INTERNATIONAL BUSINESS

SIXTH EDITION

About the Author

Dr. K. Aswathappa has a vast and diverse teaching experience, spanning over a period of nearly four decades; he has the honour of occupying almost all positions in Bangalore University. He was the Chairman of Department of Commerce; Dean, Faculty of Commerce and Management; Director, Canara Bank School of Management Studies and Member of Syndicate, Senate, and Academic Council. Now retired, he is spending all his time in reading; updating titles in circulation and writing new ones. He is a visiting professor at a few institutions in Bangalore.

Besides guiding twenty-five Ph. D research scholars, Dr. Aswathappa is also credited with adjudicating theses of other universities. He takes interest in content development and has been instrumental in revising syllabi of all commerce and management courses periodically, in order to make them reflect current developments in business world. His contribution to business education, though little, is significant, especially in Karnataka. At his instance, a course on business education was introduced for plus two students of commerce stream in the state of Karnataka, and he was invited by the Central Bank Trust to develop contents for a course on factory organisation for CBSE students.

Dr. Aswathappa has been an author of three decades' standing. Having authored books on *Human Resource Management, International Business, Organisational Behaviour* and *Business Environment*. All his books are bestsellers and have run into multiple editions and reprints which demonstrate their acceptance all over.

He has enriched his titles with unique didactic aids, such as "Running Cases", "Walk the Talk", "Successful Manager". "Pause and Ponder", "Relook", "Self-Check", "Reinforcing Exercises" and the like. His writings reflect as much success stories of Tatas, Birlas, Ambanis, Mittals, Murthys, Azimjis and Bill Gates as workplace harassments, beheading of expatriates, murdering of HR executives inside factories, plight of female employees in garments units, families living on pavements and impoverished children, and so on.

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K Aswathappa

Former Director

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Dedicated to
My Parents

Preface to the Sixth Edition

In this column of the last two editions of *International Business*, I had exhibited pessimism about the relevance of globalisation and the need to study the subject international business; but sounded optimism nevertheless. This optimism made me revise *International Business* on the earlier two occasions.

The same trend continues even now. Enjoying unfettered flow of people, capital and goods and services across the globe for more than three decades, globalisation is now under check, particularly since 2008, when the worst financial crisis hit the world economy. Both developed and developing countries are resorting to hidden protectionist measures. Governments have become increasingly selective on who they trade with; type of capital they invite; and degree of freedom they allow for doing business overseas. Countries are erecting gates, if not walls, against globalisation. It is gated globalisation now.

What does the future hold for international business? It seems to be promising if one goes by the following trends:

- Pace of people movement is continuing unabated. A visit to the American Consulate that clears your visa to fly to the US convinces you about the ever-increasing number of people who desire to go to their 'dreamland' either as tourists or as professionals. Queues in front of other consulates are no less encouraging.
- More than $ 15 trillion worth of goods and services are traded across the globe every day.
- Some $ 3 trillion worth forex transactions take place every day.
- WTO and the world's powerful economies are relentlessly pursuing and are convincing others to follow the path towards greater free trade.
- World is increasingly becoming one nation, one culture, one language, one taste and one style.
- People all over the world are witnessing improved living standards, better health, better education and better earnings – thanks to globalisation.
- What future holds for mankind (and for international business) is very well summed up by Bill Gates and Melinda Gates in their letter published on January 22, 2015. Write they: "The lives of people in poor countries will improve faster in the next 15 years than at any other time in history". They also forecast the eradication of polio and other dreadful diseases. Financial security will improve as two billion people who do not have bank accounts start saving money and making payments using mobile phones. Affordable online courses will open up huge educational opportunities for people, especially for girls.
- World Bank and the IMF have predicted that in the next few years, India would overtake China in growth rate; this is a piece of news that all of us should be proud of. With huge population and enormous skill base, India should play key role in shaping world economy.
- Obviously, as days go by, gates against globalisation will be dismantled and there shall be more and more free flow of people, capital and goods across the globe.

All these factors indicate that globalisation continues to be the buzzword and a book on international business remains to be relevant as ever and its updated edition is all the more welcome. Hence the sixth edition of *International Business*.

Changes

The present edition carries several changes. Chapter-wise changes are listed below:

Chapter 1: New opening case; Gated globalisation

Chapter 2: Two tables replaced; Additional inputs to closing case

Chapter 3: New opening case; Additional protectionist measures; Additional trade theories; Closing case on GM updated

Chapter 4: Additional information to opening case; FDI Confidence Index added; Additional data on the extent of FDI; Updated closing case

Chapter 5: Additional inputs on opening case; Additional inputs on democracy; A new figure on bribery cases detected; A new figure on the rulers of African Countries; New figure on sovereign defaulters; Additional inputs on lobbying; OECD report (2014) on bribery and corruption; New closing case

Chapter 6: Additional inputs on opening case; Additional inputs on Islam; Additional inputs on culture and attitudes; Additional inputs on women participation in business

Chapter 7: Additional inputs on Hofstede's cultural dimensions

Chapter 8: Additional inputs to opening case; Additional inputs to the nature of negotiation

Chapter 9: Additional inputs to features of technology; Additional inputs to social change; Additional inputs to closing case

Chapter 10: Opening case rewritten; Two new figures; New section on subterranean economies; Economic scenario rewritten; Additional inputs to structural adjustments; Additional information on China; New closing case

Chapter 11: Strategy formulation rewritten

Chapter 12: New opening case; Section on external environment rewritten; Additional inputs to related issues in global design; Additional inputs to culture in international business; Additional inputs to managing change

Chapter 14: Additional inputs to opening case; Two new figures; Additional inputs to free trade area; Additional inputs to NAFTA; Indian subcontinent rewritten; New write up on BRICS; Commodity agreements rewritten

Chapter 15: New opening case; World Bank write up rewritten; New write up on sustainable development goals; Write up on African Development Bank

Chapter 16: New opening case; Additional inputs to review of performance; Doha negotiations updated

Chapter 17: Table 17.1 redrawn; New figure on competitive advantage; Closing case recast

Chapter 18: Opening case rewritten; Additional inputs on pricing and dumping; Future of advertising

Chapter 19: Status of Indian banks; Merges and acquisitions rewritten; New table on bidders in 2014; Transfer pricing; New closing case

Chapter 20: New section on types of letters of credit

Chapter 22: New figure on Glass Ceiling Index

Chapter 23: Chapter recast

Chapter 24: New section added on industries; Two new figures on corporate governance and best board composition added

Chapter 25: New opening case; Additional inputs on e-marketing

Others

Data and tables in all the chapters have been updated. No effort has been spared to make the text as close to the contemporary developments as possible.

New Features

Every chapter ends with reinforcing exercises. Answering these enables the reader to have a clear understanding of the chapter contents and how they can be applied to real life business situations.

Learning objectives have been serial numbered and where the objectives have been met within the text, have been indicated with respective numbers. Same logic is extended to summary, review and discussion questions. The purpose is to maintain connectivity between objectives and the text.

Acknowledgement

I wish to thank all the readers for their patronage to the book!

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Preface to the First Edition

Globalisation of business is the order of the day. Increasingly, firms are buying and selling goods and services or investing funds across the globe. It is not just the multinational firms that are active players in international business; even small enterprises are busy in cross-border business, as is evidenced by India's experience. Again, it is not only the rich countries who are active in cross-country business; developing countries too are active participants—in fact, developed countries are looking more and more towards less developed countries to do business with. Further, global business is not confined to shipping, machinery, oil, chemicals and the like across the globe. Products meant for day-to-day usage, such as razor blades, books, CD ROMs and computers, are bought and sold between continents and among nations.

Internationalisation of business poses challenges and offers opportunities to captains of industries. The CEO of a firm no more remains insulated. He or she now has to operate in an open market where big players—domestic and foreign—jostle with each other for market share. If one were to compete successfully, opportunities for growth are aplenty.

A typical CEO needs global perspective to manage his or her business. Be it operations, marketing, finance, human resources or systems, strategies need to be formulated and implemented keeping overseas markets in mind. Knowledge about international business, therefore, assumes great relevance for the CEOs.

A student pursuing management education from Bangalore University, for example, may find himself or herself placed in a firm located in a totally different country. Knowledge about international business keeps the youngster mentally prepared to accept assignment in an alien environment. Forewarning is definitely forearming, for the fresh graduate.

Realising the importance, universities and institutes in India have started courses on international business either at graduate, post-graduate or diploma level in management education. Expectedly, a large number of books have been written and published on this subject.

International Business is an attempt in the direction to provide to the readers a comprehensive text about global business.

The text has been divided into four parts containing 17 chapters. Part I (Chapters 1–5) sets the tone for international business. Starting with discussion on the nature of cross-border business, this part goes on to discuss theories of global business, environment of international business, strategic management process, and organizational design for an MNC.

Part 2 (Chapters 6–12) covers a detailed discussion on all functional areas of international business. This part covers chapters on operations management, managing technology transfers, marketing management, financial management, financing foreign trade, international accounting, and human resources management. More coverage (three chapters) is given to financial management because of its crucial role in international business.

Part 3 (Chapters 13–15) contains interesting discussion on facilitators of global business. It goes on to explain how, at the micro level, strategic alliances are formed by competing firms, and between countries. It discusses how countries are grouping themselves with a view to minimise or remove trade barriers, and how strategic alliances between firms and regional groupings between countries are a great help to international business.

Chapters 16 and 17 form Part 4 of the text. This part explains why and how removing cross-cultural illiteracy and managing cultural diversity are crucial for success in international business. Chapter 16 throws light on these two and other related issues. Chapter 17 covers a detailed discussion on social responsibility and ethics of international business and stresses that in the lure of making profit, the MNCs should not compromise on ethical behavior and should not forget their obligation to society's well-being.

Obviously, every effort has been made to ensure that the coverage of the subject is comprehensive and arrangement of parts and chapters is logical.

The text is replete with anecdotes (shown in the form of exhibits) drawn from contemporary business. All the concepts are explained using live examples.

Each chapter commences with its outline and its objectives. Cases woven around MNCs operating in India and Indian firms active in global business are added to each chapter.

I hope the readers will find reading *International Business* refreshing and rewarding, just as its writing has been to me.

K ASWATHAPPA

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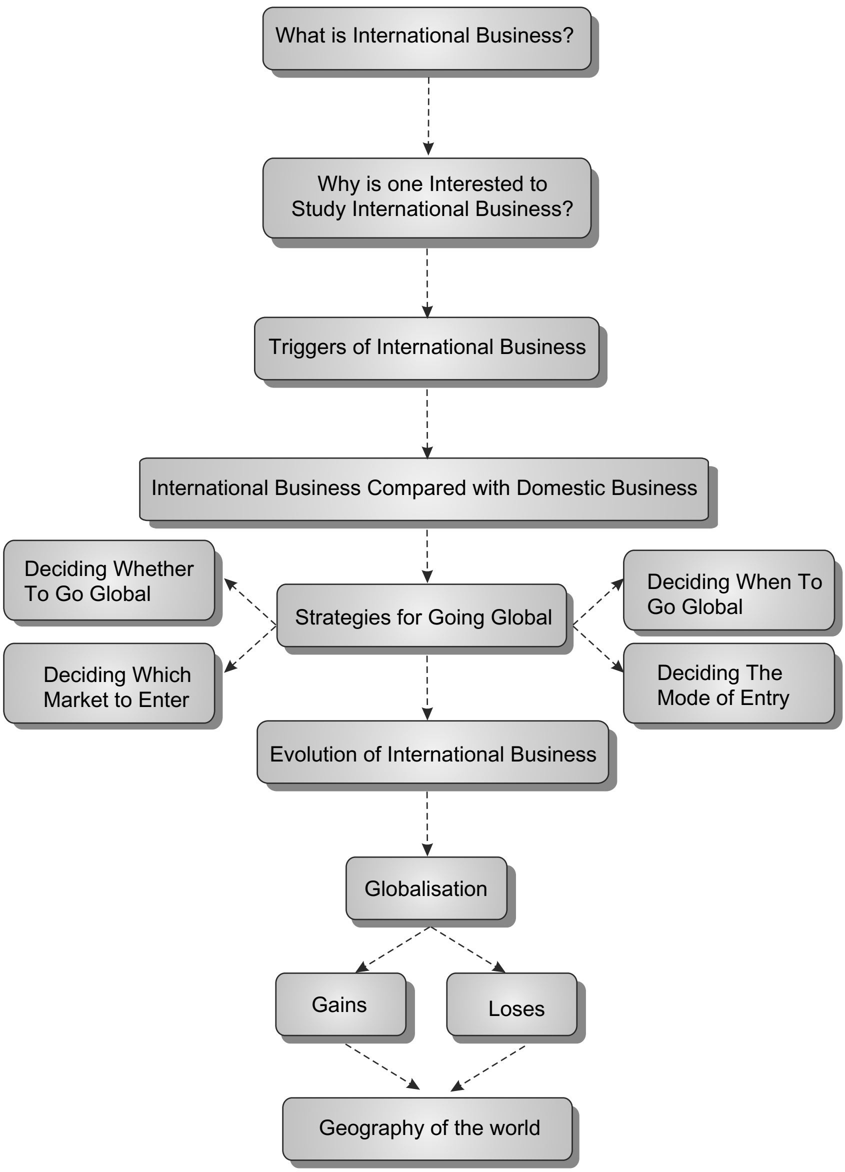
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1

Nature of International Business

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Identify the nature of international business
- **LO 2:** Infer the reasons to study international business
- **LO 3:** Relate to the drivers of international business
- **LO 4:** Distinguish between international business and domestic business
- **LO 5:** Illustrate the evolution of international business
- **LO 6:** Bring out the strategies of going international
- **LO 7:** Analyse aspects of globalisation
- **LO 8:** Recognise the geography of the world

Opening Case

Around the World with Millions and Billions

What has Amitabh Bachchan, Sharukh Khan, Hrithik Roshan and Rajnikanth got to do with globalisation? In fact, globalisation is their buzzword, their reach, spread, impact and money, everything has global implication. These and other heroes of the tinsel world who not only act and dance in the films, but have taken Indian films around the world (spread now into 156 countries)

India and the United States are two top films producing countries in the world. In 2006, India produced 1090 films while only 607 films came out of Hollywood. Indian film industry has an annual growth rate of 12.6% when compared to Hollywood which registers a rate of only 5.6%.

It was in 1999 when Sir Laurence Oliver and Sir Alec Guinness lost to Amitabh Bachchan in the "BBC Super Star of the Millennium". This made the world to wake up and take notice of the Indian films.

Some examples are worth stating. *My Name is Khan* went to Germany, Poland, Peru and South Korea; *Chennai Express* was released in 50 territories including Israel, Ireland, Srilanka, Australia, Myanmar, and Norway; and *Dhoom 3* opened in several countries including Australia, Netherland, Singapore and Vietnam.

Indian made Hindi films are as popular in

Pakistan as in India. But we are not allowing Pakistan films to be screened in India.

The erstwhile USSR was a big market for Indian films. Raj Kapoor had vast fan following in the communist countries. Naming a few mainstream films like *Abdullah* and *Disco Dancer* and the latter attracting 60.9 mn Soviet viewers in 1984 being the highest turnout for any films (domestic and foreign) for that year.

It is not that only Hindi films are screened overseas, regional films too are in great demand, particularly Tamil movies in Malaysia, Srilanka and other Asian markets. Telugu, Malayalam and Kannada movies too are exhibited overseas.

Movie lore about enterprising distributors carting cans of 35mm prints across borders for homesick immigrants has given way to press releases from Mumbai-based companies extolling the conquest of yet another exotic destination. The movies do not release as widely as they do at home, but they are totting up respectable enough figures. Eros claimed $100,000 (around ₹60 lakh today) box-office figures for *Cocktail* across Kazakhstan and Kyrgyzstan, and $300,000 for *English Vinglish* in Taiwan, while *Dhoom 3* posted gross collections of $25 million within the first two weeks.

Facilitating around the world travel is the overhaul of film distribution in general. Until decades ago, producers sold their wares to buyers who in turn sold them to theatres, raking in huge money and the producers watch helplessly. From there distribution has moved on to more corporate and transparent system.

Nostalgic is the story of Maganbhai Savani (now 91) who started exporting Hindi films in 1947 through his company – International Film Distributors. He started with East Africa, a major Indian diaspora hub. Savani is a textile exporter too; he sold cloth and cinema during his visits to the region.

His experiences convince us that the people who ushered in economic reforms in 1991 are not the only heroes of globalisation. Listen to what Savani says, "We took all kinds of films to East Africa, mainly to Kenya, Uganda and Tansania. Then, we started exploring new markets, like the Gulf, West Africa and North Africa, places like Bahrain and Dubai, Syria, Lebanon, Jordan, Iran, Morocco, Tunisia, Algeria, Nigeria, Ghana, Sierra Leone, Cameroon, Ghana, Gambia".

The scene was characterised by guess work and gumption. "I would explain what the movie was about, since our culture was so different," Savani said. "There was the problem of language, so I started subtitling and dubbing the films. We would often cut down the length – the songs were usually dropped."

Over time, Savani came to understand the tastes and preferences of diaspora audiences.

"*Jai Santoshi Maa* (the successful 1975 mythological) was a hit even in places like Birmingham and Manchester that have large Muslim populations," he said. South Africa and East Africa like the social movies while West Africa likes action movies, and North Africa likes both the categories. One of his biggest successes is *Haathi Mera Saathi*, the 1971 movie starring Rajesh Khanna, Tanuja and an elephant. "The movie created history in Singapore and Malaysia," Savani said. "We sent three prints, but then we required 35." In some cases, audience interest needed to be created where none existed. "In Greece, theatres would not touch Hindi films, so we gave them away for free", he added.

Spread of Indian movies overseas is not confined to only their distribution. They are there around the world in production too. As of now, every film made in India has one or two songs shot overseas, most preferred locations include Singapore, New York, Switzerland, Paris, Dubai and Japan.

The journey overseas is always bumpy. Fluctuating foreign exchange rates, political instability (for example, apartheid ruined the South African market and the civil war has gutted Arab countries such as Egypt, Iraq, Syria and Lebanon) and dominance of Hollywood in lucrative markets, such as China, are posing challenges to Indian movies.

Thus, it is endless. International business has pluses and minuses, cogent defenders and congenital critics. Through the pages of this book, we present to you the various facets of global business, bringing out merits and demerits of each, without of course, passing judgement on any.

NATURE OF INTERNATIONAL BUSINESS

LO 1
Identify the Nature of International Business

Nearly all business enterprises, large and small, are inspired to carry on business across the globe. This may involve purchase of raw materials from foreign suppliers, assembling products from components made in several countries, or selling goods or services to customers in other nations. One of the most important trends in the late 20th century has been the lowering of barriers to facilitate easy movement of goods and services across national borders. The list of firms affected by international competitive forces grows longer each day, and even small retailers—such as those surrounding your house—are affected by the global production and sales practices of companies that manufacture, import, and sell clothing, CDs, snack foods, books, and computers. Many Indian companies have subsidiaries, and joint-venture partners in other nations—particularly in developing countries.

The basic tasks and functions of international business are almost the same as domestic business. But there is greater difficulty in performing the functions effectively and integrating them to serve organisational objectives. The subsequent chapters in this book seek to explain the complexities involved in doing global business. For the sake of clarity, international business may be understood as those business transactions that involve the crossing of national boundaries. They include:

- Product presence in different markets of the world
- Production bases across the globe
- Human resource to contain high diversity
- Investment in international services like banking, advertising, tourism, retailing, and construction
- Transactions involving intellectual properties such as copyrights, patents, trade marks, and process technology

Specifically, internationalisation of business can be viewed as a four-dimensional construct based on the premise that an enterprise can be more or less global along each of four major characteristics: internationalisation of market presence, internationalisation of supply chain, internationalisation of capital base, and internationalisation of corporate mindset (see Fig. 1.1).

The first dimension—*globalisation of market presence*—refers to the extent to which a company targets customers in all major markets within its industry throughout the world. On this count the presence of companies vary from low to high. For example, in 1993, NTT of Japan had no presence at all either in North America or in Europe. In comparison, IBM, Sun Microsystems, and Canon were the most globalised firms (see Table 1.1).

Internationalisation of supply chain (second dimension) refers to the extent to which the company is accessing the most optimal locations for the performance of various activities in its supply chain. It may be possible for a firm to have a fairly regional market presence and yet a highly globalised supply chain, or vice versa. For example, Toyota has a good supply chain. In one year, Toyota produced about two-thirds of all its cars in Japan; the remaining one-third were produced in its affiliates spread over 25 countries in America, Europe, and Asia. Furthermore, the company exported 38 per cent of its domestic production to foreign markets. Apart from this flow of capital, goods, and know-how between Japan and overseas affiliates, Toyota is also engaged in considerable intra-firm flows among the affiliates. For example, within its South East Asian regional network, it exported diesel engines from Thailand, transmissions from the Philippines, steering gears from Malaysia, and engines from Indonesia.

The third dimension—*internationalisation of capital base*—refers to the extent to which the company is accessing optimal sources of capital on a worldwide basis. The Hong Kong based Internet

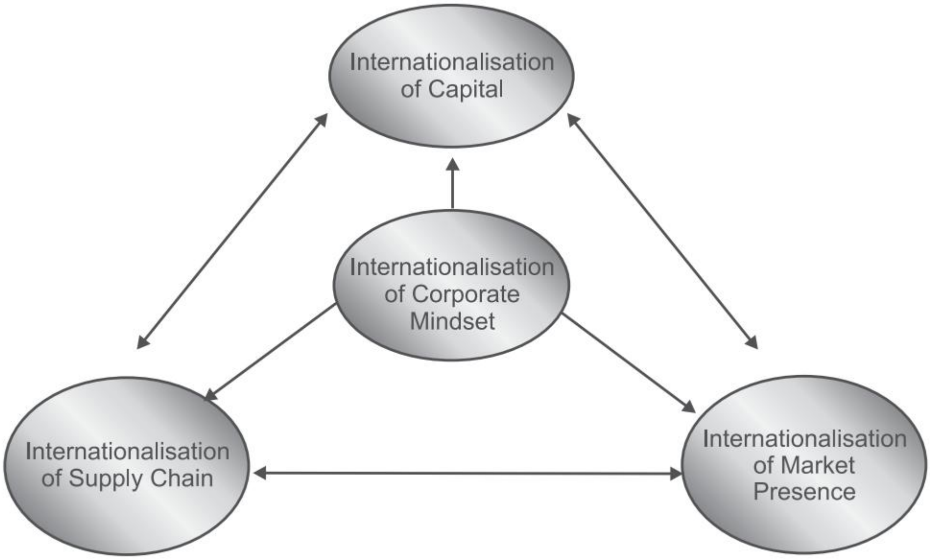

Fig. 1.1 Assessing Corporate Globality

Table 1.1 World View (Percentage Regional Distribution of IT Sales for Selected Companies in 1993)

	North America	*Europe*	*Asia*
IBM	41	33	16
Fujitsu	6	26	65
HP	51	34	9
NEC	6	4	88
Compaq	45	38	5
Canon	30	29	37
Sun Microsystems	51	24	25
NTT	0	0	100
Microsoft	56	30	9

service provider China.com represents a good example of how a company can be 'local' in terms of market presence as well as supply chain, and yet have a highly globalised capital base. In 1999, China.com's market base and operations were centered primarily around Hong Kong and China. Yet, in the same year, the company got itself listed on the US based Nasdaq.

The last but most important dimension is the *internationalisation of corporate mindset*. This dimension refers to the ability of the company to understand and integrate diversity across cultures, and markets. General Electric (GE) serves as a good example of a firm with an increasingly global mindset. The human capital of GE is highly globalised, it has strong worldwide corporate culture and the composition of the leadership is increasingly diverse in terms of nationalities.

A true global company is the one which scores high on all the four dimensions discussed above. But as the examples cited till now show, a global firm can be low on one dimension and high on others.

Even as there are measures to assess globality of companies, there are indices to determine internationalisation-potentiality of nations. One of the most comprehensive indices is the one provided by A.T. Kearney, a management consultancy and *Foreign Policy* magazine.

Each nation's gloabality is assessed considering four variables: political engagement, technological connectivity, personal contact and economic integration.

1. *Political engagement* refers to the extent of a nation's memberships in world bodies, human resource and financial contributions to UN Security Council missions and international treaties ratified.
2. *Technological connectivity* is assessed in terms of the numbers of Internet users, Internet hosts and secure servers.
3. *Personal contact* refers to international trade and tourism, international telephone traffic, remittances, and personal transfers including compensation to employees.
4. *Economic integration* includes trade, foreign direct investment, portfolio capital flows and income from investment.

To the above four are added an array of social factors to capture the broad nature of *internationalisation*. Table 1.2 brings out the 20 highest-ranking nations in the 2003–06 *internationalisation* index. India's score is 61, preceded by Iran with 62.

Table 1.2 shows the relative ranking of each nation. In other words, the extent to which any nation is global is best viewed in the context of how international it is relative to other nations.

The Kearney index also covers the 10 least international nations spread over Africa, East Asia, South Asia, Latin America and the Middle East. Certain features are common to these 10 countries. *First*, together these nations account for 50 percent of the world's population. This is a signal to all MNC's. Global companies cannot afford to ignore these countries. *Second*, these 10 counties carry lowest technological connectivity. *Third*, some nations are characterised by perennial political unrest and corruption (for example Bangladesh, Indonesia and Venezuela). *Fourth*, some other nations with large agricultural sectors face trade barriers in developed countries and are subject to highly volatile prices on commodity markets (for example Brazil, China and India). *Fifth*, some others are heavily dependent on oil exports but are plagued by erratic prices in energy markets (for example Iran and Venezuela). *Finally*, Turkey and Egypt, along with the entire Middle East, suffer from continued concerns over terrorism, high barriers to trade and investment, and heavy government involvement in the economy.

REASONS TO STUDY INTERNATIONAL BUSINESS

LO 2
Infer the reasons to why study International Business

As a subject of study, international business has attracted considerable attention from all quarters. The subject is taught in MBA, M.Com and other management related courses all over the country and IIMs have started a separate course on international business. Bangalore University is offering a Masters Degree and a Diploma Course in International Business. Why the subject has assumed such widespread acceptance all over?

1. Increasingly, companies are sourcing their human resource requirement globally. Sony Corporation, for example, has only 50 per cent of its employees who are Japanese. The remaining 50 per

Table 1.2 Globalisation's Top 20 Nations

Country	*2006*	*2005*	*2004*	*2003*
Singapore	1	1	2	4
Switzerland	2	3	3	2
United States	3	4	7	11
Ireland	4	2	1	1
Denmark	5	7	10	6
Canada	6	6	6	7
Netherlands	7	5	4	5
Australia	8	13	13	21
Austria	9	9	9	8
Sweden	10	8	11	3
New Zealand	11	11	8	16
United Kingdom	12	13	12	9
Finland	13	10	5	10
Norway	14	14	17	13
Israel	15	17	22	19
Czech Republic	16	15	14	15
Slovenia	17	20	19	25
Germany	18	21	18	17
Malaysia	19	19	20	18
Hungary	20	23	26	23

(*Source:* Adapted from *International Business* by John Wild, et al., 2006, p. 14)

cent are non-Japanese. After completing a course in international business, a boy or a girl may find himself or herself employed in a multinational business firm and working in an alien land. It is advisable that the student is taught international business—its complexities, opportunities, and challenges. Prior knowledge about global business keeps the youngster prepared to accept jobs in multinational corporations.

2. Most of the products we consume everyday are supplied to us by global businesses. The paste we use to clean our teeth, the powder we use to brew coffee, the vehicle we use to commute to the college or office, the shirts we wear, the entertainment programmes we enjoy, and the news we listen to are all provided to us at our doorsteps by multinational corporations. It is advisable that each of us knows where toothpaste, for example, is manufactured, who manufactures it, and how it is made available to us. Such knowledge enables us to identify and associate quality with brand. We are sure of quality if the products bear such names as Sony, Nike, Levi, Toyota, Colgate, Gap T-shirt, and the like. To know these brands is to understand international business.

3. It is the manager of today's business who needs knowledge about international business more than anybody else. Managing an international business is more complex than running a domestic business. Global business involves production of goods in facilities located in different countries with resources— physical and human, sourced from all parts of the globe—and marketing goods and services to users across the globe. To operate effectively, international managers must understand the various facets of global business, which will be discussed in the chapters that follow.

4. A lay person has a negative perception about the role of government. The general understanding is that the government of a land is inimical to the growth of international business. Contrary to popular belief, government plays an important role in the development and promotion of international business activities. They provide a host of financial and non-financial incentives to attract FDI into their countries, often in competition with their neighbours. The increasing scale of liberalisation of trade and investment, deregulation of domestic industries, and privatisation of state-owned enterprises has the attraction of foreign business as one of its primary objectives. These programmes have created immense international business opportunities. The major impact of international business in this area has been the impetus on governments to open up their borders to international trade and investment, standardise their systems and procedures, adopt internationally acceptable values and attitudes, particularly with respect to human rights and child labour, and encourage the development of democratic institutions. For example, in order to get into the WTO, the Chinese government softened its attitude towards capitalism, undertook a review of and improvements in its human rights record, liberalised its investment and trade policies, and privatised its state enterprises. One needs to have knowledge of international business to get a proper and appropriate perspective about the role of political environment on global business.
5. International business executives play a powerful role in determining the relative competitiveness of various countries in the global arena. The foundation for India's economic development was no doubt laid by the Tatas, Birlas and Goenkas. But the sharp edge the country is enjoying in the globe has definitely been given by Azim Premzi, Narayana Murthy and a score of other contemporary business leaders. Skills and predilictions of these people will subtly influence strategies and resource allocation. They will be faced with "more cultures to understand, more social responsibilities to master, more time pressures to juggle and more relationships to rethink."
6. As the world is becoming a global village, more job opportunities are being made available to the youth. India is placed in a unique position to take advantage of the explosion in job opportunities. The country has the largest number of young people in the world today. There are only two countries in the world with a billion people apiece, China and India. China curtailed birth of children with its 'one child' policy while population control sputtered in India. India has approximately 65 million children below 15 years of age, and as many as 400 million young people below the age of 23. These young people will join the ranks of working people in the years to come, thus creating a huge surge of productive activity, income and savings. This is the 'demographic dividend' on which the BRICS (Brazil, Russia, India, China and South Africa) report bases its projection that India will be the third largest economy in 2050, behind China and the US, and way ahead of Japan and Germany. India's young people will be an asset to the global economy because while India's population will be growing younger over the coming decades, the population of all the developed countries will be getting older. The richer countries will face a shortage of working-age people while India will have a surplus. Indians need to be well prepared to face the challenges of global assignments.
7. Businesses throughout the world have benefitted by following the best human resource practices, inventory management techniques and operations management principles of global enterprises. India, in particular, has gained immensely from the professional management practices of the MNCs. But there are also practices of some business houses about how not to run a business which need to be condemned. From the East India Company's greed to Enron's debacle, business executives everywhere have well-documented practices which should be listed under the list of don'ts.

DRIVERS OF INTERNATIONAL BUSINESS

LO 3
Relate to the drivers of International Business

International business is not a new phenomenon. As will be noted in a subsequent section in this chapter, trade across the globe is as old as business itself. However, the volume of international trade and the number of players in it have increased dramatically over the last decade. Today, every nation and an increasing number of companies buy and sell goods in the international marketplace. A number of developments around the world have helped to fuel this activity.

Specifically, the developments that facilitate international business include:

- Developing markets have huge markets
- Emerging countries offer low cost locational advantage
- Demographics are changing
- Regional trading blocks boost world business
- Trade and investment barriers have crumbled
- Advancements in technology
- Availability of services all over
- International business offers huge money
- Firms seek resources through international business
- Growing richness adding presume for quality and new products and services
- World bodies and institutions are playing facilitating roles

These are elaborated in the following pages in this section.

More and more companies are seeking to internationalise their economies for a number of reasons. *First*, developing markets have huge markets. For companies, mostly in the developed countries, which have been operating below their capacities, the developing markets offer immense opportunities to increase their sales and profits.

McKinsey, a consultancy firm, calculates that people in developing world would buy $20 trillion worth of goods a year by 2020. Vodafone is one example to demonstrate how important the emerging markets for one MNC. Its sales fell in the rich world while those in the developing world rose sharply. Vodafone is one of the many western companies that are betting on the developing world. The mobile phone major has invested more than $25 billion in Turkey and India.

Most MNCs are far more profitable in developing countries than Vodafone. American firms, for example, made a 12% return on equity in 2012. In terms of take-overs, emerging markets are fertile grounds. In 2007, purchases in these markets reached $225 bn.

Take the case of GM. In the US, the car maker has applied for bankruptcy. But its operations in the emerging markets are virtually unscathed, infact growing. Sales increased by 10% in Brazil in 2008, 9% in India and by 6% in China. GM's sales in the Asia Pacific region were up 44% in May 2009, as compared with the year before.

In the emerging markets, GM has often acted like an entirely different company from the one that is collapsing in Detroit. In China, GM has spent years emphasising fuel economy and affordability. In Brazil, it created flexible engines that run on ethanol or gasoline and compact pick up cars. Cheap labour in these markets helps bolster profit margins, while millions of people who do not yet own a car can take sales growth easy.

Of particular significance are the BRICS countries. The growth rates of these BRICS countries have been much greater than the developed nations. During boom periods, when the developed markets were growing at 3%, the BRICS countries were growing 7% to 9%. When developed markets are not growing at all because of the global meltdown, these countries are growing at 7%. Taken together, the

BRICS countries account for substantial share of world's output and growth. By 2020, their output will be 40 percent of global GDP. They account for 25% of the earth's land mass and 40% of its population and will play an ever increasing role in strategic sectors such as energy. An MNC which ignores the emerging markets does so at its own peril.

Second, many MNC's are locating their subsidiaries in low wage countries to take advantage of low cost production. This is especially important when labour accounts for a large portion of total production costs. Many car makers have set up their operations in India because of low wage rates. However, the lower wage rates of a nation need to be balanced against its potentially lower productivity. Most emerging markets carry low wage rate, no doubt. But their productivity rates are low.

Third, changing demographics also adds to increasing globalisation. As stated above, demographic changes are more visible in India. In the days to come, richer countries will face shortage of working-age people while India will have a surplus.

It is not just the number of people that India has, but also its quality of the people, that is on the country's side. India has a large low-cost and skilled workforce. This large labour pool will limit increases in wage rates for the next 20 years. In addition, India has a high availability of engineers, producing over 400,000 every year, next only to China's 490,000 and nearly 25 times Thailand's 17,000. In addition to engineers, India produces 850,000 graduates and over 70,000 diploma holders every year.

What do all these mean?

- Multinational corporations increasingly use India as a destination for contracting out their functions.
- In addition, large number of Indians are available and are prepared to take-up overseas assignments.

Fourth, regional trading blocks are adding to the pace of globalisation. WTO, EU, NAFTA, MERCOSUR and FTAA are major alliances among countries. Trading blocks seek to promote international business by removing trade and investment barriers. Integration among countries results in efficient allocation of resources throughout the trading area, promoting growth of some businesses and decline of others, development of new technologies and products, and elimination of old. This process has resulted in large scale restructuring of industries and firms in the EU, with relocation of industry and many cross-border mergers and alliances.

But there are potential problems associated with alliances. It is said that trading blocks might compete with each other. If this happens, free trade will exist within each bloc and each bloc will protect its market from outside competition with high tariffs. The possibility of the EU and NAFTA turning into 'economic fortresses' that shut out foreign producers with high tariff barriers is not ruled out.

Trading blocks generate more job opportunities. For example, between 90,000 and 160,000 jobs of various sorts were created in the US because of greater exports to Mexico (in the wake of the creation of NAFTA). There will also be easy movement of people among alliance partnering countries and replication of best HR practices. But, there is also the possibility of jobs being shifted to low wage and low cost countries within or outside a trading block.

Fifth, declining trade and investment barriers have vastly contributed to cross-border business.

The early period of the 20th century witnessed high levels of barriers on trade and investment. The aim of such restrictions was to protect domestic industries from foreign competition underlying the argument for protection of domestic industries — the infant industry argument. Tariff protection against the imported commodity is needed, so the infant industry argument goes, in order to allow the now higher-period domestic producers enough time to learn the business and to achieve the economies of scale in production, and the external economies of learning that are necessary to lower unit costs and prices. With enough time and sufficient protection, the infant will eventually grow and become

Table 1.3 Average Tariff Rates on Manufactured Products as Percent of Value

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

(*Source*: W.L. Hill and Arun Kumar Jain, *International Business,* McGraw-Hill, 2014, p. 10)

competitive with developed country producers. Ultimately, many domestic producers will not only be able to produce for the domestic market without a tariff wall or government subsidies, but will also be able to export their now lower cost goods to the rest of the world.

The infant industry argument had several takers. Each country started imposing tariffs on the goods of other countries. This led to the cumulative curtailment of demand resulting in the Great Depression of the 1930s.

The Depression was characterised by a vicious circle: no jobs → no income → no demand → no supply → no income. In order to break this circle, free-flow of goods, services and capital across the globe was thought necessary. In other words, barriers were required to be dismantled. Thus came the free trade regime resulting in the WTO. Table 1.3 summarises how trade barriers were lifted over a period of time. As can be seen from Table 1.3, average rates of tariff have fallen considerably since 1950s and now stand at 3.9 per cent.

Thanks to the free trade regime, business across the globe has grown considerably. Goods, services, capital and technology are moving across the nations significantly. The volume of world trade has grown over 20 fold between 1950 and 2002. The average yearly outflow of FDI increased from about $25 billion in 1975 to a record $1.3 trillion in 2000.

Internationalisation of business is being accompanied by outsourcing and off-shoring of activities. While outsourcing benefitted India, Chinese are the gainers from off-shoring business processes.

Free trade also meant movement of labour across the globe, though not as freely as goods, services and capital. There is dichotomy here. Though all nations expect goods, services and capital to move freely, they place several conditionalities when it comes to the movement of people across countries. Nevertheless, globalisation has benefitted people in terms of increased jobs and enhanced salaries.

Sixth, the most powerful instrument that triggered internationalisation is technology. Revolution is probably the right word which can best describe the pace at which technology has changed in the recent past and is continuing to change. Significant developments are being witnessed in communication, transportation and information processing, including the emergence of the Internet and the world wide web. It is said that the cost of a three-minute telephone call from New York to London, in current prices, has dropped from about $250 in 1930 to a few cents today. In more recent years, the number of voice paths across the Atlantic has sky-rocketed, from 100,000 in 1986 to more than 2 million today. The number of Internet hosts has risen from 5,000 in 1986 to more than 700 million now.

Thanks to these developments in technology, MNCs are able to locate production facilities anywhere in the world to take advantage of low cost production. This trend helps create job opportunities in countries like Philippines, Mexico, China and India.

Seventh, governments and organisations across the world have developed services that facilitate internationalisation. Typical services include banking, engineering, insurance, consulting and e-commerce.

Banking services facilitate conversion of one currency into another which is essential for settling international transactions. Providers of *engineering services* can achieve economies of scale not only for machinery and material but also in areas such as project management. *Insurance services* specialise in underwriting, risk evaluation, and operations. *Consulting services* are available and are provided for firms in need of them. *Electronic commerce* has opened up new horizons for global services reach, and has drastically reduced the meaning of distance. For example, when geographic obstacles make the establishment of retail outlets cumbersome and expensive, organisations can approach their customers via the worldwide web.

Eighth, there is money in international business and no organisation would wish to miss the opportunity. Between 2002 and 2009, the share of foreign revenues for the top 100 companies rose sharply from 17% to 19%. HCL, for example, earns 63% of its total revenue form the US and 32% from Europe, a total of 95%. Similarly 90% of the total earnings of Infosys are from foreign markets (62% from the US and 28% from Europe), Wipro earns 56% from the US and 30% from Europe, totaling 86% and TCS also has foreign revenues to the extent of 80% (51% percent from the US and 29% from Europe). It is not just Indian companies alone. Even foreign companies earn huge revenues form overseas markets as Table 1.4 shows.

Ninth, resource-seeking is another motive for firms going international. Resources can be natural or strategic assets. With reference to the former, firms seek three categories of resources. First, there are those seeking physical resources which include mineral fuels, industrial minerals, metals, and agricultural products. Indian and Chinese firms, of late have invested in Africa to take advantage of the physical resources there. The second group of resource-seeking MNCs comprises those seeking plentiful supplies of cheap and well-motivated unskilled or semiskilled labour. Mexico, Taiwan and Malaysia have attracted FDI for the same reason. Within Europe too, there has been some labour-seeking investment in Southern, Central and Eastern European countries.

The third type of resource-seeking FDI is prompted by the need for acquiring technology. The fact that several Indian, Taiwanese and Korean companies have collaborative alliances with EU or US firm shows how strong is the pull of technologies.

Strategic assets include global portfolio of physical assets and human competencies which add to the competitive edge of a firm. Tata's acquisition of Corus and Chinese Lenova's acquisition of IBM's PC business are examples of asset-seeking investments. Strategic asset seekers aim to capitalise on the benefits of the common ownership of diversified activities and capabilities.

Tenth, growing affluence of people across the globe is pressuring organisations to offer newer and finely differentiated products. Countries like China and India are witnessing consumption boon necessitating transfer of goods and services across the globe.

The availability of rich markets has spurred companies to spend more heavily on R&D and to search world wide – via the Internet, industry journals, trade fairs and trips abroad – for innovations and products that can be sold to demanding consumers.

Finally, internationalisation is triggered by world bodies and institutions. World Trade Organisation (WTO) is the international organisation that regulates and promotes business across nations. The three main purposes of WTO are: (1) help free trade, (2) help negotiate further opening of markets, and (3) settle trade disputes between members.

Similarly, treaties and conventions signed and binding on member countries facilitate international

Table 1.4 The World's Top 25 Non-financial MNEs Ranked by Foreign Assets, 2004

MNE	Country	Industry	Assets		Sales		Employment	
			Foreign	Total	Foreign	Total	Foreign	Total
General Electric	US	Electrical & electronic eq.	448,901	750,507	56,896	152,866	142,000	307,000
Vodafone Group Plc	UK	Telecommunications	247,850	258,626	53,307	62,494,	45,981	57,378
Ford Motor	US	Motor vehicles	179,856	305,341	71,444	171,652	102,749	225,626
General Motors	US	Motor vehicles	173,690	479,603	59,137	193,517	114,612	324,000
British Petroleum	UK	Petroleum expl./ref/distr.	154,513	193,213	232,388	285,059	85,50	102,900
Exxon Mobil	US	Petroleum expl./ref/distr.	134,923	195,256	202,870	291,252	52,968	105,200
Royal Dutch/Shell	UK/NL	Petroleum expl./ref/distr.	129,939	192,811	170,286	265,190	96,000	114,000
Toyota Motor Corp	Japan	Motor vehicles	122,967	233,721	102,995	171,467	94,666	265,753
Total	France	Petroleum expl./ref/distr.	98,719	114,636	123,265	152,355	62,227	111,404
France Telecom	France	Telecommunications	85,669	131,204	24,252	58,554	81,651	206,524
Volkswagen	Germany	Motor vehicles	84,042	172,949	80,037	110,463	165,152	342,502
Sanofi-Aventis	France	Pharmaceuticals	82,612	104,548	15,418	18,678	68,776	96,439
Deutsche Telekom AG	Germany	Telecommunications	79,654	146,834	47,118	71,868	73,808	244,645
RWE Group	Germany	Electricity, gas and water	78,728	127,179	23,636	52,320	42,370	97,777
Suez	France	Electricity, gas and water	74,050	85,788	38,838	50,585	100,485	160,712
E.ON	Germany	Electricity, gas and water	72,726	155,364	21,996	60,970	32,819	72,484
Hutchison Whampoa	Hong Kong	Diversified	67,638	84,162	17,039	23,037	150,687	180,000
Siemens AG	Germany	Electrical & electronic eq.	65,830	108,312	59,224	93,333	266,000	430,000
Nestle SA	Switzerland	Food & beverages	65,396	76,965	68,586	69,778	240,406	247,000
Electicite de France	France	Electricity, gas and water	65,365	200,093	17,886	55,775	50,543	156,152
Honda Motor Co Ltd	Japan	Motor vehicles	65,036	89,483	61,621	79,951	76,763	137,827
Vivendi Universal	France	Diversified	57,589	94,439	11,613	26,607	23,377	37,906
Chevron Texaco	US	Petroleum expl./ref/distr.	57,186	93,208	80,034	150,865	31,000	56,000
BMW AG	Germany	Motor vehicles	55,726	91,826	40,198	55,050	70,846	105,972
Daimler Chrysler	US/Germany	Motor vehicles	54,869	248,850	68,928	176,391	101,450	384,723

business considerably. The Treaty of Rome, Paris Convention, Chemical Weapons Convention, The Warsaw Convention and GATS are but a few examples of international institutions facilitating business. Chapter 15 provides more details on institutions and treaties.

INTERNATIONAL BUSINESS AND DOMESTIC BUSINESS COMPARED

LO 4
Distinguish between International and Domestic Business

Global business, as was noted earlier, is an extension of domestic business. There are, however, important differences as well as similarities. Business, whether global or domestic, involves buying and selling goods and services. In most cases, profit is the driving force behind each transaction.

Differences between domestic and international businesses are pronounced primarily in the areas of currency, interest rates, inflation, taxation systems, government regulations, language, geographic, cultural and economic barriers.

Differences between international business and domestic business are a matter of concern for any MNC. An MNC is typically into international business and each of its subsidiaries is located in a different country which has its own domestic business. An MNC can function smoothly if differences are ironed and can even propser when the environment of home country and host country are identical.

In the matter of payments, a buyer of foreign goods must pay for them in a currency different from that which he is accustomed to use in his own country. For example, an Indian importer of American goods needs to make payment in dollars and not in rupees. Exchange rate fluctuations become a problem and to insure against such fluctuations, the importer has to enter a six-month forward contract with a banker.

Once commodities cross a country's border, they become subject to a different set of laws. Quotas and licences make movement of goods difficult, creation of WTO notwithstanding.

Businessmen selling abroad have to contend with differences in customs, institutions, and language. Cultural factors abroad affect the kinds of commodities that can be sold in foreign countries as well as the individual's conduct and procedures in selling overseas.

A businessman operating exclusively within the domestic market faces a single pattern of short-term and long-term interest rates, only one rate of inflation, and a single tax system. These variables are all different for the business person engaged in global business, having operations in a number of countries.

In international business, managerial practices need to be altered and fine-tuned to correspond with different environmental variables.

For example, a firm engaged in international business needs to adopt the geocentric orientation in its management. Geocentric approach is an orientation whereby executives believe that a global view is needed in both the headquarters of the parent company and its various subsidiaries and that the best individuals, regardless of home or host country origin, should be utilised to solve company problems anywhere in the world. The geocentric approach is the most difficult to achieve because it requires that managers acquire both local and global knowledge. (Read Exhibit 1.1 for an illustration of how geocentric approach benefits a firm).

A look at the world's geography makes it clear that the natural resources are unevenly distributed. Some regions / countries are gifted with abundant resources and others are deprived of them. Qatar, a tiny country of four million, has richest deposits of oil, whereas India which supports 1.2 bn people is made to import most of the valuable resources. It is the wisdom of the international manager to scout an ideal country to set up subsidiaries there.

Geographic vagaries make the life of an MNC difficult many times. Rains, hurricanes, floods, earthquakes, tsunamis and the like render movement of people and goods difficult. MNCs cannot

Exhibit 1.1

MANAGING DIVERSITY—THE BOEING WAY

A geocentric approach helped Boeing save its 737 airplane. When sales began to slow down in the early 1970s, a group of Boeing engineers began to recognise that they had not given enough attention to a major potential market, the developing regions of the world. Through visits abroad, the engineers found that runways in developing countries were generally too short for the 737 and were mainly asphalt, a softer material than concrete. Consequently, they redesigned the wings to allow shorter landings on soft pavement and changed the engine so that take-offs would be quicker. They also developed a new landing gear and installed low-pressure tires. Boeing soon began to get small orders for the 737 from a number of developing countries, which later bought larger Boeing planes because of their satisfaction with the 737. The 737 ultimately became the best selling commercial jet in aviation history and is still selling well. The Boeing situation helps illustrate the importance of understanding the international environment within which one is attempting to conduct business.

withdraw from such terrains. Surprisingly, countries prone to natural disasters are also gifted with natural resources. African countries fall under this category.

It needs no mentioning that a domestic business is relatively free from such hurdles. More dissimilarities between domestic business and international business will be explained in subsequent chapters.

EVOLUTION OF INTERNATIONAL BUSINESS

LO 5
Illustrate the evolution of International Business

Trade is so old that one cannot know when it began, but it certainly originated in human needs. Primitive people living by the sea would barter fish for vegetables, flint axes or the skins of hunted and trapped animals inland. But, organised trade goes back to the period of Sumerians, a near Eastern people, whose capital was Babylon. Thousands of years before Christ, a new profession came into being in Mesopatamia, Southern Arabia, Egypt, Greece, and Asia Minor—that of the merchant, who took upon himself the organisation and carrying on of trade among the people of the ancient world.

Trade across the globe began to be organised ever since the first national borders were formed. In many instances, international business itself has been a major force in shaping borders and changing world history. For example, global business played a vital role in the formation and decline of the Roman Empire. The Romans used as a major stimulus the Pax Romania, or Roman peace. This ensured that merchants were able to travel safely on roads built, maintained, and protected by the Roman regions and their troops. A second stimulus was the use of common coinage, which enabled business transactions to be carried out and easily compared throughout the empire. In addition, Rome developed a systematic law, central market locations through the founding of cities, and an effective communication system; all of these actions contributed to the functioning of the market place and a reduction of business risks.

International business flourished within the empire, and the improved standard of living within the empire became apparent to those outside. Soon city-nations and tribes that were not part of the empire decided to join as allies. They agreed to pay tribute and taxes because the benefits were greater than the drawbacks. Thus, the immense growth of the Roman Empire occurred mainly through the linkages of business.

Similar patterns also can be seen during later cycles of history. The Spaniards and the Portuguese won trade routes from the Mediterranean powers in the 14th and the 16th centuries, subsequently these routes were won over and monopolised by the British, the Dutch, and the French. Major areas of the world that began as "economic" colonies subsequently became political colonies (including North America). Numerous wars were fought in Europe and elsewhere over international trading rights, trade routes, and maintenance of trading monopolies.

By the late 18th century, propelled by the Industrial Revolution, Britain had become the undisputed world economic power. Economic historians have attributed a combination of factors, such as the technical progress and innovations in textiles, coal, iron, and steel, the harnessing of steam, the displacement of agricultural workforce to meet the needs of a fast-expanding industrial base, the Protestant ethic, riches plundered from colonies, and the like, as the reasons why Britain became the world's first industrial country.

More recently, the US developed a world leadership position mainly due to its championship of market based business dealings in the Western world, the broad flow of ideas, products, and services across national borders, and an encouragement of international communications and transportation.

Internationalisation via the development and spread of the MNE through direct foreign investment is a more recent phenomenon. The earliest MNCs were mainly European firms, setting up manufacturing facilities in the colonies to extract primary resources for conversion into finished products back at home. However, by the mid-19th century, many US firms began to globalise—for example, Singer Sewing Machines, which set up a joint venture in France in 1855, Westing House, which set up a plant in Paris in 1879, and Kodak, which set up a plant in London 1889. Infact, the American influence was so much that by the early 20th century, there was considerable alarm in Europe over the invasion of the US MNCs. Nevertheless, the expansion of American firms continued and the Second World War gave a further boost to the magnification. The war resulted in the destruction of European and Japanese infrastructure and the resource transfers for rebuilding these economies through programmes such as the "Marshall Plan" gave the US firms the ability to consolidate their position even more firmly. Japanese firms were relatively late entrants into the world of MNCs. Although they were major exporters prior to the Second War, most did not begin to set up joint ventures abroad until the second half of the 20th century.

Alongside the development of the MNC through the direct investment abroad, the numerous international accords and institutions that came into being after the Second War, acted as further catalysts to the process of globalisation. Such institutions include the Bretton Woods agreement, the IMF, the World Bank, WTO, and the World Court. Although these institutions provided a stable worldwide environment in which MNCs could conduct their businesses, many of these agreements have subsequently broken down (for example Bretton Woods), or are considered ineffective (the World Court), or have strayed from the original agenda that led to their creation (the IMF). Yet, by the 1970s, globalisation, propelled by the MNCs, became irreversible. In terms of its ability to move knowledge, people, capital, goods and services and technology across borders, the process of globalisation, led by the MNCs had gone far beyond the reach of any national sovereign government or international agreement. To borrow a phrase from an expert on international business, Raymond Vernon, the MNC had reached a level of maturity and influence worldwide whereby it could keep "sovereignty at bay."

International trade was not unknown to ancient India. Trade across the seas was popular by the time of the Buddha. By the time of the Buddha, sailors had circumnavigated the subcontinent, and made first contracts with Burma, Malaya, and the Islands of Indonesia. In the early centuries of the Christian era, maritime trade became most vigorous, especially with the West, where the Roman empire demanded the luxuries of the East in great quantities.

India's exports to the West were spices, perfumes, jewels, and fine textiles, but lesser luxuries such as sugar, rice, and ghee were also sold abroad, as well as ivory, both raw and worked. Indian iron was much esteemed for its purity and hardness, and dyestuffs such as lac and indigo were also in demand. Another requirement was live animals and birds—elephants, lions, tigers, buffaloes, monkeys, parrots, and peacocks.

In return for her exports, India wanted mainly gold. Pottery and glassware from the West found their way to India. There was also demand for wine and the Western traders also bought tin, teas, coral, and slave girls. But the balance of trade was very unfavourable to the West and resulted in a serious drain of gold from the Roman Empire.

With the fall of the Roman Empire, the trade with the West declined, but it was maintained by the Arabs, and improved gradually with the rising material standard of Medieval Europe. Before the time of the Guptas, contact was made by sea between South India and China, and as trade with the West declined, that with China increased, the Chinese demand for Indian spices, jewels, perfumes, and other luxury commodities continued till the early 20th century. (See also Exhibit 1.2)

Exhibit 1.2

INDIA'S EARLY TRADE

The Yemenites, Nabataeans, and Himyars also had their share in Indian trade. Commercial relations existed between India, Rome and Greece, and the balance of trade was in favour of India from the very beginning, as a result of which Roman gold poured into India. The price of Indian goods was settled in Roman gold coins. The Romans also used Indian seasme oil in their food and indigo for colouring. Many kinds of Indian precious and semi-precious stones such as diamonds, onyx, sardonyx, agate, carnelian, crystal, amethyst, opal, cat's eye, ruby, turquoise and garnet were in great demand in Rome. India used to export at least three kinds of parrots to Rome, and Rome imported skins, pearls and coloured hides as well as wool for weaving shawls from India. Ivory from India and Africa was extensively used for inlay work. Indian ivory used to reach Rome by the land and sea routes and Indian made ivory figures also reached Rome. (One such figure has been found in Pompeii). The Romans had a great liking for toroise shells from the Indian Ocean and used to purchase pearls from the Gulf of Mannar, as the fashionable women of Rome were very keen to possess pearls. Rome also used to import silk and costly textiles by the silk routes. Shellac and some Indian herbs were used as medicines. But due to the difficulties of communication, the prices of these products were high. Black pepper had an important place in the trade between India and Rome. In addition to black pepper, India also exported ginger, cardamom, and cinnamon which the Romans used to use both as a spice and incense. The Greek traders imported the oils of lemon grass and ginger grass and the nard oil. The saffron costus produced in Kashmir was used in Rome for ointments and medicines and for perfuming the wines.

A voyage from Italy to India took sixteen weeks. The Greek merchants of the Roman Empire used to sail directly to India. The Gulf of Mannar and the Palk Straits were famous for their pearl fisheries. Indian shipping was in a highly developed state by the first century AD; even in ancient times, Indian ships used to sail to Malay, East Africa and the Persian Gulf.

(*Source:* P.N. Agarwala, *A Comprehensive History of Business in India*, TMH, 2001, p. 262)

STRATEGIES FOR GOING INTERNATIONAL

LO 6
Bring out the strategies of going International

Any enterprise planning to go global, needs to be clear about the following strategies:

- Deciding whether to go global
- Deciding which markets to enter
- Deciding when to enter
- Deciding how to enter the chosen market

Deciding Whether to go Global

This question is easily answered. The entire world is moving in one direction —economic integration. No country and no enterprise can and should remain isolated.

However, difficulty may arise when domestic market is vast enough and the business is earning enough profit by serving local needs. This was the scenario in our country during pre-reforms days. Such isolationist and protectionist policies have now been archived. Going international benefits countries and organisations as we described elsewhere.

Experience of TCS is illustrative. From the beginning, TCS forayed into overseas markets because in the earlier days there was no demand for software products in India.

Nevertheless, before going international, the enterprise should weigh several risks and benefits and answer questions about its preparedness to operate globally. Can the organisation serve needs of foreign markets well? Does the organisation have the resources, experience and scales to serve foreign markets? Can the enterprise meet high quality expectations of overseas markets? These are only a few questions which need convincing answers before planning to go global.

Deciding which Markets to Enter

This involves making decisions on: (i) volume of foreign sales, (ii) number of countries to enter, and (iii) the type of countries to make a foray into.

Most businesses start small when they enter foreign soil. Some plan to stay small, viewing foreign sales as a minor proportion of total revenue. Others entertain bigger plans, viewing foreign sales as equal as or bigger than domestic operations.

There is a temptation for a company to spread its wings as wide as possible knocking at the doors of as many countries as possible. But it makes better sense to focus on a few countries with a deeper penetration in each market.

The types of countries to enter depend on the nature of product, political environment, economic conditions, geographic and demographic factors, cultural factors and the like. It is advisable to assess and rank the countries on specific factors. The goal is to determine the potential and advisability of each country. It goes without asserting that a country which assures long-term return on investment should be the choice of investment destination.

A recent publication by the *Economist* ranked the countries of the world according to the friendliness of the business environment. The rankings reflect the opportunities, and the hindrances to, the conduct of business, as measured by the countries ranking in ten categories, including market potential, tax and labour market policies, infrastructure, skills and the political environment. The top 20 countries are shown in Table 1.5.

Obviously, Singapore, Switzerland, Finland, Canada and others down the line in ranking are the most ideal markets to enter.

Table 1.5 Most Business-Friendly Environments

1.	Singapore	13.	United States
2.	Swtizerland	14.	Germany
3.	Finland	15.	Chile
4.	Canada/Hong Kong (tied)	16.	Belgium
6.	Australia/Denmark (tied)	17.	Ireland
8.	New Zealand/Sweden (tied)	18.	Qatar
10.	Netherlands	19.	France
11.	Norway/Taiwan (tied)	20.	Austria

Timing of Entry

Timing of entry involves decision on first mover, early mover, and late mover into foreign markets. First mover obviously refers to the MNC which happens to be the first entrant and early mover is one of the first movers. Being the first mover, into a foreign market, an MNC garners several advantages. These include capturing learning effects important for expanding market share, achieving scale economies that accrue from opportunities for capturing that increased share, and development of alliances with the most attractive (many times the only) local partner. First mover also benefits in as much as there are practically no competitors (they need time to catch up); and customer loyalty is also built up.

First investor is in a stronger position in emerging markets. In those economies that are undergoing rapid changes such as privatisation and market liberalisation, there may be a narrow window of time within which these opportunities can be best exploited. In these conditions, first entry strategies allow entrants to preempt competitions, establish beachhead positions, and influence the evolving competitive environment in a manner conducive to their long-term interests in market position.

Pioneer investors have more strategic options in choosing industries, locations, and market orientations (e.g. import-substitution, local market-oriented, export-market-oriented and infra structure-oriented). In addition, early movers are often given priority access to natural resources, scarce materials, distribution channels, promotional arrangements, and infrastructure. As early movers into Poland, Matsushita and Philipps were better able to access scarce or government controlled resources.

There are problems nevertheless. Pioneer investors may be confronted with greater environmental uncertainties and operational risks. Environmental uncertainties stem from (1) non-existent or poorly defined laws relating to FDI, (2) host government's lack of experience dealings with MNCs, and (3) infant or embryonic stages of the industry or market in a host country. Operational risks originate from (i) a shortage of qualified supply sources and other production inputs such as talented managers and R&D scientists; (ii) under-developed support services such as local financing, foreign exchange, arbitration, consulting, and marketing; (iii) poor infrastructure; and (iv) an unstable market structure in which market demand and supply are misaligned and host governments often interfere with MNC operations.

First investors also tend to pay higher costs in learning and adapting to local environment. Many early investors are compelled to build from "scratch" – huge investment on industrial infrastructure. Finally, early movers may have to fight followers who imitate their strategies or innovations, counterfeit their products, or infringe on their intellectual properties. This risk is all the more severe when the host government has not enacted adequate laws to protect intellectual properties.

Thus, first or early investment in a host country carries with itself both benefits as well as disadvantages. Late investor has reverse of the scenario. In other words, what are advantages of the first or the early mover become disadvantages of late mover and vice versa.

Obviously, entry decision should be based on a cost-benefit analysis. After assessing the advantages and disadvantages of the timing choice (first, early or late), international managers consider other factors in formulating timing strategy. These include: (i) MNCs strengths as manifested in technological, organisational, and financial resources; (ii) the host-country environment; and (iii) potential competition from late movers as well as local entrants.

Deciding How to Enter?

How to enter refers to the choice to be made about an entry mode option. The options available include: trade-related, transfer-related and FDI-related modes (see Fig 1.2). These entry modes represent specific routes to enter a target country.

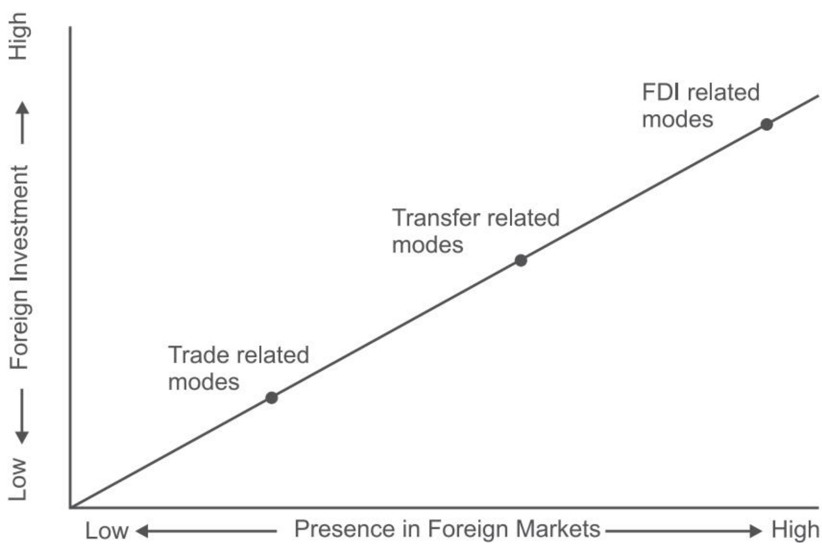

Fig. 1.2 Routes of Going Global

Trade-related Entry Modes This category includes exporting, management contract, sub-contracting, and countertrade.

Exporting Exporting is the most desirable entry mode for a new entrant in the international business. Exporting mode offers a ground for an enterprise to test its luck.

If selling in an overseas market proves successful, gradually other modes of entry can be tried. Besides, exporting offers valuable expertise to the organisation and helps gain knowledge about host countries. Minimum risk and easy access and exit are other advantages associated with exporting. Exporting suits the requirements of small and medium enterprises which seek to foray into international markets. Jordan Toothbrush, a one-plant enterprise in Norway, exports around the world.

A firm can export goods directly to foreign customers or through export intermediaries. Export intermediaries are the third parties that facilitate exporting and importing.

International Sub-contracting This mode of entry is possible when a firm in a host country has surplus manufacturing capacity. MNCs use the surplus capacity to manufacture their products. They supply materials, semi-finished products and sophisticated components to the host company for producing final goods that will be bought back by the foreign company. The local manufacturer is responsible only for processing or assembly in exchange for processing fee. The host manufacturer does not enjoy any right on the raw-materials or components supplied by the MNC. P&G was using the surplus facility available with Karnataka Soaps and Detergents Ltd., Bangalore, to manufacture its (P&Gs) range of soaps and detergents. Nike uses sub-contracting as its entry mode in China, Vietnam, Thailand, Indonesia, and Bangladesh. International organisations that use contract manufacturing are spread in such industries as automotive and electronics, sports and leisure equipment, retail apparel and other sectors. Indeed, sub-contracting organisations have emerged as production arms of many well-known MNCs.

Manufacturing contract has several advantages such as cost expertise, nil investment and the like. Possibility of contractee becoming a competitor and low quality standards are the disadvantages of sub-contracting.

Countertrade This is a form of trade in which a seller and a buyer from different countries exchange goods for goods with little or no cash changing hands. Countertrade is also viewed as flexible financing of international trade (Chapter 20 contains more details on countertrade).

Management Contract Management contracts are agreements where MNCs, for a fee, train local employees and manage foreign based facilities for a prescribed time period. Such contracts often include the setting up of foreign subsidiaries, and include technical help to operationalise the plant. An example of management contract was Bell Canada's contract with the Government of Saudi Arabia to manage the installation of modern transmission and switching equipment in Saudi's telephone system. Similarly, under a management contract for a 10-year period (1969–79), Citibank had lent its managerial expertise to Grindlays Bank. Disney receives management fees for managing theme parks in France and Japan.

Nearer at home, the late Aditya Birla was controlling his companies abroad through management contracts. Engineers India Ltd. is managing aluminium related projects for Balco, Nalco, and Hindalco on similar basis.

Transfer-Related Entry Modes These entry modes result in transfer of ownership from one party to another for royalty payment. Unlike trade-related entry modes, transfer routes involve purchase of ownership of property by one party from another. Transfer-related modes are popular in technology-related or intellectual property-oriented deals. In themselves, transfer-related modes include: leasing, licensing, franchising and build-operate-transfer routes.

International Leasing Leasing transaction occurs when the owner of a property (lessor) leases it out to other party (lessee). In international leasing, an MNC (lessor) leases out its new or used equipment to the local company (lessee). Lessees are generally from developing countries who cannot afford to own such properties. The lessor company retains ownership and the lessee firm obtains possession of the property. During the possession period, the lessee company continues to use the property but needs to pay leasing fee every year. In many cases, the leased property is kept idle with the lessor. A company from a developing country finds use for the idled equipment and thus leasing transactions takes place.

The lessor MNCs gain immensely from a lease agreement. Easy access to a target market, earnings from an idled machinery and experience in a foreign market are the typical benefits available for the lessor. The lessee company also gains in as much as, it obtains an asset without much investment, minimised operational and investment risks and familiarity with a foreign high-tech equipment. In the late 1970s, Japan's Mitsubishi leased 100 new and used heavy trucks to Chinese companies engaged in mining, construction and transportation.

International Licensing Under a licence agreement, one firm permits another to use its intellectual property for a compensation called royalty. The firm that makes the offer is the licensor and the receipient firm becomes the licensee. The property licensed generally includes such assets as patents, trademarks, copy-rights, technology, business skills and the like. Licensing typically amounts exporting intangibles.

Licensing has intutive appeal to many prospective global players. As an entry mode, licensing requires no capital investment nor detailed involvement with foreign customers. By generating royalty income, licensing provides an opportunity to exploit research and development already conducted. Post initial costs, the licensor continues to earn royalty during the rest of the license period. Licensing also mitigates the risk of exproportion because the licensee is a local company that can provide leverage against government action. In recent years, a number of host countries have demanded that MNCs license their assets instead of waiting for FDI to take place.

