, "What Does Product Quality Really Mean," *Sloan Management Review* 26 (Fall 1984), pp. 25–44.
3. See the articles published in the special issue of the *Academy of Management Review on Total Quality Management* 19, no. 3 (1994). The following article provides a good overview of many of the issues involved from an academic perspective: J. W. Dean and D. E. Bowen, "Management Theory and Total Quality," *Academy of Management Review* 19 (1994), pp. 392–418. Also see T. C. Powell, "Total Quality Management as Competitive Advantage," *Strategic Management Journal* 16 (1995), pp. 15–37; and S. B. Han et al., "The Impact of ISO 9000 on TQM and Business Performance," *Journal of Business and Economic Studies* 13, no. 2 (2007), pp. 1–25.
4. For general background information, see "How to Build Quality," *The Economist*, September 23, 1989, pp. 91–92; A. Gabor, *The Man Who Discovered Quality* (New York: Penguin, 1990); P. B. Crosby, *Quality Is Free* (New York: Mentor, 1980); and M. Elliot et al., "A Quality World, a Quality Life," *Industrial Engineer*, January 2003, pp. 26–33.
5. G. T. Lucier and S. Seshadri, "GE Takes Six Sigma beyond the Bottom line," *Strategic Finance*, May 2001, pp. 40–46; and U. D. Kumar et al., "On the Optimal Selection of Process Alternatives in a Six Sigma Implementation," *International Journal of Production Economics* 111, no. 2 (2008), pp. 456–70.
6. M. Saunders, "U.S. Firms Doing Business in Europe Have Options in Registering for ISO 9000 Quality Standards," *Business America*, June 14, 1993, p. 7; and Han et al., "The Impact of ISO 9000 on TQM and Business Performance."
7. G. Stalk and T. M. Hout, *Competing against Time* (New York: Free Press, 1990).
8. N. Tokatli, "Global Sourcing: Insights from the Global Clothing Industry—The Case of Zara, a Fast Fashion Retailer," *Journal of Economic Geography* 8, no. 1 (2008), pp. 21–39.
9. Diana Farrell, "Beyond Offshoring," *Harvard Business Review*, December 2004, pp. 1–8; and M. A. Cohen and H. L. Lee, "Resource Deployment Analysis of Global Manufacturing and Distribution Networks," *Journal of Manufacturing and Operations Management* 2 (1989), pp. 81–104.
10. P. Krugman, "Increasing Returns and Economic Geography," *Journal of Political Economy* 99, no. 3 (1991), pp. 483–99; J. M. Shaver and F. Flyer, "Agglomeration Economies, Firm Heterogeneity, and Foreign Direct Investment in the United States," *Strategic Management Journal* 21 (2000), pp. 1175–93; and R. E. Baldwin and T. Okubo, "Heterogeneous Firms, Agglomeration Economies, and Economic Geography," *Journal of Economic Geography* 6, no. 3 (2006), pp. 323–50.
11. For a review of the technical arguments, see D. A. Hay and D. J. Morris, *Industrial Economics: Theory and Evidence* (Oxford: Oxford University Press, 1979). See also C. W. L. Hill and G. R. Jones, *Strategic Management: An Integrated Approach* (Boston: Houghton Mifflin, 2004).
12. See P. Nemetz and L. Fry, "Flexible Manufacturing Organizations: Implications for Strategy Formulation," *Academy of Management Review* 13 (1988), pp. 627–38; N. Greenwood, *Implementing Flexible Manufacturing Systems* (New York: Halstead Press, 1986); J. P. Womack, D. T. Jones, and D. Roos, *The Machine That Changed the World* (New York: Rawson Associates, 1990); and R. Parthasarthy and S. P. Seith, "The Impact of Flexible Automation on Business Strategy and Organizational Structure," *Academy of Management Review* 17 (1992), pp. 86–111.
13. B. J. Pine, *Mass Customization: The New Frontier in Business Competition* (Boston: Harvard Business School Press, 1993); S. Kotha, "Mass Customization: Implementing the Emerging Paradigm for Competitive Advantage," *Strategic Management Journal* 16 (1995), pp. 21–42; J. H. Gilmore and B. J. Pine II, "The Four Faces of Mass Customization," *Harvard Business Review*, January–February 1997, pp. 91–101; and M. Zerenler and D. Ozilhan, "Mass Customization Manufacturing: The Drivers and Concepts," *Journal of American Academy of Business* 12, no. 1 (2007), pp. 262–30.
14. "Toyota Motor Corporation Captures Ten Segment Awards," J. D. Power press release, March 19, 2009. Archived at <http://businesscenter.jdpower.com/news/pressrelease.aspx?ID=2009043>.
15. M. A. Cusumano, *The Japanese Automobile Industry* (Cambridge, MA: Harvard University Press, 1989); T. Ohno, *Toyota Production System* (Cambridge, MA: Productivity Press, 1990); and Womack, Jones, and Roos, *The Machine That Changed the World*.
16. P. Waurzyniak, "Ford's Flexible Push," *Manufacturing Engineering*, September 2003, pp. 47–50.

17. K. Ferdows, "Making the Most of Foreign Factories," *Harvard Business Review*, March–April 1997, pp. 73–88.
 18. This argument represents a simple extension of the dynamic capabilities research stream in the strategic management literature. See D. J. Teece, G. Pisano, and A. Shuen, "Dynamic Capabilities and Strategic Management," *Strategic Management Journal* 18 (1997), pp. 509–33.
 19. T. S. Frost, J. M. Birkinshaw, and P. C. Ensign, "Centers of Excellence in Multinational Corporations," *Strategic Management Journal* 23 (November 2002), pp. 997–1018.
 20. C. W. L. Hill, "Globalization, the Myth of the Nomadic Multinational Enterprise, and the Advantages of Location Persistence," School of Business working paper, University of Washington, 2001.
 21. Anne Parmigiani, "Why Do Firms Both Make and Buy?" *Strategic Management Journal* 29, no. 3 (2007), pp. 285–303.
 22. J. Solomon and E. Cherney, "A Global Report: Outsourcing to India Sees a Twist," *The Wall Street Journal*, April 1, 2004, p. A2.
 23. The material in this section is based primarily on the transaction cost literature of vertical integration; for example, O. E. Williamson, *The Economic Institutions of Capitalism* (New York: The Free Press, 1985).
 24. For a review of the evidence, see Williamson, *The Economic Institutions of Capitalism*. See also L. Poppo and T. Zenger, "Testing Alternative Theories of the Firm: Transaction Cost, Knowledge Based, and Measurement Explanations for Make or Buy Decisions in Information Services," *Strategic Management Journal* 19 (1998), pp. 853–78; and R. Carter and G. M. Hodgson, "The Impact of Empirical Tests to Transaction Cost Economics on the Debate on the Nature of the Firm," *Strategic Management Journal* 27, no. 5 (2006), pp. 461–80.
 25. A. D. Chandler, *The Visible Hand* (Cambridge, MA: Harvard University Press, 1977).
 26. For a review of these arguments, see C. W. L. Hill and R. E. Hoskisson, "Strategy and Structure in the Multiproduct Firm," *Academy of Management Review* 12 (1987), pp. 331–41.
 27. C. W. L. Hill, "Cooperation, Opportunism, and the Invisible Hand," *Academy of Management Review* 15 (1990), pp. 500–13.
 28. See R. Narasimhan and J. R. Carter, "Organization, Communication and Coordination of International Sourcing," *International Marketing Review* 7 (1990), pp. 6–20; and Arntzen, Brown, Harrison, and Trafton, "Global Supply Chain Management at Digital Equipment Corporation."
 29. H. F. Busch, "Integrated Materials Management," *IJPD & MM* 18 (1990), pp. 28–39.
 30. T. Aeppel, "Manufacturers Cope with the Costs of Strained Global Supply Lines," *The Wall Street Journal*, December 8, 2004, p. A1.
- ## Chapter 15
1. See R. W. Ruekert and O. C. Walker, "Interactions between Marketing and R&D Departments in Implementing Different Business-Level Strategies," *Strategic Management Journal* 8 (1987), pp. 233–48; and K. B. Clark and S. C. Wheelwright, *Managing New Product and Process Development* (New York: Free Press, 1993).
 2. T. Levitt, "The Globalization of Markets," *Harvard Business Review*, May–June 1983, pp. 92–102. Reprinted by permission of *Harvard Business Review*, an excerpt from "The Globalization of Markets," by Theodore Levitt, May–June 1983. Copyright © 1983 by the President and Fellows of Harvard College. All rights reserved.
 3. For example, see S. P. Douglas and Y. Wind, "The Myth of Globalization," *Columbia Journal of World Business*, Winter 1987, pp. 19–29; C. A. Bartlett and S. Ghoshal, *Managing across Borders: The Transnational Solution* (Boston: Harvard Business School Press, 1989); V. J. Govindarajan and A. K. Gupta, *The Quest for Global Dominance* (San Francisco: Jossey Bass, 2001); J. Quelch, "The Return of the Global Brand," *Harvard Business Review*, August 2003, pp. 1–3; and P. J. Ghemawat, *Redefining Global Strategy* (Boston: Harvard Business School Press, 2007).
 4. J. Tagliabue, "U.S. Brands Are Feeling Global Tension," *The New York Times*, March 15, 2003, p. C3.
 5. D. B. Holt, J. A. Quelch, and E. L. Taylor, "How Global Brands Compete," *Harvard Business Review*, September 2004.
 6. J. T. Landry, "Emerging Markets: Are Chinese Consumers Coming of Age?" *Harvard Business Review*, May–June 1998, pp. 17–20.
 7. C. Miller, "Teens Seen as the First Truly Global Consumers," *Marketing News*, March 27, 1995, p. 9.
 8. This approach was originally developed in K. Lancaster, "A New Approach to Demand Theory," *Journal of Political Economy* 74 (1965), pp. 132–57.
 9. V. R. Alden, "Who Says You Can't Crack Japanese Markets?" *Harvard Business Review*, January–February 1987, pp. 52–56.
 10. T. Parker-Pope, "Custom Made," *The Wall Street Journal*, September 26, 1996, p. 22.
 11. "RCA's New Vista: The Bottom Line," *BusinessWeek*, July 4, 1987, p. 44.

12. N. Gross and K. Rebello, "Apple? Japan Can't Say No," *BusinessWeek*, June 29, 1992, pp. 32–33.
13. "After Early Stumbles P&G Is Making Inroads Overseas," *The Wall Street Journal*, February 6, 1989, p. B1.
14. C. Matlack and P. Gogoi, "What's This? The French Love McDonald's?" *BusinessWeek*, January 13, 2003, pp. 50–51.
15. Z. Gurhan-Cvanli and D. Maheswaran, "Cultural Variation in Country of Origin Effects," *Journal of Marketing Research*, August 2000, pp. 309–17.
16. See M. Laroche, V. H. Kirpalani, F. Pons, and L. Zhou, "A Model of Advertising Standardization in Multinational Corporations," *Journal of International Business Studies*, 32 (2001), pp. 249–66; and D. A. Aaker and E. Joachimsthaler, "The Lure of Global Branding," *Harvard Business Review*, November–December 1999, pp. 137–44.
17. "Advertising in a Single Market," *The Economist*, March 24, 1990, p. 64.
18. D. Waller, "Charged Up over Competition Law," *Financial Times*, June 23, 1994, p. 14.
19. R. G. Matthews and D. Pringle, "Nokia Bets One Global Message Will Ring True in Many Markets," *The Wall Street Journal*, September 27, 2004, p. B6.
20. R. J. Dolan and H. Simon, *Power Pricing* (New York: Free Press, 1999).
21. B. Stottinger, "Strategic Export Pricing: A Long Winding Road," *Journal of International Marketing* 9 (2001), pp. 40–63; S. Gil-Pareja "Export Process Discrimination in Europe and Exchange Rates," *Review of International Economics*, May 2002, pp. 299–312; and G. Corsetti and L. Dedola, "A Macro Economic Model of International Price Discrimination," *Journal of International Economics*, September 2005, pp. 129–40.
22. These allegations were made on a PBS *Frontline* documentary telecast in the United States in May 1992.
23. Y. Tsurumi and H. Tsurumi, "Fujifilm–Kodak Duopolistic Competition in Japan and the United States," *Journal of International Business Studies* 30 (1999), pp. 813–30.
24. G. Smith and B. Wolverson, "A Dark Moment for Kodak," *BusinessWeek*, August 4, 1997, pp. 30–31.
25. R. Narisette and J. Friedland, "Disposable Income: Diaper Wars of P&G and Kimberly-Clark Now Heat Up in Brazil," *The Wall Street Journal*, June 4, 1997, p. A1.
26. J. F. Pickering, *Industrial Structure and Market Conduct* (London: Martin Robertson, 1974).
27. S. P. Douglas, C. Samuel Craig, and E. J. Nijissen, "Integrating Branding Strategy across Markets," *Journal of International Marketing* 9, no. 2 (2001), pp. 97–114.
28. The phrase was first used by economist Joseph Schumpeter in *Capitalism, Socialism, and Democracy* (New York: Harper Brothers, 1942).
29. S. Kotabe, S. Srinivasan, and P. S. Aulakh, "Multinationality and Firm Performance: The Moderating Role of R&D and Marketing," *Journal of International Business Studies* 33 (2002), pp. 79–97.
30. See D. C. Mowery and N. Rosenberg, *Technology and the Pursuit of Economic Growth* (Cambridge, UK: Cambridge University Press, 1989); and M. E. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990).
31. W. Kuemmerle, "Building Effective R&D Capabilities Abroad," *Harvard Business Review*, March–April 1997, pp. 61–70; and C. Le Bas and C. Sierra, "Location versus Home Country Advantages in R&D Activities," *Research Policy* 31 (2002), pp. 589–609.
32. "When the Corporate Lab Goes to Japan," *The New York Times*, April 28, 1991, sec. 3, p. 1.
33. D. Shapley, "Globalization Prompts Exodus," *Financial Times*, March 17, 1994, p. 10.
34. E. Mansfield, "How Economists See R&D," *Harvard Business Review*, November–December, 1981, pp. 98–106.
35. Ibid.
36. G. A. Stevens and J. Burley, "Piloting the Rocket of Radical Innovation," *Research Technology Management* 46 (2003), pp. 16–26.
37. K. B. Clark and S. C. Wheelwright, *Managing New Product and Process Development* (New York: Free Press, 1993); and M. A. Shilling and C. W. L. Hill, "Managing the New Product Development Process," *Academy of Management Executive* 12, no. 3 (1998), pp. 67–81.
38. O. Port, "Moving Past the Assembly Line," *BusinessWeek Special Issue: Reinventing America*, 1992, pp. 177–80.
39. K. B. Clark and T. Fujimoto, "The Power of Product Integrity," *Harvard Business Review*, November–December 1990, pp. 107–18; Clark and Wheelwright, *Managing New Product and Process Development*; S. L. Brown and K. M. Eisenhardt, "Product Development: Past Research, Present Findings, and Future Directions," *Academy of Management Review* 20 (1995), pp. 348–78; and G. Stalk and T. M. Hout, *Competing against Time* (New York: Free Press, 1990).
40. Shilling and Hill, "Managing the New Product Development Process."
41. C. Christensen. "Quantum Corporation—Business and Product Teams," Harvard Business School case no. 9-692-023.

42. R. Nobel and J. Birkinshaw, "Innovation in Multinational Corporations: Control and Communication Patterns in International R&D Operations," *Strategic Management Journal* 19 (1998), pp. 479–96.
43. Information comes from the company's Web site; also see K. Ferdows, "Making the Most of Foreign Factories," *Harvard Business Review*, March–April 1997, pp. 73–88.

Chapter 16

1. P. J. Dowling and R. S. Schuler, *International Dimensions of Human Resource Management* (Boston: PSW-Kent, 1990).
2. J. Millman, M. A. von Glinow, and M. Nathan, "Organizational Life Cycles and Strategic International Human Resource Management in Multinational Companies," *Academy of Management Review* 16 (1991), pp. 318–39; A. Bird and S. Beechler, "Links Between Business Strategy and Human Resource Management," *Journal of International Business Studies* 26 (1995), pp. 23–47; B. A. Colbert, "The Complex Resource Based View: Implications for Theory and Practice of Strategic Human Resource Management," *Academy of Management Review* 29 (2004), pp. 341–60; and C. J. Collins and K. D. Clark, "Strategic Human Resource Practices, Top Management Team Social Networks, and Firm Performance," *Academy of Management Journal* 46 (2003), pp. 740–60.
3. See Peter Bamberger and Ilan Meshoulam, *Human Resource Strategy: Formulation, Implementation, and Impact* (Thousand Oaks, CA: Sage, 2000); P. M. Wright and S. Snell, "Towards a Unifying Framework for Exploring Fit and Flexibility in Human Resource Management," *Academy of Management Review* 23 (October 1998), pp. 756–72; and B.A. Colbert, "The Complex Resource-Based View: Implications for Theory and Practice in Strategic Human Resource Management," *Academy of Management Review* 29 (July 2004), pp. 341–60.
4. R. Colman, "HR Management Lags behind at World Class Firms," *CMA Management*, July–August 2002, p. 9.
5. E. H. Schein, *Organizational Culture and Leadership* (San Francisco: Jossey-Bass, 1985).
6. H. V. Perlmutter, "The Tortuous Evolution of the Multinational Corporation," *Columbia Journal of World Business* 4 (1969), pp. 9–18; D. A. Heenan and H. V. Perlmutter, *Multinational Organizational Development* (Reading, MA: Addison-Wesley, 1979); D. A. Ondrack, "International Human Resources Management in European and North American Firms," *International Studies of Management and Organization* 15 (1985), pp. 6–32; and T. Jackson, "The Management of People across Cultures: Valuing People Differently," *Human Resource Management* 41 (2002), pp. 455–75.
7. V. Reitman and M. Schuman, "Men's Club: Japanese and Korean Companies Rarely Look Outside for People to Run Their Overseas Operations," *The Wall Street Journal*, September 26, 1996, p. 17.
8. S. Beechler and J. Z. Yang, "The Transfer of Japanese Style Management to American Subsidiaries," *Journal of International Business Studies* 25 (1994), pp. 467–91. See also R. Konopaske, S. Warner, and K. E. Neupert, "Entry Mode Strategy and Performance: The Role of FDI Staffing," *Journal of Business Research*, September 2002, pp. 759–70.
9. M. Banai and L. M. Sama, "Ethical Dilemma in MNCs' International Staffing Policies," *Journal of Business Ethics*, June 2000, pp. 221–35.
10. Reitman and Schuman, "Men's Club."
11. C. A. Bartlett and S. Ghoshal, *Managing across Borders: The Transnational Solution* (Boston: Harvard Business School Press, 1989).
12. S. J. Kobrin, "Geocentric Mindset and Multinational Strategy," *Journal of International Business Studies* 25 (1994), pp. 493–511.
13. F. Hansen, "International Business Machine," *Workforce Management*, July 2005, pp. 36–44.
14. P. M. Rosenzweig and N. Nohria, "Influences on Human Resource Management Practices in Multinational Corporations," *Journal of International Business Studies* 25 (1994), pp. 229–51.
15. Kobrin, "Geocentric Mindset and Multinational Strategy."
16. M. Harvey and H. Fung, "Inpatriate Managers: The Need for Realistic Relocation Reviews," *International Journal of Management* 17 (2000), pp. 151–59.
17. S. Black, M. Mendenhall, and G. Oddou, "Toward a Comprehensive Model of International Adjustment," *Academy of Management Review* 16 (1991), pp. 291–317; J. Shay and T. J. Bruce, "Expatriate Managers," *Cornell Hotel & Restaurant Administration Quarterly*, February 1997, p. 30–40; and Y. Baruch and Y. Altman, "Expatriation and Repatriation in MNCs—A Taxonomy," *Human Resource Management* 41 (2002), pp. 239–59.
18. M. G. Harvey, "The Multinational Corporation's Expatriate Problem: An Application of Murphy's Law," *Business Horizons* 26 (1983), pp. 71–78.
19. J. Barbian, "Return to Sender," *Training*, January 2002, pp. 40–43.
20. Shay and Bruce, "Expatriate Managers." Also see J. S. Black and H. Gregersen, "The Right Way to Manage Expatriates," *Harvard Business Review*, March–April