There are disadvantages associated with licensing. Main drawback is that the returns from a licence tend to be lower than profits from franchising or FDI. The other weeknesses include:

- Possible loss of quality control
- Inviting a potential competitor in third-country markets
- Possible improvement of the technology by the licensee, which may enter licensor's home market.
- Risk of pirating technology
- High agency costs

International Franchising Another entry mode is franchising. This involves granting of right by a company (franchisor) to another (franchisee) to do business in a specified manner. This right can take the form of selling the franchisor's products, using its name, production and marketing techniques or using business models. Compared to licensing, franchising fosters longer commitments, offers greater control over overseas operations, and includes a broader package of rights and resources. Production equipment, managerial systems, operating procedures, access to advertising and promotional materials, loans, and financing may all be part of a franchise. The franchisee operates the business under the franchisor's proprietary rights and is contractually obliged to adhere to the procedures and methods of operation prescribed in the agreement. The franchisor generally maintains tight control over the quality of products and services so that the franchisee cannot dent the company's image. In exchange for the franchisee, the franchisor receives royalty calculated at a given percentage on sales made by the franchisee. Sometimes, the franchise agreement contains certain conditionalities such as mandating the franchisee buy equipment or key inputs only from the franchisor.

Manufacturing organisations tend to prefer licensing as an entry mode. But firms engaged in food-bakery, restaurants and fast food hotels and motels, real estate, education, clothing, shoes, travel, laundry, greeting cards, furniture, hair care products, recruiting firms, advertising services and accounting and law practices choose franchising route.

In fast food, McDonald's and KFC have used franchise mode to expand their markets from Paris to Tokyo and from Cairo to Caracas. In the hotel industry, Le-Merdian, among others, has been very successful in gaining worldwide presence through franchises. In computers, Aptech has penetrated into

40 countries mainly through franchising. Other successful users of franchising mode include Midas, Cullingam, Singer Machine, and Coca-Cola.

Like licensing, franchising has both the bright side as the well as dark side. Merits that make up the bright side include low political risk, low cost, and fast and easy avenues for leveraging assets such as patents or trade marks. Franchising can be an ideal entry mode for small businesses as outlets require little investment in capital or people. The dark side of franchising is made up by such drawbacks as likely damage done to the company's image, and stealth operations by the franchisee, particularly after the franchisee period expires.

Build-Operate-Transfer (BOT) Also called turnkey operations, in BOT, a foreign investor assumes responsiblity for the design and the construction of an entire operation and, upon completion of the project, turns the project over to the purchaser and hands over management to local personnel whom it has trained. In return for completion of the project, the investor receives periodic payments that are normally guaranteed. BOT is highly useful in huge projects such as airports, power generation, dams, national highways, chemical plants and steel mills. Large construction firms undertake BOT projects as their execution needs vast expertise. The famous names that come to one's memory in this context include Tata Consulting Engineers, L&T, GMR (all Indian), Bechtel (US), Hyundai (Korea), and Friedrich Krupp (Germany).

Large forms often syndicate themselves to bid for BOT projects. Because of huge investments involved, BOT mode is generally used in combination with other entry modes.

FDI-related Entry Modes There are atleast four modes of entry which come under the above headline. One thing common to all the five modes is that there is investment by an MNC in the host country. This feature contrasts with earlier modes of entry which generally involved only trade agreements without equity investment. The four FDI-related entry modes are:

- Branch office
- Co-operative joint-venture
- Equity joint venture
- Portfolio investment
- Wholly owned subsidiary

Branch Office An MNC opens a branch office in a host country. The branch may be required to engage in production and operating activities, but fully monitored by the parent company. Branch offices are particularly opened by international banks, law firms, accounting and consulting firms. British's Standard Bank, for example, has more than 1000 branches in South Africa. It also has branches in 14 other sub-Saharan countries.

Co-operative joint-venture Strategic alliance is another name for co-operative joint-venture. This is a co-operative agreement between firms that go beyond normal company to company dealings. Alliances can involve joint research efforts, technology sharing, joint use of production facilities, marketing one another's products, or joining forces to manufacture components or assemble finished products. Co-operative ventures may be equity or non-equity based. In an non-equity alliance, co-operating firms agree to work together to carry on activities, but do not take equity positions in each other or form an independent organisation to manage their co-operative efforts. These non-equity alliances are managed through contracts which may be either trade-related or transfer-related entry modes. In an equity alliance, co-operating firms supplement contracts with equity holdings. (Chapter 13 carries more details on strategic alliances.)

Portfolio Investments This involves investments in the equity of another company or lending money to it in the form of bonds or bills. They are important for many companies with extensive international operations, and except for equity, they are used mainly for short-term financial gain—as a relatively safe means of earning more money on a company's investment. To earn higher yields on short term investments, companies routinely move funds from country to country.

Equity Joint-Venture Equity joint venture is a shared ownership in a foreign business. Generally, the venture is 50-50 ownership firm in which there are two (or more) parties, each holding a 50 percent ownership stake. The venture is together managed by the alliance partners. Host countries generally prescribe investment limits on alliance partners. The Government of India had put ceilings on foreign investments in India, but now has relaxed in many industries.

Fuji Xerox is one of the most enduring and successful joint ventures. Indian companies have set up joint ventures in several other developing countries such as Malaysia, Indonesia, Singapore, Srilanka, Nigeria, Kenya, UAE and Thailand. Joint ventures have been set up both by private entrepreneurs as well as by public sector enterprises.

One discordant observation about the joint-ventures is that they are short- lived. The average life of a 50-50 venture is about 7 to 10 years, though exceptions are not found wanting. The other weaknesses of this entry mode are likely political risk if a wrong partner is selected, and apprehensions about local partner's interference in managerial decisions and actions.

Lack of trust between the two partners makes the life short lived. It is observed that the partners do not share trade secrets with each other. Exception to this perception is the collaboration between Tatas and Starbucks. Starbucks shared with Tatas some of the roasting secrets, which the MNC had perfected for over four decades and guarded very closely.

On the plus side, Joint-ventures facilitate easy access into host markets; local partners are familiar with wishes and dislikes of host country citizens; and host partner's distribution networks, brand image and managerial skills are made available to the joint-venture.

Wholly-owned subsidiary As the title itself suggests, this entry mode involves 100 percent ownership by an MNC in a venture located in a host country. Such a firm can come into being in either of two ways: setting up a totally new project or acquisition of an existing company. The MNC can establish a totally new facility in which case it is called greenfield project and the finance is called greenfield investment. The 'green' is appended for the reason that such a venture is a set up in a green agricultural field. In the alternative, the MNC can acquire an existing company located in the host country outright.

Developing countries prefer greenfield investments because they generate employment opportunities, add to the existing manufacturing capacities and bring new technology. Compared to greenfield investment, a cross-border acquisition benefits the MNC in atleast two ways. First, acquisition is quicker than establishing a firm. Second, acquisition may be a cost-effective way of gaining competitive advantage such as technology, brand name, and logistical and distribution advantages, while simultaneously eliminating any local competitor. There are problems associated with acquisition. There may be the possiblity of paying too high a price. Meshing different cultures can be a traumatic experience. Managing the post acquisition process is generally characterised by downsizing to minimise costs. This leaves bitterness in the host country citizens. Host governments may interfere in matters relating to pricing, financing, employee hiring and other activities.

Greenfield or acquisition, wholly-owned subsidiary route represents fully blown cross-border transactions. Infact, such entry modes manifest the true spirit of international business.

Choosing a Mode of Entry?

Till now we have described the different entry modes. With the knowledge thus gained about different routes, an international manager should make a choice. Choice should be based on country-specific factors, industry-specific factors, firm-specific factors and project-specific factors.

Country-Specific Factors Host country factors determine selection of an entry mode significantly. Ceilings or restrictions on FDI imposed by the host country government tend to limit the choice to transfer-related or trade-related modes. Second, infrastructural facilities affect the extent to which an MNC can commit its resources in a host country. Third, political risks obtaining in a host country may compel an MNC to be content with only non-investment modes. Finally, cultural distance between home and host countries influences entry mode decision. The longer the cultural distance, the more likely that an MNC prefers non-FDI modes.

Industry-Specific Factors Two industry-specific variables are factored in while deciding on entry modes. First, entry barriers into a target industry in the host country constitute a significant impediment to entry mode selection. Contractual or equity joint ventures may be effective vehicle to by-pass these barriers. Second, industrial uncertainty and complexity impact entry mode selection. Uncertain industry prospects compel an MNC to commit minimum resources and to choose easy modes of entry.

Firm-Specific Factors Entry mode selection is influenced by certain firm- specific factors as well. First, resource position of the firm is one such factor. An MNC that is rich in resources financial, technological and organisational—is in a stronger position to explore fully owned investment based entry modes. A not-so-rich firm may remain content with joint-venture or even trade-related or transfer-related routes. Second, chances of pirating technology may force the multinational business to opt for fully-owned subsidiary mode. Finally, international or host country experience tends to influence decision relating to entry mode. MNCs with little or no experience about international or host country environment tend to be content with low risk and low resources commitment modes of entry.

Project-Specific Factors Where project is large, MNCs may shy away from fully-owned subsidiary route. In addition, availability of a local partner may affect an MNCs decision to select a mode of entry. An MNC's ability to enter a joint-venture deal, or pursue a non-integrated entry mode depends upon the availability of a trusted and capable local partner.

GLOBALISATION

LO 7
Analyse every aspect of globalisation

Any discussion on international business should refer to globalisation. For, globalisation tandems international business like rear wheels of an automobile following their counterparts at the front.

In simple terms, globalisation refers to the economic integration of the world. More precisely, the key characteristics of globalisation include: liberalisation of world trade; expansion of FDI; massive cross-border financial, technical and human flows; and coordination of cross-border manufacturing and marketing activities.

Globalisation has been accompanied by the creation of new institutions to work across borders and has led to renewed attention to long-established international inter-governmental institutions: the UNO, the ILO and the WHO. WHO seeks to improve health in the developing world; ILO promotes its agenda around the world under its slogan "decent work", and UNO attempts to maintain peace in the world.

While globalisation has been criticised severely, it has also been praised with equal force. The views and perceptions of people on globalisation depend on who they are, where they live and what they possess. Globalisation can be judged by what it has delivered. And it has delivered benefits to some, but at the same time, its deliverables have been frightening, and destructive for many others. A person hit by globalisation made a cryptic remark: "We were sleeping on the shore when a big wave came".

Let us speak about the benefits of globalisation first. Globalisation has promoted open societies and open economics and encouraged a freer exchange of goods, ideas and knowledge. In many parts of the world, innovation, creativity and entrepreneurship have flourished. In East Asia, growth lifted over 200 million people out of poverty in a single decade. Better communications have enhanced awareness of rights and identities, and enabled social movements to mobilise opinion and strengthen democratic accountability. As a result, a truly global conscience is beginning to emerge, sensitive to the inequities of poverty, gender discrimination, child labour, and environmental degradation, wherever these may occur.

China would not emerge as the fastest growing economy; India would not have already "arisen"; and many underdeveloped economies would never be called emerging economies, but for globalisation.

India is an example to be cited as a beneficiary of globalisation. Bangalore which has become the world's hub of software technology, is a home for world's famous R&D establishments, and is the centre for business process outsourcing. Youth from villages and small towns have shifted to cities and from there migrated to foreign countries. Every house has one or two cell phones, but may not have lavatory. GDP growth rate has been hovering around 8 percent for the past one decade, and poverty rate has fallen significantly.

Globalisation has reduced the sense of isolation felt in much of the developing world and has given many people in the poor countries access to knowledge well beyond the reach of even the wealthiest in any country a century ago. The anti-globalisation protests themselves are a result of their connectedness. Links between activists in different parts of the world, particularly those links forged through Internet communication, brought about the pressure that resulted in the International Landmines Treaty, despite the opposition from many powerful governments. Signed by 121 countries in 1997, it reduces the likelihood that children and other innocent victims will be maimed by mines. Similarly, well-orchestrated public pressure forced the international community to forgive the debts of some of the poorest countries.

Globalisation has spread the spirit of democracy to countries ruled by dictators. The Arab Spring – movement for democracy – resulted in the dethroning of dictators in Egypt, Libya, Yemen and other neighbouring countries. The youth in these countries have seen the success of democracies (like the one in India) and have valiantly fought and overthrown decades-long dictatorships. Globalisation has converted the entire world into a small village, highly interdependent and interconnected. Such an integration has sprung the fight for democracy.

Probably, the most striking and positive outcome of globalisation is the shift in the world economic clout. The power of the world economy is gradually shifting from developed countries to emerging markets. Sources of wealth creation which were once confined to only developed countries are now available to all the countries, of course at a price. Technology can be sourced, skills can be acquired, natural resources can be imported and funds transferable from one corner of the globe to another. Developing countries are exploiting their sources and are catching up with the rich countries.

In a widely read report, Goldman Sachs argues that the economic potential of the BRICS countries is such that they may become amongst the four most economies by the year 2050, with China surpassing the US in output by 2035. Growth of the BRICS countries in the total global output will be more than 40% by 2025. In addition, their total weight in the world economy would rise from about 10% in 2004 to more than 20% in 2025.

Globalisation has also minimised human rights violations. Universal Declaration of Human Rights calls for an international commitment to ensure the basic material and other requirements of human dignity for all. The eradication of poverty and the attainment of the Millennium Development Goals (MDGs) could be seen as steps in the right direction to protect human rights.

One needs to sit still and reflect. Globalisation as we are witnessing today is only at its beginning. If one goes by certain activities that move within and between countries, infancy of globalisation becomes crystal clear. One activity is the ubiquitous telephone calling minutes. Only less than two percent of telephone calling minutes involve international calls. In other words, practically all our calls are still restricted to people inside a country. Only about one percent of letters physically mailed in the world cross national boundaries.

Similar patterns seem to apply to technological information. Of patents filed in rich OECD countries—which still account for about 95 percent of patents world wide—foreign owned patents represent only 15 percent of the total, and the percentage of patents actually involving international cooperation in research is only half of that.

No better data are probably available than the movement of people across the globe. Only three percent of world population are first-generation immigrants. Students studying overseas account for just two percent of all university students. Adding up all kinds of cross-border movements of people, it is estimated that about 90 percent of the world's people never leave the country in which they were born.

Coming to foreign trade, it is said that global exports account for only 20 percent of all the value produced in the world (GDP). Taking FDI, globalisation infancy reveals itself more strikingly. FDI flowing across borders accounted only for nine percent of all fixed investment in 2009. Stated differently, about 90 percent of all fixed investment in the world is still domestic.

Only 15 to 20 percent of venture capital money is deployed outside the investing fund in home country. Only about 20 percent of the stock market (equity) is owned by foreign investors. And cross-border ownership of bank deposits and government debt remains closer to 25 percent and 35 percent, respectively.

Thus, what we are witnessing is only semi-globalisation. When it passes its infancy and ages itself into maturity, consequences will be mind-boggling.

Dark side of Globalisation

Globalisation is not uncontrolled. The movement of people remains tightly restricted. The flow of capital is highly asymmetrical. Over the last two decades, overseas development assistance from the rich to poor countries has totalled \$50–80 billion per year. In the same period every year, \$500–800 billion of illegal funds have been sent from the poor to rich countries. That is, for every one dollar of aid money over the table, the West gets back \$10 under the table.

The benefits and costs of linking and delinking are unequally distributed. Industrialised countries are mutually interdependent; developing countries are largely independent in economic relations with one another; and developing countries are highly dependent on industrialised countries. Brazil, China and India are starting to change this equation.

There is a growing divergence in income levels between countries and peoples, with widening inequality among and within nations. Assets and incomes are more concentrated. Wage shares have fallen. Profit shares have risen. Capital mobility alongside labour immobility has reduced the bargaining power of organised labour.

The deepening of poverty and inequality—prosperity for a few countries and people, marginalisation and exclusion for the many—has implications for social and political stability among and within states. The rapid growth of global markets has not seen the parallel development of social and economic institutions to ensure balanced, inclusive and sustainable growth. Labour rights have been less sedulously protected than capital and property rights, and global rules on trade and finance are inequitable. This has asymmetric effects on rich and poor countries.

Globalisation has also let loose the forces of "uncivil society" and accelerated the trans-national flows of terrorism, human and drug trafficking, organised crime, piracy, and pandemic diseases.

Figure 1.3 brings out the negatives aspects of globalisation more clearly. Each of these is explained in subsequent paragraphs.

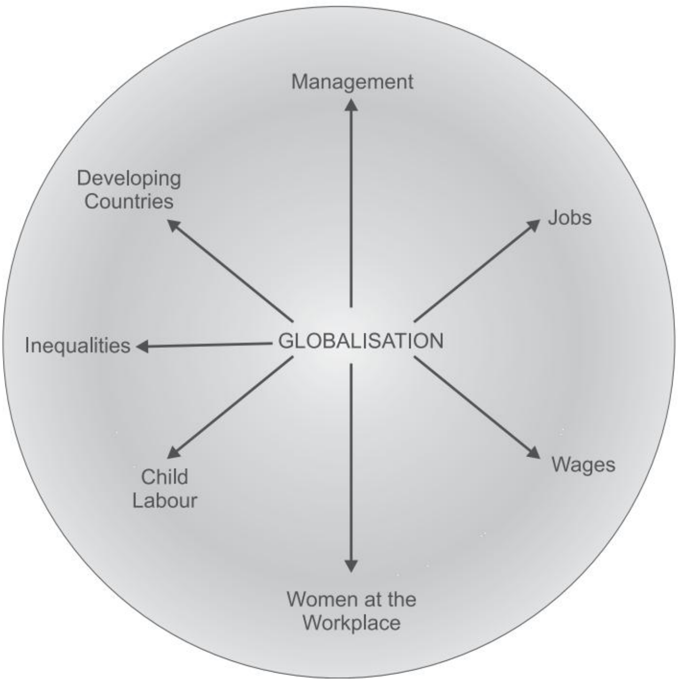

Fig. 1.3 Dark Side of Globalisation

Globalisation and Management

One of the most significant yet subtle shifts has occurred in the area of management practices. While management is well researched and documented in the western and EU countries, it is not the same with rest of the countries. The skill or the cost advantages that drive globalisation efforts also impact the way people are managed in organisations. The older 'personnel management' and Theory X approach have given way to the 'Human Resources Management' (Theory Y) approach. The autocratic style that was fed by the 'hierarchical position conscious systems' is being swiftly replaced by flat organisation structures, driven by competency and a highly decentralised decision making and problem solving styles. An individual in the position of power, driving policies and processes, has evolved into team-based collaborative management methods. Another landmark change in management methods initiated by globalisation happened in the area of organisational leadership. A new generation of leadership skills, styles and methods has evolved. The straight-jacketed approach to certain defined ‘good and bad’ leadership styles has been replaced with multiple theories supporting a variety of leadership styles. Leadership today is associated with a particular phase in the life-cycle of an organisation, it is industry specific and increasingly, leaders are hired to achieve a very specific objective for an MNC.

Hence, new work methods and newer ways to managing people and processes are evolving. Exhibit 1.3 speaks about how management methods are being innovated at the Indian workplace to ensure collaboration and commitment.

Significant and meaningful ‘research’ in the management domain is yet to pick up the desired momentum in most developing countries. Academic and industry interactions are mostly limited and restricted to the post-graduation and the management educational institutions.

Exhibit 1.3

FUTURE OF MANAGEMENT IS INDIA

Indian management and the people processes that have been put in place by top companies, particularly in the information technology industry, are the best in the world and are setting new benchmarks for rest of the corporate world to emulate.

Fortune’s Senior Editor David Kirkpatrick writes: “I have seen the future of management, and it is Indian.”

“Good at motivating employees...”, “Committed to building a great team...”. “Employees come first and customers second...”, are some of the observations made by Kirkpatrick in his column.

“In an extraordinary process of upward evaluation at Indian outsourcing major HCL Technologies, every employee rates his or her boss, boss’ boss, and any three other company managers they choose, on 18 questions using a 1-5 scale. Such 360-degree evaluations are not uncommon, but all results are posted online for every employee to see. That’s unheard of!”

Kirkpatrick, who met HCL president Vineet Nayar in the US some time back, had this to write in his column: “Every HCL employee can, at any time, create an electronic ‘ticket’ to flag anything he thinks requires action in the company... It can be ‘I have a problem with my bonus,’ or ‘My set is not working,’ or ‘My boss sucks.’

The ticket is routed to a manager for resolution. Amazingly, such tickets can only be ‘closed’ by the employees themselves. Managers are evaluated, partly based on how many tickets their departments are creating, the more the better. Nonetheless, I’m sure it continues to be recommended not to be the employee who regularly posts a ‘my boss sucks’ ticket.”

“You can’t become a manager until you’ve passed a group of courses that include negotiation skills, presentation skills, account management, and what they call ‘expectation management’, dealing with the expectations of both customers and employees,’ Kirkpatrick writes. “There is a method to what some might consider madness. [At HCL,] Nayar has concluded that what he calls the ‘effort-based’ model of Indian IT up to now will not win long term. That’s because IBM and other global IT companies now have their own local employees and can match many long-time Indian cost advantages.”

“The winners will be those that deliver the best results to customers. Employees who are secure and happy can better focus on customer success,” Kirkpatrick concludes.

(*Source: Fortune*, April 18, 2006)

Globalisation and Jobs

Has globalisation resulted in loss of jobs or has it created additional jobs? The answer is both yes and no. Going by India's experience, employment in the manufacturing (organised) sector had declined during the 1980s and 1990s as Table 1.6 shows. The decline in employment in the organised sector may be for reasons which predate economic liberalisation, but liberalisation (and globalisation) has created an enabling environment for cutting down regular, salaried jobs through VRS, contractual employment, subcontracting and outsourcing.

Table 1.6 Employment in Manufacturing

	Organised Sector (in millions)
1978-79	14,903
1983-84	10,198
1989-90	7,252
1991-92	4,234
1996-97	2,881

(*Source: Economic and Political Weekly*, January 3, 2004, p.106)

Contrary view is held by supporters of globalisation. According to them, "globalisation adds to the employment, particularly in developing countries, as shown in Table 1.7. Thanks to free trade, more than five lakh jobs moved out of the US by 2005, and the figure will go up to 33 lakh by 2015. It is not that the US economy suffers as a result of this loss of jobs. Supporters of globalisation argue that free trade will result in countries specialising in the production of those goods and services that they can produce most efficiently, while importing goods that they cannot produce as efficiently. If, for example, US is outsourcing 14,000 legal jobs, the country is saving enormously the cost of performing those jobs within the country. The savings, thus gained, can be diverted for other more productive jobs. Additionally, incomes in developing countries would multiply, thanks to the jobs they gain, adding to the demand for more goods and services produced in the US. The US economy is not the loser. On the other hand, it is better-off now thanks to globalisation." The developing countries are also the gainers, as Table 1.7 clearly shows.

Table 1.7 Number of US Jobs Moving Offshore*

	2005	*2010*	*2015*
Lifesciences	3,700	14,000	37,000
Legal	14,000	35,000	75,000
Art Design	6,000	14,000	30,000
Management	37,000	118,000	288,000
Business Operations	61,000	162,000	348,000
Computer	109,000	277,000	473,000
Architecture	32,000	83,000	184,000
Sales	29,000	97,000	227,000
Office Support	295,000	791,000	1,700,000
TOTAL	588,000		3,300,000

*To low wage countries such as India, China, Mexico and the Philippines.

(*Source: The Economic Times*, February 2, 2003)

Globalisation and Wages

Globalisation has no doubt resulted in shifting jobs to the developing countries. But the shift is accompanied by disparities in wages. The work that would cost $100 an hour in the US, amounts to one-fifth of that in India. In other words, an employee in the US gets paid $100 per hour, whereas his or her counterpart in India is paid only $20 per hour for the same work. While admitting this as a fact, what needs to be underlined is what would Indian workers do if jobs were not shifted from the US, and would they not go without those $20 an hour?

There is another argument in support of low wages in poor countries. Low labour costs constitute a competitive advantage for a poor country, and attracting investment on this basis provides jobs that can lead to greater development. Former low-wage countries such as Korea, Taiwan, and Malaysia were successful in using this strategy to create high paying jobs. To demand high wages is to deny competitive advantage for a poor country. To deny competitive advantage is to deny foreign investment, obviously subjecting the country to eternal poverty.

Globalisation and Child Labour

Child labour is common in all the countries, rich or poor. The ILO recently estimated that some 120 million children in developing countries, between the ages of five and fourteen, are working full time, with another 130 million working half-time. 61% of the 250 million working children live in Asia, while 32% live in Africa and 7% live in Latin America. Even a rich country like the US has child labour grossly abused. Though subjecting a child (below 14 years of age) is illegal both in Sri Lanka and Mexico, 500,000 children work in Sri Lanka and millions work in Mexico. It goes to the credit of the Government of India that it has now banned child labour (see Exhibit 1.4).

Exhibit 1.4

A BAN THAT WAS OVERDUE

The Government of India has announced a ban on the employment of children as domestic workers, and as workers in restaurants, dhabas, hotels, spas and resorts effective from October 10, 2006. This is a welcome move that will benefit many of India's child workers, of whom there are a staggering 13 million or more, forming the largest number of child labourers in the world. Many of these children experience physical, psychological, and sexual abuse on a regular basis. For instance, the exploitation of children is high in roadside eateries, tea shops and dhabas where child labour is rampant. The horrific murder of 10-year-old Sonu, a child domestic worker, who was brutally beaten to death by her employers in Mumbai recently for trying on some lipstick, is an appalling example of the kind of cruelty that these children often endure. It is reasonable to assume that there are such myriad incidents going unreported; cases of young children whose childhoods are stolen from them, who are abused and who die at the hands of their employers. The present law, The Child Labour (Prohibition and Regulation) Act 1986, bans employment of children only in hazardous industrial processes such as mining, chemical production, carpet weaving, bidi making, wool cleaning and in workplaces where toxic substances are used. Rules under this law were framed in 1989 and, through further notifications and schedules, rules for 'working conditions' were formulated for children working in environments not prohibited by the 1986 Act, while increasing the number of hazardous industries covered by it.

The Government also launched the National Child Labour Projects in 1988 to rehabilitate working children by getting them into special schools for non-formal education, and by other measures such as enforcing labour laws to make it illegal for them to be hired. The Supreme Court has also issued various directions in this regard, but the existing laws are ineffective and are not implemented in many parts of the country. Children continue to work under extremely adverse and dangerous conditions, with their plight accorded low importance by various State Governments. The latest ban will be ineffective unless the law is enforced and the violators are prosecuted. Surprise inspections of establishments where children are likely to be employed and mechanisms to prevent recurrence need to be established. Non-enforcement by States should entail deterrent action. Such strategies will work well to control the demand for child labour. But also needed is a choking off of the supply. An effective way to do this would be to ensure that the constitutional obligation of providing free and compulsory education for all children under 14 is met, so that children cannot be elsewhere than school. The main, and invaluable, consequence of securing children's basic rights will of course be the powerful enrichment of the nation's human capital, necessary for the country's road to prosperity.

(*Source: The Hindu*, 7 August, 2006)

Illegality of employing children is only one crime against them. There are others too. Children cannot attend school and receive formal education. They lack resistance to diseases in unsanitary environments. Children in Indian carpet making units, for example, have a high incidence of tuberculosis, worm infection, and enlarged lymph glands.

It is good to know that there are four main approaches to child labour policy. The first stresses the need for eliminating poverty as that is the main cause for child labour. Obviously, this approach does not address child labour directly. The second approach emphasises on the strategies to get more children to school, particularly incentives to induce parents to send their children to school, such as free text books, uniform and the mid-day meal scheme as implemented in Karnataka. The third approach considers child labour inevitable, atleast in the short run, and stresses palliative measures, such as regulating it to prevent abuse and providing support services for working children. This approach is most commonly associated with UNICEF which has prepared a check list of regulatory and social approaches that could meet the 'best interests of the child.' Workplace schooling, stricter law enforcement against illegal child labour trafficking, and providing support services for parents and for children working on the streets are some of the regulations contained in the UNICEF's agenda. The fourth approach, advocated by the ILO, favours banning child labour altogether. If this is not possible, atleast child labour in its most abusive form should be banned. The most abusive practices include slavery, sale and trafficking of children, debt bondage and serfdom. This modified approach has received much attention and in 1999, the ILO's 'Worst Forms of Child Labour Convention' was adopted.

Child labour is practised for several reasons. In the first place, poverty creates child labour. Obviously, high incidence of child labour occurs in poor countries. Secondly, children are best fitted in such areas of employment as inflating tubes, cleaning glasses and cups in hotels and bars, carpet weaving, rolling beedies and incense sticks, and the like. Third, it adds to the income of parents, and the money brought by the boy enables his father to have his daily quota of drink. Fourth, the employer sees the child as an instrument which can be groomed and moulded in the way that suits his business. Finally, demands from children are minimal or non-existent, unlike the grown-ups who keep on mounting pressures on management for higher remuneration and improved amenities.

How does globalisation affect child labour? First, globalisation results in creation of job opportunities and enhances for earnings in developing countries because of inflows of foreign investment, or increases the value of a developing country's export products. This development is likely to accelerate the reduction of child labour and enhance school enrolment and literacy. Therefore, poverty breeds child labour while prosperity should bring down its incidence.

Second, integration of world economies will enable rich countries to influence poor countries in their policies towards child labour. As developing countries join globalisation and increasingly rely on export markets to sell their products, rich countries can use the threat of trade sanctions to coerce policies that attempt to curtail child labour. This has positive impact on child labour.

The third development has a deleterious effect on child labour. The world bodies, particularly the IMF and the World Bank, mandate structural adjustments in economies before sanctioning aid to the developing countries. One of the planks of structural adjustments is privatisation. Privatisation results in large-scale laying-off of workers. Suddenly, male workers find their incomes dwindling as the alternative jobs they manage to secure may not guarantee the same salaries which they were earning as employees in government jobs. This tends to force parents to withdraw their children from school and put them on odd jobs.

Globalisation and Women

The most striking thing about women all over the world is the high degree of discrimination meted against them. Some statistics are worth recollecting in support of this assertion. Out of the 1.3 billion poor people in the world, 70 per cent are women, the majority of whom are illiterate with no access to basic amenities like safe drinking water. Two-thirds of the 130 million children worldwide who are not in school are girls. Between 75 and 80 per cent of the world's 27 million refugees are women and children. The majority of women earn, on average, about three-fourths of the pay of males for the same work. Worldwide, 20 to 50 per cent of women experience some degree of domestic violence during marriage. India is ranked second in the number of missing girl children, first place being given to China. Were it not for India and China, world population would have been plus 1.2 million with girl children. The primary victims in today's armed conflicts are civilian women and children who are sexually abused by soldiers. On opening the pages of newspapers, you read stories about bride burning, dowry harassment and rape of teenaged girls.

What is the impact of globalisation on women? There are positive developments as well as negative impacts. Let us first discuss the positive dimensions of globalisation.

First, globalisation has enhanced employment opportunities for women. Companies everywhere are increasingly feminising their labour force in the name of promoting gender diversity, women empowerment and as a strategy to remain competitive. There is a shift in organisations towards using non-regular, flexible employment, such as, part-time, temporary, sub-contracted and home-based workers. Women are preferred to men in these areas. The export boom in Southeast and East Asia, particularly in the last quarter of the 20th century, has thrown open thousands of job opportunities for women.

Second, the migration of women in search of employment opportunities has helped ease the burden of poverty in many cases and also helped meet the labour needs of a number of countries.

Third, globalisation has contributed to the creation of new associations of women and strengthening of their networks to offer mutual support and resources.

Finally, advanced information and communications technology has made health, micro-credit, employment and information more accessible to women.

There are some negative dimensions of globalisation which reinforce existing gender inequalities.

First, free trade, the cause and consequence of globalisation, hurts women. Women, no doubt, find more job opportunities available to them. But majority of female employees work under inferior working conditions, and often on shifts, with serious implications on their social and physical health. The rape and murder of Prathiba Murthy, a BPO employee of HP, in December 2005 in Bangalore is a reminder of how women are targets of abuse and exploitation. Those in the lower and labour-intensive consumer electronics industries suffer from health problems ranging from extreme fatigue to general health problems due to chemical hazards and job stress.

Second and the most critical impact of globalisation on women is the worsening situation of violence against women. Workplace harassment is on the rise. The fact that a woman is sitting next to him makes the man think that she is available for him. It was this attitude of men that made Shylaja Praveen, a 24 years old employee of ING Vysya Financial Services, Bangalore, commit suicide in August, 2007. Women migrant workers are increasingly becoming victims of sexual violence.

Third, companies are increasingly commoditising sexuality and women's bodies, projecting them in advertisements and movies. Sex tourism and sex trafficking are on the rise.

Fourth, women are among the first to feel the negative impacts of the presence of multinational corporations. MNCs dismantle local economies and 'mine' the natural resources needed by local and regional communities. The consequence is break-up, displacement and migration, which isolates emigrant women from the safety of familial and community support structures.

Probably nowhere else this phenomenon is witnessed more than in India. Over two decades, the number of towns in India went up to 7935 (2011) from 4689 in 1991. From 2001–11, urban India added 91 million to its total population in 2001, against rural India's 90.6 million. These figures indicate that more and more people migrated to towns. Positively speaking, this amounts to bringing so many people into the nation's main stream.

But this phenomenon has its dark side. Millions of people have migrated to towns because of the collapse of farming activities. Villages have lost able-bodied adults, leaving behind the old, hungry and vulnerable. Families broke as members headed towards different directions. It is the women who have to bear the brunt.

Globalisation and Developing Countries

Has globalisation benefitted all countries equally? The answer is in the negative. Stated differently, internationalisation has benefitted mainly the already rich countries while the poor countries have become poorer. The case of India is typical. Supposed to be one of the BRIC countries, claimed to become a superpower a decade hence, and hailed to be the hub of global business, India's experience has been disappointing. At the time of Independence, nearly 200 million out of a population of 365 million were below the poverty line. But 60 years later, the number of poor has risen to 300 million. Poverty speaks of everything—illiteracy, malnutrition, drinking water scarcity, and lack of sanitation and health facilities. What the World Bank has noted is worth recollecting in this context:

- About 1.2 billion people live on less than $1 a day. This number has increased, not decreased, over the last decade. About 2.8 billion live on less than $2 a day.
- Underweight children number over 150 million.
- The average income of the twenty richest countries was 15 times that of the twenty poorest countries in 1960. It is now 30 times the average of the twenty poorest countries.
- The world population reached 6 billion in 2000 and is set to reach over 7 billion by 2015. Most of these increases will occur in the developing world.
- In the US, from 1990–1998, eight women died during childbirth for every 1,00,000 live-births. In Eritrea and the Central African Republic, this number was 1000.
- Average life expectancies in many African nations have fallen from over 60 years to below 40 years because of AIDS. Over 95 per cent of AIDS victims are in the developing world.

- In 1998, about one quarter of 3.4 billion adults in the developing world were illiterate, and females were twice as likely to be illiterate as males (18 per cent versus 33 per cent).
- The poorest 40 per cent of the 15–19 years age group of the population of India, Pakistan, Mali and Benin averaged 0 years of schooling.
- In the developing world, 90 per cent of sewage was discharged into rivers, lakes, and coastal waterways without any treatment.

The new economy, a characteristic feature of the present century, itself demands trading across the globe. The Internet, the main stream of the new economy, facilitates globalisation in a big way. The Internet is making national borders irrelevant in the case of many goods and services. More and more firms are embracing the Net and are taking full advantage of its vast potential.

A company like Dell Computer has been able to achieve vertical integration using e-business. Amazon.com has found it possible to sell books globally without the need to set up stores anywhere. Ebay has used the Internet to conduct auctions among people across the world for a mind-boggling range of items. Virtual universities are providing world class education on the Net to students all over the world.

Inequalities

International business has resulted in inequalities of income within nations, between nations and globally. Inequality within a country takes into account the income distribution within the countries. International inequality shows differences in average incomes across countries. Global inequality takes into account both within and between countries' income inequalities.

There is growing inequality in incomes among people confirming to the saying that rich become richer and poor the poorer (see also Fig 1.4). As shown in Fig 1.4, a gap is clearly visible between rich and poor countries and it is clearly widening. From America to Egypt, the fruits of globalisation went-mostly to the top, causing growing resentment among the middle and working classes.

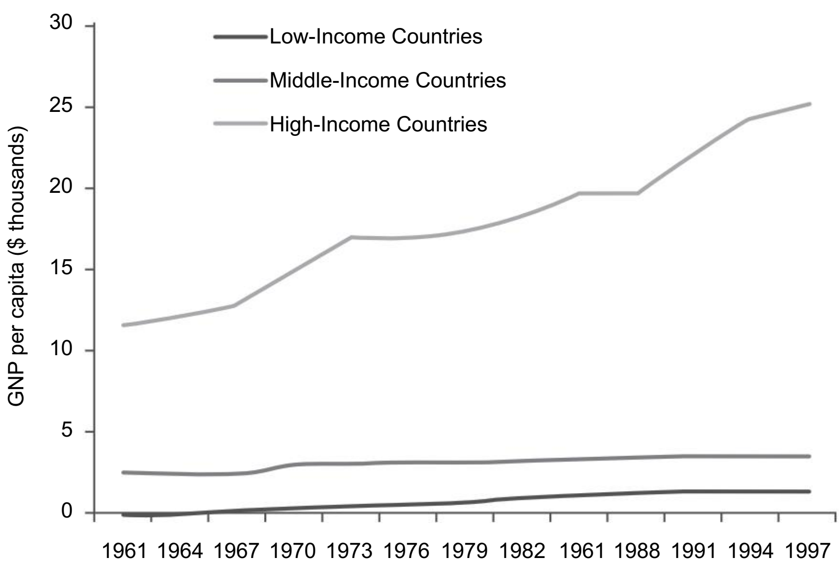

Fig. 1.4 Income of rich and poor countries

Inequalities in income lead to several problems. For example, income inequality increases black-market and property crimes; low-income households lack the resources to maintain and improve their health status, and inequality tends to breed corruption. The unequal distribution of income may create incentives for certain high-income groups to interfere with the political process and democratic governance. In particular, a heavy concentration of wealth and income will provide richer individuals with sufficient resources to offer bribes to high ranking officials and policy makers.

Recent statistics from the Government of India show that nearly one-third of the population lives in absolute poverty; and 77 percent of the population lives on less than ₹20 per person per day.

Another dimension of economic disparity in India can be found by comparing corporate profits with wages. The ratio of corporate profits to Gross National Product (GNP) in India rose by 330 percent during 2001–05, while in the same period, the ratio of corporate wages to GNP fell by 2 percent.

The corporate sector, which is controlled by 0.1 percent of the population, has trippled its share of GDP in the last six years. In 2000–01, corporate profits were 6 percent of GDP, which rose to 21 percent in 2005–06.

What is not shown in Fig. 1.3 is the globalisation penalty which is assuming major proportion in the corporate sector. A brief write-up on the issue is relevant in this context.

Globalisation Penalty

Globalisation has no doubt benefited millions of people around the globe but has also hit hard business executives who carry the mantle of cross-border business. Executives need to pay what Meckinsey & Co., consultants called "globalisation penalty". Penalties emerge in several forms.

- High performing MNCs are less effective at setting a shared vision and engaging employees around it than are their local counterparts.
- Global leaders find maintaining professional standards and encouraging innovation of all kinds more difficult. They do business in multiple countries and hence find it more challenging to build government and community relationships and business alliances.
- Firms go international expecting huge revenues but such an expectation may not come true, particularly when overseas markets are hit by economic recession. Small problems in any subsidiary eat away much time and energy. Any mistake committed in global operations will badly hit home operations.
- Often MNCs pickup wrong candidates and are expatriated to head subsidiaries. The consequence could be anything from bad marketing strategy at best to the arrest of the unsuitable managers at worst.
- MNCs evolve own codes of conduct. But framing such codes is easier written than done. Policies relating to whistle-blowing, sexual harassment, gift giving and the like are subject to local cultures that vary from country to country making it difficult to evolve a code applicable to all subsidiaries.
- Earlier, many Indian companies - especially in the pharma sector - acquired companies overseas with the sole purpose of moving their manufacturing operations to India. That may help reduce the acquired company's cost but when done indiscreetly; it upsets regulators and local communities affecting country's reputation. Consequently, when Indian companies make acquisition bids now they are regarded with suspicion.
- KPMG has a peculiar globalisation penalty to pay. Since the consulting firm is structured as a

partnership firm in every country, KPMG's headquarters in the Netherlands wields limited power over operations abroad. This is a risky proposition.

- Ownership structures make MNCs pay unique globalisation penalty. Many-have a mix of 100% subsidiaries, majority and minority owned companies and joint ventures. AIG, for example has a joint venture with Tatas in life and general insurance, but it also has eight other companies in India, all wholly owned subsidiaries. But the way the two are handled by HQ is different.
- Foreign language can be yet another globalisation penalty. Omnitek Info Solutions is a Mumbai based IT company. It forayed into Japan, believing it to be a lucrative market, but ultimately withdraw from there when it could not cope with communication barriers. It later acquired a company in The Netherlands and has retained KPMG to help with integration.
- Executives of MNCs are battered from all sides and their failures are sculpted on rocks but successes are written on sand. Their status has been lowered so much that a new set of phrases have been invented to describe leadership. The latest buzz phrases doing rounds in executive circles include: "humble leadership", 'servant leadership", and "bottom up leadership". What made them become so helpless? In the first place, tenure of a typical executive in a global corporation has become short and uncertain.
- Among the world's 2500 biggest public companies, the average job tenure for departing CEOs has fallen from 8.1 yrs in 2006 to 6.6 yrs as of now. In 2010 CEO turnover worldwide was 11.6%. Shareholders now give bosses very little time to prove themselves.
- Two decades ago, executives were powerful, heroes and unbound. But thanks to the implosion of Enron in 2001 and the financial crisis in 2007-08, bosses have become embattled.
- Time was when CEOs were chairing their respective boards but not anymore. In Booz's global study, the finding is that the proportion of incoming CEOs who double as chairmen fell from 48% in 2002 to less than 12% in 2009. Trend is the same in the US. The proportion of CEOs chairing boards in S&P 500 firms fell from 78% in 2002 to 59% in 2010. This means to imply that executives do not have voice in assessing their own performance.
- Shareholding pattern is undergoing a change. More of institutional investors (mutual funds) are replacing dispersed shareholdings. Mutual funds are highly demanding and interventioning in the affairs of the corporates.

Gated Globalisation

Enjoying unfettered movement of people, capital and goods across the globe for more than three decades, globalisation is under check, particularly since 2008 when the worst financial crisis hit the world economy. Both developed and emerging economies are resorting to hidden protectionist measures. Governments increasingly pick and choose whom they would trade with, what sort of capital they must welcome, and how much freedom they should allow for doing business overseas. In the past decade, the number of incidents, when countries imposed punishments for dumping offences in the name of tariffs and quotas, had been running at about 200 per year, which is lesser than that in the late 1990s.

Countries are not using conventional protechonist measures such as quotas and tariffs. They are invoking covert tools to erect gates, if not walls, against globalisation. The measures include capital controls, subsidies in the name of promotion, local content requirements on government purchases, health and safety requirements, industrial policy and shift from multilateral trade agreements to bilateral agreements. Consequences are visible. World exports as a share of global GDP rose steadily from 1986 to 2008 but have fallen flat since then. Global capital flows, which in 2007 topped at $11 trillion, amounted barely to a third of the total figure in 2012. Cross-border direct investment has also come down from its peak in 2007.

International summits are besieged by protestors and Doha round negotiations of WTO scraped through after series of failed talks. Reasons are many. First, if the Depression of 1930s forced countries to erect walls against internationalisation, it is the financial crisis of 2008 that made them install gates against free trade. Second, from Africa to Egypt, fruits of globalisation have gone mainly to the creamy layers causing resentment among the middle class and the working class.

Third, historically globalisation has been thriving on hegemon. The economic hegemon would act as an importer of last resort and financier of the world's monitory system. From the mid-1800s until 1914 that hegemon was Britain. In 1846, it unilaterally reduced import tariffs by repeating the Corn Laws and, in 1860, it signed free trade agreements with France, starting a virtuous cycle of falling tariffs worldwide. As the guarantor of the gold standard, Britain made it possible a system of fixed exchange rates, financing the deficits of some countries while absorbing the surpluses of others.

In 1945, America took up the mantle of benevolent hegemon. It underwrote the International Monetary Fund and the Bretton Woods system of fixed exchange rates to end beggar-thy-neighbour currency devaluations, and the General Agreements on Tariffs and Trade to end trade disputes.

The breakdown of Bretton Woods, two oil-price shocks and the Latin American debt crisis severely tested globalisation in the 1970s and 1980s. Fearful of Japan's growing economic clout, America turned protectionist. Free trade gave way to managed trade. But in 1989, the Berlin Wall fell and in 1990, Japan's bubble economy burst. America became the "hyperpower" and presided over an unprecedented expansion of globalisation.

These days America is acting less like a hegemon. China with its own protectionist wall is not a candidate for the role of a hero.

The other ill effects of globalisation were explained earlier in this chapter. Pitfalls notwithstanding, the globalisation juggernaut must move forward as free trade has benefited people worldwide. Openness must be a norm and protectionism an exception.

GEOGRAPHY OF THE WORLD

LO 8
Recognise the geography of the World

As we go into the years to come, our dependence on global markets will become more pronounced. We may have to buy even perishable products like milk and water from foreign countries. Transportation and communication advances and government-to-government accords have contributed to our increasing dependence on foreign goods and markets. As this dependence grows, we need to know more about countries—their locations, people, economies and markets. Updated maps provide these and other related details. We urge the readers to take a look at the following maps:

Map 1 : World View

Map 2 : Africa

Map 3 : Europe

Map 4 : Asia

Map 5 : North America

Map 6 : South America

Plan of this Book

The book has 25 chapters divided into five parts (see Fig. 1.5). Part 1 (Chapters 1 to 4) sets the tone for international business. Starting with the discussion on the nature of international business, this part covers such topics as MNCs and trade and investment theories.

Part 2 (Chapter 5 to 10) covers all environmental factors impacting global business. The external forces discussed in this part include political-legal, cultural, managing across cultures, negotiating across cultures, technological and economic.

Chapter 11 to 16 form part 3 of the book. This part focuses on strategic preparedness of international business. The topics covered here include strategic management, institutional support, organisational structure, strategic alliances, integration between counties and WTO.

The various functional areas of international business – operations, marketing, financial, and HR management form part of part 4 of the book (Chapters 17 to 22).

Part 5 of the book (Chapter 23 to 25) focuses on the CSR, e-business and the future of globalisation.

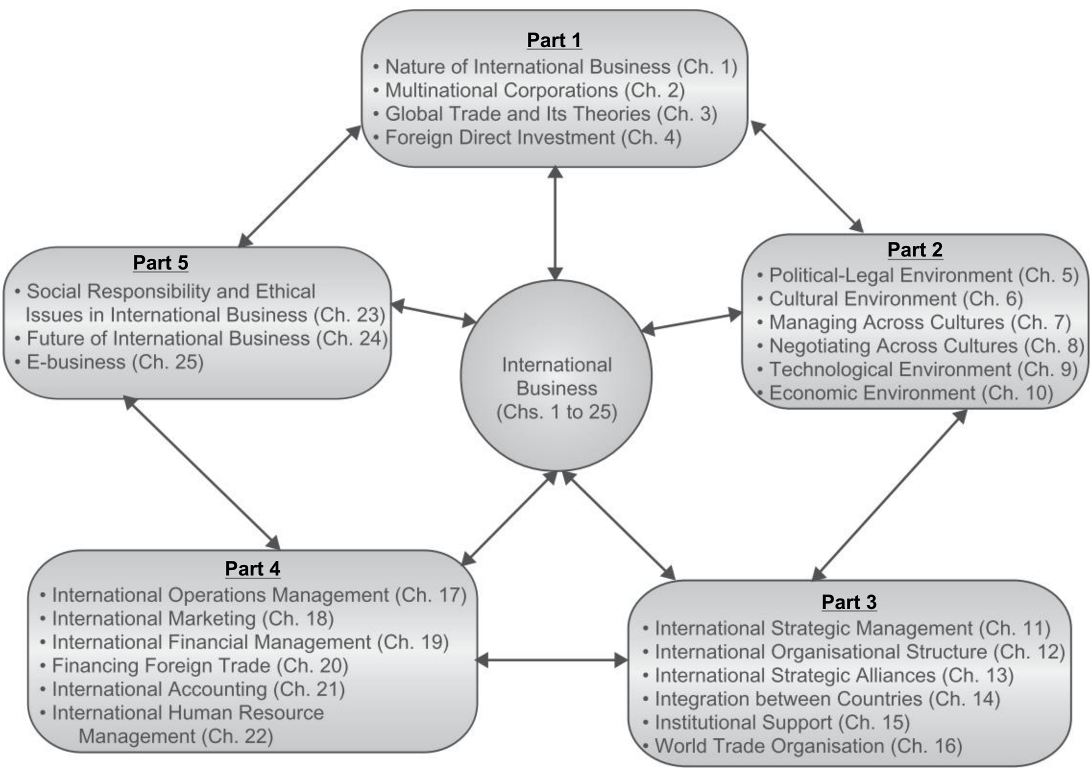

Fig. 1.5 Plan of the Book

SUMMARY

- International business is doing business across national borders. Product presence in different countries, manufacturing bases in various countries, free flow technology and people are the hallmarks of international business. (LO1)
- Several reasons make study of IB almost essential. Most compelling reason is the career choices lying before a student. (LO2)
- Many triggers have contributed to the predominance of international business. Primary motive is the money available in foreign markets. (LO3)
- Differences exist between domestic business and foreign business. Essentially both are businesses but scales and complexities differ. (LO4)
- International business is as old as business itself. India happens to be the pioneer. (LO5)
- A firm planning to foray into oversees markets needs to be clear about atleast four strategies. (LO6)
- Globalisation has benefited millions of people across the globe but has hit developing countries hard. (LO7)
- A look at world geography is useful before studying about international business in depth. (LO8)

REVIEW QUESTIONS

1. Define the term 'international business'. Compare and contrast international business with domestic business. (LO1 and LO4)
2. Outline the drivers of international business. (LO3)
3. Bring out the routes of going global. Which route, according to you, is most appropriate for India? (LO6)
4. Bring out the effects of globalisation on wages, women and on developing countries. (LO7)
5. Trace the evolution of international business. (LO5)

DISCUSSION QUESTIONS

1. Do you think Indian firms should go global? Why not they remain content with domestic market, which is vast? (LO2)
2. "The study of international business is fine if you are going to work in an MNC, but it has no relevance for individuals who are going to work in small firms". Evaluate the statement. (LO2)
3. What do you believe makes foreign business activities more complex than purely domestic ones? (LO4)
4. You have decided to take a job after MBA in Bangalore. Why should you study international business? (LO2)

REINFORCING EXCERCISES

- In 1995, Toyota produced 2/3 of its cars in Japan and the remaining in 25 affiliates spread over several countries. Nearly 40% of its output was exported to other countries. The MNC leveraged its supply chain to the best advantage. For example, within its South East Asian regional network, Toyota exported diesel engines from Thailand, transmissions from Philippines, steering gears from Malaysia and engines from Indonesia. Besides, it had intra-firm transfer of people, capital and technology. Is Toyota the only MNC which has globalised supply chain system? Any other example?

- While most companies begin by serving their local markets and then expand their operations overseas, TCS did the opposite. It took a challenge that very few companies have taken on: to look outside the home base and establish a presence in a foreign market – in this case the US. TCS had no choice but go global from the very beginning. It could have built business in India, but there was no real business within the country. Looking back, what do you think about the choice made by TCS?
- Omnitek Info Solutions is a Mumbai based IT company. It forayed into Japan, believing it to be a lucrative market, but ultimately withdrew from there when it could not cope with communication barriers. It later acquired a company in The Netherlands and has retained KPMG to help bring integration. Comment on this.

CLOSING CASE 1

Where Success is a Burden

What is common with *upma, idli, pavbaji, roti, samosa*, KSIC saree, white dhoti, white cap, salvar kameez, gold chain, wrist watches, *kurta pyjama* and a four-wheeler? These are the essential possessions of a middle or upper income family in India. When it comes to the four-wheeler, it should one among 15 (150 varieties) stables of Maruti Suzuki India Ltd. (MSIL), formerly known as Maruti Udyog Ltd.

MSIL is a subsidiary of Suzuki Corporation, Japan. MSIL has been a leader in the Indian car market for over two and a half decades. With two manufacturing facilities located at Gurgaon and Manesar, MSIL has a formidable combined capacity to produce over 1.2 million vehicles per annum and has plans to expand the capacity to 1.75 million by 2013.

MSIL offers a wide range of cars, popular among them include the smart baby Maruti 800, Omni, Eeco, Alto, Swift, WagonR, Ritz, Estilo, Gypsy, Vitara, SX4 and Kizashi. With an employee strength of 8500, MSIL sold (2010–11) over 1.27 mn vehicles including 138,266 units being sold in overseas markets. It has been listed both in Bombay Stock Exchange, as well as in National Stock Exchange.

Sales turnover of MSIL has been rising y-o-y as shown in the following table.

(₹ in million)

Year	Net Sales	Year	Net Sales
2005–06	120034	2006–07	145922
2007–08	178603	2008–09	203583
2009–10	301198	2010–11	361282

More than the numbers, it is the penetration of the brand of MSIL that deserves accolades. Maruti has become a household name from Kashmir to Kanyakumari and its cars are ubiquitous across the country.

Maruti Udyog Ltd was incorporated on February 24, 1981 as a fully-owned government company. The government then decided that the company should have production capacity of 100,000 passenger cars and 40,000 light commercial vehicles per annum. The government had also decided that Maruti Udyog should source and secure foreign technology (hence the tie up with Suzuki). Over time, the company became a joint-venture enterprise between the Government of India and the Suzuki Motor Corporation, Japan. Recently, Government of India divested its holding and now the leading Indian car maker is fully-owned by Suzuki Motor Corporation, but its Indian subsidiary continues to be called MSIL.

What made MSIL tick?

MSIL has a lot going in its favour. It is the biggest car marker, one out of two cars sold in India bears a big M on the grill. The firm has a strong R&D establishment with 1110 scientists and engineers, most of them being third country nationals. The R&D thrust is to help Maruti transition from doing piecemeal innovation to developing an entire car from scratch, all in-house.

Maruti's vendor network is very strong. It has 80 odd vendors and the company works closely with tier 1 and tier 2 vendors to help them upgrade on several fronts, including talent, productivity, and R&D. The company advises on HR policies of vendors and is helping many of them in clearing up their accounts so as to ease the risk of seeking credit for expansion.

Maruti's dealer network is worth recounting. As of now, it has 970 dealers in 643 cities, almost three times the size of the network of the second-placed Hyundai. MSIL plans to double its dealer network to 2000 in 800 cities by 2015. To further deepen its reach in the rural areas, it has appointed close to 5000 resident dealer sales executives – villagers who act as the company's sales agents. The company is tying up with PSU banks and RRBs to finance car purchase by villagers. The car maker's 16 regional offices have been directed to identify one segment of market that could be targeted—for instance software engineers in Bangalore, fishermen in Kolkota, orange growers in Nagpur and diamond workers in Surat.

Over time, MSIL has built enviable organisational culture. When the first car rolled out, the employees requested that it should be donated to Lord Venkateshwara at Tirumala. But the request was turned down by the management lest such a practice would spin off similar demands in future. Employees, dealers and vendors pitched in, bought the car and was donated to the famous temple.

MSIL has evolved unique HR policies. It is probably the first Indian company to have introduced common uniform for all its employees – from managing director to the janitor. The uniform is made of the same material, has the same design and the same manufacture. And all employees are insisted that they should wear uniform when in office.

MSIL's management took initiative in promoting a union in the factory much before any politician or outsider took advantage. One K.K. Datta, who was the union leader at BHEL, was brought in and became general secretary of the newly formed Maruti Udyog Employees Union (MUEU). Workers were encouraged to join the union. MUEU was not only recognised, but was given importance. The importance of the union was highlighted by ensuring that the president and the general secretary of the union were seated on the dais at every Maruti function. They would join top management to receive VVIP guests and garland them.

The company introduced an attractive suggestion scheme in 1984. Maruti paid ₹ 2 for every suggestion, accepted or not. For a suggestion accepted, a part of the savings achieved was paid as incentive to the worker who made it. The worker making the most suggestions each month would lunch with the Japanese Joint MD in the canteen. At the end of the year, the worker who has made highest number of suggestions would be invited with the family, to have lunch with the chairman in a five-star hotel.

Many of the HR practices of MSIL have been replicated by the Indian private sector. Sushil Poddar, Chairman of Gillette India, visited Maruti, observed the practices there, and replicated the same in his plant. Soon, the Gillette Indian facility became the best among all Gillette factories globally.

Weaknesses Multiply

Major weakness of MSIL is its own sucess which has become a big burden on it. Employees have become arrogant, lethargic and complacent. Bhargava, the Chairman, himself admitted thus "Our number one enemy is our complacency". The taken-for-granted attitude kills vibrancy, initiative and innovation.

Complacency is showing off in the declining market share. From a virtual monopoly during 1980s' MSIL's share came down to 63% in 1999 and to 45% as of now. Maruti's fiefdom has been the compact A2 segment with models like Alto, WagonR, Ritz and Swift. The company's share in this segment too is slipping from 58% in 2006 to 56% in 2011, as newer, snazzier entrants like VW's Polo and Ford's Figo attract younger audience that is less price – sensitive and more keen on looks and features. MSIL's small car segment too is under attack what with the entry of Etios Liva (Toyoto) and Brio (Hyundai).

Competition is becoming tougher by the day as more and more auto giants are making their presence felt on Indian roads. Ford, Toyota, Honda, and VolksWagan have made significant in-roads into the market but MSIL has only marginally improved its share (see the table below).

MSIL is deeply entrenched in the no-frills value-for-money segment. It needs to shed this image and reposition itself to the growing Indian middle class. The company needs to do a lot of make-over and convince well-healed consumers that MSIL too has a drool quotient.

Market Shares of Auto Giants (%)

	2009–10	2010–11
MSIL	44.63	44.94
Hyundai	16.14	14.26
Tata Motors	14.65	13.97
Mahindra	07.72	06.79
G M	04.46	04.25
Ford	01.89	03.91
Toyota	03.27	03.34
Honda	03.17	02.36
Volkswagen	00.21	02.05
Fiat India	01.27	00.84

By 2030, India will be bracketed with US and China as leading car markets in the world. Indian market could help Suzuki get what it badly needs—size and scale. In many businesses, small start-ups have humbled giant MNCs (think HUL vs Nirma, Nokia vs Micromax) with their agility and smartness. But automobile sector is different – here size matters. Look at what Hyundai has done. Hyundai has out-competed Toyota in the market for reliable efficient and cheap cars-all achieved through scale.

Size is one thing Suzuki is not strong. It has a mindset of being No.7 or No.8 in global ranking. Shizo Nakanishi, CEO, MSIL admits "we were always No.7, No.8. Toyota, Honda, Nissan—everybody was ahead of us".

Excepting exporting a lakh plus cars to overseas markets, MSIL has not made significant foray into world markets. Experience, success, deep pockets, and expertise behind, the company should have become aggressive and set up subsidiaries overseas either as greenfield projects or acquisitions. The promoters of the company dreamt of producing a small car to reach out to the average Indian. Even today, the management seems to have been trapped in the same mindset.

The much hyped strategic alliance with the German car maker Volkswagen to help Suzuki through diesel engine technology is likely to collapse. The partnership between the two car makers has so far been beset with problems and failed to deliver any meaningful progress for either company. Volkswagen accuses Suzuki of breaching their partnership pact by agreeing to a diesel engine deal with Italy's Fiat SpA.

Infact, Suzuki has a record of sort in having broken marriages. Its earlier deals with GM, Daimler AG and Chrysler have similarly ended before the stated objectives were realised.

The recent exit of 30 employees (all of them union activists), who spearheaded agitation against the management on the issue of union registration, casts a showdown on the HR policies of MSIL. On Nov. 3, 2011, in a unique settlement, 30 workers received a combined ₹ 4.2 cr to ₹ 4.8 cr and quit the company. Overnight; they became Crorepatis without being quizzed by Amitabh Bachchan.

Questions

1. Why has MSIL's management not tried to enter foreign markets via FDI route?
2. What can MSIL do to regain its near-monopoly position in the Indian market?

(Sources: R.C. Bhargava, "The Maruti Story", *The Economic Times*, dated May 29, 2011; *mint*, dated Nov. 8, 2011; and the Company's website.)

CLOSING CASE 2

Racing to Close the Gap on Global Rivals

If doubt arises in anybody's mind as to who is racing to close gaps with whom, the answer is simple – Tata Consultancy Services (TCS) Ltd. TCS belongs to the most respectable and oldest group of companies in India, namely Tatas. It is enviable that no Tata scion was ever rated as the richest businessman, though the Tata empire is the biggest with 100 companies under its fold manufacturing and supplying diversified products. As of now, TCS is the flagship company of Tata and a proud jewel of India.

The idea that inspired the founders of TCS began in a humble way, that too when the sophisticated software as found today was non-existent. JRD Tata, the then chairman of the Tata Group, whose interests varied from steel and automobiles to power and chemicals, took a historic decision. Like his forefathers who pioneered basic infrastructure in the country, JRD Tata too had a keen business sense. When his brother-in-law, aide and confidant Colonel Sawhney suggested pooling together the Group's needs for data processing in a single business unit, he readily agreed. This was in early 1960s. The seed thus sown generated, groomed and in 1968 became the TCS, the first to be borne when rest of India did not know much about computers.

To start with, TCS undertook lot of banking work, mostly reconciling inter-branch accounts, payroll and head office accounting. The volume of banking work was so much that TCS then had a headcount of 500 professionals on its payroll. This was not enough.

TCS had to go global to grow big. Generally, companies first test their luck in local markets and then go global. But TCS did the opposite. Domestic market being too small, TCS had to internationalise its operations. But the preceptors of overseas markets towards TCS were negative. Foreign businesses doubted the capabilities of TCS to accept and execute huge orders. Such negative image persisted even in 1990s. The company proved the perception wrong and now more than 95% of annual revenue of $12 bn is generated from overseas markets, spread across the globe but majority from the US and Japan.

Initially, TCS followed organic growth which proved to be inadequate for the image of the firm. It started acquiring companies and the first buyout was CMC, a government owned company. This was in 2001 and there was no going back since then.

Within India, TCS is an emperor with its ₹5 trillion worth capitalisation, the first Indian company to scale up to that level. Its market Cap of ₹5 trillion eclipsed the combined figure of Infosys, WIPRO, HCL and Tech Mahindra.

Globally too TCS ranking is envious. On global market value TCS score is 2, employee count 2, revenue 7 and profitability 4. What is more interesting is that TCS is in big league with such IT majors as IBM, HP, Accenture, SAP, NIIT, Oracle and CSC.

TCS is moving gradually beyond just traditional services to a social, mobility, analytics, and cloud (Smac) framework. It has invested in building a network of cloud data centres across the globe. It is also building a 3000 sq. feet, UK-based data centre for providing cloud computing. TCS has also set up a digital enterprise unit in Silicon services.

TCS is a model company for others. It has over 300,000 employees, and will soon have more than 100,000 women on its payrolls. TCS has readied itself for future growth by building an efficient business. It has a lean bench and lower attrition (attrition rates of TCS and others are: TCS 10.4%, Infosys 18.7%, WIPRO 15.1%, and HCL 16.9%) than most Indian based outsourcers. TCS has strong foot-prints in IT infrastructure services and BPOs.

TCS is no more a monolith. It is split into 23 strategic business units. Each unit has finance, HR and other functions attached to it and is headed by a leader who has responsibility for its profit or loss. Each unit runs as a profit centre but draws on the strength of TCS's scale. This has turned managers into entrepreneurs, and the entire TCS remains nimble.

But there are challenges nevertheless. One apprehension expressed is that TCS will face formidable challenge to maintain its existing pace of growth, as it gains immense scale with each passing year. Again, it is not enough for TCS to spread its wings worldwide, but also overhaul the kind of technology services it provides. TCS needs to invest in expansion activities, particularly in Continental Europe and in its digital business. Also TCS needs to diversify vertical portfolios into sectors where it has a less pronounced presence, such as life sciences, health, high-tech and media verticals.

Questions

1. Technology robs jobs. What is your views on this? How true is it?
2. Will SBUs help TCS close in on global rivals fast?

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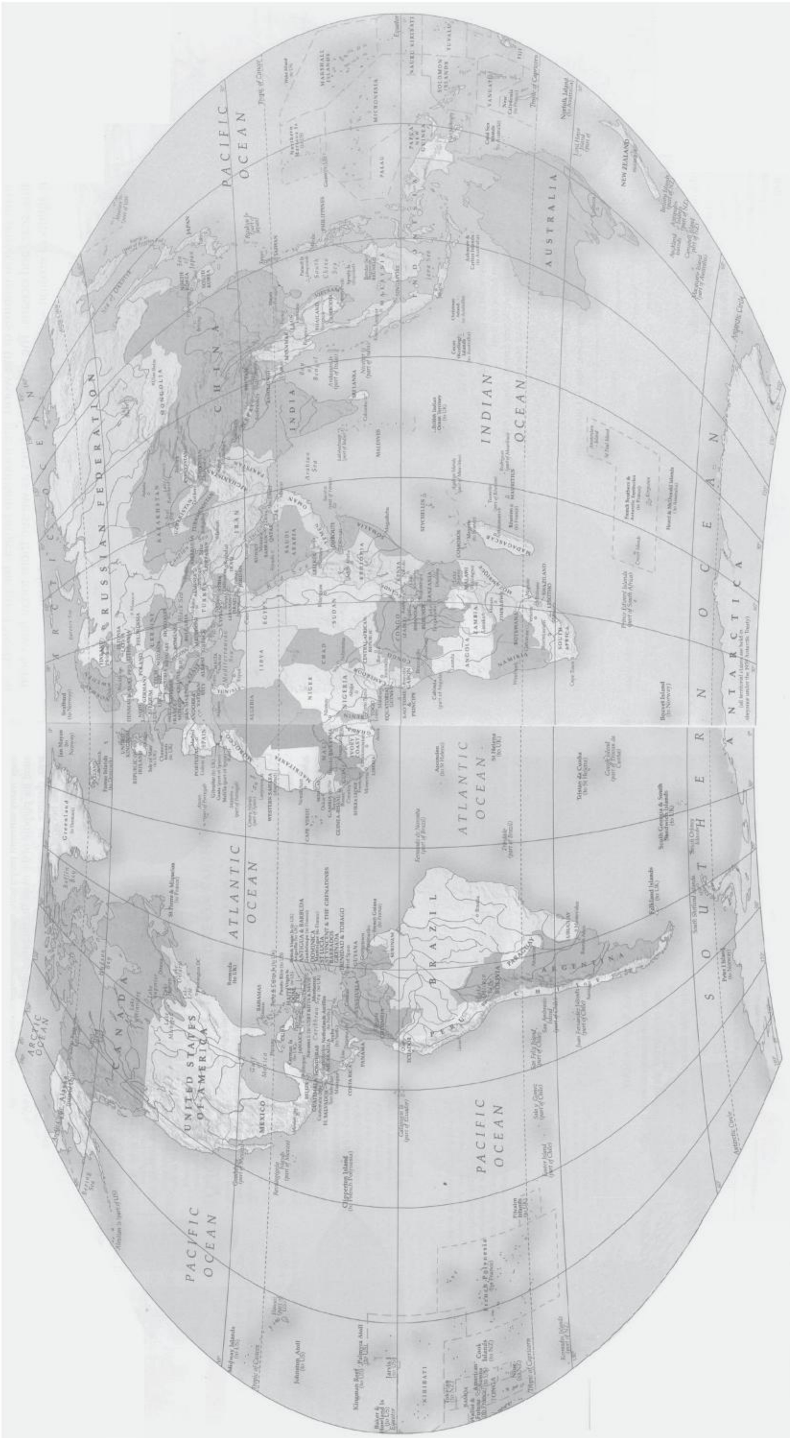
Map 1.1 World View



Map not to scale

Map 1.2 Africa

Map not to scale

Map 1.3 Europe

Map not to scale

Map 1.4 Asia

Map not to scale

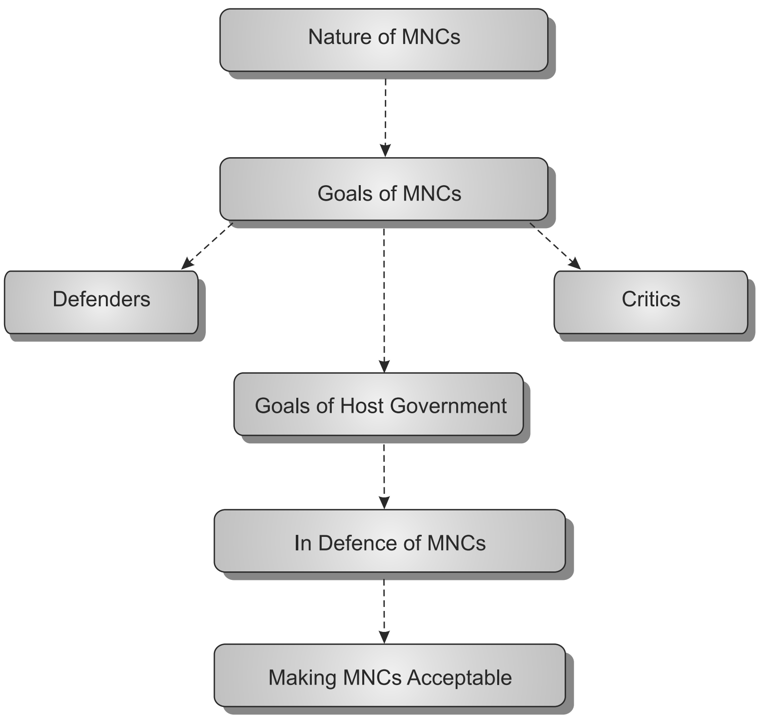
Map 1.5 North America

Map not to scale

Map 1.6 South America

Map not to scale

CHAPTER


Nature of MNCs
Goals of MNCs
Defenders
Critics
Goals of Host Government
In Defence of MNCs
Making MNCs Acceptable

2

Multinational Corporations

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Recognise the nature of multinational corporations (MNCs)
- **LO 2:** Identify India's presence
- **LO 3:** List the goals of MNCs
- **LO 4:** Discuss the fundamental goals of host governments
- **LO 5:** Criticise MNCs
- **LO 6:** Argue in defence of MNCs
- **LO 7:** Design how MNCs can become acceptable

Opening Case

A Strange Invisibility

Established on a cold New Year's Eve in 1600 A.D., England's East India Company is the mother of the modern corporation. In its more than two and a half centuries of existence, it bridged the mercantilist world of chartered monopolies and the industrial age of corporations accountable solely to shareholders. The Company's establishment by royal charter, its monopoly of all trade between Britain and Asia and its semi-sovereign privileges to rule territories and raise armies certainly mark it out as a corporate institution from another time.

It was in India that the Company's impacts were most profound. Some of the country's major cities grew on the back of the Company's trade, not least Bombay (Mumbai), Calcutta (Kolkata) and Madras (Chennai). Beyond these coastal ports, the Company established a huge land empire, first as an opportunistic quest for extra revenues and later as an end in itself, eventually ruling most of the subcontinent. Yet, the Company's footprint did not stop there, but stretched to South-East Asia and beyond, to China and Japan. Penang and Singapore were both ports purchased by the Company in an age when territories could be bought and sold like commodities. And if India was the site of the Company's first commercial triumphs, it was in China that it made its second fortune. The Company's 'factory' at Canton was the funnel through which millions of pounds of

Bohea, Congo, Souchon and Pekoe teas flowed west to Britain and beyond. On another level, silver, and later a flood of Patna opium, were smuggled in chests proudly bearing the Company chop (or logo).

Throughout its existence, the Company was in a state of almost constant metamorphosis. Its end came following the uprising against the Company rule in 1857-58, a contest generally known as the Indian Mutiny in Britain and the First War of Independence in India. By then, the Company had lost almost all connections with the band of merchants who had set out in four tiny ships to break into the Indonesian pepper market at the beginning of the seventeenth century. It no longer traded. Instead, it administered its conquests in India as a licensed agent, on behalf of the British Crown. But one abiding link remained: its ultimate purpose as a profit-making agency, always with an eye to its shareholders' profit and the annual dividend. Following the suppression of the great rebellion, there was a fierce public backlash against the Company's anachronistic status. In the India Act of 1858, the Company was effectively nationalised, with all its rights and responsibilities taken over by the British state; the British Raj had begun. Yet, the Company lingered on, 'a shadow of a shade', according to one observer. It may have lost its purpose, but its directors were insistent that its capital should be protected for the remaining years of its last charter. Eventually, time ran out, its shares were exchanged for government bonds, and on June 1, 1874, the Company ceased to exist.

Between the years 1600 and 1874 A.D., the company had pioneered the shareholder model of corporate ownership and built the foundations for modern business administration. With single-minded pursuit of personal and corporate gain, the company and its executives eventually achieved market dominance in Asia, ruling over large swathes of India for a profit. But the company also shocked its age with the scale of executive malpractices, stock market excesses and human oppression.

THE East India Company's track record has been archieved, no doubt. But the ghost of the company is hovering around the world even now. We have the Enron and investment banks debacle; Nestle's campaign to persuade Third World mothers to use infant formula instead of breast feeding their children; Monsanto's development of seeds that produced plants which, in turn, produced seeds that could not be replanted, thereby forcing farmers to buy new seeds annually; and Exxon's massive oil spill and the company's subsequent attempts to avoid paying compensation. There are other such stories as well.

Do we recollect names of global companies only for their misdeeds? No. They have also played a positive role in the economic development of the developing countries. This chapter examines the various facets of the multinational companies.

NATURE OF MULTINATIONAL CORPORATIONS

LO 1
Recognise the nature of multinational corporations (MNCs)

The most active players in international business are the multinational corporations (MNCs). MNCs are the very essence of globalisation. Any talk about international business or about globalisation ipso facto reflects on the MNCs.

An MNC is an organisation that engages in production or service activities, through its own affiliates, in several countries, maintains control over the policies of those affiliates and manages from a global perspective. With a global perspective, top managers allocate resources and coordinate activities to take the best advantage of favourable business conditions throughout the world.

More specifically, a multinational enterprise is characterised by the following:

1. the number and size of foreign affiliates or associate companies it owns or exercises control over;
2. the number of countries in which it owns or in some way controls value-added activities such as mines, plantations, factories, sales outlets, banks, offices and hotels;

3. the proportion of its global assets, revenue, income or employment accounted for by its foreign affiliates;
4. the degree to which its management or ownership is internationalised;
5. the extent to which its higher-value activities, for example, research and development (R&D), are internationalised. *Inter alia,* this measure is intended to capture the *quality* or *depth* of foreign production; and the contribution of foreign affiliates to accessing, or directly creating, new knowledge;
6. the extent and pattern of the systemic advantages arising from its governance of, and influence over, a network of economic activities located in different countries; and
7. the extent to which responsibility for the creation and usage of institutions and assets, as well as decision making concerning financial and marketing issues, are devolved to foreign affiliates.

World bodies generally use Transnationality Index (TNI) to assess the spread of MNCs across the globe. TNI is made up of three ratios: foreign sales to total sales, foreign assets to total assets and foreign employment to total employment.

There are considerable variations in the TNI between firms in any particular sector. But sectors such as mining, paper and building materials, metals and food/beverages and tobacco have the highest average levels of transnationality-TNI hovering around 68%–81%. The average TNI for the primary sector as a whole is 63%, as compared to 62% for the secondary sector and 51% for the tertiary sector. The average TNI of the top 100 MNCs from developed countries is 58% as compared to 51% of the top 10 MNC's belonging to developing countries.

Going by nationality of firms, European companies (among the UNCTAD's top 100 list) are the most transnational, with those from the UK, Switzerland, and the Netherlands in the lead, while US firms are among the least transnational in the relative terms.

MNCs are alternatively called TNCs, MNEs and global corporations (see Exhibit 2.1). The term multinational corporation is most commonly used in business and academic circles. We too follow the same trend.

Exhibit 2.1

WHAT'S IN A NAME?

There is a debate about what to call a company whose business ranges across national borders, tying together home and host countries through corporate policies and practices. Here are some of the terms used to describe these companies.

Transnational Corporation (TNC)

Because companies "transcend" or operate across national borders, some experts prefer the term transnational corporation, or TNC. The United Nations favours this term and has created a Research Centre for the study of Transnational Corporations.

Multinational Corporation (MNC)

The fact that companies operate in multiple countries has led some experts to adopt the term multinational corporation, or MNC. This term is very popular in the business press and in textbooks. It seems to be the most generic name to describe corporations operating around the world.

Multinational Enterprise (MNE)

Because some of the international giants are state-owned enterprises, rather than corporations, the term multinational enterprise, or MNE, has entered the vocabulary of international trade.

Global Corporation

This term became very popular in the1990s. The term seems to have first been used to describe a small number of companies whose business was conducted in dozens of—perhaps more than 100—

nations. Hence, Nestle has long been described as truly global because the scope of its operations extends to more than 150 nations around the globe. The term is often applied to companies doing business in several areas of the world (e.g., Europe, Latin America, Asia-Pacific, and North America).

(*Source:* James E. Post, *et al., Business and Society*, p. 157)

Colossal is probably the right word to describe the pre-eminent position of MNCs in global business. There are more than 65,000 MNCs around the world today, controlling over 8,50,000 affiliates (UNCTAD- 2006). Table 2.1 contains the list of the top 20 MNCs around the world.

A quick look at Table 2.1 shows that MNCs are predominantly hosted by developed countries. Developing countries are no strangers to MNCs. Companies from emerging countries such as India, Brazil, and China are too well known and are even providing formidable competition to their North American, European and Japanese counterparts. Names like Lenovo, LG Electronics, Ranbaxy, Tata Motors, Reliance, TCS, Telefonica, Santander and Samsung have become well-known global brands.

It is estimated that roughly half of all cross-border corporate assets are accounted for by just the top 100 MNCs. Some MNCs are richer than most developing countries. In 2004, the revenues of GM were $191.4 billion, greater than the GDP of more than 148 countries. In its fiscal year ending 2005, the retail giant Wal-Mart (1,30,000 employees) earned $285.2 billion as revenue, larger than the combined GDP of sub-Saharan Africa. PetroChina's market value is larger than the GDP of South Africa, a

Table 2.1 The World's Biggest Pubic Companies, April 2012 (US $ billions)

Rank	*Company*	*Revenue*	*Home*
1	Wal-Mart Stores	469.20	USA
2	Royal Dutch Shell	467.20	Netherlands
3	Exxon Mobile	420.70	USA
4	Sinopec China Petroleum	411.70	China
5	BP	370.90	UK
6	Petro China	308.90	China
7	Volkswagen	254.00	Germany
8	Total	240.50	France
9	Toyota Motor	224.50	Japan
10	Chevron	222.60	USA
11	Glencore International	214.40	Switzerland
12	Samsung Electronics	187.80	Korea
13	E.ON	174.20	Germany
14	Phillips 66	166.10	USA
15	Apple	164.70	USA
16	ENI	163.70	Italy
17	Berkshire Hathaway	162.50	USA
18	General Motors	152.30	USA
19	Daimler	150.80	Germany
20	AXA Group	147.50	France

(*Source: Forbes*, 2012)

G-20 country. The profits of Russian oil company Gazprom are the same as the GDP of Jordan.These corporations are not only rich, but are politically powerful too. If host governments decide to tax or regulate them in the ways not favourable to them, they threaten to relocate elsewhere. There is always another country that spreads the red-carpet with several incentives.

Figure 2.1 shows the origin of largest MNCs from 1973 to 2010. For more than three decades, US dominated the world economy after the World War II. In 1973, 48.5% of the world's 260 largest MNCs were US originated. Second came Britain with 18.8% and Japan came third with 3.5%.

But things changed subsequently. By 2010, only 21 of the world's 100 largest MNCs were US born; 15 were French; 11 German; 15 British; and 8 Japanese. Globalisation has resulted in the decline of US dominance over the world company.

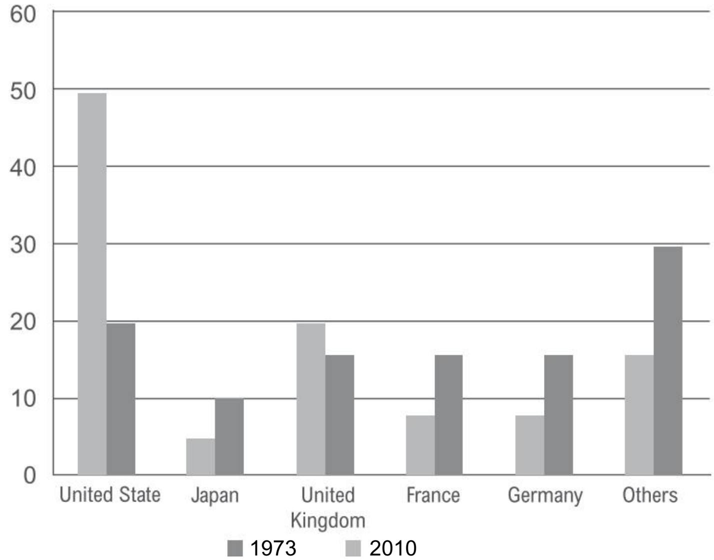


Fig. 2.1 National Origin of Largest Multinational Enterprise, 1973 and 2010

(*Source:* Charles W.L. Hill and Arun Kumar Jain, *International Business*, McGraw-Hill, 2014, p.19)

Another interesting development, again thanks to globalisation, is the emergence of developing economies over the world economic scene. Seven firms from developing economies have entered the list of 100 largest MNCs. Firms from developing economies 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.

The enormous size confers great economic (and sometimes political) power on MNCs vis-a-vis the countries in which they operate. This power is greatly strengthened by their predominantly oligopolistic market positions, that is, the fact that they tend to operate in worldwide markets dominated by a few sellers. This situation gives them the ability to manipulate prices and profits, to collude with other firms in determining areas of control, and generally, to restrict the entry of potential competition by dominating new technologies and special skills, and through product differentiation and advertising.

It may be stated that the MNCs are not in the development business, their objective is to maximise their return on capital. This is the reason why 90 per cent of cross country capital investment goes to other rich countries and the fastest growing developing countries. MNCs seek out the best profit opportunities and are largely unconcerned with issues such as poverty, inequality and unemployment alleviation.

Historically, MNCs, especially those operating in developing nations, focused on extractive and primary industries, mainly petroleum, non-fuel minerals and plantation activities. Recently, however, manufacturing, high-tech and services have occupied an increasing share of MNC activities.

INDIA'S PRESENCE

LO 2
Identify India's presence

India's presence in global business can now be felt more than ever before. Several developments work in her favour. The country has a vast educated and skilled human resource, strong R&D base, world class IT firms, excellent track record in manufacturing sector and a vast market. Leveraging these advantages, Indian economy has registered a reasonable GDP growth rate for a long period and hopes to sustain it in future. Table 2.2 shows the extent of overseas earnings in total revenues of select Indian companies. Table 2.3 lists the major Indian MNCs.

Table 2.2 Extent of Overseas Earnings in Total Revenues of Indian Companies

Company	*Sector*	*% of foreign sales in total sales*
Infosys	IT	98
TCS	IT	88
WIPRO	IT	75
Ranbaxy	Pharma	73
Nalco	Manufacturing	59
Tata Tea	Manufacturing	62
Reliance	Manufacturing	36
Cummins India	Manufacturing	34
Arvind Mills	Textiles	41

Compared to global MNCs, Indian firms are small in size, low in visibility, and narrow in spread. However, a beginning has been made and seven companies have made it to the list of *Fortune 500*. Those seven companies include Indian Oil, Reliance Industries, Bharat Petroleum, Hindustan Petroleum, Tata Steel, Oil & Natural Gas Commission (ONGC), and State Bank of India (see Table 2.4).

GOALS OF MNCs

LO 3
List the goals of MNCs

The fundamental objective of an MNC is to earn profit and this might clash with the host government's objective of achieving better quality of life for its citizens. Such conflicts need to be resolved by the MNCs using their own initiative.

Following are the goals of MNCs and their subsidiares.

- Manufacture in those countries where it finds the greatest competitive advantage.
- Buy and sell anywhere in the world to take advantage of the most favorable price to the company.
- Take advantage, throughout the world, of changes in labour costs, productivity, trade agreements and currency fluctuations.
- Expand or contract, based on worldwide competitive advantages.

Table 2.3 Indian Companies with Global Presence

Company	*Foreign Subsidiary/Asset*	*Global Presence*	*Foreign Assets in %*
Bharti Airtel	Zain Africa BV	Africa	9.81
Crompton Greaves	Multiple	US, Europe	57.90
Glenmark Pharmaceuticals	Glenmark Genercis Inc, Servycal SA, others	US, Europe, South America	62.95
Hindalco	Novelis Inc, others	Canada	60.83
Indian Hotels	Taj Hotels Resorts and Palaces	Asia, Australia, Africa, UK, US, Middle East	39.28
Karuturi Global	Sher Agencies, Ethiopian Meadows	Kenya, Ethiopia	84.42
Motherson Sumi	Multiple	Asia, Europe, Australia, North America	64.94
Sasken Communications	Sasken Inc	Asia, Finland, Mexico, USA	61.29
Sun Pharma	Caraco Pharma, others	US, Europe, Asia	51.44
Suzlon Energy	Multiple	Australia, Europe, US, China	71.52
Tata Global Beverages	Multiple	Asia, Africa, Europe, Australia, North and South America	62.70
Tata Motors	Jaguar, Land Rover, others	Europe	54.43
Tata Steel	Corus, Millennium Steel, others	Europe, Asia	75.00
Voltas	Metrovol FZE, Saudi Ensas, others	Middle East	41.08
Wockhardt	Multiple	US, Europe	68.35

Table 2.4 Indian Companies in the Fortune 500 Hall of Fame (2008)

Country Rank	*Company*	*Global 500 Rank*	*Revenues ($ millions)*
1	Indian Oil	116	57,427
2	Reliance Industries	206	35,915
3	Bharat Petroleum	287	27,873
4	Hindustan Petroleum	290	27,718
5	Tata Steel	315	25,707
6	ONGC	335	24,032
7	State Bank of India	380	22,402

- Obtain a high and rising return on invested capital.
- Achieve greater sales.
- Hold risks within reasonable limits in relation to profits.
- Maintain and improve technological and other company strengths.
- Maintain control of important decisions.
- Encounter fewer barriers in host countries.

FUNDAMENTAL GOALS OF HOST GOVERNMENTS

LO 4
Discuss the fundamental goals of host governments

Individual countries have different goals they wish to achieve. Their differences are wider than variations of goals of individual MNCs. However, most countries, developed and less developed, want to:

- Achieve economic growth.
- Achieve full employment of people and optimum use of resources.
- Improve managerial and worker skills.
- Maintain price stability.
- Develop a favourable balance of trade.
- Achieve a more equitable distribution of income among the population.
- Retain a fair share of profits made by MNCs in their country.
- Improve technological development.
- Improve worker productivity.
- Increase local ownership of the means of production.
- Retain hegemony over the economic system.
- Control national security decisions.
- Develop and maintain social and political stability.
- Advance the quality of life of its people.
- Protect the nation's physical environment.

DEFENDERS AND CRITICS OF MNCs

LO 5
Criticise MNCs

MNCs are criticised, particularly by developing countries, on grounds like low wages, exploitation of labour, depletion of resources and abuse of human rights.

A few grey areas of globalisation were brought out in the previous chapter. Criticisms of globalisation are also comments on MNCs as the latter are the manifestations of globalisation. Nevertheless, we prefer to focus on the murky areas of MNCs separately, as we believe that the multinational companies are the actors, the complete stage being the globalisation. The stage comprises the director, artists, technicians, supporting staff and the script.

It may be recollected that the MNCs' main objective is to earn money. They are operating in any country and in any form to earn profit and not to indulge in philanthropic activities.

It may also be stated that the MNCs are not the only entities that indulge in activities unacceptable to the developing countries. Many of the domestic businesses in the respective developing countries may engage in much more harmful practices. Why, then, are MNCs singled out? It is because of their clout, the resources they command, the deep pockets they carry and the high visibility they exhibit.

In particular, developing countries nurture the following grievances against the MNCs (also see Fig. 2.2).

(i) Costly Damages Inflicted with Impunity We state only two instances to prove this criticism against MNCs. Take the case of OK Tedi, a gold and copper mine, in Papua New Guinea. The company dumped 80,000 tons of contaminated material daily, for 12 years, into the OK Tedi and Fly Rivers, as it extracted some $6 billion worth of ore. Once the mine was exhausted, the Australian - Majority ownership, after admitting that it had vastly underestimated the environmental impact, deserted the mines, leaving the local government to bear the cleaning up costs.

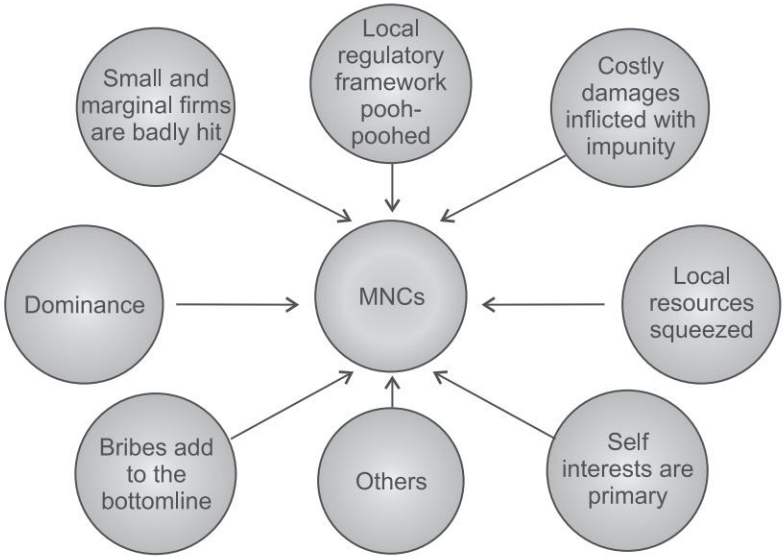


Fig. 2.2 Criticisms of MNCs

Commencing from the East India Company, anti-corporate mood has never been dissipated. Modern MNCs are portrayed as over mighty, using their wealth to subvert politicians through their campaign contributions, and lobbying for power and to evade their social responsibility.

Nearer to home, the infamous Union Carbide caused the explosion at Bhopal, killing more than 4,000 instantly and injuring 100,000 people. After a prolonged battle fought in courts, the company paid a paltry sum of $500 per victim as compensation. In contrast, BP paid huge compensation to the victims of its oil spill and that too in post hate. Compensation was paid even before the flames from the spill were doused.

The Government of India tried to prosecute the executives of Union Carbide but the United States refused to co-operate (Union Carbide was an American company). Charges against the executives were brought before an Indian court in 1991, but they did not appear before the court. India demanded their extradition, but the US State Department refused the extradition request.

(ii) Self Interests are Primary Earlier we argued that when interests of MNCs clash with the needs of host countries, the former must compromise its interests for the satisfaction of the latter. This is not happening in practice. Take the case of Coca-Cola's self-serving fights in countries where its subsidiaries are located. In Mexico, the company is trying to stop a plan to levy 20 per cent tax on soft drinks. In Costa Rica, it is battling anti-trust allegations that it entered exclusive agreements with retailers to stop competition. If found guilty, it could be fined 10 per cent of its annual sales in that country. In India, the company silenced an NGO which revealed that the soft drink contained pesticides.

Food companies entice children with sugary cereals that are bad for their teeth, auto companies campaign against public transportation and in some cases, actively remove it, regardless of its effect on the environment. Los Angeles once had the world's largest urban rail system (1,100 miles of track), until a group led by GM bought it, dismantled it and replaced it with GM buses. (See also Table 2.5.)

Table 2.5 Seven Key Disputed Issues about the Role and Impact of Multinational Corporations on Developing Countries

	Key Issues		*Sources of Dispute*
1.	International capital movements (income flows and balance of payments)	**a.**	Do they bring in much capital (saving)?
		b.	Do they improve the balance of payments?
		c.	Do they remit "excessive" profits?
		d.	Do they employ transfer pricing and disguise capital out flows?
		e.	Do they establish few linkages to the local economy?
		f.	Do they generate significant tax revenues?
2.	Displacement of indigenous production	**a.**	Do they buyout existing import-competing industries?
		b.	Do they use their competitive advantage to drive local competitors out of business?
3.	Extent of technology transfer	**a.**	Do they keep all R&D in home countries?
		b.	Do they retain monopoly power over their technology?
4.	Appropriateness of technology transfer	**a.**	Do they use only capital-intensive technologies?
		b.	Do they adapt technology to local factor endowments or leave it unchanged?
5.	Patterns of consumption	**a.**	Do they encourage inappropriate patterns of consumption through elite orientation, advertising, and superior marketing techniques?
		b.	Do they increase consumption of their products at the expense of other (perhaps more needed) goods?
6.	Social structure and stratification	**a.**	Do they develop allied local groups through higher wage payments, hiring (displacing) the best of the local entrepreneurs, and fostering elite loyalty and socialisation through pressures for conformity?
		b.	Do they foster alien values, images and life-styles incompatible with local customs and beliefs?
7.	Income distribution and dualistic development	**a.**	Do they contribute to the widening gap between rich and poor?
		b.	Do they exacerbate urban bias and widen urban-rural differentials?

(*Source:* Michael P. Todaro and Stephen C. Smith, *Economic Development*, Pearson 2003, p. 643)

(iii) Bribes Add to the Bottomline MNCs justify bribery as it adds to their bottomline. Mining and oil companies often reduce the cost of acquiring natural resources by bribing government officials for concessions. It is far cheaper to pay a government official a large bribe than to pay market price for oil or some other natural resource. In practice, companies in many industries pay bribes to get all types of favours, such as protection from outside competition which allows them to raise prices, or enables them to overlook environmental or safety regulations.

In some societies, US for example, bribing has been banned. But this has been replaced by contributions to political parties. 41 companies (including GE, Microsoft and Disney), which invested (read contributed) $150 million in political parties and campaigns for US Federal candidates between

1991 and 2001, enjoyed $55 billion in tax breaks in three years alone. Pharmaceutical firms spent $759 million to influence 1,400 concessional bills between 1998–2004; the pharmacy industry ranks first in terms of lobbying money and the number of lobbyists employed (3,000). In return, the US government has made their interests paramount in international trade negotiations. The 'big five' US accounting firms contributed $29 million to federal candidates and parties between 1989 and 2001, in order to shield themselves from threatened regulations.

(iv) Small and Marginal Firms are Worst Hit Thousands of small firms in developing countries have closed their shutters because of the competition from large MNCs (see Exhibit 2.2). Corporate giants like Wal-Mart believe in buying cheap and at such low rates that they drive small firms to bankruptcy. Much of Wal-Mart's success lies in its ability to squeeze its suppliers and workers. Its strict policy against unionisation means that its workers are often low-paid, and their low wages force down wages at competitor organisations and thus, the entire workforce is affected.

(v) The other criticisms against MNCs include-interference with economic objectives, social disruption, environmental degradation, imperialism, and technology.

Exhibit 2.2

MANY LOOMS IN BANGALORE HAVE FALLEN SILENT

The looms that once produced quality silk saris and provided livelihood to thousands of households in and around Bangalore for decades are falling silent at a rapid pace.

Unable to compete with the flooding of imitation silk saris, the traditional weaving families are moving out of the profession in search of other employment avenues.

For hundreds of weavers' families, the dreams of earning a decent livelihood have evaporated, as they are unable to sustain the onslaught of art silk, blend silk, China silk and other varieties that closely resemble a sari made of pure silk.

M.N.Hanumaraju of Cubbon Pet, a traditional weaver, today does not want his children to continue the family vocation that has been followed for centuries. He says: "I am providing my children with good education and I do not want them to struggle for livelihood like us."

Small weavers owning two or three looms are facing a crisis because they are not getting the right price for the product. "Dumping of saris made of blends and produced in Surat, as well as mill products, has killed the source of livelihood of the weavers. The weavers are also at the mercy of the traders who often pay less than the cost incurred on the product," said N.K. Gopal, another weaver.

If a pure silk sari costs around ₹ 2,500, the imitation could cost just around ₹ 500, he said.

Mr. Hanumaraju is not alone in his community who has taken the drastic decision of putting an end to the family tradition. Hundreds of weavers have sold their looms to weavers from across the border in Tamil Nadu and have started working in other professions. While some have joined garment factories that have mushroomed in Bangalore, a large number of weavers today are driving autorickshaws or working as construction labourers.

The statistics provided by the Department of Textiles has also chronicled the decline of both powerlooms and handlooms in Bangalore, which once patronised these looms for its quality. While a survey conducted in 1996 identified 8,308 handlooms in and around the city, the number had declined to 4,960 by 2005. Similarly, the number of powerlooms came down from 58,887 to around 42,030 during the same period.

Interference with Economic Objectives Interference can occur in many ways. For example, an MNC may wish to locate a plant in an area of prosperity when the host country would prefer its location in an underdeveloped region. MNC demands of local support can add to host-country expenditures for infrastructure. Since MNCs typically do their research and development at home, host countries become technologically dependent on the MNCs for innovation and invention. The MNCs have the strength to attract bank loans that otherwise might be available for local businesses.

What less developed countries need is investment in infrastructure. But MNCs are hardly known for developing this sector. A Wharton School study cites a survey of 7,500 MNCs, which showed that 84 per cent of operations initiated in the infrastucture sector during the last three years failed to meet their financial targets.

The host country may also lose control over its own economy. International businesses are guided more by worldwide needs than internal needs of the host nation. Thus, some actions may not be consistent with what is desired by the host country (Read also Exhibit 2.3).

Exhibit 2.3

COKE POURS INTO ASIA

The biggest prize and challenge is China. To woo the country of more than 1.2 billion people, the company has made unprecedented compromises.

In 1993, it entered a marriage of convenience with the Chinese government, gaining wide access to the market—but at a high cost. Coke pledged to keep its predatory instincts in check, promising to do everything from upgrading the local industry to providing cash income to farmers by starting a new line of fruit drinks.

Beijing is counting on Coke to provide its expertise in key areas from hygiene to packaging to distribution. In return, the Chinese have allowed Coke and its partners to invest $300 million to build 10 new bottling plants, giving it a total of 23 by the end of 1997.

The first fruits of the company's investment are in sight. Coke says it has grabbed 23 per cent of the soft drink value in China and figures on eventually topping 40 per cent. A new study by McKinsey & Co. says Coca-Cola is one of a handful of consumer goods companies that has a chance to hit $1 billion in sales in China by 2000, thanks to its large, systematic investment in the country.

The problem is, China is so large that Coke can't rely on its usual methods to ensure that all is well. In more developed markets, Coke bottlers distribute all of the products directly, giving the company complete control over its goods. But that's not feasible in China, where some 75 per cent of Coke products go through independent wholesalers. That means it is nearly impossible for the company to police such things as coolers, product display, and pricing. All Coke can do in most cases is ship its product out and hope for the best.

Moreover, Coke doesn't always succeed in staying out of the way of nationalist crosscurrents. In 1995, a group of National People's Congress legislators called for Beijing to restrict the expansion of Coke and Pepsi to protect local manufacturers. This legislative motion spurred an announcement last May that further approvals of soft drink plants for joint ventures would be put on hold.

Coke takes the threat of a backlash seriously. It recently subsidised a study by Cambridge University Professor Peter Nolan to defuse criticism that it wasn't helping China's economy. Nolan estimated that every job at a Coca-Cola plant leads to six additional jobs elsewhere. The company is spending heavily to build rural schools and libraries. And it has launched the line of fruit drinks even though the premi umpriced Tian yu di—'Heaven and Earth' is a flop, say Coke's sales representatives. They say that it's too sweet and too expensive for Chinese tastes. Politically, though, it's a winner, since it provides cash for local fruit growers.

Further, MNCs were invited into the country to set up greenfield projects so that additional manufacturing capacity may be created. The experience has not been encouraging. A very large amount of foreign capital has been used for acquiring local companies or merging with them, thus denying the country the benefits of new manufacturing capacity.

Social Disruption The introduction of different mores, habits, behaviour, and ethical values, new products, management styles, distribution systems, more money, and technology, do affect local ways of thinking and doing things. The introduction of blue jeans, movies, Western attitudes towards women, work habits, or automobiles, shifts cultures towards Western values. Some locals may applaud the changes while others deplore them (see Exhibit 2.4).

The ethical fabric of the society of a host country is often dented by undesirable and corrupt practices of MNCs. A report of the UN has brought to light many such practices as unfair competition and restrictive trade practices, rigging of bids, price discrimination and other forms of market distortions. They also resort to devious means to increase their profits. MNCs repatriate profits surreptitiously through transfer pricing and increase the import content of the production.

Far into the history, in the name of commerce and free trade (read MNCs) immigrants were imposed on indigenous societies. This occurred during the 19th Century in the ports of the British and Dutch sea borne cities such as Akyab (now Sitwe) and Rangoon (Yangon) in Burma, in Perong and Singapore of the Straight Settlements and in Batavia (now Jakarta) on the island of Java, cpaital of the Dutch East Indies.

Environmental Degradation Many nations are becoming more concerned about the impact of MNCs on their environment. Environmental concerns are rapidly moving higher in the chain of priorities throughout the world, including in most of the LDCs.

Exhibit 2.4

BUSINESS PROBLEMS BECAUSE OF CULTURAL DIFFERENCES

A few years back, Japanese television audiences watched as a Japanese woman's husband walked into the bathroom as she was bathing. While she told him about the new beauty soap she was using, he stroked her shoulder and hinted that he was interested in more than her soap. Many Japanese viewers were offended, feeling that the man was displaying bad manners by intruding in his wife's bath. Procter & Gamble's efforts to sell its Camay soap to Japanese consumers were set back by this advertisement. P&G had similar troubles marketing its US brand of bulky disposable diapers to Japanese buyers, who preferred cloth diapers or Japanese brands that fit Japanese babies better. When they advertised P&G laundry detergent as suitable in all temperatures of water, they discovered that many Japanese wash clothes in cold water and did not care about P&G's claim. Problems like these caused the company to lose $200 million in its first years of entering Japanese markets. In Europe, the company's liquid laundry detergent could not be used in European-made washing machines which were designed to take only powdered laundry detergent. In trying to design portable liquid dispensers to be included in P&G's detergent package, the company discovered that each brand of washing machine required a different design. Procter & Gamble's marketing staff eventually overcame these blunders encountered in entering foreign market so well that the company expected over half of its total revenues to come from foreign sales in the 1990s. The lesson was clear. Successful marketing requires a thorough knowledge of differing cultural attitudes and practices.

(*Source:* W.C. Frederick, et al., *Busines s* and *Society*, p. 130)

The track record of MNCs in this respect is shocking. In Thailand and Peru, MNCs threatened to move elsewhere if environmental regulations were enforced. In Peru, a mining company went so far as to pressure the government not to test children living near their mining operations to see if they had been exposed to health hazards. At one point, Papua Guinea passed a law making it illegal to sue international mining companies outside the country even for the enforcement of health, environmental, or legal rights, fearing that such suits would discourage investment in that country. In a perfectly competitive market a threat to leave would not be a problem; if one mining firm pulled out, others would step in. But there are large barriers to entry—the development of a mine can cost more than a billion dollars, and entails a great deal of risk. If one company leaves, another may not fill the gap—or if it does, it may demand even more unfavourable terms.

Imperialism Many of the awakening nations look on foreign managers with fear and distrust as the embodiment of an old, not easily forgotten, exploitative colonialism. Many LDCs feel relegated to the role of supplying raw materials and cheap labour because they are denied the technology to develop into industrialised nations.

MNCs and Technology The technology brought in by MNCs is hardly suitable to less developed countries. Such technology is highly capital intensive but developing countries need a labour intensive one. In addition, technology brought in by MNCs is highly expensive. The MNCs charge exorbitantly in the form of fee and royalty, which put a severe strain on the foreign exchange resources of a developing country. There are also instances of “technology dumping”, which implies that MNCs use obsolete technology with the help of turnkey projects shipped down from the principals of other countries. MNCs tend to make industries in developing countries permanently dependent on foreign expertise and technology. Take the case of Japan. If only Japan had followed a free trade policy along with free entry of US and European firms in the 50’s, there would have been no Toyota or Nissan.

(vi) Host Country Regulations Pooh-poohed MNCs often show scant respect to host countries' regulations. For them earning money is the main goal and any thing that comes in pursuing this objective is sought to be circumvented (see Exhibit 2.5).

Exhibit 2.5

THINK LOCAL AND ACT LOCAL

‘Think local, Act local’ is the first of the ‘ten commandments’ listed by Douglas N Daft, chairman and CEO of TCCC, before Christmas of 2000, in his Red Book ‘Renewing Our Promise for the 21st Century’ for senior Coke executives and heads of groups, divisions and countries across the globe. The advice appeared to have been taken too seriously as well as literally by the Coke management to drive business growth in India. Many top Coke managers interpreted the idiom as ‘when in Rome, do as the Romans do’. That seemed to have led to a lot of problems for the company in almost every part of the country, at operation centres and marketplaces, involving the Central and State governments, regulatory authorities, consumers and NGOs.

With a forward looking India going global by freeing restrictions on imports and foreign investments, lifting ceilings on executive remuneration and lowering corporate and personal income tax, the country expected global corporations operating in India to ‘think global and act local’ to ensure that they followed international practices at workplace and marketplace, manufactured standard products, respected local laws, local society, local community and acted like an ideal local company.

Unfortunately, Cokes's behaviour was contrary to expectations as it used unorthodox means to tackle troubles. It also appeared as a possible trouble maker in its attempt to pursue a two-point business objective – drive volume and make money. Actually, India has always been an ideal ground for such entrepreneurs to succeed and thrive.

Indian laws and regulations concerning industry are not often very clear, resulting in various interpretations by entrepreneurs or businesses. For most industries, there is no single point regulatory authority. The country's federal structure provides the states with a lot of legal and regulatory powers with regard to industrial regulations alongside the Union laws and regulations. The 'grass root democracy' provides power even to local village level community administration to regulate industry and business. Therefore, there exists an enormous opportunity to manipulate the system and often get away with blue murder to achieve the ultimate business goal. Business manipulation was particularly common during the rigorous control through licence, permit and tax regime.

The soft drinks industry has been an ideal sector for entrepreneurs to perform the go-as-you-like act. Why should one follow strong and highly conscientious global practices in a country where local practices are so lax and underdefined? There are at least a dozen acts and regulatory authorities that govern the soft drinks industry in India. The ministries involved at the Union and state levels include Industry, Public Health, Food Processing, Water Resources and Environment, and Consumer Affairs. All of them have their own laws and regulations of which many of the existing ones are archaic. For instance, the present Prevention of Food Adulteration (PFA) Act, which defines soft drinks (carbonated water and sweetened aerated water), is of Second World War vintage enacted by the administration of British India in 1945.

Despite the existence of such an elaborate definition, certain soft drinks brands created an impression that they contained juices because of their tastes and flavours. Therefore, one day the government came out with an order that manufacturers must ensure that they embossed the declaration 'contains no fruit' on all soft drinks bottles or containers from a specific date, allowing the industry reasonable time to implement the directive. Although the directive was several years old, Coke came in for a severe reprimand and its production and distribution units were randomly raided in 1993 with the threat to destroy tens of thousands of glass bottles which did not have the declaration printed on them. The company went to a high court to seek an injunction against such government action. There are instances of companies dodging such directives, which were issued when manufacturers followed 'local' ways to mislead consumers with wrong claims and practices.

For a long time, Indian manufacturers promoted bottled drinking water as 'mineral water'. The bulk packaged drinking water is sold in blue-tinted plastic jars instead of transparent white despite the directive against such a practice. They defend the sale of soft drinks after their expiry date for consumption by hiding behind another directive according to which the manufacturers are required to print on the bottles or containers 'best before date' or BBD in industry jargon. The BBD allows consumption of soft drinks within six months of their date of manufacture. However, the drinks could be contaminated or change colour even before this date (BBD) if kept or displayed in the sun for weeks or months. Most small retail outlets do keep them out in the sun. The manufacturers are supposed to get BBD stocks collected after the date expires and destroy them under an established protocol. Few follow this established protocol as per media reports of official raids of BBD stocks of brands like Coke would suggest.

Manufacturers always manage to strike a deal with regulatory or enforcement authorities whenever their ways are questioned or raids are conducted. Rules are bent and quality is compromised. In the end, nothing happens to the offenders and the consumers continue to suffer.

Companies are only sensitive to media reports. Negative stories, however correct they may be, must be stopped. If this is the way business operates in India, why should a company like Coke be any different? It would rather 'think local and act local' than follow global practices and go strictly by the international rule book. In 2002, the resident editor of the New Delhi edition of *The Times of India*, the country's largest English language daily, called up Coke to find out if the company was actually using defective PET bottles for their beverages, after receiving complaints from an army officer's wife. It was reported that two large coke PET bottles purchased from the Army canteen in Delhi burst inside her car while she was driving. There were similar complaints of Coke's PET bottles bursting like missiles. Apparently, some of Coke's bottling plants were using poor quality PET preforms leading to these incidents. The practice was soon stopped. The company would never attempt to do such a thing in Europe, North America or Japan. In India, any compensation demand from aggrieved consumers is immediately branded as a 'blackmail' bid. The standard response to quality complaints is that the company follows TCCC's strict quality control and inspection regime, which leaves no room for complacency and mistake. The suggestion is that it could just be another spurious Coke bottle. Yet, consumer complaints pour in from every part of the country. And, they are nearly similar-burnt cigarette butts, tiny tobacco pouches, dust, nails, earthworms and even tiny reptiles inside the company's returnable glass bottles.

At the end of 2003, there were nearly 1,000 consumer complaints against Coke pending before various consumer courts in the country. Coke has an elaborate consumer response system, but few are ready to trust and hand over such bottles, which are their only evidence, to the company to conduct tests. They would rather visit a media establishment with their exhibits and show the contaminated bottle to reporters and photographers. In more advanced countries, this would have been regarded as a criminal offence and led to prosecution of top management personnel for slapping exemplary damages on the manufacturers. In India, the practice is to offer some free samples of drinks to complainants. If they refuse to accept, they are branded as ransom seekers.

The purposes of globalisation is to import global technologies and the best manufacturing practices to make the Indian industry efficient, price and quality competitive in the global market. The actions of companies like Coke should force the authorities to think twice before clearing FDI proposals in sectors that concern public health and environment. Coke and Pepsi's involvement in reckless painting of eco-sensitive Himalayan rocks along River Beas, near the picturesque Rohtang Pass was described as a 'Rape of the Rock' by a national English daily, *The Indian Express*, which ran a campaign against the wrongdoings of the two MNCs and more so by Coke. The Solicitor General of India himself filed *amicus curiae* before the Supreme Court. The two companies along with others were made to deposit large sums with a court appointed body for restoration of the site. Ironically, the Chief Justice of the Supreme Court, who admitted the case, later sat on Coca-Cola India's first advisory board, created to deal with such controversies to lead the company's environment council.

(Source: Nantoo Banerjee, *The Real Thing – Cokes's Bumpy Road Through India*, Front Page, 2009, pp. 55–59)

Not only are local regulations undermined, local communities are weakened too. MNCs eliminate small businesses which are backbone of a community. Just as markets and governments are essential for economic development, so are communities which are the real pillars of any country's development. Communities promote economic development with the help of government and non-governmental agencies.

World Bank studies have highlighted the importance of community involvement in making its projects successful. The Bank now has a programme that allocates $25,000 grants to communities to spend as they wish. MNCs weaken such local communities and in the long run weaken economic development also.

(vii) Local Resources Squeezed Natural resources are unevenly distributed all over the world. While poor and developing countries are richly endowed with natural resources, Western countries are devoid of them. The West is obviously depending upon the developing countries for the supply of natural resources. Infact, the exploitation of natural resources is an important part of globalisation. But what is at stake is the plight of the developing countries. Their resources are over exploited, ecology is disrupted and under ground water resources are dried up (see Exhibit 2.6). Future generations of developing countries will have no water to drink, no greenery to watch and no rainfall to get drenched.

Exhibit 2.6

WATER THIEF

Kerala gets the highest rainfall in the country. It receives two monsoons—summer and winter—every year. No other Indian state is so lucky with rains. But, the state's environmental groups would rather allow the rainwater to flow down into the sea rather than use it to generate hydroelectric power as that could destroy rainforests, flora and fauna. Some 30 years ago, the government planned to set up a giant hydroelectric power project that would harness this heavy flow of rainwater. Popularly known as the 'Silent Valley Project', it was meant to export electricity to neighbouring power and water-starved states like Tamil Nadu and Karnataka. But it never saw the light of the day in the face of strong resistance from environmental groups and their persistent legal action. If Coke had done its homework well, it would have avoided Plachimada..

It was a huge mistake. Coke soon found itself locked in a bitter battle with Plachimada's 'water warriors'. The recriminations flew between the village Panchayat (a local self-government), a symbol of India's grass root democracy and Coke, and threw up several basic questions. Firstly, what was the social and economic utility of water guzzlers like Coke in a country precariously short for freshwater resource? Next, should there be a strong regulatory framework to discipline water-based non-essential industries like soft drinks and monitor their menacing operations in water-starved locations? Should India encourage companies like Coke to indulge in reckless commercial exploitation of groundwater, depriving millions of people of their right to clean drinking water? India faces a massive shortage of clean potable water for its people; it is a universal problem faced by mega-cities like Delhi, Mumbai and Chennai as well as several hundreds of thousands of villages like Kerala's Plachimada.

There have been several geophysical studies on the earth's proven reserves of freshwater. Coke's own study of global 'water situation' says that by 2025, two thirds of humanity is likely to suffer from a moderate to severe shortage of water. It says that in India, the per capita water availability is only 1,967 cubic metres as against 10,230 cubic metres in the USA. The 'stress factor' applies when the per capita water supplies drop below 1,700 cubic metres. With 2.45 percent of the earth's land mass and over 17 percent of its population, India accounts for only 4 percent of the earth's freshwater resources. By 2025, the freshwater availability in India per head will fall to 1,600 cubic metres.

In such circumstances, it may be interesting to assess the future of water guzzling companies like Coke and how they can avoid compounding the misery of the country's teeming millions, who are thirsty and unclean for want of water. How many people consume soft drinks in India? According to the industry, it is close to 200 million or less than 20 percent of its total population. A production of 550 million cases of carbonated water by Coke and Pepsi in 2004 would mean the production of over 3,000 million litres of soft drinks. Going by Coke's claim that it consumes 4 litres of water to make 1 litre of soft drinks, this means that the two soft drinks makers would have consumed 12,000 million litres of freshwater during 2004. Coke's soft drinks business grew at a phenomenal rate of 27 percent in 2002. Inclusive of its bottled drinking water, the business growth that year was nearly 40 percent. Despite the pesticides controversy, Coke's volume growth in 2003 was claimed to be 22 percent. The bottled water business is fast catching up with the soft drinks business in India. The size of the bottled water business (retail packs) in 2001 was estimated at 185 million unit cases or 1,052 million litres. This business is growing at an exponential rate of 40–50 percent a year. The introduction of highly popular bulk packs of bottled water, each containing 20 to 25 litres, for in-home as well as institutional consumption will further boost the business in the coming years. It is no wonder that Coke's Indian operations have come under increasing attack from local communities, especially around its plants that have been accused of exploiting millions of litres of groundwater everyday and fouling the environment as well.

(*Source:* Ninto Banerjee, op. cit., pp. 129–131)

(viii) Dominance MNC's tend to acquire enormous clout economically in the host countries. 'Power corrupts', goes the saying, and MNCs are no exception. Host countries are forced to depend on MNCs for jobs, goods and services and cultural values and practices. The role of MNCs may even extend to host country's politics. MNCs seek to influence local government policies and regulations and change them to suit their own businesses.

Probably, the way the East India Company (the first MNC in the world) conducted itself reveals the extent of dominance of an MNC. The company's growing involvement in Indian politics is infuriating. How could the company justify having a monopoly of trade as well as the right to tax Indians? How could a commercial enterprise justify ruling 90 million Indians, controlling 70 million acres (2,43,000 sq km) of land, issuing its own coins completely with the company crest, and supporting an army of 2,00,000 men, all of which the East India Company did by the year 1800? Adam Smith denounced the Company as a blood-stained monopoly: "burdensome", "useless" and responsible for grotesque massacres in Bengal. Anti-Company opinion hardened further in 1770 when a famine wiped out a third of the population of Bengal, reducing local productivity, depressing the Company's business and eventually forcing it to go begging to the British government to avoid bankruptcy. (Also recollect the opening case).

Ever since its collapse, the East India Company has been treated as an historical curiosity—an "anomaly without parallel in the history of the world." Regrettably, these days similar strange creatures are surfacing everywhere. The Chinese state-owned enterprises, for example, are betraying such symptoms. They account for some of the biggest recent flotations in the Hong Kong Stock Exchange. There are also some of the few business organiations brave enough to tread in Sudan. Such organisations are in business only for the sake of business. But they are no different from the East India Company. This trend calls for caution.

IN DEFENCE OF MNCs

LO 6
Argue in defence of MNCs

MNCs have played a significant role in the development of poor countries. Be it transfer of technology, introducing best management practices, help in improving productivity, making local people become competitive or improving the quality of life of people, the contribution of MNCs has been praiseworthy. Specifically, the contribution of MNCs to developing countries has been on the following lines.

- Provide employment.
- Train managers.
- Provide products and services that raise the standard of living.
- Introduce and develop new technical skills.
- Introduce new managerial techniques.
- Provide greater access to international markets.
- Raise the gross national product.
- Increase productivity.
- Help build foreign exchange reserves.
- Encourage the development and spin-off of new industries.
- Assume investment risk that might not otherwise be undertaken.
- Mobilise capital for productive purposes from less productive uses.

Naturally, MNC managers and their defenders respond that many of the criticisms of their behaviour are only partially true at best and outright false at worst. Despite their alleged shortcomings, they say, MNCs significantly help host governments achieve their national aims.

HOW CAN MNCs BECOME ACCEPTABLE?

LO 7
Design how MNCs can become acceptable

Can we live without the MNCs? The answer is an emphatic 'NO'. We need to depend on them for our economic growth. Obviously, many of the evils associated with the MNCs need to be shed and more constructive role should be assigned to them. Here are a few action plans that would help MNCs across the globe become acceptable to all sections of societies.

Corporate Social Responsibility (CSR)

Chapter 23 contains more details on CSR. It is adequate to say that MNCs need to reach out to the needy through social actions and not to be profit-motivated all the time. Doing good for the society is also good business, and doing bad entails expensive legal suits. Doing bad dents the image too. Where the corporate sector fails to undertake social actions voluntarily, CSR can be made mandatory.

Limiting the power of MNCs

As stated earlier, MNCs wield power but they seek to enrich it through squelching competition, cartelling to hike prices or buying up potential competitors. Where competition is minimal or non-existent, the potential for abuse grows much worse.

With the advent of globalisation and globally traded commodities, monopolies and cartels have also become global in scope. Globalisation has unleashed a new potential for anti-competitive behaviour that may be harder both to detect and curtail.

How to break global monopolies? We need to have global competition law. We also need global competition authority to enforce the law.

Improving Corporate Governance

Corporate governance is the overall control of a company's activities. It is concerned with the formulation of long-term objectives, strategies and plans and a proper management structure to realise them. Some major features of corporate governance include the following:

- It helps ensure that an adequate and appropriate system of control operates within a company so that its assets can be safeguarded.
- It prevents any single individual exercising undue power.
- It is concerned with the relationship between a company's management, the board of directors, shareholders, and other stakeholders.
- It seeks to ensure that the company is managed in the best interests of the shareholders and other stakeholders.
- It tries to encourage both transparency and accountability, which investors are increasingly looking for in the functioning of an organisation.

Who should be made accountable for any wrongdoing in a company's functioning? Obviously, the answer is the executives. Executives should be held personally responsible for their actions, making it difficult for them to hide behind the veil of their corporations. An interesting example is what happened post-WorldCom bust. The board of directors agreed to provide some compensation to investors who had lost as a result of WorldCom's misrepresentations.

Besides punitive actions against executives of a failed corporation, there are other mechanisms to ensure good corporate governance. The Indian regulatory mechanism is worth recollecting in this context. We have the Companies Act and the SEBI Act, which mandate good practices on companies operating in India. In addition, statutory audit, code of conduct, independent-director-members, company disclosures and the like seek to enforce good conduct on companies.

Minimising the Scope for Corruption

Rich countries talk eloquently about the need for honest business practices and may even enact legislations for the purpose. Powerful MNCs may draft high-sounding codes of conduct and exhibit them to the public. But most of the MNCs do not follow them strictly. Bribes paid by the multinational corporations run into billions of dollars (Read Chapter 23 for more details). The US Commerce Department has estimated that during 1995–98, foreign firms paid bribes of around $80 billion to officials in other countries. The recent Volcker Report commissioned by the UN lists over 2000 companies from 66 countries that paid bribes to Saddam Hussain, the late Iraqui dictator, in the $64 billion oil-for-food programme. And, as we stated in the previous chapter, for every one dollar of aid money over the table, the West gets back $10 under the table.

Thus, corruption is common, but should not be allowed to exist. It has debilitating effects all round. Corruption stalls development, undermines social progress, demoralises the confidence of citizens in the fairness and impartiality of public administration, impedes good governance, erodes the rule of law, distorts competition in business, discourages domestic and FDI, fosters a black market economy, and raises new security threats.

Obviously, steps should be taken to eradicate bribe-giving practices. Every government needs to enact a Foreign Corrupt Practices Act, and penalties should be imposed on those who fail to legislate or enforce such laws. Bribery should be viewed as an unfair competitive practice and, just like any other unfair competitive practice outlawed under WTO rules, be subject to sanctions.

Banks add to the problem of corruption by providing safe haven for ill-gotten gains. Money accumulated by dodging laws and avoiding taxes is deposited in such banks. International community must wake up and come out with rules against such bank secrecy.

Summary

- MNCs are business enterprises that conduct businesses across borders. They are the most active players in global business. Infact, MNCs are held synonym with international business. (LO1)
- India is gradually becoming a home for MNCs. Seven of the large Indian companies are listed in the Fortune 500 list. (LO2)
- MNCs have their own goals which often conflict with those of host countries. (LO3)
- Governments that host MNCs seek their cooperation to achieve growth. (LO4)
- MNCs are criticised mainly by developing countries. (LO5)
- MNCs are not demons as they are made out to be. They have benefited host countries immensely. (LO6)
- MNCs can be made more acceptable if they, among other things, improve their governance. (LO7)

Review Questions

1. What is an MNC? What are its salient features? (LO1)
2. Why have MNCs been criticised by developing countries? (LO5)
3. What is the contribution of MNCs towards the development of developing countries? (LO6)

Discussion Questions

1. Which is more important for MNCs, self interest or host government's economic interest? Discuss. (LO3 and LO4)

2. What lessons have you been able to learn from the opening case and the chapter-end cases? (LO1 to LO7)

Reinforcing Excercises

- Turkey is an Islamic country and has been lobbying the EU to allow it to join the free trade block. Many EU countries oppose the lobby on the ground that Western capitalism and Islam do not jell and if admitted, there would be cultural backlash between EU members and Turkey. But unlike other Islamic countries, Turkey is known for its entrepreneurial spirit, export potential and progressive government. Local business leaders attribute the success of companies in Turkey to the tenets of Islam. They point out that the prophet Mohammad was himself a trader and encouraged others to take up trading and business activities.

  Globalisation has converted many Turkish people, who once eschewed making money in favour of focussing on religion, are now becoming rich by becoming successful businessmen. Hypothesising that Turkey would join EU, how would Western MNCs resolve clashes?

- In 2006, Hutchison Essar Ltd., (HEL) had, along with its Indian subsidiaries, held licences for providing cellular services in 23 telecom circles in India. 67% of HEL's shares were held by Hutchison Telecommunications International Ltd., (HTIL) and the rest by the Essar Group of Companies.

  Vodafone, a British firm, acquired in 2007 controlling interest in HEL through share purchase from HTIL. The stake involved is $11.1bn.

  The Indian revenue authorities alleged that Vodafone failed to withhold income tax on the payment of consideration made to HTIL and, hence, sought to assess tax and issued a notice to Vodafone accordingly. The revenue authorities were justified in their allegation against Vodafone as the transaction took place on the Indian soil and the income generated here was subject to taxation.

  Vodafone challenged the notice before the Bombay High Court and the ease was decided against it. Vodafone then filed a petition before the Supreme Court and the apex court dismissed the petition and directed the revenue authorities to decide whether they had the jurisdiction to tax the share purchase by Vodafone.

  Bring out the issues involved for an MNC and a developing country.

- BP, one of the world's largest oil companies, has invested heavily in developing countries. In Algeria, the oil major has been investing in a major project to develop gas fields near the desert town of Salah. When the company noticed the lack of clear water in Salah, it built two desalinations plants to provide drinking water to 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 the social investment, but the company believes it is normally obliged to use its power in constructive ways. The action, though a small thing for BP, is a very important thing for the local community. Is BP's action a PR exercise or a genuine concern for poor countries?

CLOSING CASE

At the Receiving End!

Spread over 121 countries with 30,000 restaurants, and serving 46 million customers each day with the help of more than 19,05,000 employees, and revenue of $27.6 bn, the reach of McDonald's is amazing. It all started in 1948 when two brothers, Richard and Maurice 'Mac' McDonald, built several hamburger stands, with golden arches in southern California. One day a travelling salesman, Ray Kroc, came to sell milkshake mixers. The popularity of their $0.15 hamburgers impressed him, so he bought the world franchise rights from them and spread the golden arches around the globe.

McDonald's depends on its overseas restaurants for revenue. In fact, 60 per cent of its revenues are generated outside of the United States. The key to the company's success is its ability to standardise the formula of quality, service, cleanliness and value, and apply it everywhere.

The company, well known for its golden arches, is not the world's largest company. Its systemwide sales are only about one-fifth of Exxon Mobil or Wal-Mart stores. However, it owns one of the world's best known brands, and the golden arches are familiar to more people than the Christian cross. This prominence, and its conquest of global markets, makes the company a focal point for inquiry and criticism.

McDonald's is a frequent target of criticism by anti-globalisation protesters. In France, a pipe-smoking sheep farmer named Jose Bove shot to fame by leading a campaign against the fast-food chain. McDonald's is a symbol of American trade hegemony and economic globalisation. Jose Bove organised fellow sheep farmers in France, and the group led by him drove tractors to the construction site of a new McDonald's restaurant and ransacked it. Bove was jailed for 20 days, and almost overnight an international anti-globalisation star was borne. Bove, who resembles the irreverent French comic book hero Asterix, travelled to Seattle in 1999, as part of the French delegation to lead the protest against commercialisation of food crops promoted by the WTO. Food, according to him, is too vital a part of life to be trusted to the vagaries of the world trade. In Seattle, he led a demonstration in which some ski-masked protestors trashed at McDonald's. As Bove explained, his movement was for small farmers against industrial farming, brought about by globalisation. For them, McDonald's was a symbol of globalisation, implying the standardisation of food through industrial farming. If this was allowed to go on, he said, there would no longer be need for farmers. "For us," he declared, "McDonald's is a symbol of what WTO and the big companies want to do with the world." Ironically, for all of Bove's fulminations against McDonald's, the fast food chain counts its French operations among its most profitable in 121 countries. As employer of about 35,000 workers, in 2006, McDonald's was also one of France's biggest foreign employers.

Bove's and his followers are not the only critics of McDonald's. Leftists, anarchists, nationalists, farmers, labour unions, environmentalists, consumer advocates, protectors of animal rights, religious orders and intellectuals are equally critical of the fast food chain. For these and others, McDonald's represents an evil America. Within hours after US bombers began to pound Afghanistan in 2001, angry Pakistanis damaged McDonald's restaurants in Islamabad and an Indonesian mob burned an American flag.

McDonald's entered India in the late 1990s. On its entry, the company encountered a unique situation. Majority of the Indians did not eat beef but the company's preparations contained cow's meat. Nor could the company use pork as Muslims were against eating it. This left chicken and mutton. McDonald's came out with 'Maharaja Mac', which is made from mutton and 'McAloo Tikki Burger' with chicken potato as the main input. Food items were segregated into vegetarian and non-vegetarian categories.

Though it worked for sometime, this arrangement did not last long. In 2001, three Indian businessmen settled in Seattle sued McDonald's for fraudulently concealing the existence of beef in its French fries. The company admitted its guilt of mixing miniscule quantity of beef extract in the oil. The company settled the suit for $10 million and tendered an apology too. Further, the company pledged to label the ingredients of its food items, and to find a substitute for the beef extract used in its oil.

McDonald's cup of woes is never dry. Criticisms of the MNC have been a common feature of the past three decades. Nowhere has this been more evident than Europe, where McDonald's became the *bete noir* of environmentalists and social justice campaigners in the 1980s and 1990s. Not only did the company gain the distinction of being the subject of England's largest ever trial (McLibel case) but anti-globalisation campaigners all over targeted the company with store occupations and assaults. More recently, nutritionists and healthy eating campaigners roundly criticised the company for its standards fare of high calorie burgers and fries that many saw as a major cause of obesity rates, especially among young people. With a loss of market share to apparently healthier offerings, and government's pushing for increasing regulation of fast food for advertising to children, McDonald's reached a crisis that saw its attempts to fight back in the mid 2000s. In came with healthy options, such as fresh salads and fruits, as well as sports campaigns for young people, and enhanced nutritional labelling. The strategy brought some cheers to the company.

However, despite the apparent success of the McDonald's turnaround in Europe, many of the same threats have reverted to haunt the company in Asia. With increasing prosperity in emerging economies such as India and China, the demand for eating out and for a whole range of convenience foods has expanded widely in recent years. In both India and China, the market for eating out now exceeds $120 billions a year, much of it in fast food restaurants, with further growth predicted in Asia. Capitalising on this trend, McDonald's has plans to open more restaurants in China in the days to come. But eating habits are changing, so too are health problems. Rates of obesity in China have doubled in the last ten years, and even though only a few decades ago famine was a common threat, the company is now said to be facing an ongoing obesity problem. Other diet-related problems such as diabetes and heart disease are also on the rise.

McDonald's succeeded in spreading American culture in the East Asian countries. In Hong Kong and Taiwan, the company's clean restrooms and kitchens set a new standard that elevated expectations throughout those countries. In Hong Kong, children's birthdays had traditionally gone unrecognised, but McDonald's introduced the practice of birthday parties in its restaurants, and now such parties have become popular among the public. A journalist set forth a 'Golden Arches Theory of Conflict Prevention' based on the notion that countries with McDonald's restaurants do not go to war with each other. A British magazine, *The Economist*, prints an yearly 'Big Mac Index' that uses the price of a Big Mac in different foreign currencies to assess exchange rate distortions.

Questions

1. What lessons can other MNCs learn from the experience of McDonald's?

2. Aware of the food habits of Indians, why did McDonald's err in mixing beef extract in the oil used for fries?

3. How far has McDonald's succeeded in strategising and meeting local cultures and needs?

4. How does the company cope with the threat from Asia?

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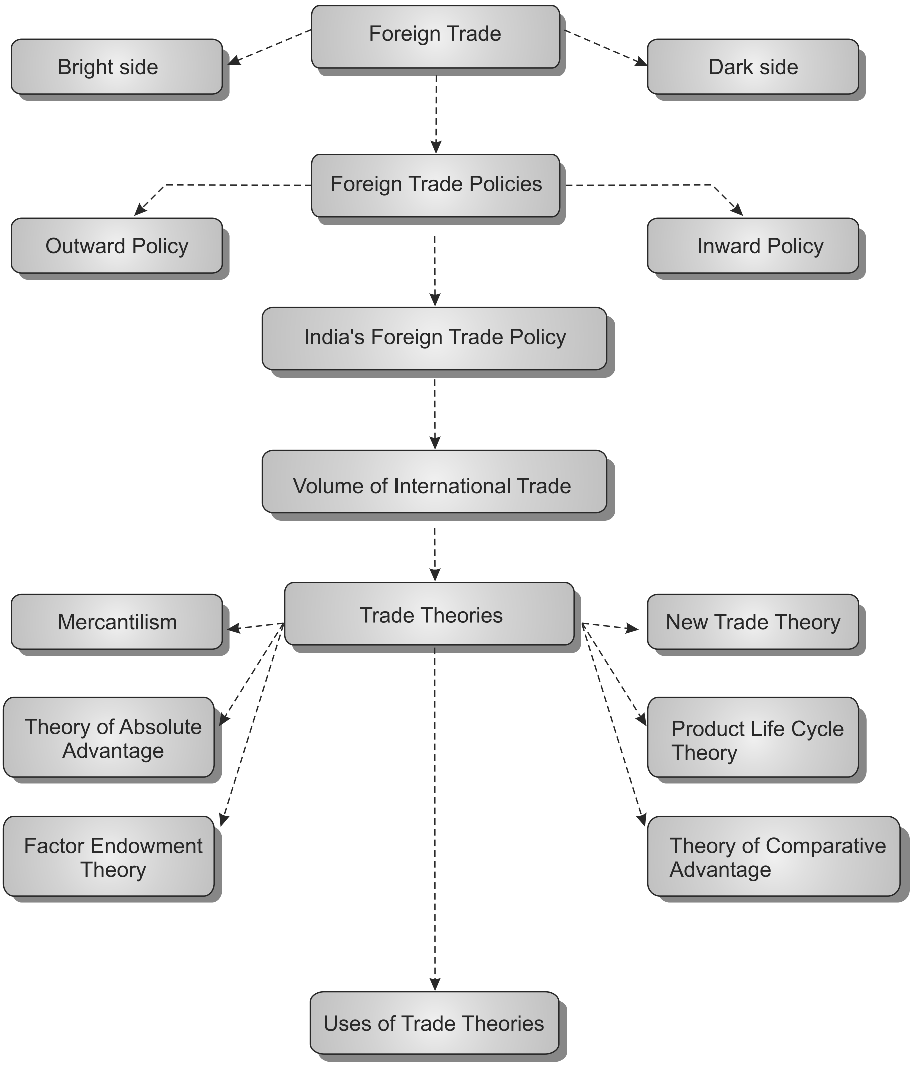
CHAPTER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Theory of Absolute Advantage
Product Life Cycle Theory
Factor Endowment Theory
Theory of Comparative Advantage
Uses of Trade Theories

3

Global Trade and its Theories

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Recognise the benefits of foreign trade
- **LO 2:** Identify different forms of foreign trade policies
- **LO 3:** Relate to India's foreign trade policy
- **LO 4:** Outline the volume of international trade
- **LO 5:** Discuss different trade theories
- **LO 6:** Estimate the usefulness of trade theories

Opening Case

Absolute Advantage

Started in a small house in a scanty street of Calcutta (now Kolkata) in 1884, Dabur India has spread far and wide and has raked in a revenue of ₹ 7,073 cr (2012) and has a whopping market capitalisation of more than ₹ 25,000 cr, ₹ 30% of the revenue comes from 60 overseas markets. If Tata Motors, Reliance, TCS, Reddy Labs, and Infosys have become Indian MNCs there is no surprise. These and others are into sunrise industries and access to state-of-the-art technology. DaburIndia becoming an MNC is unique. This is a company which specialises in production and supply of products that are churned out of ayurvedic system which is rooted in Indian tradition. Brands of the company are not catchy and jingly, are un-pronounceable and are tinged with Hindu religion. Yet they are darlings in the Middle East, Egypt, Nigeria, Pakistan and Bangladesh, which are Muslim majoritarian countries. Take a look at the product portfolio of the company:

- Master brands:

  Dabur – Ayurvedic healthcare products

  Vatika – Premium hair care

  Hajmola – Tasty digestives

  Real – Fruit juices beverages

  Fem – Fairness bleaches and skin care products

- **12 Billion-Rupee brands: Dabur Amla, Dabur Chyawanprash, Vatika, Real, Dabur Red Toothpaste, Dabur Lal Dant Manjan, Babool, Hajmola, Dabur Honey, Glucose, Fem and Odonil.**
- Strategic positioning of **Honey** as food product, leading to market leadership (over 75%) is branded honey market.
- Dabur Chyawanprash the largest selling ayurvedic medicine with over 65% market share.
- **Vatika** has been the **fastest growing hair care brand in the Middle East.**
- Hajmola tablets command 60% market share of digestive tablets category. About **2.5 crore Hajmola tablets are consumed in India everyday.**
- Leader in herbal digestives with 90% market share.
- **Consumer Health Division** (CHD) offers a range of classical ayurvedic medicines and ayurvedic OTC products that deliver the age-old benefits of ayurveda in modern ready-to-use formats.
- Has more than 300 products sold through prescriptions as well as over the counter.
- Major categories in traditional formulations include:
  –Asav Arishtas
  –Ras Rasayanas
  –Churnas
  –Medicated oils
- Proprietary ayurvedic medicines developed by Dabur include:
  –Nature care Isabgol
  –Madhuvaani
  –Trifgol

Started as a small and family owned business, Dabur has transformed itself into a public, professionally managed and global company. Nuances of the company's professional management put any blue chip company anywhere into shame. The company has vision, mission and value statements. CSR activities of Dabur are envious. They include the following:

1. Eradicating hunger, poverty and malnutrition
2. Promoting healthcare including preventive healthcare
3. Ensuring environmental sustainability and ecological balance
4. Employment and livelihood enhancing vocational skills and projects
5. Promotion of education especially among children and women
6. Promoting gender equality and empowering women
7. Contribution or funds provided to technology incubators
8. Rural development projects
9. Other activities
   - Promotion of sports with special focus on training for rural sports, nationally recognised sports, paralympics and olympic sports.
   - Welfare for differently disabled persons.
   - Setting up public libraries.
   - Reducing inequalities faced by the socially and economically backward groups.
   - Protection of national heritage, art, culture and handicraft; restoration of buildings and sites of historical importance and work of art.
   - Welfare of armed forces personnel, war widows and their dependants.