- 1999, pp. 52–63; and Baruch and Altman, “Expatriation and Repatriation in MNCs.”
21. N. Foster, “The Persistent Myth of High Expatriate Failure Rates,” *Journal of Human Resource Management* 8 (1997), pp. 177–205.
22. Barbian, “Return to Sender.”
23. Black, Mendenhall, and Oddou, “Toward a Comprehensive Model of International Adjustment.”
24. R. L. Tung, “Selection and Training Procedures of U.S., European, and Japanese Multinationals,” *California Management Review* 25 (1982), pp. 57–71.
25. H. W. Lee, “Factors That Influence Expatriate Failure,” *International Journal of Management* 24 (2007), pp. 403–15.
26. C. M. Solomon, “Success Abroad Depends upon More than Job Skills,” *Personnel Journal*, April 1994, pp. 51–58.
27. C. M. Solomon, “Unhappy Trails,” *Workforce*, August 2000, pp. 36–41.
28. Solomon, “Success Abroad.”
29. Solomon, “Unhappy Trails.”
30. M. Harvey, “Addressing the Dual-Career Expatriation Dilemma,” *Human Resource Planning* 19, no. 4 (1996), pp. 18–32.
31. M. Mendenhall and G. Oddou, “The Dimensions of Expatriate Acculturation: A Review,” *Academy of Management Review* 10 (1985), pp. 39–47.
32. I. Torbierin, *Living Abroad: Personal Adjustment and Personnel Policy in the Overseas Setting* (New York: John Wiley & Sons, Inc., 1982).
33. R. L. Tung, “Selection and Training of Personnel for Overseas Assignments,” *Columbia Journal of World Business* 16 (1981), pp. 68–78.
34. Solomon, “Success Abroad.”
35. S. Ronen, “Training and International Assignee,” in *Training and Career Development*, ed. I. Goldstein (San Francisco: Jossey-Bass, 1985); and Tung, “Selection and Training of Personnel for Overseas Assignments.”
36. Solomon, “Success Abroad.”
37. Harvey, “Addressing the Dual-Career Expatriation Dilemma”; and J. W. Hunt, “The Perils of Foreign Postings for Two,” *Financial Times*, May 6, 1998, p. 22.
38. C. M. Daily, S. T. Certo, and D. R. Dalton, “International Experience in the Executive Suite: A Path to Prosperity?” *Strategic Management Journal* 21 (2000), pp. 515–23.
39. Dowling and Schuler, *International Dimensions of Human Resource Management*.
40. Ibid.
41. G. Baliga and J. C. Baker, “Multinational Corporate Policies for Expatriate Managers: Selection, Training, and Evaluation,” *Advanced Management Journal*, Autumn 1985, pp. 31–38.
42. J. C. Baker, “Foreign Language and Departure Training in U.S. Multinational Firms,” *Personnel Administrator*, July 1984, pp. 68–70.
43. A 1997 study by the Conference Board looked at this in depth. For a summary, see L. Grant, “That Overseas Job Could Derail Your Career,” *Fortune*, April 14, 1997, p. 166. Also see J. S. Black and H. Gregersen, “The Right Way to Manage Expatriates,” *Harvard Business Review*, March–April 1999, pp. 52–63.
44. J. S. Black and M. E. Mendenhall, *Global Assignments: Successfully Expatriating and Repatriating International Managers* (San Francisco: Jossey-Bass, 1992); and K. Vermont, “Expatriates Come Home,” *CMA Management*, October 2001, pp. 30–33.
45. Ibid.
46. Figures from the Conference Board study. For a summary, see Grant, “That Overseas Job Could Derail Your Career.”
47. S. C. Schneider, “National v. Corporate Culture: Implications for Human Resource Management,” *Human Resource Management* 27 (Summer 1988), pp. 231–46.
48. I. M. Manve and W. B. Stevenson, “Nationality, Cultural Distance and Expatriate Status,” *Journal of International Business Studies* 32 (2001), pp. 285–303; and D. Minbaeva et al., “MNC Knowledge Transfer, Subsidiary Absorptive Capacity, and HRM,” *Journal of International Business Studies* 34, no. 6 (2003), pp. 586–604.
49. Bartlett and Ghoshal, *Managing across Borders*.
50. See G. Oddou and M. Mendenhall, “Expatriate Performance Appraisal: Problems and Solutions,” in *International Human Resource Management*, ed. Mendenhall and Oddou (Boston: PWS-Kent, 1991); Dowling and Schuler, *International Dimensions*; R. S. Schuler and G.W. Florkowski, “International Human Resource Management,” in *Handbook for International Management Research*, ed. B. J. Punnett and O. Shenkar (Oxford: Blackwell, 1996); and K. Roth and S. O'Donnell, “Foreign Subsidiary Compensation Strategy: An Agency Theory Perspective,” *Academy of Management Journal* 39, no. 3 (1996), pp. 678–703.
51. Oddou and Mendenhall, “Expatriate Performance Appraisal.”
52. “Expatriates Often See Little Benefit to Careers in Foreign Stints, Indifference at Home,” *The Wall Street Journal*, December 11, 1989, p. B1.

53. Oddou and Mendenhall, "Expatriate Performance Appraisal"; and Schuler and Florkowski, "International Human Resource Management."
54. Towers Perrin, *Towers Perrin Worldwide Total Remuneration Study, 2005–2006*, www.towersperrin.com.
55. J. Cummings and L. Brannen, "The New World of Compensation," *Business Finance*, June 2005, p. 8.
56. "Multinational Tighten Control of Benefit Plans," *Workforce Management*, May 2005, p. 5.
57. Organizational Resource Counselors, *2002 Survey of International Assignment Policies and Practices*, March 2003.
58. C. Reynolds, "Compensation of Overseas Personnel," in *Handbook of Human Resource Administration*, ed. J. J. Famularo (New York: McGraw-Hill, 1986).
59. M. Helms, "International Executive Compensation Practices," in *International Human Resource Management*, ed. M. Mendenhall and G. Oddou (Boston: PWS-Kent, 1991).
60. G. W. Latta, "Expatriate Incentives," *HR Focus* 75, no. 3 (March 1998), p. S3.
61. C. K. Prahalad and Y. L. Doz, *The Multinational Mission* (New York: Free Press, 1987).
62. Ibid.
63. Schuler and Florkowski, "International Human Resource Management."
64. See J. P. Womack, D. T. Jones, and D. Roos, *The Machine That Changed the World* (New York: Rawson Associates, 1990).



photo credits

Chapter 1

page 2 © Mario Tama/Getty Images
page 11 © Ludovic/REA/Redux
page 16 © Royalty-Free Corbis
page 27 © Daniel Sheehan/Getty Images
page 29 AP Photo/Gautam Singh
page 35 © Jason Larkin/Getty Images

Chapter 2

page 42 © Patrick Pleul/dpa/Corbis
page 51 © Tim Hall/Getty Images
page 60 © ChinaFotoPress/Getty Images

Chapter 3

page 90 © Imaginechina via AP Images
page 102 © Stephen Shaver/Bloomberg via Getty Images
page 106 © Newhouse News Service/Landov
page 119 AP Photo/Rajesh Nirgude
page 121 © Adrian Wilson/Beateworks/Corbis

Chapter 4

page 128 © Imaginechina via AP Images
page 131 © AP Photo/Anat Givon
page 136 © AP Photo
page 138 The McGraw-Hill Companies, Inc./
John Flournoy, photographer
page 143 © Mark Wilson/Getty Images
page 155 © Justin Sullivan/Getty Images

Chapter 5

page 160 © Keri Johnson
page 184 Courtesy of Airbus Americas

Chapter 6

page 202 © Images.com/Corbis
page 214 © Royalty-Free Corbis
page 217 AP Photo/Vincent Thian
page 226 © Daniel Sheehan/Liaison Agency/
Newsmakers/Getty Images

Chapter 7

page 240 © AP Photo/Katsumi Kasahara
page 249 Courtesy BP plc
page 255 Courtesy of Trestria, Inc.
page 266 Courtesy of Toyota Motor North America, Inc.

Chapter 8

page 274 © David McNew/Getty Images
page 283 © Pierre Verdy/AFP/Getty Images
page 287 © PhotoDisc/Getty Images/DAL
page 296 © Steve Starr/Corbis

Chapter 9

page 310 © Sylvain Cazenave/Corbis
page 316 © Jewel Samad/AFP/Getty Images
page 319 © PhotoLink/Getty Images/DAL
page 328 © Najlah Feanny/Corbis
page 333 © Reprinted Courtesy of Caterpillar, Inc.

Chapter 10

page 342 © Franck Guiziou/Hemis/Corbis
page 348 © Bettmann/Corbis
page 365 © Udo Weitz/Bloomberg via Getty Images

Chapter 11

page 378 © AP Photo/Gregory Bull
page 399 © Lon C. Diehl/PhotoEdit, Inc.
page 404 © Spencer Platt/Getty Images

Chapter 12

page 416 © Imaginechina via AP Images
page 424 © AP Photo/Nathan Martin
page 428 © Ryan McVay/Getty Images
page 434 © AP Photo/Dave Caulkin

Chapter 13

page 442 © AP Photo/Mary Altaffer
page 448 Courtesy of Export.gov
page 458 Courtesy of Export-Import Bank of the
United States

Chapter 14

page 466 © AP Photo/Saurabh Das
page 471 © George Steinmetz/Corbis
page 475 © AP Photo/Brian Bohannon
page 482 © AP Photo/Dinda

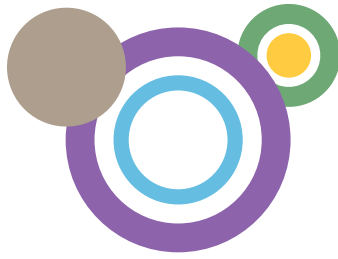
Chapter 15

page 492 © David McNew/Getty Images
page 497 © AP Photo/Ed Bailey
page 499 © AP Photo/David Guttenfelder

page 505 © The McGraw-Hill Companies, Inc./
Andrew Resek, photographer
page 510 © Peter Yates/Corbis
page 519 © AP Photo/Feature Photo Service/Kodak

Chapter 16

page 526 © AP Photo/Kirsty Wigglesworth
page 539 © Reprinted Courtesy of Caterpillar, Inc.
page 549 © International Labour Organization



name index

- Aaker, D. A., 587
Abacha, Sani, 58
Abbasi, S. M., 569
Acemoglu, D., 572
Ackerman, S. Rose, 58, 566
Adonis, A., 568
Aepfel, T., 176, 586
Agarwal, R., 573
Agon, Jean-Paul, 283
Aidt, T. S., 566
Alchain, A. A., 580
Alden, V. R., 586
Allen, H. L., 578
Altman, Y., 588, 589
Anand, J., 575, 583
Anderson, E., 582
Anderson, J. E., 566
Anderson, Kym, 573, 574
Anderson, R., 344
Andersson, U., 581
Anderton, D., 212
Andrews, E. L., 215
Andrews, Kenneth R., 571
Annett, A., 569, 570
Annett, Tim, 166
Aoki, M., 566, 568, 569
Aristotle, 47
Arndt, S., 578
Arntzen, B. C., 585, 586
Arslan, Saffet, 108
Arterian, S., 579
Aulakh, P. S., 584, 587
Avery, K. B., 570

Bahree, M., 525
Bailey, R., 41
Baily, R., 215
Baker, G., 330, 577, 579
Baker, J. C., 589
Balassa, B., 571
Baldwin, R. E., 585
Baliga, G., 589
Ballon, M., 425
Balls, A., 166
Bamberger, Peter, 588

Banai, M., 588
Barber, Tony, 577
Barbian, J., 537, 588, 589
Barboza, D., 553, 580
Bardham, P., 566
Barkeme, H., 582
Barney, J. B., 580
Barro, Robert, 103, 569
Bartlett, C. A., 576, 580, 581, 582, 586, 588, 589
Bartlett, Christopher, 404, 423, 425
Bartlett, D. L., 29, 565
Baruch, Y., 588, 589
Batra, Ravi, 565
Bazerman, Max H., 571, 576
Beamish, P. W., 583
Beauchamp, Tom L., 571
Bechler, K. A., 196
Beechler, S., 588
Bellman, Eric, 100, 468
Belman, D., 565
Belson, K., 581
Benady, A., 516
Ben-David, D., 566
Bennett, D., 4
Benoit, B., 564
Bentham, Jeremy, 147
Bergsten, C. F., 233, 574
Bernanke, Ben, 361
Bernstein, A., 176
Bernstein, Jared, 565
Besanko, D., 580
Bevan, D. L., 58
Bhagwati, J., 564, 565, 572, 573, 574, 576
Bian, Y., 569
Bigoness, W. J., 569
Bilefsky, D., 108
Bird, A., 588
Birkinshaw, J., 581, 588
Birkinshaw, J. M., 581, 586
Black, J. S., 588, 589
Black, S., 588, 589
Blakely, G. L., 569

Blanchard, O., 573
Blau, J., 473
Blecker, R. A., 565, 566
Bleeke, J., 581
Block, Walter, 567
Blustein, P., 371
Bogenr, W. C., 582
Bond, M. H., 570
Bono, 35
Boudette, N., 318
Boulding, W., 573
Bove, Jose, 28, 506
Bowen, D. E., 585
Bowen, H. P., 572
Bower, Joseph, 571
Bowie, Norman E., 571
Brada, J. C., 568
Bradford, S. C., 233, 574
Bradley, D. G., 583
Bradsher, K., 162
Brander, J. A., 574
Brannen, L., 590
Brannen, Mary Yoko, 568
Branstetter, L. G., 575
Bream, R., 308
Brook, Stephen, 568
Brouthers, K. D., 575, 582, 583
Brouthers, L. B., 582, 583
Brouthers, L. E., 575
Brown, G. G., 585, 586
Brown, S. L., 587
Browne, A., 166
Bruce, T. J., 588
Brune, N., 568
Bruno, Michael, 578
Brush, T. H., 583
Bryan, J., 112
Bryan-Low, C., 403
Bryce, Robert, 142–143, 571
Buchan, D., 576
Buchanan, James, 47
Buck, T., 288
Buckley, N., 565
Buckley, P. J., 580
Burgers, W., 581

- Burgess, K., 421
 Burley, J., 587
 Burpitt, W. J., 584
 Burton, J., 330, 579
 Busch, H. F., 586
 Bush, George W., 207, 213
 Bussey, J., 465
 Butler, A., 130
 Byrnes, N., 380

 Cannella, A. A., 584
 Carlton, Jim, 135, 574
 Carroll, P., 579
 Carter, J. R., 579, 584, 586
 Carter, R., 586
 Castle, Stephen, 291
 Castleman, Ben, 186
 Castro, Fidel, 83
 Cavanagh, J., 577
 Caves, R. E., 564, 575, 576, 583
 Cavusgil, S. T., 584
 Certo, S. T., 589
 Chan, S., 247
 Chandler, A. D., 586
 Chandler, Alfred, 185, 572
 Chandler, M., 465
 Chang, A., 380
 Chang, L. T., 581
 Chang, S. J., 575
 Chavez, Hugo, 49, 83, 86, 300, 355
 Chazan, G., 371
 Chen, C. C., 569
 Chen, Steve, 247
 Chen, Y. R., 569
 Chen, Z., 570
 Cherney, E., 586
 Chetty, S., 565
 Chi, P. S. K., 582
 Chi, T., 583
 Child, P. N., 421
 Chipello, C. J., 581
 Choate, P., 565
 Choi, C. J., 584
 Chong, W., 166
 Christen, M., 573
 Christensen, C., 587
 Christofferson, S. A., 583
 Clarida, R. H., 578
 Clark, K. B., 586, 587
 Clark, K. D., 588
 Clinton, Bill, 9
 Clinton, Hillary, 149
 Coffee, J. C., 583
 Cohen, J., 506
 Cohen, M. A., 585
 Colbert, B. A., 588

 Colchester, N., 576
 Coleman, B., 580
 Collier, P., 58
 Collins, C. J., 588
 Collins-Dodd, C., 584
 Collis, A., 582
 Colman, R., 588
 Colvin, G., 41
 Confucius, 111
 Conklin, David, 437
 Conner, K. R., 580
 Conners, L., 567
 Contractor, F. J., 582
 Coolidge, J., 58, 566
 Copeland, B. R., 565, 573
 Copeland, T., 580
 Coppock, L., 578
 Corsetti, G., 587
 Cortés, Hernán, 423
 Costa, I., 576
 Craig, C. Samuel, 587
 Crandall, R. W., 573
 Crosby, P. B., 585
 Cultice, C. K., 444, 465
 Cumby, R. E., 578
 Cummings, J., 590
 Cusumano, M. A., 585

 Daily, C. M., 589
 Dalai Lama, 35, 139
 Dalton, D. R., 589
 Dana, L., 92
 Davey, W. J., 574
 Davis, D. R., 572
 Davis, P., 577
 Dayaram, K., 568
 De Forrest, Adrienne, 40
 De Gaulle, Charles, 351
 De George, Richard T., 570, 571
 de Jonquieres, G., 215, 574, 577
 de la Cruz, Erik, 425
 de la Torre, A., 576
 de Queiroz, R., 576
 de Soto, Hernando, 69, 567
 Dean, J. W., 585
 Decker, Bill, 95
 Dedola, L., 587
 Dekmejian, R. H., 569
 Delios, A., 583
 Delors, Jacques, 287
 Deming, W. Edwards, 471
 Deng Xiaoping, 139
 Deraniyagala, S., 572
 Derham, M. T., 251

 Dertouzos, M. L., 568, 570
 Deutsch, C. H., 441, 581
 Devereux, M., 578
 Dial, Jay, 571
 Diamond, Jared, 567
 Diaz, Manuel, 28
 Dickie, M., 61
 Dickson, M., 578
 Ding Guangen, 139
 Dixit, A., 572, 574, 576
 Dobbs, Lou, 27–28, 565
 Dobnik, V., 570
 Doherty, Sharon, 443–444
 Dolan, R. J., 587
 Dollar, D., 572
 Donaldson, Thomas, 570, 571
 Done, K., 372
 Donkin, R., 312
 Donnan, S., 251
 Dore, R., 568, 569
 Dornbusch, R., 571
 Douglas, M., 568
 Douglas, S. P., 586, 587
 Dowling, P. J., 588, 589
 Doz, Yves L., 411, 412, 548, 581, 582, 590
 Draffen, C. M., 564
 Dranove, D., 580
 Drozdak, W., 285
 Dunne, N., 573
 Dunning, John H., 254–256, 268, 271, 575, 583
 Dyck, J., 208
 Dyer, G., 166

 Easterly, W., 566
 Edison, H. J., 578
 Edison, J. R., 578
 Edwards, S., 573, 579
 Ehrlich, I., 570
 Eiben, T., 451
 Eichengreen, B., 579
 Eigen-Zucchi, C., 577
 Eilat, Y., 568
 Einhorn, B., 473
 Eisenhardt, K. M., 587
 El Qorchi, M., 566
 Elliot, M., 585
 Elliott, Z. A., 573
 Ellis, R., 568
 Engardio, P., 9, 176
 Engel, C., 578, 579
 Enis, B. M., 584
 Ensign, P. C., 581, 586
 Ernst, D., 581
 Esterl, M., 577

- Evelyn, Irtani, 135
 Everett, J., 570
 Ewing, J., 159
- Fackler, M., 468
 Fagerberg, J., 567
 Fama, E., 578
 Famularo, J. J., 590
 Farrell, Diana, 585
 Fastow, Andrew, 143
 Feigenbaum, A. V., 471
 Feldstein, M., 577
 Ferdows, K., 480, 586, 588
 Fernald, J. G., 564, 565
 Field, A., 58
 Fine, B., 572
 Fischer, S., 571
 Fisher, Irvin, 327
 Fisher, S., 567, 568
 Fitchard, K., 188
 Fittipaldi, S., 371
 Fladmoe-Lindquist, K., 583
 Flannery, T., 573
 Florkowski, G. W., 589, 590
 Flyer, F., 575, 585
 Forelle, C., 553, 575
 Forney, M., 139
 Forrester, M., 242
 Forsgren, M., 581
 Forster, M., 565
 Foster, N., 589
 Fox, J., 196
 Francis, J., 584
 Frankel, Jeffrey, 177, 564, 565, 572
 Frankel, M., 581
 Frazee, V., 537
 Freeman, E., 571
 Freeman, R., 565
 Freeman, R. Edward, 571
 Freenstra, R. C., 575
 Friberg, E. G., 578
 Friedland, J., 587
 Friedman, Milton, 47, 144, 566, 571, 578
 Friedman, R., 566, 578
 Friedman, Thomas, 6, 564
 Frost, T. S., 581, 586
 Fry, L., 585
 Fuentelsaz, L., 575
 Fujimoto, T., 587
 Fukuda, H., 208
 Fukuyama, Francis, 74–75, 567
 Fung, H., 588
- Gabor, A., 585
 Gagne, G., 577
- Gagne, J., 579, 584
 Gagnon, J. E., 578
 Gallego, R., 49
 Gallion, Don, 446
 Gandhi, Mahatma, 110
 Gao, Z., 575
 Gapper, J., 491
 Garland, S., 577
 Garrett, G., 568
 Garten, J. E., 581
 Garvin, D. A., 585
 Gatignon, H., 582
 Gay, G. D., 578
 Geist, L. C., 494
 Geithner, Timothy F., 361
 Gellerman, Saul W., 571
 Gerondeau, J. L., 372
 Gerstein, M., 580
 Gerteis, J., 568
 Ghadar, F., 583
 Ghemawat, P., 580, 581, 582, 583, 586
 Ghosh, A. R., 579
 Ghoshal, S., 576, 580, 581, 582, 586, 588, 589
 Ghoshal, Sumantra, 404, 423, 425
 Giddens, A., 566, 569
 Gilbert, Daniel, 571
 Gilligan, Carol, 150
 Gilmore, J. H., 585
 Gil-Pareja, S., 587
 Glain, Stephen, 19
 Glassman, David, 391–392
 Goering, Laurie, 145
 Gogoi, P., 587
 Goldsmith, E., 565
 Goldsmith, James, 565
 Goldstein, Alan, 573
 Goldstein, I., 589
 Gomes-Casseres, B., 581, 582
 Gomez, J., 575
 Gongzheng, C., 88
 Gooch, L., 577
 Goodman, N., 569
 Gordon, B. K., 576
 Gort, M., 573
 Govindarajan, V. J., 581, 582, 586
 Grant, Colin, 571
 Grant, L., 589
 Grant, R. M., 573
 Graser, M., 112
 Graves, S. B., 570
 Greene, J., 525
 Greenfield, V., 564, 565
 Greenhouse, S., 570
 Greenwood, N., 585
- Gregersen, H., 588, 589
 Greider, William, 565
 Grieco, P. L. E., 233, 574
 Griswold, D., 573
 Gross, N., 587
 Grossman, G., 572
 Grossman, G. M., 32, 565, 567
 Guerrino, K., 196
 Gulati, R., 581
 Gulde, A. M., 579
 Gumbel, P., 580
 Gunning, J. W., 58
 Gupta, A. K., 581, 582, 586
 Gurhan-Cvanli, Z., 587
 Gwartney, James, 567
- Habib, M., 566
 Haigh, R. W., 584
 Hall, Edward T., 121, 568, 570
 Hall, G., 580
 Hall, M. R., 568, 570
 Halliday, Jess, 399
 Hambrick, D. C., 584
 Hamel, G., 580, 581, 582
 Hamel, Gary, 411, 412
 Hamilton, Alexander, 219
 Hamilton, C. A., 573
 Hamilton, H., 570
 Hamilton, J. D., 579
 Hamm, S., 415
 Han, S. B., 585
 Hanke, S. H., 166
 Hannibal, E., 542
 Hansen, F., 553, 588
 Harben, G. N., 584
 Hardin, Garrett, 136, 570
 Hargreaves, D., 285, 288
 Harrison, T. P., 585, 586
 Harvey, M., 588, 589
 Harvey, M. G., 588
 Hashai, N., 580
 Haspeslagh, P., 584
 Haveman, H., 575
 Hay, D. A., 585
 Hayek, Friedrich von, 47, 567
 Heath, P. S., 569
 Heckscher, Eli, 163, 177–178
 Heenan, D. A., 588
 Helft, D., 251
 Helms, M., 590
 Helpman, E., 567, 572
 Henley, J., 28
 Hennart, J. F., 583, 584
 Hernandez, Javier C., 447
 Hewlett, Bill, 143
 Higgins, A., 196