Dabur has a competitive edge stemming from several factors. First, its raw materials include mainly herbal products which are less costly. Second, manufacturing and distributing are highly localised. This enables the company to exercise strict control over quality and cost. Third, no competition worth the name in India or abroad. Fourth, unlike other pharmaceutical companies, Dabur is not in a rat race to capture markets. Fifth, history of 130 years behind has enabled Dabur to learn from mistakes, forget and forgive lapses, build human capital and grow in wisdom and maturity.

Dabur India was established by a great philanthropist and visionary – Dr. S.K. Burman. Over the years, the word Doctor became "Datkar" and together with Burman gave birth to Dabur.

BEFORE describing the trade theories, it is useful to understand the importance of international trade and policies of foreign trade.

BENEFITS OF FOREIGN TRADE

LO 1
Recognise the benefits of foreign Trade

Foreign trade is as old as history. Trade among countries is natural and desirable. It exists for different reasons, as the theories explained later will explain. The fact remains that the natural resources of the earth are unevenly distributed. One country possesses product X in surplus and lacks in respect of product Y. In another country the reverse may be true. Countries also differ in their preferences and technologies, scale economies, economic and social institutions, and capacities for growth and development. All these account for ever growing foreign trade.

Whatever the reasons for the existence of foreign trade, there is no gainsaying the fact that external trade is significant for the economic development of countries, particularly the developing ones. It provides the urge to develop the knowledge and experience that makes development possible, and the means to accomplish it. An economy which has decided to embark on a programme of development is required to extend its productive capacity at a fast rate. For this, imports of machinery and equipment, which cannot be produced in the initial stages at home, are essential. Such imports which either help create new capacity in some lines of production or enlarge capacity in the other lines of production are called developmental imports. For instance, imports required for the setting up of steel plants, locomotives, and hydro-electric projects are developmental imports. Second, a developing country which sets in motion the process of industrialisation at home requires the imports of raw materials and intermediate goods so as to properly utilise the capacity created in the country. Imports which are made in order to make full use of the productive capacity are called 'maintenance imports'. These imports are vital for a developing economy as many of the industrial projects are also held up for lack of maintenance imports. For a developing economy, developmental and maintenance imports set limits to the extent of industrialisation which can be carried out in a given period. Besides these imports, a developing economy is also required to import consumer goods which are in short supply at home during industrialisation. Such imports are anti-inflationary because they reduce the scarcity of consumer goods. One example of such imports is the foodgrains imports by India in the post-Independence period which helped arrest the rise of prices at home.

It is, therefore, inevitable that during the early years of development, imports have to be increased at a very fast rate. It is natural that the balance of trade in such a situation will turn heavily against the developing countries. This necessitates the increase of exports. External assistance can help share the burden of growth in the short run, but in the long period, the developing country has to bear the burden of development itself. To meet the growing foreign debt in view of inelastic imports, a developing country must increase its exports.

The influx of foreign goods into the country and along with them the flow of technology, the skills, speed and feed of production, the tastes and experiences will have considerable influence on domestic production, marketing, lifestyles, and standard of living of people. In order to pay for imports and to service earlier borrowings, developing countries have to export their goods and services. This is a challenging task; a challenge in terms of upgrading technology, increasing productivity, reducing costs, and improving the quality of goods and services to meet international challenges. The challenge compels these countries to shed their ennui, spruce up and develop fast to survive in the global business scenario.

Thus, international trade sets in a chain of events which help transform the less developed economies into developed ones. This was the reason why G. Heberler remarked that "My overall conclusion is that international trade has made a tremendous contribution to the development of less developed countries in the 19^{th} and 20^{th} centuries and can be expected to make an equally big contribution in the future".

In the nearly five thousand years since humans began to exchange obsidian and clothes, the number of traders and the variety of goods they ship across borders have grown spectacularly. From Assyrian Pusu-ken to Jewish Abraham Yiju, from Torne Pires to Jean de la Roque and from Steve Jobs to Narayana Murthy, merchants have continuously expanded their wares, reached wider markets and integrated the world. The urge for profit has led them to seek faster and higher capacity transportation, and rapid and accurate means of payment. The rise of personal computers with ever-accelerating processing power, combined with the warp speed of fibre-optic telecommunications, effectively eliminated distance, laying the foundation for a new type of business and industry in which geography was no longer a factor. Thousands of e-commerce sites, from Amazon to Travelocity, mushroomed to cater to customers who preferred to shop for books, electronics and even holiday packages from the comfort of their own homes and offices. A new derivation of a quintessentially 'old' business was born in 1995 with eBay, the global Internet flea market. Like their bazaar merchant ancestors, ordinary people could now sell their used appliances, vintage movie posters and trinkets to a globally inter-linked community of potential highest bidders. The introduction of the online payment system Pay Pal as an intermediary between the bank and the vendor meant that anyone, anywhere in the world with a bank or credit card account could make a bid for an old book or a camera that you were ready to discard.

The other benefits of international trade include: enhanced domestic competitiveness, access to overseas markets, reduced dependence on existing markets, stabilised seasonal market fluctuations, and overall growth of the economy.

Not that foreign trade is always beneficial to a given country. There are potential problems. Disadvantages from overseas trade include: modifications in product and packaging to suit overseas markets, added costs, delay in getting payments, preference for foreign markets at the cost of domestic markets, and tough competition.

FOREIGN TRADE POLICIES

LO 2
Identify different forms of foreign trade policies

A foreign trade policy refers to a set of rules, procedures and regulations that govern a country's trade with other countries. Exports, imports, tariffs, quotas, inspections, product safety, agreements, treaties, conventions and the like form part of a country's trade policy. The purpose of a trade policy is to smoothen a country's trade. No surprise, every country will have its own trade policy. Trade policies can be free trade, fair trade, inward trade or outward oriented. **Free trade** implies that the government of the land exerts minimal influence on decisions relating to exports or imports made by private individuals and businesses. Dovetailing with 'outward' trade policy, promotion of free trade is the main plank of the WTO.

Fair trade, also called **managed trade**, suggests that the government of the land should actively intervene and ensure that exports from the own country receive a fair share in the global trade and that imports are controlled so as to minimise losses of domestic jobs and market share in specific industries. Fair trade orientation corresponds with the inward trade policy.

Outward-oriented Policies

There are proponents for both the approaches. Outward trade policy (read free trade) is supported on the following grounds:

1. Free Trade Promotes World Trade Increased world trade benefits all the participating countries. World business promotes competition. In a competitive environment, countries specialise and export those goods in which they have comparative advantage and import products that they produce less efficiently than other nations. This benefits buyers and consumers in the form of availability of quality goods and services at reasonable prices.

2. The Economic Interdependence among Countries makes Countries Engage Less in Conflicts One reason why the European Economic Community was formed after World War II was that countries with economic interdependence were less likely to enter conflicts. But the problem is that commercial disputes have taken place of military rivalries as forums for country-based competition.

3. Uneven Distribution of Resources makes Trade Inevitable Concentration of resources such as oil in the Middle East, timber in South America and Asia or gold and diamonds in South Africa, make trade among countries inevitable. The majority of suppliers of commodities worldwide are the developing countries. Benefits of world trade in commodities have not been passed on to their provides, as prices of oil, timber, onions, tomatoes and the like have not kept pace with global inflation. Efforts to increase prices of commodities such as oil have generally been resisted by developed countries as inflationary.

Worse, prices of some of the commodities have been falling. Some African countries, for example, Benin, Mali, Niger, Sudan, and Uganda continue to receive 3% or less of their merchandise export earnings from the manufacturers.

4. World Trade Encourages Efficient use of Global Resources Competition forces countries to concentrate on industries in which they are competitive. Developing countries, for example, can concentrate on labour-intensive industries whereas rich countries can focus on activities which require high skills.

5. Global Competition Forces Companies to become more Efficient and Innovative Many of the management philosophies and techniques of the 1990s have been transferred across countries by MNCs in their quest to attain competitive advantages. BPRE, TQM, JIT and lean manufacturing are only a few examples cited in this context.

6. World Trade has Created Awareness Global media give instantaneous news coverage worldwide, educating citizens of different countries and broadening their appreciation of foreign markets. Similarly, increased product varieties educate consumers about labour-saving devices and alternative consumption styles.

7. Exports Create Jobs Exports create jobs. It has been estimated that during 1970s for every one billion dollar worth of exports, 20,000 jobs were created. The corresponding figure in 1990s is 7,000 jobs. For countries like Japan, a $100 billion trade surplus means about 700,000 additional jobs.

Inward-oriented Policies

An inward-oriented strategy, usually, means overt protection. What is less obvious is that sheltering domestic industries puts exports at a great disadvantage because it raises the cost of the foreign inputs used in their production. Moreover, an increase in the relative costs of domestic inputs may also occur through inflation or because of appreciation of the exchange rate as import restrictions are introduced. However, inward trade policy has its own justification as explained latter in this chapter.

In practice, the distinction between inward-looking and outward-looking approaches gets blurred. Most of the less developed countries have employed both strategies with different degrees of emphasis at one time or another. For example, in the 1950s and 1960s, the inward-looking industrialisation strategies of the larger Latin Americans and Asian countries such as Chile, Peru, Argentina, India, Pakistan, and the Philippines were heavily import substitution-oriented. By the end of the 1960s, some of the key sub-Saharan African countries like Nigeria, Ethiopia, Ghana, and Zambia began to pursue import substitution strategies and some smaller Latin American and Asian countries also followed suit. However, since the mid 1970s, the export promotion strategy has been increasingly adopted by a growing number of countries. The early followers of export promotion strategy—South Korea, Taiwan, Singapore, and Hong Kong—were joined by Brazil, Chile, Thailand, and Turkey which switched from import substitution approach.

Barriers to Trade

As stated above, some countries pursue an inward-looking strategy towards foreign trade. These countries use several barriers to protect domestic industries from competition from foreign firms. The barriers generally include tariff and non-tariff strategies (See Fig. 3.1).

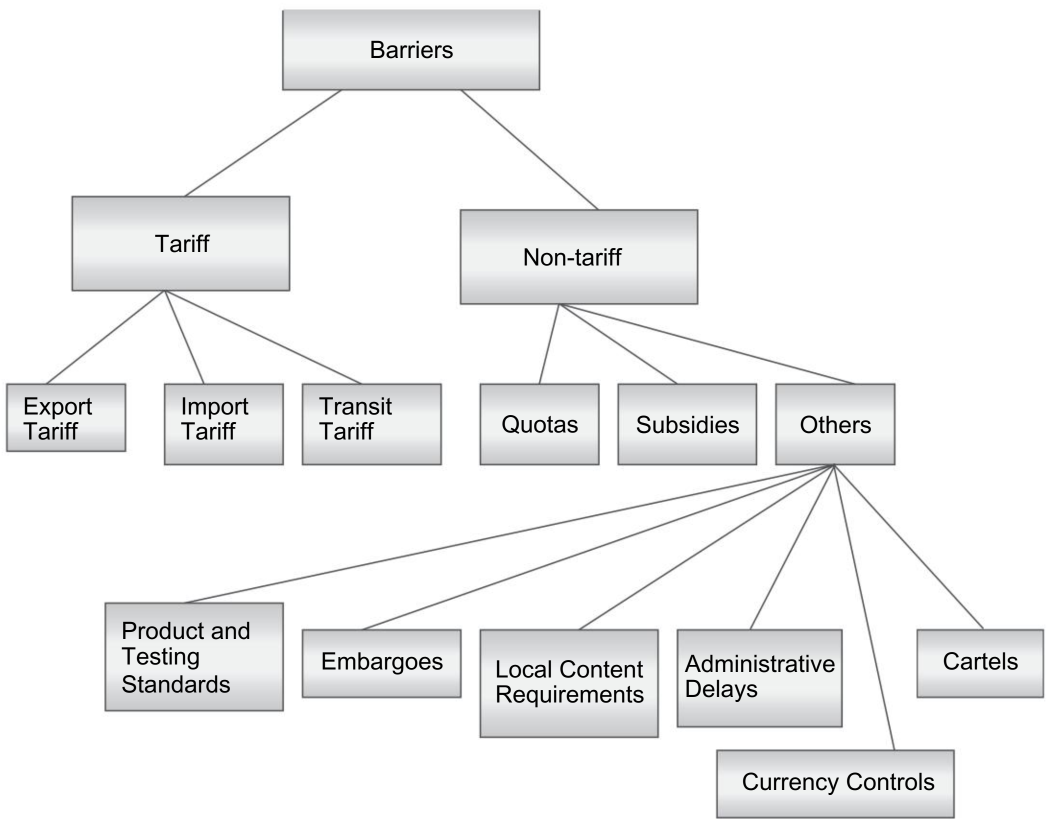

Fig. 3.1 Barriers to Trade

Tariff Barriers These include mainly tariffs on imports and exports. A tariff is a tax imposed on goods involved in international trade. When taxes are levied on imports, they are called *import tariffs*. When taxes are imposed on goods exported to other countries, they become *export tariffs*. There are *transit tariffs too*. These are levied on goods passing through one country bound for another country.

Tariffs are transparent and are typically set *ad valorem*, that is based on the value of the product or service. Tariffs may be specific also. *Specific tariffs* relate to some particular attributes of goods—weight and quantity. A *combined tariff* may also be levied and shall be calculated partly as a percentage on value and partly as a rate per unit or weight.

Expectedly, tariffs have been on the agenda of virtually all rounds of trade negotiations through GATT (the previous name for WTO), and remarkable progress has been made towards their elimination or reduction. But hikes in tariffs do occur across the globe.

Non-Tariff Barriers These, unlike tariff barriers, are not transparent in the sense that non-tariff barriers are not anchored in laws and government regulations. It is difficult to fight non-tariff barriers as the offending party will not admit the guilt. Some barriers are difficult to detect and monitor. For instance, a change in domestic product standards will typically be published only in that country with the result that foreign manufacturers may not be aware of it and may take a long time to make adjustments so that their products comply with the new standards. When a developing country limits the importation of used cars, the argument stated is safety even though bought-in cars are safer than those already on roads. The idea is to protect local manufacturers and/or reduce imports altogether since most consumers cannot afford an import.

Non-tariff barriers, also called covert protectionist measures, are on the rise. The reason is rational. Countries want to avoid running foul of WTO rules, which restrict use of tariffs.

Viewed broadly, protectionism is understood as anything that hurts the commercial interests of another country. It thus includes government bailout of domestic companies, wage subsidies, export and VAT rebates, export credits, financing from state-owned banks and a host of others. It is estimated that as many as 400 such protectionist policies have been put in place each year since 2009, and the trend is on the rise. BRICS countries stand out in using covert protectionist measures. China has long used compulsory joint-ventures, technology transfer and access to cheap land and loans from state-owned banks to boost companies in strategic sectors. In the mid-2000s it invited foreign manufacturers, including Germany's Siemens and Japan's Kawasaki, to supply locomotives for its high speed rail network. Later it switched to Chinese companies which now compete with Siemens and Kawasaki in foreign markets.

India is no holy cow. Priority sector lendings, loan waivers and subsides are too well known. Russia expects private sector enterprises to fight mighty and highly protected state enterprises. Brazil has perfected the art of hidden protectionism. A year back, in order to reduce car imports, Brazil introduced a new programme to encourage innovations, Inovar-Auto. Designed to stay within in the WTO rules, this requires local car manufacture (all foreign owned) to invest in local innovation and engineering and to meet certain fuel efficiency standards by 2017 or else face higher excise taxes and import tariffs on domestic sales. This has boosted domestic investments in engineering and fuel saving technology.

We focus here on the most popularly used hidden protectionist measures which include quotas, administrative barriers, subsidies, embargoes and boycotts, corruption, technical standards, environmental standards, cartels and currency controls.

Quotas These refer to numerical limits on the quantity of goods that may be imported into a country during a specified period. Quotas may also be levied in terms of value (*ad valorem*). Some quotas allow for a preset increase or decrease, as for example, an annual 3 percent. Quotas may also be established in terms of a market share beyond which either tariff or cessation of imports are triggered. Quotas are mainly fixed on textile products but their use elsewhere is not ruled out. Quotas, unlike tariffs, hold the promise of definitive, quantifiable protection of domestic producers.

Administrative Barriers Regulatory control or bureucratic rules designed to impair the flow of imports into a country are called administrative barriers. Administrative barriers include requiring international air carriers to land at inconvenient airports; mandating stringent product inspection which might damage the product itself; understaffing customs departments to cause undue delays; and necessitating special licenses that take a long time to obtain. The Government of India's decision not to permit sugar mills export sugar, notwithstanding the fact that the mills carry surplus sugar and prices in the overseas markets are highly attractive, is an example of administrative barrier.

In one case, the French government tried to protect its domestic VCR manufacturer against Japanese competition by channelising those imports through a tiny customs station. This caused enormous delays and added to the cost of Japanese product, making it less attractive in France. And French government could not be accused of violating provisions of any trade agreement.

Labelling is another administrative barrier. Most governments insist that labelling should be in local language. This is a valid agreement, but to comply with it may be embarrassing for an exporter. Many times, translation fails to do justice to the home country's language. The experience of Parker Pen Company is typical of such embarrassment. The company translated a counter display card for its brand of ink. The card said, "Avoid Embarrassment—Use Quink" translated into Spanish it read "Avoid Pregnancy—Use Quink".

Another example is the ban imposed on Mexican trucks from plying on the US roads—the motive behind the ban being safety. This ban by the US is a clear violation of the NAFTA trading agreement among the US, Canada and Mexico.

Dispute resolution mechanisms themselves may turn out to be barriers. The Canadian government once complained to the WTO that the US was dragging its feet on appointing representatives to the world body which was supposed to investigate US sanctions against softwood imports from Canada.

Subsidies A subsidy is a government payment to a domestic producer. Subsidies take several forms, including cash grants, low-interest loans, tax breaks, and government equity participation in local firms. By lowering costs, subsidies help domestic producers in two ways: they help them compete against low-cost foreign imports and gain access to foreign markets.

The WTO distinguishes three types of subsidies: prohibited, actionable, and non-actionable. *Prohibited subsidies* require the recipient to meet export targets or to use domestic rather than foreign goods. *Actionable subsidies* are disallowed when damage to national interests (of the complaining country) is proved. *Non-actionable* subsidies include support for disenfranchised regions (e.g. China's western province), to help companies comply with more stringent environmental laws and to meet R&D costs. Countervailing duties cannot be imposed on non-actionable subsidies.

Subsidies are common in international business. Every country grants subsidies to protect domestic business. More than business, it is the agricultural sector which receives heavy subsidies in the form of free electricity, seeds and fertilisers supply. Coming to the industries, when losses of state-owned undertakings are written off by the government or when the government bails out loss-making units through fiscal support, the action is nothing but subsidising. The US government is not free from this happening. When the GM was bailed out by the government, the once premier auto maker benefited from subsidy.

Subsidies are highly popular in shipping. Subsidies to shipping were first developed under Elizabeth I. Rewards were based on tonnage of ship, and included bounties to fishing boats heading for the North Sea in search of herring.

Modern governments support shipping as the industry is highly labour-intensive. By subsidizing shipping, China, for example, is indirectly supporting its workers. So is the case with South Korea and Japan.

Subsidies can invite *countervailing* duties. As per the WTO agreement, any country hurt because of subsidies in an exporting country, can approach dispute redressal panel of the world body to remove or modify such subsidies. In the alternative, the importing country can investigate on its own, and when proved, can charge extra duties. Such duties are called countervailing duties. Two conditions need to be fulfilled: the exporter has really subsidised, and the importer has been hurt as a result.

Embargoes and Boycotts An embargo is a complete ban on trade (imports or exports) in one or more products with a particular country. The US imposed embargo on India in 1998 in the wake of successful nuclear test. Embargo is the most repressive barrier and is typically used to achieve political goals or avoid hurting religious beliefs. Import of beef or pork made products are not permitted to enter Indian markets. Beef is shunned by the majority Hindus and pork is not touched by muslims.

Popularly called economic sanctions, embargoes can be decreed by individual nations or by organisations such as the UN. (See also Exhibit 3.1)

Exhibit 3.1

BLOCKADE BLUES

"We always say of ourselves that we have 11 million people and 11 million opinions. This does not mean chaos. It means 11 million people are thinking."

"Cuba is a humanistic society, an open society, an alternative social project, a country where no one is excluded. But our effort to build our own model is constantly influenced by an economic, political, cultural and ideological war from the US. We are prepared to think, to understand, no matter what, not to allow the US to rule us."

"We are not saying Cuba is a perfect, ideal society. There are a number of problems to be solved. But the struggle against the blockade is priority for Cuban society."

Humbero Luis Miranda Lorenzo and Gilberto Valdes Gutierrez, researchers at the Institute of Philosophy, Havana, made clear Cuba's present concerns when asked "freedom and democracy in Fidel Castro's Communist regime", a question they answer everywhere. They work hard to convince people that the economic blockade and not Communism, is the pressing matter in Cuba today.

The pair, who spoke on Cuba at a discussion organised by the Centre for Informal Education and Development Studies (CIEDS) here last week, remarked that Cubans had problems with the 1959 Revolution, but had far greater problems with the crippling US sanctions that came with the Revolution. Also, they are in no hurry to see off President Fidel Castro. "Fidel Castro is a human being and all human beings make mistakes. There is criticism about him, but that does not mean we will throw him out. He is the moral reference for our society today."

Four generations of Cubans have grown up in the mentality of the blockade, the most devastating cultural impact on their society. They lived then in restriction and still do. Meanwhile, they gave themselves a schooling and health the world envied. "If we did not go to school, we would have to go the police," Sonia, a Cuban living in Bangalore, remarked.

The blockade, however, has crippled the Cuban economy too. Sugarcane and nickel have taken a beating. Sugarcane is sold in "secondary markets" that offer low prices compared to prices in the US; steel imports with Cuban nickel from anywhere in the world is disallowed into the US; ships docking at Cuban ports are not allowed to dock at US ports for six months; Cuba imports tons of food and milk from a third country at high prices; it is not permitted to receive credit from international institutions—it borrows from private banks for short terms at high interest.

"After the Soviet Union collapsed, we lost 85 per cent of our foreign trade. The US now discourages investment by threatening not to trade with firms that trade with us. Some oil that we produce, and tourism, is what sustains us now," says Humberto.

What the US does to the Cuban economy is unbelievable. Sonia had arranged for chocolates from Germany for her brother-in-law in the US. But US authorities didn't allow the packet into the country when they saw that sugar for the chocolates was made in Cuba. No third country involved with the US in trade is allowed to trade with Cuba and vice versa. "But which country can afford not to trade with the US ? They do not even allow us to use the dollar for exchange."

The blockade works not only on goods, but on people too. US citizens cannot invest in or travel to Cuba unless authorised and anyone caught doing so is fined $250,000 or faces imprisonment between five and 25 years. They can only travel via a third country at some risk.

Interestingly, Cubans are allowed to travel to the US. Humberto and Gilberto say that the very first migrants to the US were those who looted Cuba just before the Revolution. They have now made it good in Miami. This was in the '60s. In '70s, '80s and '90s, a different set of people moved on. "The migration in the later phase has been and is largely economic. This is normal everywhere. Everyone looks for better opportunities. This is a direct result of the blockade. The very first who went are now a powerful minority who work against Cuba. The others are forced to talk anti-Cuban politics for fear of losing privileges the US offers."

The US Cuban Adjustment Act is the catalyst in this migration. "The US is the only country in the world that encourages illegal migration from another country." If you do so, you get social security, a job, green card, and eventually citizenship. It is in the US interest to encourage such migration. It is remarkable that no one ever talks of the "high wall between Mexico and the US, bigger than the Berlin wall" or of people from Haiti pushed back, "some of whom die on the way". "Why are they encouraging illegal migration only from Cuba?"

The US, Humberto says, also lends an obsessive ideological padding to its blockade. US citizens have paid $10 million annually in taxes over the last 10 years for a satellite signal that beams 24-hour, anti-Cuba propaganda into Cuba. "Fidel (Castro) has jammed that signal. It is funny. But why are people paying for a stupid signal that no one sees in Cuba?"

The Cubans are clear that they will resist the blockade for as long as it takes and will offer no pretext for the US to invade them. They ask why it should hurt anyone at all if education and health came at no expense to people willing to share their best with the rest of the world. "We prefer to share. We don't like to own. We can share things even without having nothing. We live that mentality. That is what scares the system. That is what makes us different," says Gilberto.

It is attempting to think of the Cubans as a romantic people. They certainly are, like the Latinos. But the struggle against the blockade, even if rooted sometimes in the risky "humanist ideal of Cuba", is not. And even as they very aesthetically outline a vision of Cuba that would not entirely be governed by the market, you still ask if exclusivist living of any kind is possible at all in today's militarised global political economy.

(*Source*: *The Hindu*, February 9, 2004)

Sanctions imposed by the US on Cuba, and France's embargo on Israel after the 1967 war are two examples of embargoes. Because of their punitive and repressive nature, embargoes are used rarely nowadays. (US is gradually lifting sanctions on Cuba)

A boycott is the blank prohibition on the import of all goods or services imposed by a designated country. Quit India Movement launched by Mahatma Gandhi is a classic example of boycott. Anti-globalisation movement is another instance of boycott. Call to buy *swadeshi* and oppose *videshi* goods is yet another boycott.

Embargoes and boycotts interfere with the free flow of trade by halting trade that would otherwise take place. Both seek to damage a country by withdrawing the benefits of international trade.

Cartels Cartels, also referred to as collusions, refer to a group of manufacturers having an informal understanding to enter a market as a single entity. The single entity fixes a price at which the concerned product shall be sold. Cartel can be formed when there is relatively small group of manufacturers who hold an oligopoly position on the market. Two-thirds of cartels are said to be in industry in which the top four firms have 75% or more of the market share.

Collusion comes in many forms: agreements to raise, freeze or even lower prices, co-operate in tenders, not to compete in certain markets and the like. Price-fixing can be horizontal (among competitors in a particular product) or vertical (involving, for example, a manufacturer and dealers).

Cartels are common in industries that offer standardised products such as industrial components road building, car parts, air freight; computer monitors, sea-food, and even candle wax. The most notable cartel in recent years has been the Organisation of Petroleum Exporting Countries (OPEC), which has a membership of 12 oil-producing nations. It is composed of six Middle East countries and six other oil producing countries in the world.

Internet service providers are likely to form a cartel among themselves. The big players in the field are Amazon (about half of America's book market); Alibaba (about 80% of e-commerce in China); Facebook (which claims 1.3 bn active members); and Google (68% of online searches in America, more than 90% in Europe). Regulators, particularly European Countries, are worried that such dominance lays consumers and competitors open to abuse.

Collusions are not confined only to corporate sector. Vegetable vendors, flower merchants and fruit sellers are forming cartels with impunity. If one measure of flowers is a given price with one vendor, it is the same price with all the sellers in the area.

Carteling among corporate is outlawed. In India, till 2009, only cease and desist order was passed by the then Monopolies and Restrictive Trade Practices Commission on the colluding firms. Now they face heavy fines. In America, price-fixers are put behind bars and are fined too. The European Commission can only bring civil cases, but criminal penalties can be imposed in Ireland and Britain. Table 3.1 shows the fines imposed on price-fixers.

Frequently cartels fail because members violate their agreements by dropping prices or hiking output and forcing the other members back into competitive position. Although this did not occur with OPEC, the cartel's hold on world markets has now begun to decline. Several reasons are cited for the fall in the position of the oil cartel. Worst threat to OPEC has come from the US which invented shale gas. With this US has almost became selfsufficient. Worldwide recession and oil conservation on the part of importing countries have also contributed to the fall in demand for oil.

Corruption Corruption itself can be a barrier to trade. How does it happen? Answer is obvious. When corruption-free countries refuse to trade with nations known for bribery, trade to that extent is restricted. Similarly, exporters may refrain from selling in markets where intellectual property rights are infringed.

Table 3.1 Corporate Punishment

Largest cartel fines on individual firms:

Company (year)	*Products*	*$ m*
Imposed by the European Commission		
Saint-Gobain (2008)	Car glass	986
Philips (2012)	TV tubes	907
LG Electronics (2012)	TV tubes	884
Deutsche Bank (2013)	Interest-rate derivatives	619
F. Hoffman-La Roche (2013)	Vitamins	414
Imposed by the US Department of Justice		
AU Optronics(2012)	LCD Panels	500
F. Hoffman-La Roche (1999)	Vitamins	500
Yazaki Corporation (2012)	Car parts	470
Bridgestone (2014)	Car parts	425
LG Electronics (2009)	LCD Panels	400

(Source: *The Economist*, March 29, 2014)

Ironically, the efforts to fight corruption can themselves become trade barriers. An example is "Pre-shipment Inspection", a practice in many developing countries presumably aimed at preventing capital flight, tax evasion, and fraud by subjecting incoming imports to rigorous inspection by contracted private companies. In many instances, such inspections are used to delay or block imports in order to protect domestic producers that may be associated with the inspections.

Technical Standards These are provisions made by governmental agencies in various countries relating to such areas as safety, pollution, technical performance, and the like. Companies seeking to sell in such countries are expected to meet the standards. Existence of such standards that are in variance with those of other countries, represent a trade barrier.

Environmental Standards Concerns about environment are common across the globe. At the international level, several agreements have been entered by countries to safeguard the environment. The major agreements are: Montreal Protocal for the protection of the ozone layer, the Basel Convention on the trade or transportation of hazardous waste across the globe, and the Convention on International Trade in Endangered Species (CITES). Often environmental standards turn out to be counterproductive. The Government of India denied permission to international mining firms to mine iron ore in Odisha, all in the name of maintaining ecology.

Currency Control This refers to restrictions on the convertibility of a currency into other currencies. A company that wishes to import goods, generally, must pay for those in a common, internationally acceptable currency such as the US dollar, European Union Euro or Japanese Yen. It must also obtain the currency from its nation's domestic banking system. Governments can declare that companies desiring such a currency apply for a licence to obtain it. Thus, a country's government can discourage imports by restricting who is allowed to convert the nation's currency into an internationally acceptable currency.

Another way governments apply currency controls to restrict imports is by stipulating an exchange rate that is unfavourable to potential importers. Because the unfavourable exchange rate can force the cost of the imported goods to an impractical level, many potential importers may stop importing. Meanwhile, the country will often allow exporters to exchange the home currency for an international currency at favourable rates to encourage exports.

Product and Testing Standards This non-tariff barrier requires that foreign goods meet a country's domestic product or testing standards before they can be offered for sale in that country. China, for example, requires extensive and expensive testing of foreign motor vehicles machinery, electronic goods, and pesticides before they enter its market.

The Case for Protectionism

After having understood the various trade barriers, it is desirable that we also know why these barriers are enforced. Arguments for protection of domestic firms fall into broadly two categories: political and economic. (See Fig. 3.2)

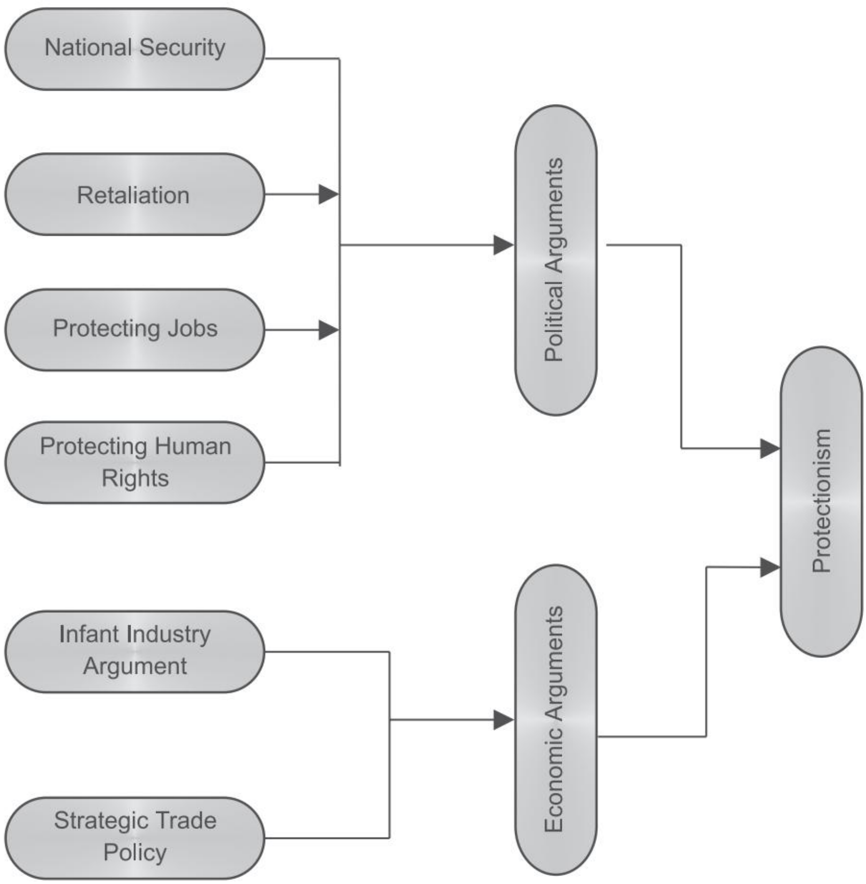

Fig. 3.2 Arguments for Protectionism

Political Arguments The political rationale for enforcing trade barriers include national security argument, retaliation, protecting jobs, and human rights.

National Security Countries enforce barriers in the name of national security. The Industrial Policy (1991) of the Government of India, for example, lists industries related to defence under Category A and states that these industries are exclusively reserved for the government sector. This means that no foreign firm or Indian private sector enterprise can set up a production unit in defence related items.

Retaliation Some argue that governments should use threat to intervene in trade policy as a bargaining tool to help open foreign markets and force trading partners to provide free access. The United States seeks to gain control over events in all of Central, North, and South America as well as the Caribbean basin. This is the main reason behind the free trade initiatives in the Americas that are strongly supported by the United States. Similarly, Japan has a certain amount of influence in Asia. Many countries throughout Asia and Southeast Asia rely on Japan for a large amount of their foreign trade. Japan lent a large amount of money to these countries to help them recover from financial crises in recent years. Obviously, Japan generates goodwill among the neighbours through such deals. The retaliation argument carries one more dimension. According to some observers, it makes no sense for one nation to allow free trade if other nations actively protect their own industries. Governments often threaten to close their ports to another nation's ships or impose extremely high tariffs on its goods if it does not concede on some trade issue as being unfair.

Protecting Jobs Governments intervene when imports threaten jobs created by domestic businesses. Business Process Outsourcing (BPO) is an example to be cited in this context. Many firms in the United States are outsourcing their functions out of India. Fearing loss of jobs for locals, many states in the US are legislating bans on such BPOs. The Union of Telecommunications workers in the UK are in the streets protesting British Telecom's Policy of outsourcing out of India. "Be Indian, buy Indian", "Swadeshi vs Videshi" are also slogans sounding similar sentiments. India and the US are no exception. Japan's quotas on rice imports are aimed at protecting jobs in that country's agricultural sector. The same motives underlay the establishment of the Common Agricultural Policy (CAP) by the European Union. The CAP was designed to protect the jobs of politically powerful farmers in Europe by restricting imports and guaranteeing prices.

Protecting Human Rights Protecting and promoting human rights in other countries is an important element of foreign trade policy in several democracies. For a long time, entry of China into WTO was opposed because the country has poor human rights record (the country has now been admitted into the WTO).

Human rights violation is at its peak in Myanmar. The military government (junta) uses violence, torture, intimidation, harassment, and fear to remain in power. Travel can be dangerous in the country. Medical facilities are inadequate for even routine medical care. Common drugs, such as insulin, are inadequate and unsafe to use. HIV/AIDS is rampant, as are malaria and hepatitis. The harshest prison term can be handed out, even to foreigners, for unknowingly violating Burmese law. It is illegal to own or possess an unregistered computer modem and foreigners entering Myannar with a computer are likely to have it confiscated. US citizens have been detained, arrested, tried, and deported for distributing pro-democracy literature and for visiting the homes and offices of local pro-democracy leaders. With the proliferation of drug trade in Burma, individuals openly carrying automatic weapons is a common sight. Crimes such as vehicle hijacking are being reported.

Many US and European firms—Eddie Bauer, Levi Strauss, Liz Claibome, Pepsi and others—have stopped doing business in Burma.

Economic Arguments Economic reasons for government intervention in foreign trade include the famous infant industry argument and strategic trade policy.

Protecting Infant Industries According to the infant industry argument, a country's emerging industries need protection from foreign competition during the early phases of their development and until they become internationally competitive. The argument is based on the assumption that infant industries need protection because of a steep learning curve. In other words, as an industry grows and matures, it gains the required capabilities to become more innovative, efficient, and competitive. Till such time, the industry needs to be insulated from foreign competition.

First propounded in 1792 by Alexander Hamilton, the infant industry argument has appealed to most developing countries during the past 40 years. The argument has been recognised as a legitimate reason for protectionism by the WTO.

The Government of India has been protecting small scale industries through various subsidies and incentives. This is an example of the infant industry protection argument in practice.

Strategic Trade Policy This argument is of recent origin. According to this reasoning for protectionism, countries shall dominate in the export of certain products simply because of first mover advantage enjoyed by some of their domestic industries. Given suitable protection such companies can capture foreign markets, earn good profits, and plough the money back to the country of origin. It is the strategic trade policy that helped South Korea build global conglomerates (chaebol). For example, Korean ship builders received a variety of government subsidies for several years, including low-cost financing, from the Korean Development Bank.

The chaebol made it possible for companies to survive economic downturns because of the wide range of industries in which they competed. These strategic trade policies also had spinoff effects on other related industries such as transport. By the mid-1990s, one of the country's largest shipping firms, Hanjing Shipping, had become the largest cargo transporter between Asia and the US.

Trade-policies—Application

In practice, trade policy contains elements of both approaches. Differences arise as much from the choice of instruments as from the absence or presence of intervention. Outward-oriented policies favour tariff over qualitative restrictions. These tariffs are usually counterbalanced by other measures, including production subsidies and the provision of inputs at 'free trade' prices. Governments aim to keep the exchange rate at a level that provides equal incentives to produce exports and imports substitutes. Overall protection is lower under an outward strategy than under an inward strategy. Equally important, the spread between the highest and lowest rates of protection is narrower.

Inward strategies typically prefer quantitative restrictions over tariffs and they involve a higher overall level of protection, together with greater variation across activities. Exchange rates are generally overvalued because of high protection and the use of quantitative restrictions. Industrial incentives are administered by an elaborate and expensive bureaucracy.

It may also be stated that the relationship of the government to international trade is based on the concept of sovereignty, a concept which recognises that a nation has complete control over her international affairs as far as other nations are concerned. Accordingly, a nation becomes very much concerned about her nationals and their property once these have passed into the confines of another nation or are on the high seas. In a world of strict sovereignty, nations would probably have no relations with each other except at war. But sovereignty has been tempered by reciprocity; that is, there are treaties of friendship and commerce, and treaties covering many other situations and relationships that give the nationals of the signatories the right to travel, reside, trade, hold property, and make investments in other countries. These treaties also provide for the interchange of diplomatic officials and consuls (representatives of business interests). Treaties also cover the treatment of ships, sailors, airplanes, and cargo when in foreign jurisdictions.

INDIA'S FOREIGN TRADE POLICY

LO 3
Relate to India's foreign trade policy

Foreign trade policy of India, like that of any developing country was inward-looking till 1991. Through series of restrictions and substitution approach, imports into India were highly restricted. With regard to exports, the policy of the government was not harsh. Exports were sought to be allowed and encouraged to earn precious foreign exchange. But a country cannot think of only exporting without importing. The arguments for adopting protectionist policy towards foreign trade were more or less the same as explained earlier.

The period after 1991 has been marked by substantial liberalisation of the trade policy. While some liberalisation measures were initiated by self realisation of the government about the need for making exports competitive in the overseas markets, majority of the initiatives were introduced as a part of structural adjustment programmes forced on India by IMF and World Bank. In addition, India became one of the founding member of WTO in 1995, forcing it to remove its own trade barriers imposed earlier on foreign markets.

India's foreign trade policy is formulated and implemented by the Ministry of Commerce and Industry. Other concerned ministries also pitch in for the formulation and implementation of the policy. Majority of the ministries involved are (in addition to the Ministry of Commerce and Industry): Finance, Agriculture, and Textiles. Reserve Bank of India is also involved in the process. The Director General of Foreign Trade (DGFT) is responsible for execution of the foreign trade policy.

The current trade policy seeks to achieve dual objectives:

- Doubling India's share in global merchandise trade within the next five years.
- Economic growth with due emphasis on jobs generation.

In order to achieve the twin objectives, the following strategies, have been adopted:

- Unshackling controls and creating an atmosphere of trust and transparency to unleash the innate entrepreneurship of Indian businessmen, industrialists and traders
- Simplifying procedures and bringing down transaction costs
- Neutralising incidence of all levies and duties on inputs used in export products, based on the fundamental principle that duties and levies should not be exported
- Facilitating development of India as a global hub for manufacturing, trading, and services
- Identifying and nurturing special focus areas to generate additional employment opportunities
- Facilitating technological and infrastructural upgradation through import of capital goods and equipment leading to increase in value addition, productivity and quality
- Strengthening the role of Indian embassies in exports

Salient features of India's trade policy, post 1991 can be summarised as follows:

- Removal of restrictions on exports and imports
- Rationalisation and reduction of tariffs

- Several items of exports and imports have been decanalised-taken away from state run trading agencies
- Rupee has been made convertible in current account. Consequently, the exchange rate of the rupee is now market determined
- Special economic zones (SEZs) have been set up to promote exports
- Agri export zones (AEZ's) have been set up to give a push to agri exports
- Market access initiative scheme has been launched for undertaking marketing and promotion efforts abroad
- Service exports have been conceived as engines of growth. Lot of encouragement is given for the export of services
- Tax benefits and exemptions have been intensified

Policy in Force India's foreign trade policy is announced once in five years and is revised every time before being publicised. Called the Export-Import Policy (Exim Policy), the present trade policy was announced on August 27, 2009 and is valid upto 2014. The targets and initiatives planned to reach the targets are as follows:

Targets

- Annual export growth of 15% with an annual export target of $200 billion by March 2011
- 2011–2014 annual export growth of 25% per annum. Double India's exports of goods and services by 2014
- Double India's share in global trade by 2020

Initiatives

- 26 new markets added under the Focus Market Scheme, incentives hiked form 2.5% to 3%
- Incentive under Focus Product Scheme raised to 2% from 1.25%, more products included
- EPCG Scheme at zero duty introduced
- Duty entitlement passbook(DEPB) scheme extended till 31 December 2010
- 2% interest subvention on pre-shipment credit extended till 31 March 2010
- The drawback of duty on gold jewellery exports allowed
- India to promote diamond bourses to make the country an international diamond trading hub
- Single-window scheme for export of perishable farm goods
- EOUS allowed to sell products in the domestic tariff area to an extent of 90%
- Market linked focus product scheme introduced for export of identified products to 13 identified markets

VOLUME OF INTERNATIONAL TRADE

LO 4
Outline the volume of international trade

World trade, both in volume and value, has been increasing as Fig. 3.3 shows. China retains the top slot as number one exporter (see Table 3.2). China's exports grew by 17.1 boosting it to close the gap with Germany. The top three exporters accounted for more than a quarter of the world's exports in 2011, though their combined market share fell slightly. That is because of an increase in commodity prices, which lifted the value of exports from resource-rich countries such as Australia, Russia and Arabia.

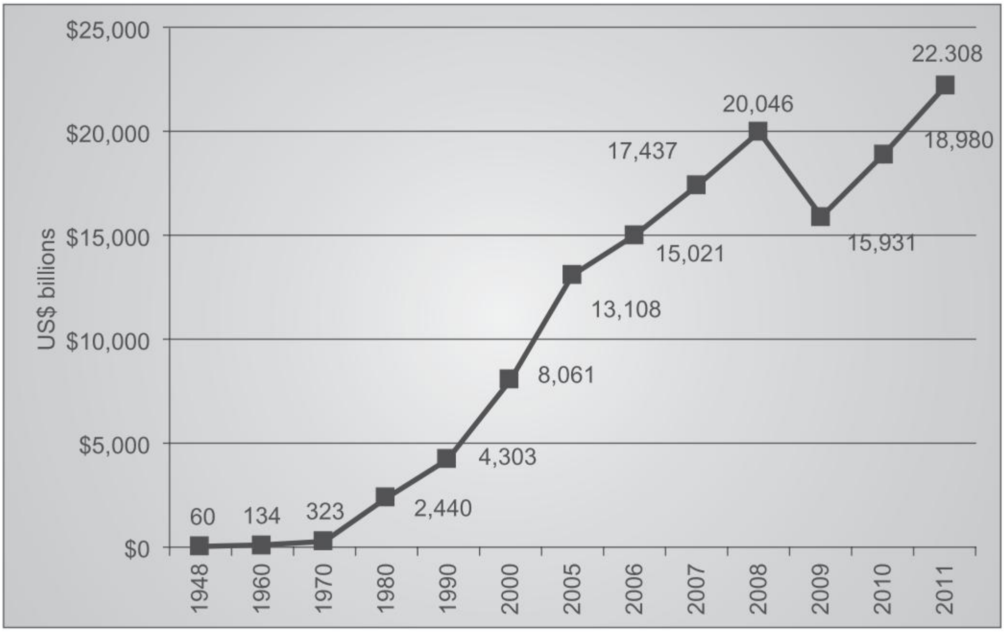

Fig. 3.3 Growth in World Trade *Source:* WTO Statistical Database

One positive development is that services constitute major share of India's exports. According to WTO, India ranks 19th in world for export and import of services. Indian computer and BPO services have been growing rapidly and the trend will further sharpen in the days to come.

Coming to the composition of world trade, manufactured goods constitute the major chunk and this trend is likely to continue in the near future. The reason being that the growth of manufactured goods is faster than other two components, mining and agriculture. Although, the importance of trade

Table 3.2 World's Leading Exporters, 2011

		Percent of world exports		
	Country	*Goods*	*Services*	*Total*
1.	China	10.4	4.4	9.30
2.	United States	8.1	13.9	9.20
3.	Germany	8.1	6.1	7.72
4.	Japan	4.5	3.4	4.32
5.	Netherlands	3.6	3.1	3.53
6.	France	3.3	3.9	3.39
7.	United Kingdom	2.6	6.6	3.34
8.	Korea, Republic of	3.0	2.3	2.90
9.	Italy	2.9	2.6	2.81
10.	Hong Kong, China	2.5	2.9	2.58

Source: World Trade Organization (WTO), "Statistical Database", 2012 in services is growing, it is confined mainly to rich nations. Trade in services accounts for 20 per cent of the world trade.

TRADE THEORIES

LO 5
Discuss different trade theories

Trade between and among countries has occurred for many thousands of years. But it was not until the 15th century that people tried to explain why trade occurs and how trade benefits both parties to an exchange. Figure 3.4 shows a time line of when the main theories of international trade were proposed. Efforts are being made to modify existing theories and develop new ones.

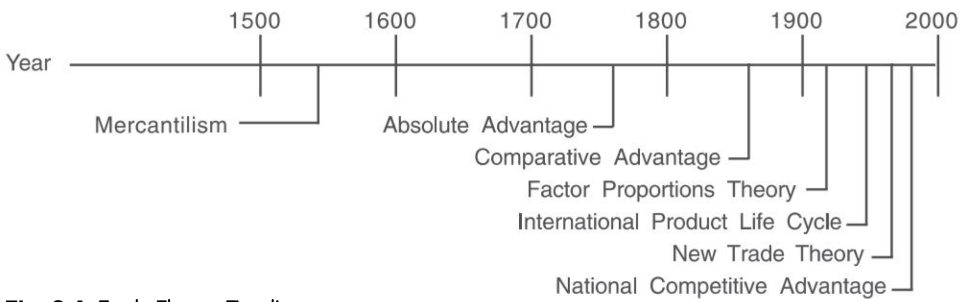

Fig. 3.4 Trade Theory Timeline

Mercantilism

Mercantilism is the first international trade theory and it emerged in England in the mid-16th century. The main hypothesis of mercantilism is that gold and silver are the mainstays of national wealth and essentials to vigorous commerce. During the 17th century, gold and silver were the currency of trade between countries; a country could earn gold and silver by exporting goods. By the same token, importing goods from other countries would result in an outflow of gold and silver to other countries. Earning of gold and silver is the main motive for countries to trade with each other. The main tenet of mercantilism is that it is in a country's best interest to maintain trade surplus—to export more than what it imports. By doing so, a country can accumulate gold and silver and increase its wealth and prestige.

Consistent with this belief, the mercantilist doctrine advocates state intervention to achieve surplus in the balance of trade. To achieve surplus, government is expected to discourage imports by imposing tariffs and quotas and subsidising exports.

Colonising resource rich, less developed countries was yet another source of mercantilism. Colonies were the source of many essential raw materials, including tea, sugar, tobacco, rubber and cotton. These resources were shipped to the mercantilist nation, where they were converted into finished goods such as clothing, cigars and other products. These finished goods were then shipped to the colonies for sale. The mercantilist nation made huge profits by buying raw materials cheap and selling finished goods dear. Thus, the mercantilist nation built trade surplus for itself.

The most conspicuous colonisation was of India by the UK. In the name of trade with India, the East India Company virtually plundered the country, as Exhibit 3.2 indicates.

Mercantilist policy is being criticised. Government resorts to subsidising exports and putting restrictions on imports in order to build surplus. In both ways, citizens are hit hard. Export subsidies are passed on to tax payers, adding to their burden. Import restrictions too are paid for by consumers in the form of higher prices as domestic firms face less competition from foreign produces. However, exporters welcome mercantilism because of the susbsidies and incentives they receive from the government. Local manufacturers also welcome the policy as it would protect them from competition from imports.

International trade experts also criticise the doctrine of mercantilism on the ground that it believes in a zero-sum game. (A zero-sum game is one in which a gain by one country results in a loss to another country). But multinational trade is a positive-sum game in which all countries can benefit. The theory is also criticised because of it being too simple.

Certain terms of the mercantilist period are still in use, for example, the balance of trade. A country has either favourable balance of trade or has the opposite of it. In the former, exports exceed imports and reverse is true in the latter. Mercantilism favoured favourable balance of trade for any country. It is not merely in phrases that mercantilism is alive. It is there in overt actions. For example, the institution called export and import bank (ExIm bank). Every country (including India) has its own ExIm bank. The US's bank is 80-year-old and in Britain, it was set up in 1919. In Britain, ExIm bank was established to improve the country's balance and thus return to gold standard.

The global financial crisis gave ExIm banks a new lease of life. When banks stopped trade finance after Lehman Brothers collapsed, governments encouraged their ExIm banks to fill the gap to prevent fall in trade volumes. Official export credit extended by the G7 alone soared from $35 bn in 2007 to $64 bn in 2009. Thus, subsidised exports are a form of mercantilism.

Neo-Mercantilism

The earlier mercantilism emphasised that a country should export more and accumulate gold and silver so that it can have trade surplus. New-mercantilism which has emerged recently also believes in the same approach for any nation. It equates political power with economic power and economic power with trade surplus, and trade surplus can be obviously achieved by encouraging exports and curbing imports.

However, a more useful explanation of why nations trade with each other is provided by trade theories, which focus on specialisation of effort. The theories of absolute and comparative advantages are good examples.

Theory of Absolute Advantage

The theory of absolute advantage has been propounded by Adam Smith, generally considered to be the father of economics. In his book, *The Wealth of Nations,* published in 1776 in London, 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 favourable 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 the *absolute advantage* in the production of wine.

According to Smith, countries should specialise in the production of goods for which they have an absolute advantage and then trade these goods for the goods traded by other countries. Thus, the English should specialise in the production of textiles while the French should specialise in 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. By specialising in the production of goods in which each nation has an advantage and by

Exhibit 3.2

THE PERISHING

While the London establishment were contemplating the costs of its financial excesses in the summer of 1769, across the world, in Bengal, a drought of unprecedented ferocity was just commencing. For six whole months, from August 1769 to January 1770, the monsoon rains failed to arrive, delivering a chronic water shortage that destroyed up to half the crops, particularly in the west and north-west Bengal. With the New Year, drought started to turn into famine. Plentiful rain fell in June 1770, but 'hopes of relief were disappointed by the overflowing of the rivers in the eastern provinces', adding flood to famine.

Famine had been an established part of India's social reality for thousands of years, and was only truly defeated following Independence in 1947. Early English travellers had commented with horror on the scale of the terrible famine of 1631, which had severely disrupted normal trade. Yet, the incidence of famine expanded dramatically, first under Company and then under the British Crown. In fact, British control of India started with a famine in Bengal in 1770 and ended in a famine—again in Bengal—in 1943. Working in the midst of the terrible 1877 famine that he estimated had cost another 10 million lives, Cornelius Walford calculated that in the 120 years of British rule there had been 34 famines in India, compared with only 17 recorded famines in the entire previous two millennia. One of factors that explained this divergence was the Company's abandonment of the Mughal system of public regulation and investment. Not only did the Mughals use tax revenues to finance water conservation, thus boosting food production, but when famine struck they imposed 'embargoes on food exports, anti-speculative price regulation, tax relief and distribution of free food'. More brutally, if merchants were found to have short-changed peasants during famines, an equivalent weight in human flesh would be taken from them in exchange.

Like previous failures of the natural cycle, the inadequate monsoon of 1769 in Bengal could have been managed without great loss of life. But the Company had significantly increased Bengal's vulnerability to natural disaster. Bengal had been picked clean by the Company and its executives in the preceding decade. Revenue collection had increased dramatically from just £606,000 the year before the Company took over the diwani to a peak of £2,500,000 two years later. Flows of bullion into Bengal fell from £345,000 in 1764 to £54,000 in 1765, and ceased entirely in 1766. Instead, silver started leaving Bengal to pay for the Company's tea trade. By 1769, Richard Becher, the Company's Resident at Murshidabad, admitted with some shame that 'the condition of the people of this country has been worse than it was before', arguing that 'this fine country, which flourished under the most despotic and arbitrary government, is verging towards its ruin while the English have so great a share in the administration'.

Throughout 1769, the Company monitored the situation, and in November, the Calcutta Council wrote back to London that revenues would be reduced in the year ahead. A harrowing letter published under the name of J.C. in the Gentleman's Magazine in September 1771 reveals the unrelenting pursuit of self-interest that governed the Company's approach to the crisis. Rather than take action to curb price speculation in grain, 'as soon as the dryness of the season foretold the approaching dearness of rice', wrote J.C., 'our Gentlemen in the Company's service were as early as possible in buying up all they could lay hold of'. The peasants quickly complained to the Nawab that the English had 'engrossed all the rice'. But when these accusations were put before the Company's Calcutta Council, the complaint was met with howls of laughter and thrown out. Huge fortunes were made as Company staff cornered the market. One junior executive accumulated over £60,000, as rice prices soared from 120 seers of rice per rupee at the beginning of the famine to just three seers a rupee in June 1770. At the time, a seer was equivalent to about 2 lb in weight. The Nawab and other Bengali nobles tried to respond in the traditional way and distributed rice free of charge. But because of the hoarding by the Company's executives, their stocks were soon depleted.

As the famine intensified, thousands flocked to Calcutta, many dying in the streets. Whoever he was, J.C. clearly had humanitarian feelings and would hand out food to the starving who gathered near his Calcutta residence. But he was also squeamish. On one occasion, he sent his servants to get the starving to move away from his house. But one of the near-dead rebelled, and cried out: 'Baba! Baba!, my Father, My Father! This affliction comes from the hands of your countrymen, and I am come here to die, if it pleases God, in your presence.' J.C. concludes his letter by describing Calcutta's good fortune of having both vultures and dogs to deal with the dead—the first to take out the eyes and intestines, and the latter to gnaw the feet and the hands.

With no pictures or photographs to drive home the horror of the event, we are left with eye-witness accounts of the living feeding off the dead, of the Hugli full of swollen bodies and, in the words of Karim Ali, author of *Muzaffarnamah*, of whole families being yielded up to the 'talons of the wrath of the godless'. However, the Company's first concern was to feed its army and then to ensure that its taxes were secure. Not only did the Company continue to collect its land revenues throughout the famine—instead of introducing some form of relief in the Mughal fashion—it actually increased the rate. In February 1771, Calcutta reported back to the directors that 'notwithstanding the great severity of the late famine and the great reduction of people thereby, some increase has been made in revenue collection. Many of the Company's leading executives used their position to purchase grain by force—even seed for the next year's planting—and then sold this at famine prices in the big cities of Calcutta and Murshidabad. Eventually, the Company did act, providing Rs. 90,000 in relief, a pittance in a land of some 30 million people with annual revenues of over Rs. 17 million. Even later imperial historians admitted that the Company did not even 'attempt to cope with the disaster'. This was a man-made catastrophe.

The Bengal Famine stands out as perhaps one of the worst examples of corporate mismanagement in history. Yet, the preconditions for such a disaster had been in place for decades. The onrush of easy money from coups and corruption extinguished the scrupulous concern for trade that had previously characterised the Company's management. While those in England squabbled over how to divide the spoils, in India all systems of administrative control broke down, allowing abuse to flourish at the expense of both the people of Bengal and the Company itself. William Bolts captured this dual collapse perfectly when he wrote in 1772, 'while this nation is gazing after the fruit, the Company and their substitutes are suffered to be rooting up the tree'. Remittances home from the Company's executives stood at just £79,000 in 1756. But following the victory at Plassey, they would average an annual £.500,000 in the years to 1784. In 1770-71, in the midst of the Bengal Famine, a staggering £1,086,255 was transferred home by the Company's executives—equivalent to nearly £ 100 million in twenty-first-century terms.

In London, news of the famine generated a genuine sense of horror and humanitarian concern. The first inklings of what was taking place reached London in December 1770, when the Gentleman's Magazine reported that 'provisions were so scarce in the Company's new acquisitions that parents brought their children to sell them for a morsel of bread'. When the full story became known, horror turned to outrage at the Company's negligence. As Horace Walpole said at the time, 'we have murdered, deposed, plundered, usurped - nay, what think you of the famine in Bengal, in which three millions perished, being caused by a monopoly of provisions by the servants of the East Indies'.

(***Source:*** Nick Robins, *The Corporation that Changed the World*, Orient Longman, 2006, pp. 90–95).

selling/buying from the other, both countries stand to gain by engaging in trade. This was the argument on which Smith denounced the doctrine of zero-sum game and advocated in its place, the principle of positive-game.

The theory of absolute advantage can be explained with the help of a numerical example. The example given in Table 3.3 illustrates the theory better. The efficiency of each country in the production of the two products is measured in terms of the labour hours required to produce one unit of each product.

Table 3.3 Absolute Advantage

Country	*Olive Oil*	*Shoes*
Spain	2	4
Italy	4	2

Obviously, Spain has an absolute advantage in the production of olive oil (it takes only 2 hours to produce one unit), whereas Italy has absolute advantage to produce shoes (it takes just 2 hours per unit of shoes). Thus, according to the theory, Spain should export olive oil and import shoes. Likewise, Italy should export shoes to Spain and import oil from it.

How could Spain enjoy the absolute advantage over production of olive oil? How could Italy enjoy the absolute advantage over the production of shoes? Spain or Italy enjoys absolute advantage, either naturally or is consciously acquired.

Climatic conditions, skilled labour and deposits of natural resources contribute to the absolute advantage of a country. If Spain is able to produce one unit of oil in just two hours, may be the country has skilled labour, climate is suitable and/or it has vast deposits of oil. Similar reasoning applies to Italy's advantage in the production of shoes.

Acquired advantage makes a country strong in manufacturered goods and services. If Tata Steel is the sixth largest producer of steel globally; Hero Honda is the largest two-wheeler company in the world; Hero Cycles is the largest producer of bicycles internationally; or Sundaram Fasteners is the world's third largest manufacturer of fasteners; it is because each of these companies has acquired absolute advantage over the rest of the world. (See also opening case)

The theory of absolute advantage has certain merits. First, it advocates trade bereft of government intervention, unlike mercantilism which invoked government initiative to earn gold and silver. Benefits of free trade are there for everybody to see. Prosperity of nations, particularly of the emergining ones, has improved and millions of people across the globe have been lifted out of poverty. Countries have realised the benefits of free trade and in its furtherance they have created a world body (WTO). Second, the theory proposes positive sum-game in which all trading partners gain by participating in the world trade. Spain and Italy have absolute advantages in producing oil and shoes, respectively. If those two countries specialised in their respective areas, resource wastage is prevented and buyers will obtain quality goods at reasonable prices in both of them. Third, gradually free trade promoted capitalism along with democracy also.

A more complicated picture emerges when one of the trading partners has an absolute advantage in the production of both the goods, namely, oil and shoes. However, trade under these conditions still brings gains, as David Ricardo first demonstrated in his theory of comparative advantage.

Theory of Comparative Advantage

This theory holds that nations should produce those goods for which they have the greatest relative advantage. In his book, *Principles of Political Economy* (1817), Ricardo argued that it makes sense for a country to specialise 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 itself efficiently. It is worth recollecting what Ricardo himself had told about his principle of comparative advantage. In providing an example of production of wine and cloth by England and Portugal, Ricardo noted:

"England may be so circumstanced that to produce the cloth must require the labour of 100 men for one year; and if she attempted to make the wine, it might require the labour of 120 men for the same time. England would therefore find it in her interest to import wine, and to purchase it by the exportation of cloth.

"To produce the wine in Portugal might require only the labour of 80 men for one year, and to produce the cloth in the same country might require the labour of 90 men for the same time. It would therefore be advantageous to her to export wine in exchange for cloth. This exchange might even take place notwithstanding that the commodity imported by Portugal could be produced there with less labour than in England. Though she could make the cloth with the labour of 90 men, she would import it from a country where it required the labour of 100 men to produce it, because it would be advantageous to her rather to employ her capital in the production of wine, for which she would obtain more cloth from England, than she could produce by diverting a portion of her capital from the cultivation of wines to the manufacture of cloth."

Ricardo reinforced the principle of positive-game by stressing how a country, at an apparent disadvantage relative to other countries, could engage in foreign trade and both countries could gain.

The theory of comparative advantage too can be explained with some numerals. Take the same example of Spain and Italy (and not England and Portugal as illustrated by Ricardo) and refer to Table 3.4.

Table 3.4 Comparative Advantage

Country	*Olive Oil*	*Shoes*
Spain	1	2
Italy	6	3

Note: In Spain, 1 unit of resources = 1 unit of oil or 1/2 unit of shoes.
In Italy, 1 unit of resources = 1/6 unit of oil or 1/3 of shoes.

Obviously, for every unit of resource used, Spain can produce more oil and shoes than Italy—it has absolute advantage in the production of both the goods. Will Spain, having absolute advantage in production of oil and shoes gain from trade? Apparently no. But a second look convinces us that Spain does stand to gain. This is so because though Spain has absolute advantage in both oil and shoes, it only has comparative advantage in shoes. Likewise, Italy is unable to produce oil or shoes more efficiently than Spain but is able to produce shoes more efficiently than oil.

Now, Italy could use 1 unit of resources to produce 1/6 unit of oil. It would be better to produce 1/3 unit of shoes with this unit of resources and trade with Spain to get 1/3 unit of oil. Thus, by specialising and trading, Italy gets twice as much oil than it could if it were to produce the oil itself. How about Spain? There are gains for Spain too, though it has absolute advantage in both oil and shoes. Spain could use 1 unit of resources to produce 1/2 unit of shoes. However, it would be better to produce one unit of oil with one unit of resources and trade that oil for one unit of shoes. Thus, Spain gets twice as much in shoes through trade than if it were to produce the shoes itself. This is so despite the fact that Spain is a more efficient producer of oil and shoes.

The difference between the theory of absolute advantage and the theory of comparative advantage is subtle. Absolute advantage looks at absolute productivity differences; comparative advantage looks at relative productivity differences. The destinction occurs because comparative advantage incorporates the concept of opportunity cost in determining goods a country should produce. The opportunity cost of product is the value of the thing that is given up to get the product.

The principle of comparative advantage has takers even today as Exhibits 3.3 and 3.4 and the opening case to this chapter show. Probably the best example for the theory is business process outsourcing (BPO). The underlying assumption behind BPO is that somebody else can do better job than doing by self.

Exhibit 3.3

THE ADVANTAGE OF KNOWING ECONOMIC THEORY

When Chile's new government took over from the Marxist regime of Salvador Allende, the country's economy was in shambles. Inflation was running at more than 1000 per cent annually, and the country's external debt load was totally unmanageable. The previous government had been following the policy of many developing nations at that time—heavy involvement in the economy. This included placing high duties on imports to protect local industry, levying high income taxes on private sector to obtain funds for government directed investment, and granting huge subsidies for selected industries.

- Recognising that drastic changes had to be made, the new government appointed a group of Chilean conservative economists to design a new program. Known as the Chicago Boys for having graduated from the University of Chicago, they were followers of the free-market teachings of its economics professor and Nobel Prize winner Milton Friedman.
- The contents of the Chicago Boy's program and its impact on business would not have surprised anyone with a knowledge of economies theory. In fact, much of what they proposed was based on the theory of comparative advantage. One of their most important reforms was to reduce import duties, which were as high as 1,000 per cent to a basic level of 10 per cent. Except for a few sensitive items, virtually anyone is free to import anything. These actions forced Chile to become a free-market economy where manufacturers and growers had to compete in world markets to stay in business. The lower import duties also reduced the costs of imported capital equipment, which encouraged business investment.