- Hill, Charles W. L., 567, 569, 571, 575, 581, 582, 583, 585, 586, 587
- Hirschman, A. O., 566, 567
- Hitt, G., 575
- Hitt, M. A., 580
- Hodgson, G. M., 586
- Hodson, J., 380
- Hoffa, James P., 275, 276
- Hoffman, B. G., 494
- Hofheinz, P., 288
- Hofstede, Geert, 94, 115–118, 124, 568, 569, 570
- Hollander, S., 571
- Hollman, K. W., 569
- Holm, U., 581
- Holstein, 565
- Holt, D. B., 586
- Holt, D. H., 569
- Homes, S., 4
- Hood, N., 565, 581
- Hood, S., 575
- Hookway, J., 425
- Horn, R., 583
- Horwitz, T., 578
- Hoskisson, R. E., 580, 586
- Houghton, J., 573
- Houston, D. A., 567
- Hout, T., 581, 585, 587
- Howell, S., 580
- Hufbauer, G. C., 233, 573, 574, 577
- Hulland, J., 581
- Hume, David, 47, 147, 166–167, 579
- Hunt, J. W., 589
- Huntington, Samuel P., 75, 96, 567, 568
- Hunya, G., 576
- Hussein, Saddam, 96
- Huus, Kari, 574
- Hwang, P., 582, 583
- Hymer, S. H., 575
- Immelt, Jeffery, 440
- Inglehart, R., 570
- Inkpen, A. C., 583
- Isern, J., 571
- Isobe, T., 582
- Ito, K., 575
- Ito, T., 578
- Itoh, M., 575
- Jack, A., 576
- Jackson, T., 588
- Jemison, D., 584
- Jensen, M. C., 583
- Jiang Zemin, 139
- Joachimsthaler, E., 587
- Jobs, Steve, 132
- John, D. R., 242
- Johnson, Lyndon B., 351
- Johnson, S., 355, 572
- Johnston, C., 576
- Jolly, V. K., 196
- Jones, D. T., 569, 575, 580, 585, 590
- Jones, David, 40
- Jones, G. R., 585
- Jones, Jim, 107
- Jones, R. W., 572
- Jones, T. M., 571
- Jordan, M., 498
- Jordan, Peter S., 573
- Jospin, Lionel, 28
- Julien, P. A., 584
- Jung, Andrea, 379–380, 381, 389
- Juran, Joseph, 471
- Kai-Cheng, Y., 569
- Kale, P., 581
- Kallyegira, Keith, 260
- Kalotay, K., 576
- Kant, Immanuel, 147–148
- Katsikeas, C. S., 584
- Kawai, H., 573
- Keers, H., 421
- Keliang, Z., 70
- Kelleher, J. B., 341
- Kelly, Arthur, 571
- Kelly, M., 576
- Kenen, P. B., 572
- Khanna, T., 581
- Kilian, L., 578, 579
- Kim, H., 580
- Kim, J., 584
- Kim, J. B., 584
- Kim, W. C., 575, 581, 582, 583
- Kim Young-Sam, 329, 364
- Kirchner, Nestor, 376
- Kirpalani, V. H., 587
- Kitsantonis, Niki, 291
- Kiyono, K., 575
- Klebnikov, P., 566
- Knickerbocker, F. T., 253, 254, 270, 271, 564, 575
- Knox, Robert, 152
- Kobayashi, Tony, 583
- Kobayashi, Yotaro, 431
- Kobrin, S. J., 588
- Koch, J., 584
- Kogut, B., 568, 573, 575, 583
- Kolbasuk McGee, M., 407
- Kold, R. W., 578
- Koller, T., 580
- Komiya, R., 575
- Konopaske, R., 588
- Koresh, David, 107
- Kotabe, M., 584
- Kotabe, S., 587
- Kotchian, Carl, 136–137
- Kotha, S., 585
- Koves, P. F., 569, 570
- Kraay, A., 572
- Kripalani, M., 176
- Krueger, A. B., 32, 565
- Krugman, Paul R., 165, 221, 565, 571, 572, 573, 574, 575, 578, 579, 585
- Kuemmerle, W., 587
- Kumar, U. D., 585
- Kurtenbach, E., 132
- Kurtzer, D. C., 88
- Kuttner, R., 566
- Kynge, J., 579
- Lagnado, Sylvia, 511
- Lakshman, N., 468
- Lambrecht, Bill, 573
- Lancaster, K., 586
- Landers, P., 126
- Landler, M., 336
- Landler, Mark, 318
- Landry, J. T., 586
- Lane, H., 154
- Laroche, M., 587
- Latta, G., 590
- Lawrence, J. J., 570
- Lawson, Robert, 567
- Lay, Kenneth, 142–143
- Lay, Mark, 142–143
- Le Bas, C., 587
- Leamer, E. E., 572
- Lecraw, D. J., 585
- Lee, H. L., 585
- Lee, H. W., 589
- Lee, L., 553
- Lee, S. H., 584
- Lee, T. M., 565
- Lee Kuan Yew, 70
- Leebrick, Kristol, 114
- Leggett, K., 473
- Leipziger, D. M., 577
- Leonidou, L. C., 584
- Leontief, Wassily, 178, 572
- Lester, R. K., 568
- Leung, S., 581
- Levich, R. M., 578
- Levine, D. S., 579
- Levine, Steve, 230
- Levitt, T., 495–496, 500, 509, 515, 522, 564, 581, 586

- Lewis, W. W., 567, 581
 Li, J., 580
 Li, X., 575
 Li Ka-shing, 91, 92
 Liberman, M., 568
 Lichtenberg, F., 576
 Lieberman, M. B., 572, 573, 582
 Lifson, T. B., 584
 Limongi, F., 567
 Lindquist, Diane, 251
 Lippman, T. W., 566, 569
 Lipsey, R. E., 575
 Litvin, Daniel, 139, 570
 Liu, X., 575
 Lockyer, S. E., 425
 Lohr, S., 572
 Lomborg, B., 565
 Longfellow, T. A., 584
 Lorenz, C., 582
 Lowenstein, L., 583
 Luce, E., 568
 Lucier, G. T., 585
 Luecke, R., 582
 Luhnow, D., 49
 Lui, F., 570
 Lula da Silva, Luiz Inacio, 298
 Luna, J. P., 58
 Lunsford, J. L., 491
 Luo, Y., 569
 Lustog, N. C., 577
 Lyles, M. A., 583
 Lynch, D. J., 9
 Lyons, J., 251
 Lyons, R. K., 578

 Ma, Mary, 552
 Madden, N., 418
 Madhok, A., 582
 Magdoff, H., 575
 Magnusson, P., 576
 Maheswaran, D., 587
 Makino, S., 582
 Mander, J., 565
 Maneerungsee, W., 584
 Mankin, E. D., 581
 Manning, M., 570
 Mansfield, E., 587
 Manve, I. M., 589
 March, J. G., 571
 Marcos, Ferdinand, 56
 Marcouiller, D., 566
 Marquez, J., 546
 Marquis, M., 570
 Marriott, C., 312
 Martin, W., 573, 574
 Martin, X., 582

 Marx, Karl, 46
 Maskus, K., 572
 Maskus, K. E., 567
 Massie, Robert Kinloch, 570
 Matlack, C., 4, 587
 Matson, Bill, 553
 Matthews, R. G., 587
 Matusitz, J., 242
 Mauro, P., 570
 Maznevski, M., 154
 Mazurkevich, K., 511
 McBride, E., 371
 McCleary, Rachel, 103, 569
 McGee, J., 582
 McKinnon, J. D., 577
 McKinnon, Robert, 579
 McLean, C., 4
 McNett, J., 154
 McNichol, Elizabeth C., 565
 McNish, R. S., 583
 McQuade, K., 581, 582
 McQueen, M., 583
 McTaggart, J., 421
 Mead, R., 568, 569, 570
 Mehta, S. M., 584
 Melick, W. R., 578
 Mellow, C., 566
 Mendenhall, M., 154, 537–539, 543, 588, 589, 590
 Merchant, H., 583
 Merchant, K., 508
 Merritt, Al, 464
 Mertens, Brian, 419
 Meshoulam, Ilan, 588
 Messick, David, 571
 Metthee, I., 564
 Meyer, B., 584
 Michaels, D., 372
 Milanovic, B., 565
 Miles, M., 568
 Miliband, R., 568
 Mill, John Stuart, 47–48, 147, 566
 Millard, P., 49
 Miller, C., 159, 586
 Miller, H. L., 570
 Miller, R., 579
 Miller, Scott, 215
 Millman, J., 588
 Milne, R., 564
 Min, Sungwook, 572, 573
 Minbaeva, D., 589
 Minder, L., 92
 Ming Wang, Z., 569
 Mintz, Dan, 112
 Mishel, Lawrence, 565
 Mitchell, W., 582

 Mittal, Lakshmi, 258
 Mittelstaedt, J. D., 584
 Mkrtchyan, Levon, 47
 Moden, K. M., 576
 Moffett, M., 577
 Mohn, T., 528
 Mondavi, Robert, 28
 Monger, J., 568
 Montgomery, D., 568, 582
 Montgomery, D. B., 572, 573, 582
 Monti, Mario, 285
 Moore, Gordon, 564
 Morales, Evo, 258
 Morales, Juan-Antino, 578
 Moreno, J., 276
 Morgan, E. J., 577
 Morgan, G., 580
 Morgan, N. A., 584
 Morgenthau, Henry, 348
 Morris, D. J., 585
 Morrison, A., 581
 Mosakowski, E., 582
 Mosbacher, R. A., 565
 Mowery, D. C., 587
 Mubarak, Hosni, 87–88
 Mueller, S. L., 569
 Muhammad, 54, 105, 107, 108
 Mun, Thomas, 165
 Murdoch, James, 139
 Murdoch, Rupert, 139, 140
 Murphy, K. M., 566, 567
 Murphy, P. E., 584
 Murrey, J. H., 569
 Murrin, J., 580

 Nader, Ralph, 34, 566
 Naidler, D., 580
 Nakamura, Kunio, 126
 Nakane, C., 98, 568
 Nalebuff, B., 574, 576
 Namenwirth, J. Z., 94, 568, 570
 Narasimhan, R., 586
 Narisette, R., 587
 Narula, R., 575
 Nathan, M., 588
 Nazif, Ahmed, 87
 Neale, M. A., 576
 Neary, J. P., 572
 Neff, J., 407, 511
 Nellis, J., 568
 Nemetz, P., 585
 Neu, D., 570
 Neupert, K. E., 588
 Ng, Linda, 247
 Nielsen, Guillermo, 377
 Nijissen, E. J., 587

- Nixon, Richard M., 351
 Nobel, R., 588
 Nohria, N., 581, 588
 Nonnemaker, L., 575
 Nordstrom, H., 565, 566
 Norman, P., 288
 North, Douglass, 69, 566, 567
 Nussbaum, Bruce, 149
 Nydell, M. K., 569
- Obama, Barack, 25, 33
 Obasanjo, Olusegun, 58
 Oberbeck, S., 212
 Obstfeld, M., 573, 578, 579
 Oddou, G., 537–539, 543, 588, 589, 590
 O'Donnell, S., 589
 O'Dwyer, Gerard, 460
 Ogbuehi, A. O., 584
 Ohlin, Bertil, 163, 177–178, 572
 Ohmae, K., 581
 Ohno, Taiichi, 476, 585
 Okubo, T., 585
 Okuno, M., 575
 Olson, M., 567
 Ondrack, D. A., 588
 O'Neill, J., 542
 Ordonez, J., 4
 O'Shea, D., 188
 Ostrovsky, A., 565
 Ostry, J. D., 579
 Owen-Jones, Lindsay, 283
 Ozawa, T., 576
 Ozilhan, D., 585
- Pachauri, R. K., 239
 Packard, David, 143
 Palmisano, Sam, 414–415
 Pan, Y., 582
 Panagariya, A., 572
 Park, S. H., 583
 Park, Y. H., 583
 Parker, G., 403
 Parker-Pope, T., 586
 Parmigiani, Anne, 586
 Parthasarthy, R., 585
 Patten, Chris, 139
 Pauls, B. D., 579
 Pearson, M., 565
 Peng, M. W., 92, 569
 Perlmutter, H., 581
 Perlmutter, H. V., 588
 Perot, Ross, 295
 Peters, J. W., 573
 Peterson, M. F., 569
 Pettit, R. R., 575, 583
- Pfeiffer, Udo, 336
 Philips, M., 577
 Pick, D., 568
 Pickering, J. F., 587
 Pierro, T., 446
 Piggott, C., 251
 Pine, B. J., 585
 Pine, B. J., II, 585
 Ping, L., 70
 Pisano, G., 586
 Plato, 46, 47
 Poitras, M., 578
 Polanyi, Karl, 278
 Pollack, A., 41
 Pollard, S., 568
 Pons, F., 587
 Pope, H., 371
 Pope, R. A., 584
 Poppo, L., 586
 Port, O., 587
 Porter, Michael E., 115, 165, 185–187, 189–190, 192, 383, 384, 566, 569, 573, 580, 581, 584, 587
 Posen, A. S., 576
 Potterie, B., 576
 Powell, Colin, 76
 Powell, T. C., 585
 Prahalad, C. K., 411, 412, 548, 580, 581, 582, 590
 Pranab, Bardhan, 570
 Pringle, D., 587
 Pritchard, D., 564
 Pritchett, Lant, 566
 Przeworski, A., 567
 Punnett, B. J., 589
 Putra, Hutomo Mandala, 364
- Qin, D., 570
 Qingyang, G., 247
 Qiu, L. D., 576
 Quelch, J., 586
 Quintanilla, C., 452
- Raddock, D. M., 576
 Radrik, D., 565
 Rahaman, A. S., 570
 Rai, S., 576
 Raiffa, H., 576
 Ralston, D. H., 569
 Ram, R., 576
 Ramagalahy, C., 584
 Randzio-Plath, C., 288
 Ransom, D., 584
 Rapach, D. R., 578
 Ravenscraft, D. J., 435, 575, 583
- Rawls, John, 149–150, 153, 154, 157, 571
 Raymond, M. A., 584
 Rebello, K., 587
 Reich, Robert B., 9, 263, 564, 576, 580, 581
 Reitman, V., 588
 Reynolds, C., 590
 Ricardo, David, 163, 164, 167, 169, 221, 222, 223, 257, 571
 Richardson, J., 578
 Ricks, D. A., 569
 Ridding, J., 579
 Riley, Alan, 577
 Roberts, D., 553
 Robins, J. A., 583
 Robinson, J., 572
 Robinson, W. T., 572, 573
 Robles, S., 576
 Robock, S. H., 568
 Rodriguez, Francisco, 572
 Rodrik, Dani, 572
 Roehl, W., 581
 Rogoff, K., 578, 579
 Roll, R., 583
 Romalis, J., 577
 Romer, David, 177, 572
 Romer, P. M., 566
 Rondinelli, D. A., 584
 Ronen, S., 589
 Roos, D., 569, 575, 580, 585, 590
 Root, F. R., 582
 Rose, E. L., 575
 Rose, R. L., 451, 452
 Rose, S., 583
 Rosenberg, N., 587
 Rosenzweig, P. M., 588
 Rostowski, J., 44
 Roth, K., 589
 Rothenberg, R., 511
 Rowell, Andy, 570
 Ruback, R. S., 583
 Rudden, E., 581
 Ruekert, R. W., 586
 Rugman, A. M., 575
- Sachs, Jeffrey, 35, 71–72, 177, 369, 566, 567, 568, 572, 580
 Saggi, K., 576
 Sahay, R., 567
 Saini, Sanjay, 40
 Salmon, R., 582
 Sama, L. M., 588
 Samuelson, Paul, 172, 175–177, 571, 572
 Sanders, P., 491

- Sapir, Edward, 569
 Sarno, L., 578
 Saunders, M., 585
 Saunderson, M., 473
 Savage, M., 568
 Sazanami, Y., 573
 Schaefer, J., 542
 Schein, E. H., 588
 Schendel, D., 583
 Scherer, F. M., 435, 575, 583
 Schifferes, S., 418
 Schleifer, A., 583
 Schneider, S. C., 589
 Schroeder, M., 176
 Schubert, S., 159
 Schuler, R. S., 588, 589, 590
 Schultz, Howard, 3
 Schuman, M., 588
 Schumpeter, Joseph, 587
 Scott, J. J., 577
 Scott, Peter Dale, 354
 Seith, S. P., 585
 Seligman, S. D., 92
 Seligson, Hannah, 92
 Sen, Amartya, 65, 71, 72, 86, 567
 Serafin, T., 273
 Serwer, Andrew E., 583
 Seshadri, S., 585
 Seth, A., 575, 583
 Shan, W., 575
 Shane, S. A., 569
 Shanley, M., 580
 Shao, A. T., 584
 Shapiro, C., 567
 Shapley, D., 587
 Shaver, J. M., 575, 582, 585
 Shaw, R., 580
 Shay, J., 588
 Shelton, J., 579
 Shenkar, O., 589
 Shenon, P., 579
 Shilling, M. A., 587
 Shleifer, A., 566, 570
 Shorrock, T. S., 579
 Shuen, A., 586
 Sias, D. L., 583
 Siddhartha Gautama, 110
 Sierra, C., 587
 Sievers, C., 537
 Simon, H., 587
 Simon, H. A., 571
 Simonin, B. L., 581
 Singer, Peter, 570
 Singh, H., 581
 Sirinivasan, T. N., 572
 Sirkin, Harold L., 23
 Skilling, Jeffrey, 143
 Slim, Carlos, 273
 Smith, Adam, 47, 48, 71, 163, 164, 167, 221, 222, 257, 566
 Smith, G., 273, 587
 Smith, J. F., 251
 Smith, P. B., 569
 Smith, R. A., 516
 Smockum, E., 537
 Snell, S., 588
 Solis, M., 571
 Solomon, C. M., 542, 589
 Solomon, J., 586
 Solomon, R., 579
 Solomon, S., 570, 573
 Solow, R. M., 568
 Son, Masayoshi, 122
 Song, J., 575
 Song, K. P., 575, 583
 Soros, George, 328
 Southey, C., 215
 Souza, C., 581
 Sparshott, J., 446
 Spencer, J. W., 581
 Spiegel, H. W., 566, 571
 Spielberg, Steven, 112
 Squire, L., 565
 Srinivasan, S., 587
 Stackhouse, Dale, 567
 Stalin, Joseph, 281
 Stalk, G., 585, 587
 Steele, J. B., 29, 565
 Steensma, H. K., 583
 Stern, R. M., 572
 Stern, S., 528
 Stern, Seth, 135
 Stertz, B. A., 583
 Stevens, G. A., 587
 Stevenson, W. B., 589
 Stiglitz, J. E., 565
 Stoff, Michael, 449
 Storms, Charles, 452
 Stottinger, B., 587
 Stout, J., 208
 Strauss, G., 407
 Stringer, Howard, 387, 533
 Suharto, 56, 364, 366–367
 Sullivan, Leon, 133
 Suzumura, K., 575
 Sveikayskas, L., 572
 Swann, D., 576
 Sweezy, P. M., 575
 Tagliabue, J., 586
 Tallman, S., 580, 582, 583
 Tang, E. W. K., 581
 Tang, L., 569, 570
 Tanikawa, M., 126
 Tanzer, A., 574
 Tao, Z., 576
 Taub, E., 9
 Taylor, A., 341
 Taylor, E. L., 586
 Taylor, M., 578
 Taylor, M. P., 578, 579
 Taylor, M. Scott, 565, 573
 Taylor, P., 188
 Taylor, T., 572
 Teece, D. J., 575, 586
 Teegen, H., 584
 Templeman, J., 583
 Teoh, Siew Hong, 570
 Terazono, E., 582
 Teresko, J., 491
 Terpstra, R. H., 569
 Thatcher, Margaret, 78
 Thomas, A. S., 569
 Thomas, H., 582
 Thomas, L., 292
 Thompson, E. P., 568
 Thompson, M., 568
 Thompson, R., 130
 Thomsen, S., 575
 Thorbecke, W., 577
 Tiano, Joe, 133
 Tignor, M., 570
 Timewell, S., 566
 Tisdell, C., 575
 Tokatli, N., 585
 Tolchin, M., 576
 Tolchin, S., 576
 Tomlinson, R., 273
 Tomson, B., 573
 Torbiorin, I., 589
 Torres, C., 579
 Trafton, L. L., 585, 586
 Trager, C. S., 580
 Trefler, D., 572
 Trueheart, C., 28
 Truitt, J. F., 581
 Tsurumi, H., 587
 Tsurumi, Y., 587
 Tuan, C., 247
 Tuller, L. W., 584
 Tung, R. L., 535–536, 539, 589
 Turner, M., 508, 577
 Tybout, J. R., 572
 Tylor, Edward, 94, 568
 Ungar, Kenneth, 567
 Ungson, G. R., 583
 Urata, S., 573