  The president of Chile's largest appliance manufacturer, whose industry had been protected from foreign competition by a 1,000 per cent import duty, gave his opinion of the new program: "We used to have 5,000 workers and an annual productivity of only $9,000 per worker. Now we have 1,860 workers and a productivity of $43,000 per worker, and we are finally showing a profit."

  There was, however, a disadvantage to lowering the high protectionist import duties. Although the leading appliance maker mentioned above was able to compete after losing its import protection, a number of other local appliance makers were forced to either go out of business or contract their operations. "We're going to lose a large part of our appliances industry," conceded Alvaro Bardon, a 37-years old Chicago Boy, then head of the Central Bank of Chile, "and also our electronics industry and our automobile assembly plants." Mr Bardon was hardly disappointed, however, "Those are products we should be importing," he said. "We have other things based on our own farm products, our timberlands, our fisheries, and our mineral resources that we should be making because they give us a natural advantage over other countries."

A second key reform was the privatisation of the nation's social security system by another American trained economist (a Harvard Ph.D), the minister of labour and social security. According to the economist Sebastian Edwards of UCLA, this privatisation led to an increase in national saving from 10 per cent in 1986 to 29 per cent in 1996. This resulted in lower interest rates, making borrowing for investment considerably less expensive.

How successful were these free market measures taken by the government? Exports certainly increased—from 14 per cent of the gross domestic product in 1980 to 29 per cent in 1995. Not only are Chilean firms exporting more, they are investing more in foreign ventures—at least $3 billion in the last four years. Investments include supermarkets in Paraguay, electric companies in Argentina and Peru, a railroad in Bolivia, a Coca-Cola bottling plant in Brazil, and banks in Peru, Bolivia, and Argentina. Chile's gross domestic product grew at a rate of 6 per cent annually from 1980 to 1995, the highest rate in the region. It has a GNP/capita of $4,160 whose purchasing power is equivalent to $9,520.

In the 1997 Index of Economic Freedom, a global survey made by the Heritage Foundation, a Washington think tank, and *The Wall Street Journal*, Chile was ranked 22nd in a list of 150 countries. The factors in the survey were trade policy, tax policy, government consumption of economic output, monetary policy, foreign investment, banking, wage and price controls, property rights, regulation, and the size of the black market. According to the report's co-author, Chile has the most free economy in Latin America, largely as a result of progress in reducing trade barriers and eliminating price controls.

(*Source*: Donald A Ball and Wendell H McCulloch, *International Business*, Irwin McGraw-Hill, 1999, pp 83–84)

Exhibit 3.4

THE ADVANTAGE IN COMPARISON

How do atomistic individuals combine to form society? And does this result in the 'survival of the fittest'? Do weaker, lesser skilled or handicapped people face extinction in free market competition?

The answer to all these questions lies in David Ricardo's principle of comparative advantage, propounded in 1817. However, the manner in which Ricardo laid down this principle is flawed. It looks at nation's trading, not individuals. Such abstract theorising in economics has rightly been called the 'Ricardian vice'. Yet, Ricardo's principle is hailed by the great classical liberal, Ludwig von Misses—as the law of human association, or the 'first law of sociology'. There is much that misses our perception of earthly reality if this law is not firmly ingrained in the intellect.

Recently, I was asked by a student if Ricardian comparative advantage applied to the modern world. As I groped for a quick answer, the doorbell rang and my gardener entered. I replied: "I am a better gardener than my gardener, but he has the job because he possesses a comparative advantage over me."

Indeed, this phenomenon of a lesser skilled individual being gainfully associated with one who has far better skills in the same area is common. The woman of the house is almost invariably a better cook than the person she hires. The owner of a car is often a better driver than his chauffeur. The only reason why these individuals with inferior skills hold jobs is because each possesses a comparative advantage.

In a market catallaxy, each of us must specialise in our own area of comparative advantage. Among all my skills, which include gardening, cooking, driving, singing and writing, I must specialise in what the market will reward the highest. I have chosen to write. I therefore have to hire a second-rate gardener, a third-rate chauffeur and a fourth rate cook. This is an economical arrangement because of comparative costs I pay these people less than what it would cost me, in terms of opportunities forgone, if I did them myself. This is why they possess a comparative advantage over me.

Note that I myself am not the 'best writer'. Catallactic competition is different from 'games' where the winner takes it all. In catallactic competition, all are winners. The market merely grades them according to consumer choice. The best whisky sells alongside the worst. Life in the jungle is 'survival of the fittest'. Life in the city is not. Stevie Wonder though blind from birth, is a superstar only because of free markets.

Indeed, the law of human association is valid even in non-market situations, when individuals spontaneously specialise. My girlfriend does the cooking while I do the dishes because I am 'least bad' at the latter task. She is better than me at both. But when we associate spontaneously, we both gain. I get better meals, while she gains from an extra pair of hands. Both, the not so skilled as well as the skilled individuals gain.

This means free trade, free immigration and free markets will not benefit the rich and the strong alone. On the contrary, poorer nations have even more to gain by obliterating national boundaries. By trading our poor skills, we will obtain the products of highly skilled nations. So, by working at a call centre, through a low-end skill, we can buy German cars, Finnish mobile phones, American software-all 'hi-tech'. This means globalisation is a good thing. Free trade will benefit the entire developing world.

The law of human association tells us that there are eternal harmonies between all our economic relations. The rich, the poor, the unlettered, the scholars and even the blind and the lame can happily coexist in the free market and all will gain. There are no mutual antagonisms. Rather, all dissensions are the products of spurious ideologies, from pure xenophobia to protectionism and economic nationalism. These spurious ideologies, when translated into official policies, harm the entire world.

(*Source*: Sauvik Chakraverti, "The advantage in comparison", *Mint*, May 29, 2009, p. 23)

Assumptions and Limitations

The two theories—absolute and comparative advantage—are based on several assumptions that limit their real-world application. *First,* it is assumed that countries are driven only by the maximisation of production and consumption. This is not the case. Governments of most countries are guided by other considerations when they are trading with other nations. *Second,* the theories assume that there are only two countries engaged in the production and consumption of just two goods. This is also not the case. There are currently more than 180 countries and literally a countless number of transactions take place worldwide. *Third,* it is assumed that there are no transportation costs for shipping goods from one country to another. In reality, transportation costs are major expenses in international trade. If transportation costs outweigh the benefits, trade will not occur at all. *Fourth,* the two theories consider that labour is the only factor of production that helps convert raw materials into finished products. At the time when the theories were propounded, production processes were highly labour intensive and wage cost was the major element in the total cost of production. It was also assumed that labour was immobile. The scenario is different now. It is no secret that Silicon Valley is hugely staffed by Indians. *Finally,* it is assumed that specialisation in the production of one particular good does not result in increased efficiency. But it is too well known that specialisation does improve the ways of performing tasks. Experience curve, for example, shall help reduce the amount of resources needed to produce one unit of output over time.

Despite the assumptions made in the theory of comparative advantage, enough evidence is available to prove the relevance of the theory. Nevertheless, researchers continue to develop and test new theories to explain the international purchase and sale of goods. Some such theories are explained below.

Recent Theories While mercantilism, absolute advantage and comparative advantage theories of trade described till now came under the classical mould, new theories have come up recently. We propose to cover here factor endowment, Leontiff Paradox, international product life cycle, new trade and competitive advantage theories.

Factor Endowments Theory

Ricardo's theory stresses that comparative advantage arises from differences in productivity. Thus, whether England is more efficient than Portugal in the production of cloth depends on how productively it uses its resources particularly labour productivity. Ricardo emphasised that differences in labour productivity between nations underlie the nature of comparative advantage. Swedish economists Eli Heckscher (in 1919) and Bertil Ohlin (in 1933) put forward a different explanation of comparative advantage. They argued that comparative advantage arises from difference in national factor endowments.

By factor endowments they meant land, labour and capital on a basic level and on a more complex level, such factors as management, technological skills and specialised distribution networks. Now, according to them each country allocates its production according to the relative proportion of factor endowments.

Thus, the range of products made or grown for export would depend on the relative availability of different factors in each country. For example, agricultural production or cattle grazing would be emphasised in such countries as Canada and Australia, which are land-rich. Conversely, in small land-mass countries with high populations, exportable products would centre around labour-intensive articles. Similarly, rich nations might centre their export base on capital-intensive production.

In this way, countries would be expected to produce goods that require large amount of the factors they hold in relative abundance. Because of availability and low costs of these factors, each country should also be able to sell its products in foreign markets at less than international price levels.

Often a country's exports do not depend upon only factor differentials but on taste preferences as well which has not been considered by the theory. For example, luxury imported goods such as Italian leather products, deluxe automobiles, and French wine are valuable for their quality, prestige or panache. This has not been recognised in the theory. But the factor endowment theory has high common sense appeal.

Economist Paul Samuelson extended the factor endowment theory to look at the effect to trade upon national welfare and the prices of production factors. He posited that the effect of free trade among nations would be the same in all countries.

Tata Steel (earlier called TISCO) in India is now ranked the first among the top world-class steel makers because of the factors favourable to it. (See Table 3.5 and read Exhibit 3.5 for details on factor endowments of TISCO.)

Exhibit 3.5

TISCO–LOW COST STEEL MAKER

What did Tisco actually do to achieve the low-cost producer status? Answers Tridib Mukherjee, deputy managing director, who is in charge of operations and marketing : "We concentrated on four to five areas. First of all, we looked at our strengths. We have captive raw materials like coal, iron ore, and lime stone so we can be the cheapest hot metal producers. When we looked at that part, we found that we were using up to 30 per cent of imported scrap as feedstock. This was totally unnecessary and we reduced it over a period of time to 5 per cent. Secondly, we increased the output of hot metal by increasing what we could get out of existing assets like blast furnaces. We used to produce 2,800 tonnes per day with our BF-G, which we gradually took up to 4,000 tpd. We benchmarked with the best practices of leaders like Nippon, CST (Brazil), and Posco in this regard. We fine-tuned our sinter plant and increased production from 2.2 MT of sinter to 3.9 mt which is as good as having one sinter plant free. Similarly, we were using imported coal for coke ovens and found that by changing the way we charge the ovens to Stamp Charging, we could produce high-quality coke with our own pulverized coal. Now our mix is 70:30 for Indian and imported coke. We were also able to develop high quality low phosphorus steel with our own technology. This was necessary since our ore contains high phosphorus. For this we had to develop a dolomite-free process. We reduced the labour from 72,000 to 48,000. A major factor for cost reduction is, of course, employee involvement. We received literally thousands of suggestions. Our estimate is that the suggestions have saved us Rs 250 crore last year," says Mukherjee.

(*Source*: *Business India*, July 23–Aug 5, 2001)

The Leontiff Paradox

W.W.Leontiff (winner of the Nobel Prize in economics in 1973) studied closely exports and imports of the US and published his findings in a paper in 1953. His observations in the paper contradicted with the factors endowments theory explained above. Lenotiff found that US exports were less capital intensive than US imports. Since his findings were in variance with the factor endowments theory, it has become to be known as the Leontiff Paradox.

Leontiff cleared his own paradox. The answer, as outlined by him, is that the factor endowments are not homogenous, and they differ along parameters other than relative abundance. Labour pools, for example, can range from being skilled to unskilled. Similarly, production methods can be technically more sophisticated or advanced in different locations within a country. Thus, it makes sense for the US to export goods that heavily use skilled labour and innovative entrepreneurship such as computer software, while import heavy manufacturing products that use large amount of capital.

Product Life Cycle Theory

Product life cycle theory, propounded in 1960s by Raymond Vernon of the Harvard Business School, has two lessons: why trade takes place, and why investment occurs. The second part is explained in the next chapter. The focus here is obviously on the first part of the theory.

Also called the International Product Life Cycle Theory (IPLC) the theory seeks to explain how a company will begin by exporting its products and eventually undertake foreign direct investment, as the product moves through its life cycle. The theory also says that for a number of reasons, a country's export eventually becomes its import.

Table 3.5 World Steel Dynamics on 12 World-Class Steel Makers

Factors	*Tata*	*Usinor*	*Posco*	*CSN*	*Baosteel*	*China Steel*	*Gerdau*	*Nucor*	*Car Tech*	*Sever-stal*	*Nippon steel*	*Dofasco*
Operating Costs	9	8	8	10	8	8	9	7	6	10	6	7
Ownership of low-cost iron ore and coking coal	10	6	1	9	3	1	nmf	nmf	nmf	9	1	6
Favourable location for procuring raw materials	10	6	8	9	5	6	6	7	6	7	8	6
Skilled and productive workforce	7	9	10	7	7	9	8	10	8	7	10	8
Price paid for electricity	7	7	8	6	6	5	7	8	5	8	6	6
High quality and niche products	7	9	9	6	5	8	6	8	10	6	10	8
Low legacy (retired-workers) costs	6	5	6	8	8	6	8	5	4	6	5	4
Ongoing cost-cutting efforts	8	9	8	8	8	8	8	8	8	8	8	8
Cost position of nearby competitors	7	7	9	8	6	6	7	8	8	6	6	8
Owns downstream steel using businesses	5	7	6	4	5	5	7	8	8	6	10	5
Domestic market growing at a high rate	9	8	6	6	10	6	7	3	6	6	2	4
Proportion of sales in the home market	7	8	6	6	9	8	8	10	8	1	4	7
Degree of pricing power with large steel buyers	8	8	7	7	8	9	6	3	6	6	6	5
Dominant in region	7	7	9	6	7	8	8	2	7	7	6	3
Balance sheet	7	8	8	8	7	8	7	10	7	7	6	9
Borrowed funds and equity on a favourable basis	8	8	9	6	10	9	7	10	6	2	8	6
Management is experienced, aggressive, proactive	9	9	9	9	9	9	9	9	9	9	9	9
Total	131	129	127	123	121	119	118	116	112	111	111	109
Average score	7.71	7.59	7.47	7.24	7.12	7.00	7.38	7.25	7.00	6.53	6.53	6.41
Ranking	1	2	3	4	5	6	7	8	9	10	10	11

(Source: Business India, July 23–August 5, 2001)

The theory proposes a different motive for any country to indulge in foreign trade. It relies primarily on the traditional marketing theory regarding the development, progress, and life span of products in markets. This theory looks at the potential export possibility of a product in four discrete stages in its life cycle. The stages include innovation, growth, maturity and decline.

Innovation In this stage, a firm introduces an innovation product in response to a felt need in the domestic market. As the fortunes of the product are not known, it is produced in limited quantities and sold mainly in the domestic market. Exports are either non-existent or take place in a limited way.

Growth Here, sales of the product tend to increase. So also competition as other firms enter the area and the product becomes increasingly standardised. At this point, the firm sets up subsidiaries in different countries and starts production in them. This helps the firm to maximise service of foreign markets and meet competition also.

Maturity As the product enters the maturity stage, export from the home country decrease, not because the product loses its sheen, but production in subsidiaries increases. Foreign manufacturing facilities are put in place to counter increasing competition and to maximise profit from scales aboard. At this point, price becomes a critical factor in determining competitiveness. Obviously, cost minimisation assumes greater relevance. Manufacturing facilities may from now onwards be set up in low cost locations. The innovator country may even decide to discontinue home country production and concentrate more on third-world countries, and re-export the product back to home country and to other markets.

Decline Here, the product enters a period of decline, often because new competitors have achieved levels of production high enough to effect scale economies in the production that are equivalent to those of the original manufacturing country. The product has now become a commodity.

Figure 3.5 carries the salient features of the four stages of a product life cycle.

Fig. 3.5 Life Cycle of the International Product

	LIFE CYCLE STAGE			
	1: Introduction	*2: Growth*	*3: Maturity*	*4: Decline*
Production location	• In innovating (usually industrial) country	• In innovating and other industrial countries	• Multiple countries	• Mainly in developing countries
Market location	• Mainly in innovating country, with some exports	• Mainly in industrial countries • Shift in export markets as foreign production replaces exports in some markets	• Growth in developing countries • Some decrease in industrial countries	• Mainly in developing countries • Some developing country exports
Competitive factors	• Near-monopoly position • Sales based on uniqueness rather than price • Evolving product characteristics	• Fast-growing demand • Number of competitors increasses • Some competitors begin price cutting • Product becoming more standardized	• Overall stabilized demand • Number of competitors decreases • Price is very important, especially in developing countries	• Overall declining demand • Price is key weapon • Number of producers continues to decline
Production technology	• Short production runs • Evolving methods to coincide with product evolution. • High labor inputs and labor skills relative to capital input	• Capital input increases • Methods more standardized	• Long production runs using high capital inputs • Highly standardized • Less labor skill needed	• Unskilled labor con mechanized long production runs

(Source: John D. Daniels, et al, *International Business*, Pearson, 2013, p.241)

The product life cycle (PLC) theory has been validated by real life experiences. This is the strength of the Vernon's theory. Xerox Corporation invented and produced photocopier in the US in early 1960s and sold initially to the US users. Xerox Corporation started exporting to Japan and the advanced countries of Western Europe. As demand began to rise in those countries, Xerox Corporation set up joint ventures in Britain and Japan to produce photocopiers there. In the meanwhile, Xerox's patents on the photo copiers expired; other foreign competitions started entering the market. As a consequence, exports from the US declined, and US users began to buy photocopiers from low cost countries, 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, to start with US and later Japan and Britain began as exporters have became importers. Similar happenings occurred in ballpoint pens and hand calculators. They were first produced in a single developed country and sold at high prices. Then production shifted to several developed country locations to serve those local markets. Finally, production is now shifted to developing countries, and prices too have declined.

However, the PLC theory is found applicable for such products as consumer durables, synthetic fabrics, and electronic equipment; that is those products that have long shelf life in terms of the time span between innovations and decline stages. The theory does not hold for products with rapid time span of innovation, development and obsolescence.

Particularly, these days PLC theory seems to be less relevant. MNCs now introduce products simultaneously in several markets of the world. Similarly, MNCs no longer first introduce a product at home only. Instead, they might launch an innovation from a foreign source in the domestic markets to test production methods and the markets itself, without incurring the high initial production costs of the domestic environment.

New Trade Theory

A new theory to explain foreign trade emerged during the 1970s and 1980s. The new trade theory states that (1) there are gains to be made from specialisation and economies of scale, (2) the first movers into any market can create entry barriers to others, and (3) governments may have a role to play in assisting its home based firms. Because the theory emphasises productivity rather than a country's resources, it is in line with the theory of comparative advantage but at odds with the factor endowments model.

According to the new trade theory, a company increases its output because of specialisation and its consequent rise in efficiency. As the output increases, the fixed cost of production gets spread over a large number of units of output. The fixed cost per unit of output falls enabling the company to fix a competitive price for its product. The firm is now in a position to force potential competitors to produce at the same level and fix identical prices. Obviously, the first entrant gains *first mover advantage*—the economic and strategic advantage gained by being the first entrant into an industry. The first mover advantage can create a formidable barrier to entry for potential rivals.

Government's assistance may be sought by business people to enable the first entrant to sustain its competitive advantage.

The new trade theory is still too fresh and not enough evidence is available to judge its relevance and applicability. The main theme of the theory—first mover advantage—may not always be true. As the ending case to the chapter on International Strategic Management indicates, a late mover into a market can also gain competitive advantage.

Competitive Advantage

Michael Porter, Professor at Harvard, is of the opinion that classical trade theories on comparative advantage fail to explain adequately why trade takes place across countries. He studied 100 companies in 10 developed countries to learn how a firm can become competitive. A company which enjoys competitive advantage is in a stronger position to trade with firms in other countries. According to Porter, a firm's competitive advantage stems from (i) factor conditions, (ii) demand conditions, (iii) strategy and rivalry, and (iv) related and supporting industries.

Porter represents these elements as the four corners of a diamond as shown in Fig. 3.6. These four factors are posited in a diamond shaped diagram, hence the name Porter's diamond.

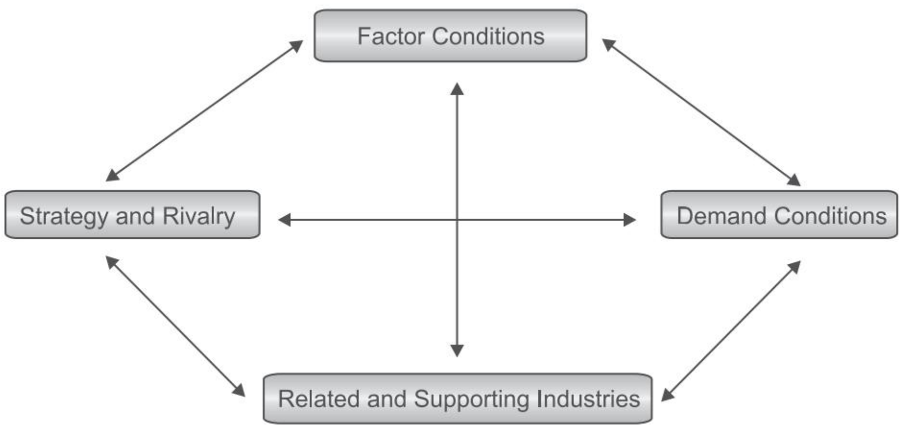

Fig. 3.6 Porter's Diamond

Factor Conditions Factor conditions include land, labour, natural resources and infrastructure. These factors will give initial competitive advantage to a nation. But a sustained competitive advantage comes from, what Porter calls, advanced or specialised factors. Such advanced factors include skilled labour, capital and infrastructure. These are created but not inherited. Specialised factors are difficult to duplicate and a firm that possesses these factors enjoys competitive advantage because others cannot easily replicate them.

Demand Conditions Demand conditions in a country include the size and sophistication of its market and the appropriateness of product standards. Sophisticated local customers enhance the country's competitiveness by providing firms with insight into emerging customer needs. One example is the French wine industry. The French are discernible wine consumers. Those consumers force, help and expect French wineries to produce high quality wines.[10] So are the Italian users of leather products. Because of exacting demands of Italian buyers, producers are producing high quality leather products.

Related and Supporting Industries Extant related and supporting industries enhance competitive advantage of a firm through close working relationships, joint research and problem-solving, close proximity and sharing of knowledge and experience. While it is possible to outsource some of these facilities to distant suppliers, using nearby vendors is better.

Firm Strategy, Structure and Rivalry The ability of a firm to compete successfully in global markets depends on its strategy, its structure and domestic rivalry.

Vigorous domestic competition compels the firm to become vibrant and proactive. It constantly seeks to reduce costs, improve quality and come out with innovative ideas and products. The resilience, thus gained, enables the company to take-on global competition.

Structure refers to the management styles being practised by the firm. Best management styles tend to vary across industries. At the macro level, some countries tend to be oriented towards a particular style of management. Those countries tend to be more competitive in industries for which the particular style of management is more suited. For example, Germany tends to have a hierarchical management structure comprising managers with strong technical backgrounds and Italy has small family businesses. In Japan's close-knit, authoritarian culture, firms are organised in networks, work practices are highly integrated and there are strong corporate goals.

National policies tend to affect the firm's international strategies. The rules, incentives and norms governing competition in a nation influence productivity. Policies that encourage investment, protect intellectual property, open local markets to overseas trade, break-up or prevent cartelisation, and reduce corruption make firms strong and vibrant.

In addition to the emphasis on the four elements in the diamond, Porter brings in two more elements that contribute to a firm's competitiveness, role of government and role of chance.

Government's role in fostering competitive environment is significant. India's case is typical. Till 1991, Indian firms were denied exposure to competition, both domestic as well as international. They remained almost morbid. The scenario changed from 1991 onwards. Their vibrancy and strength is visible by the way the Indian companies are acquiring global firms.

Chance refers to random events such as major technological breakthroughs, political decisions by foreign governments, war and destruction, fluctuations in exchange rates, sudden drop in demand, sudden discovery of pesticides in food or diseases and the like. These chance happenings either enhance or impede competitiveness of firms.

Porter's theory carries a clear message to governments all over. Instead of protecting domestic industries through trade barriers, governments should focus on improving the four components of the diamond. This helps a firm acquire competitive advantage. There are a number of limitations of Porter's model. A few demerits are: (i) focus more on developed countries, (ii) natural resources are too important, (iii) government has a role in determining competitiveness, and (iv) chance factors play their role in promoting or hampering competitive strength of firms.

USEFULNESS OF TRADE THEORIES

LO 6
Estimate the usefulness of trade theories

A trade theory (any theory for that matter) becomes useful, if it can dictate imports and exports. In other words, trade should follow theory. Classical theories and Porter's diamond model fit into this requirement. In many others, theories followed the trade.

In general, trade theories serve several purposes. First, they attempt to provide explanations for trade motives, underlying trade patterns, and ultimate benefits that come from trade. An understanding of these basic factors enables individuals, private interests, and governments to better determine how to act for their own benefit within the trading systems.

Second, trade theories discussed till now, as stated in the beginning of this chapter, tell us that purely from profit perspective, it makes sense for any firm to locate its production facilities in countries where cost of production works out to be the least.

Third, Porter's theory has definite policy implications. The theory suggests that it is in a firm's best interest to upgrade 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 interest of business to lobby the government to adopt policies that have a favourable impact on each component of the national "diamond". Thus, according to Porter, international managers should urge government to increase its investment in education, infrastructure, and basic research and to adopt policies that promote strong competition with domestic markets.

Fourth, for international businesses, trade theories are useful in yet another way too. Firms sell and buy goods and services from different countries. Because of their pivotal role in international trade, businesses are in a better position to influence government policies. Firms can lobby government to remove trade restrictions and to promote free trade. Promoting free trade generally benefits nations, if not specific firms. Realizing this, businesses should lobby for open markets.

Finally, for an international manager willing to set up a subsidiary in a foreign location, knowledge about the trade theories is useful. Governments anywhere have economists sitting as advisers or bureaucrats and their approval is necessary to set up operations. These officials and experts subject any proposal to scrutiny from the perspectives of international trade theories. In order to prepare a project report and defend the proposal when doubts are raised by the experts and officials, international managers need to understand the trade theories.

SUMMARY

- External trade benefits participating countries immensely. This is particularly true for developing economies. (LO1)
- Foreign trade policy of a country can be in-ward policy or out-ward. In practice, it is the mix of both that any country follows. (LO2)
- India's foreign trade is high on in-ward but slowly becoming outward. India's foreign trade policy is pronounced in exim policy which is announced once in five years. (LO3)
- International trade has been increasing both in volumes and values. China is ahead of other countries. India ranks down the line (LO4)
- Different trade theories are propounded by experts – some are classic and others are recent ones. (LO5)
- Trade theories have not just earned Nobel Prizes for their authors. They have practical relevance even now. (LO6)

REVIEW QUESTIONS

1. What is international trade? What are its inward looking and outward looking dimensions? (LO2)
2. What is mercantilism? How does it explain cross-border business transactions? (LO5)
3. Explain the theory of absolute advantage for world trade. (LO5)
4. Explain the comparative advantage theory for world trade. (LO5)

5. Explain the following: (LO5)
   (a) Factor proportions theory,
   (b) Product life cycle theory
6. Bring out Porter's diamond theory. How far is it relevant to a developing country? (LO5)
7. What lessons do trade theories carry for today's governments and policy makers? (LO5)
8. State the salient features of India's post-liberalisation trade policy? (LO3)

Discussion Questions

1. How do the theories of absolute advantage and comparative advantage differ from each other? (LO5)
2. Critically examine the impact of product life cycle theory on international trade. (LO5)
3. What are the four elements of Porter's diamond? Critically comment on each. (LO5)
4. Using the comparative advantage trade theory, outline the case for free trade. (LO5)
5. Brazil is gifted with several natural resources. But Brazil's economy remains an economic 'basket case.' How do trade theories account for this paradox? (LO6)

Reinforcing Exercises

- Dumping is one of inward looking trade policy measures. In simple terms, dumping refers to selling goods and services below cost of production. Two South Korean firms, namely, LG Semieon and Hyundai Electronics, indulged in dumping in 1997. The two were accused of selling dynamic random access memory (DRAM) chips in the US market at below their costs of production. This action occurred in the middle of a world-wide glut of chip making. It was alleged that the two firms were trying to unload their excess output in the US.
  What is your take on the above?
- Government intervention in trade is justified as a retaliatory measure. That is threatening a government to play by the rules of the game. The US government has warned the Chinese counterpart to enforce tighter intellectual property regulations. Lax enforcement of these laws had given rise to massive infringements in China that had been costing Microsoft huge loss in the form of lost sales. After the US threatened to impose 100% tariffs on a range of Chinese imports and after harsh words between the two governments, did China fall in line. Recollect some more of this type.
- "Mercantilism though the oldest theory, has relevance even today. The neo-mercantilism which has emerged recently also believes in trade surplus. It equates political power with economic power and economic power with trade surplus, and trade surplus through encouraging exports and curbing imports".

  Offer your views on the above.

CLOSING CASE

What is Good for GM is Not so for Others

General Motors (GM) is the case of a company which grew like dinosaur and unlike cocroach that survived, the US car maker perished under its own weight. The company very well proves the adage—difficult to achieve success and more difficult to sustain it. The company also proves how disastrous it is to be too greedy, depend much on inorganic route to grow and be megalomaniac.

History

GM was started in 1908 by William C 'Billy' Durant, a high school drop out who had risen to be president of the Buick Motor Company. GM was initially set up as a holding company to acquire other automakers. It soon took over OldsMobile, Cadillac and Oakland, which would later change its name to Pontiac and eventually Chevrolet.

Under the leadership of Alfred Sloan, a Massachusetts Institute of Technology trained engineer who ran the company in the 1920's, the car maker pioneered a strategy of organising its various divisions in a way that would fuel its growth for decades.

The idea of Sloan was to use the brands to offer 'a car for every purse and purpose'. Chevrolet made affordable cars. Pontiac and Oldsmobile were progressively more upscale. Buick was a true premium brand and Cadillac, the pinnacle of luxury. Together, they formed a 'ladder of success', allowing customers to move on to better cars as their status in life improved, without having to leave the GM family.

In 1932, a focused GM moved past its oldest rival, Ford Motor Co., to become the world's largest car maker a title it would hold for 77 years. By the late 1950s, GM alone had 50% of the US auto market. GM's dominance in the US auto market was so much that the government questioned whether it should use antitrust laws to break up the firm.

Beyond the US, GM's major markets included Europe, Asia Pacific, Latin America, Africa and the Middle East. With manufacturing operations spread over 32 countries and an employee strength of 324000, GM was sitting pretty at the top of the world. In 2004, the GM's revenues were $ 191.4 billion, that was greater than the GDP of more than 148 countires. Charles Wilson, the CEO of GM was emboldened in 1953 to point out: "What was good for our country was good for GM, and vice-versa".

GM was Microsoft, Apple and Toyota, all rolled into one. It set the standards of how a company should be run, how utilitarian products could be made and how they should be sold. It helped win a world war (Peter Drucker said it was not the generals but GM who won the Second World War for America), drove American prosperity and reinvigorated business schools curricula. Behind the success of GM were the famous brands which became household names throughout the world.

Troubles Galore

GM became a victim of its own success. Its path to bankruptcy paved with the very management, marketing and human resource practices that made it the world's largest and most profitable company for much of the 20^{th} century. Strategies that had once been deemed innovative became a millstone on the whole company. Big trouble started in 1970s with the entry of Japanese car makers who gained market share with well made small cars and helped by two spikes in oil prices.

GM's strategy of offering multiple brands started to backfire. To cut costs, GM began stocking its makes with nearly identical cars. That blurred the differences between brands and made it hard for consumers to tell a Chevy from a Pontiac or a Buick.

To confront the threat from foreign car makers, GM introduced a slew of new cars at a cost of several billon dollars. But things went wrong as days went by and GM reported a loss of $ 8.65 billion for 2005. Losses mounted as years rolled by. Talks to enter an alliance with Chrysler proved futile. GM approached government for a bail out, which did not come through.

Finally, GM with a debt burden of $70 billion, filed for bankruptcy. As the saying goes—GM is dead, long live GM—a new GM with the collaboration between Canada and US has come into being. But as of now, what was good for GM proved to be bad for shareholders, bondholders, employees, government and the public.

Surprisingly, five years after bankruptcy, GM turned profitable, its profits were exceeding expectations and its share price was rising. However, a new problem surfaced. What happened to be a routine recall in mid-Feb 2014 of about 800,000 older models, linked to a faulty ignition switch, has turned out to be a major challenge. The number of cars recalled has leapt to more than 2.6 mn. The company's inept handling of a safety problem that first became apparent a decade ago is now linked to the death of 13 motorists. Called before the Congress on April 1st to answer for GM's failings, the new CEO said she was "deeply sorry" but insisted that the post-bankruptcy "new GM" was not like the "old GM", which had failed to deal with the ignition switches for years. Politicians and the public alike want to know how such a problem could have remained unaddressed for so long.

Questions

1. What went wrong with GM? Why was it forced to seek bankruptcy protection?
2. What signals does GM send out to other MNCs in general and car makers in particular?
3. Which theory of international trade shall better explain the fate of GM?

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Suggested Readings

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CHAPTER


Nature of FDI
Why FDI?
Theories of FDI
• Product Life Cycle
• Market Imperfections
• Eclectic
• Market Power
• Internationalisation
Factors Influencing FDI
• Political Factors
• Supply Factors
• Demand Factors
Extent of FDI
Where does India Stand?

4

Foreign Direct Investment

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Discuss the nature of FDI
- **LO 2:** Justify the need of FDI
- **LO 3:** Label the problems from FDI
- **LO 4:** Explain the theories of FDI
- **LO 5:** Analyse the factors influencing FDI
- **LO 6:** Estimate the extent of FDI
- **LO 7:** Assess India's share
- **LO 8:** Examine the measures of attracting foreign capital

Opening Case

Hullabaloo about Coffee!

Grandma knows how to prepare coffee better, quicker and cheaper. Pour water in a kettle, heat it, mix coffee powder with hot water, close the kettle with a plate for a few minutes, collect enough sugar and milk in a separate utensil, pick up a piece of cloth and filter through it the hot water mixed with coffee powder into milk and sweetener. Lo and behold! Coffee is ready. Excellent aroma and wonderful taste. You cannot help drinking the hot coffee, twanging and tongue twisting.

Starbucks also prepares coffee (process may be different) and supplies it to users all over the world. Huge investments are made by the company all over the world and lot of hullabaloo is made over a simple hot drink called coffee.

Sardonicism apart, Starbuck's story is indeed worth recollecting. Starbucks today (30 years back it was a single store in Seattle) is a global roaster and retailer of coffee with 13,000 retail stores, majority of whom are found in 40 countries outside of the US.

In 1995, with almost 700 stores across the US, Starbucks began exploring foreign opportunities. Its first target market was Japan. Licensing route to enter Japan was easy but Starbucks was against the proposal, as licensing would not give the company complete control over the licensees to ensure replication of Starbuck's success formula. So the company established a joint venture with a local retailer, Sazabay Inc. Each company held 50 per cent stake in the venture Starbucks Coffee of Japan (set up in Tokyo). Starbucks initially invested $10 million in this venture, its first foreign direct investment. The Starbucks format was then licensed to the Joint Venture and was entrusted with the responsibility for growing Starbuck's presence in Japan.

Starbucks did not stop at this. To make sure that Starbucks Coffee of Japan did replicate the Starbucks success formula, the company 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 the US employees. The agreement also required that the stores were designed on the same lines as found in the US. The company also introduced employee stock option scheme to the Japanese employees in 2001, making it the first company to do so in Japan. Many doubted the success of these initiatives but they were proved wrong. As of today, Starbucks has 500 stores in Japan.

Having tasted success in Japan, Starbucks started spreading its wings. In 1998, the company bought Seattle Coffee, a British Coffee Chain with 60 retail stores, for $84 million.

Chinese are essentially tea lovers. Starbucks is encouraged by the fact that one-third of all Chinese households keep a jar of instant coffee on hand. Starbucks does not expect to change the tea drinking habits of the older generation. It is targeting China's newly rich, trying to establish its coffee as the drink of choice for the average 18 to 45 year old Chinese consumer.

In most countries, particularly in Asia, Starbucks entered licensing agreements with local operators in return for fees and royalties. Starbucks also sold coffee and related products to the local licensees, who then resold them to customers. As in Japan, Starbucks insisted on intensive employee training programmes and strict specifications regarding the design of the stores. However, the presence was not encouraging. As a result, Starbuck's converted several licensing agreements into joint ventures or wholly owned subsidiaries, particularly in Korea and Thailand.

Today, Starbucks has stores in Singapore (1996); the Philippines (1997); the UK, Taiwan, Thailand, New Zealand and Malaysia (1998); Beijing, Kuwait, S.Korea and Lebanon (1999); UAR, Hong Kong, Shanghai, Australia, Qatar, Saudi Arabia, and Baharain (2000); Switzerland and Austria (2001); Oman, Germany, Spain, Mexico, Puerto Rico, Southern China, Greece and Indonesia (2002); Turkey, Peru, Chile and Cyprus (2003); France (2004); Jordan, Bahamas, and Ireland (2005); Brazil and Egypt (2006); Rumania (2007) and India (2012).

Starbucks engages in the purchase, roasting, and sale of whole bean coffee worldwide. The company offers brewed coffee, espresso beverages, cold blended beverages, complimentary food items, coffee-related accessories and equipment, a selection of premium teas and a line of compact discs through its retail stores.

Starbucks cannot sit pretty. It has threats to encounter, weaknesses to get over and opportunities to grasp. The coffee maker is strong in the US but needs to spread its wings to other countries. The company is highly focussed on brewing and supplying coffee. It is time that the company gets into other, atleast related businesses.

Ever since Starbuks made its presence felt, other competitors have joined the bandwagon. But it has rescilience to fight-back and foray into overseas markets which are vast.

What is worth-mentioning here is that the sentiments Starbucks carries towards India. The coffee major already has 49 stores in India and is confident of bigger plans for the country. Listen to what its CEO – Howard Schultz – said on the occasion of inaugurating in Mumbai the company's joint venture operation with Tatas.

"At Starbucks, the people in our coffee department, who source coffee beans and oversee the roasting process, are respected and enthroned like royalty. Within the company, they have enormous influence. So when I sat down and asked their support for doing something special in India, they were not in agreement. They were most sceptical when I said, 'We want to create a different blend of coffee for India'. And when I told them that the India blend was not going to be roasted by our team, they looked at me incredulously. 'Are you suggesting that we do something we have not done in the forty-two-year history of Starbucks? How can we guarantee quality'? It was a tense conversation."

"I promised them they would have full decision rights on what the blend would be. But it was a real test of our trust in our new partner. To get the blend we wanted for India, we would have to share with Tata some of the family-jewels-roasting secrets we have perfected over four decades and guarded very closely".

The investments made by Starbucks in 40 countries outside of the US are typical of foreign direct investment (FDI). And Starbucks is no exception. Every multinational enterprise invests in foreign countries.

This chapter examines different dimensions of FDI—its nature, theories, extent, India's experience and the like.

NATURE OF FDI

LO 1
Discuss the nature of FDI

In simple terms, FDI refers to the purchase of a significant number of shares of a foreign company in order to gain certain degree of management control. Obviously, at the core of FDI are the international flows of capital. What share of equity bestows management control in a foreign company? Countries set different thresholds at which they classify an international capital flow as FDI. Most governments set the threshold at anywhere from 10 to 25 per cent of equity ownership in a company abroad (In the US, it is 10 per cent). In contrast, an investment that does not involve obtaining a degree of control in a foreign company is called *portfolio investment*.

Specifically, FDI assumes either or all the four forms as explained below:

(i) **Equity Capital** This represents an MNC's investment in a foreign subsidiary primarily to gain management control in it. An MNC may either acquire a subsidiary outright or resort to a merger. In the alternative, the MNC may invest in a greenfield project. Greenfield investment is most welcome for any developing country as it adds to the country's manufacturing capacity, besides creating new jobs.

(ii) **Private Equity** In fact, this form is the most sought after investment in recent years.

(iii) **Retained Earnings** These represent surpluses ploughed back into subsidiary instead of repatriating to home country. Such retained earnings will be used to reinvest in the subsidiary.

(iv) **Others** These represent capital flows between an MNC and its subsidiary in the form of short and long-term borrowing and lending.

The UN's *World Investment Report* goes beyond equity investment. According to the *Report*, FDI includes three components, equity capital, reinvested earnings and intra-company loans.

In India, FDI is understood to cover a few more routes than the equity route stated above. Specifically, FDI inflow in India is said to include the following:

1. Reserve Bank of India's automatic approval route for equity holding upto 51 per cent,
2. Foreign Investment Board's discretionary approval route for larger projects with equity holding greater than 51 per cent,
3. Acquisition of shares (since 1996),
4. RBI's non-resident Indian (NRI) schemes, and
5. External commercial borrowings (ADR/GDR route).

Understandably, the Indian definition of FDI differs from that of the IMF, as well as of the *World Investment Report*. IMF's definition includes external commercial borrowings, reinvested earnings and subordinated debts, while the *World Investment Report* excludes external commercial borrowings.

Where do mergers and acquisitions (M&As) and green field projects appear in these schemes of things?Obviously, these are a part of equity investment.

Ideally, FDI flows, in the recipient country should get reflected in (1) capital formation, (2) formation of new firms and factories, (3) increase in foreign equity holdings in the existing firms, and (4) mergers and acquisitions of existing firms and factories.

NEED OF FDI?

LO 2
Justify the need of FDI

Why do countries want FDI? There are strong reasons why MNCs are welcomed to invest in foreign countries.

1. Traditionally, foreign investment is seen as a way of filling the gap between the domestically available supplies of savings, foreign exchange, government revenue and human capital skills and the desired level of these resources necessary to achieve growth and development targets.

If domestic savings are inadequate to generate enough investments, foreign capital is expected to fill the gap between targeted or desired investment and locally mobilised savings.

Often, the foreign exchange earnings generated from exports and foreign aid fall short of the targeted requirements. This is typically called trade deficit or gap. An inflow of FDI can not only alleviate part or all of the deficit on the balance of payments current account, but can also function to remove that deficit over time, if the MNCs can generate a net positive inflow of export earnings.

There can be a gap between targeted government tax revenues and locally raised taxes. By taxing the MNC's profits and participating financially in their local operations, governments of developing countries are expected to be able to mobilise public financial resources for development projects.

There is also a gap in management, entrepreneurship, technology and skill which is presumed to be partly or wholly filled by the local operations of MNCs. Not only do multinationals provide financial resources and new factories to poor countries, but they also supply a 'package' of needed resources, including managerial experience, entrepreneurial abilities, and technological skills that can then be transferred to their local counterparts by means of training programmes and by the process of learning by doing. In addition, MNCs can educate local managers about how to establish contacts with foreign banks, locate alternative sources of supply, diversify market outlets and become better acquainted with international marketing practices. Besides, MNCs bring with them, the most sophisticated technological knowledge about production processes alongwith modern machinery and equipment to the capital-starved developing countries. It is assumed that some of this knowledge leaks out to the broader economy when engineers and managers leave to start their own enterprises. Such transfers of knowledge, skills and technology are assumed to be both desirable and productive for the recipient nations.

2. Factories set up by MNCs act as nuclii of growth. An industrial enterprise established by a foreign company gives birth to several other enterprises which supply inputs to the parent company. It is not as if only a few surrounding firms are the beneficiaries. An entire industry, steel for example, may get a boost. It is estimated that every dollar of FDI increases domestic investment by 80 per cent of the amount of FDI.

3. FDI can generate healthy competition in the recipient countries. When FDI assumes the form of green-field projects, the result is the creation of new enterprises, adding to the number of players

in the market. By implication, this can increase the level of competition in the host country. Intense competition enhances consumer choice, tends to bring down prices and boosts economic welfare of the consumers. Increased competition tends to stimulate capital investments by firms in plant, equipment and R&D, in order to gain competitive advantage over their rivals. All these tend to result, in the long run, in increased productivity, innovations and greater economic growth.

But when MNCs buy out popular local brands/companies, benefits from the expected competition will not result. For example, Coca Cola bought the dominant domestic brand Thumps-up, and the then Hindustan Lever (now Hindustan Unilever) acquired Tomco, the largest domestic rival and the second largest firm in the industry, and the largest cosmetics company, Lakme. Such acquisitions do not add to any additional benefits to the economy.

4. Too often, locational advantages attract FDI. The location-specific advantages, in particular, include natural resources such as oil and other minerals, which are, by nature, specific to certain locations. A firm must undertake FDI to exploit such endowments. This explains the FDI undertaken by many of the world's oil companies, which had to invest where oil was located. Another example is the valuable human resource, such as low-cost highly skilled labour force. The cost and skill of labour varies from country to country. A Canadian medium-sized plant is thinking in terms of renovating a plant near Warsaw in Poland as the price of labour in that country is fairly low. Other nearby countries have lower wage rates, but Warsaw, the company's specific choice, has a cadre of well-trained factory workers who could be transferred to the renovated factory. Similarly, one major benefit of locating plants in Mexico is the highly skilled labour force that can be hired at fairly low wage rates. Additionally, manufacturing firms located in Mexico report high productivity growth rates and quality performance. France has been the target of much MNC activity. Daimler-Chrysler has recently built a new factory in France because of its faith in the workers' productivity and work ethics. Additionally, France's recent economic growth has impressed many MNCs.

Hyundai, the automobile giant from South Korea, has chosen Chennai in India for its new car manufacturing plant. Skilled labour at low wages, location of auto parts manufacturers such as Wheels India, Brakes India, Sundaram Fasteners, Sundaram Brakes, Bimetal Bearings, Tafe, and India Pistons in and around Chennai, guaranteed power supply, cheap land and proximity to sea port have attracted the plant to the capital city of Tamil Nadu.

The argument that location-specific advantages attract FDI is propounded by the British economist John Dunning. Dunning believes that market imperfections make licensing and exporting difficult and thereby render FDI an obvious choice for globalisation.

5. FDI often depends on a country's political attempts to reduce security risks. For example, Chinese state-owned petroleum companies have been investing abroad so as to minimise dependence on foreign companies for oil supplies. The move may also help China hold down prices on the petroleum it receives.

There is one more political motive behind FDI. During the early 1980s, the US government instituted various incentives to increase the profitability of US investments in Caribbean countries that were unfriendly to Cuba's Castro regime. The US wanted to strengthen the economies of those friendly nations through the growth of the FDI and make it difficult for unfriendly leftist governments to gain control. But with the end of the Civil war, the US ended investment incentives in the Caribbean region, and much investment was diverted to Mexico because of NAFTA.

6. It is the poor countries that deserve FDI more than any others. Poverty is prevalent despite globalisation, the world becoming flat and the millennium agenda. Following statistics speak for themselves:

- 12,000 children die every day from poverty-related diseases. Underweight children number over 150 million.
- A typical house in a village buys a bucket of drinking water at ₹ 2.
- About 1.2 billion people live on less than $1 a day.
- The average income of the 20 richest countries was 15 times more than that of the 20 poorest countries in 1960. It is now 30 times the average of the 20 poorest countries.
- Average life expectancies in many African countries have fallen from over 60 years to below 40 years because of AIDS. Over 95 per cent of AIDS victims are in the poor countries.
- The poorest 40 per cent of the 15–19 years age group of the populations of India, Pakistan, Mali and Benin averaged nil years of schooling.

How to alleviate poverty? Aid from international institutions and rich countries can be a temporary measure. Economic growth ushered in by increased investment can be a permanent solution.

Jeffrey Sachs, Special Adviser to the then Secretary General Kofi Annan on the Millennium Development Goals, told a press briefing on Sept 22, 2004, "Many of the poorest countries are simply being bypassed by globalisation, and the promises of the rich countries are not being fulfilled. We need more globalisation that reaches poor countries, and more successful globalisation, not less. The kind of globalisation that the poorest countries are feeling is brain drain. They are not seeing the inflow of foreign investment." Sachs added that FDI would be the strongest engine of growth in the developing world.

7. Forward integration can be another motive for FDI. Many MNCs desire to eliminate middlemen from their operations and forward integrate the different stages involved in the manufacture and sale of their products. For example, a firm may produce a soft-drink concentrate and sell it to another bottler who bottles and sells it in foreign markets. The profits generated are shared by the firm and the local bottler. Instead, if the firm has its own bottling plant in the foreign market, it would be able to control the entire operation and eliminate the need to share profits. This motive may prompt the company manufacturing the concentrate to set up its own bottling plant overseas.

PROBLEMS FROM FDI

LO 3
Label the problems from FDI

The problems associated with FDI are the same as the criticisms leveled against the MNCs (Read chapter 2 for details). FDI results in aggrandisement of wealth even at the cost of host country's interests, breeds bribery and corruption, interferes with the political system of the host country, small and marginal firms are made to exit, and leads to social and cultural disruption.

THEORIES OF FDI

LO 4
Explain the theories of FDI

We propose to discuss five models which provide theoretical rationale for FDI to occur. The theories are: product life cycle, market imperfections, eclectic, market power and internalisation. (see Fig 4.1).

Product Life Cycle

Product life cycle theory was considered in the previous chapter to explain the flow of trade among countries. Since the theory has investment implications, it is being revisited here. The product life cycle theory states that a company will begin by exporting its product and later undertake FDI as the product moves through its life cycle. The theory identifies four stages in the life cycle of a product: innovation, growth, maturity and decline. As will be seen, FDI occurs in the later two stages.

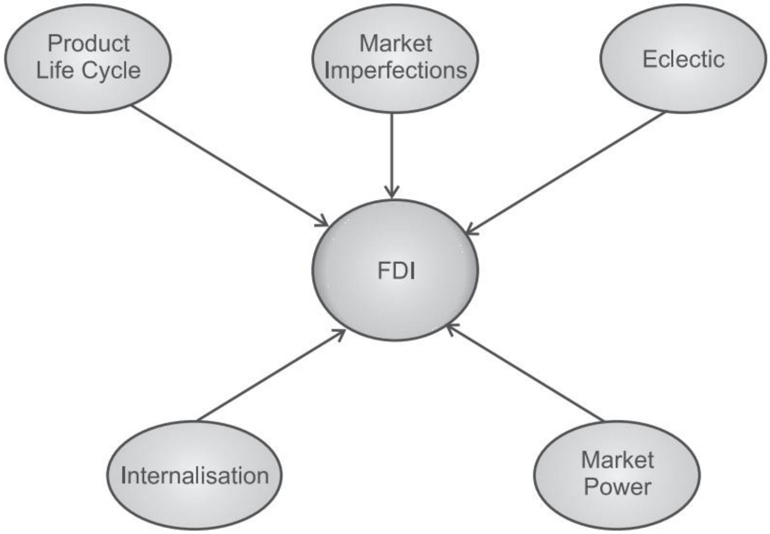


Fig. 4.1 Theories of FDI

In the *innovation stage* production takes place in the home country and any demand from overseas markets is met by exports. In the *growth stage*, sales tend to increase and to meet increasing demand from foreign markets, the firm sets up manufacturing facilities abroad. In the *maturity stage*, exports from home country decrease because of increased production in overseas locations. Foreign manufacturing facilities are put in place to counter increasing competition and to maximise profits from higher sales in foreign markets. In the *declining stage*, the product becomes a commodity. Competitors take over production and distribution often with better scale economies. The original manufacturing country needs no investment overseas.

The product life cycle theory has merits as well as demerits. On the merits side, it may be stated that the theory makes economic sense, in as much as it presumes that no company dares to invest in other countries when the fortunes of the product are not known. Developing countries often accuse MNCs of transferring outdated technology. Toyota, for example, introduced Qualis in India, a vehicle which was almost junked in other countries. But, from the product life cycle perspective, such late transfer of technology (read FDI) is a natural phenomenon. Any innovative company would like to wait and watch before venturing to invest in other countries.

Negatives of the theory seem to be more in number. The theory, for example, fails to explain why some MNCs do not believe in gradual expansion of production facilities. In computer industry, where disruption of technology occurs fast, any given company seeks to enter the world market simultaneously, recover costs and make profit, before its product enters its final stage of abandonment.

The theory is also silent on the reason why companies choose FDI over other forms of market entry. Licensing route can be used to access special assets needed to manufacture a particular product. This route helps avoid the risks associated with FDI. Finally, the theory fails to explain why firms choose FDI over exporting activities. It might be less expensive to serve a market abroad by increasing output at the home-country factory rather than by building additional capacity within the target market.

Market Imperfections

Market imperfections, also called internalisation theory, focuses on imperfections in the market (for example trade barriers) that would decide FDI. If trade barriers render a transaction less efficient than it could be, a company will undertake FDI to internalise the transaction and thereby remove the imperfections. In other words, a firm chooses to invest in overseas facilities if a transaction with a foreign firm (through franchise, licensing or supply agreement) proves to be more costly. The transaction tends to be costlier because of lengthy negotiations, entering and monitoring, all brought about by market imperfections.

Conversely, internalisation theory holds that when transaction costs are low, MNCs are likely to contract with outsiders through licensing or franchising, instead of resorting to FDI. For example, Starbucks (see the opening case) is an expert in franchising with local stores and enforcing the contracts. Because Starbucks is so successful in reducing transaction costs between itself and its franchisees, it has more franchised stores overseas than own outlets.

Eclectic Theory

Advocated by John Dunning, eclectic theory argues that a location in question attracts FDI because it combines the unique advantages of ownership, location and internalisation. According to Dunning, FDI will occur when three conditions are uniquely combined.

Ownership advantage This advantage stems from the fact that the firm is proprietary to some unique competitive advantage that helps it overcome the disadvantages of competing with foreign firms in overseas markets. This unique advantage may be brand recognition, technical knowledge, economies of scale or management ability.

Location advantage This refers to the advantage of locating a particular factory in a specific location because of the unique characteristics of that location. These advantages have historically been natural resources such as oil in the Middle East, timber in Canada and copper in Chile. Cater Pillar, for example, manufactures bulldozers in Brazil to take advantage of lower labour costs and avoid high tariff walls on goods exported from its US factories.

Internalisation advantage This arises from internalising a business activity rather than leaving it to a relatively inefficient market. The firm must benefit from controlling (internalising) the foreign business activity than leaving it to a local company to provide the service. Control is advantageous when monitoring and enforcing the contractual performance of the local company. It is expensive where the local firm may misappropriate proprietary technology, or when the firm's reputation and brand name could be jeopardized by the poor behaviour of the local company. Table 4.1 sums up the eclectic theory.

Table 4.1 The Eclectic Theory of FDI

	Ownership advantage	*Location advantage*	*Internalisation*
Exporting	X	–	X
Licensing, franchising etc.	X	X	–
Wholly owned (FDI)	X	X	X

(*Source:* Adopted from *International Management* by Arvind Pathak et al., p. 242)

Market Power

Yet another theory of FDI is the market power model. This theory states that a firm seeks to establish a dominant market presence in an industry by undertaking FDI. Dominant market presence results in greater profits to the firm.

Market power is often sought to be achieved through vertical integration. Such integration may be the extension of the company's activities into its supply chain (backward integration) or the absorbing of its output (forward integration).

Forward integration involves gaining ownership or increased control over distributors or retailers. Increasing numbers of manufacturers today are pursuing a forward integration strategy by establishing websites to sell products directly to consumers. An effective means of implementing forward integration is *franchising*. Businesses can expand rapidly by franchising because costs and opportunities are spread across many individuals. Total sales by franchises in the US are about $1 trillion annually.

Backward integration is a strategy of seeking ownership or increased control of a firm's suppliers. This strategy can be especially appropriate when a firm's current suppliers are unreliable, too costly or cannot meet the firm's needs.

Internalisation Approach

Propounded by Buckley and Casson, the internalisation theory is based on two principles: (1) firms internalise missing or imperfect external markets until the costs of further internalisation outweigh the benefits; and (2) firms choose locations for their constituent activities that minimise the overall costs of their operations. Expansion by internalisation of markets means that firms use FDI to replace imperfect external markets in intermediate products and knowledge (as exemplified by exporting and licensing) and appropriate the profits from doing so.

The location aspect of the theory suggests three primary motivations:

- Foreign-market-seeking FDI;
- Efficiency (cost reduction)-seeking FDI;
- Resource-seeking FDI (including a subset that is known as strategic-asset-seeking FDI).

Market-seeking FDI will be undertaken by firms for traditional trade supporting reasons, to access distribution networks, to facilitate the exports of domestic products and to enhance exports from the host country. Efficiency-seeking FDI will occur when outward investors seeks lower-cost locations for operations, in particular, in their search for lower cost labour. Resource-seeking FDI occurs when there is need to acquire or secure the supply of raw materials and energy sources in short supply at home.

FACTORS INFLUENCING FDI

LO 5
Analyse the factors influencing FDI

Several factors influence the decision relating to the flow of FDI. These can be classified into three categories: supply, demand and government (See Table 4.2).

Supply Factors

Supply factors include production costs, logistics, resource availability and access to technology. These factors influence a firm's decision relating to FDI.

Table 4.2 Factors Affecting the FDI Decision

Supply Factors	*Demand Factors*	*Government Factors*
Production costs	Customer access	Economic priorities
Logistics	Follow clients	Avoidance of trade barriers
Resource availability	Follow rivals	Economic development incentives
Access to technology	Exploitation of competitive advantage	

(*Source:* Adapted from *International Business*, by Griffin and Pustay, p.169)

Production Costs Firms seek competitive advantage through low production cost. Obviously, MNCs locate production facilities in low wage countries. It is just not low labour cost, a host of other factors also figure in the low cost, for example, lower real estate prices and lower taxes. Ford has set up a company at Chennai (India) to make one lakh vehicles per annum. Ford plans to export cars to South Africa from Chennai. Over the last two decades, more than 2000 maquiladoras have sprung up near the US-Mexico border. These plants take advantage of low wages to assemble American-made components for re-export to the US. Besides, inside Mexico, Japanese, German and American automotive firms have assembly facilities that ship final products to the US and elsewhere. Similarly, local incentives were the main motive behind establishing manufacturing operations by Intel in Costa Rica, and for locating a manufacturing plant by Mercedes in Alabama.

Logistics MNCs seek to invest in subsidiaries in foreign markets if the cost of shipping raw material is high. Coke and Pepsi have set up bottling plants in India as the cost of transporting water from the country is considerable. Also, international businesses often make investments in host countries to reduce distribution costs. The liberalisation of Latin American markets brought a surge of foreign direct investment in transportation and physical distribution, and foreign logistic providers have upgraded the region's transportation and warehousing facilities.

Natural Resources MNCs tend to utilise FDI to access natural resources that are critical to them. Natural resources attract many MNCs. Japan, for example, is a small densely populated island nation with very few natural resources of its own, especially forests. But Japan's largest paper mill, Nippon Seishi, does more than simply import wood pulp. The company owns huge forests and corresponding processing facilities in Australia, Canada and the US. This enables Nippon Seishi to have access to an essential resource. Likewise, to access cheaper energy resources used in manufacturing, several Japanese firms are relocating production to China, Mexico and Vietnam, where energy costs are lower. US oil companies are a classic example. Because of the decrease in oil production in the US, many oil companies have been forced to make significant investments worldwide to obtain new oil reserves.

Key Technology Technology and business have been intertwined since the Industrial Revolution. The connection between the two became even stronger in the information age, particularly with the advent of electronic business exchanges. Technology influences every aspect of the global market place, driving innovation, affecting partnerships and locations, and changing business-stakeholder relationships.

One of the motives behind FDI is to gain access to technology. Many of the Swiss Pharmaceutical companies, for example, have invested in US small biogenetics companies in order to gain cutting edge technology. Similarly, IBM and Lion Bioscience AG (German Company) established a joint venture in 2001 in which the alliance partners will develop and market their computer technologies and data-mining software, as a package to major drug makers and to other research laboratories trying to assimilate research data being generated in human gene research. The partners say that their alliance will shorten the discovery and development time for new medicines. Britain's Smith Kline (now merged with pharmaceutical firm Glasgow) invested $86 million in Cadus Pharmaceutical Corporation of New York to access the latter's yeastwork.

Demand Factors

Market expansion is another motive behind FDI. Included under this motive are such factors as customer access, following clients, following rivals, exploitation of competitive advantage and customer mobility.

Customer Access Certain international businesses need to be physically present in foreign markets to serve customers better. Starbucks, for example, cannot serve fresh coffee to its customers in Japan from its head office in the US nor can KFC provide freshly fried chicken to customers in India from its restaurants in the US.

Some countries have quality reputation in certain product categories. German automotive engineering, Italian shoes, French perfume and Swiss watches are known for excellence in quality. Because of these buyer perceptions, it can be profitable for a firm to produce its product in the country with quality reputation, although the company is based in another country. For example, a perfume producer might want to bottle its fragrance in France and give it a French name. Such image appeal can be strong enough to attract FDI.

Competitive Advantage A company enjoying great reputation may seek to establish subsidiaries in overseas countries to encash on its popularity. An owner of a valuable trade mark, brand name or technology may choose to operate in foreign countries rather than export to them. Toyota's presence in India is a case in context. Though it entered Indian market late, Toyota has been able to leaverge its world wide reputation and position itself well among Indian buyers.

Follow the Clients Often, clients of a company attract FDI. If one of the clients builds a foreign facility, the company may decide to locate a new factory of its own nearby, thus enabling it to continue to supply its customer promptly and attentively. This practice of 'following clients' is likely to be followed in industries in which main component parts are obtained from suppliers with whom the company has a close working relationship. For example, when Japanese automakers set up their plants in the US, several Japanese component parts suppliers also joined the bandwagon by establishing their own factories, warehouses and research facilities there. Similarly, after Samsung decided to construct and operate an electronics factory in northeast England, six of its Korean parts suppliers also moved into England.

Follow the Rivals Competitor analysis indicates the geographic strengths and weaknesses of individual rivals. From such analysis, firms can select markets for investment. MNCs routinely monitor market sizes and growth rates in over 150 countries. Obviously, as shown in Table 4.3, large and medium-sized growth markets are always attractive propositions, and firms compete to build factories in these regions (Asia or Latin America) and in countries such as India, Brazil and China. Similarly, large stable markets, such as North America and Western Europe also attract FDI. These regions continue to get a lion's share of global FDI. MNCs maintain positive outlook towards small-growth,

Table 4.3 Market Size/Growth and Investment Priorities

Market Size/Growth	*Growth*	*Stable*	*Declining*
Large	1	2	3
Medium	4	5	6
Small	7	8	9

Top Investment Priorities 1, 2 and 4
Medium Investment Priorities 7, 5 and 3
Low Investment Priorities 6, 8 and 9

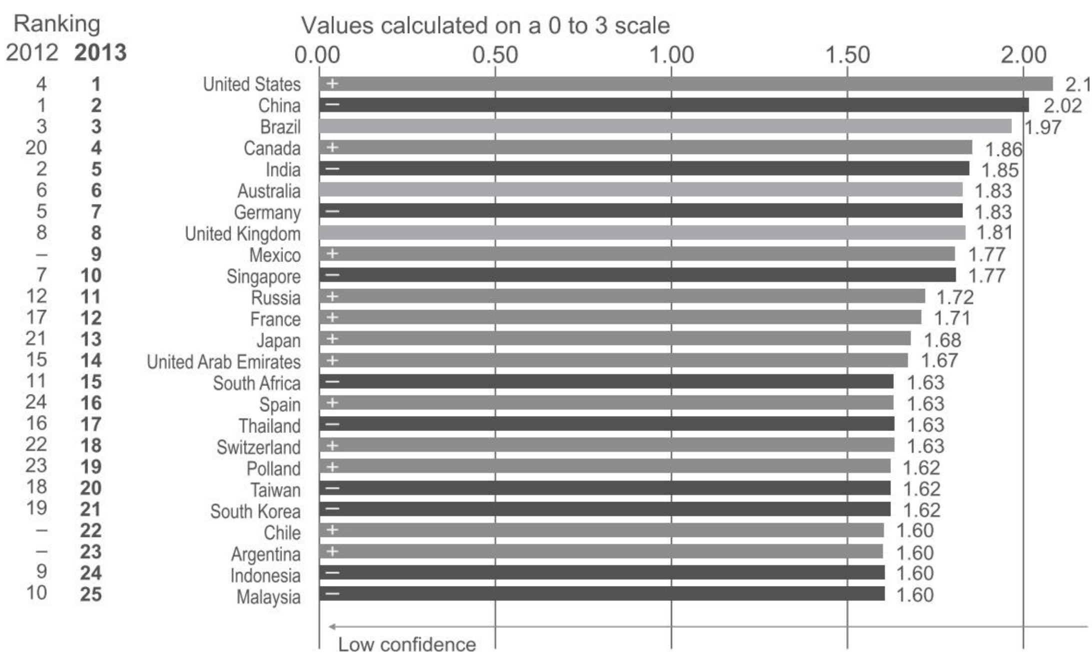
(*Source:* John S.Hill, *World Business*, Thomson, 2005, p. 225)

medium-sized, stable and large declining markets, as they know that markets grow, right economic and government policies being in place. The same is true with smaller markets, where patience pays. Only where there are adverse political and/or economic situations, do managers consider closure or disinvestment strategies.

Political Factors

Political factors are often determinants of the quantum and direction of FDI. Economic priorities of the host country, avoidance of trade barriers and development incentives are the major political factors impacting FDI.

More significant political factor is the confidence of investors in a particular country for investment. This confidence is sought to be measured by the FDI confidence index calculated by A.T. Kearney, a global think tank. Its ranking of nations on the confidence index is shown in Fig. 4.2. Obviously United



(*Source:* A.T. Kearney Foreign *Direct Investment Confidence Index*®, 2013)

Fig. 4.2 2013 FDI Confidence Index®

States, China, Brazil, Canada, India and Australia are the top ranks out of 25 countries ranked in the study.

Economic Priorities Economic priorities of developing countries often clash with profit motives of MNCs seeking to invest in such markets. In other words, developing countries want MNCs to invest in infrastructure development areas but the international businesses seek to invest in consumer goods industries. Obviously, developing countries impose restrictions on the flow of FDI into their economies.

Take India's case as an instance. Compared to other developing countries, India followed a restrictive policy towards FDI until 1991, relying more on bilateral and multilateral agreements with long maturities. Inward flow of FDI was perceived essentially as a means of acquiring technology that was not available through licensing agreements and capital goods imports. FDI was allowed in designated industries, subject to varying conditions on setting up joint-ventures with local partners, local content clauses and export obligations.

The then Foreign Exchange Regulation Act, 1974 stipulated foreign firms to have equity holding only upto 40 per cent, exemptions were at the government's discretion. Setting up of branch plants was generally disallowed; foreign subsidiaries were induced to gradually dilute their equity holdings to less than 40 per cent in the domestic capital market. The law also prohibited the use of foreign brands. Precisely for this reason, MNCs were avoiding investment in India till 1991. But, as is too well known, the scenario in India is totally different now.

Avoidance of Trade Barriers Fuji Photo Film Company has invested $200 million to set up a manufacturing plant in the US. Earlier, the company supplied film to its US customers from its factories in the Netherlands and Japan. While exporting to the US, Fuji was paying 3.7 per cent tariff imposed by the US Government. This tax has been saved by producing film in the US itself.

Development Incentives Many governments offer attractive incentives, many throw red carpet welcome to MNCs, to invest in their economies, particularly the developing countries. The theories of FDI explained earlier, give the reasons why developing countries invite FDI. The primary motive to attract FDI is to fill the resource gaps which exist in industrialising countries.

EXTENT OF FDI

LO 6
Estimate the extent of FDI

Figure 4.3 shows the world FDI inflows from 1998 to 2010. The year 1998 witnessed an inflow of $1971 billion and shut up to $1971 bn in 2007. Lowest inflow was witnessed in 2003. Figure 4.4 shows FDI inflows between developed and developing nations. Only in 2010, share of developing and transition economics slightly exceeded that of the developed countries.