- Valente, G., 578
 van der Mensbrugghe, D., 573, 574
 van Wolferen, K., 566
 Vance, A., 525
 Varian, H. R., 567
 Vaughan, S., 565
 Vegh, C. A., 567
 Verbeke, A., 575, 582
 Vermeulen, F., 582
 Vermond, K., 589
 Vernon, Raymond, 164–165, 179, 180, 181, 254, 271, 572
 Vieth, W., 564, 574
 Vijitpongpun, Thongma, 419
 Vishny, R., 566, 570, 583
 Vlastic, B., 583
 Von Bergen, J. M., 528
 Von Braun, J., 239
 von Glinow, M. A., 588

 Wacziarg, R., 177, 572
 Waddock, S. A., 570
 Walker, O. C., 586
 Wallach, Lori, 566
 Waller, D., 587
 Walsh, J. P., 583
 Wang, Jing, 118
 Wang Yan, 195
 Wang You, 132
 Ward, Stephen, 552
 Ward, W. A., 584
 Warner, Andrew, 177, 572
 Warner, J., 583
 Warner, S., 575, 588
 Waters, R., 573

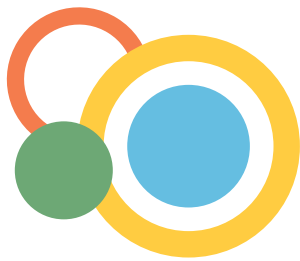
 Waurzyniak, P., 585
 Wazzan, C. Paul, 570
 Weber, Max, 105, 110, 111, 123, 569
 Weber, R. B., 94, 568, 570
 Weinstein, D. E., 572
 Weisweiler, R., 578
 Welch, Ivo, 570
 Welch, Jack, 153
 Welch, K. H., 177, 572
 Wells, L. T., 181, 572
 Weng Bao, 132
 Werhane, Patricia, 571
 Wesson, R., 566
 West, D., 584
 Wheelwright, S. C., 586, 587
 Whorf, Benjamin Lee, 569
 Wildavsky, A., 568
 Williams, Bryan, 452
 Williams, F., 215, 564, 584
 Williams, Frances, 574
 Williamson, J., 578
 Williamson, O. E., 582, 586
 Wind, Y., 586
 Winfrey, Oprah, 511
 Winters, L. A., 566
 Wohar, M. E., 578
 Wolf, H. C., 579
 Wolf, M., 239
 Wolf, Martin, 580
 Wolverton, B., 587
 Womack, B., 9
 Womack, J. P., 569, 575, 580, 585, 590
 Wonacott, P., 473
 Woyka, E., 9

 Wray, R., 196
 Wright, P. M., 588
 Wu, Bing, 112
 Wyploze, C., 577
 Wysocki, B., 582

 Xiao, Peter, 112
 Xin, K., 569

 Yang, J. Z., 588
 Yang Yuanqing, 552
 Yar'Adua, Umaru, 58
 Yeats, A. J., 298, 577
 Yeh, A., 4
 Yeh, R. S., 570
 Yeung, B., 582
 Yoshino, M. Y., 584
 Young, J., 565
 Young, S., 575
 Yu Xiang, 25

 Zaheer, S., 582
 Zahra, S., 568
 Zahradnik, Robert, 565
 Zang, K. H., 576
 Zelaya, Manuel, 133
 Zeng, M., 583
 Zenger, T., 586
 Zerenler, M., 585
 Zhan, X. J., 576
 Zhongwen, Y., 88
 Zhou, L., 587
 Zhou Huijuan, 23
 Zinnes, C., 568
 Zurawicki, L., 566



subject index

- AACSB; *see* Association to Advance Collegiate of Business
- ABB, 404–405
- ABB SAE Sadelmi SpA, 459
- Absolute advantage, 163, 164, 167–169
- Accenture, 176
- Account management, global, 487
- Accounting firms, 6, 176, 487
- Acquisitions; *see also* Mergers
 - compared to greenfield ventures, 249, 434, 437–438
 - failures, 435–436
 - of foreign companies, 243, 249, 431–432
 - minority stakes, 243
 - proportion of foreign investment, 249, 434
 - pros and cons, 249, 434–435
 - reducing failure risk, 436–437
 - screening, 436
- Ad valorem tariffs, 206
- Administrative trade policies, 210–211
- Advertising
 - in China, 112
 - cultural issues, 505–506
 - global, 509–510, 515–516
 - media, 508–509
 - regulation of, 509, 510
- Aetna, 41
- Africa; *see also* Nigeria; South Africa
 - cultures, 95
 - foreign direct investment in, 246, 260
 - regional economic integration, 303
 - toxic waste disposal, 149
 - tribal totalitarianism, 50
- Agilent Technologies, 195–196
- Agricultural subsidies
 - biofuels, 239
 - controversies, 227
 - costs and benefits, 208, 230, 234
 - efforts to reduce, 224, 227, 230, 234
 - Japanese, 207, 208
 - negative effects on developing nations, 36, 230
 - in United States, 207, 230, 239
- Agriculture
 - Common Agricultural Policy (EU), 213, 221
 - genetically modified crops, 147, 214–216
 - protectionism, 229–230
 - tariffs, 36, 229–230, 239
- Ahold, 421
- AIG, 53
- Air India, 461, 485
- Airbus Industrie, 8, 165, 183, 185, 207, 220, 221, 334, 372, 461
- Aircraft manufacturing; *see* Airbus Industrie; Boeing
- AirTouch Communications, 434
- Albania, countertrade deals, 459
- Alcoa, 212
- Alenia Aeronautical, 491
- Alliances; *see* Strategic alliances
- Allied Signal, 471
- Allowances, 547
- Alps, 195
- Amena, 273
- American Express, 510, 515
- Americas, regional economic
 - integration, 293, 294, 299–300;
 - see also* Latin America;
 - North American Free Trade Agreement
- Amgen, 30, 428
- Andean Community (Andean Pact), 279, 297–298
- Antidumping policies
 - countervailing duties, 211, 212, 228–229
 - definition, 211
 - effects on pricing strategies, 515
 - industry support, 192, 235
 - steel imports, 192, 235
 - use of, 192, 228–229
- Antiglobalization protests, 26–29, 227, 228
- Antitrust policy, 284–285; *see also* Competition policy
- AOL, 285
- Apartheid system, 133, 266
- APEC; *see* Asia-Pacific Economic Cooperation
- Apple Computer, 5, 132, 190, 191–192, 195, 255, 318–319, 400, 504, 519
- Applied Materials, 326
- Arab cultures, 121–122; *see also* Islam
- Arbitrage, 320
- Arcelor, 258
- Argentina; *see also* Mercosur
 - currency board, 360
 - monetary crisis, 376–377
- Armenia, 47
- ASEAN; *see* Association of Southeast Asian Nations
- Asia; *see also individual countries*
 - exports, 363
 - foreign debt, 364–365
 - free trade agreements, 300
 - investment boom, 363–364
 - regional economic integration, 300–303
- Asian Development Bank, 366
- Asian financial crisis (1997), 366–368
 - background, 83, 359–360, 363–365
 - bandwagon effects, 328–330
 - global effects, 26
 - Hong Kong's currency board and, 360
 - IMF rescue packages, 345–346, 363, 366–368
 - recovery, 368, 369
- Asia-Pacific Economic Cooperation (APEC), 302–303
- Association of Southeast Asian Nations (ASEAN), 300, 301
- Association to Advance Collegiate Schools of Business (AACSB), 76
- AstraZeneca, 527–528, 529, 531, 533
- AT&T, 427
- Atag Holdings NV, 304–305
- Audi, 112
- Australia, exchange rates, 311–312

- Autarky, 444
- Automobile industry
 - global marketing, 493–494
 - in India, 467–468
 - labor unions, 548, 549, 550
 - local preferences, 399, 400–401, 500
 - price differentials in EU, 512
 - strategic alliances, 412
 - supplier relationships, 486
 - voluntary export restrictions, 209, 210, 224
 - world cars, 399
- Avon Products, 379–380, 381, 389
- B&S Aircraft Alloys, 7
- BAC-Credomatic, 440
- Baidu, 149
- Balance-of-payments accounts
 - capital account, 197, 199
 - current account, 197–199, 200–201
 - definition, 197
 - double-entry bookkeeping, 199–200
 - effects of foreign investment, 261–262, 263, 264
 - exchange rates and, 331–332
 - financial account, 197, 199
- Balance-of-trade equilibrium, 347; *see also* Trade balance
- Bandwagon effects, 328, 330
- Bangladesh, textile exports, 161–162
- Bank for International Settlements, 363
- Bank of America, 176
- Bank of Italy, 288
- Banker's acceptances, 455–456
- Banking crises, 361–362
- Banks; *see* Central banks; Financial services
- Barter, 460; *see also* Countertrade
- Base salary, 547
- Bayer, 231
- BBC, 139
- Beef, hormone-treated, 28, 214, 215
- Bell Laboratories, 427
- Benefits, employee, 547
- Benetton, 505–506
- Bertelsmann, 285
- Big Mac Index, 322, 323, 324
- Billabong, 311–312, 313
- Bills of exchange, 455–456
- Bills of lading, 456
- Biofuel subsidies, 239
- Black & Decker, 337
- BMW, 468, 499, 507
- Body Shop International, 283
- Boeing, 8, 9, 14, 30, 137, 165, 183, 185, 207, 220, 221, 372, 408, 409, 410, 430, 459, 460, 461, 485, 490–491
- Bolivia; *see also* Andean Community
 - foreign oil and gas companies, 25, 258
 - hyperinflation, 324, 325
 - state role in economy, 25
- Bombardier, 401
- Bon Appetit Group, 4
- Bound tariff rates, 231–232
- BP, 5, 138, 140, 145, 146, 249, 506
- Brand names, 429, 496
- Brazil; *see also* Mercosur
 - currency crisis, 361
 - disposable diaper prices, 514
 - distribution system, 401
 - foreign direct investment in, 273
 - marketing to black population, 498
 - privatizations, 79
 - sugarcane production, 239
 - U.S. agricultural subsidies and, 230, 239
- Bretton Woods system
 - collapse, 346, 350–352
 - establishment, 345, 348–349
- Bribery; *see also* Corruption
 - company policies, 138, 145, 146
 - facilitating payments
 - economic effects, 137–138
 - legal exceptions for, 57–58, 137, 138, 145
 - zero-tolerance policies, 145, 146
 - OECD convention on, 57–58, 137
 - scandals, 136–137, 158–159
 - in totalitarian countries, 82
- Bristol-Myers Squibb, 519
- Britain; *see* Great Britain
- British East India Company, 139
- British Monopolies and Mergers Commission, 515
- British Petroleum; *see* BP
- British Telecom (BT), 78
- Brookings Institution, 303
- Brother Industries, 504
- Buddhism, 103, 110–111
- Budweiser, 112
- Bundesbank, 290, 351
- Burma; *see* Myanmar
- Bush administration, 259, 276, 300, 515
- Business ethics; *see also* Corruption; Ethical issues
 - audits, 155
 - cultural context, 140–141, 154
 - definition, 130
 - dilemmas, 140–141, 314
 - ethics codes, 138, 152, 155
 - ethics officers, 154–155
 - managerial implications, 150–156
 - roots of unethical behavior
 - decision-making processes, 142, 153–154
 - leadership, 143
 - organization culture, 142–143, 152–153
 - personal ethics, 141–142, 151
 - unrealistic performance expectations, 143
- Business Software Alliance, 59
- Buy America Act, 210
- Buybacks, 461
- CAFTA; *see* Central American Free Trade Agreement
- Canada; *see also* North American Free Trade Agreement
 - cultures, 95, 113
 - prescription drug prices, 322
 - textile industry, 281
- Canon, 180, 406, 485
- CAP; *see* Common Agricultural Policy
- Capital account, 197, 199
- Capital flight, 333–334
- Capro, 468
- Caribbean Community, 299
- Caribbean Single Market and Economy (CSME), 299
- CARICOM, 299
- Carrefour, 262, 407, 421, 502, 503
- Carry trade, 315
- Caste systems, 99, 110
- Caterpillar, 8, 326, 334, 336, 340–341, 371, 386, 405, 459, 539
- CBS, 533
- Cell phones
 - banking use in India, 68
 - consumer preferences, 399–400, 403
 - innovations, 188, 518
 - market growth, 188
- Cemex, 250, 251, 263
- Central American Common Market, 299
- Central American Free Trade Agreement (CAFTA), 299
- Central banks; *see also* Monetary policy
 - Bundesbank, 290, 351
 - European, 281, 290, 291, 292
 - Federal Reserve, 360
 - South Korean, 329–330, 367
- Channel exclusivity, 503

- Channel lengths, 502–503, 504, 507–508
- Channel quality, 503–504
- Chevron, 135
- Child labor, 140–141, 144, 145, 227
- Chile, free trade agreements, 297;
 see also Andean Community
- China
 - advertising agencies, 112
 - censorship, 139, 149
 - class divisions, 101
 - Confucianism, 91–92, 111–112
 - consumer segments, 498
 - consumerism, 118
 - countertrade deals, 459
 - culture, 91–92, 93, 111–112
 - distribution system, 502
 - economic growth, 18, 19, 24, 65, 80
 - economic reforms, 24
 - environmental problems, 217–218
 - exchange rate policies, 166, 322, 345
 - export tariffs, 207
 - exports, 166, 196, 262, 473
 - film industry, 408
 - financial system, 80
 - foreign direct investment in
 - auto manufacturers, 417–418
 - exports, 262
 - incentives, 247
 - increase, 25
 - inflows, 21–22, 81, 246, 247
 - joint ventures, 417–418, 430
 - obstacles, 247
 - stocks, 247
 - foreign relations, 25
 - free trade agreements, 300
 - guanxi* (relationships), 91, 93, 111–112, 113
 - human rights violations, 71, 134, 216–217
 - incomes, 63
 - intellectual property issues, 59, 60, 61, 213
 - Internet freedom, 149
 - manufacturing, 195, 196
 - McDonald's restaurants, 91, 92
 - most favored nation status, 216–217
 - multinationals based in, 23
 - neo-mercantilist policies, 166, 167
 - output, 18, 19
 - product safety issues, 447
 - production in, 473
 - property rights laws, 70
 - tariffs, 207
 - working conditions, 129–130, 132
 - WTO membership, 217, 247, 473
- China Business News*, 132
- China Mobile, 112
- China National Offshore Oil Company, 258
- Christianity
 - churches, 103
 - economic implications, 105
 - fundamentalism, 106
 - number of adherents, 103
 - Protestant work ethic, 105
 - relationship to Islam, 105
- Chrysler Corporation, 373, 434, 435–436, 500
- CIGS; *see* Convention on Contracts for the International Sale of Goods
- Cisco Systems, 30, 68, 408, 409, 517
- Citigroup Inc., 7, 29, 53, 109
- Civil law systems, 54, 55
- Civilizations, conflicts among, 75
- Class consciousness, 102
- Class systems, 99–101
- Clear Vision, 391–392
- CNN, 17, 27–28
- Coca-Cola, 5, 7, 8, 75, 81, 84, 383, 399, 427, 496, 499, 509
- Codes of ethics, 138, 152, 155
- Codex Alimentarius, 215
- Colgate-Palmolive, 407
- Collectivism, 45–46, 48, 116
- Colombia, terrorism, 76; *see also* Andean Community
- Colors, interpretations of, 506
- Command economies, 52, 69
- Committee on Foreign Investment in the United States, 257
- Common Agricultural Policy (CAP), 213, 221
- Common law systems, 54, 55
- Common markets, 279
- Communication; *see also* Advertising; Language; Telecommunications
 - barriers to international, 505–507
 - country of origin effects, 506–507
 - cultural differences, 505–506
 - noise levels, 507
 - pull strategy, 507–509
 - push strategy, 507–509
 - source effects, 506–507
- Communism
 - command economies, 52
 - decline, 50, 72, 74
 - definition, 46
 - fall of, 24, 46, 47, 48
- Communist totalitarianism, 50
- Comparative advantage theory
 - argument for free trade, 163
 - description, 169–170
 - explanation of trade patterns, 164, 178–179
 - extensions, 173–177
 - gains from trade, 170–172
 - qualifications and assumptions, 172
 - Samuelson critique, 172, 175–177
 - view of foreign direct investment, 257
- Compensation
 - allowances, 547
 - balance sheet approach, 545, 546
 - base salary, 547
 - benefits, 547
 - of expatriate managers, 545–547
 - foreign service premium, 547
 - national differences, 544–545
 - policies, 544
- Competition policy
 - effects on pricing strategies, 515
 - European, 284–285, 305, 308
- Competitiveness, country rankings, 205
- Complexity, 26
- Computers; *see* Information systems
- Concentrated retail systems, 501–502
- Confederation of Indian Industry, 100
- Confucian dynamism, 118
- Confucianism
 - in China, 91–92, 111–112
 - economic implications, 111–113, 118, 122
 - as ethical system, 103
 - in Japan, 111, 113, 122, 125–126
 - principles, 91–92, 111–113
- Constant returns to specialization, 173
- Consumer preferences
 - global convergence, 496, 500
 - national differences
 - adapting products, 399–400, 403–404, 496, 499–500
 - cultural differences, 304–305, 499–500
 - implications for marketing strategy, 496–497, 499–500
- Consumer protection, 214–215
- Consumer surplus, 382
- Contract law, 55
- Contracts, 55
- Controls, 388
- Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, 57–58, 137

- Convention on Contracts for the International Sale of Goods (CIGS), 55
- Copyrights, 59, 60, 230–231; *see also* Intellectual property
- Core competence, 390–391, 432–433
- Corning, 519
- Corporate culture, 531, 541–542; *see also* Organizational culture
- Corruption; *see also* Bribery
 - country rankings, 56, 57
 - economic effects, 56–57
 - in Nigeria, 58, 158
 - OECD convention on, 57–58, 137
 - property rights violations, 56–57
 - relationship to economic growth, 137–138
 - scandals, 136–137, 158–159
 - U.S. laws on, 57–58, 137, 145, 159
 - in Venezuela, 49
- Cost reductions
 - as factor in make-or-buy decisions, 482, 484–485
 - from outsourcing, 30
 - pressure for, 397–398, 433–434
 - relationship to quality, 470
 - role of logistics, 486
 - as strategy, 383
- Costco, 9, 262
- Costs
 - fixed, 474
 - production, 318, 336, 372, 473–474
 - transportation, 425–426, 477
- Cotton subsidies, 230
- Council of Supply Chain Management Professionals (CSCMP), 470
- Counterpurchase, 460
- Countertrade
 - with countries with nonconvertible currencies, 334, 459
 - definition, 334, 459
 - incidence, 459–460
 - proportion of world trade, 334
 - pros and cons, 461–462
 - types, 460–461
- Countervailing duties, 211, 212, 228–229
- Country of origin effects, 506–507
- Court of Justice, European, 286
- Cross-cultural literacy, 93, 121–122, 506
- Cross-functional teams, 520–521
- Cross-licensing agreements, 428
- CSCMP; *see* Council of Supply Chain Management Professionals
- CSME; *see* Caribbean Single Market and Economy
- Cuba, trade sanctions on, 216
- Cultural differences; *see also* Religions
 - communication, 505–506
 - comparative advantages, 26
 - consumer preferences, 304–305, 399–400, 499–500
 - context for ethical analysis, 140–141, 154
 - cross-cultural literacy, 93, 121–122, 506
 - effects in workplace, 115–118
 - effects on cost of doing business, 93
 - folkways, 94–95
 - Hofstede study, 115–118
 - language, 113–114
 - managerial implications, 120–123
 - within nation-states, 95–96, 113–114
 - role of education, 114–115
 - training in, 540
 - values and norms, 94–95
- Cultural myopia, 532
- Cultural relativism, 144–145
- Culture; *see also* Organizational culture; Social structures
 - definition, 94
 - determinants, 96–97
 - evolution, 93, 118–120
 - national competitive advantage and, 122–123
- Currencies; *see also* Dollar; Euro; Exchange rates; Foreign exchange market
 - convertibility, 332–334
 - vehicle, 320
- Currency boards, 360
- Currency conversion, 314–315
- Currency crises, 361; *see also* Asian financial crisis (1997)
 - Argentina, 376–377
 - Latvia, 343–344
 - Mexico, 362–363
 - Turkey, 370–371
- Currency speculation, 315, 328, 357
- Currency swaps, 317–319
- Current account, 197–199; *see also* Trade balance
 - deficits, 198–199, 200–201, 331
 - definition, 261
 - effects of foreign investment, 261
 - surpluses, 198
- Customs unions, 279
- Daimler-Benz, 373, 434, 435–436
- DaimlerChrysler, 336, 434, 435–436
- Daksh, 414
- D'Amato Act, 216
- Debt crises, 362
- Debt relief, 35–36
- DeHavilland, 185
- Dell Computer, 16–17, 29, 68, 129, 130, 132, 257, 314, 387, 474, 552
- Deloitte, 40
- Delors Commission, 287
- Demand, price elasticity of, 512–513
- Democracies
 - definition, 48
 - market economies and, 70, 71
 - representative, 50
 - spread of, 25, 72–74
- Demographics of world economy, 17–18
- Denmark, countertrade deals, 460
- Deregulation, 78
- Deutsche Telekom, 5, 434–435
- Developing nations; *see also* Economic development
 - advertising media, 509
 - businesses based in, 423–425
 - countertrade deals, 459–460
 - debt, 34–36
 - financial crises, 362
 - financial services in, 68
 - foreign direct investment in, 21–22, 245–246
 - incomes, 34
 - multinationals based in, 23
 - output, 18, 19
 - trade policies, 227–228
 - World Bank loans, 350
- Diageo, 248
- Dictatorships; *see* Totalitarianism
- Difference principle, 149–150
- Differentiation strategy, 383
- Digital Equipment, 519
- Diminishing returns to specialization, 173–174
- Dirty float, 345
- Disney, 5, 120
- Distribution systems
 - channel exclusivity, 503
 - channel lengths, 502–503, 504, 507–508
 - channel quality, 503–504
 - choosing strategy, 504
 - national differences, 401, 501–504
 - typical, 501
- DMG, 112

- Doha Round, 12, 232–234
- Dollar, U.S.
 end of convertibility into gold, 351
 exchange rate volatility, 352–356
 exchange rates, 200, 311–312
 exchange rates against euro
 effects on companies, 318, 335, 336, 372
 trading history, 291, 292, 313, 318
 gold standard, 346–348
 petrodollars, 354, 355
 role in foreign exchange market, 320, 351
- Dollops, 263
- Dow Corning, 138
- DP World, 259, 355
- Drafts, 455–456
- Drug lord problem, 146
- Du Pont, 517, 519
- Dubai, 259
- Dubai International Capital, 355
- Dumping; *see also* Antidumping policies
 accusations, 212
 definition, 211, 515
- E. I. du Pont, 517, 519
- EAC; *see* East African Community
- EADS, 372
- East African Community (EAC), 303
- EC; *see* European Community
- ECB; *see* European Central Bank
- Eclectic paradigm, 250, 254–256
- Economic development
 broader measures, 65
 geographical influences, 71–72
 influence on consumer behavior, 500
 measures, 61–63
 national differences, 61–65, 500
 role of education, 72
 roles of innovation and entrepreneurship, 68–70
- Economic exposure
 definition, 335
 managing, 336, 372–373
- Economic freedom, 32, 69, 73, 76–78
- Economic growth
 current account deficits and, 200
 effects of corruption, 137–138
 national differences, 65, 66
 relationship to economic freedom, 69
 relationship to free trade, 223, 233
 relationship to freedom, 32
 relationship to religious beliefs, 103
 relationship to trade, 177
- Economic integration, 278–279; *see also* Regional economic integration
- Economic risk, 83
- Economic systems
 command economies, 52, 69
 market economies, 51–52
 entrepreneurship, 68, 69
 government role, 52
 innovation in, 68, 69
 relationship to political systems, 71
 spread of, 76
 mixed economies, 52–53, 69, 76, 78
 relationship to political systems, 70–71
 transformation
 deregulation, 78
 legal systems, 79–80
 privatization, 78–79
 rationale, 76
 shift toward market economies, 76
- Economic unions, 279
- Economies of scale
 definition, 182, 394
 global expansion and, 394–395
 minimum efficient scale, 474–475
 in new trade theory, 183
- Economist*, 322, 324
- Ecuador; *see also* Andean Community
 banana exports, 152
 rose exports, 17
- Eddie Bauer, 135
- EDI; *see* Electronic data interchange
- EDS, 20
- Education
 cultural differences and, 114–115
 as factor endowment, 187
 influence on economic development, 72
 measures, 187
 role in national competitive advantage, 115
 in value chain, 382
- Efficiency frontier, 384–385
- Efficient markets, 321, 330–331
- EFTA; *see* European Free Trade Association
- Egypt, 87–88
- Eko, 68
- ELAN; *see* Export Legal Assistance Network
- Elastic demand curves, 512–513
- Eldorado of France, 506
- Electricité de France, 308
- Electricity Generating Authority of Thailand, 459
- Electronic data interchange (EDI), 488
- E-Mart, 262
- EMC Corp., 164
- EMCs; *see* Export management companies
- EMI, 285
- Employees; *see* Human resources management; Workers
- Employment; *see also* Outsourcing
 effects of foreign direct investment, 260–261, 264, 265
 effects of NAFTA, 277, 281, 295–296, 297
 effects of regional trade agreements, 264, 281
 effects of trade liberalization, 233
 ethical issues, 131–132, 140–141
 slave labor, 135
- EMS; *see* European Monetary System
- Endesa, 308
- Enel, 308
- Enron, 142–143, 151
- Entrepreneurs, 68–70, 122, 123
- Environmental issues
 arguments against free trade agreements, 31–33, 227–228, 296
 climate change, 33, 136, 218
 fair trade, 152
 relationship of pollution and income levels, 32–33
- Environmental safeguards
 countries with lax, 134–136, 219
 globalization debate and, 31–33, 227–228
 trade and, 217–219
- E.ON, 308
- Equal Employment Opportunity Commission, 532
- Ericsson Telecom AB, 187, 188, 262, 401, 518, 542
- Ethanol, 239
- Ethical algorithms, 153
- Ethical dilemmas, 140–141, 314
- Ethical issues; *see also* Business ethics; Corruption; Human rights issues
 child labor, 140–141, 144, 145
 employment practices, 129–130, 131–132, 140–141
 environmental pollution, 134–136
 moral obligations, 138–140
 product safety and product liability, 61

- Ethical issues—*Cont.*
 - sweatshop labor, 129–130, 131–132, 144
 - totalitarian regimes, 81
- Ethical strategies, 130
- Ethical systems, 103, 105; *see also* Confucianism
- Ethics; *see also* Business ethics
 - definition, 130
 - personal, 141–142, 151
 - philosophical approaches
 - caring approach, 150
 - cultural relativism, 144–145
 - Friedman doctrine, 144
 - justice theories, 149–150, 153
 - Kantian, 146–148
 - naive immoralism, 146
 - righteous moralism, 145–146
 - rights theories, 148–149
 - straw men, 144–146
 - utilitarianism, 146–147
- Ethics codes, 138, 152, 155
- Ethics officers, 154–155
- Ethnocentric staffing policy, 531–532, 534
- Ethnocentrism, 121
- Euro
 - benefits, 289–290
 - costs, 290–291
 - EU members not participating, 281–282, 289
 - exchange rates against dollar
 - effects on companies, 318, 335, 336, 372
 - trading history, 291, 292, 313, 318
 - experience to date, 291–292
 - introduction, 277, 289
 - as reserve currency, 291–292
 - as vehicle currency, 320
- European Central Bank (ECB), 281, 290, 291, 292
- European Coal and Steel Community, 283
- European Commission, 283–285, 287, 288; *see also* European Union
- European Community (EC)
 - as common market, 279, 283
 - as customs union, 279
 - establishment, 281, 282–283
 - members, 283
- European Council, 285–286
- European Court of Justice, 286
- European Free Trade Association (EFTA), 279, 282
- European Monetary System (EMS), 345, 352
- European Parliament, 280, 283, 286, 288
- European Stability Initiative, 108
- European Union (EU)
 - agricultural subsidies, 207
 - ban on hormone-treated beef, 28, 214, 215
 - biofuel subsidies, 239
 - candidate members, 284, 293
 - car price differentials, 512
 - Common Agricultural Policy, 213, 221
 - competition policy, 284–285, 305, 308
 - definition, 282
 - as economic union, 279
 - energy market, 308
 - evolution, 282–283
 - expansion, 277, 283, 292–293
 - foreign direct investment in, 245, 258
 - free trade, 163
 - Greek bailout, 291, 292
 - implications for businesses, 303–305
 - ISO 9000 standard, 471
 - labor mobility, 280–281
 - Latvian bailout, 344
 - Maastricht Treaty, 289, 290
 - members, 283, 284, 292–293
 - Polish membership, 43–44, 45
 - political structure, 280, 283–286
 - population, 283
 - single currency, 277, 289
 - Single European Act, 286–289
 - single market, 277, 286–289
 - Turkish membership issue, 108, 293
- Excel Communications, 435
- Exchange rate determination,
 - economic theories, 320–321
 - bandwagon effects, 328
 - interest rate relationships, 327–328
 - investor psychology, 328, 330
 - price relationships
 - law of one price, 321, 322
 - money supply and inflation, 322–325
 - purchasing power parity, 321–322, 325–327
 - short- and long-term movements, 330
- Exchange rate forecasting
 - approaches
 - fundamental analysis, 331–332
 - technical analysis, 332
 - efficient market school, 330–331
 - importance, 337
 - inefficient market school, 331
- Exchange rate regimes
 - adjustable parities, 350
 - currency boards, 360
 - dirty float, 345
 - fixed
 - Bretton Woods system, 348–349
 - case for, 357–358
 - definition, 345
 - discipline of, 349
 - monetary policy, 357
 - floating
 - case for, 356–357
 - current regime, 351, 354–356
 - definition, 345
 - dirty float, 345
 - Jamaica Agreement, 352
 - managed float, 356, 358
 - monetary policy, 356–357
 - in practice, 358
 - volatility, 352–354, 356–358
 - gold standard, 346–348, 351
 - pegged, 345, 359–360
 - in practice, 358–359, 371–372
- Exchange rates; *see also* Euro, exchange rates against dollar; Foreign exchange market
 - currency conversion, 314–315
 - current account deficits and, 200
 - definition, 313
 - forward, 316–317
 - production costs and, 318, 336, 372, 473–474
 - spot, 315–316
 - terminology, 319
 - volatility, 352–354, 371–372
- Exclusive distribution channels, 503
- Ex-Im Bank; *see* Export-Import Bank
- Expatriate failure, 535–537
- Expatriate managers
 - characteristics of successful, 537–538
 - compensation, 545–547
 - cultural adaptation, 532, 537
 - cultural context of ethical issues, 154
 - definition, 529
 - failures, 535–537, 539
 - global mind-set, 538–539
 - performance evaluations, 543
 - repatriation, 541, 542
 - resources for, 547
 - selecting, 537–538
 - spouse's adjustment problems, 536–537, 539
 - training, 540
 - women, 534
- Expediting payments; *see* Facilitating payments

- Experience curve, 393, 394, 395
- Experience curve pricing, 514
- Experience effects, 393–397
- Export and import financing
 - mechanisms
 - bills of exchange, 455–456
 - bills of lading, 456
 - drafts, 455–456
 - letters of credit, 454–455
 - solutions to lack of trust problem, 452–454
 - typical transactions, 456–457
- Export credit insurance, 458–459
- Export Legal Assistance Network (ELAN), 450
- Export management companies (EMCs), 450
- Export tariffs, 207
- Export-Import Bank, 457, 458, 464
- Exporting
 - advantages, 425
 - challenges, 445–447
 - by China, 166, 196, 262, 473
 - compared to foreign direct investment, 250, 253
 - definition, 250
 - disadvantages, 425–426
 - government assistance, 457–458
 - information sources, 447–450
 - lack of information on
 - opportunities, 445, 447
 - limitations, 250, 268
 - paperwork, 446–447
 - product safety issues, 447
 - promise of, 445
 - by small businesses
 - challenges, 445–447
 - examples, 443–444, 446, 449
 - government assistance, 449
 - share of U.S. exports, 7, 449
 - strategies, 450–452
 - transportation costs, 425–426, 477
 - by United States, 18
 - volume, 444
 - voluntary restrictions, 192, 209–210, 224
- External stakeholders, 153
- Externalities, 255–256, 472
- Externally convertible currencies, 332
- Exxon, 24, 133
- Facilitating payments; *see also* Bribery
 - economic effects, 137–138
 - legal exceptions for, 57–58, 137, 138, 145
 - zero-tolerance policies, 145, 146
- Factor endowments
 - Heckscher-Ohlin theory, 177–179
 - national competitive advantage and, 186, 187
- Factors of production, 8
- Fair trade, 152
- Falck Schmidt Defence Systems, 460
- Falun Gong, 139
- Fanuc, 441
- Fascism, 51
- FCX Systems, 446
- FDI; *see* Foreign direct investment
- Federal Express, 211
- Federal Reserve, 360
- Federal Trade Commission, 210, 284
- Femininity, 116
- Financial account, 197, 199
- Financial crises; *see also* Asian
 - financial crisis; Currency crises
 - of 2008–09, 13–14, 26, 203–204, 369
 - banking, 361–362
 - causes, 362
 - frequency, 362
 - global effects, 26
 - Greek, 291, 292
 - types, 361–362
- Financial services
 - banking crises, 361–362
 - in developing countries, 68
 - entry into foreign markets, 422
 - Islamic banking methods, 54, 109
 - marketing mix, 515
 - mergers, 288
 - single European market, 288
 - trade liberalization, 226, 267
- Financial statements, translation
 - exposure, 335
- First-mover advantages
 - definition, 81, 420
 - in foreign markets, 420
 - in new trade theory, 183, 185, 191
- First-mover disadvantages, 420–422
- Fisher effect, 327–328
- Fixed costs, 474
- Fixed exchange rates
 - Bretton Woods system, 348–349
 - case for, 357–358
 - definition, 345
 - discipline of, 349
- Flat-panel display manufacturing, 9
- Flexible machine cells, 476
- Flexible manufacturing technology, 475–477
- Flextronics, 485
- Floating exchange rates
 - case for, 356–357
 - current regime, 351, 354–356
 - definition, 345
 - dirty float, 345
 - Jamaica Agreement, 352
 - managed float, 356, 358
 - monetary policy, 356–357
 - in practice, 358
 - volatility, 352–354, 357–358
- Flows of foreign direct
 - investment, 243
- Fluor Corp., 176
- Fokker, 185
- Folkways, 94–95
- Food and Agriculture
 - Organization, 215
- Food prices, 208, 230, 238–239
- Ford Motor Company, 5, 6, 8, 14, 24, 264, 386, 390, 399, 402, 404–405, 411, 435, 468, 475, 476–477, 482–483, 493–494, 495, 500, 512, 548, 550
- Forecasting; *see* Exchange rate
 - forecasting
- Foreign Corrupt Practices Act, 57–58, 137, 145, 159
- Foreign Credit Insurance Association, 457, 458–459
- Foreign debt crises, 362
- Foreign direct investment (FDI), 243–244; *see also* Acquisitions; Greenfield ventures
 - benefits
 - balance-of-payments effects, 261–262, 263–264
 - effects on competition, 262
 - employment effects, 260–261, 264, 265
 - to home countries, 263–264
 - to host countries, 259–262
 - resource-transfer effects, 259–260, 264
 - costs
 - adverse effects on competition, 262–263
 - balance-of-payments effects, 263, 264
 - employment effects, 264
 - to home countries, 264
 - to host countries, 262–263
 - national sovereignty and autonomy, 263
 - criticism of, 264
 - definition, 12
 - direction, 245–248

- Foreign direct investment (FDI)—*Cont.*
 explanations of increase, 243–245
 flows, 14, 21–22, 243, 244
 government policies
 encouraging, 243, 265
 of home countries, 257, 265–266
 of host countries, 243–244, 257–259, 266–267
 impact on investment decisions, 270
 incentives, 266
 restrictions on inflows, 84, 244, 257, 258, 266–267
 restrictions on outflows, 257, 265–266
 gross fixed capital formation
 percentage, 246–248
 inflows, 243, 245–246
 insurance programs, 265
 liberalization, 13, 267
 outflows, 243, 244, 248–249
 political views, 256–259
 source countries, 248–249
 sources, 19
 stocks, 14, 20–21, 243
 trade theory and, 265
 treaties, 245, 267–268
 trends, 14, 19–22, 243–245
- Foreign direct investment theories, 249–250
 eclectic paradigm, 250, 254–256
 explanation of patterns, 253–254
 explanations of investment decisions, 250, 252–254, 268–270
 internalization, 252, 254, 268
 location-specific advantages, 254–255, 268
 managerial implications, 268–270
 product life-cycle, 254, 270
 strategic behavior, 253–254, 270
- Foreign exchange market; *see also*
 Exchange rates
 arbitrage, 320
 carry trade, 315
 currency swaps, 317–319
 definition, 313
 dollar's role, 320
 forward contracts, 316–317, 318, 372
 functions, 313–315
 government intervention, 326–327, 356
 managerial implications, 334–337
 nature of, 319–320
 participants, 314
 speculation, 315, 328, 357
 spot trading, 315–316
 trading centers, 319–320
 use by international businesses, 314
 vehicle currencies, 320
- Foreign exchange reserves, 333, 459
- Foreign exchange risk
 categories, 334–335
 definition, 313
 economic exposure, 335, 336, 372–373
 hedging, 315, 317, 318
 insuring against, 315
 managing, 335–337, 372–373
 transaction exposure, 334, 335–336
 translation exposure, 335–336
- Foreign markets; *see also* Exporting;
 Global expansion; Local responsiveness
 attractiveness, 84
 entry decisions, 419, 423
 choosing markets, 419–420
 scale, 422–423
 timing, 420–422
 entry modes, 418–419
 comparison, 432
 core competences and, 432–433
 cost reductions and, 433–434
 exporting, 425–426
 franchising, 428–429
 greenfield ventures vs.
 acquisitions, 434, 437–438
 joint ventures, 429–431
 licensing, 427–428
 selecting, 432–433
 turnkey projects, 426–427
 wholly owned subsidiaries, 431–432
 human rights issues, 133–134
 risks, 82–84, 437
 strategic commitments, 422–423
 totalitarian regimes, 81
- Foreign service premium, 547
- Forward exchange rates, 316–317, 318
- Forward exchanges, 317, 372
- Four Seasons, 384, 429
- Foxconn, 132
- Fragmented retail systems, 501–502
- France
 advertising regulations, 510
 antiglobalization protests, 27, 28
 foreign direct investment in, 28
 mixed economy, 53
 nontariff barriers, 211
- France Telecom, 273
- Franchising, 269, 428–429
- Frasier Institute, 32
- Free trade; *see also* Globalization
 benefits to international business, 235–236
 business support, 191–192
 costs and benefits, 233
 debates on, 227–228
 definition, 163, 204
 employment effects, 233
 relationship to economic growth, 223, 233
 revised case for, 221
 theoretical arguments, 165
- Free trade agreements; *see also*
 European Union; North American Free Trade Agreement; Regional trade agreements
 environmental issues, 31–33, 227–228, 296
 union objections, 264, 275
- Free Trade Area of the Americas (FTAA), 299–300
- Free trade areas, 278–279, 300
- Freedom; *see also* Economic freedom
 political, 72–74, 78
 religious, 105
- Freedom House, 49, 72–74, 78
- Freely convertible currencies, 332
- Freeport McMoRan, 144
- Friedman doctrine, 144
- Friends of the Earth, 217
- FTAA; *see* Free Trade Area of the Americas
- Fuji Heavy Industries, 491
- Fuji Photo Film Co., 24, 254, 410, 411, 427, 428, 429, 430, 431, 513–514
- Fujitsu, 408, 409
- Fuji-Xerox, 180, 254, 409, 411, 427, 428, 429, 430, 431
- Fundamental analysis, 331–332
- Fundamental rights of stakeholders, 154
- G20, 11
- GAM; *see* Global account management
- Gap, 120, 399
- GATS; *see* General Agreement on Trade in Services
- GATT; *see* General Agreement on Tariffs and Trade
- GE Healthcare, 517
- GE Money, 440
- Genentech, 215