INDIA'S SHARE

LO 7
Assess India's share

India's share in the global scenario is interesting—outflows exceed inflows. Fig. 4.5 shows the outflow from India from 2001 to 2013. Outflows fell in 2013. This was because of sharp decline in the rupee value, domestic economic downtime and unwillingness of investors to part with assets because of global uncertainties.

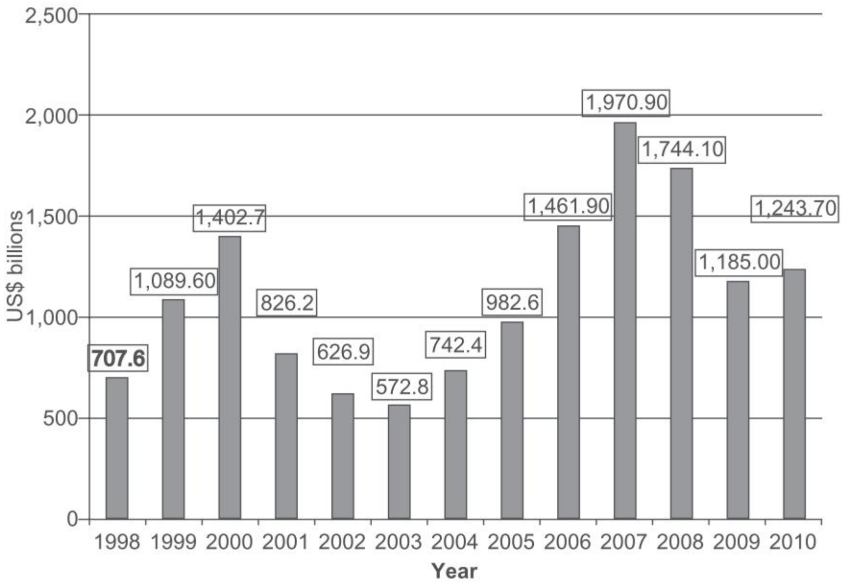


Fig. 4.3 World FDI Inflows 1998-2010

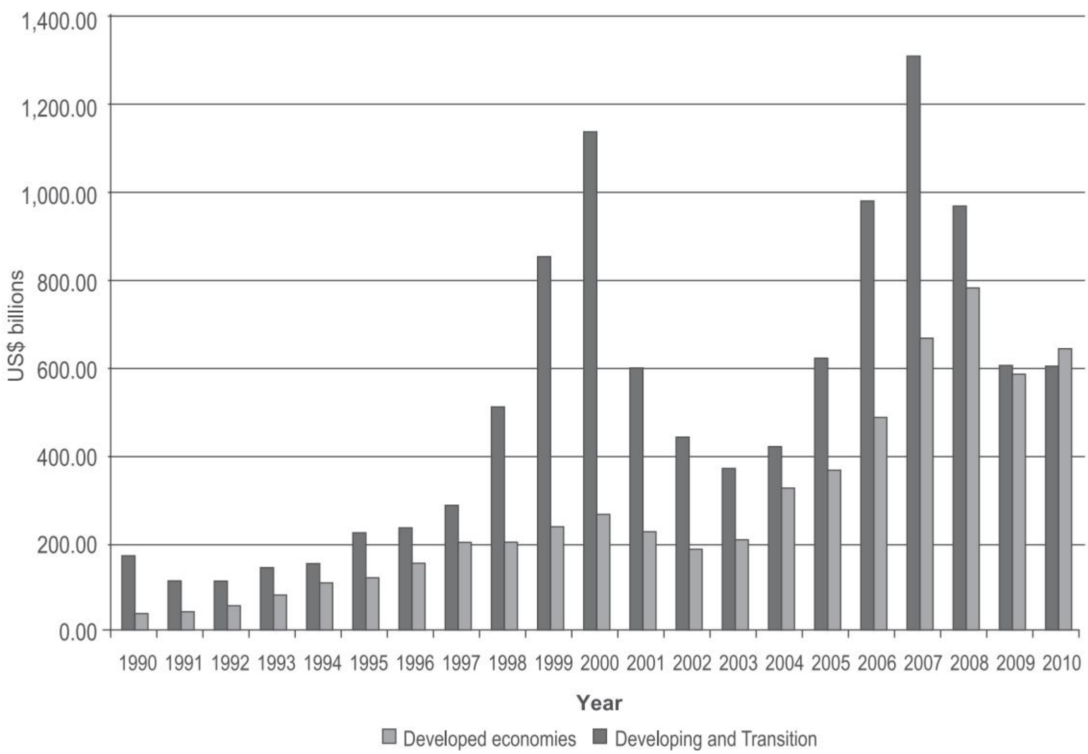


Fig. 4.4 FDI Inflows Developed vs. Developing and Transition

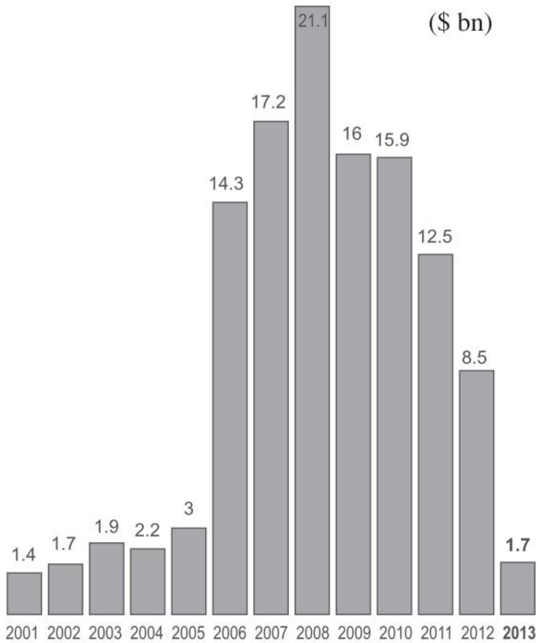


Fig. 4.5 Outflows from India (*Source:* UNCTAD)

The outflows comprise cross-border acquisitions.

But, the real concern for India is the poor inflow of FDI as Fig.4.6 shows. India is behind even smaller countries like Singapore as a recipient of foreign investment. If China has received $116 billion as FDI during 2011-12, India could get only $46 billion in the same period.

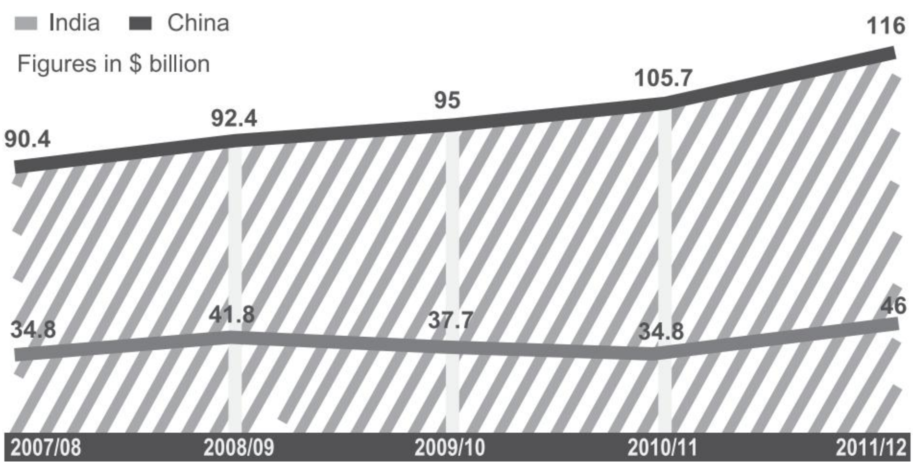


Fig. 4.6 FDI Inflows into India and China

There are several barriers to foreign investment. And most of the barriers are the ones created within the country. Among the factors hampering the inflow of foreign investment is an increasingly visible distaste for democracy. As Indian democracy matures, it is throwing up situations and leaders that do not fit easily into old ideological patterns that the developed world is familiar with. The uncertainty of political ethos that is not fully understood stands out in sharp contrast to the clarity of authoritarian regimes. Some investors even argue that since authoritarian regimes are more dependent on economic success to divert attention from political issues, they are more focused on the economy than democracies like India where other issues like religion, caste, language or even cricket take a major portion of a government's attention.

Nothing can be more illustrative than the way the proposed project to put up an international airport at Bangalore was put on hold for decades. After dilly-dallying for a decade, the airport is ready and is operationalised in March 2008. In contrast, in the past decade, China has built at least 12 major international airports. The National Highway Authority of India has not been able to lay roads as promised. But the Chinese Government has laid in the last decade 29,000 km of high quality four-lane highways.

Apprehensions about investing in India have not been helped by the early record of joint ventures. American executives monitoring joint ventures in India believe that Indian partners are often not in a position to live up to their part of the deal. In some cases, this is the result of unrealistic expectations and in others, it has to do with the liquidity crisis, making it difficult for smaller Indian partners to come up with their share of capital.

The sensitivity of foreign investors to these risks is heightened by the fact that India has less to offer than some other developing countries. The Indian market is proving to be smaller than investors may have believed. The earlier enthusiasm about a large middle class is tempered by the realisation that it does not have the purchasing power to absorb even items targeted at the lower middle class in the West. Western fast food chains, for instance, have become items of luxury consumption in India. The Indian market can be seen in perspective from one rather startling statistic. By 2001, the Indian demand for Pagers was expected to grow rapidly to 1.7 million, but in that year, China's demand was estimated to be 73 million. Without the buffer of a large domestic market, the main attraction India can offer to foreign capital is its cheaper costs of production, particularly labour costs. Taken individually, each small country may not have the advantage of lower labour costs for long. A rush of foreign capital into each country will raise wages there and eat into its advantage in labour costs. But taken together, foreign capital can move from one small country to another. Since some of the other countries like Indonesia are quite large, India would have a long wait before its competitors exhaust their low labour cost advantage. And other countries may also be able to offer advantages like less rigorous environmental standards.

The ability to attract foreign investment can also be adversely affected if the inflow of foreign capital is not appropriately integrated into the economy. This could happen in different ways. Sometimes, the concessions offered to attract foreign capital can distort the local economy to such an extent that foreign capital no longer finds it worthwhile to invest. This has already happened in the stock markets. In the effort to woo foreign institutional investors, the small investor has been ignored. As a result, the kind of small investor participation that helped Reliance emerge as a major industrial house is no longer seen. Without the emergence of new giants with the help of the capital market, the number of companies that are actively traded remains small. This narrow base reduces the options that Foreign Institutional Investors (FIIs) have, dampening their enthusiasm to invest.

The tendency to ignore the consequences of the concessions that are being offered may soon become more visible in other sectors. In the eagerness to attract foreign investment in the infrastructure sector, the prices are being offered without sufficient attention being paid to whether the economy can absorb these higher prices. So when the project is completed, investors may find that they have overestimated the demand. The fast track power projects have tried to overcome this risk by getting guarantees of a fixed off take of power. But such guarantees can hurt NTPC units, if in a relatively better power situation, they are asked to stop producing power so that the predetermined quantity of power can be evacuated from the foreign power plants. And if the government tries to avoid this situation by not offering guarantees, foreign investment in the power sector can also slow down.

The ability to integrate foreign capital into the economy is also hampered by the project-oriented approach to this task. With the focus being on individual projects, the linkage between individual projects and the rest of the economy is often not given sufficient attention. The value of a modern expressway, for instance, is ended if the time saved on it is lost in going from the expressway to the city. Despite Bangalore's Electronic City being built on one such expressway, several computer firms are considering moving out of the city, citing poor infrastructure as the reason.

Policy guidelines lack clarity between the central and state governments. Most policy guidelines are laid down by the central government but are left to the state governments for implementation. Delays take place at the implementation stage.

NRIs (numbering 25 million scattered across the globe and possessing collective wealth of $200,000 crore), who once accounted for 30% of the direct investment flow, have their own woes. They complain of bureaucratic red tape and demanding officials trying to extract money at every stage. Consequently, their interest in Indian companies declined.

We have innumerable labour laws which come in the way of improved labour productivity and the firm's profitability. Labour laws are so strange that even perennially sick units are made to pay wages to workers even if they have no work to do. Payment of bonus is mandated even for a loss making unit. Dismissal of an errant worker or closure of a perennially sick unit is almost impossible (See Exhibit 4.1). Labour laws need to be streamlined in tune with the demands of the competitive environment.

The much promised economic reforms have not been fully put in place, further demotivating foreign investors. The benefits of integrating with the global economy were the key selling points of economic reforms in 1991. Liberalisation was promised on the hope that it would make the local industry more competitive and turn India into a manufacturing power. The reformers hoped that manufactured products from India would capture world markets, opening up opportunities for millions to shift from farms to factories. More than two decades after those radical reforms, India's manufacturing dream

Exhibit 4.1

INCORRIGIBLE

The case of Uttam Nakote illustrates the need for reforms in Indian labour laws. In the early 1984, Nakote was found at 11.40 am, sleeping soundly while on duty on the shop floor in a factory located at Pune. His employer, Bharat Forge, let him off with a warning. But he was caught napping again, and then again. On the 4th occasion, the management began discipline proceedings, and after five months of hearing, he was found guilty and sacked. But Nakote went to labour court which forced the management to take him back and pay 50 percent of his lost wages. 17 years later, after appeals to the Bombay High Court and Supreme Court, the management finally won and Nakote was sacked for good.

still remains unfulfilled. It is not that reforms did not benefit the Indian economy at all. Reforms led to sharp growth in exports of services, but the rise of manufacturing exports has been very slow. If this is the in-house business environment, has can we attract FDI to our country?

India continues to be a mystery wrapped in an enigma in terms of business development to many foreign investors. The common causes for concern include delays in decision making, unexpected bottlenecks in implementation and ambiguities in policies and tax laws. These are the concerns expressed by investors across the globe. To the Japanese, India is totally a different world with communal riots, unhygienic conditions, severe poverty and many linguistic and caste conflicts unlike their own monoculture, single language country. Caste is something which they cannot grasp and religious conflicts frighten them as investors. And, of course, India's last few decades of socialism have left their own negative impacts.

Scams and corruption have vitiated the environment considerably. Civil servants, politicians and sections of media have shouted from rooftops about the frauds in spectrum allocation, coal mining and land deals. Truth has not been known but damage is caused to the reputation of the country as a whole.

How easy for a country to do business with India indicates her attractiveness for FDI. Figure 4.7 shows India's rank on several dimensions (see also Table 4.4).

Parameter	Previous Rank	Latest Rank
Overall Rank	140	142
Starting a Business	156	158
Dealing with Permits	183	184
Getting Electricity	134	137
Registering Property	115	121
Getting Credit	30	36
Paying Taxes	154	156
Enforcing Contracts	186	186

Note: A total of 189 countries were considered
Source: *Economic Times*, Nov. 16-22, 2014

Fig. 4.7 An Obstacle Race

The overall rank of India slipped from 116 in 2005 and further to 142 as of now. India has been unable to fix most business regulations, including the basic ones such as those for better contract enforcement. Obviously, foreign investors think twice before venturing into India.

Different political parties, wedded to their own ideologies, impede industrial progress, particularly when they are voted to power. The case in point is repudiation of the Enron power project. Agreement to execute the power project was signed by ruling party in Maharastra and the Enron Corporation. Later, a different party came to power in the state and it thought it fit, purely for political reasons though, to cancel the project. Such cancellations send wrong signals to foreign investors.

ATTRACTING FOREIGN CAPITAL

Two pronged measures have been initiated to promote the inflow of FDI: institutional framework and policy framework.

Institutional Framework

A number of exclusive agencies have been set up to promote the inflow of FDI. The Department of Industrial Policy and Promotion, Secretariat for Industrial Assistance, RBI, Department of Economic Affairs, Department of Company Affairs, Foreign Investment Implementation Authority, Department of Revenue, Central Board of Direct Taxes, Central Board of Excise and Customs, Director General of Foreign Trade, and Overseas Investment Division of RBI are the agencies which are actively involved in promotion of FDI inflow. The Department of Industrial Policy and Promotion is responsible for facilitating and promoting inflows. It plays an active role in creating awareness in investors about the

Table 4.4 India vs. South Asia

Ease of Starting/ Doing Business Rank	*Dealing a Business*	*Gettiing with Construction Permits*	*Register Electricity*	*Getting Property*	*Protect-Credit*	*Paying Investors*	*Trading Taxes*	*Enforcing Across Boarders*	*Resolving Contracts*	*Insolvency*
Maldives	Afghanistan	Maldives	Sri Lanka	Nepal	**India**	Bangladesh & Pakistan	Maldives	Sri Lanka	Bhutan	Maldives
Sri Lanka	Sri Lanka	Bangladesh	**India**	Bhutan	Nepal & Pakistan		Afghanistan & Bhutan	Pakistan	Maldives	Sri Lanka
Pakistan	Maldives	Pakistan	Nepal	**India**		Sri Lanka & **India**		**India**	Sri Lanka	Pakistan
Nepal	Bhutan	Sri Lanka	Afghanistan	Pakistan	Sri Lanka & Bangladesh		Nepal	Bangladesh	Nepal	Afghanistan
Bangladesh	Bangladesh	Bhutan	Maldives	Maldives		Maldives & Nepal	Bangladesh & **India**	Maldives	Pakistan	Bangladesh
India	Pakistan	Nepal	Bhutan	Sri Lanka	Bhutan			Nepal	Afghanistan	Nepal
Bhutan	Nepal	Afghanistan	Pakistan	Afghanistan	Afghanistan	Bhutan	Pakistan	Bhutan	Bangladesh	**India**
Afghanistan	**India**	**India**	Bangladesh	Bangladesh	Bangladesh	Afghanistan	Sri Lanka	Afghanistan	**India**	Bhutan

(*Source: Doing Business 2.12 Report*, World Bank) prospects and potential of investing in India. It also ensures smooth implementation of the projects in India.

Policy Framework

From a protectionist trade policy, India has moved a long way. The country is throwing virtually a red carpet welcome to foreign investors through a series of policy initiatives. (See Exhibit 4.2)

Exhibit 4.2

SECTOR SPECIFIC LIMITS OF FOREIGN INVESTMENT IN INDIA

Sector	*FDI Cap/Equity (%)*
A. Agriculture	
1. Floriculture, horticulture, development of seeds, animal husbandry, pisciculture, aquaculture, cultivation of vegetables and mushrooms and services related to agro and allied sectors	100
2. Tea sector, including plantation (FDI is not allowed in any other agricultural sector/activity)	100
B. Industry	
1. Mining covering exploration and mining of diamonds and precious stones: gold, silver and minerals	100
2. Coal and lignite mining for captive consumption by power projects, and iron and steel, cement production	100
3. Mining and mineral separation of titanium bearing minerals	100
C. Manufacturing	
1. Alcohol – distillation and brewing	100
2. Coffee and rubber processing and warehousing	100
3. Defence production	26
4. Hazardous chemicals and isocyanides	100
5. Industrial explosives – manufacture	100
6. Drugs and pharmaceuticals	100
7. Power including generation (except atomic energy); transmission, distribution and power trading	100
D. Services	
1. Civilisation (Greenfield projects and existing projects)	100
2. Asset reconstruction companies	49
3. Banking (private sector)	74 (FDI + FII) FII not to exceed 49
4. NBFCs: Underwriting, portfolio management services, investment advisory services, financial consultancy, stock broking, asset management, venture capital, custodian, factoring, leasing and finance, forex broking, etc.,	100

5. Broadcasting	
(a) FM Radio	20
(b) Cable network	
(c) Direct to home	
(d) Hardware facilities such as up-linking, HUB	49 (FDI + FII)
(e) Up-linking a news and current affairs TV channel	100
	49 (FDI + FII)
6. Commodity exchanges	(FDI 26)
7. Insurance	26
8. Petroleum and natural gas	49 (PSUs)
9. Print media	
(a) Publishing of newspaper and periodicals dealing with news and current affairs	26
(b) Publishing of scientific magazines /speciality journals / periodicals	100
10. Telecommunications	74% (including FDI, FII, NRI FCCBs, ADRs/GDRs, convertible shares, etc.)
(a) Basic and cellular, unified access services, national / international long – distance, V-SAT, public mobile radio trunk services (PMRTS), global mobile personal communication services preference (GMPCS) and others	

Sectors where FDI is banned

1. Atomic Energy;
2. Lottery business including government / private lottery, online lotteries, etc;
3. Gambling and betting including casinos, etc;
4. Business of chit fund;
5. Nidhi company;
6. Trading in Transferrable Development Rights (TDRs);
7. Activities / sectors not opened to private sector investment;
8. Agriculture (excluding floriculture, horticulture, development of seeds, animal husbandry, pisciculture and cultivation of vegetables, mushrooms, etc. under controlled conditions and services related to agro and allied sectors) and plantations (other than tea plantations);
9. Real estate business, or construction of farm houses, manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes.

Finally, a given country is in a better position to attract FDI. if certain facilities are created and provided. Exhibit 4.3 contains some such facilities. The Indian policy makers and regulators do well to ponder on these facilities.

Exhibit 4.3

HOST COUNTRY'S DETERMINANTS OF FDI

I. General policy framework
   - Economic, political and social stability

- Good governance (transparent and credible policies and their enforcement)
- Policies on functioning and structure of markets (especially competition and M&A policies)
- Private property protection (including IPR)
- Industrial and regional policies; development of competitive clusters
- Trade policy (tariffs and no-traffic barriers) and stable exchange rates

II. Policies specific to FDI
- Bilateral international investment agreements (IIAs)
- Investment incentives and performance requirements (pre- and post-entry)
- Pre- and post-investment services (e.g., one-stop shopping)
- Social amenities (international schools, quality of life, etc.)

III. Economic determinants by type of investment

(a) Market-seeking investment
- Market size and per capita income
- Market growth
- Country-specific consumer preferences
- Structure of markets
- Psychic distance
- Access to regional and global markets

(b) Resource-seeking investment
- Land and building costs: rents and rates
- Cost of raw materials, components, parts
- Low-cost unskilled labour
- Availability and cost of skilled labour

(c) Efficiency-seeking investment
- Costs of resources and capabilities listed under (b) adjusted for productivity of labour inputs
- Other input costs, e.g., transport and communication costs to, from and within host economy
- Membership of regional integration agreement conducive to promoting a more cost-effective inter-country division of labour
- Quality of market-facilitating institutions

(d) Asset-seeking/asset-augmenting investment
- Competition policy (including M&As)
- Technological, managerial, relational and other created assets
- Physical infrastructure (ports, roads, power, telecommunications)
- Macro inventory, entrepreneurial and educational capacity/environment.

(*Source:* John H. Dunning and Sarianna M. Lundan, *Multinational Enterprises And the Global Economy*, Edward Elgar, 2008, p. 325)

Summary

- FDI refers to the purchase of shares of a foreign company with a view to gain management control. At the core of FDI is international flow of capital (LO1)
- More than developed countries, it is the developing countries that need FDI as they are required to fill resource gaps (LO2)
- Problems from FDI are same as those of MNCs (LO3)

- Product life cycle, market imperfections, market power and internalisation are the theories behind FDI (LO4)
- FDI flows are impacted by supply, demand and government factors (LO5)
- Developing countries are receiving bigger share of FDI (LO6)
- India stands nowhere near China in attracting FDI. Nevertheless outflows form India exceed those of inflows (LO7)
- Government of India has initiated several policy – related and institutional – related measures to attract FDI (LO8)

Review Questions

1. What is FDI? State and explain the factors that influence FDI. (LO1 and LO5)
2. Explain the following theories of FDI: (LO4)
   (i) Product Life Cycle
   (ii) Market Imperfections
3. Explain the following theories of FDI: (LO4)
   (i) Eclectic
   (ii) Internalisation

Discussion Questions

1. How do foreign portfolio investments and FDI differ? Give examples. (LO1)
2. How do political factors decide FDI? Cite India's example. (LO5)
3. What are the major incentives for developed countries to invest in developing countries? (LO8)

Reinforcing Exercises

- One of the implications of the product life cycle theory is that a product can find a rebirth in overseas markets if the domestic market for the same is close to extinction. Consumption of cigarettes in the US market has been rapidly declining due to health consciousness of consumers and changes in public policy towards smoking. But the markets for American cigarettes are expanding in China, Eastern Europe, and Russia. The handloom – produced "Bleaching Madras" fabrics were almost extinct in the Indian domestic market when they gained a new lease of life after being introduced as a fashion product for summer wear in the US. What lessons can international managers learn from instances of the above two and similar others.
- China holds a monopoly position so far as the supply of rare earth metals to the rest of the world is concerned. In 1990, China accounted for 27% of global rare earth production. By 2010, this went upto 97%. In 2010, China sent shock waves to the rest of the world by announcing high quotas on the export of rare earths.

The reason given by China for imposing the export quota is that several of its mining companies did not meet environmental standards and had to be shut down. (Rare earth mining is a dirty process resulting in heavy environmental hazards). But the real reason behind the quotas is what *The Economist* said. According to the news magazine: "Slashing their exports of rare earth metals has little to do with dwindling supplies or environmental concerns. It is all about moving Chinese manufacturers up the supply chain, so they can sell valuable finished products to the world rather than lowly raw materials." In other words, China may have been using trade policy to support its industrial policy.

How does move of the China type affect FDI flows?

CLOSING CASE

The Saga Continues

It was the talk of the town in Bangalore during the late 1970s and early 1980s. The plant was coming up on the Bangalore-Yelahanka Road, about 20 km from the city. Everything the people over there did become a folklore. The buildings were huge with wonderful architecture, beautifully built with wide roads and huge spaces. Should a situation demand, the entire plant could be dismantled, bundled up, loaded into trucks and ferried to other places. Lighting inside the building had to be seen to be believed. Interiors had to be seen to be believed. Washrooms, stores, reception, canteen, healthcare, had to be seen to be believed. It had never happened elsewhere. It was amazing, the boss was not addressed as Sir, he was called Mr so and so! The yellow painted buses on the city roads made a delightful sight. Legends were told about the two gentlemen who founded the company.

An interesting story is told about how one of the surviving founders (Larsen who lived till 2003) visited the Bangalore plant once a year, he stayed in a hotel on his own, hired his own cab, went to the plant and greeted every employee, from the top brass down to the last person in the hierarchy. Story is also told about how, on one such visit Larsen went to the reception and asked for permission to enter the plant. Not knowing who he was, the young lass in reception room made him wait for half-an-hour. By luck, someone recognised him.

A budding author captured all these and many more in his first book, which became a big hit with all the teachers and students in different colleges buying and reading it.

It cannot be anything other than L&T, the huge engineering and construction multi-plant organisation, founded in 1938 by two Danish engineers, Henning Holck-Larsen and Soren Kristin Toubro.

Henning Holck-Larsen and Soren Kristin Toubro, school-mates in Denmark, would not have dreamt, as they were learning about India in history classes that they would, one day, create history in that land. In 1938, the two friends decided to forgo the comforts of working in Europe and started their own operation in India. All they had was a dream. And the courage to dare. Their first office in Mumbai (Bombay) was so small that only one of the partners could use the office at a time! Today, L&T is one of India's biggest and best known industrial organizations with a reputation for technological excellence, high quality of products and services and strong customer orientation.

As on today, L&T is a $ 14 bn (around ₹ 85,400 cr) conglomerate, has more than 54,000 employees and has 137 subsidiaries and 16 associate companies. The firm's customers spread over 30 countries. Besides India, L&T has manufacturing facilities in the Middle East, South-East Asia, China and Australia.

No, L&T is not sitting pretty. It want to hit Rs. 30,000 crore turnover mark by 2010 and is busy restructuring, sniffing new pastures, grooming new talent and projecting the new company credo—"It's all about imagineering." With the sole idea of creating several MNCs within, with footprints across nations, L&T is shedding the old economy and embracing the emergent opportunities and challenges.

Stagrant Revenues and Low Margins

Not everything went the L&T way.

In the late nineties, the macro environment was not very inspiring with stagnant revenues and low margins, and L&T's core strength, its engineers, were being constantly weaned away by the fast-growing software sector. So, the general comment around the bourses was about the credibility of the company, 'L&T is a good company but its stock price, for some reason or the other, is fixed at the Rs.140–210 band. So the company had to change by keeping its core intact. As a senior executive remarks, "L&T was perceived to be un-sexy and we had to create a new buzz around the campuses." The metamorphosis must echo through a whimper, not a bang. Even before the company divested its cement business in 2003, which accounted for 25% of its total sales, there were years of incremental and low visibility organisational moves towards a new L&T.

At a 52-week high of Rs. 2400, the L&T scrip today looks dapper, a far cry from the nineties when the stock price was in a state of flux. Much of the change started as a ripple way back in 1999 when Naik took over as the CEO. He visited employees at all levels across the organisation and asked them what it took to transform the company. The insights were mapped and implemented. "None of our employees thought that we build shareholder value. They thought we build monuments," the chairman reminisces. The focus on people became stronger and formed the basis of restructuring. It became the first old economy company to provide stock options to its employees.

When Naik came to the helm, he set upon himself a 90-day transformational agenda. Portfolios were reviewed and a vision clearly chalked out. He drew up a simple, brief, 'L&T has to be a multinational company and it has to deliver shareholder value at any cost. At the end of 90 days, between July 22 and July 24, 1999, the company launched Project Blue Chip, which essentially fast-tracked projects. The moot point was to complete all projects by February of the new millennium. Strategy formation teams were formed, portfolios reviewed and structures were optimised. Young leadership was brought to the fore and the business streamlining process kicked in.

Hiving off from 1999–2001, L&T went about de-bottle-necking its cement plants. They were modernised and capacities were raised from 12 million tonnes to 16 million tonnes annually, with minimum costs. The mantra really was to grow the business and then divest it as cement fell in the non-core category.

So, in September 2003, L&T sold its cement business to the Aditya Birla Group, which resulted in the company's Economic Value Add (EVA), an important indicator of the financial health of the company, swinging from a negative Rs.350-crore to a positive Rs. 50-crore immediately. The move also enabled L&T to reduce its debt-equity ratio from 1:1 to 0.2:1.

From then on, began L&T's transformation into a lean and mean machine. In 2004, the company envisaged a growth curve for the next five years. This marked the beginning of *Project Lakshya*, which was centered around people, operations, capabilities and new ventures. The company set out with over 300 initiatives in hand, and also placed a rigorous risk management system. For instance, any project above Rs.1,000-crore needed the signature of the chairman. *Project Lakshya* is known for targeting and selecting the right projects.

By now, the Indian economy had started witnessing unprecedented boom and despite divesting the cement business, the L&T turnover scaled the Rs.10,000 crore mark. Alongside, the lucrative Middle East market was booming and L&T forayed into six countries in the Gulf with joint ventures. "The idea was to develop a mini L&T in the region," observes a senior company executive. The company also set up manufacturing facilities in China to leverage the cost structure. Exports in 2007 constituted 18% of net sales. With soaring revenues and operating margins, L&T started benchmarking itself with the best in the world. Suddenly, the notion of an Indian MNC became a reality.

Leaders such as N.M. Desai, S.R. Subramanian, U.V. Rao, S.D. Kulkarni and Anil Manibhai Naik steered the company in its journey to become India's largest engineering and construction firm. L&T has entered a wide spectrum of businesses: hydro-carbon, ship-building, construction, electrical, automation, financing, information technology, insurance and real estate.

What is amazing about L&T is the enormous goodwill it has built around itself over the years. The name of L&T spells transparency, quality and prompt execution. This itself works against the firm. Few government contracts are awarded to L&T for obvious reasons.

After the exit of the two promoters, L&T became a company with no promoters. Bigger conglomerates such as Reliance and the Aditya Birla Group were keen to buy the promoter-less blue chip, but these moves were successfully thwarted.

The Road Ahead

L&T is no longer a monolith. It is being carved into nine independent companies, each with a billion dollar in revenues or with a potential to reach there soon. These will be independent companies with a board of directors of each, but not in statutory terms. The nine companies will be functioning within L&T. The goal is to get each of them at least 75% ready for listing on a stock market, should L&T choose to spin them off.

Each of the nine independent companies will be made up of two to three special business groups (SBGs); each SBG will have Rs. 2000 cr in revenue; and each SBG will further be divided into three to four strategic business units (SBUs), with Rs.500 revenue each.

Three Issues

L&T is currently facing three challenges. First, entire top management and middle management—about 200 of them—will retire and replacements need to be found soon. Second, L&T has been averse to bring in lateral talent from outside; preference is to groom in-house talent. Reason being, L&T's business involves complex engineering, infrastructure and construction projects. New hires from outside may not be able to comprehend and cope with. Besides, L&T has seniority- driven promotions policy which obviously shuns outsiders. Third, L&T as an organisation is set in its ways. Its past success itself has become a curse—L&T does not want to change.

Questions

1. Having a strong presence in India, what drives L&T to think of emerging a strong MNC?
2. What challenges lie ahead of L&T? How is it prepared to cope with them?
3. Will the L&T saga continue?

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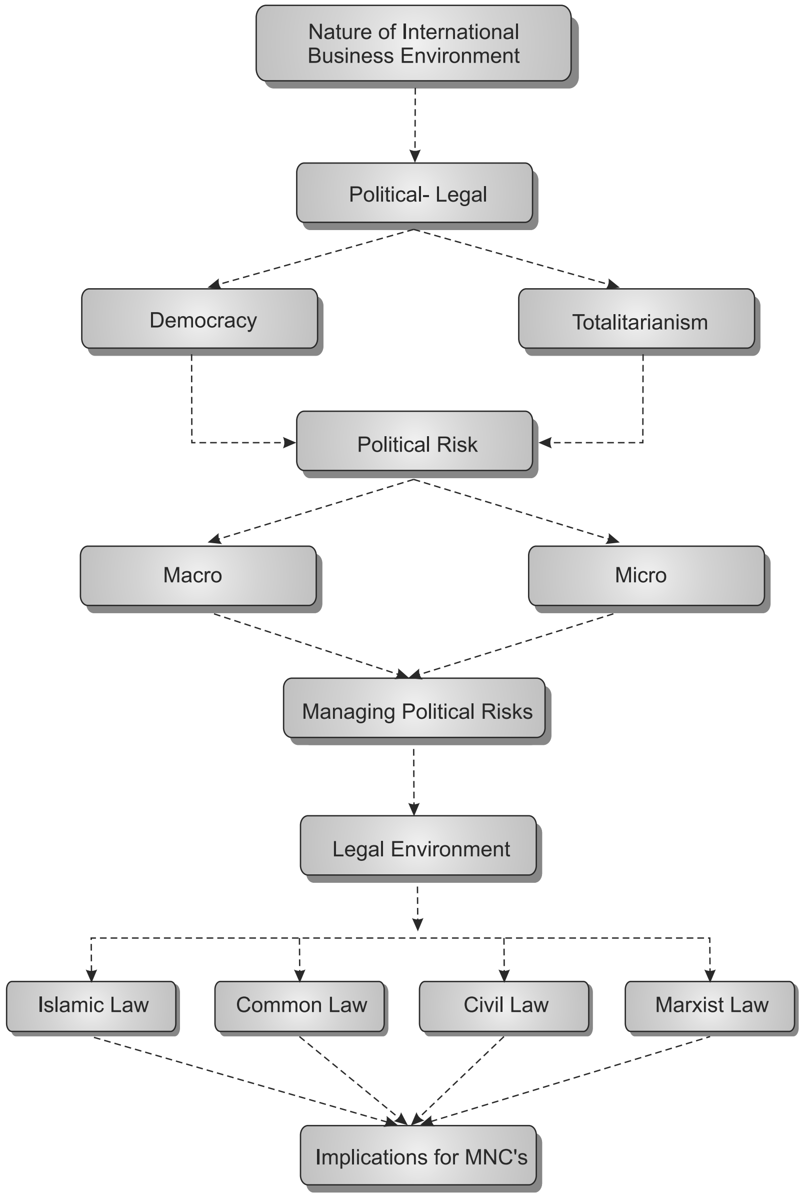
Suggested Readings

The Economist, July 5-11, 2014.

PART 2

CHAPTER


Nature of International Business Environment
Political- Legal
Democracy
Totalitarianism
Political Risk
Macro
Micro
Managing Political Risks
Legal Environment
Islamic Law
Common Law
Civil Law
Marxist Law
Implications for MNC's

5

Political and Legal Environment

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Identify the nature of international business environment
- **LO 2:** Analyse the concept of political environment
- **LO 3:** Interpret the different types of political risks and their assessment
- **LO 4:** Analyse the concept of legal environment
- **LO 5:** Evaluate the processes of international disputes resolution
- **LO 6:** Understand the legal implications for MNCs

Opening Case

Taming the Wild, Wild Web

Beijing, China. "We're not looking to put provocative information on the site," admits Maury Zeff, regional director of production for Yahoo! Asia. "It's all up to the interpretation of the government." Although the story about human organ selling in China never appeared on Yahoo's website there, it did run on the company's US website. Yahoo decided it was better to censor itself rather than risk offending the Chinese authorities.

But this was not the first time that Yahoo adapted itself to local market constraints; it had already been forced to adapt to the laws in Europe. French judge Jean-Jacques Gomez ordered Yahoo to stop offering Nazi artifacts to French consumers on its auction sites because buying Nazi memorabilia was illegal in the country. Since identifying every French bidder on its auction sites would be impossible, Yahoo withdrew all such items and filtered its websites globally to comply with French law.

The internet has been presented by many as a great force for connectivity, freedom of speech, and democracy. However, not all governments are quite as enamoured with the great freedoms that the web brings as others. In authoritarian regimes, the internet is often seen as a threat to the rulers and, therefore, efforts are made to censor or monitor internet activity around politically sensitive subjects. Such restrictions can impede freedom of speech and expression by internet users and by extension, that of consumers of internet service providers, search engines, and other technology services. In a 2009 report, the Press Freedom Organisation (Reporters without Borders) identified 12 countries as 'enemies of the internet' for their efforts to prevent their populations from accessing online information. The countries included Burma, China, Cuba, Egypt, Iran, North Korea, Saudi Arabia, Syria, Tunisia, Turkmenistan, Uzbekistan, and Vietnam. This suggests that the authorities in these countries had effectively transformed their internet into an intranet; Reporters Without Borders claimed that 'all these countries distinguish themselves not only by their ability to censor online news and information but also by their systematic persecution of troublesome internet users'. The Organisation also placed ten other organisations 'under surveillance' for adopting measures that could endanger online free expression, including democracies such as Australia and South Korea.

Much of the world's attention to internet censorship has thus far focused on China. The country now has the most internet users in the world – some 300 mn – yet internet use is highly restricted and the government regularly blocks websites and blogs that it views as a threat to state security. Reporters Without Borders marks China out as 'the world's biggest prison for cyber dissidents', with a total of 49 imprisoned bloggers in 2009. According to the Organisation, the state employs nearly 40,000 workers to monitor files circulating on the internet, and the authorities maintain strict enforcement of internet restrictions through filtering technologies and regular instructions to news media and websites. Blackouts are also used during particularly sensitive events.

Internet censorship is a difficult area for IT firms to navigate. Whilst countries such as China offer huge potential for developing new markets, dealings with overseas governments can raise a host of problems that firms are not prepared to deal with, especially when they are operating through a local subsidiary or joint venture.

Firms most vulnerable to censorship threats include not only Yahoo, but Google and Microsoft as well.

Around the world, Yahoo helps people communicate, access information and sell things on the Internet while it remains conscious of the political and legal differences. David Fiio and Jerry Yang never thought that they would one day get caught up in such sensitive global issues when they started Yahoo in 1994 as 'Jerry's Guide to the World Wide Web.' Wanting a snappier name, the pair liked the general definition of yahoo: 'rude, unsophisticated, uncouth.' Today the company has over 237 million users in 25 countries, communicating in 13 languages.

Yet in its own country, the founder of Yahoo was lambasted by the US House of Foreign Affairs Committee Chair in 2007 who remarked caustically: "Technically and financially, you are giants, but morally, you are pigmies". MNCs are subject to the idiosyncrasies of their host countries and have to learn to live with them.

As you read this chapter, think about the different ways companies adapt to local political and legal conditions around the world.

IT is the environment, particularly political-legal, that has made India what it is today. What is true with India is true with other countries too. It is but natural that we understand what these environmental forces are and how they influence international business. This, and the next two chapters are devoted to this study.

NATURE OF INTERNATIONAL BUSINESS ENVIRONMENT

LO 1
Identify the nature of international business environment

The environment of international business is regarded as the sum total of all the external forces working upon the firm as it goes about its affairs in foreign and domestic markets.

The environment can be classified in terms of domestic, foreign, and international spheres of impact. The domestic environment is familiar to managers and consists of those uncontrollable external forces that affect the firm in its home market. However, it may be underlined that some of these forces (e.g., the cost of capital and export restrictions) can also have a significant effect on global operations of a firm. The foreign environment can be taken as those factors which operate in those other countries within which the MNC operates. Generally, the factors are the same, but they can have widely differing impacts from the home country situation. For the purpose of study, the international environment is conceived as the interaction between domestic and foreign factors and indeed they cover a wide spectrum of forces.

The Forces

For the sake of clarity we divide the environmental factors into (1) political-legal, (2) economic, (3) cultural, and (4) technological groups. (See Fig 5.1).We discuss political-legal environment in this chapter. Economic, technological and cultural forces will be covered in subsequent chapters.

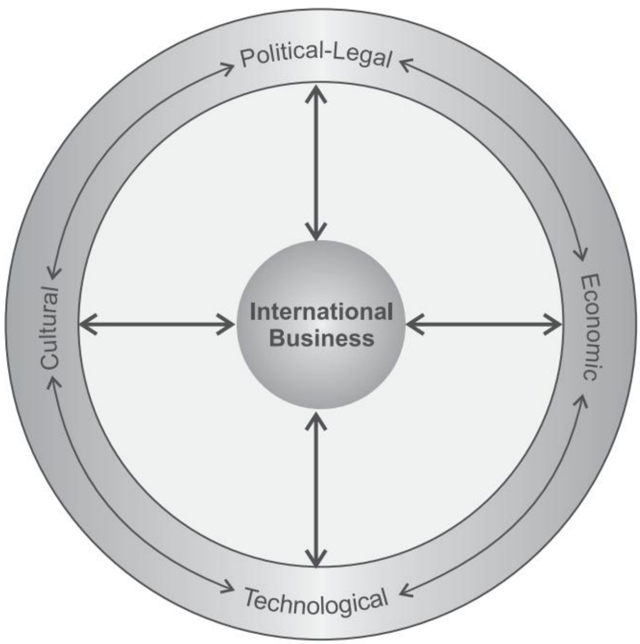


Fig. 5.1 Environment of International Business

POLITICAL ENVIRONMENT

> **LO 2**
> Analyse the concept of political environment

Political environment refers to the influence of the *system of government* and *judiciary* in a nation on international business. The system of government in a nation wields considerable impact on its business. The type and structure of government prevailing in a country decides, promotes, fosters, encourages, shelters, directs, and controls the business of that country. A political system (another name for the type of government) that is stable, honest, efficient, and dynamic and which ensures political participation to the people, and assures personal security to the citizens, is a primary factor for economic development. The developed economies of today owe their success to a large extent to the political system they richly enjoyed "There is today", comments John Kenneth Galbraith, "no country with a stable and honest government that does not have or has not had a reasonably satisfactory state of economic progress".

Italy probably better exemplifies the impact of political environment on a nation's economy. Italy holds a record in political instability. In the last 63 years since World War II, the country has had 63 governments. This instability has engendered slow growth rate (the economy is growing at a dismal 0.7 percent a year, (two years ago, the growth was negative). Inflation is at its highest in 10 years and successive governments have been plagued by corruption, chronic and massive fiscal erosion and a huge and inefficient bureaucracy.

Democracy

The basic political systems in existence across the world are: democracy and totalitarianism. In its pure sense, democracy refers to a political arrangement in which the supreme power is vested in the citizens. Democracy manifests itself in either of the two fundamental forms. If each citizen is given the right to rule and vote on every subject, the result is pure democracy, which in practice, may not work in a complex society with large constituency. Hence, the republican form of government follows whereby the public, in a democratic manner, elect their representatives who do the ruling. A representative democracy rests on the assumption that should the elected representatives fail to perform adequately, they will be voted down at the next election.

Totalitarianism

In totalitarianism, also called authoritarianism, individual freedom is completely subordinated to the power of the authority of state and concentrated in the hands of one person or in a small group, which is not constitutionally accountable to the people. Societies ruled by a pressure clique—political, economic or military or by a dictator, plus most oligarchies and monarchies—belong to this category. The doctrines of fascism and erstwhile communism are examples of totalitarianism.

During the First and Second World Wars the authoritarian governments began to appear in most mature economies. Even after the Second War, the totalitarian system became most common in newly independent nations. Administrative efficiency of the dictators was often cited as an advantage for coping with the problems of new-born states. Surprisingly many nations are ruled by dictators or monarchies even today.

Nazi Germany (under Adolf Hitler) and the former Soviet Union under (under Joseph Stalin) are historic examples of totalitarian governments. Today, Cambodia, Myanmar, China, Cuba, Congo, and Iraq are prominent examples of totalitarian governments.

Strange, but true. Many Latin American countries have registered impressive economic growth under the iron rule of military dictators. So is the case with Korea. East and south-east Asian countries have similar experience. As of today, the fastest growing economy is China which is ruled by an authoritarian regime.

Table 5.1 lists some of the countries which enjoy full, partial or no political rights and civil liberties. In all, 81 countries (22 per cent of world population) are listed as being free, 57 countries (39 per cent of world population) as partly free, and 53 countries (39 per cent of world population) as not free. (See also Table 5.2)

Table 5.1 Political and Civil Liberties Around the World

Free countries	*Partly free countries*	*Not free countries*
India	Russia	Afghanistan
US	Mexico	Bhutan*
Canada	Brazil	Myanmar
Denmark	Ethiopia	Burundi
Venezuela	Tanzania	China
Chile	Madagascar	Guinea
Argentina	Columbia	Libya
West Europe		Saudi Arabia
Australia		Somalia
South Africa		Syria
South America		Iraq
		Vietnam
		Sudan
		North Korea

Note: The list of countries under each category is only representative and not comprehensive.

Table 5.2 A Sampling of Government Types

Country	*Government Type*
Afghanistan	Islamic republic
Belarus	Republic in name, although in fact a dictatorship
Bosnia and Herzegovina	Emerging federal democratic republic
Burma (Myanmar)	Military junta
Canada	Confederation with parliamentary democracy
China	Communist state
Congo, Democratic Republic of the	Dictatorship, presumably undergoing a transition to representative government
Cuba	Communist state
Iran	Theocratic republic
Libya	Jamahiriya (a state of the masses) in theory, governed by the populace through local councils; in fact a military dictatorship
North Korea	Communist state, one-man dictatorship
Saudi Arabia	Monarchy
Somalia	No permanent national government; transitional, parliamentary federal government
Sudan	Authoritarian regime – ruling military junta
United Kingdom	Constitutional monarchy
United States	Constitutional federal republic
Uzbekistan	Republic; authoritarian presidential rule, with little power outside the executive branch
Vietnam	Communist state

Source: www.cia.gov/cia/publications/factbook/,2005.

Types of Totalitarianism Totalitarianism, in itself is of four types: theocratic, secular, tribal and right wing.

Theocratic When a country's religious leaders are also its political leaders, its political system is called a *theocracy*. Religious leaders frame and enforce laws and regulations that are based on religious beliefs. A political system that is under the control of religious leaders is *theocratic totalitarianism.* Afghanistan, some Sheikhs of the Middle East and Iran are the countries which have such a political dispensation.

Secular A political system in which political leaders are guided by military and bureaucratic power is called *secular totalitarianism*. In such a system, the military controls the government and makes decisions which it deems to be in the best interest of the country. An example is Pakistan. Until the early 1980s, secular totalitarianisms 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 losing its ground. The majority of Latin American countries are now genuine democracies, while significant political freedom has been granted to the political opposition in countries such as South Korea, Taiwan, and the Philippines.

Tribal A third form of totalitarianism is the *tribal totalitarianism*. This exists principally in African countries such as Zimbabwe, Tanzania, Uganda, and Kenya. Tribal totalitarianism occurs when a political party that represents the interests of a particular tribe monopolises power.

Right-Wing Totalitarianism Here, private ownership of property is endorsed by government, market forces are also allowed free play, but political freedoms are rarely granted. Argentina, Brazil, Chile and Paraguay were under right-wing totalitarian governments in the 1980s.

China is a classic example of polity which though communist by definition, is pursuing right-wing policies. The country is privatising state-owned enterprises, attracting FDI, pursuing pro-business policies and is registering a hefty growth rate. The country appears to be an open and free society, but is essentially totalitarian.

Implications of Doing Business with Totalitarian Regimes One positive aspect is that MNCs need not worry about any opposition to their activities from rival political parties. On the negative side, they may be required to pay bribes and kickbacks to government officials. Refusal to pay could result in loss of market access or even forfeiture of investment in the country.

In any case, doing business with a totalitarian regime is a risky proposition. Many facets of business law pertain to contractual disputes. In such regimes, contract law is either non-existent or vaguely defined and people in powerful positions interpret the law (in case it exists) as they please.

With a few exceptions, most totalitarian governments have been opening up and liberalising since 1989 when the Berlin Wall fell and the Soviet bloc broke apart. As these countries shift from totalitarianism to democracies, the degree of instability increases—making the situation for MNCs difficult.

Ethical Issues There are also ethical issues involved in having business deals with military regimes. Take China for example. Human rights of Chinese citizens are blatantly suppressed. Investments by MNCs in such countries will encourage dictators to justify their actions and probably reinforce repressive measures. It is no secret that the Chinese government stepped up its repression of political dissidents in 1996 after the Clinton administration removed human rights as a factor in determining China's trade status with the US.

The other ethical issue relates to the payment of bribes to government officials to gain access in market in a foreign country. Paying bribes is a corrupt and morally repugnant way of doing business. Some countries have enacted laws to prohibit their citizens from paying bribes to foreign government officials in return for economic favours. The Foreign Corrupt Practices Act, 1977 of the US is an example in the context. Members of the OECD (Organisation for Economic Cooperation and Development) countries are working on a convention that would oblige member states to make bribery a criminal offence.

The ethical issues involved in having business deals with authoritarian countries are: (i) should a firm do business in a repressive totalitarianism state, and (ii) should a firm pay bribes to dictators to gain market access? A situation as the one involving BP, the British Oil firm, is an example fit enough in this context. BP owns 20% stake in Rosnett, a Russian state owned company. BP now fears that sanctions imposed on Russia by Europe would heist its interests. Should BP divest its stake? Wind up its operations in Russia? No easy answers are available to these questions because no investor has shunned a totalitarian state so far as investment is concerned, and paying bribes for economic favours has become a part of life, no matter which country an international business belongs to.

Between democracy and totalitarianism, it is the former which offers several advantages for business growth. Generally, democracy is accompanied by capitalism which confers freedom to business to decide and act. Freedom to invest, produce and earn is essential for business growth. Democracy ensures security to citizens by allowing them to participate in decision making. Non-government-organisations (NGOs), social activist groups and other voluntary organisations form part of democracy. They bring pressure on a given government to change a policy which is considered to be debilitating in its effect. Transparency and openness are the virtues of democracy. Deviation in any policy is brought to light thanks to media which enjoy freedom of expression. Democracy ensures its people the right to know as is guaranteed by the Right to Information Act in force in India. As Niels Bohr has opined, "The best weapon of dictatorship is secrecy, but the best weapon of a democracy should be the weapon of openness". Democracy empowers citizens by conferring franchise. A government which is not pro-business may be displaced through an election and bring in its place, a set of elected leaders who may be more pro-growth oriented. Once in five years, a new government is installed, bringing in vibrancy in governance. Democracy guarantees safety to the citizens. Rarely democracies wage wars against each other. A democracy having similar governments as neighbours is free from external aggression. Democracies confer to citizens the right to own property, protect intellectual properties and ensures that contractual obligations are honoured. Justice is made available to all individuals – locals or foreigners. Finally, many international trade agreements – especially bilateral trade agreements – are premised on the principles of democracy (see also Exhibit 5.1).

All middle income countries that moved to high-income status became democracies first followed by strong civil liberties and independent judiciaries. Spain and Portugal rose to high-income status only after the departure of respective dictators. Japan became rich only after becoming democracy. Same is the case with South Korea and Taiwan. Singapore is the richest Asian tiger. Some question about its democratic credentials, but the country has rule of law and fair elections.

No surprise, the number of democracies all over the world is rising considerably. In 1941, there were only 11 democracies and the number shot up to 120 by 2010. (see also Exhibit 5.2 and Fig 5.2).

Africa is a telling example to be mentioned here. The continent is marching towards peace and democracy. Soviet Union has gone, and Mozambique and Ethiopia have given up on Marxism. Several dictators have fallen. Civil wars like the one which crippled Angola have mostly ended. Two out of three African countries now hold elections.

Africa is rising economically, registering a growth rate of six plus percent for the past six years, earning the sobriquet "lion economies" analogous to the Asian tigers. More than the growth rate, it is people's expectations that are noteworthy. In many African countries people have started to see

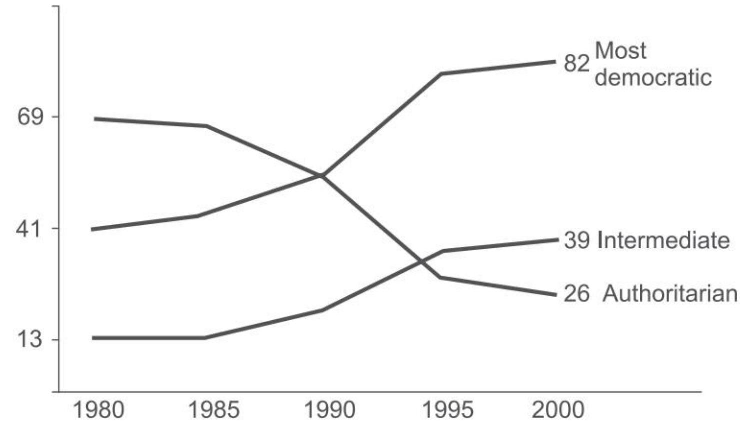


Fig. 5.2 The Rise of Democratic Regimes

(*Source:* UNDP, *Human Development Report 2002*, p. 15)

Exhibit 5.1

MERITS OF DEMOCRACY

What is our national aim? It must be to make India a highly prosperous country for all its citizens, not just for a handful of people. For that, it is necessary to have a high degree of industrialisation.

Even setting up and running a single primary school requires a lot of money, for buying land, erecting the school building and providing for the recurrent expenditure for salaries of teachers, staff and so on. We need to set up not just one but hundreds and thousands of primary schools, tens of thousands of high schools and colleges, engineering colleges, technical institutes, medical colleges, scientific research centres, hospitals and libraries.

Where is the money for all this to come from? It can only come from a highly developed industry. Rapid industrialisation alone can generate the wealth we need for the welfare for our people by abolishing poverty and unemployment, which are the main causes of crime and terrorism.

For industrialisation, the development of science is absolutely necessary, and for this freedom to think, write, discuss with others, to explain, criticize and to dissent are a must.

Need for supportive values

The growth of science requires certain supportive values, particularly liberty. This is because the thought process cannot develop without freedom. The values of a scientific community, namely pluralism, tolerance, individual freedom and free flow of information are very similar to the values of a democratic society.

A democratic society permits freedom of speech and expression, freedom to practise one's own religion, which is based on tolerance and freedom to dissent and criticise. These are precisely the values of the scientific community. In scientific matters authoritarianism and dogmatism are wholly out of place. Scientists must be left to govern themselves and for innovation and creativity. Democracy and liberty go hand in hand with the growth of science because both are based on tolerance, individual freedom and the free flow of ideas. In democracy as in a scientific community, there is freedom to speak, discuss, criticize and to dissent.

Function of free speech

The method of Shastrarthas was developed in ancient India. These were debates in which the thinkers of those times had full freedom to speak and to criticise their opponents in the opponent's presence and also in the presence of a large assembly of people. There are thousands of references to such Shastrarthas in our epics and other literature. It was this freedom to freely discuss and criticise that resulted in a tremendous growth of knowledge—in philosophy and grammar but also in scientific knowledge in mathematics, astronomy, medicine and so on. The names of Aryabhatt, Brahmagupta, Bhaskar, Sushrut and Charak are well known. With the aid of science, we built mighty civilisations, like the Indus Valley Civilisation, at a time when people in Europe were still living in forests.

Modern European history is also instructive. England was the first country in the world to industrialise and modernise. This economic process was accompanied by the political struggle for liberty and democracy in the 17th and 18th centuries, which was particularly a struggle between the King and the Parliament. Parliament's triumph laid the foundation of freedom and civil liberties in England, which was necessary to create the atmosphere science needs to prosper. In pre-revolutionary France, the thinkers of the Enlightenment-Rousseau, Voltaire, Diderot, Holbach and several others—who attacked feudalism and religious dogmatism paved the way for the Revolution of 1789 which destroyed feudalism and led to scientific progress.

On the other hand, in Italy, Spain and some other countries, the Inquisition stifled free thinking and thereby scientific growth. All scientific ideas inconsistent with the Bible were regarded as crimes, for example, the theory of Copernicus, which stated that the earth moved around the sun and not the sun around the earth. As a result, these countries were left far behind England and France, and remained in the feudal dark ages for centuries.

The struggle to establish the scientific outlook was not easy. Scientific Ideas were initially condemned because they were regarded as opposed to religious dogma. Voltaire and Rousseau had to fly for their lives to other countries. The Church persecuted the greatest scientists with blind cruelty, burning them at the stake (for example, Bruno), torturing them (for example, Galieo) and forbidding or destroying their works. As recently as 1925, the teaching of Darwin's theory of evolution was forbidden in the state of Tennessee in the United States and a teacher, John Scopes, was tried in the famous 'Monkey Trial' for teaching that theory. For centuries, the Church in Europe played an extremely reactionary role and fought pitilessly against the scientific conception of the world and against the democratic movements.

In India, if we are to progress and rise as a world power, we must spread the scientific outlook to every nook and corner of our country to destroy superstitions, for example, the belief in astrology, palmistry and the feudal ideas of casteism and communalism.

Science is that knowledge by which we can understand nature (and human society) and use the knowledge for our benefit. For doing so, the scientists rely on reason, observation and experiment. This obviously cannot be done on the dictates of anyone (though the government can certainly create the atmosphere where these can flourish). Science and democratic values go hand in hand.

In science, there is no final word, unlike in religion. Science questions everything and does not take anything for granted. Obviously, this approach is not permitted in an undemocratic society, for example, a feudal society (which is governed by religion) or a fascist society (in which there is a dictator). Thus, Hitler, with his Nazi racial philosophy, caused an enormous setback to science in Germany by persecuting Jewish scientists and banning their works (for example, Einstein).

In India, after the Constitution was adopted in 1950, there was an atmosphere of liberal freedom in view of the fundamental rights guaranteed by the Constitution: the right to free speech (Article 19), to liberty (Article 21), to equality (Articles 14–17), to religious freedom (Article 25), and so on. This helped the growth of science and technology, because it created an atmosphere of freedom where people, including scientists could freely discuss and dissent. If we compare our country with our neighbours, it becomes clear that they lagged far behind in economic growth precisely because such freedoms were lacking.

Further, the advanced sections of society who want to take the country forward and have the knowledge to do so, must have a lot of freedom to discuss, debate and criticise each other. They are the pioneers and are entering new fields, much of which are unknown.

Freedom to dissent

As John Stuart Mill argued in his celebrated essay 'On Liberty', all progress, the advancement of knowledge, and progressive change and, the improvement of old ways of thinking, old behaviour patterns, habits, customs and traditions can come only from free individual dissent, dissensions and innovations which are at first usually resisted by inert or conservative people (usually the vast majority), and by free competition between the old and new ideas. Ordinarily in any society, he pointed out, the majority shares old thoughts and traditions. There is a strong tendency to insist on conformity and collective unity or solidarity, to repress dissent and innovation, and to tolerate only what the majority agrees with. This inevitably works to prevent any progress and to thwart the creative impulses of the more creative and original minds. Extensive freedom to dissent and innovate, in all spheres of life, activity, culture and thought in all directions, including expressing ideas initially thought strange and often disliked by the conservative, tradition-bound majority, is indispensable to progress. The intellectually advanced and creative individuals are often in the minority, and are regarded as non-conforming eccentrics and deviants, and there is often a tendency to suppress them. This is why liberal democracy, majority rule but qualified and limited by firm protection of minorities, and individual rights and liberties, even against the governing majority is essential for progress.

India needs democracy and scientific knowledge, and that means patiently spreading scientific ideas among the vast masses, raising their cultural level and involving them actively in the task of nation building.

Harsh and draconian laws will curb liberty. That will not only violate the right to liberty granted by Article 21 of the Constitution. It will also lead to great evils such as an increase in corruption in the police and other law enforcing agencies, which will have much more opportunity to extort money from the citizens, apart from impeding scientific and economic growth.

Crime and terrorism cannot be eliminated by draconian laws. They can be eliminated only by the abolition of poverty and unemployment, which are the main sources of crime. Only industrialisation can abolish poverty and unemployment, which will largely eliminate crime and terrorism.

(*Source: The Hindu*, dated June 26, 2009)

Exhibit 5.2

HISTORIC TRANSITION

Almost unnoticed by the rest of the world, the tiny kingdom of Bhutan is embarking on an extraordinary experiment in democracy-building, that deserves more attention in India.

Last year, at the age of 52, absurdly young for an act of monarchical renunciation, the fourth King of Bhutan, Jigme Singye Wangchuck, abdicated the throne after 34 years of rule, in favour of his son. But, before doing so, he committed his nation to the path of democracy, launching the groundwork for a new Constitution that would reduce the occupant of the throne to a constitutional monarch. In a country where the king has long been revered as a father figure of almost divinely-ordained authority, that was a remarkable change. It was one his people were not ready for: people of all classes protested that they were perfectly content with their king and his benevolent autocracy, which had coined the notion of 'Gross National Happiness'. But the king would not be deterred. He travelled to all the 20 districts of this mountainous Himalayan kingdom, explaining his vision of the future and exhorting his people to assume control of their own destiny. He appointed a constitution-drafting committee, chaired by the Chief Justice, that drew heavily from international precedents, notably India's.

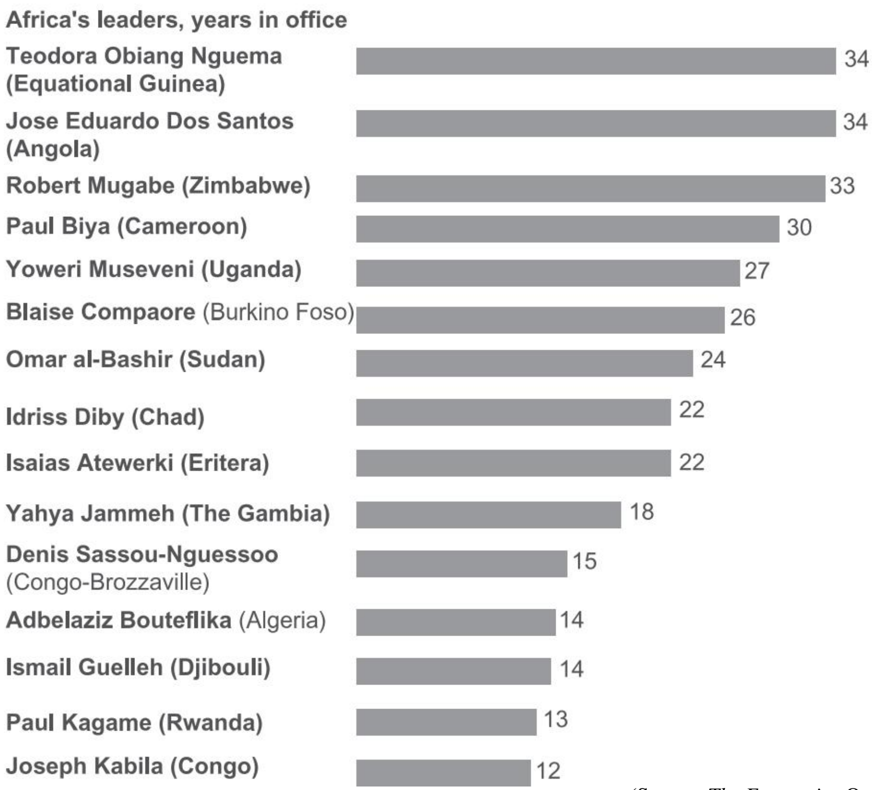
Unusual features

The result is the creation of a system of democracy with some decidedly unusual features. The King was determined that his country needed a multi-party system; he was not enamoured of the partyless panchayats favoured by Nepal when it first took a similar step, nor the one-party systems followed in Africa. But he and his countrymen were equally concerned about the risk of political fragmentation: they only had to look southward to see how far democracy could go in the construction of multiple political parties representing every polarising, particularist interest. So Bhutan created a two-phase electoral system; a 'primary' election in which any number of parties could compete on the party lists, followed by a general election in which only the top two parties in the primary could put forward candidates, this time not on lists but on the basis of individual Constituencies. It is a unique formula, untried anywhere else in the world, but it simultaneously encourages the development of coherent parties and discourages fragmentation.

(*Source: The Hindu*, Oct. 28, 2007)

themselves as citizens, with the rights that the citizenship brings. Bastions of the continent's past – destitute, violent and isolated – are becoming exceptions.

Though the above description is pleasing, many of the African countries are still ruled by dictators. These rulers hold elections but ensure that they only get elected. As a result, many of the rulers in Africa have been at the helm for decades as Fig.5.3 shows, and several of their economies have been tottering.



(Source: *The Economist,* Oct.12, 2013)

Fig. 5.3 Ruling the Roost

But democracy may not guarantee economic growth even as dictatorship cannot check prosperity. The so called Asian tigers – Hong Kong, Singapore, Taiwan and South Korea – have prospered under dictatorships and India with democratic dispensation is still grappling with problems relating to poverty, unemployment, deprivation, and disparities. Take China and India. Efforts towards economic growth were initiated in China during 1980s and in three decades, the country has become cynosure of all eyes. The launch of the First Five Year Plan in 1951 was the beginning of economic development in India. It is six decades since, India is literally a tortoise racing against China's hare. Many economists are of the opinion, justifiably so, in India development should have preceded democracy instead of the otherway, highlighting the point that policy makers, post Independence, should have placed emphasis first on economic prosperity.

India is an example of a successful democracy and not so successful economy. If democracy has a strong foothold in India, elsewhere it is going through a difficult phase. Two reasons explain this phenomenon. First is the financial crisis of 2007-2008, and second is the rise of China. The damage that the crisis did was psychological as well as financial. The crisis revealed the fundamental weaknesses in the political system of the West, undermining the self-confidence that had been one of their great assets. Governments had steadily extended entitlements over decades, allowing debts to mount, and politicians came to believe that they had managed trade cycles and tamed risk. Many people became disillusioned with the functioning of the political systems – particularly when governments bailed out bankers with tax payers' money and stood mute as financiers continued to pay themselves with huge bonuses.

Meanwhile, the Chinese Communist party has broken the democratic world's monopoly on economic progress. Critics point out several wrongs on the Chinese government. Lack of freedom to express and to dissent is curtailed, internet is censored, and environmentalists are put behind bars, and voices for democracies are crushed. Yet citizens are enjoying richness, are healthier and are more vibrant. When America was growing fastest, it doubled living standards roughly in every 30 years, China has been doubling living standards even in a decade for the past 30 years. Freedom or no freedom, Chinese are better off than citizens of any country anywhere. No surprise, countries look at the Chinese growth story as a model for replication.

But democracy should come out of the difficult phase. A few hurdles need to be sorted out. First, politicians need to give up the majoritarian attitude, a tendency that winning majority seats in an election gives a government powers to do what it likes and not what people deserve. Second, strong democracy needs institutions such as political parties, parliaments, and electoral systems. These help elicit popular preferences and turn them into policy action. Third, democracy also needs institutions of restraint, such as an independent judiciary and media, and a Constitution to uphold the fundamental rights such as freedom of speech and to prevent governments from abusing their power. Fourth, reform of party funding (may be state financing) can reduce corruption and influence of special interests. Fifth, a much smaller state can help democracy revitalise. Expansion of state reduces liberty and enhances power of special interests.