- General Agreement on Tariffs and Trade (GATT); *see also* World Trade Organization
 accomplishments, 223
 antidumping actions, 515
 definition, 10
 establishment, 223
 infant industry argument and, 219
 intellectual property protection, 60, 225
 trade liberalization goals, 10, 223
 treaties, 205
 Uruguay Round, 12, 223, 224–225
- General Agreement on Trade in Services (GATS), 225
- General Electric, 8, 153, 334, 410, 440–441, 459, 462, 471, 531
- General Motors, 6, 14, 24, 53, 81, 114, 133, 264, 390, 399, 412, 417–418, 419, 420, 429, 430, 468, 548
- Genetically modified crops, 147, 214–216
- Geocentric staffing policy, 533–534, 545
- Geography, influence on economic development, 71–72
- Germany
 advertising regulations, 510
 bribery laws, 158–159
 Bundesbank, 290, 351
 culture, 121
 currency, 373
 exporting information, 447
- Global (grocery chain), 421
- Global account management (GAM), 487
- Global expansion; *see also* Foreign markets; Global production
 benefits, 81–82
 costs, 82
 experience effects, 393–397
 human rights issues, 133–134
 leveraging subsidiary skills, 396–397, 481
 location economies, 391–393
 of markets, 390–391
 risks, 82–84, 437
- Global learning, 481
- Global managers, 36–37, 538–539
- Global marketing; *see also* Marketing and sales functions
 advertising, 509–510
 market segments, 497–499
 product attributes, 499–501
 strategies, 495–496
- Global production; *see also* Outsourcing
 centralized strategy, 478
 decentralized strategy, 478–479
 decisions, 468–469
 country factors, 472–474
 cultural issues, 123
 product factors, 477–478
 technological factors, 474–477
 trade theory and, 190–191
- drivers, 13, 16–17
 of flat-panel televisions, 9
 services activities, 8–9
 strategic objectives, 479–481
- Global standardization strategy, 402–403
- Global warming, 33, 136, 218
- Global web, 392–393
- Globalization; *see also* Outsourcing
 debate on
 critics, 26–29, 31, 33–34
 jobs issue, 29–31
 labor and environmental protections, 31–33, 227–228
 national sovereignty issue, 33–34
 poverty issue, 34–36
 supporters, 26, 29–30
 definition, 7
 drivers, 11
 declining trade and investment barriers, 12–14
 technological change, 14–17
 future of, 25–26
 increased foreign direct investment, 245
 institutions, 10–11, 33–34
 of markets, 7–8, 17, 495–496
 opportunities, 6
 protests against, 26–29, 227, 228
 threats, 6
 trends, 5–7
- Globalization of production, 8–10, 16–17
- GNI; *see* Gross national income
- Gold par value, 347
- Gold standard
 definition, 346
 end of, 348, 351
 in interwar period, 347–348
 mechanics, 346–347
 strength, 347
- Google, 68, 149, 508, 525
- Governments; *see also* Competition policy; Monetary policy; State-owned enterprises; Trade policies
 corporate relations with, 373–374
 foreign direct investment policies
 encouraging, 243, 265
 of home countries, 257, 265–266
 of host countries, 257–259, 266–267
 impact on investment decisions, 270
 incentives, 266
 restrictions on inflows, 84, 257, 258, 266–267
 restrictions on outflows, 257, 265–266
 intervention in foreign exchange market, 326–327, 356
 roles in market economies, 52
- Grease payments; *see* Facilitating payments
- Great Britain
 class divisions, 93, 100–101, 102
 Corn Laws, 222
 culture, 93
 currency, 281–282
 distribution system, 401
 foreign direct investment in, 257, 258, 263
 gold standard, 347
 London as foreign exchange trading center, 319
 mercantilism, 165–166
 Monopolies and Mergers Commission, 515
 privatization, 47, 78
 state-owned enterprises, 46–47
- Great Depression, 222–223
- Greece
 countertrade deals, 461
 financial crisis, 291, 292
- Greenfield ventures
 compared to acquisitions, 249, 434, 437–438
 definition, 243
 in foreign markets, 431
 proportion of foreign investment, 249
 pros and cons, 437
 wholly owned subsidiaries, 431
- Greenhouse gases; *see* Global warming
- Greenpoint Mortgage, 176
- Gross fixed capital formation, 246–248

- Gross national income (GNI), 61–63
 Groups, 97, 98–99
 Gucci, 507
 G. W. Barth, 24
- Haiti, property rights obstacles, 69
 HarperCollins, 139
 Harwood Industries, 29
 Hawker Siddeley, 185
 HBO, 17
 HCL Technologies, 20
 HDI; *see* Human Development Index
 Heckscher-Ohlin theory, 163, 164, 177–179
 Hedging
 absence of, 318
 costs, 318
 definition, 315
 foreign exchange risk, 315, 317, 318
 Helms-Burton Act, 216
 Heritage Foundation, 76–78
 Hewlett-Packard (HP), 129, 130, 143, 255, 479–480, 481, 521–522
 Highly indebted poorer countries (HIPC)s, 34–36
 Hinduism
 economic implications, 110, 123
 number of adherents, 103, 109
 principles, 109–110
 Hindustan Lever Ltd., 263, 508
 HIPC)s; *see* Highly indebted poorer countries
 Hiring decisions, 151
 Hisense Co. Ltd., 23
 Hitachi, 9, 120, 396, 405
 Hoffman-LaRoche, 515
 Holcim, 251
 Homeplus, 421
 Honda, 253, 258, 402, 506
 Honduras, human rights violations, 133
 Hong Kong
 currency board, 360
 exports, 363
 Hongfujin Precision Industries, 132
 HP; *see* Hewlett-Packard
 HRM; *see* Human resources management
 HSBC, 109
 Huawei Technologies, 409
 Hubris hypothesis, 435–436
 Human Development Index (HDI), 58, 65, 67
 Human resources management (HRM)
 activities, 528, 530
 compensation policies, 544–547
 definition, 528
 labor relations, 547–550
 national differences, 528–529
 performance appraisals, 543
 planning, 541
 staffing policies, 531–534
 strategic role, 529–531
 as support activity, 387
 training and management development, 539–540
 Human rights issues
 in China, 71, 134, 216–217
 doing business in countries with, 133–134
 in Honduras, 133
 in Myanmar, 134, 135
 in Nigeria, 134
 trade policy and, 216–217, 227
 Universal Declaration of Human Rights, 148, 152
 Hutchison Whampoa, 23
 Hymall, 421
 Hytech, 7
 Hyundai, 440, 441, 467, 468, 469, 506
 Hyundai Electronics, 211
- IBM, 8, 9, 20, 29, 84, 115, 117, 133, 190, 191–192, 195, 258, 393, 410, 414–415, 449, 519, 552
 IBRD; *see* International Bank for Reconstruction or Development
 IDA; *see* International Development Association
 IKEA, 5, 7, 404
 ILO; *see* International Labor Organization
 IMF; *see* International Monetary Fund
 Import quotas, 208–210
 Importing, fair trade, 152; *see also* Antidumping policies; Export and import financing mechanisms; Tariffs
 Incentives, 388
 Income distribution, 30–31
 Income taxes, 547
 India
 automobile industry, 467–468, 517
 British East India Company, 139
 call centers, 30, 482
 caste system, 99, 100, 110
 child labor, 145
 countertrade deals, 461
 distribution system, 508
 economic growth, 18, 19, 65, 80
 education, 115
 entrepreneurship, 110, 123
 foreign direct investment in, 84, 263, 266–267
 incomes, 63
 information technology industry, 20, 100, 176, 414–415, 482
 intellectual property issues, 84
 jobs outsourced to, 115, 176, 482
 knowledge-based jobs, 176, 482
 McDonald's restaurants, 110
 pharmaceutical industry, 231
 radiologists, 8, 40
 selling to poor in, 508
 software market, 524–525
 Individualism
 cultural differences, 116
 political philosophy, 47–48
 Protestantism and, 105
 society and, 97–98
 Individuals, in social structures, 97–98
 Indonesia
 ASEAN membership, 300
 countertrade deals, 334
 currency crisis, 366
 foreign direct investment in, 264
 IMF rescue package, 363, 366–367
 investment boom, 364
 Inefficient markets, 331
 Inelastic demand curves, 512–513
 Infant industry argument, 219–220
 Inflation
 food prices, 230, 238–239
 hyper-, 324
 interest rates and expectations of, 327–328
 relationship to money supply, 322–325
 Inflows of foreign direct investment, 243, 245–246
 Information systems
 logistics use, 487–488
 as support activity, 386–387
 technological change, 15
 Infosys Technologies Ltd., 20, 100, 176, 414
 Infrastructure, 387, 400
 ING Group, 422, 431
 Innovation, 68–70; *see also* Research and development
 Inpatriates, 535
 Institute for International Economics, 233
 Insurance industry; *see* Financial services

- Intel, 30, 132, 164, 196, 213, 255, 395, 396, 403, 517, 518
- Intellectual property
 - definition, 59
 - GATT coverage, 60, 225
 - piracy, 59–60, 213, 231
 - protection, 59–60, 61, 83–84
 - TRIPS agreement, 60, 225, 230–231
 - WTO negotiations, 233
- Interest rates, relationship to
 - exchange rates, 327–328
- Internal stakeholders, 153
- Internalization theory, 252, 254, 268
- International Bank for
 - Reconstruction or Development (IBRD), 350; *see also* World Bank
- International businesses, 36–37
- International Chamber of Commerce, 55
- International Court of Arbitration, 55
- International Development Association (IDA), 350
- International Federation of the Phonographic Industry, 59
- International Fisher effect, 327–328
- International Labor Organization (ILO), 549
- International Monetary Fund (IMF)
 - agricultural protectionism study, 230
 - board of governors, 361
 - crisis management, 361–362
 - Argentina, 376
 - Asia (1997), 345–346, 363, 366–368
 - global crisis (2008–2009), 369
 - Greece, 292
 - Latvia, 344
 - Mexico, 362–363
 - moral hazard issue, 368–369
 - rescue packages, 345–346, 361
 - South Korea, 329, 363, 367, 368, 369
 - Thailand, 363, 366
 - Turkey, 370–371
 - criticism of, 11, 346, 367–369
 - debt relief program, 36
 - definition, 10
 - establishment, 10, 345, 348
 - exchange rate policies of members, 358–359
 - financial crisis study, 362
 - implications for businesses, 373
 - independence, 361
 - loans, 10–11, 346, 349–350, 360–361
 - members, 352, 361
 - monetary and fiscal conditions, 350, 367–368, 369
 - OPEC member spending report, 355
 - quotas, 352
 - role, 349–350, 360–361
- International monetary system; *see also*
 - Exchange rate regimes
 - Bretton Woods system, 345–346, 348–349
 - definition, 344
 - gold standard, 346–348, 351
 - history, 346–348
 - managerial implications, 371–374
 - mixed system, 346
 - shocks, 352
- International Orientation Resources, 536, 539
- International strategy, 405–406
- International trade; *see also* Exporting; Free trade; Trade policies
 - definition, 12
 - development of system, 222–224
 - fair trade, 152
 - laws applied in disputes, 55
 - relationship to economic growth, 177
 - theoretical explanations of patterns, 164–165, 178–179
 - typical transactions, 456–457
 - volume, 13–14
- International Trade Administration, 448
- International Trade Commission (ITC), 211, 212, 235
- International trade secretariats, 548–549
- Internet
 - freedom, 149
 - growth, 15
 - logistics use, 488
 - outsourcing service activities via, 8–9, 17
 - role in globalization, 8–9, 15
 - role in political change, 74
 - shopping on, 503
- Inventory, just-in-time systems, 486–487
- Investment; *see* Foreign direct investment
- Investment treaties, 245
- Investor psychology, 328, 330
- Ipek, 108
- Iraq
 - cultures, 95–96
 - oil production, 19
 - trade sanctions on, 216
- Islam
 - banking methods, 54, 109
 - culture, 95–96
 - economic implications, 107–109
 - fundamentalism, 75, 106–107, 120
 - number of adherents, 103, 105
 - origins, 105
 - principles, 105–106
 - Shiites and Sunnis, 95–96
- Islamic Calvinism, 108
- Islamic countries
 - religious resurgence, 75
 - theocratic law systems, 54, 107
 - theocratic totalitarianism, 50
- Islamic law, 54, 107
- ISO 9000, 471
- Isuzu, 264
- Italy, banks, 288
- ITC; *see* International Trade Commission
- Jamaica Agreement, 352
- Japan
 - agricultural subsidies, 207, 208
 - bribery scandals, 136–137
 - culture
 - changes in, 118–119, 126
 - Confucianism, 111, 113, 122, 125–126
 - economic advantages, 93
 - folkways, 95
 - group membership, 98–99
 - influence on competitive advantage, 122
 - distribution system, 401, 502, 503, 504, 507
 - economic growth, 80
 - education, 115
 - entrepreneurs, 122
 - foreign direct investment in, 241–242, 258, 265, 267
 - Ministry of Agriculture, Forestry, and Fisheries, 208
 - Ministry of International Trade and Industry, 447
 - national competitive advantage, 122
 - new-product development, 518
 - nontariff barriers, 210–211, 223–224
 - social structure, 98–99
 - tariffs, 208
 - trading firms (*sogo shosha*), 447, 462
 - Walmart in, 242
- Japanese Overseas Enterprise Association, 531
- J.D. Power and Associates, 476

- JIT; *see* Just-in-time inventory systems
- Joint ventures; *see also* Strategic alliances
- advantages, 430
 - definition, 429
 - disadvantages, 430–431
 - in foreign markets, 429–431
- Jollibee Foods Corporation, 424–425
- J-Phone, 403
- Judaism, 103, 105
- Juniper Technologies, 409
- Just distribution, 149
- Justice theories, 149–150, 153
- Just-in-time inventory systems (JIT), 486–487
- JVC, 14
- Kantian ethics, 146–148
- Kawasaki Heavy Industries, 491
- Keiper, 336
- Kellogg, 510
- KFC, 422, 429
- Kia Motors, 364
- Kimberly-Clark, 407, 514
- Kirin, 428
- Kmart, 421
- Kodak, 14, 24, 133, 254, 485, 513–514, 519
- Kokuyo, 504
- Komatsu, 8, 326, 340, 405
- Korea; *see* South Korea
- KPMG, 435
- Kwality, 263
- Labor; *see* Workers
- Labor policies, globalization debate and, 31–33
- Labor relations, international, 547–550
- Labor unions; *see* Organized labor
- Lafarge Group, 251
- Lag strategy, 335–336
- Landmark Systems, 449
- Language
- differences, 113–114
 - foreign, 540
 - spoken, 113–114
 - unspoken, 114
- Late-mover disadvantages, 81
- Latin America; *see also individual countries*
- Andean Community, 279, 297–298
 - culture, 94–95, 114
 - democratization, 25
 - economic reforms, 25
 - foreign direct investment in, 244, 246, 272–273
 - Mercosur, 277, 279, 298–299
 - regional trade agreements, 277
- Latvia
- currency crisis, 343–344
 - pegged exchange rate, 343, 345
- Law of one price, 321, 322
- Laws; *see* Legal systems
- L/Cs; *see* Letters of credit
- Lead strategy, 335–336
- Lean production, 252, 475–477
- Learning
- from alliance partners, 411–412
 - global, 481
- Learning effects, 394
- Legal risk, 83–84
- Legal systems; *see also* Property rights
- civil law, 54, 55
 - common law, 54, 55
 - contract law, 55
 - definition, 53
 - intellectual property protection, 59–60, 84
 - product liability laws, 60–61
 - product safety laws, 60–61
 - theocratic, 54, 107
 - in transition economies, 79–80
- Lenovo, 129, 130, 393, 552–553
- Leontief paradox, 178–179
- Letters of credit (L/Cs), 454–455
- Levi Strauss, 120, 132, 135, 496, 515, 516
- LG Electronics, 14, 408
- LG Semicon, 211
- Libya, countertrade deals, 334
- Licensing
- advantages, 427
 - compared to foreign direct investment, 252–253
 - cross-licensing agreements, 428
 - definition, 250
 - disadvantages, 427–428
 - limitations, 252–253, 268–269
 - use of, 269–270
- Lincoln Electric, 437, 438
- Lixi, Inc., 24
- Lobbying, 191–192, 373–374
- Local content requirements, 210, 235
- Local responsiveness
- customer preferences, 399–400, 403, 496
 - distribution systems, 401
 - host government demands, 401
 - infrastructure and practices, 400–401
 - pressure for, 397–399
- Localization strategy, 403–404, 406
- Location economies, 391–393
- Location externalities, 255–256, 472
- Location selection; *see* Foreign markets; Global production
- Location-specific advantages, 254–255, 268
- Lockheed, 136–137
- Logistics
- definition, 469
 - objectives, 486
 - strategic objectives, 470, 472
 - as support activity, 387
 - use of technology, 487–488
- Logitech, 195–196
- L'Oreal, 283
- Lotus, 421
- Louvre Accord, 354
- Lubricating Systems, Inc., 24
- Maastricht Treaty, 289, 290
- Mafia, 56
- Make-or-buy decisions; *see also* Outsourcing
- advantages of buy, 484–485
 - advantages of make, 482–484
 - definition, 481
 - trade-offs, 485
- Malaysia
- ASEAN membership, 300
 - currency crisis, 366
 - exchange rate policies, 359–360
 - investment boom, 363–364
- Managed-float system, 356, 358
- Management development, 539–540, 541–542
- Management in global markets, 36–37, 538–539; *see also* Expatriate managers
- Manufacturing; *see also* Global production; Production
- flexible, 475–477
 - lean production, 252, 475–477
 - mass customization, 475–477
- Market economies, 51–52
- entrepreneurship, 68, 69
 - government role, 52
 - innovation in, 68, 69
 - relationship to political systems, 70, 71
 - spread of, 76
- Market imperfections, 252
- Market segmentation, 497–499

- Marketing and sales functions; *see also*
 Global marketing
 creation of value, 386
 direct selling, 507
 integrating with research and
 production, 519–520
 relationship to R&D, 386, 495
- Marketing mix; *see also*
 Communication; Pricing
 strategies
 configuring, 515–517
 definition, 495
 distribution strategy, 501–504
 product attributes, 499–501,
 516–517
- Markets; *see also* Foreign exchange
 market; Foreign markets
 efficient, 321, 330–331
 global expansion, 390–391
 globalization of, 7–8, 17, 495–496
 inefficient, 331
 national differences, 7
 relatively efficient, 321
- Marriott International, 384
- Marxism, 46, 256
- Masculinity, 116
- Mass customization, 475–477
- Massachusetts General Hospital,
 40, 176
- Massachusetts Institute of
 Technology, 98, 118
- Matsushita, 14, 23, 24, 122, 125,
 252, 395–396, 425, 428,
 433, 513, 531
- Mazda, 264, 411
- McCann-Erickson, 509
- McDonald's Corporation, 7, 17, 27,
 28, 29, 82, 91, 92, 110, 120,
 140, 269–270, 322, 391, 396,
 399, 402, 422, 424, 429, 433,
 437, 438, 496, 506, 515–516,
 545, 546
- McKinsey & Co., 435
- MD International, 464–465
- Media availability, 508–509; *see also*
 Advertising
- Medical tourism, 40–41
- Mercantilism, 165–167
- Mercer Management Consulting,
 435, 545
- Mercosur, 277, 279, 298–299
- Mergers; *see also* Acquisitions;
 Competition policy
 financial services industry, 288
 regulatory approval, 284–285, 305
- Metai, 129–130
- Mexico; *see also* North American Free
 Trade Agreement
 Cemex, 250, 251, 263
 currency crisis (1995), 362–363
 economic recovery, 369
 oil industry, 281
 opposition to NAFTA, 295–296
 political system, 297
 textile industry, 281
 trucking industry, 275–276, 277
- MFA; *see* Multi-Fiber Agreement
- Micron Technology, 211
- Microprocessors, 15
- Microsoft, 8, 17, 20, 30, 60, 68, 87,
 120, 129, 130, 182, 195, 213,
 326, 390, 406, 408, 409, 485,
 512, 519, 522, 524–525, 535
- Milkfood, 263
- Mini-multinationals, 24
- Minimum efficient scale, 474–475
- Minnesota Mining and Manufacturing
 Co.; *see* 3M Company
- Minolta, 504
- Mitsubishi, 504
- Mitsubishi Heavy Industries, 184,
 409, 430, 491
- Mitsubishi Motors, 532
- Mitsui & Company, 462
- Mittal Steel, 258
- Mixed economies, 52–53, 69,
 76, 78
- MMO Music Group, 445
- MNEs; *see* Multinational enterprises
- Mobil Oil, 506
- Monetary policy
 effects of euro, 288, 290–291
 of European Union, 290–291
 with fixed exchange rates, 357
 with floating exchange rates,
 356–357
 IMF supervision, 350
 money supply growth, 324–325
- Money supply
 growth, 324–325
 relationship to inflation, 322–325
 U.S. policies, 351
- Monopolies, 52
- Monsanto, 147, 215, 216, 519,
 541, 542
- Moore's Law, 15, 17
- Moral courage, 155
- Moral hazard, 368–369
- Moral imagination, 153
- Mores, 95
- Motorola, 188, 190, 195, 196, 262,
 401, 403, 471, 519
- Movil, 273
- MRI scans, 8, 40
- MTV Networks, 5, 17, 75, 119, 120
- Multi-Fiber Agreement (MFA), 209
- Multilateral agreement on
 investment, 267–268
- Multinational enterprises (MNEs);
 see also Foreign direct
 investment
 changing nature, 22–24
 definition, 22
 largest, 22–23
 mini-, 24
 non-U.S., 22–23
 pricing power, 326
 radical view of, 256
- Multipoint competition, 254
- Multipoint pricing, 513–514
- Music piracy, 59, 231
- Muslim Brotherhood, 88
- Muslims; *see* Islam
- Myanmar
 ASEAN membership, 300
 human rights violations, 134, 135
- Nabisco, 112
- NAFTA; *see* North American Free
 Trade Agreement
- Naive immoralism, 146
- National competitive advantage, 165
 demand conditions, 186, 187
 evaluation, 189–190
 factor endowments, 186, 187
 firm strategy, structure, and rivalry,
 186, 189
 policy implications, 192
 Porter's diamond, 185–187,
 189–190
 related and supporting industries,
 186, 187–189
 relationship to culture, 122–123
 role of education, 115
- National differences; *see also* Cultural
 differences
 compensation, 544–545
 distribution systems, 401, 501–504
 economic development, 61–65, 500
 economic growth, 65, 66
 human resources management
 (HRM), 528–529
 markets, 7
 organized labor, 549
 regulation, 401
- National Science Foundation, 518
- National sovereignty, 33–34
- Neo-mercantilism, 166, 167

- Nepal, distribution system, 502
- Nestlé, 399, 499, 500
- Netherlands, advertising regulations, 510
- New-product development, 517–519
- New trade theory, 165, 182
 - economies of scale, 182, 183
 - explanation of trade patterns, 184–185
 - first-mover advantages, 183, 185, 191
 - implications, 183–185
 - product variety and costs, 182–183
- New United Motor Manufacturing, Inc., 412
- New world order, 74–75
- News Corporation, 139–140
- Nigeria
 - corruption, 58, 158
 - foreign oil companies, 134–135
 - human rights violations, 134
 - toxic waste disposal, 149
- Nike, 131, 142, 152, 481, 482, 496
- Nintendo, 8, 518
- Nippon Air, 136–137
- Nissan Motor Co., 253, 258, 263, 435, 467–468, 469, 549
- Noblesse oblige, 138
- Noise levels, 507
- Nokia, 5, 187, 188, 189, 262, 399, 401, 510, 518
- Nonconvertible currencies, 332, 334, 459
- Nontariff barriers, 210–211, 223–224
- Nonverbal communication, 114
- Norms, 94, 114–115
- North American Free Trade Agreement (NAFTA)
 - case for, 295
 - contents, 294–295
 - definition, 294
 - economic impact, 277, 296–297
 - enlargement issue, 297
 - establishment, 293–294
 - implications for businesses, 303–305
 - job losses, 277, 281, 295–296, 297
 - Mexican trucking and, 275–276, 277
 - motives, 163
 - opponents
 - environmental concerns, 31, 296
 - fears of job losses, 264, 281, 295
 - Mexican, 296
 - results, 296–297
 - side agreements, 33
 - textile industry job losses in U.S., 281
- North Dakota, 186
- Novi, Inc., 449
- O2, 273
- Occidental Petroleum, 461
- OECD; *see* Organization for Economic Cooperation and Development
- Offsets, 460–461, 485
- Offshore production, 265; *see also* Outsourcing
- Ogilvy and Mather Worldwide, 511
- Oil companies, 49, 134–135, 140
- Oil prices, 355
- Oké USA, 150
- Oligopolies, 253–254
- Olivetti, 180
- One 2 One, 434–435
- Onex Corporation, 491
- OPEC; *see* Organization of Petroleum Exporting Countries
- Operations
 - definition, 385
 - primary activities, 385–386
 - support activities, 386–387
- Optimal currency areas, 290–291
- Oracle, 68, 87
- Organization architecture, 387–389
- Organization for Economic Cooperation and Development (OECD)
 - agricultural subsidies of members, 230
 - bribery convention, 57–58, 137
 - foreign investment studies, 241–242, 260, 261
 - income distribution study, 30–31
 - labor relations code of conduct, 549
 - multilateral agreement on investment, 267–268
- Organization of Petroleum Exporting Countries (OPEC), 19, 352, 354, 355
- Organizational culture
 - attitudes toward ethical behavior, 142–143, 152–153
 - clashes in acquisitions, 436
 - definition, 142, 388
 - performance expectations, 143
 - socialization in, 541–542
 - staffing policies and, 531
- Organizational Resources Consulting, 545
- Organizational structure, 387
- Organized labor concerns, 548
 - international trade secretariats, 548–549
 - national differences, 549
 - relations with, 549–550
 - strategies, 548–549
 - views of free trade agreements, 264, 275
- Orthodox Church, 103
- Outflows of foreign direct investment, 243, 244, 248–249
- Output, world, 18–19
- Outsourcing; *see also* Global production; Make-or-buy decisions
 - benefits, 164
 - to countries with good educational systems, 115
 - economic exposure reductions, 373
 - employment effects, 29–31
 - opposition to, 29
 - of production, 8–10, 19–20
 - of service activities
 - call centers, 30, 482
 - cost reductions, 30
 - debates on, 30
 - medical, 8, 40–41, 176
 - software development, 176, 482
 - use of technology, 8–9, 17
 - strategic role, 482, 484
 - wage effects, 29–31
 - of white-collar jobs, 176
- P&G; *see* Procter & Gamble
- P&O, 259, 355
- Pakistan
 - education, 72
 - Islamic banking methods, 54
- Palm Computer, 408
- Panasonic, 122, 125–126, 531
- Paraguay; *see* Mercosur
- Parex, 343
- Paris Convention for the Protection of Industrial Property, 59
- Patents, 59, 60, 230–231, 233; *see also* Intellectual property
- Peace, promotion of, 76
- Pegged exchange rates, 345, 359–360
- People, 388; *see also* Human resources management
- PepsiCo, 8, 247, 496, 499–500
- Performance appraisals, 543
- Personal ethics, 141–142, 151
- Peru; *see* Andean Community
- Petrodollars, 354, 355

- Petroleos de Venezuela SA, 49
- Pfizer, 386, 517, 519
- Pharmaceutical industry
 - cross-licensing agreements, 428
 - distribution system, 401
 - government regulation, 401
 - law of one price, 322
 - patents, 231, 233
- Philip Morris, 459, 462, 509
- Philippines
 - ASEAN membership, 300
 - expatriate workers, 529
 - Jollibee Foods Corporation, 424–425
 - knowledge-based jobs, 176
- Philips NV, 14, 395, 473, 518, 531
- Pioneering costs, 420–422
- Plaza Accord, 353–354, 371
- Poland
 - countertrade deals, 461
 - distribution system, 401
 - economic policies, 43–44, 45
- Political economy, 45, 80; *see also* Economic systems; Trade policies
- Political risk, 82–83
- Political systems
 - collectivism, 45–46, 48
 - definition, 45
 - democracy, 48
 - democratization, 24, 25, 72–74
 - freedom, 72–74
 - individualism, 47–48
 - relationship to economic systems, 70–71
 - socialism, 46–47
 - totalitarianism, 48
 - transitions, 24–25, 72–74
- Political unions, 280
- Pollution, relationship to income
 - levels, 32–33; *see also* Environmental issues
- Polycentric staffing policy, 532–533, 534
- Port management, 259, 355
- Poverty, globalization debate and, 34–36
- Power distance, 116
- PPF; *see* Production possibility frontier
- PPP; *see* Purchasing power parity
- Pragmatic nationalism, 257–258
- Predatory pricing, 513
- Price discrimination, 326, 512–513
- Price elasticity of demand, 512–513
- Price inflation; *see* Inflation
- Prices, exchange rate determination
 - law of one price, 321, 322
 - money supply and inflation, 322–325
 - purchasing power parity, 321–322, 325–327
- Pricing strategies
 - experience curve, 514
 - multipoint, 513–514
 - predatory, 513
 - price discrimination, 512–513
 - regulatory influences, 514–515
 - strategic pricing, 513–514
- Primary activities, 385–386
- Private action, 56
- Privatization, 47, 78–79
- Processes, 388
- Procter & Gamble (P&G), 14, 24, 176, 326, 390, 391, 406, 407, 503, 505, 514, 519, 531
- Product attributes, 499–501, 516–517; *see also* Consumer preferences
- Product liability laws, 60–61
- Product life cycles, shortening, 517
- Product life-cycle theory
 - explanation of foreign investment patterns, 254, 270
 - explanation of trade patterns, 164–165, 179–181
- Product safety, 60–61, 447
- Production; *see also* Global production; Make-or-buy decisions; Manufacturing; Outsourcing
 - centralized, 478
 - costs, 318, 336, 372, 473–474
 - creation of value, 386
 - definition, 469
 - integrating with research and marketing, 519–520
 - quality issues, 470–471
 - strategic objectives, 470–472
- Production possibility frontier (PPF), 167–168, 175
- Products; *see also* Consumer preferences
 - adapting to different markets, 399–400, 499–501
 - developing, 517–519
 - local standards, 500–501
 - standardization, 494–495, 496, 516–517
- Profit growth, 381–382, 390, 397
- Profitability, 381–382, 390, 397
- Property rights; *see also* Intellectual property
 - in China, 70
 - corruption and, 56–57
 - definition, 55
 - Islamic view of, 107
 - legal risk and, 83–84
 - required for innovation and entrepreneurship, 69–70
 - in transition economies, 79–80
 - violations by private action, 56
- Protectionism; *see also* Trade policies
 - in 1980s and 1990s, 223–224
 - in agriculture, 229–230
 - costs, 230
- Protestant work ethic, 105
- Protestantism, 103, 105
- Pruksa Real Estate, 419
- Public action, 56
- Pull strategy, 507–509
- Purchasing power parity (PPP)
 - definition, 63
 - explanations of exchange rates, 321–322, 325–327
 - national differences, 63, 64
- Push strategy, 507–509
- Qinghai Satellite, 139
- Quality
 - international standards, 471
 - relationship to cost reductions, 470
 - Six Sigma, 471
 - total quality management, 470–471
- Quantum Corporation, 521
- Quicksilver, 497
- Quota rents, 210
- Quotas
 - import, 208–210
 - Multi-Fiber Agreement, 209
 - tariff rate, 209
- R&D; *see* Research and development
- Radical view of foreign direct investment, 256, 258
- Rank-Xerox, 180, 254
- RCA Corporation, 9, 252, 428, 500–501
- Red Spot Paint & Varnish Company, 450, 452
- Reebok, 481
- Regional economic integration
 - in Africa, 303
 - in Americas, 293, 294, 299–300
 - in Asia, 300–303
 - benefits, 277
 - case against, 282

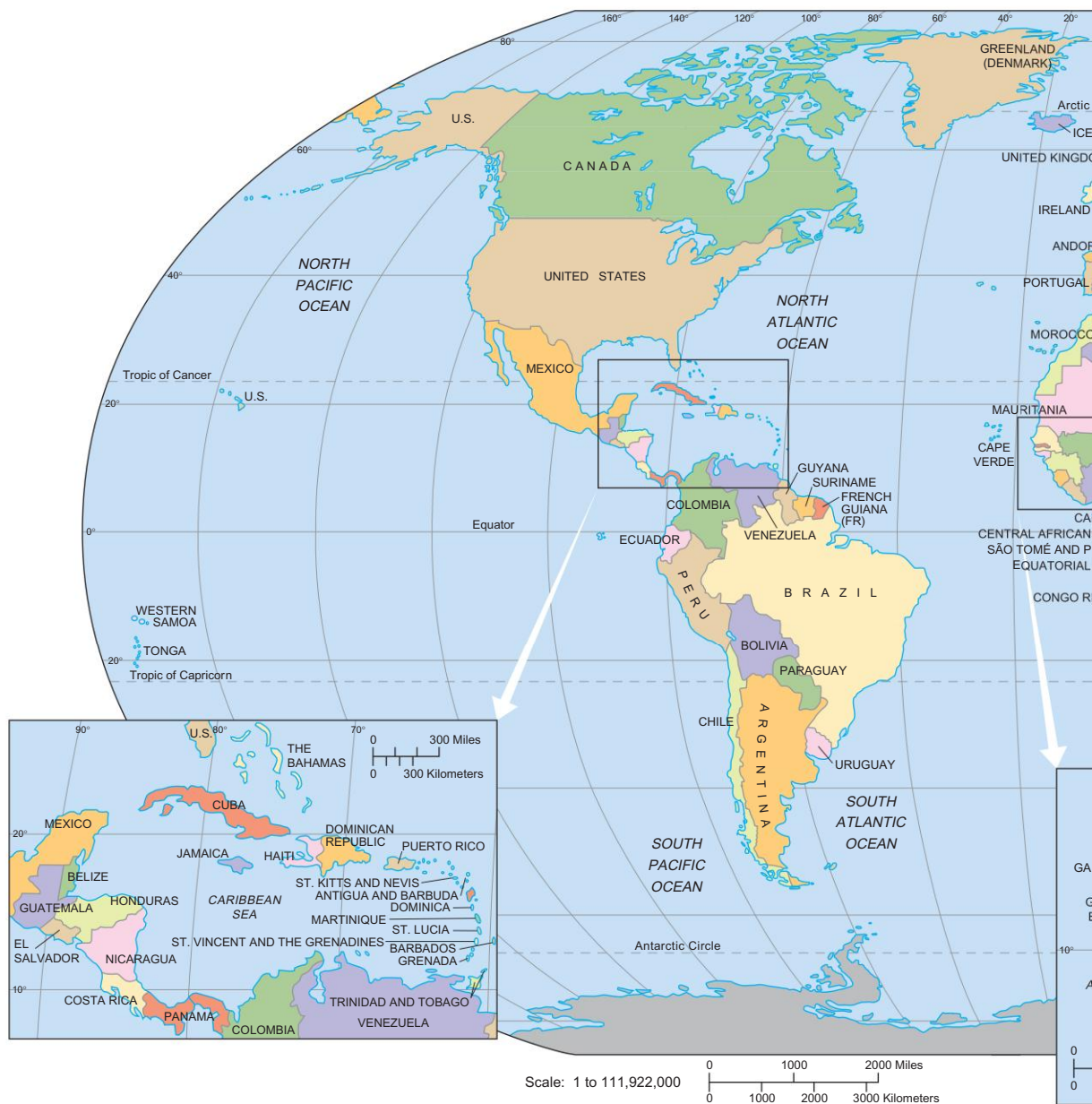
- Regional economic integration—*Cont.*
 case for, 280–281
 concerns, 277–278
 definition, 277
 impediments, 281–282
 managerial implications, 303–305
 Roman Empire, 278
- Regional trade agreements; *see also*
 European Union; North
 American Free Trade
 Agreement
 Andean Community, 279, 297–298
 in Asia, 300
 in Caribbean, 299
 gains from trade, 277
 in Latin America, 277
 Mercosur, 277, 279, 298–299
 number of, 277
- Regulation; *see also* Antidumping
 policies; Competition policy
 of advertising, 509, 510
 effects on pricing strategies,
 514–515
 of human resources practices, 529
 national differences, 401
- REI, 503, 504
- Relational capital, 411
- Relatively efficient markets, 321
- Religions; *see also* Islam
 Buddhism, 103, 110–111
 business implications, 103
 Christianity, 103, 105, 106
 definition, 103
 freedom, 105
 Hinduism, 103, 109–110
 Judaism, 103, 105
 largest, 103
 theocratic law systems, 54, 107
 theocratic totalitarianism, 50
 of world, 104
- Renault SA, 53, 435
- Repatriation of expatriate managers,
 541, 542
- Reporters Without Borders, 132
- Representative democracies, 50
- Research and development (R&D)
 centralized, 518
 creation of value, 385–386
 foreign investment in, 260
 global capabilities, 521–522
 integrating with marketing and
 production, 519–520
 location, 518–519
 need for, 517
 new-product development, 517–519
 relationship to marketing, 386, 495
- Retail systems; *see also* Distribution
 systems
 concentrated, 501–502
 fragmented, 501–502
 quality, 503–504
- Return on invested capital (ROIC),
 381–382
- Revlon, 496
- Righteous moralism, 145–146
- Rights, of stakeholders, 153–154; *see also* Human rights issues;
 Property rights
- Rights theories, 148–149
- Right-wing totalitarianism, 51
- Risks; *see also* Foreign exchange risk
 economic, 83
 in foreign markets, 82–84, 437
 legal, 83–84
 political, 82–83
- RMC, 251, 263
- ROIC; *see* Return on invested capital
- Rolex, 507
- Rolls-Royce, 8, 460
- Roman Catholic Church, 103, 105;
see also Christianity
- Roman Empire, 278
- Romania, countertrade deals,
 334, 459
- Royal Dutch Shell, 134, 537, 539
- Runde Investment Corp., 139
- Russia
 countertrade deals, 459, 461
 distribution system, 401
 fall of communism, 24
 Mafia, 56
 McDonald's restaurants, 82
 political system, 24, 72
- SAIC; *see* Shanghai Automotive
 Industry Corp.
- Sales; *see* Marketing and sales
 functions
- Sam's Club, 9
- Samsung, 14, 421, 425, 518, 531
- Sanyo, 9
- SARS (severe acute respiratory
 syndrome), 473, 487
- Saudi Arabia
 countertrade deals, 459
 oil production, 19
 phosphate exports, 426
- Saudi Ports Authority, 426
- Sazaby Inc., 3
- SBA; *see* Small Business
 Administration
- SC Johnson, 499
- SCORE; *see* Service Corps of Retired
 Executives
- Sea Containers, 441
- Seagate Technology, 196
- Seattle Coffee, 4
- Sega, 519
- Seiyu, 242
- Sematech, 213
- Service activities, outsourcing
 call centers, 30, 482
 cost reductions, 30
 debates on, 30
 medical, 8, 40–41, 176
 software development, 176, 482
 use of technology, 8–9, 17
- Service activity, 386
- Service Corps of Retired Executives
 (SCORE), 449
- Service industries, global account
 management, 487
- Services, trade in
 financial services, 226, 267
 GATT coverage, 225
 telecommunications, 226, 262, 267
 WTO agreements, 225, 262, 267
- Sexual harassment, 532
- Shamans, 111
- Shanghai Automotive Industry Corp.
 (SAIC), 417, 418, 419, 430
- Sharp, 9, 504, 518
- Shell; *see* Royal Dutch Shell
- Short selling, 328
- Siemens AG, 158–159, 262
- Sierra Club, 217
- Sight drafts, 455
- Silicon Valley, 255–256
- Singapore
 ASEAN membership, 300
 currency crisis, 366
 exports, 363
 Hewlett-Packard operation,
 479–480, 481, 521–522
- Single European Act, 286–289
- Six Sigma, 471
- Slave labor, 135
- Small Business Administration (SBA),
 446, 449–450
- Small businesses, exports
 challenges, 445–447
 examples, 443–444, 446, 449
 government assistance, 449
 share of U.S. exports, 7, 449
- Smiths Group, 441
- Smoot-Hawley Act, 223
- SMS Elotherm, 336
- Snecma, 410, 441

- Social democrats, 46–47, 48
- Social mobility, 99–101, 102
- Social responsibility, 138–140, 144, 399
- Social strata, 99–102
- Social structures
 - definition, 97
 - groups, 97, 98–99
 - individuals, 97–98
 - stratification, 99–102
- Socialism, 46–47
- Society; *see also* Culture
 - definition, 94
 - nation-states and, 95–96
- Softbank, 122
- Software piracy, 59, 60, 213, 231
- Sogo shosha* (trading firms), 447, 462
- Sony, 5, 7, 8, 9, 14, 24, 112, 122, 132, 190, 252, 387, 395, 399, 408, 410, 425, 428, 496, 517, 518, 519, 533
- Source effects, 506–507
- South Africa
 - apartheid system, 133, 266
 - divestment movement, 133, 266
- South America; *see* Latin America
- South Korea
 - central bank, 329–330, 367
 - culture, 111
 - currency crisis, 328–330, 367, 368
 - democratization, 74
 - economic growth, 81
 - education, 72
 - exchange rates, 329–330
 - foreign direct investment in, 262
 - IMF rescue package, 329, 363, 367, 368, 369
 - industrial conglomerates (*chaebol*), 329, 363, 364
 - investment boom, 83, 364
 - recovery, 368
- Southland, 251
- Specialized assets, 482–483
- Specific tariffs, 206
- Speculation; *see* Currency speculation
- Speed money; *see* Facilitating payments
- Spot exchange rates, 315–316
- Sprint, 285
- Staffing policies; *see also* Human resources management
 - comparison, 534
 - definition, 531
 - ethnocentric, 531–532, 534
 - geocentric, 533–534, 545
 - goals, 531
 - polycentric, 532–533, 534
- Stakeholders, 153–154
- Standard & Poor's, 329
- Standards
 - national, 500–501
 - quality, 471
- Standards of living, 63
- Star TV, 139, 140
- Starbucks Coffee of Japan, 3–4
- Starbucks Corporation, 3–4, 5, 6, 7, 29, 60, 61, 391, 433
- Starbucks Index, 324
- Starwood Hotels & Resorts, 384, 496
- State Bank of India, 68
- State-owned enterprises
 - in Britain, 46–47
 - in China, 23
 - in Marxist systems, 46
 - in mixed economies, 53
 - privatization, 47, 78–79
 - in socialist systems, 46
 - in Venezuela, 49
- Stavia, 421
- Steel imports
 - antidumping policies, 192, 235
 - restrictions, 192
 - tariffs, 206, 213
- Stocks of foreign direct investment, 14, 20–21, 243
- Stop & Shop, 152
- Strategic alliances
 - advantages, 408
 - definition, 407
 - disadvantages, 408–409, 486
 - failure rate, 409–410
 - learning benefits, 411–412
 - managing, 411–412
 - partner selection, 410
 - structures, 410–411
 - success factors, 409–412
 - with suppliers, 485–486
- Strategic behavior theory, 253–254, 270
- Strategic commitments, 422–423
- Strategic fit, 389
- Strategic positioning, 384–385
- Strategic pricing, 513–514
- Strategic trade policy, 165, 185, 220–221
- Strategies; *see also* Global expansion
 - choosing, 401–402
 - definition, 381
 - differentiation, 383
 - evolution, 406, 407
 - global standardization, 402–403
 - international, 405–406
 - localization, 403–404, 406
 - low-cost, 383
 - outsourcing, 482
 - profit growth, 381–382, 390, 397
 - profitability, 381–382, 390, 397
 - transnational, 404–405, 481
 - value creation, 382–383
- Stratification; *see* Social strata
- Subsidiaries, foreign
 - skills, 396–397
 - wholly owned, 243, 431–432
- Subsidies
 - agricultural
 - biofuels, 239
 - controversies, 227
 - costs and benefits, 208, 230, 234
 - efforts to reduce, 224, 227, 230, 234
 - Japanese, 207, 208
 - negative effects on developing nations, 36, 230
 - in United States, 207, 230, 239
 - to aircraft companies, 207, 220
 - costs and benefits, 207–208
 - definition, 207
 - political arguments for, 213
- Sullivan principles, 133
- Sunbeam Corporation, 114
- Suntory, 509
- Suppliers; *see also* Sweatshop labor
 - codes of conduct, 132
 - strategic alliances, 485–486
- Supply chain management, 470, 486–488; *see also* Logistics
- Support activities, 386–387
- Supranational organizations, 33
- Suzuki, 467
- Swaps; *see* Currency swaps
- Sweatshop labor, 129–130, 131–132, 144
- Switch trading, 461
- Symbols, interpretations of, 506
- Taiwan, manufacturing, 195, 472
- Tariff rate quotas, 209
- Tariffs
 - ad valorem, 206
 - agricultural, 36, 229–230, 239
 - benefits of reductions, 233
 - bound rates, 231–232
 - business opposition, 191–192
 - definition, 206
 - economic effects, 206–207
 - export, 207
 - future reductions, 231–232
 - history, 222–223
 - rates, 12, 206, 223, 229–230, 231–232