POLITICAL RISK

LO 3
Interpret the different types of political risks and their assessment

Corporates face political risk when they conduct business with the outside world. Political risk is any governmental action or politically motivated event that could adversely affect the long-term profitability or value of a firm. Political risk affects different firms in different ways. It can threaten the market of an exporter, the production facilities of a manufacturer, or the ability of a firm to repatriate its profits from a host country to its home country.

Political risk is common. It prevails in all countries and regions, regardless of political or economic system. It is very high in countries like Yugoslavia, Turkey, Iraq, Algeria, Sudan, Nigeria, Afghanistan, Iraq, Somalia, Congo, Angola, Myanmar, and Indonesia (Also see Table 5.3). It is almost non-existent in the US, Canada, Denmark, Australia and Western European countries.

Table 5.3 Top 20 States in Danger of Failing (Ranked)

Ivory Coast	Yemen	Guinea
Democratic Republic of Congo	Liberia	Bangladesh
	Haiti	Burundi
Sudan	Afghanistan	Dominican Republic
Iraq	Rwanda	Central African Republic
Somalia	North Korea	
Sierra Leone	Colombia	
Chad	Zimbabwe	

Source: From *Foreign Policy*, "Failed States Index", July/August 2005, pp. 56–65.

Political risk arise when the host government makes a decision which is adverse to the interests of the subsidiary. It also arises when laws and government policies instituted by the firm's home country, adversely affect the firms that do business in a foreign country. Political risk can take many forms from war and revolution to changes in law or policy. It can affect all aspects of international business, such as the right to ship goods to a country, or to own and operate a subsidiary there.

Types of Risks Distinction is often made between macro and micro risks.

Macro Political Risk A macro political risk affects all international businesses in the same way. Expropriation, the seizure of privately owned assets, as for example, a farm or a factory, by government with little or no compensation to the owners, is a macro political risk. Examples for macro risks are many. Foreign firms operating in Iraq, for example, are prone to face serious risks. They are taking risks if they make oil deals in the Kurdish north, since the Bhagdad government and the Kurd's regional authorities have failed to agree on how to divide the returns despite years of acrimonics negotiations. After Exxon Mobil decided to sign a deal with Kurds in Oct. 2011, the Bhagdad government threatened to penalise any firm that deals with the Kurds without its agreement.

There can be exceptions also. An interrational arbitration tribunal recently awarded Exxon Mobil $ 908 mn in compensation for assets nationalised by the government of Venezuela in 2007. Exxon had demanded more than $10 bn, but PDVSA, a Venezuela's state oil company said it would pay only $255 mn. Exxon is pursuing a separate case against Venezuela at the World Bank's arbitration panel.

Expropriations did take place over the years as Table 5.4 shows. Between 1970–75, rapid acts of

Table 5.4 Expropriation Acts–1970–92

Year	*No. of Acts*
1970–75	336
1976–79	87
1980–85	15
1986–92	1

expropriation have been identified as 87 between 1976–79, 15 from 1980 to 85 and only one between 1986 and 1992. The most popular sectors for expropriation were agriculture and oil industry.

Taking of ownership of an entire industry that had been generated privately, as a part of a plan to restructure an entire economy, is called nationalisation, again a macro political risk. Communist governments in eastern Europe and China expropriated private firms following World War II. Fidel Castro did the same in Cuba during 1958–59. Recently, governments in Angola, Chile, Ethiopia, Peru, and Zambia have expropriated private firms. Field Marshall Ayub Khan nationalised four hotels of M.S. Oberoi without paying any compensation. In all these cases, international businesses were hard hit.

Political boycotts also result in macro political risk. Since 1955, a number of Arab countries have boycotted firms with branches in Israel or companies that have allowed the use of their trade name there. Macro political risk can also come about because of indigenisation laws which bind international businesses to accept equity participation by local citizens.

The level of macro political risk has been changing in recent years. For example, Eastern European countries such as Poland, Hungary, and the Czech Republic are now inviting private investment, as does Russia. China's entry into the WTO is a pointer to the changing environment in Asia. Vietnam's recent trade agreement with the US is another positive indicator. All these developments have certainly minimised the political risk, but it still continues to exist.

Micro Political Risk A micro political risk affects a specific foreign business. Micro political risks include industry regulations, taxes, kidnapping and terrorist threats. India occupies the sixth place among the top 10 worst record holders in kidnapping and ransom. The number of cases registered in 2005 stood at 15,750 and it went up by 52% to touch 23 991 in 2006.

India's decision in 1975 to reduce foreign equity to 40 per cent and Peru's decision to nationalise its copper mines are examples of micro political risks. The US decision to tax textile imports is another instance. Yet another example is the bombing of the Chinese embassy in Belgrade by NATO forces in 1997. In retaliation, demonstrators in China thrashed KFC stores but did not touch Pizza Hut stores though both were owned by a US based company. Chinese protestors did not attack Pizza Hut thinking that it was Italian-owned. Recent investigation launched by China into Microsoft and Qualcomm, a big American wireless technology firm, are also examples of micro political risk.

Jindal Steel and Power and Essor Group are subject to similar risks. The former is having a face-off with the Bolivian government. Jindal has filed a case in the international Court of Arbitration against the host government for reneging on a pact for grant of land for $2 bn iron-ore project. The Bolivian government encashed bank guarantees without giving land to Jindal Steel and Power.

Essor Group is facing delays in completion of its revival programme for state-owned Zimbabwe Iron & Steel, which it acquired for $750 mn in 2010. The deal includes taking an 80 percent stake in an iron ore mine with one of the largest deposits in the world.

There are other instances too. Two Indian steel majors—Vedanta Resources and ONGC Videsh are facing law and order problems and widespread corruption and conflict in several African and Latin American countries. These countries have also raised taxes and imposed hefty royalties in their bid to assert hold over their minerals and extract maximum financial benefits.

The cancellation of 122 2G telecom licences on 2nd Feb. 2012 by the Supreme Court of India is a typical micro political risk. Nine telecom service providers are the losers and the worst affected among them includes Unitech Wireless Ltd. (Norway).

The other foreign firms affected include Sistema (Russia), and Etisalat DB (UAE). Verdict of the apex court has hit Uninor more than rivals as it has the largest presence in India. Clouds of uncertainty loom over 36 million users, 17500 employees, 22,000 vendors and partners and investment of nearly ₹14000 cr.

Table 5.5 shows macro and micro risks more clearly.

Table 5.5 Types of Political Risks

(A) Macro Risks
• Expropriation of corporate assets without prompt and adequate compensation
• Barriers to repatriation of profits
• Loss of technology or other intellectual properties
• Campaigns against and boycott of foreign goods
• Mandatory labour laws
• Protectionist measures
• Civil wars and wars between countries
• Inflation, recession, currency devaluation
• Politically motivated debt default, renegotiation or rescheduling
• Indiginisation requirements
• Natural calamities
• Long term slow down of the economy
• Strikes and labour disputes
• Poverty
(B) Micro Risks
• Kidnappings, ransom, terrorism
• Official dishonesty
• Increased taxation
• Caps on FDI

Firms which have high visibility in host countries are targets of micro political risk. If agitations are caused by animosity between factions in the host country and the government of a foreign country, agitators may target only the most visible companies from that foreign country, like KFC.

Tables 5.6 and 5.7 show the level of attacks and terrorism, respectively, around the world. These acts expose MNCs to heavy micro risks.

Political risks can also be categorised into firm-specific, country-specific and global-specific risks (see Fig. 5.4)

Table 5.6 International Attacks, by Region (1995–2000)

	1995	*1996*	*1997*	*1998*	*1999*	*2000*
Africa	10	11	11	21	53	55
Asia	16	11	21	49	72	98
Eurasia	5	24	42	14	35	31
Latin America	92	84	128	111	121	193
Middle East	45	45	37	31	25	16
N.America	0	0	13	0	2	0
Western Europe	272	121	52	48	85	30

(*Source:* CIA Fact Book, 2003)

Table 5.7 International Terrorist Attacks (1981–2000)

1981	489
1985	635
1990	437
1991	565
1992	363
1993	435
1994	322
1995	440
1996	226
1997	303
1998	274
1999	392
2000	423

(Source: CIA Fact Book, 2003)

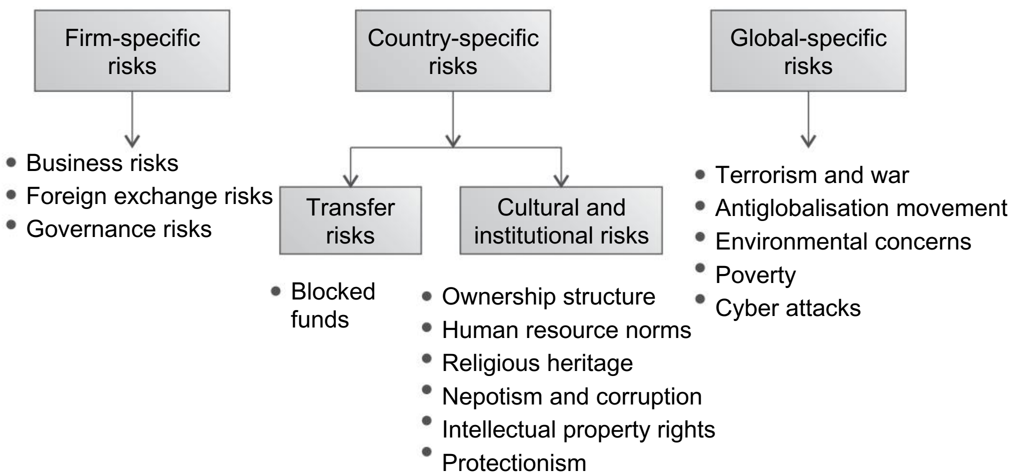


Fig. 5.4 Classification of Political Risks

(*Soruce:* David Eiteman, et al. *Multinational Business Finance*, p. 509)

Firm-specific risks These risks, also called micro risks, affect an MNC at the project or corporate level. One such firm-specific risk relates to governance. Governance risk arises when there is a conflict between the MNC and its host government. Business and foreign exchange risks also belong to the firm-specific category.

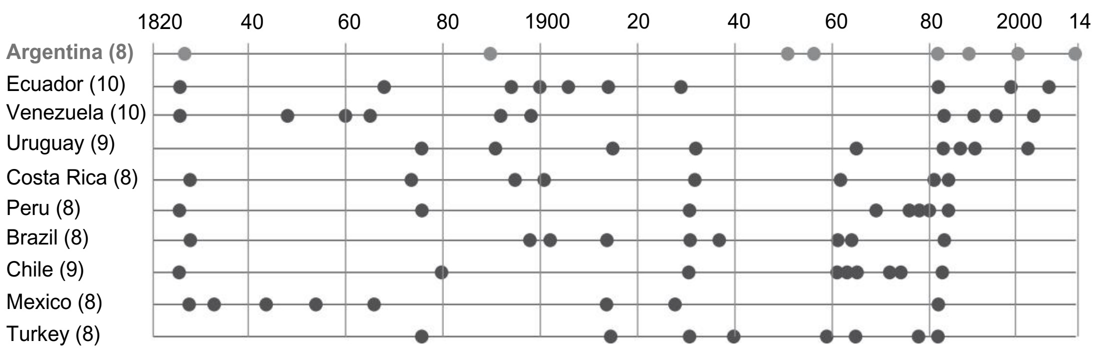
Country-specific risks These risks, also known as macro risks, affect an MNC at the project or corporate level, but originate at the country level. Country-specific risks themselves are of two types: transfer risks and cultural and institutional risks. *Transfer risks* relate to blocked funds. *Cultural and institutional risks* crop up from ownership structure, human resource norms, religious heritage, nepotism and corruption, intellectual property rights, environmental concerns and protectionism.

Global-specific risks They affect an MNC at the corporate or project level but originate at the global level. Terrorism and war, anti-globalisation movement, environmental concerns, poverty and cyber attacks are the typical global-specific risks.

Sources of Political Risks

Political risks arise out of ideological, sociological, psychological and economic constraints. Ideology can be a major motivator behind political risks. It generated the Soviet expropriation of foreign investors to turn Russia and its captive countries into planned economies and was a major cause of world conflict during Civil War. Newly independent countries were inspired by sociological compulsions. They sought to assert their sovereignty over local resources by expropriating foreign investors. Similarly, sociological considerations are behind the ethnic and religious strife that undermine the overall economic atmosphere and can culminate in destruction of human and material assets. Rwanda, Israel, the former Yugoslavia and Northern Ireland are some of the most prominent recent examples. The psychology of political leaders is another major factor behind political risks. Saddam Hussein's invasion of Kuwait, Aytollah Khomeini's xenophobic economic policy and Kim II Jong's sabre-rattling are some of the most notorious and recent examples. Economic constraints can explain many of the political strains on foreign firms. Lack of hard currency will cause restrictions on remittances abroad. Recession can lead to conservative policies concerning transfer of funds, hiring of foreigners, production standards, taxation and price controls.

Finally, misgovernance of the economy forces sovereign governments to default on their payments to bondholders. Ecuador and Venezuela missed payments 10 times since 1820. (See Fig. 5.5).



Source: *The Economist*, August 2-8, 2014

Fig. 5.5 Soverign Defaults, Top Ten Countries (no. of defaults)

Political Risk Assessment

International businesses must conduct political risk assessment in order to manage risks. Typically, managers in host countries assess the potentially destabilising issues and evaluate their future impact on the firm, making suggestions for handling problems. Top management at the head office will then establish guidelines for each host country managers to solve such problems.

Risk assessment by international businesses usually takes two forms. One is through the use of experts or consultants familiar with the host country or region under consideration. Such consultants, advisors, or committees usually monitor important indicators that may portend political change. They then assess the likelihood of political change and develop several scenarios to describe alternative political conditions in the future.

A second and increasingly common means of political risk assessment used by international businesses is through the use of their internal staff and in-house capabilities. This type of assessment may be accomplished by having staff assigned to foreign subsidiaries or affiliates monitor local political activities or by hiring people with expertise in the political and economic conditions in regions critical to the firm's operations.

Whatever the method, timely information from the people in the front line should not be missed. Experts or consultants are no substitute for the line managers in the foreign subsidiaries, many of whom are host country nationals. These managers represent the most important resource for current information on the political environment and how it might affect their firm because they are uniquely situated at the meeting point of the firm and the host country. Prudent international businesses, however, weigh the subjectivity of these managers' assessments and also realise that similar events will have different effects in different countries.

Eurasia Group, a political and economic risk analysis firm, has composed Global Politicl Risk Index (GPRI). The index is a composite measure of the state of a country's government, security, society and economy. All indicators are scored on a scale of 0 to 100. The higher the number, the greater the political stability.

Table 5.8 contains ranking of countries on GPRI by Eurasia. The ranking relates to 2006 and 2007.

Table 5.8 Composite Score

	2006	*2007*
Hungary	78	77
S. Korea	76	75
Poland	74	72
Bulgaria	70	69
Mexico	67	67
China	61	66
Brazil	66	64
Turkey	65	64
Argentina	66	66
S. Africa	64	65
Russia	63	61
India	62	62
Thailand	61	60
Egypt	60	58
Algeria	59	59
Saudi Arabia	57	57
Indonesia	57	55
Colombia	56	55
Ukrain	56	57
Philippines	55	56
Iran	51	49
Venezuela	50	52
Nigeria	48	47
Pakistan	45	50

The safest countries are Hungary, South Korea, Poland and Bulgaria. Pakistan, Nigeria, Venezuela and Iran are the countries with least safety. India stays at 62 both in 2006 and 2007. China has improved its ranking from 61 in 2006 to 66 in 2007.

Some international businesses try to quantify the political risks associated with different countries. Using these criteria (see Table 5.9), countries are ranked (see Table 5.10) as being high or low in

Table 5.9 An Illustration of Select Criteria for Evaluating Political Risk

Major Area	*Criteria*		*Score*	
			Min.	*Max.*
Political-economic environment	1	Stability of the political system	3	14
	2	Imminent internal conflicts	0	14
	3	External threats to stability	0	12
	4	Degree of control of the economic system	5	9
	5	Reliability of the country as a trading partner	4	12
	6	Constitutional guarantees	2	12
	7	Effectiveness of public administration	3	12
	8	Labour relations and social peace	3	15
Domestic economic conditions	9	Size of the population	4	8
	10	Per capita income	2	10
	11	Economic growth over the last 5 years	2	7
	12	Potential growth over the next 3 years	3	10
	13	Inflation over the past 2 years	2	10
	14	Accessibility of the domestic capital market to outsiders	3	7
	15	Availability of high-quality local labour force	2	8
	16	Possibility of employing foreign nationals	2	8
	17	Availability of energy resources	2	14
	18	Legal requirements regarding environmental pollution	4	8
	19	Infrastructure, including transportation and communication systems	2	14
External economic relations	20	Import restrictions	2	10
	21	Export restrictions	2	10
	22	Restrictions on foreign investments	3	9
	23	Freedom to set up or engage in partnerships	3	9
	24	Legal protection for brands and products	3	9
	25	Restrictions on monetary transfers	2	8
	26	Revaluation of the currency during the last 5 years	2	7
	27	Balance of payments situation	2	9
	28	Drain on foreign funds through oil and energy imports	3	14
	29	International financial standing	3	8
	30	Restriction on the exchange of local money into foreign currencies	2	8

(*Source*: Adapted from E. Dichtl and H.G. Koeglmayr, "Country Risk Ratings" *Management International Review,* vol. 26 no. 4 (Fourth Quarter 1986), p. 6)

Table 5.10 Comparative Country Risk Rankings

Country	*Overall rating*	*Political risk*	*GDP growth*	*Per capita income*	*Trade flow with US*
Italy	4.13	5	3	5	4
Denmark	4.25	5	3	5	2
Netherlands	4.63	5	3	5	4
Japan	4.19	5	3	5	5
Australia	4.5	5	4	5	4
Ireland	4.38	5	3	5	3
Germany	4.5	5	3	5	5
Sweden	4	5	3	5	3
France	4.38	5	3	5	5
Switzerland	4.5	5	3	5	4
Singapore	4.88	5	5	5	5
Belgium	4.38	5	3	5	4
United Kingdom	4.63	5	3	5	5
Canada	4.38	5	3	4	5
Israel	4	4	4	4	4
Malaysia	3.75	4	4	–	4
Chile	2.88	4	3	–	2
Thailand	3.5	4	4	–	4
South Korea	3.63	4	4	3	5
Spain	3.5	4	3	4	3
Hong Kong	4.5	4	4	5	4
Saudi Arabia	3.38	4	3	2	4
Taiwan	4.13	4	4	4	5
Turkey	2.13	3	–	–	2
South Africa	2.75	3	3	–	2
Argentina	3.25	3	4	3	3
Poland	2.75	3	4	–	2
Indonesia	2.63	3	4	–	3
Philippines	3	3	4	–	4
Costa Rica	2.38	3	3	–	2
Czech Republic	2.75	3	3	–	–
Columbia	3.25	3	4	3	3
India	2.75	3	3	–	3
China	2.88	3	4	–	5
Mexico	3.38	3	3	2	5
Brazil	3	3	4	–	4
Egypt	2.38	2	3	–	2
Venezuela	2.38	2	2	–	4
Peru	2.56	2	4.5	–	2
Russia	2	–	–	2	2

Contd.

Table 5.10 (contd.) Comparative Country Risk Rankings

Country	*Monetary Policy*	*Trade Policy*	*Protection of Property Rights*	*Foreign Investment Climate*
Italy	4	4	4	4
Denmark	5	4	5	5
Netherlands	5	5	5	5
Japan	5	4	4	2.5
Australia	5	4	5	4
Ireland	5	4	5	5
Germany	5	4	5	4
Sweden	4	4	4	4
France	5	4	5	3
Switzerland	5	4	5	5
Singapore	5	5	4	5
Belgium	5	4	5	4
United Kingdom	5	4	5	5
Canada	5	4	5	4
Israel	3	4	4	5
Malaysia	5	4	4	4
Chile	3	3	3	4
Thailand	5	3	3	4
South Korea	5	3	3	2
Spain	3	4	3	4
Hong Kong	4	5	5	5
Saudi Arabia	5	3	3	3
Taiwan	5	4	4	3
Turkey	–	3	2	4
South Africa	4	3	3	3
Argentina	4	3	3	3
Poland	2	3	3	4
Indonesia	3	2	3	2
Philippines	4	2	4	4
Costa Rica	2	2	3	3
Czech Republic	3	4	3	4
Colombia	4	3	3	3
India	4	2	3	3
China	3	2	2	3
Mexico	4	3	3	4
Brazil	3	3	3	3
Egypt	4	2	2	3
Venezuela	2	2	3	3
Peru	2.5	2.5	3	3
Russia	–	3	3	3

Ranking Scale: 1 – 5, with 5 = best, or lowest risk

(*Source*: Data from T. Morrison, W. Conaway and J. Douress, *Dun & Bradstreet's Guide to Doing Business Around the World* (Englewood Cliffs, NJ: Prentice-Hall, 1997) political risks. The criteria generally used include the political-economic environment, domestic economic conditions, and external economic relations (see Table 5.9). As Table 5.10 indicates, Russia and Turkey rank high on risk and Singapore and the Netherlands have very low risk.

The other methods of assessing political risk include: (i) qualitative approaches, (ii) aggregates of expert opinions, (iii) decision-tree methods, and (iv) scenario approaches. These are self-explanatory. Many MNCs use their own customised instruments to guage political risk, and others rely on independent assessments, e.g. by the Economic Intelligence Unit (EIU).

Having thus assessed political risk associated with doing business in foreign countries, firms should evolve suitable strategies to manage such risks.

Managing Political Risks International businesses employ different methods for managing political risks. (See Fig. 5.6). As Fig. 5.6 shows, an MNC involves itself in each of these either directly or indirectly. Similarly, its actions can be defensive or proactive.

	Direct	Indirect
Reactive	1. Host operations dependent on home control 2. Diversification 3. Legal action	1. Risk insurance 2. Home country government pressuring host country government
Proactive	1. Joint ventures 2. Licensing agreements 3. Promote host goals	1. Lobbying home and host governments 2. Corporate citizenship in host country

Fig. 5.6 Managing Risks

(*Source*: Arvind V. Phatak, et al., *International Management*, TMH, 2006, p. 99)

(1) Avoiding Investment The simplest way to manage political risks is to avoid investing in a country ranked high on such risks. Where investment has already been made, plants may be wound up or transferred to some other country which is considered to be relatively safe. This may be a poor choice as the opportunity to do business in a country will be lost.

(2) Adaptation Another way of managing political risk is adaptation. Adaptation means incorporating risk into business strategies. MNCs incorporate risk by means of the following three strategies: local equity and debt, development assistance, and insurance.

Local Equity and Debt This involves financing subsidiaries with the help of local firms, trade unions, financial institutions, and government. As partners in local businesses, these groups ensure that political developments do not disturb operations. *Localisation* entails modifying operations, product mix, or any such activity to suit local tastes and culture. When McDonald's commenced franchisee operations in India, it ensured that sandwiches did not contain any beef.

Developmental Assistance Offering development assistance allows an international business to assist the host country in improving its quality of life. Since the firm and the nation become partners, both stand to gain. In Myanmar, for instance, the US oil company Unocal and France's Total have invested billions of dollars to develop natural gas fields and also spent $6 million on local education, medical care, and other improvements.

Insurance This is the last means of adaptation. Companies buy insurance against the potential effects of political risk. Some policies protect companies when host governments restrict the convertibility of their currency into parent country currency. Others insure against losses created by violent events, including war and terrorism.

Most developed countries have created agencies to insure the firms against risks. These agencies are generally state owned/sponsored. The **Overseas Private Investment Corporation (OPIC)**, for instance, insures US overseas investments against nationalisation, revolutions and foreign exchange inconvertibility. Similarly, the **Multilateral Investment Guarantee Agency (MIGA)**, a subsidiary of the World Bank, provides insurance against political risks. Private insurance firms, such as Lloyd's of London, also underwrites political risk insurance.

In India, ICICI Lombard, Bajaj Allianz Gen. Insurance, National Insurance and TATA AIG General Insurance insure companies against kidnapping and ransom (See also Exhibit 5.3).

(3) Threat Political risk can also be managed by trying to prove to the host country that it cannot do without the activities of the firm. This may be done by trying to control raw materials, technology, and distribution channels in the host country. The firm may threaten the host country that the supply of materials, products, or technology would be stopped if its functioning is disrupted.

(4) Legal Action If threatened, MNCs can resort to legal action, but this approach is useful only in countries that have an efficient legal system and an independent judiciary. Recourse to the law would be warranted when an MNC is of the opinion that a new decision or regulation of the host government is illegal under the laws of the country or violates any initial agreement made with the host government. Legal action, however, should be the last resort and to be taken only when other options are not available. Legal actions are usually taken only by those MNCs that have decided to exit from the host country, because bringing a legal suit against the host is likely to result in retaliation.

(5) Lobbying Many MNCs resort to lobbying politicians and officials of host governments to influence the direction of policies and decisions that affect them, because much political risk arises from the potential actions that can be taken by host governments. One way of lobbying is to establish a liaison or representative office in the capital city of the host country. The representative of the MNC establishes direct contacts with local officials and politicians and lobbies them to maintain favourable policies for it. In the alternative a local liaison agent is used to lobby local officials, especially in those countries where the domestic political and official structure is complex and is not easily understood by outsiders.

Lobbying can be direct or indirect. *Indirect lobbying* or the use of news media or advertising to shape public opinion is favoured by many MNCs in countries where local officials are averse to dealing directly with foreigners. *Direct lobbying* involves the use of influence through buying or bribing officials and politicians who are important players in shaping official policy and attitudes of the host government towards the MNC. Although many MNCs do not admit offering such bribes, for obvious reasons, it is a common practice in many countries, particularly in the US where it is a constitutional right conferred on businesses.

Where services of liasion agents are retained, they render variety of services for fees. Whether brokering a deal relating to merger or acquisition, obtaining a refund from government departments or getting clearances to start new projects, services of lobbyists, who come from different hues, are always available (Exhibit 5.4).

Exhibit 5.3

RISK AND COVER

Indian corporate is increasingly exposed to kidnapping and ransom (K&Rs) risks. India ranks among the top 10 countries in the world with growing kidnapping incidents. Approximately over 4,000 incidents of kidnapping occur annually. Risks are going to intensify with increase in the number of Indian companies expanding their global presence in areas such as Africa, Sri Lanka and Middle East.

Insurers are covering risks of executives being abducted. ICICI Lombard, HDFC ERGO, Bharti Axa General Insurance, Lloyads, Bajaj Allianz and Tata AIG General Insurance are the active players in insuring K&R risks.

K&R insurance is a big and growing industry. The industry is expected to grow Rs. 184 to 210 cr. by 2012-13, from Rs 92-116 cr. as of now.

Given the nature of the product, insurers say confidentiality is critical for the clients and hence the insurers do not normally share the details of the business figures in this segment. 'More than the industry profile, the geography is pertinent. Persons who need to work in naxalism or terrorism-prone areas or areas with danger of coups usually opt for such a cover', says Kimsoon Chua, chief operating officer at Bharti Axa General Insurance.

Lloyd's of London introduced the policy in 1932 after the kidnapping of the 20-month child of Aviator Charles Lindbers. But historically, K&R insurance was shunned. 'Having ransom compensation in place for top executives and celebrities was like posting a "Wanted: dead or alive" notice for the global criminal network. Any leaks in security regarding coverage could only serve to increase the insured's risk. In Germany, K&R insurance was banned by law until 1998 for this reason', says a Bajaj Allianz official.

Insurance brokers say the coverage is much broader outside India as this product is offered in countries like Afghanistan, Iraq and now, for transits through the Gulf of Aden and Indian Ocean due to increased extortion activity in those waters. 'We see a lot of shipping companies buy these policies due to the increased activities of Somali pirates in the Gulf of Aden and now the Indian Ocean. The risk as we foresee is a long-term risk as it has more to do with economic problems of the failed states, and that's the reason why the locals resort to such easy money-making measures,' says Mr. Kedia. Projections by the UK's Foreign Policy Centre show kidnappers earn $500 million annually in ransom money from both local and expatriate kidnappings.

Companies, especially those with a large employee base engaged in frequent travel to remake or sensitive parts of the world like Latin America, some parts of Asia, Eastern Europe and Africa are potential buyers of the product. So are organisations which have high-profile executives, handle large amounts of cash, or work with sensitive information technologies.

The challenges for insurance companies are reach and expertise in such products. The sales process is kept highly confidential and is carried out through the internal database of the insurance companies. 'Agents and development officers are not involved. Only the regional heads are allowed to issue these policies, which is also done in consultation with the head office. This is not a product where we would like to have a spread. But the numbers are growing and more spreads are mitigating the risk. The claim ratio, in fact so far has been less than 5% for those policies,' says RK Kaul, chairman and managing director of Oriental Insurance.

Another feature of the policy is the complete crisis management solution it provides. 'Our crisis management consultants assist and guide them to help successful resolution of crises', says a senior Tata AIG General Insurance official. The objective remains to help the insured and their family tide over the crisis at the time of the actual or attempted kidnapping or extortion situation.

The other concern is the lower cost of services provided by security agencies in India. This is a direct competition to the product offered by insurance companies. Besides, the policy acts on a reimbursement basis only after all the expenses have been incurred. 'Such a process is perceived as a reactive process by potential clients. The premium is generally determined on the basis of a risk assessment that covers country risk, risk profile of the insured, locations and countries he travels to, occurrence of prior incidents, sectors involved and past trends in kidnap incidents', says Bali of E&Y.

(*Source: The Economic Times*, Feb. 7, 2010)

Exhibit 5.4

THE LOBBYIST UNIVERSE

Types	***Individuals***	***Modes of Operandi***	***Effectiveness***
Owner-Promoters	From Ratan Tata to Mukesh Ambani to N.R.Narayana Murthy to Azim Premji to Sunil Mittal, everyone has lobbied for, variously, better policies in telecom, oil & gas, education and retail.	Meet key policy makers personally, drum up popular support via media	Very high, since they bring a lot of personal credibility and the heft of their busines empires to weigh on the issues they champion.
Consultants	Typically, retired bureaucrats themselves, such as Pradip Baijal, former TRAI Chairman, and C.M.Vasudev former Expenditure Secretary in the Ministry of Finance.	They work the 'old boys' network, have better access than employee-lobbyists, and know the lay of the land better than most.	High, since they know how the system works, and which levers to pull.
PR Firms	Increasingly being used to do more than just public relations, PR firms offer 'back office' support. Perfect Relations, Genesis and IPAN are some such firms.	They work through informal channels and media.	Medium to low, because they have limited access to both the bureaucracy and the media.
Professional Employees	Reliance Industries' Shankar Adawal, ITC's K.S. Vaidyanathan, Ranbaxy Laboratories' Ramesh Adiga, are some senior executives who have extensive domain knowledge and champion specific issues.	Mostly interact with key bureaucrats, or lobby via industry associations.	High, since they know the innards of their industries and can make compelling, fact-based arguments.
Politicos	Usually, members of Parliament or those embedded in the organisational machinery. S. Gurumurthy and Salman Khurshid are two examples.	They try to appeal to the party high commands or the concerned ministers directly.	Medium, they are typically used in addition to other lobbyists.
Agents	Dime a dozen, these are largely fixers and do not have the domain knowledge or the credibility of other lobbyists.	They keep track of bids, file status, work through lower level bureaucracy and grease palms.	Medium, to high, this is an 'evergreen' species.

(*Source*: *Business Today*, July 15, 2007, p. 75)

Amounts spent on lobbying vary. Top spender is the US based Cognizant which spent \$1.95mn on lobbying in 2012. Nasscom in India spends \$1.15 mn, Wipro \$290,000 and Infosys spent \$5,000 in the same year.

(6) Terrorism Consultants To manage terrorism risk, MNCs hire consultants in counterterrorism to train employees to cope with the threat of terrorism.

Other Measures

The other strategies to manage political risks include:

- Signing bilateral and multilateral treaties that help protect mutual investment
- Avoiding high visibility acquisitions, particularly those considered to be pride of host countries
- Accelerating profit repatriation
- Developing a staggered technology transfer policy
- Opting for strategic alliances with local partners, neutralising local resentment against MNCs
- Scanning political environment so as to introduce pro-active strategies.

Bargaining and Integrative Approaches

The five strategies for managing political risk which have been discussed above fall under three broad approaches: (i) relative bargaining power, (ii) integrative as well as protective and defensive techniques and (iii) proactive political strategies.

Relative Bargaining Power This theory is simple—an MNC has more bargaining power than the host country. In other words, the firm has the power and position to do business in a host country on its own terms and conditions. Initiating investment in a host country, possessing proprietary technology, and owning critical raw materials will enable a firm to enjoy high bargaining power. Figure 5.7

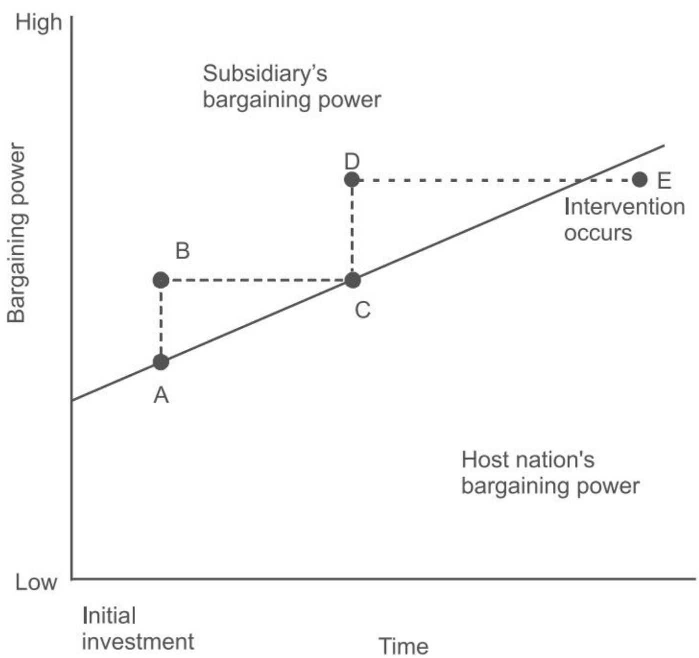


Fig. 5.7 Relative Bargaining Power over Time

illustrates this approach. As long as the MNC's bargaining power remains at or above the diagonal line, government intervention will not occur. At point E in the figure, however, this power declines and the host country government will intervene.

Integrative as well as Protective and Defensive Techniques Another means by which an international business seeks to avoid political risk is by integration and the implementation of protective and defensive techniques. *Integrative techniques* are designed to help the subsidiary to become one with the host country's needs and culture. The adaptation strategies discussed earlier belong to this category. *Protective and defensive techniques* are designed to discourage the host government from interfering in operations. In contrast to the integrative techniques, these actually encourage non-integration of the subsidiary in the host country environment. Examples include: (1) doing as little local manufacturing as possible and conducting all research and development outside the host country; (2) limiting the responsibility of local personnel and hiring only those who are vital to the operation; (3) raising capital from local banks and the host government as well as outside sources; and (4) dispersing production of the product among a number of countries.

When should a firm use integrative techniques and when should it use protective and defensive strategies? Answers to these questions depend on the technology being used, expertise and skills, logistics, and labour transmission of the MNC. In all, four basic types of firms are said to use these techniques.

The first type comprises dynamic, high technology MNCs which possess the unique knowledge that the host country needs. Computer companies are a good example. As seen from Fig. 5.8, these firms may not use integrative techniques. They keep distance from host country governments and rely heavily on protective and defensive techniques.

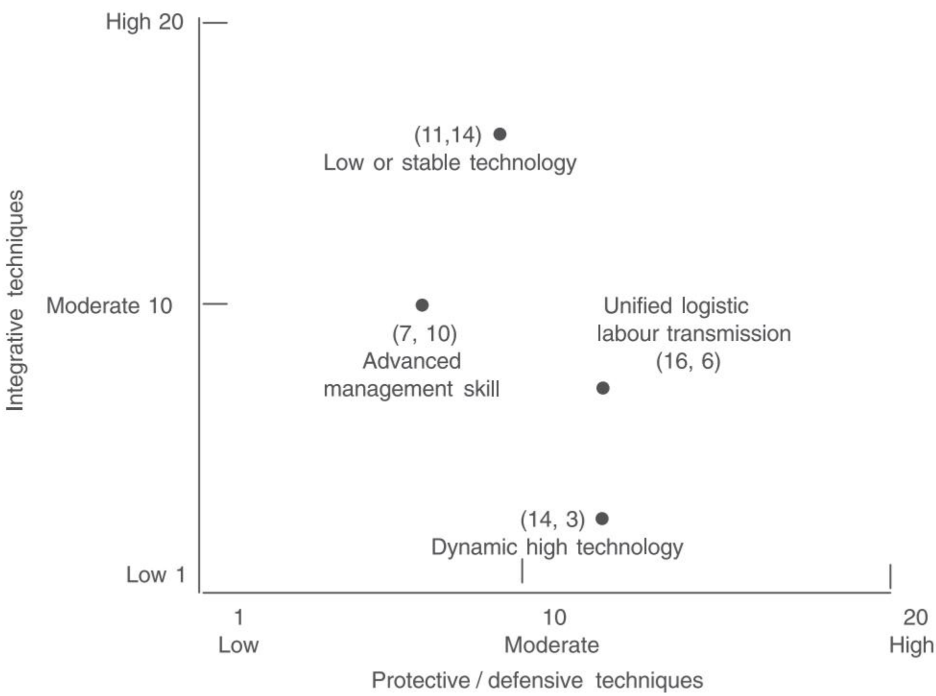


Fig. 5.8 Use of Integrative and Protective and Defensive Techniques by Firms in Select Industries

(*Source*: Figures 5.5 and 5.6 are reproduced from *International Management* by Richard Hodgetts and Fred Luthans, pp. 306-07)

The second type consists of MNCs with low or stable technology. These firms use relatively unsophisticated technology. Steel companies are one such example. As seen from Fig. 5.8, these MNCs use both high integration and high protective and defensive strategies, although they tend to rely more on integration than on defensive approach.

The third type consists of international businesses whose managers need to be highly skilled. For example, food production firms require advanced marketing and management skills to be competitive. These firms typically use a balanced approach of integration and protective and defensive techniques.

The last type comprises firms characterised by highly labour—intensive products, high value in relation to weight and / or volume, and need for a strong global marketing system for selling the product. Firms manufacturing sewing machines are an appropirate example. Companies in this category tend to rely more heavily on protective and defensive measures than any of the other three groups and employ only a moderate concern for integrative techniques.

Proactive Political Strategies These may include leveraging bilateral, regional and international trade and investment agreements, drawing on bilateral and multilateral financial support, and using project finance structures to separate project exposure from the firm's overall risk. In addition, entering markets early in the liberalisation/privatisation cycle can also be a proactive political strategy.

These strategies are designed to develop and maintain or gaining favourable relationships with host governments as a tool to mitigate risk before it becomes unmanageable.

LEGAL ENVIRONMENT

LO 4
Analyse the concept of legal environment

Legal environment refers to the legal system obtaining in a country. The legal system then refers to the rules and laws that regulate behaviour of individuals and organisations. Failure to comply with the laws means that penalties will be inflicted by the courts depending on the seriousness of the offence.

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 carried out and set down the rights and obligations of those involved in business deals.

The legal system prevailing in India should be emulated by all the countries. The legal recource is available to all—Indians or foreigners. Justice is meted to any petitioner, depending on the merits of the case. GE, for example, got back the entire investments of \$115 million from Dhabol once the latter vent bust. Scott Bayman, the CEO, admitted that nowhere else this would have been possible.

The recent judgment of Supreme Court exonerating Vodafone from paying tax on its acquisition deal worth \$11.2 bn of Hutchinson is yet another example to demonstrate the secularity of Indian judiciary. The apex court asserted that the deal between the two foreign telecom firms does not fall under the territorial jurisdiction of the Indian tax authorities. The loss to the exchequer is nearly ₹ 11,000 cr.

Laws do not change overnight. They change over a long period of time and may lag behind important cultural changes which are taking place in a country. In many cases, it is not cultural changes which invite changes in the law but ambiguities in the law themselves which are challenged in the courts.

The legal system in a country is also influenced by its political system. The government of a country defines the legal framework within which firms conduct business and often the laws that regulate business reflect the rulers' political ideology. Totalitarian states, for example, tend to enact laws that severely restrict private enterprise, while democratically elected governments pass laws that are pro-private enterprises and pro-consumer.

Systems of Law

There are four basic legal systems prevailing around the world : (1) *Islamic law,* derived from the interpretation of the Quran and practised in countries where Muslims are in majority; (2) *Common law,* derived from English law, is prevalent in countries which were under British influence; (3) *Civil or Code law,* derived from Roman law, practised in Germany, Japan, France, and non-Marxist and non-Islamic countries, and (4) *Marxist legal* system which has takers in Communist countries. (See Fig. 5.9)

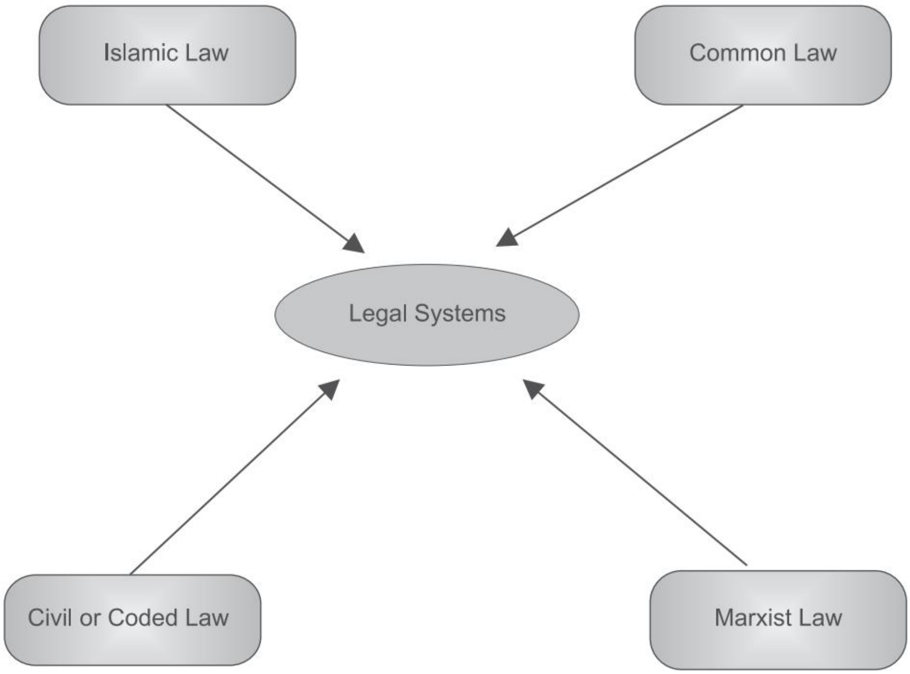


Fig. 5.9 Systems of Law

The laws among these four systems, and within each, vary considerably. Even though a country's laws may be based on the doctrine of one of the four legal systems, its individual interpretation may vary significantly—from a fundamentalist interpretation of Islamic law as found in Saudi Arabia to a combination of several legal systems found in the US, where both common and civil law are reflected in the laws.

Islamic Law Islamic law, also called theocratic law, is derived from the interpretation of the Quran and teachings of Prophet Mohammed. The word Islam translates into English as 'submission' or 'surrender'. Muslims submit to the will of God, who decrees what is proper and what is improper. God's commandments, as revealed to Mohammed, provide a path, or *shari'a,* for true believers to follow. The *shari'a* is not a coded law. It provides ethical and moral precepts as well as rules of public order. Countries from Philippines to the former Soviet Union have substantial Muslims who follow Islamic cultural and legal traditions and Islamic traditions dominate the legal and social environment of most Arab nations.

The idea of law in Islamic societies is quite different from that in most Western cultures. Where most Western nations perceive law as an expression of the will of the people acting through their legislatures, Islamic law is the product of divine revelation. It cannot be changed as the people believe in the will of the God. The immutability of the law requires Islamic nations to look to other sources of law to govern and resolve disputes.

Among the unique aspects of Islamic law is the prohibition of paying or receiving interest. The Islamic law of contracts states that any given transaction should be devoid of *riba*, which is understood as unlawful gain by way of interest or usuary. Prohibiting receipt and payment of interest is the nucleus of the Islamic system. Prohibition against interest affects banking and business practices severely. However, risk sharing, property rights, individual rights and duties, and sanctity of contracts are advocated. Investments in alcohol, gambling, and casinos are prohibited.

Followers of Islam and their financial institutions have had to develop alternative financing arrangements to source and finance capital. Businesses often rely on leasing arrangements, rather than borrowing money, in order to obtain fixed assets. In Iran, banks often charge up-front fees that act as a substitute for interest payments, and depositors receive shares of the bank instead of interest payments. Banks in Pakistan are in the process of adopting similar policies, often referred to as Islamic banking, as Pakistan's Supreme Court issued a ruling in 1999 declaring all interest-bearing transactions to be unislamic. The ruling gave the government, bankers and investors two years to revise laws, rewrite existing laws and eliminate interest payments.

The international manager should have knowledge of the religion's tenets and understand the way the law may be interpreted in each region. Regional courts can interpret Islamic law from the viewpoint of fundamentalists or they may use a more liberal translation. The international manager should also know that the Islamic legal system places emphasis on the ethical, moral, social, and religious dimensions to enhance equality and fairness for the good of society.

Socialist Law This law evolves from the Marxist socialist system and continues to influence regulations in former communist countries, particularly those from the former Soviet Union, as well as present day China, Vietnam, North Korea, and Cuba.

Extensive codes are the primary sources of socialist law. From this perspective socialist law can be classified as civil law, but the ideology thrust on the codes makes socialist law different from others. The legislature is the primary branch of government and judiciary comes next. This structure owes its origin to the founding fathers of the socialist legal system who were trained as civil lawyers and pre-revolutionary Russia was essentially a civil law country.

Ideology plays a crucial role in socialist law. Unlike a civil law code, which can be used by governments of widely differing political viewpoints, socialist legal codes are designed to achieve personal and societal transformation. The legal system is not just a set of institutions, but means to achieve a Communist society, where each gives according to his or her abilities and takes according to his or her needs.

Communist ideology permeates socialist law. The legal environment provides for state ownership of the means of production and distribution, including most businesses. It also calls for state ownership of land and, in most cases, collective use of land. There is little tolerance of private property rights. The codes support centralised planning, allowing the government to set national and uniform standards for business practices.

At the centre of the socialist legal tradition is the Communist party. The party is the keeper of the ideology of the state and through its power to nominate officers, staff the bureaucracy, and monitor workplaces, it determines the norms that become law.

Russia and China are the two countries which come to one's mind while discussing socialist law. Each country has taken a different direction in its political and economic growth. Russia is moving towards a democratic system, whereas China is attempting to activate private sector within a multicomponent or mixed economy in a socialist legal framework. Both the countries are busy with passing laws to suit changed political environments. China has implemented over 150 laws but most laws are vague. Russia's experience has been identical. Vaguely worded laws have been passed without mechanisms for implementation. These countries are struggling with universal issues such as states' rights, freedom, rights of property owners, taxation, and price control.

Common Law World's well known countries—the U.S., the U.K., India, Canada, Australia, Hong Kong, New Zealand, Malaysia and Norway, follow the principles of Common Law. Common law, also known as case law, is a legal system that is largely formed by the decisions previously made by courts and not imposed by legislatures or government officials. Common law thrives on precedential weight, on the principle that it is unfair to treat similar facts differently on different occasions. In cases where the parties to a dispute disagree on what the law is, common law looks to the past precedential decisions of relevant courts. If a similar dispute had been resolved in the past, the court is bound to follow the reasoning used in the prior decision (this principle is known as *stare decisis*). Common law has centuries of history to fall back. If, however, the court finds that the current dispute is fundamentally distinct from all previous cases (called a "matter of first impression"), judges have the authority and duty to make law by creating a precedent. Thereafter, the new decision becomes precedent, and will bind future courts.

The *stare decisis* principle of common law is of great significance for business. As the law gives reasonably precise guidance on almost every issue, the contracting parties to commercial transactions can predict whether a proposed course of action is likely to be lawful or unlawful. Commercial contracts tend to become more economically efficient, and create greater wealth, because the contracting parties know ahead of time that the proposed arrangement is legal.

Common law tends to become rigid as it relies on precedent. What was good once should be so in the days to come drives to the inflexible stance. Such a fear is ill founded. The common law is more malleable than any other law. Courts in common law are not always bound by precedent, but can (when a good reason is shown) re-interpret and revise the law to adapt to new trends in political, legal and social philosophy.

Common law involves independent judiciary with minimal or non-existing executive intervention. Finally, ownership property rights are affected by actual use and are, therefore, better protected.

Common law has a long history owing its origin to England. The collapse of the feudal system triggered the emergence of common law. In medieval times, feudal lords were the supreme rulers of their castles, lands, and serfs who lived within their territory. Disputes between lords were settled mainly through battle and the serfs had few rights. There were very few laws too.

As serfs began to attain some rights as tenant farmers, disputes between them needed to be resolved. At first, the feudal lords and later judges or registrars would simply listen to both sides of the dispute and then make a judgement. Since there were no laws to guide these early registrars in their decisions, they wrote down their judgements for others to refer to, when similar cases arose.

After the conquest of England in 1066 by William the Conqueror, who was also the Duke of Normandy, English kings established a legal system alongside developing the common law. In this system, the king was the highest legal authority. Because most kings were not knowledgeable about the common law, they based their decisions on common sense and the principle of fairness or equity. The king's courts were, therefore, referred to as the courts of *equity*. Equity courts had exclusive jurisprudence over contracts. Gradually, the equity courts merged into the common law system.

Civil Law Civil law or civilian law is a legal system that has all the laws written into a collection, codified and not (as in common law) co-created by judges. The principle of civil law is to provide all citizens with an accessible and written collection of the laws which apply to them and which judges must follow. Rules for conducting business transactions are a part of the code. Judges have wide latitude to interpret statutes, but that results in the risk of springing legal surprises. Civil law is the most widespread system of law in the world, followed in about 150 countries including all European Union except UK, Brazil, Canada, China (except Hong Kong), Japan, Mexico, Switzerland and Turkey.

As with common law, codified law has a long history. Hammurabi, a Babylonian King, enacted the first civil law in the 17th century. Modern civil law is based on the Justinian code and the Napoleanic code. Justinian was the leader of the Byzantine Empire, which had embarked almost the entire world known to the West. In 1529 A.D, Jastinian codified the law in a complete system of rules to govern the citizens of the empire. The Justinian Code was based on the traditions of the Roman Empire that preceded the Byzantine Empire and described in detail the rights of Byzantine citizens, including rights to property.

In 1804, Napolean Bonaparte became the emperor of France and established a civil code, also based on the Roman model. The Napoleanic code was established as law after many of the changes that occurred in the aftermoth of French Revolution, including to a jury trial and civil equality.

Common law differs from civil law in protection of intellectual property rights. Under the common law, ownership is established by usage; under code law, ownership is determined by registration. In some countries, where code law prevails, certain agreements may not be enforceable, unless properly notorised or registered; in a common law country, the same agreement may be binding so long as proof of the agreement can be established.

Yet another distinction between the two systems of law relates to the roles of judges and lawyers. In the common law system, the judge serves as a neutral reference, defining points of law and ruling on various motions put forth by the opposing party's lawyers. These lawyers are responsible for developing their clients' cases and choosing which evidence to submit on their client's behalf. In the civil law system, the judge takes on many of the tasks of the lawyers, for example, determining the scope of evidence to be collected and presented to the court.

The third difference between common law and civil law relates to the qualification of judges. In common law, experienced lawyers are appointed or elected to act as judges. But career judges act as arbiters in civil law.

Comparative Law Comparative law is not a source or system of law but an emerging discipline that examines differences between legal systems prevailing in different countries. Before a manager is posted on a foreign assignment, he or she is briefed about the host country's legal system. Understanding the legal system of a host country is not enough. The international manager needs to know how the laws of one country compare with those obtaining in another nation. Taking own country's experience and generalising them as applicable to other countries may be a costly mistake.

The comparison of foreign criminal law is important to business people who find themselves under the control of a foreign government and accused of crimes. For example, a businesswoman was arrested in Nigeria for selling oil without a licence. The penalty (changed after she was arrested) was death. She was tried and finally acquitted—the acquittal occurred because of active intervention by the counsel and US Congressional representatives. Another interesting case relates to a consultant named Flynn who was assisting a US printing company that was unable to comply with the contract terms with a Mexican company. Flynn flew to Mexico to resolve the issue and was arrested and sentenced to six years in prison. After three years of imprisonment, the conviction was overturned on the ground that he had not been a party to the contract.

It is not only criminal law which needs comparison. Foreign investment law also invites comparison. Many countries, including East European, Latin, and South American ones, have been changing their laws to attract foreign capital, including laws on government approval for foreign investment and technology transfer agreements. Some countries have removed restrictions on profit repatriations, movement of capital, and form of ownership and lowered tax rates as incentives.

Each country, depending upon its stage of development as well as past experience with foreign investment, will develop unique investment codes. Assumptions about what is permissible for business in a particular country are dangerous because while one country allows wholly owned foreign companies, other nations may require some level of local participation.

INTERNATIONAL DISPUTES RESOLUTION

LO 5
Evaluate the processes of international disputes resolution

Legal disputes can arise in three situations: between governments, between a firm and a government, and between two firms. Disputes between governments are resolved through the intervention of the World Court at the Hague and the International Court of Justice, the principal judicial organ of the United Nations. Disputes of the other two situations must be handled in the courts of the country of one of the parties involved or through arbitration.

Which country's court should handle a dispute is a relevant question. This is so because each party to a contract is likely to want any dispute arising from it to be settled in its own country according to that nation's laws. But this is obviously not possible when businesses from different countries are involved. Often, contracts contain jurisdictional clauses which specify that the law of a particular country will apply, as agreed by the parties to the contract. Often, the law of England is specified even though neither party resides in the UK. This is because English law has dealt with questions of international trade for many countries, is well documented, and has ready answers for most questions arising from cross-border transactions.

If a contract does not contain a jurisdictional clause, then the law of the country in which the case is heard (normally the defendant's nation, because the defendant cannot be compelled to attend a court outside his or her own country) will apply. Jurisdictional issues within the European Union are covered by the Brussels Convention of 1982 and the Rome Convention of 1990 which establish the circumstances in which cases will be heard. Either the contract of sale will name a country, or the country with 'the closest connection' with the country must be chosen.

The principal means of resolving international disputes are conciliation, arbitration, and litigation (See Fig. 5.10). Most international businesses prefer a settlement through arbitration rather than by suing a foreign country.

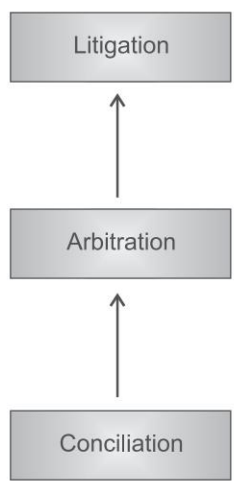


Fig. 5.10 Methods of Dispute Settlement

Conciliation Also known as mediation, this is a nonbonding agreement between parties to resolve disputes by asking a third party to mediate. The function of the mediator is to carefully listen to each party and to explore, clarify, and discuss the various practical options and possibilities for a solution with the intent that the parties will agree to it. Unlike arbitration and litigation, conciliation sessions are private and all conferences between parties and the mediator are confidential; the statements made by the parties may not be disclosed or used as evidence in any subsequent litigation or arbitration. The track record for the conciliation process is excellent, with a majority of disputes reaching settlement and leading to the resumption of business between the disputants.

Conciliation is considered to be especially effective when resolving disputes with Chinese business partners because they feel less threatened by conciliation than arbitration. The Chinese believe that when a dispute occurs, informal, friendly negotiation should be used first to solve the problem; if that fails, conciliation should be tried. In fact, some Chinese companies may avoid doing business with companies that resort first to arbitration. Conciliation can be either formal or informal. Both sides agreeing on a third party to mediate can establish informal conciliation. Formal conciliation is conducted under the auspices of a tribunal, such as the Beijing Conciliation Center, which assigns one or two conciliators to mediate. If an agreement is reached, a conciliation statement based on the signed agreement is recorded. Although conciliation may be the friendly route to resolving disputes in China, it is not legally binding; thus, an arbitration clause should be included in all conciliation agreements. Having an arbitration clause in the conciliation agreement makes it easier to move to arbitration if necessary.

Arbitration If conciliation is not used or an agreement cannot be achieved, the next step often used is arbitration. When all else fails, arbitration, rather than litigation, is the preferred method for resolving international commercial disputes. The usual arbitration procedure is for the parties involved to select a disinterested and informed party or parties as referee to determine the merits of the case and make a judgement that both parties agree to honour. Although informal arbitration is workable, most arbitration is conducted under the auspices of one of the more formal domestic or international arbitration groups organised specifically to facilitate the resolution of commercial disputes. These groups have formal rules for the process and experienced arbitrators to assist. In most countries, decisions reached in formal arbitration are enforceable under the law.

The popularity of arbitration has led to a proliferation of arbitral centers in countries, organisations, and institutions. All have adopted standardised rules and procedures to administer cases and each has its strengths and weaknesses. Some of the more active are the following:

- The Inter-American Commercial Arbitration Commission
- The Canadian-American Commercial Arbitration Commission (for disputes between Canadian and US businesses)
- The London Court of Arbitration (decisions are enforceable under English law and English courts)
- The American Arbitration Association
- The International Chamber of Commerce
- The Commercial Dispute Resolution Center of the Americas

The procedures used by formal arbitration organisations are similar. Arbitration under the rules of the International Chamber of Commerce (ICC) affords an excellent example of how most organisations operate. When an initial request for arbitration is received, the Chamber first attempts conciliation between the disputants. If this fails, the process of arbitration is started. The plaintiff and the defendant select one person each from among acceptable arbitrators to defend their case and the ICC Court of

Arbitration appoints a third member, generally chosen from a list of distinguished lawyers, jurists, and professors.

The advantages of arbitrating an international contract dispute are many. The arbitrators may or may not be lawyers. For example, a construction contract dispute may have engineers as arbitrators. The arbitration process is likely to be faster than litigation. It may have a more streamlined process of getting to a hearing, especially when compared to the expensive and cumbersome discovery process in countries. A major factor in favour of arbitration is its lack of publicity. Unlike court proceedings, which are open to the public and often result in published decisions, arbitration is a private process. The ultimate decision is known only to the involved parties. A business concerned about the disclosure of confidential information will tend to try to resolve disputes through arbitration. Other advantages of arbitration include flexibility in rules on the admissibility of evidence, compellability to implement decisions, and limited rights of a party to appeal.

In order to arbitrate a dispute, the parties must agree to do so, usually in their initial contract. For example, a typical arbitration clause would have the parties agree to arbitrate any dispute 'arising from or related to' the contract before a specific group, such as the ICC; would designate a substantive law to govern the contract; would contain language allowing the enforcement of an arbitral award in court; could specify the number of arbitrators; and could choose a place and language for the arbitration proceedings.

Arbitration has become popular in both domestic and international business agreements. An arbitration clause may be inserted in an employment contract, credit card agreement, cruise ship ticket, or bank account application, as well as in big contracts.

However, arbitration can be expensive and even lengthy, despite its reputation as the quicker and cheaper alternative to litigation. A new trend is emerging—inclusion of a resolution mechanism for immediate problems in addition to arbitration, including a neutral advisor or special dispute passed.

Litigation Seeking justice in a court is generally avoided by parties to an agreement. The costs incurred, the frustrating delays involved, and extended aggravation make victories in law suits spurious. There are other grey areas also in litigation:

1. Fear of creating a poor image and damaging public relations
2. Fear of unfair treatment in a foreign court
3. Difficulty in obtaining judgement that may otherwise have been possible in a mutually agreed settlement through arbitration
4. The relatively high cost and time required to settle the dispute. The issue of paying compensation to victims of the Bhopal gas tragedy has been only recently decided though decades have gone by since the disaster occurred.
5. Loss of confidentiality. Unlike arbitration and conciliation that are confidential, litigation is public.

The three approaches to dispute settlement—conciliation, arbitration and litigation have their advantages as well as limitations. To sum up, we may state that to settle any dispute (international or domestic), four steps are needed: *first,* try to placate the affected party; *second,* if this does not work conciliate; *third,* if this also fails, seek arbitration, and *fourth,* if arbitration fails; resolve through litigation. Though litigation is recommended as one of the options, a wise course of action would be to seek a settlement other than by sueing.

Principles of International Law

International law, unlike domestic law, is less coherent because its sources embody not only the laws of individual countries concerned with any dispute but also treaties and conventions. Besides, international law contains unwritten understandings that arise from repeated interactions among nations. Obviously, international law carries different rules and regulations and these can create major problems for MNCs. Happily, many things which the international manager needs to know have been classified under broad principles.

Principle of Sovereignty and Immunity The principle of sovereignty implies that the governments have the right to rule themselves as they see fit. This has legal implication in as much as no country's judiciary can prosecute another country citizen unless that country agrees. For example, Indians working for an employer in Japan cannot sue the firm for any unfair treatment under the provisions of Indian laws.

International Jurisdiction An MNC is governed by *multiple jurisdictional* principle. The MNC is subject to the home country, host country and often third country laws. These laws may be in conflict – compliance with one legal jurisdiction might invoke non-compliance or violation of the other. For instance, compliance with the Arab boycott of Israeli is a violation of US law.

An MNC is also subject to the laws of a *regional entity* like NAFTA, EU, or WTO. The stronger the regional entity, the greater is the requirement of compliance of its rules and regulations. Often, uncertainty prevails as to whether regional jurisdiction supercedes national jurisdiction. For example, the European Court of Justice rules that no EU country could limit trade in a product imported into the EU. In this case, the court found that French rules prohibiting such trade were incompatible with European laws. Then, there is the *protective principle*. This principle holds that every country has jurisdiction over behaviour that adversely affects its national security, even if that conduct occurs outside its territory.

Doctrine of Comity This principle holds that there must be mutual respect for the laws, institutions, and governments of other countries in the matter of jurisdiction over their citizens. This principle is strictly not a part of international law, but is a part of international customs and traditions.

Treatment and Rights of Aliens Nations have the legal right to refuse admission of foreign citizens and impose special restrictions on their conduct, right of travel, places of stay, and what business they may conduct. Countries can also deport aliens.

AREAS OF CONCERN FOR MNCS

LO 6
Understand the legal implications for MNCs

The immediate legal issues that bother MNCs most are the following: (a) Protection of intellectual property, (b) Product liability and safety, (c) Competition among businesses, (d) Payment of bribes and other corrupt practices (e), Advertising and sales promotions, (f) Formation and termination of contracts, (g) Shipping of goods, (h) Labour legislations, and (i) Environmental laws (see also Fig. 5.11).

Intellectual property Property that results from people's intellectual talent and abilities is called intellectual property and includes designs, novels, patents, trade marks, copyrights, computer software, and secret formulae such as the one used for making Coca Cola. It is possible to establish ownership rights over intellectual property through patents, copyrights, and trade marks. A patent grants the

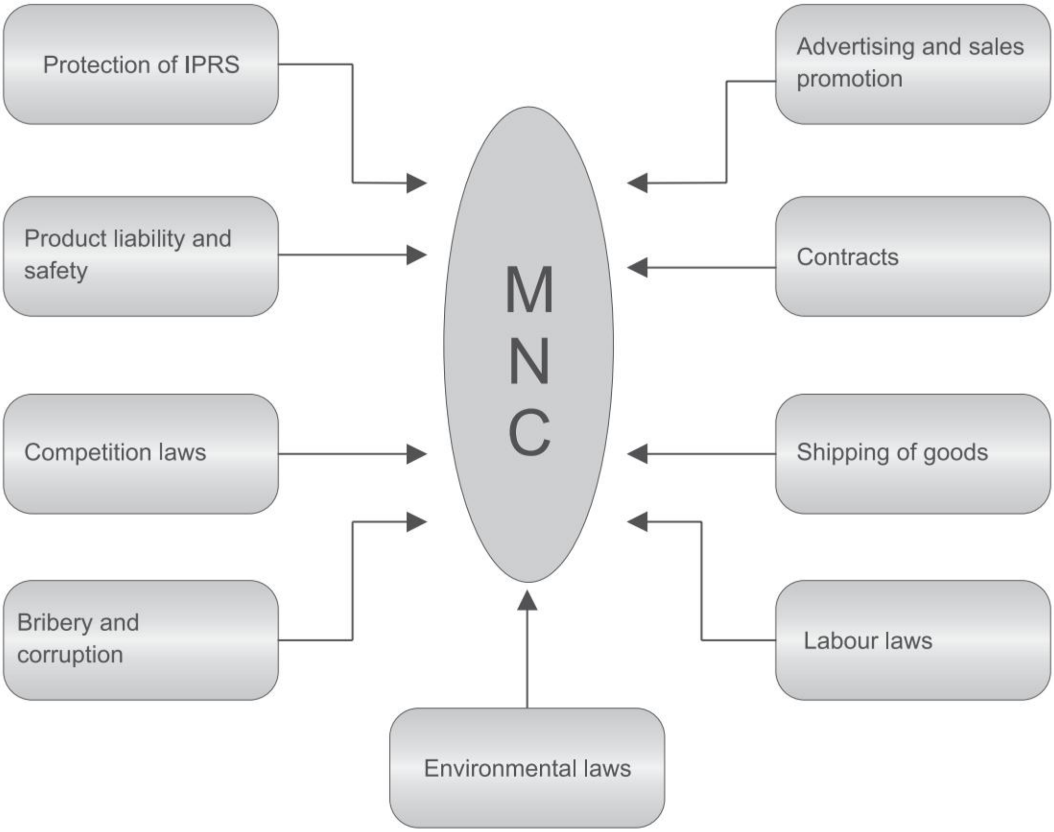


Fig. 5.11 *MNC and the Legal Environment*

inventor of a new product or process exclusive rights of 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 wish. Trade marks are designs and names, often officially registered, by which business people designate and differentiate their products.

The philosophy behind intellectual property laws is to reward the originator of an invention, book, musical record, clothes design, software and the like, for his or her idea and effort. Such laws are a very important stimulous to innovation and creative work. They provide an incentive for people to search for novel ways of doing things and reward creativity.

Countries vary widely in their intellectual property laws. While many countries have stringent intellectual property laws in their books, their enforcement has been lax. This has been the case even among the countries that have signed important international agreements to protect intellectual property, such as the Paris Convention for the Protection of Industrial Property which has 96 countries as signatories to it. Weak enforcement encourages the piracy of intellectual property. China and Thailand are the worst offenders in Asia (See Exhibit 5.5).

Product Liability and Safety Most countries have laid down product safety laws which bind manufacturers to produce safe products. Product liability holds manufacturers and sellers responsible

Exhibit 5.5

MICROSOFT BATTLES SOFTWARE PIRACY IN CHINA

Microsoft, the world's biggest personal computer software company, developed MS-DOS and then Windows, respectively, the operating system and graphical user interface that now reside on over 90 per cent of the world's personal computers. In addition, Microsoft has a slew of best-selling applications software, including its word processing program (Microsoft Word), spreadsheet program (Excel), and presentation program (Power Point). An integral part of Microsoft's international strategy has been expansion into mainland China, where 3.2 million personal computers were sold in 1997, a number that was expected to grow by at least 1 million per year through the rest of the decade. With a population of 1.5 billion, China represents a potentially huge market for Microsoft.