- Tariffs—*Cont.*
 - on services, 232
 - specific, 206
 - steel imports, 192, 206, 213, 515
- Tata Consultancy Services, 20, 414
- Tata Group, 533
- Tata Motors, 468, 517
- Tata Oil Mills, 263
- Taxes, income, 547
- Teams, cross-functional, 520–521
- Teamsters Union, 182, 275, 276
- Technical analysis, 332
- Technology; *see also* Information systems
 - as driver of globalization, 14–17
 - innovation in, 517
 - production location decision factors, 474–477
 - proprietary, 483
 - role in political change, 74
 - Silicon Valley, 255–256
 - in supply chain management, 487–488
 - transfer through foreign investment, 260
 - transportation, 15–16
- Telebras Brazil, 79
- Telecommunications; *see also* Cell phones
 - technological change, 15, 17
 - trade liberalization, 226, 262, 267
- Telefonica, 272–273, 434
- Teleglobe, 435
- Terrorism, 75–76, 106, 487
- Tesco, 262, 407, 420, 421, 503
- Texas Instruments (TI), 5, 176, 190, 258, 403, 427, 430, 519
- Textile industry
 - in Bangladesh, 161–162
 - job losses due to NAFTA, 281
 - in Mexico, 281
 - Multi-Fiber Agreement, 209
 - production outsourcing, 281
 - in United States, 281
- Thailand
 - ASEAN membership, 300
 - countertrade deals, 459, 460
 - currency crisis, 26, 365–366
 - exchange rate policies, 359–360
 - exports, 363
 - homebuilders, 419
 - IMF rescue package, 363, 366
 - intellectual property issues, 59, 60
 - investment boom, 83, 364
- Theocratic law systems, 54, 107
- Theocratic totalitarianism, 50
- 3M Company, 304, 450, 451, 452, 462, 517
- 3M Global Trading, 462
- TI; *see* Texas Instruments
- Tibet, Chinese rule, 217
- Time drafts, 455–456
- Time Warner, 285
- Timing of entry, 420–422
- Ting Hsin, 421
- Toshiba, 190, 408, 409, 410
- Total, 135
- Total quality management (TQM), 470–471
- Totalitarianism
 - communist, 50, 74
 - corruption and, 82
 - definition, 48
 - economic systems, 70–71, 74
 - right-wing, 51
 - theocratic, 50
 - tribal, 50
- Towers Perrin, 544, 545
- Toyota, 6, 8, 19–20, 113, 199, 252–253, 258, 260, 264, 266, 336, 390–391, 399, 402, 412, 417, 468, 476, 481, 486, 500, 531
- Toys “R” Us, 68, 265, 503
- TQM; *see* Total quality management
- Trade acceptances, 456
- Trade balance; *see also* Current account
 - adjustments with fixed exchange rates, 347, 358
 - adjustments with floating exchange rates, 357
 - deficits, 224
 - equilibrium, 347
 - gold standard and, 347
 - surpluses, 165–166, 167
- Trade barriers; *see also* Tariffs
 - administrative, 210–211
 - declining, 12–14
 - import quotas, 208–210
 - infant industry protection, 219–220
 - local content requirements, 210, 235
 - nontariff, 210–211, 223–224
 - voluntary export restraints, 192, 209–210, 224
- Trade creation, 282
- Trade diversion, 282, 298
- Trade liberalization; *see* Free trade
- Trade policies; *see also* Antidumping policies; Free trade
 - business influence on, 191–192, 235
 - case for free trade, 221
 - case for government intervention, 212
 - economic arguments, 219–221
 - political arguments, 213–219
 - theoretical arguments, 165, 185
 - firm strategy and, 234–235
 - managerial implications, 234–236
 - mercantilist, 165–167
 - neo-mercantilist, 166, 167
 - sanctions, 216
 - strategic, 165, 185, 220–221
 - subsidies, 207–208
 - tariffs, 206–207
- Trade Related Aspects of Intellectual Property Rights (TRIPS) agreement, 60, 225, 230–231
- Trade theories
 - absolute advantage, 163, 167–169
 - benefits of trade, 163–164
 - comparative advantage
 - argument for free trade, 163
 - description, 169–170
 - explanation of trade patterns, 164, 178–179
 - extensions, 173–177
 - gains from trade, 170–172
 - qualifications and assumptions, 172
 - Samuelson critique, 172, 175–177
 - explanations of trade patterns, 164–165, 178–179
 - on foreign direct investment, 265
 - Heckscher-Ohlin, 163, 164, 177–179
 - justification for government intervention, 165, 185
 - Leontief paradox, 178–179
 - managerial implications, 190–192
 - mercantilism, 165–167
 - national competitive advantage, 165
 - demand conditions, 186, 187
 - evaluation, 189–190
 - factor endowments, 186, 187
 - firm strategy, structure, and rivalry, 186, 189
 - policy implications, 192
 - Porter’s diamond, 185–187, 189–190
 - related and supporting industries, 186, 187–189

- new trade theory, 165, 182
- economies of scale, 182, 183
- explanation of trade patterns, 184–185
- first-mover advantages, 183, 185, 191
- implications, 183–185
- product variety and costs, 182–183
- product life-cycle, 164–165, 179–180
- support for free trade, 165
- Trademarks, 59, 60, 61, 230–231; *see also* Intellectual property
- Tragedy of the commons, 136
- Training, 539–540
- Transaction exposure, 334, 335–336
- Translation exposure, 335–336
- Transnational strategy, 404–405, 481
- Transparency International, 49, 56, 58
- Transportation
 - costs, 425–426, 477
 - technology, 15–16
- Treaty of Lisbon, 286
- Treaty of Rome, 283
- Tribal totalitarianism, 50
- TRIPS; *see* Trade Related Aspects of Intellectual Property Rights
- TRW, Inc., 411
- Turkey
 - currency crisis, 370–371
 - economic growth, 370
 - EU membership application, 108, 293
 - IMF rescue package, 370–371
 - Islamic capitalism, 108
- Turnkey projects, 426–427
- Tussauds Group, 355
- UAW; *see* United Auto Workers
- Uganda, foreign direct investment in, 260
- Uncertainty avoidance, 116
- Unethical behavior; *see* Business ethics
- Unilever, 24, 81, 112, 152, 155, 263, 304, 326, 498, 502, 507, 508, 509, 510, 511, 533
- Unions; *see* Organized labor
- United Auto Workers (UAW), 548
- United Nations Convention on Contracts for the International Sale of Goods (CIGS), 55
- United Nations (UN)
 - definition, 11
 - Earth Summit, 33
- establishment, 10, 11
- foreign direct investment studies, 13, 243, 261–262
- Human Development Index, 58, 65, 67
- trade reports, 447
- Universal Declaration of Human Rights, 148, 152
- United States
 - agricultural subsidies, 207, 230, 239
 - balance-of-payments accounts, 197, 198, 199, 200–201, 331
 - class divisions, 101
 - exports, 18
 - GDP per capita, 6
 - output, 18
 - trade deficits, 224
- U.S. Chamber of Commerce, 276
- U.S. Consumer Product Safety Commission, 447
- U.S. Department of Commerce, 211, 242, 443, 446, 447–449
- U.S. Department of Housing and Urban Development, 447
- U.S. Department of Justice, 284
- U.S. dollar; *see* Dollar, U.S.
- U.S. Export Assistance Center, 464
- U.S. Federal Reserve, 360
- U.S. Federal Trade Commission, 210
- United States Foreign Commercial Service Agency, 448
- U.S. Office of Tariff Affairs and Trade Agreements, 206
- United Technologies, 155
- Universal Declaration of Human Rights, 148, 152
- Universal needs, 398, 477–478
- University of Michigan, Institute for Social Research, 119
- Unocal, 134, 135, 258
- Upjohn, 519
- Uruguay; *see* Mercosur
- Uruguay Round, 12, 223, 224–225
- U.S. Magnesium, 211, 212
- Utilitarian approaches to ethics, 146–147
- Value chain
 - education as part of, 382
 - firm as, 385–387
- Value creation
 - activities, 385–387
 - definition, 383
 - strategies, 382–383
- Values; *see also* Ethical systems
 - changes in, 119–120
 - corporate, 142–143
 - definition, 94
 - teaching, 114–115
- Value-to-weight ratio, 477
- Vehicle currencies, 320
- Veil of ignorance, 149, 150, 154
- Vellus Products, 443–444
- Venezuela; *see also* Andean Community; Mercosur
 - Chavez government, 49, 355
 - corruption, 49
 - countertrade deals, 334, 459
 - foreign oil companies, 25, 258
 - oil revenues, 355
 - political risk, 83
 - state role in economy, 25, 49
- VERs; *see* Voluntary export restrictions
- Vertical integration, 483; *see also* Make-or-buy decisions
- Vietnam
 - ASEAN membership, 300
 - facilitating payments, 145
 - sweatshop labor, 131
- Viking, 408
- Vizio, 8, 9
- Vodafone, 87, 403, 434
- Volkswagen AG, 81, 112, 305, 318, 337, 390, 417, 418
- Voluntary export restrictions (VERs)
 - benefits, 209–210
 - bilateral, 224
 - definition, 209
 - on Japanese automobile imports to United States, 209, 210, 224
 - use of, 192
- Volvo, 435
- Vought Aircraft Industries, 491
- Walmart, 161, 175, 242, 243, 245, 262, 386, 395, 398, 407, 421, 502, 503, 516
- Warner Brothers, 408
- WEF; *see* World Economic Forum
- West Virginia, Development Office, 446
- Westinghouse, 9
- Whole Foods Market, 152
- Wholly owned subsidiaries, 243, 431–432; *see also* Acquisitions; Greenfield ventures
- Windam International, 539
- Wipro Ltd., 20, 100, 176, 414

- Wireless communication; *see* Cell phones
- Women
 - international assignments, 534
 - literacy, 187
 - sexual harassment complaints, 532
- Workers; *see also* Employment; Organized labor
 - child labor, 140–141, 144, 145, 227
 - hiring decisions, 151
 - labor relations, 547–550
 - mobility within European Union, 280–281
 - slave labor, 135
 - sweatshop conditions, 129–130, 131–132, 144
- World Bank
 - debt relief program, 36
 - definition, 10
 - economic studies, 19, 44, 49
 - establishment, 10, 345, 348
 - implications for businesses, 373
 - loans, 350, 366
 - nontariff barriers study, 224
 - role, 350
 - tariff information, 203–204
 - trade liberalization studies, 232
- World Economic Forum (WEF), 5, 205
- World Health Organization, 215
- World Intellectual Property Organization, 59
- World Trade Organization (WTO)
 - agricultural tariffs and subsidies issue, 36, 230, 239
 - Chinese membership, 217, 247, 473
 - critics, 10, 33–34
 - definition, 10
 - dispute settlement, 225–226
 - Doha Round, 12, 228, 232–234
 - enforcement mechanisms, 225–226
 - establishment, 12, 163, 205, 225
 - foreign direct investment regulations, 267
 - future issues
 - agricultural protectionism, 229–230
 - antidumping actions, 228–229
 - intellectual property protection, 230–231
 - tariff reductions, 231–232
- hormone-treated beef dispute, 28, 215
- intellectual property issues, 60, 230–231
- members, 10, 225
- notification of regional trade agreements, 277
- responsibilities, 10, 33
- rules, 203
- scope, 225
- Seattle meeting (1999), 27, 28, 226–228
- South Korea and, 367
- steel tariffs dispute, 206
- tariff information, 206
- trade data, 13–14
- trade liberalization goals, 5, 10, 232
- TRIPS agreement, 60, 225, 230–231
- World trading system, development of, 222–224; *see also* International trade
- World Values Survey, 119–120
- World War I, 347
- World Wide Web; *see* Internet
- WorldCom, 285
- WTO; *see* World Trade Organization
- Xerox, 9, 133, 180, 254, 405, 406, 409, 411, 427, 428, 429, 430, 431
- Xing Ba Ke Coffee Shop, 61
- Zero-sum games, 167
- Zodiac, 372





ACRONYM	PROPER NAME
ADB	Asian Development Bank
AfDB	African Development Bank
AFIC	Asian Finance and Investment Corporation
AFTA	Asian Free Trade Agreement
ASEAN	Association of Southeast Asian Nations
ATPA	Andean Trade Preference Act
BIS	Bank for International Settlements
BOP	Balance of Payments
CIM	Computer-Integrated Manufacturing
CIS	Commonwealth of Independent States
CISG	UN Convention on Contracts for the International Sale of Goods
CEMA	Council for Mutual Economic Assistance
CRA	Country Risk Assessment
DB	Development Bank
DC	Developed Country
DFIs	Development Finance Institutions
DISC	Domestic International Sales Corporation
EBRD	European Bank for Reconstruction and Development
ECOWAS	Economic Community of West African States
EMU	Economic and Monetary Union
EEA	European Economic Area
EFTA	European Free Trade Association
EMs	Export Management Companies
EMCF	European Monetary Cooperation Fund
EMS	European Monetary System
EPO	European Patent Organization
ETC	Export Trading Company
ETUC	European Trade Union Confederation
EU	European Union
FCPA	Foreign Corrupt Practices Act
FDI	Foreign Direct Investment
FSC	Foreign Sales Corporation
FTAA	Free Trade Agreement of the Americas
FTZ	Foreign Trade Zone
Fx	Foreign Exchange
G7	Group of Seven
GATT	General Agreement on Tariffs and Trade
GC	Global Company
GDP	Gross Domestic Product
GNP	Gross National Product
GSP	Generalized System of Preferences
IAC	International Anti-counterfeiting Coalition
IC	International Company
IDA	International Development Association

ACRONYM	PROPER NAME
IDB	Inter-American Development Bank
IEC	International Electrotechnical Commission
IFC	International Finance Corporation
IMF	International Monetary Fund
IPLC	International Product Life Cycle
IRC	International Revenue Code
ISA	International Seabed Authority
ISO	International Organization for Standardization
ITA	International Trade Administration
JIT	Just-in-Time
JV	Joint Venture
LAIA	Latin American Integration Association (formerly LAFTA)
LDC	Less Developed Country
LIBOR	London Interbank Offer Rate
LOST	Law of the Sea Treaty
MERCOSUR	Free Trade Agreement between Argentina, Brazil, Paraguay, and Uruguay
MNC	Multinational Company
MNE	Multinational Enterprise
NAFTA	North American Free Trade Agreement
NATO	North Atlantic Treaty Organization
NIC	Newly Industrializing Country
NTBs	Nontariff Barriers
OECD	Organization for Economic Cooperation & Development
OPEC	Organizational of Petroleum Exporting Countries
PPP	Purchasing Power Parity
PRC	People's Republic of China
PTA	Preferential Trade Area for Eastern and Southern Africa
SACC	Southern African Development Coordination Conference
SBA	Small Business Administration
SBC	Strategic Business Center
SBU	Small Business Unit
SDR	Special Drawing Rights
SEZ	Special Economic Zone
TQM	Total Quality Management
UN	United Nations
UNCTAD	UN Conference on Trade and Development
VAT	Value Added Tax
VER	Voluntary Export Restraint
VRAs	Voluntary Restraints Agreements
WEC	World Energy Council
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

COUNTRY	CAPITAL
Afghanistan	Kabul
Albania	Tirana
Algeria	Algiers
Andorra	Andorra la Vella
Angola	Luanda
Antigua and Barbuda	St. John's
Argentina	Buenos Aires
Armenia	Yerevan
Australia	Canberra
Austria	Vienna
Azerbaijan	Baku
Bahamas	Nassau
Bahrain	Manama
Bangladesh	Dhaka
Barbados	Bridgetown
Belarus	Minsk
Belgium	Brussels
Belize	Belmopan
Benin	Porto-Novo
Bhutan	Thimphu
Bolivia	La Paz
Bosnia and Herzegovina	Sarajevo
Botswana	Gaborone
Brazil	Brasilia
Brunei	Bandar Seri Begawan
Bulgaria	Sofia
Burkina Faso	Ouagadougou
Burundi	Bujumbura
Cambodia	Phnom Penh
Cameroon	Yaounde
Canada	Ottawa
Cape Verde	Praia
Central African Republic	Bangui
Chad	N'Djamena
Chile	Santiago
China	Beijing
Colombia	Bogota
Comoros	Moroni
Congo	Brazzaville
Congo (formerly Zaire)	Kinshasa
Costa Rica	San Jose
Cote d'Ivoire	Yamoussoukro
Croatia	Zagreb
Cuba	Havana
Cyprus	Nicosia
Czech Republic	Prague
Denmark	Copenhagen
Djibouti	Djibouti
Dominica	Roseau
Dominican Republic	Santo Domingo
Ecuador	Quito
Egypt	Cairo
El Salvador	San Salvador
Equatorial Guinea	Malabo
Eritrea	Asmara
Estonia	Tallinn
Ethiopia	Addis Ababa
Fiji	Suva
Finland	Helsinki
France	Paris
Gabon	Libreville
The Gambia	Banjul
Georgia	Tbilisi

COUNTRY	CAPITAL
Germany	Berlin
Ghana	Accra
Greece	Athens
Grenada	St. George's
Guatemala	Guatemala City
Guinea	Conakry
Guinea-Bissau	Bissau
Guyana	Georgetown
Haiti	Port-au-Prince
Honduras	Tegucigalpa
Hungary	Budapest
Iceland	Reykjavik
India	New Delhi
Indonesia	Jakarta
Iran	Tehran
Iraq	Baghdad
Ireland	Dublin
Israel	Jerusalem
Italy	Rome
Jamaica	Kingston
Japan	Tokyo
Jordan	Amman
Kazakhstan	Astana
Kenya	Nairobi
Kiribati	Tarawa
Korea, North	Pyongyang
Korea, South	Seoul
Kuwait	Kuwait City
Kyrgyzstan	Bishkek
Laos	Vientiane
Latvia	Riga
Lebanon	Beirut
Lesotho	Maseru
Liberia	Monrovia
Libya	Tripoli
Liechtenstein	Vaduz
Lithuania	Vilnius
Luxembourg	Luxembourg
Macedonia, The Former Yugoslav Republic of	Skopje
Madagascar	Antananarivo
Malawi	Lilongwe
Malaysia	Kuala Lumpur
Maldives	Male
Mali	Bamako
Malta	Valletta
Marshall Islands	Majuro
Mauritania	Nouakchott
Mauritius	Port Louis
Mexico	Mexico City
Micronesia	Palikir
Moldova	Chisinau
Monaco	Monaco
Mongolia	Ulaanbaatar
Montenegro	Podgorica
Morocco	Rabat
Mozambique	Maputo
Myanmar	Rangoon
Namibia	Windhoek
Nauru	Yaren
Nepal	Kathmandu
The Netherlands	Amsterdam
New Zealand	Wellington
Nicaragua	Managua
Niger	Niamey
Nigeria	Abuja
Norway	Oslo
Oman	Muscat

COUNTRY	CAPITAL
Pakistan	Islamabad
Palau	Koror
Panama	Panama City
Papua New Guinea	Port Moresby
Paraguay	Asuncion
Peru	Lima
Philippines	Manila
Poland	Warsaw
Portugal	Lisbon
Qatar	Doha
Romania	Bucharest
Russia	Moscow
Rwanda	Kigali
Saint Kitts and Nevis	Basseterre
Saint Lucia	Castries
Saint Vincent and the Grenadines	Kingstown
San Marino	San Marino
Sao Tome and Principe	Sao Tome
Saudi Arabia	Riyadh
Senegal	Dakar
Serbia	Belgrade
Seychelles	Victoria
Sierra Leone	Freetown
Singapore	Singapore
Slovakia	Bratislava
Slovenia	Ljubljana
Solomon Islands	Honiara
Somalia	Mogadishu
South Africa	Pretoria
Spain	Madrid
Sri Lanka	Colombo
Sudan	Khartoum
Suriname	Paramaribo
Swaziland	Mbabane
Sweden	Stockholm
Switzerland	Bern
Syria	Damascus
Taiwan	Taipei
Tajikistan	Dushanbe
Tanzania	Dar-es-Salaam
Thailand	Bangkok
Togo	Lome
Tonga	Nuku'alofa
Trinidad and Tobago	Port-of-Spain
Tunisia	Tunis
Turkey	Ankara
Turkmenistan	Ashgabat
Tuvalu	Funafuti
Uganda	Kampala
Ukraine	Kiev
United Arab Emirates	Abu Dhabi
United Kingdom	London
United States of America	Washington, DC
Uruguay	Montevideo
Uzbekistan	Tashkent
Vanuatu	Vila
Vatican City	
Venezuela	Caracas
Vietnam	Hanoi
Western Samoa	Apia
Yemen	Sanaa
Zambia	Lusaka
Zimbabwe	Harare