Microsoft's initial goal is to build up Chinese sales from nothing in 1994 to $100 million by 2000. However, before the company can achieve this goal, it has to overcome a very serious obstacle: software piracy. Over 96 per cent of the software used in China in 1996 was pirated. Microsoft is a prime target of this activity. Most Microsoft products used in China are illegal copies. China's government is believed to be one of the worst offenders. Microsoft's lawyers complain that Beijing doesn't budget for software purchases, forcing its cash-strapped bureaucracy to find cheap software solutions. Thus, Microsoft claims, much of the government ends up using pirated software.

To make matters worse, China is becoming a mass exporter of counterfeit software. Microsoft executives don't have to go far to see the problem. Just a few blocks from the company's Hong Kong office is a tiny shop that offers CD-ROMs, each crammed with dozens of computer programs that collectively are worth about $20,000. The asking price is about 500 Hong Kong dollars, or $52! In further evidence of the problem, Hong Kong customs seized a shipment of 2,200 such disks en route from China to Belgium.

Microsoft officials are quick to point out the problem arises because Chinese judicial authorities do not enforce their own laws. Microsoft found this out when it first tried to use China's judicial system to sue software pirates. Microsoft pressed officials in China's southern province of Guangdong to raid a manufacturer that was producing counterfeit holograms that Microsoft used to authenticate its software manuals. The Chinese authorities prosecuted the manufacturer, acknowledged that a copyright violation had occurred, but awarded Microsoft only $2,600 and fined the pirate company $3,000! Microsoft is appealing against the verdict and is requesting $20 million in damages.

Another Microsoft response to the problem has been to reduce the price on its software in order to compete with pirated versions. In October 1994 Microsoft reduced the price on its Chinese software by as much as 200 per cent. However, this action may have little impact, for the programs are still priced at $100 to $200, compared to $5 to $20 for an illegal copy of the same software.

Yet another tactic adopted by the company has been to lobby with the US government to pressurise Chinese authorities to start enforcing their own laws. As part of its lobbying effort, Microsoft has engaged in its own version of 'guerrilla warfare', digging through trash bins, paying locals to spy, even posing as money-grubbing businessmen to collect evidence of piracy, which they have then passed on to US trade officials. The tactic has worked because the US government currently has some leverage over China. China wishes to join the World Trade Organisation (China is now a member of the WTO) and views US support as crucial. The United States has said it will not support Chinese membership unless China starts enforcing its intellectual property laws. This demand was backed up by a threat to impose tariffs of $1.08 billion on Chinese exports unless China agreed to stricter enforcement. After a tense period during which both countries were at loggerheads, the Chinese backed down and acquiesced to US demands in February 1995. The Chinese government agreed to start enforcing its intellectual property rights laws, to crack down on factories that the United States identified as pirating US goods, to respect US trademarks including Microsoft's, and to instruct Chinese government ministries to stop using pirated software.

Whether this agreement will make a difference remains to be seen. Microsoft, however, is taking no chances. The company announced it would work with the Chinese Ministry of Electronics to develop a Chinese version of the Windows 95 operating system. Microsoft's logic is that the best way to stop the Chinese government from using pirated software is to go into business with it. Once the government has a stake in maximixing sales of legitimate Microsoft products, the company reckons it will also have a strong incentive to crack down on sales of counterfeit software.

(*Source*: Charles W.L. Hill, *International Business*, pp. 44-45)

for damage, injury, or death caused by defective products. Affected parties can sue both for monetary compensation through civil law suits, or imprisonment through criminal lawsuits. Civil lawsuits are frequently settled before cases are filed in courts.

The United States has the toughest product liability laws in the world, with Europe a close second. Less developed and emerging countries have the weakest laws. By the same token, insurance premiums and legal expenses are greater in those nations with strong product liability laws. Awarded damages tend to be several times larger in the United States than in other developed countries.

Conforming to different international laws can be a complex process. Consider a product as seemingly straightforward as Chinese-made teddy bears. Bears that were assembled in China with parts made all over the world must meet manufacturing and safety specifications for customers in Brazil, Canada, the European Union, Japan, Mexico, and the United States. Before a teddy bear can be shipped to the United States, four different certificates from four different labs must be obtained. Each one certifies that the toy complies with various US federal regulations, including ASTM F-963, the US voluntary toy-safety standard. Teddy bears headed for Brazil need certification from a recognised US or Brazilian laboratory. Shipments headed for Japan must comply with Japanese toy-safety regulations and those destined for sale in the European Union must comply with ENZI, the European safety standard.

Enforcement of product liability laws differs from nation to nation. In the United States, for instance, tobacco companies are under attack for failing to warn consumers about the health effects of tobacco and nicotine. In countries like India and Sri Lanka, however, they are free from scrutiny by public-welfare organisations. Because of far less stringent regulation, the biggest market for US cigarette makers is Asia, followed closely by eastern Europe. Philip Morris, the world's biggest tobacco company, increased international sales by 80 per cent (to 660 billion cigarettes) between 1990 and 1997. In Poland, market potential is still quite large despite the curbing of cigarette advertising, raising of taxes, and banning of smoking on the job. About 50 per cent of all Polish adults smoke, compared to 25 per cent in the United States.

Competition among Businesses Competition laws are enforced to break monopolies and protect consumer interests. It is truism that consumer interests are better protected by encouraging competition among manufacturers and sellers of products. In India there is the Competition Law. Other countries too have antitrust laws. The US has antitrust legislation, as also in Germany. In Japan, the Fair Trade Commission enforces antitrust laws. From South Korea to Brazil to the Czech Republic, all countries have enacted competition laws.

All antitrust laws are identical in their focus on two types of activities. First, competition laws tend to prohibit agreement between competitors that restrict competition. Second, such laws prohibit the abuse of a dominant market position.

Bribes and Corrupt Practices Bribery is a deliberate attempt to pursuade someone (usually in position of power and authority) to act improperly in favour of the party offering bribes in the form of money or gifts. Bribery is the root cause for corruption. Corruption then may be understood as the abuse of public office for private gain. International businesses are known to bribe officials to get favours. Investigations of the US based MNCs in the 1970s and of Italian firms in the 1990s, along with much anecdotal information from several years, indicate that the practice has been widespread.

Almost every nation in the world outlaws bribery of its own officials. For example, the Russian Federation, which in recent years has obtained a dubious reputation for official corruption, has a complex legal framework to deter official corruption. Since April 1992, Presidential Decree 351 has barred civil servants from participating in entrepreneurial activities, managing commercial activities, or accepting foreign business trips paid for by businesses. The Russian Federal Anti Monopoly Law restricts government officials from owning enterprises or serving in a voting capacity in a commercial enterprise. Penalties for violation include fines, dismissals from office, and imprisonment. South Korea, which in early 1998 experienced near collapse of its financial system due to the discovery of official corruption, also has an impressive and strict anti-bribery legal framework. In August 1996, two former South Korean presidents were convicted of criminal bribery, having accepted hundreds of millions of dollars from business enterprises. One was sentenced to death while the other was sentenced to 22 years and six months in prison.

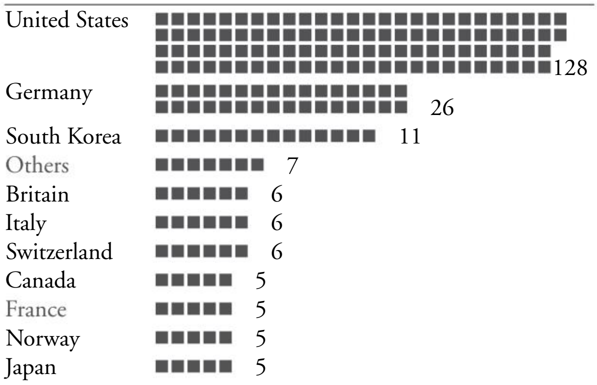
The Foreign Corrupt Practices Act 1977 of the US not only outlaws bribery of its own officials but of the public officials in other countries too. The Xerox Corporation had outlawed improper payments of $700,000 made by Modi Xerox in India, in 2002, to the government officials to secure orders. The 29 countries of the Organisation for Economic Co-operation and Development (OECD) are in the process of enacting anti-bribery law. The Council of Europe has promulgated a Criminal Law Convention which outlaws active, passive, and transnational bribes. The EU has enacted four treaties and protocols focused on criminalisation of transnational bribery.

OECD published its first report in December 2014 on bribery and corruption. It analysed more than 4000 international bribery cases and found the following dimensions:

- The most bribe prone sectors are oil, gas, mining, construction and transport. Financial services and retailing are relatively clean.
- In tune with the American Foreign Corrupt Practices Act, other countries—from Britain to Brazil—are legislating stringent acts.
- Most bribes go to managers of state-owned companies, followed by customs officials.
- Corporate managers from rich countries are the most bribe receivers.
- Cleanest countries tend to be rich, and the dirtiest poor.
- America tops the list in detecting bribe cases resulting in sanctions (See Fig 5.12).

Advertising and Sales Promotions Multinational businesses spend huge sums across the globe for advertising their products. Like advertising in domestic markets, there are temptations to make exaggerated claims and tell untruths while conveying messages about the products to be sold in international markets. Almost all nations have laws to prevent such false claims.

The EU specifically excludes fraudulent advertising from its general protection of commercial



Source: The Economist, Dec. 6, 2014

Fig 5.12 Bad bargains, foreign bribery, 1999-2014 (Enforcement actions resulting in sanctions)

speech. Even during the late 19th century, when there were no specific laws to protect consumers (those were the days of unbridled capitalism), courts found ways to save the users. In a country with no consumer protection laws, English courts protected consumer by invoking ancient contract law principles to newspaper advertising. (See Exhibit 5.6 for details on the Carbolic Smoke Ball case).

The universal condemnation of deceptive advertising, illustrated in Exhibit 5.6, is shared with varying degrees throughout the world. But some societies are less tolerant of vagueness and exaggeration in advertising than others. The exacting standards of the Japanese do not tolerate any exaggeration. In

Exhibit 5.6

CARLILL V. CARBOLIC SMOKE BALL CO. (I Q.B. 256 (1883) QUEEN'S BENCH)

Background and Facts

The defendants, proprietors and vendors of a medical preparation called the "Carbolic Smoke Ball", inserted the following advertisement in the *Pall Mall Gazette* of 13 November 1891:

£100 reward will be paid by the Carbolic Smoke Ball Company to any person who contracts the increasing epidemic influenza, colds, or any disease caused by taking cold, after having used the ball three times daily for two weeks according to the printed directions supplied with each ball. £1000 is deposited with the Alliance Bank, Regent Street, showing our sincerity in the matter. During the last epidemic of influenza many thousand carbolic smoke balls were sold as preventives against this disease and in no ascertained case was the disease contracted by those using the carbolic smoke ball.

The plaintiff was a lady who, relying on this advertisement, bought one of the balls at a chemist's shop, and used it as directed, three times a day, from 20 November 1891 to 17 January 1892, when she was attacked by influenza.

The Queen's Bench which entertained her appeal found that the ad was a definite offer that the plaintiff had accepted through her performance. It entered judgement of £100 on her behalf.

Japan the Fair Trade Committee prevented Pepsi Co. from advertising its cola drink as the "choice of the next generation". Regulators ruled that Pepsi was second to Coca Cola in the Japanese market.

Advertising can also be outlawed even if its content is perfectly true. Advertising aimed at children, for example, is closely regulated. More than 40 countries prohibit or limit such advertising, reasoning that children cannot intelligently assess the contents of commercial ads.

Some countries insist on the use of local language which complicates cross-border advertising. Indonesia, for example, insists on use of Bahasa in bill boards. But Bahasa happens to be a second language in the country of 180 million people. Similarly in France, every word used in advertising must be in French, even if the French people themselves use English.

Almost all countries limit the advertising of tobacco and alcohol. Starting in 1993, France banned all tobacco and alcohol advertising—only exception being French wine. Bulgaria has banned all tobacco advertising outside of tobacco shops and threatened violators with a $50,000 fine per violation. In Britain, tobacco commercials are not banned but the citizens believe the self-imposed and subjective industry guidelines. In 1995, Iran's spiritual leader ruled that foreign soft drinks such as Coca-Cola and Pepsi-Cola were forbidden because they somehow advocate Zionism.

The lesson the international manager must learn is that he or she should seek legal advice from local practioners and stratigise local advertising appropriately.

Sales promotions are marketing activities that stimulate consumer purchases. As is true in advertising, there are laws restricting sales promotional activities. Some countries prohibit premiums or free gifts. In some countries, laws control the amount of discount given to retailer, others require permits for all sales promotions, and atleast in one country, no competitor can spend more on a sales promotion than any other company selling the product.

Contracts A contract is an agreement by the parties concerned to establish a set of rules to govern a business transaction. Contract law plays a major role in international business transactions because of the complexities arising from the differences in the legal systems of participating countries and because the host government in many developing and communist countries is often a third party in the contract. Both common law and civil law countries enforce contracts, although their means of resolving disputes differ. Under civil law, it is assumed that a contract reflects promises that will be enforced without specifying the details in the contract; under common law, the details of promises must be written into the contract to be enforced.

Carriage of Goods Another area of concern to international business relates to the carriage of goods across countries. Three subjects are relevant in this context: (1) the liability of international carriers, (2) the liability of ocean carriers, and (3) issues in maritime and marine cargo insurance law.

International Carriers' Liability The liability of an air carrier for death or personal injury of a passenger or damage to property is determined by the Warsaw Convention of 1929, as amended in 1999. The Convention, signed by 54 nations, created the first comprehensive set of uniform rules governing the carriage of international passengers, baggage and cargo. Carriers are liable to pay for damages to cargo, but only upto 17 Special Drawing Rights (SDRs). (At the close of the year 2000, 1 SDR was worth $1.29 per kilogram or approximately $1.0 per pound of cargo.) Of course, the shippers can declare higher values and pay fees for their luggage or cargo. The liability of an airline for death or injury to a passenger has been fixed at $75,000 since 1966.

In 1999, 55 nations signed the Montreal Convention which will become law when ratified by thirty nations. This will replace the Warsaw Convention, and is intended to increase the liability of airlines for injuries and loss of human life.

Ocean Shipping Two types of vessels are involved in ocean shipping—chartered ships and common carriers. With a charter, the ship's owner agrees to carry a particular company's goods. A shipper with a large cargo of goods or commodities may decide to charter an entire ship to take goods to overseas markets. A common carrier, on the other hand, will carry anyone's goods by scheduled vessels.

The liability of the carrier (chartered or common carrier) for damage or loss to ocean-going goods, in most nations of the world, is governed by the Hague Rules. As per these Rules, the primary obligation of the carrier is to provide a seaworthy ship. Its liability for damage to cargo resulting from errors in navigation, perils of the sea, and fire is limited. The losses usually fall on the insurers of the cargo and vessel.

Insurance Insuring cargo is an essential element in international business. The potential for damage and loss to goods, particularly during ocean shipments that are more lengthy and more hazardous than air shipments, is tremendous. Such loss is sought to be minimised through insurance.

Cargo insurance is usually handled through a broker. Rates vary depending on the risk involved in the shipment, the largest one being political risk involved in the transit areas.

The well-known name in cargo insurance is Lloyd's of London. Lloyd's began business in the 17th century as a group of traders and ship-owners who met at Edward Lloyd's coffee house to discuss matters of common interest. An Act of Parliament brought Lloyd's into being. The Corporation provides services and facilities, but the actual underwriting of risks is done by the individual members of Lloyd's. Each member has unlimited personal liability for the risks he insures against. If a risk is too large for one to handle, a syndicate of members is formed to carry the risk. Although many companies in different countries now write insurance on cargo, Lloyd's is still the leading broker.

Historically, marine cargo insurance covered two separate categories of underwriting risks: marine risks and war risks. Marine risks included, among others, perils of the sea, piracy, fire, thieves and barratry (the serious misconduct of the captain or crew). War risks included the risk of aerial bombardment, mines, torpedoes, and takings or seizures by governments, factions, or belligerents in wars, civil wars, and rebellions. Today, it is common to obtain insurance to cover all risks, including war risks, rather than to rely on a listing of specific risk covered.

Some insurance policies contain the clause "free of particular average" (FPA) which means that the underwriter will not pay for any partial loss unless the loss is general to the entire cargo. If a ship jettisons some cargo in order to save the ship, all shippers and the ship owner suffer proportionately. If a shipper is shipping wool that is partially destroyed but the other shippers do not suffer any loss, her loss would be "particular" and thus not payable under an FPA clause. Some policies state "FPA unless 10 per cent". In this situation, the insurer will pay for partial losses exceeding 10 per cent of the valuation of the cargo.

Labour Laws Across the World Yet another area of concern for an MNC relates to labour legislations prevailing in different countries. Four main issues relating to labour are: (1) employee dismissals, (2) working conditions, (3) discrimination, and (4) child labour.

Employee Dismissals Any employer believes that he should have the right to terminate the services of an employee the moment the individual ceases to be productive. This is the right an employer in the US enjoys. Law in the UK mandates that an employer consults with the appropriate trade union before making a dismissal. If the workforce is to be reduced by ten or more employees, a consultation must take place sixty days prior to termination. Under German law, the employer should consult a work council which must approve the dismissal. If it does not, the employer may appeal to labour court, but is likely to lose the appeal. In Japan, an individual is expected to hold a job in the same company for a lifetime.

But conditions are changing on the labour front. US businesses, for example, are being influenced more and more by European and Japanese practices. The employees are now given unpaid leave to care for family members and are guaranteed jobs back after such leave and are warned in advance of any plant closure. More and more US managers now take a page from Japanese management practices and seek ways of providing greater assurance of employment.

Japanese, on the other hand, are being influenced by American and European practices. During the recession of the 1990s, for example, giants such as Nippon Telephone & Telegraph, NKK Corporation, and Nissan Corporation successfully implemented reductions in their staff strengths. These firms did not actually lay off employees, but effected the reductions through normal attrition, intra-company transfers, and transfers to subsidiaries. But because many employees rejected unattractive transfers and many subsidiaries went out of business, the purpose was well served. The days of lifetime employment are actually numbered.

In India, dismissal of an employee was not easy, though in the old economy firms job security is still guaranteed. Labour was highly protected in India till 1990. With the economy being liberalised since 1991, protection of employment is no more guaranteed. In the post liberalisation period, India has witnessed a series of layoffs and voluntary retirement schemes being implemented both in public sector and private sector units. Labour unions have become redundant and the most severe blow to the trade union movement came when the Supreme Court declared in 2003 that government employees cannot strike work.

Changes on the labour front notwithstanding, when acquiring a company, an MNC is required to adhere to its existing employment arrangements. In other words, when acquiring a manufacturing unit, one may be acquiring the collective bargaining agreement that the seller had negotiated with the trade union prior to the purchase of the company.

Working Conditions In many countries, conditions under which workers work are unsafe and unhealthy. Child labour is also grossly abused.

One of the most common and dangerous of unsafe practices is the blocking and locking of all exits in manufacturing facilities as a low-cost measure to prevent pilfering. This practice has caused thousands of workers to be trapped and burnt alive when fires broke out in such buildings. For example, a fire in a locked toy factory near Bangkok killed more than 240 workers and injured hundreds of others. In a separate incident, a fire in a locked facility killed 80 young women in Dongguan, China. In Ahmedabad, 127 workers were killed when an earthquake struck Gujarat in January 2003. These victims were locked from outside in a diamond cutting unit, and when the disaster occurred, the workers stampeded against bolted doors. The lack of ventilation in many factories increased the incidence of tuberculosis and sinusitis among workers.

A second, common safety issue is the use of antiquated and poorly maintained equipment. Such equipment causes the rate of workplace injuries to balloon. In fact, in many developing nations, work-related injuries have doubled in the last five years.

Harsh work rules are a third major concern. In order to maximise output per worker and thereby reduce the cost per unit, some manufacturers permit assembly line workers to use the restroom only three times in a twelve-hour day. This practice not only subjects workers to great physical discomfort, it also increases the incidence of urinary tract infections.

Child Labour Child labour is a widespread problem in developing countries. When children under age 14 work, their labour time at minimum disrupts their schooling and in a majority of cases, prevents them from attending school altogether. Compounding this, the health of child workers is significantly worse, even accounting for their poverty status, than that of children who do not work; and physical stunting among child labourers is very common. In addition, a large fraction of labouring children are subject to especially cruel and exploitative working conditions.

The International Labour Office (ILO), a U.N. body that has played a lead role on the child labour issues, recently estimated that some 120 million children in developing countries between the ages of 5 and 14 are working full time, with another 130 million working half-time. Some 61% of the 250 million working children, or nearly 153 million, live in Asia, while 32%, or 80 million, live in Africa, and 7%, or over 17 million, live in Latin America. Although Asia has the largest number of child labourers, in relative terms, Africa has the highest child labour rate, estimated at about 41% of all children 5 to 14 years old. The rates for Asia and Latin America are 21% and 17%, respectively. These numbers do not even include the many children who work full-time at home for their parents or guardians. Moreover, children work long hours, and their working conditions are often horrendous; the ILO reports that some of its surveys show that more than half of working children toil for 9 or more hours per day. For example, the Human Rights Commission of Pakistan estimated that in 1994, there were 11 to 12 million children, half of whom were under the age of 10, effectively working as indentured servants. They earned less than half than adult wage and often worked in excess of 80 hours per week, mainly in carpet-and brick-making factories. Thus child labour is not an isolated problem, but a pervasive one, especially in Africa and South Asia.

International trade treaties threaten such labour practices. Most developed nations have attempted to make non-enforcement of employment laws a violation of international trade agreements.

The ILO has also issued standards which the member countries are expected to follow.

A private initiative is also making significant progress in this direction. Some US firms—of which Levi Strauss & Co. is particularly prominent—have instituted global "sourcing guidelines" to determine with whom they will do business. Levi Strauss requires a certification from suppliers that they are in compliance with these guidelines. If Levi Strauss has reason to believe that a supplier or its subcontractors have violated any of these guidelines, it will investigate the matter. If it finds a violation, it will terminate its contract with the supplier. As a result of this programme, Levi Strauss stopped manufacturing jeans in China in 1993. Finally, by April 1998 China had made sufficient concessions to human rights to permit Levi Strauss to return. Such an approach, if adopted by more firms, would go a long way in eradicating questionable working conditions (Also refer to Chapter 1).

Discrimination Discrimination at workplaces still exists even though global firms are increasingly becoming cosmopolitan. Discrimination is made on origin, religion, and gender. In a few countries, the law actually requires discrimination based on religion or nationality. When a country is synonymous with an ethnic group, that ethnic group sometimes justifies preservation of its ethnic identity by methodical exclusion of those outside it. For example, ethnic Kuwaitis and Jordanians have excluded Palestinian co-religionists from key jobs and properties.

Likewise, when a nation does not distinguish between religion and the state, the law often calls for discrimination against infidels. In the twenty-first century, these laws are somewhat less widespread. Pro-discrimination laws are most frequently found in Middle Eastern Islamic countries such as Pakistan, Iran, and Saudi Arabia. One may also encounter such pro-discrimination statutes in countries where atheism is the state religion, such as Cuba and North Korea.

Gender discrimination is widespread. Worldwide, working women consistently earn less than men. In Japan, women earn only 63 per cent of what men do. In the United States, the figure is 74 per cent. Northern European nations are somewhat better—such as Sweden and Denmark, at 87 and 88 per cent, respectively. But others are measurably worse; Chile's booming economy has done little to improve the ratio of fifty-four cents for women to every dollar men earn. And education is clearly not the only barrier: studies have shown that in Latin America, on the average, a woman needs fifteen years of education to earn the same amount as a man does with eleven years of education.

In some Islamic nations, restrictions are imposed on women's role in workplaces. In many countries, however, anti-discrimination laws and provisions are in place. For example, Articles 7, 48, 52, and 59 of the EU Treaty forbid different types of discrimination within the Union on the basis of nationality.

Lawmakers have particularly focused on the issue of maternity leave. An EU directive now provides for a minimum of fourteen weeks maternity leave and an allowance of at least 75 or 80 per cent of net salary. It further stipulates that pregnant workers cannot be fired. In Hong Kong, a new law provides for ten weeks maternity leave at two-thirds of the woman's latest salary. India requires six weeks leave at full pay.

There has also been progress in the area of equal pay for equal work. Article 119 of the EU Treaty requires equal pay for equal work and equality in access to employment.

The Equal Remuneration Act in India underlines equal pay for equal work and prohibits any discrimination in payment of wages. Gender discrimination cases have even found success in Japan, a former bastion of male domination. In July 1990, a Tokyo district court ruled for the first time that female employees had been improperly denied promotions due to gender discrimination. Although the court awarded eighteen women $640,000 consistent with Japan's respect for the integrity of the workplace, the court declined to direct promotions because such action would interfere with personnel decisions. Movement on gender discrimination issues seems consistent throughout the world (Also refer to Chapter 1).

Environmental Laws International environmental law has lately become a topic of considerable interest. There have been large-scale international environmental disasters such as the Chernobyl nuclear plant disaster, the Samdoz Chemical spill into the Rhine river, and various oil tanker spills. At the same time, concern over the possible thinning of the ozone layer and global warming has intensified. Political parties, with environmental protection as the main plank, have been formed around the world and in countries like Germany they have become part of governing coalitions. Consequently, nations have been enacting legislations and entering treaties concerning the environment. Before listing these acts and treaties, it is useful to understand certain ethical issues concerning the environment.

Environmental Issues In the first place, it is the rich countries that talk about environment and enact laws to protect the ecology. Poor nations tend to oppose extensive environmental regulation because it impairs their ability to profit from less-sophisticated production procedures. Poor countries are more concerned about growth than about environmental protection.

Second, wealthy countries enact environmental laws to protect themselves from foreign competition. The EU has been accused of this in order to protect its meat and dairy products industry, which has been battered by foreign competition. In 1993, the EU traced an outbreak of disease in Italian livestock exported to Croatia. Rather than banning Italian hoof and mouth Croatian meat, the Union banned meat from the entire former East Bloc. Needless to say, the arbitrariness of banning meat from half a continent on the basis of an outbreak in a region of a small nation, especially while not banning meat from only the country where the disease had occurred, struck many producers as unfair.

The EU is no exception. India also has imposed similar ban on import of poultry items. In order to check the spread of bird influenza from across the borders, India first imposed ban on import of wild birds, hatching eggs, bird semen, fresh meat and processed poultry from Pakistan, Thailand, South Korea, Cambodia, Vietnam and Japan. Later on Jan 28, 2004, the country extended the ban on imports from all countries.

Third, rich countries seem to have a vested interest in enacting environmental laws and imposing them on other nations. It is the wealthy nations which manufacture machinery and equipment to check pollution of the environment. These countries are well aware of the fact that environmental industry is big business as Table 5.11 shows. These countries find a ready market for these items in developing countries, which cannot produce the equipment economically and are therefore forced to buy from rich countries.

Table 5.11 Growth of Environmental Markets in Selected Asia–Pacific Countries ($ billion)

	Japan	*Australia*	*Hong Kong*	*Indonesia*	*Malaysia*	*China*	*India*
1996	91.50	6.20	1.50	0.90	0.70	3.90	1.90
1998	91.80	6.74	1.47	0.82	0.66	4.70	2.15
2000	93.70	7.10	1.67	0.89	0.80	5.70	2.44
2002	92.40	7.42	1.77	0.98	0.84	7.15	2.85

(*Source: Environmental Business International Inc.*)

Protective Measures Historically, countries were seeking arbitration to resolve any dispute relating to pollution of the environment. In other words, the polluting country and the country which suffers the consequence of pollution would agree to arbitrate. Arbitration can proceed only when both the countries agree. This rarely happens because a nation usually does not voluntarily subject itself to a proceeding on pollution generated from its own territory.

The second way of fighting pollution by any nation is to enact legislation outlawing import of the offending products. Often, the offence lies not in the product but in its manufacturing process. Regulating such offences becomes difficult.

In the light of the perceived shortcomings of the traditional methods for addressing environmental issues, the world has been developing regional and global solutions.

Regional Approaches These are: (i) banning export of hazardous materials, as is done in the US through its Federal Insecticide, Fungicide, and Rodenticide Act; (ii) North American Environmental Treaties and NAFTA, (iii) the Single European Act 1985 for the EU; (iv) Regional marine treaties among nations sharing bodies of water; and (v) the ASEAN Agreement on the Conservation of Nature and Natural Resources for Asian countries.

Global Solutions Many environmental pollution problems are global in nature. The United Nations began its work in this arena in December 1972 when it adopted the Stockholm Declaration on the Human Environment and founded the United Nations Environmental Programme (UNEP). UNEP has become the catalyst for the formulation and adoption of almost 30 binding multilateral instruments and ten sets of non-binding environmental guidelines and principles.

Some of the global measures are: (i) the WTO; (ii) global ban on toxic substances such as PCBs, DDT, dioxins, and furans; (iii) the Basel Convention on Transboundary Movements of Hazardous Wastes and their Disposal; (iv) the Convention on International Trade in Endangered Species; (v) the Montreal Protocol; and (vi) the Climate Control Convention.

Approaches and solutions notwithstanding, countries like Italy continue to make way while sun shines, as Exhibit 5.7 indicates.

Exhibit 5.7

ITALY AND THE ECO-MAFIA

Italian magistrates confirm that criminal groups won bids to haul off toxic waste from factories in the north but never treated the waste, as promised. Instead, they dumped their poisonous cargo on some 10,000 hectares of farmland in Umbria, one of Italy's most beautiful and productive regions. The Environment Ministry estimates the cleanup cost at $1.5 billion.

Italian officials have known for more than a decade that mob-linked businesses were charging manufacturers cut-rate prices to haul away mercury, lead, battery acid, and other byproducts of industry. They would dump the refuse—untreated—in the countryside. But weak environmental laws and powerful industrial lobbies have thwarted change. Now, the business totals an estimated $7 billion in annual sales and involves 22 different criminal groups, according to a parliamentary commission and law enforcement officials. With minimal operating costs—a rented truck, a shell company, and a driver—traffickers gross from $2,000 to $10,000 a truckload, depending on the toxicity of the refuse.

In the past year, Italy has struck its first serious blow against traffickers. Legislation passed in 2001 finally makes trafficking in waste felony (it was a simple misdemeanor before) and permits wiretapping of suspected criminals. Armed with the new law, prosecutors arrested more than 29 individuals last year and charged them with waste-related crimes. Investigations currently under way could produce dozens more arrests.

Law-enforcement officials battling traffickers testify to the daunting dimensions of the problem. In October, the forestry police released the results of an aerial survey identifying 705 highly toxic illegal dump sites across almost 7 million square meters of territory, from the verdant farmlands north of Naples to the rolling hills of Umbria to the Adriatic coast near Bari. The number of illegal dumps, including all types of waste, tops 4,000.

Medical experts, meanwhile are trying to figure out just how deadly the sites are. There is no doubt about the connection between illegal toxic dump sited run by the eco-Mafia and the increase in fatal illnesses in the Caserta region. It was learnt that there was a sharp increase in leukemia, colon cancer, and stomach tumors in patients living in the area between Naples and Caserta. Physicians and investigators worry that illegal dumps containing toxins such as heavy metals are polluting groundwater and farmland.

The estimated cost of cleaning up all of these sites range into the hundreds of billions of dollars. Roughly 11 million tonnes of industrial waste in Italy disappear every year, according to Italy's Waste Industry Employer's Association (FISE). That's the amount produced by factories but whose disposal is not accounted for by legitimate waste handlers. Some 300,000 tons of this missing refuse are highly toxic.

Every country in Europe can point to cases of illegal dumping, but Italy stands out. Criminal groups control up to 30 percent of the country's waste-management business, according to Italy's highly respected Antimafia Commission.

All of the country's notorious names have a hand in the trade: the Sicilian Mafia: the Camorra from Naples; the 'Ndrangheta' which dominates in Calabria; and the Sacra Corona in Apulia; says Pier Luigi Vigna, head of the Antimafia Commission. Prosecutors say the same mob-linked companies that dump also bid for contracts to up the sites. Companies use cover-up names to appear clean but are linked to organised crime. Then, they get the state contracts for cleanup.

Industry is part of problem. The price for environmentally responsible disposal of the most dangerous industrial waste averages $1 a kilo, while traffickers may bid as low as 10 cents per kilo. The temptation to accept such a low bid is huge.

To confuse authorities, criminal gangs pass their cargo off several times or store waste materials temporarily in centers designed for treatment. Middlemen falsify documents and send the cargo on to another way station as 'non-hazardous' waste.

Meanwhile, cleanup costs keep mounting. In the tiny Umbria hamlet of Montone, the town's mayor, Franco Carpecci, spent $200,000, or 25 percent of his town's annual budget, to haul away waste from one farm after its owner received 80 truckloads of 'mulch' from a waste disposal company. When the cash-strapped farmer refused to pay for the removal of the stinking material, the town become legally responsible to protect residents from health hazards. Carpecci, who has filed a civil lawsuit against the farmer to recuperate cleanup funds, called the environmental crime "a nightmare that still keeps me awake at night." Some farmers, may face prosecution for accepting the fertiliser, thus aiding and abetting the scheme.

Police and magistrates say tougher laws and penalties are vital to prevent future disasters like that in Umbria from happening again. Environment Minister Altero Matteoli counters that current laws have plenty of it. He wants all waste to be treated locally. That would block the number of incinerators, which would reduce the total volume of waste headed for dumpsites. Italy's beleaguered frontline combatants—magistrates, carabinieri, and the forest police—toil on, even as the odds remain stacked against them, and environmental activities warn of dire consequences. "A country that can't manage to outlaw toxic dumping has no future—not for itself and not for investors, " says Enrico Fontana, national secretary at Rome-based Legambiente, an environmental group. In Italy, that message is only slowly starting to sink in.

(*Source*: "*Business Week*", reproduced in *The Economic Times*, January 26, 2004)

Summary

- Business environment of a country comprises the forces wielded by political, economic, technological and cultural factors (LO1)
- Political environment refers to the system of government prevailing in a country. The type of government is shaped by the political system which in itself is of two types: democracy and totalitarianism (LO2)
- An international business faces two types of political risks while doing business in overseas markets. The risks are macro and micro. MNCs have ways of assessing and managing the risks (LO3)
- Across the globe four systems of law are in practice: Islamic law, Common law, Civil law and Marxist law. Each system has its own implication which the international manager needs to be aware of. (LO4)
- International disputes can be resolved either through conciliation, arbitration or litigation or through all the three. (LO5)
- MNCs are subject to several legal concerns while doing business in host countries (LO6)

Review Questions

1. What is international business environment? (LO1)
2. What is political risk assessment? How do MNCs manage political risks? (LO3)

3. What is legal environment? Describe the different legal systems. (LO4)
4. How are international trade disputes resolved?(LO5)
5. What are the areas of concern for an MNC with regard to its legal environment?(LO6)

Discussion Questions

1. What is business environment? How does its study help an international manager? (LO1)
2. Which principles of international law are more important for international business? Why? (LO6)
3. Which method of dispute settlement is preferable for international business? Why? (LO5)

Reinforcing Exercises

- Westerners believe that democracy alone will foster economic growth. China, however, disapproves this notion. China remains a communist country, a closed society but people have open mind. China has embarked on economic reforms and is more capitalist than any other so called free economies. Thus China has proved that economy can progress even under communist rule.
  Come to India. India is behind China at least by 20 years in economic growth. And India has been a democratic country ever since it won Independence. Obviously, demoocracy cannot guarantee prosperity. Just as communism shall not prevent a determined country from achieving prosperity. Give your comments.
- A change in government can result in new laws that might change fortunes of a nation. In Venezuela, for example, the socialist Hugo Chavez came to power in 1998, re-elected in 2000 and again in 2006. He was a close follower of Fidel Castro of Cuba. Chavez pledged to improve the lot of the poor in his country through government intervention in private business and has frequently railed against US imperialism, all of which is a concern for Western businesses doing business in Venezuela. Among other actions, Chavez increased the royalties foreign oil companies operating in Venezuela have to pay to the government from 1 to 30 percent on sales. Can you narrate any such move by India?
- India has the distinction of being the highest labour legislated country in the world. There are more than 100 central legislations and countless state-level acts. Surprisingly, many of them are moribund and many others look totally irrelevant now. Take the provisions of the Factories Act 1948, for example. Provisions of the act might have been required decades back but look childish as of now. Section 29 of the Act says: (i) in every factory there should be provided a sufficient number of spittoons, (ii) the state government may make rules prescribing the type and the number of spittoons to be provided, and (iii) no person shall spit outside of the spittoons". How absurd these provisions look like! Today's business persons are good enough to appreciate the sheer beauty of today's buildings, their architecture, their greenery, their lightings, their colours, and their murals.
  Poor inspectors need to visit factory premises under their respective jurisdictions, inspect and report compliance or non-compliance of the Factories Act. A year back an inspector visited the Bangalore office of Mistibushi Electric. After detailed examination, he prepared report and submitted to the HR manager. Inspector's observations (some of them only) ran as follows:
  –Registration of Mistibushi is not shown

–Pay day is not notified

–Employees are found to work beyond working hours and also working on holidays

An inspector visited Infosys premises in Bangalore, a year back. His observation makes one laugh. Infosys was required to display a black board, hand written with chalk, at the entrance showing certain details. Failing which a fine of ₹100 will be imposed!

What message India can send to outsiders who are keen on investing here?

- It was in 1995. The spiritual leader in Iran ruled that foreign soft drinks such as Coca-Cola and Pepsi were forbidden in his country because they somehow advocate zionism. What can MNC do to counter such risks?

CLOSING CASE

Wasted Years

Here is a country which had everything going in its favour and had the potential to be bracketed with biggies of today – US, China, UK, France and Germany. Sadly, it has been a decline all the way mainly because of absence of a government. A country which recently defaulted in its payment on bonds, the second foreign default in 13 years. We are referring to Argentina.

In 1914, Argentina stood out as the country of the future. Its economy had grown faster than America's over the previous four decades. Its GDP per head was higher than Germany's, France's or Italy's. It boasted of fertile agricultural land, a sunny climate, a new democracy (universal male suffrage was introduced in 1912) and an educated population. The country was a magnet for European immigrants who flocked to find work on the fertile pampas, where crops and cattle were propelling Argentina's expansion. In 1914 half of Buenos Aires population was foreign-borne.

It never got better than this. Although Argentina has had periods of robust growth in the past century – not least during the commodity boom of the past ten years – and its people remain wealthier than most Latin Americans, its standing as one of the world's most vibrant economies is a distant memory. Its income per head is now 43% of those same 16 rich economies; it trails Chile and Uruguay in its own backyard.

The political symptoms of decline are also clear. If Argentina appeared to enjoy stability in the pre-war era, its history since then has been marked by a succession of military coups. The first came in 1930; others followed in 1943, 1955, 1962, 1966 and1976. The election of 1989 marked the first time in more than 60 years that a civilian president had handed power to an elected successor.

It is now more than 30 years since the end of military dictatorship, but democracy has not yet led to stability. Argentines reach for the metaphor of the "pendulum" to describe the swings of the past three decades: from loose economic policies in the 1980s to Washington-consensus liberalisation in the 1990s and back again under the presidency of Nestor Kirchner and now his widow, Cristina Fernandez de Kirchner. But the image of a pendulum does not do justice to the whiplashing of the economy – the repeated recessions of the 1970s and 1980s, the hyperinflation of 1989-90, the economic crisis of 2001, today's mix of rising prices, wage pressures and the mistrust of the peso have nasty echoes of the past.

Internationally, too, Argentina has lost its way. It has shut itself out of global capital markets, although negotiations are under way to restructure its debts with the Paris Club of international creditors. The country's dramatic decline has long puzzled economists. Simon Kuznets, a Nobel laureate, is supposed to have remarked; "There are four kinds of countries in the world: developed countries, undeveloped countries, Japan and Argentina.

Argentina did not build the institutions needed to protect its young democracy from its army, so the country became prone to coups. Unlike

Australia, another commodity-rich country, Argentina did not develop strong political parties determined to build and share wealth: its politics was captured by the Perons and focused on personalities and influence. Its Supreme Court has been repeatedly tampered with. Political interference has destroyed the credibility of its statistical office. Graft is endemic: the country ranks a shoddy 106th in Transparency International's corruption index. Building institutions is a dull, slow business. Argentine leaders prefer the quick fix – of charismatic leaders, miracle tariffs and currency pegs, rather than, say, a thorough reform of the country's schools.

Questions

1. Can Argentina be put-back on the track? If yes, how?
2. Can you recollect another country of the same fate as that of Argentina?

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Suggested Readings

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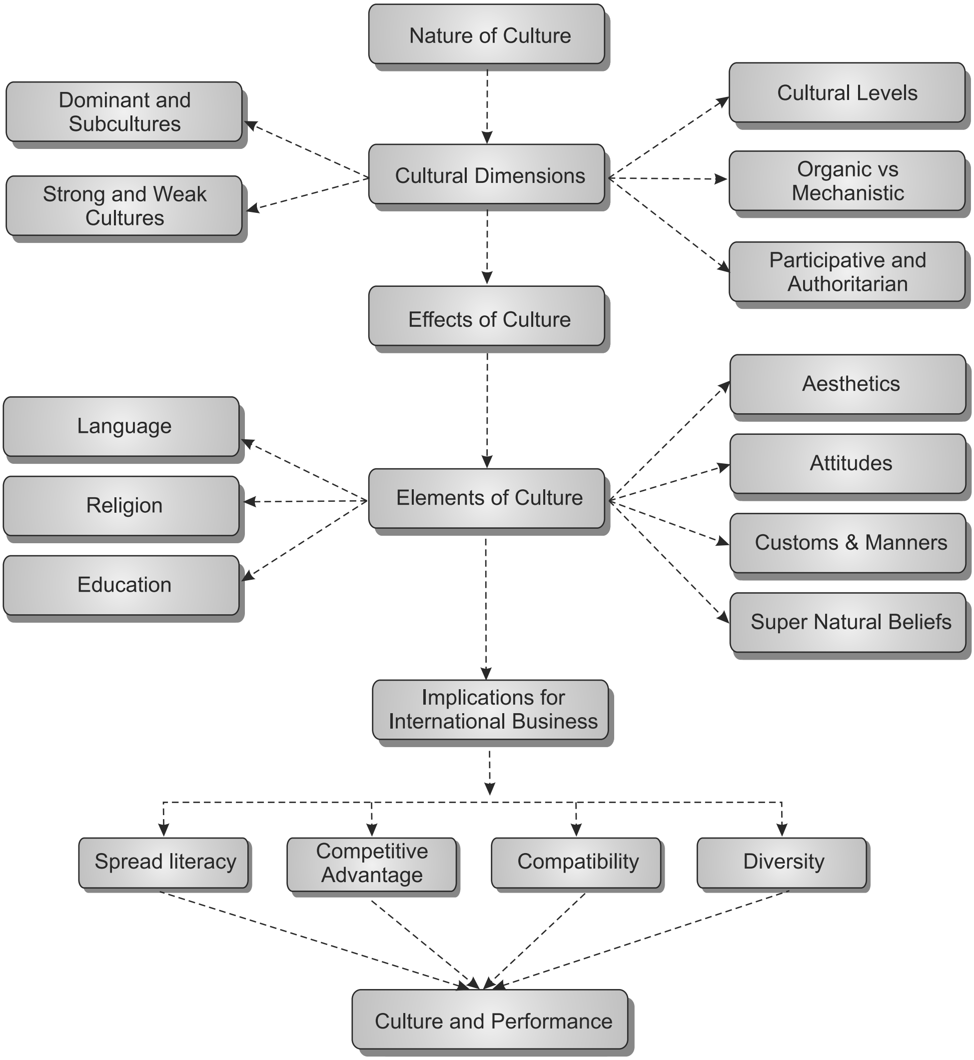
CHAPTER


Nature of Culture
Cultural Dimensions
Dominant and Subcultures
Strong and Weak Cultures
Cultural Levels
Organic vs Mechanistic
Participative and Authoritarian
Effects of Culture
Elements of Culture
Language
Religion
Education
Aesthetics
Attitudes
Customs & Manners
Super Natural Beliefs
Implications for International Business
Spread literacy
Competitive Advantage
Compatibility
Diversity
Culture and Performance

6

Cultural Environment

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Identify the nature of culture
- **LO 2:** Describe and discuss different cultural dimensions
- **LO 3**: Outline the effects of culture
- **LO 4:** Categorise the different elements of culture
- **LO 5:** Analyse the implications of culture for international business
- **LO 6:** Assess culture and performance

Opening Case

P&G—The Epitome of Culture

Procter & Gamble Co. (P&G) is a Fortune 500, American Multinational Corporation headquartered in Cincinnati, Ohio, that manufactures a wide range of consumer goods. As of 2008, P&G is the 8th largest corporation in the world by market capitalisation and 14th largest US company by profit. It is 10th in Fortune's Most Admired Companies list (as of 2007). P&G is credited with many business innovations including brand management, the soap opera and the Connect + Develop initiative.

History

William Procter, a candle maker and James Gamble, a soap maker immigranted from England and Ireland, respectively. They had settled earlier in Cincinnati, who met as they both married sisters, Olivia and Elizabeth Norris. Alexander Norris, their father-in-law, called a meeting in which he persuaded his new sons-in-law to become business partners. On October 31, 1837, as a result of the suggestion, Procter & Gamble was born.

The corporate culture of P&G provides a good example. It reflects what management theorist Daniel Denison calls the firm's legendary emphasis on 'thoroughness, market-testing and ethical behaviour; values that are transmitted to new employees through the firm's recruitment, socialisation and internal promotion processes'.

To foster its values, P&G also reportedly combines 'internal competition' and 'promotion from within' in a way that results in a sort of a tournament that determines the leaders of the firm.

Procter & Gamble has a strong corporate culture in that its underlying values exert a powerful influence on all P&G employees. Basic elements of its culture can be traced back to the firm's founders – William Procter and James Gamble. The founders' intention was to 'foster growth in an orderly manner, to reflect the standards set by the founders and to plan and prepare for the future'.

In addition to an emphasis on thoroughness, market testing and ethical behaviour, several other underlying values constitute the P&G culture. One is a system in which, according to one expert, 'individual identity is always minimised and sometimes lost'. A new recruit soon learns to say 'we' instead of 'I'. One P&G manager was quoted as saying, "Everyone at P&G is like a hand in a bucket of water—when the hand is removed, the water closes in and there is no trace".

The founder's emphasis on orderly growth also manifests itself in 'tremendous conformity'. As one manager described it, 'conform and you succeed; question and you are gone'. In turn, this conformity results in precisely the thoroughness and methodical approach desired by the company's founders. Its result, according to one past chairman, is a 'consistency of principles and policy that gives us direction, thoroughness, and self-discipline'.

An emphasis on research is also part and parcel of P&G's culture. Research is an integral part of P&G's thoroughness, as well as product of its aim of 'removing personal judgement from the equation' by testing and continually retesting all of its products. P&G's aim is to produce products that consistently win the consumers' blind tests.

The emphasis on written rather than oral communication is another manifestation of the firm's stress on the value of thoroughness. All significant events are preserved in writing and all records can be re-created at any point. Managers are taught to condense their comments to fit a one-page format. New P&G recruits reportedly 'tell horror stories' about their first memos being ripped to shreds by the boss.

P&G is a company that seeks truth. This is a deep-rooted belief that was inculcated by its purist and religious founders. When the company launched Ivory Soap in 1881, its slogan said that the soap was 99.44% pure. Not 100%, not 99% but 99.44%, and scientifically proven to be purer than other castile soaps. With that fact in hand, P&G, also keen on making a good profit, advertised it intensively and soon became the undisputed market leader. Anyone who has worked at P&G has toiled with frustration over the infamous one-page memo. It is the single page that will summarise any major business decision. It is used to recommend an action, whether it is a huge investment or a simple ad message. Every word is evaluated until it is perfect – and the truth is found. It can take weeks and several interactions between the writer and managers above to get it approved. Over the years, the P&G culture became deeply entrenched and exhibited in cult-like traits. Either an employee enjoys the culture and stays for long or he or she leaves early as there is no cultural dissent.

Secrecy is a final element of P&G's culture. As far back as the late 1800s, the firm had tried to stop giving detailed financial repots to its stockholders. As recently as the late 1980's, reports confirm that financial information was still very closely held and that P&G 'maintains a mistrust of outsiders who are overly curious about P&G'. New employees are instructed not to talk about the company to outsiders.

As is usually the case, Procter & Gamble's culture reflects and is sustained by concrete management practices. Graduates are recruited and placed in highly competitive situations and those who cannot learn the system are quickly weeded out, with the remainder enjoying the benefits of promotion form within. As a result, no one reaches middle management without five to ten years of very close scrutiny and training. This in turn creates what one researcher called 'a homogeneous leadership group with an enormous amount of common experience and strong set of shared assumptions'.

New recruits may assume major responsibility for projects almost immediately, but the authority for most big decisions is made far up the chain of command, usually by committees of managers. Nearly everything must be approved through the memo process. Stories abound that reinforce this system; one regards the decision on the colour of the Folger's coffee lid, supposedly made by the CEO after four years of extensive market testing. The internal competitive system is fostered by the brands management system at P&G. Brands compete for internal resources, have their own advertising and marketing and act as independent cost centers. The extensive use of memos, continual rechecking of each other's work and the rigid time line for promotions also contribute to (and reflect) P&G's strong corporate culture.

Behind the strong culture of P&G are its core values which are as follow:

Leadership

- We are all leaders in our area of responsibility, with a deep commitment to deliver leadership results.
- We have a clear vision of where we are going.
- We focus our resources to achieve leadership objectives and strategies.
- We develop the capability to deliver our strategies and eliminate organisational barriers.

Ownership

- We accept personal accountability to meet our business needs, improve our systems and help others improve their effectiveness.
- We all act like owners, treating the Company's assets as our own and behave with the company's long-term success in mind.

Integrity

- We always try to do the right thing.
- We are honest and straightforward with each other.
- We operate within the letter and spirit of the law.
- We uphold the values and principles of P&G in every action and decision.
- We are data-based and intellectually honest in advocating proposals, including recognising risks.

Passion for winning

- We are determined to be the best at doing what matters most.
- We have a healthy dissatisfaction with the status quo.
- We have a compelling desire to improve and to win in the marketplace.

Trust

- We respect our P&G colleagues, customers and consumers and treat them as we want to be treated.
- We have confidence in each other's capabilities and intentions.
- We believe that people work best when there is a foundation of trust.

Principles

We show Respect for All Individuals

- We believe that all individuals can and want to contribute to their fullest potential.
- We value differences.
- We inspire and enable people to achieve high expectations, standards and challenging goals.
- We are honest with people about their performance.

The Interests of the Company and the Individual Are Inseparable

- We believe that doing what is right for the business with integrity will lead to mutual success for both the company and the individual. Our quest for mutual success ties us together.
- We encourage stock ownership and ownership behaviour.

We are Strategically Focused in Our Work

- We operate against clearly articulated and aligned objectives and strategies.
- We only do work and only ask for work that adds value to the business.
- We simplify, standardise and streamline our current work whenever possible.
- We Value Personal Mastery
- We believe it is the responsibility of all individuals to continually develop themselves and others.
- We encourage and expect outstanding

technical mastery and executional excellence.

We Seek to Be the Best
- We strive to be the best in all areas of strategic importance to the Company.
- We benchmark our performance rigorously versus the very best internally and externally.
- We learn from both our successes and our failures.

Innovation Is the Cornerstone of Our Success
- We place great value on big, new consumer innovations.
- We challenge convention and reinvent the way we do business to better win in the marketplace.

Mutual Interdependency Is a Way of Life
- We work together with confidence and trust across business units, functions, categories and geographies.
- We take pride in results from reapplying others' ideas.
- We build superior relationships with all the parties who contribute to fulfilling our corporate purpose, including our customers, suppliers, universities and governments.

We Are Externally Focused
- We develop superior understanding of consumers and their needs. We create and deliver products, packaging and concepts that build winning brand equities.
- We develop close, mutually productive relationships with our customers and suppliers.
- We are good corporate citizens.

CULTURE is not just an abstract concept. It is a great asset any organisation can possess, as the opening case tells. Culture means several things to an international manager. Every action he or she initiates needs to be in tune with the culture of the land. This and the next three chapters are devoted to a detailed explanation about culture and its impact on international business.

NATURE OF CULTURE

LO 1
Identify the nature of culture

In its narrow sense, culture is understood to refer to such activities as dance, drama, music, and festivals. In its true sense, culture is understood as that complex whole which includes knowledge, belief, art, morals, law, customs, and other capabilities and habits acquired by an individual as a member of a society. Specifically, culture consists of thought and behavioural patterns that members of a society learn through language and other forms of symbolic interaction—their customs, habits, beliefs and values, the common viewpoints that bind them together as a social entity. Cultures change gradually, picking up new ideas and dropping old ones, but many of the cultures of the past have been so persistent and self-contained that the impact of any sudden change tears them apart, uprooting their people psychologically.

Most scholars of culture would agree on its following characteristics:
- *Learned*—Culture is not inherited or biologically based, it is acquired by learning and experience.
- *Shared*—People as members of a group, organisation, or society share culture; it is not specific to specific individuals.
- *Transgenerational*—Culture is transgenerational, passed from one generation to the next.
- *Symbolic*—Culture is based on the human capacity to symbolise or use one thing to represent another.
- *Patterned* —Culture has structure and is integrated; a change in one part will bring changes in another.

- *Adaptive* —Culture is based on the human capacity to change or adapt, as opposed to the more genetically driven adaptive process of animals.
- *Purpose*—Culture has a purpose in terms of achieving common objective. Perceived success will reinforce the culture and can make it stronger.
- *Pervasive*—Every individual, irrespective of religion, region, race or ethnicity has a culture. The person is largely influenced by the culture to which he or she is a part.

Essentially, culture is understood as human means of adapting to circumstances and transmitting this coping skill and knowledge to subsequent generations. Culture gives people a sense of who they are, of belonging, of how they should behave, and of what they should be doing. Culture impacts behaviour, morale and productivity at work, and includes patterns that influence company attitudes and actors.

CULTURAL DIMENSIONS

LO 2
Describe and discuss different cultural dimensions

Several cultural dimensions have been identified. For example, there are levels of culture, organic and mechanistic cultures, participative and authoritarian cultures, dominant and sub-cultures and strong and weak cultures.

Levels of culture Levels of culture include national culture, business culture, occupational culture and organisational culture[3] (see Fig. 6.1).

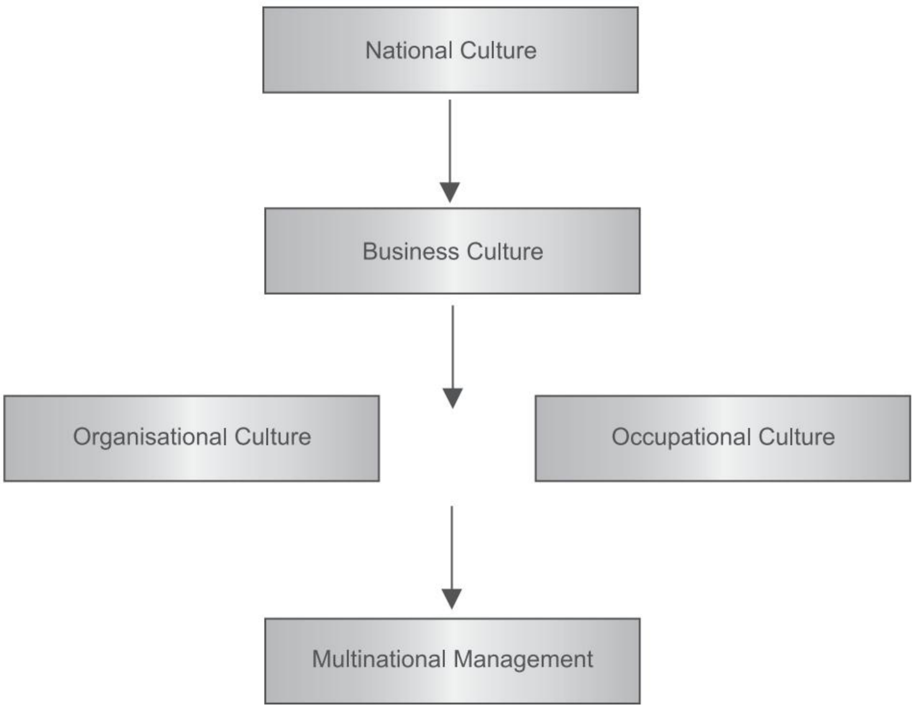


Fig. 6.1 Levels of Culture in Multinational Management

(*Source*: John B. Cullen, *Multinational Management,* p. 50)

National Culture National culture is the dominant culture within the political boundaries of a country. Formal education is usually taught and business is generally conducted in the language of the dominant culture.

Political boundaries, however, do not necessarily reflect cultural boundaries. Many countries such as India, Canada and Singapore have more than one major cultural group within their political boundaries. Moreover, even states with relatively homogeneous cultures have various sub-cultures representing regional and rural/urban cultural differences that affect business activities.

Most international businesses take place within the constraints of political boundaries of the nation-state. As such, the dominant culture of the nation-state probably has the greatest impact on international business. In particular, it usually influences not only the language of business transactions but also the nature and types of law that govern business.

Business Culture For an international manager, business culture—the way Indians, Germans, Japanese, Koreans, and others do business—is more important. More than just cultural differences in business etiquette, business culture represents norms, values, and beliefs that pertain to all aspects of doing business in a particular environment. Business cultures tell people the correct, acceptable ways to conduct business in a society.

Business culture also provides the guides for everyday business interactions. What to wear to a meeting, when and how to use business cards, whether to shake hands or embrace—are all examples of business etiquette taught by business culture. (See Exhibit 6.1 for interesting anecdotes.)

Exhibit 6.1

ETIQUETTE AND PROTOCOL

America is a country colonised by western Europeans who brought slaves from Africa with them; they were joined by immigrants from southern and eastern Europe, South and East Asia, and Latin America. The current demographics of the US are roughly as follows: White (of European or Latin origin, 83.4 per cent), of African or Caribbean origin (12.4 per cent), Asian (3.3 per cent), native American (including Alaskan and Hawaiian, 0.8 per cent). Ethnic background can be a touchy subject in the US, as there have been race-related problems and clashes throughout most of the country's history. Comments and questions about someone's heritage are best left out until well after a good working relationship has evolved.

The religions represented in the US also mark its diversity. Protestant (all denominations, 56 per cent), Roman Catholic (28 per cent), Jewish (2 per cent), and none (atheist, agnostic, non-practising, 10 per cent). Despite the high number of people who follow a major religion, most Americans treat religion as a private and personal matter and will not discuss religion with you until they have gotten to know you better.

The most important fact to understand is the concept of time in American culture. Time is considered a valued commodity, as illustrated by the common phrase "Time is money". One should always be punctual for meetings. Business people in the Northeast and Midwest are very punctual and consider it a sign of disrespect or lack of serious intent when others are late for meetings or appointments; Southern and Western business people are less sensitive about time, but being on time will always make a good impression. Americans tend to spend less time building relationships, at least until a contract has been signed and business is already underway; the emphasis is on closing the first deal or signing the first contract.

Americans also have a different perception of distance than many other cultures. The US is the fourth largest country in the world; its 48 contiguous states spanning 6,400 km from east to west and 4,000 km from north to south, not including Alaska and Hawaii, are sprawled across six times zones. It is not uncommon for a business person to spend two hours and more commuting to work every day, or to fly for just as long to meet a client or visit relatives in another part of the country. On the other hand, the proliferation of telephones, parcel delivery companies, bicycle messengers, electronic mail, and fax machines serve to cut down the time factor in long-distance business. Consider this observation: "In the United States, 100 years is a long time; in other countries 100 miles is a long distance".

Like cuisine, business practices in the United States tend to have regional "flavours". In the Northeast and Mid-Atlantic, you will find a more hectic pace and more conservative lifestyle than in many other parts of the country, while Californians are well known for their more relaxed attitudes in time, dress, and general business practices. In the South, you will be exposed to people with a strong religious heritage, which is combined with a strong tradition of hospitality and a pace more like that of California. The Midwest is known for its religious elements as well, and is also conservative (as is the South) in many political matters; the similarities between the South and the Midwest are all the more interesting because the people in either region share neither religious membership (Lutheran in the Midwest, Baptist in the South), ethnic heritage (Nordic in the Midwest, Anglo-Saxon in the South), industrial bases (heavy industry and agri-business in the Midwest and a tradition of family owned plantation and smaller manufacturing in the South), nor even political party membership (generally Republican vs Democrat) in most cases. The Southwest combines California's relaxed atmosphere with a simplified, less "glitzy" lifestyle seen only in small towns in New England and the South and Midwest. Hawaii is heavily influenced by its location in the Pacific Ocean and Alaska is coloured by the geographic isolation of its population from the rest of the country, producing a deep streak of independence.

In some cultures it is improper to use the word "no" or to say "I don't understand" in a business meeting. In America, saying "I don't understand" is expected and appreciated if there is a problem. Americans are very direct and expect the same in others. Clear communication is a must. Americans frequently use sports terminology and phrases as metaphors, such as "You're way off base with that offer" or "I think we've hit a home run"—if you do not understand the connotation do not hesitate to ask, or you may leave with the wrong impression of how a meeting went. It is best to never use a word or phrase you do not completely understand yourself, because it may be an inappropriate expression to use professionally.

Women are active and influential at every level of American business from factory floors to senior corporate executives. Secretaries in corporate offices are considered important members of the staff and are not personal servants. Any woman meeting you as an equal is likely to be someone who can speak and act with authority for her company.

Do not be offended if an American calls you by your first name. It is common in the US to be put on a first-name basis very quickly, regardless of a person's level or status. In many cultures this would be considered highly disrespectful, but in the US many Americans will call you by your first name soon after meeting you, especially if you are both at the same corporate level.

Sometimes Americans find it difficult to hear and repeat exactly how foreigners pronounce their names. When being introduced, pronounce your name slowly and carefully. Mr (mister) can be used for all men regardless of age or rank. Ms (pronounced "mizz") is used for all women regardless of age or marital status. Elected officials and high government appointees should be referred to by title ("Senator Smith", "Commissioner Jones", "Director Peterson") and military officers should be called by rank ("Major Davis"). The title "Dr" can apply to physicians, psychologists, dentists and holders of a Ph.D. or Sc.D. degree, and should be used unless you are told to do otherwise. The only educators usually referred to by title are at the collegiate or university level ("Professor"). Do not be surprised if your host and his/her spouse have different last names; this happens for personal or professional reasons, or as the result of a divorce.

Business cards are a must for doing business in the US. They can be either in both English and your language or just in English (the former will be useful if your host is expected to visit you at your office at some later date); as few Americans are bilingual, it is imperative that the cards have English. Your name, title, company name, address(es) and phone/fax number(s) should all be printed, as well as the Internet and e-mail addresses, when available. Americans tend to appreciate cards that stand out, whether that means coloured or boldfaced print, graphics, coloured backing, or oversized cards. Americans are image-conscious, and this translates into the realm of business cards also.

Shake hands firmly with your counterparts when you meet them; embracing is done only between men and women (or between women) who know each other personally, and this is seldom done in a work setting. Eye contact is very important, but you must walk a fine line here; too little eye contact and your host will think you are ashamed or have something to hide and too much signals hostility or a challenge.

Giving gift can be a touchy subject, especially early in your relations with an American businessperson. Many have heard rumors about rampant bribery in other countries, and stories of "kickbacks" prevail through some American industries as well. A small token, perhaps with your corporate logo on it, is more appropriate than alcohol, food, art or other items, though a more substantial gift given at the signing of a major contract or after several successful projects have been completed would not be taken the wrong way. The only exception to this would be when dealing with the US or local governments, which have very strict laws against the acceptance of gifts in conjunction with official business.

Each national culture has its own business culture. The more pervasive national cultures constrain and guide the development of business culture in a society. Universally, business closely interweaves with the broader cultural values, norms, and beliefs. Examples include the priorities given to age and seniority, the role expectations of women, and expectations concerning treatment of subordinates by bosses.

Occupational and Organisational Cultures It has been observed that organisation-specific and occupation-specific cultures tend to develop within national and business cultures. Organisational culture (or its sister-term corporate culture) refers to the philosophies, ideologies, values, assumptions, beliefs, expectations, attitudes, and norms that knit an organisation together and are shared by its employees.

Members of organisations tend to internalise cultural nuances and like to initiate newcomers into such mores. Some of the practices are so thoroughly internalised that no one questions them—they are taken for granted, that is, they get institutionalised. (See opening case)

Besides institutionalisation, deification or glorification tends to occur in organisational cultures. Heroes emerge, especially among the founding fathers of the firm, whose sacrifices, valorous deeds, and ingenuity in the difficult initial years of the organisation or during later crises periods are embellished into stories and sagas. The firm itself may come to be regarded as a source of pride and in some sense unique. Employees begin to feel a strong bond with it that transcends material returns given by the company, and they begin to identify with it. The organisation turns into a sort of clan and the organisational members become ethnocentric. Clannish organisations often pose problems to international managers. Most Indian companies had developed the clan culture which led to the collapse of several joint ventures between Indian companies and overseas firms. Mention may be made of the breaking up the marriage between Tatas and IBM and Daimler Benz, of Godrej with P&G and GE, of DCM with Toyota, of LML with Piaggio and of Mahindra with Ford.

Different occupational groups such as physicians, professors, lawyers, accountants, and craftspeople have distinct cultures, called occupational cultures. Occupational cultures are the norms, beliefs, and expected ways of behaving of people in the same occupational groups, regardless of which organisations they work for.

The occupational cultures cannot be ignored by the international manager, notwithstanding the dominance of national and business cultures. To demonstrate this point, a study of Hofstede (1980), that includes over forty different national cultures, found that people with similar jobs often had very similar cultural norms. Moreover, people from different occupational groups were often more similar to one another than to people from their own national cultures.

Mechanistic and Organic Cultures The mechanistic organisational culture exhibits the values of bureaucracy and feudalism. Organisational work is conceived as a system of narrow specialism and people think of their careers mainly within these specialisms. Authority is thought of as flowing down from the top of the organisation down to the lower levels and communication flows through prescribed channels. There is a great deal of departmental loyalty and inter-departmental animosity, a strong 'we' versus 'they' perception. This sort of culture resists change and innovation.

In contrast, in organic culture, formal hierarchies of authority, departmental boundaries, formal rules and regulations and prescribed channels of communications are frowned upon. There is a great deal of emphasis on task accomplishment, team work and free flow of communication—both formal and informal. In problem situations, the persons with expertise may wield far more influence than the formal boss. There is a widespread understanding of the problems, threats and opportunities the organisation is facing within the staff and they are willing and prepared to take appropriate roles to solve the problems. The culture stresses flexibility, consultation, change and innovation. CMC, a once Central Government organisation, comes to one's memory when one describes organic culture.

Authoritarian and Participative Cultures In the authoritarian culture, power is concentrated on the leader and obedience to orders and discipline are stressed. Any disobedience is punished severely to set an example to others. The basic assumption is that the leader knows what is good for the organisation and he or she always acts in its interests.

The participative culture is premised on the notion that people are more committed to the decisions that are anticipatively made than to those which are imposed on them. Further, group problem solving leads to better decisions, because several new points and information are shared during discussions. Participative cultures tend to emerge where most organisational members are professionals or see themselves as equals.

Dominant and Sub-cultures Many big companies have a dominant culture and several cells of sub-cultures which are attached to different roles, functions and levels. If the sub-cultures are accepted, a natural conclusion is that very few beliefs, attitudes or values are shared by all organisational members. A dominant culture, normally referred to as the organisational culture reflects core values that are shared by the majority of the employees. In effect, this is the distinctive personality of the organisation. (See opening case).

By contrast, sub-cultures are found in departments, divisions and geographical areas and reflect the common problems or experiences of employees who reside in these areas. A sub-culture could consist of the core values of the dominant culture as well as the values unique to the department or area to which it relates. There could be differences and clashes between one sub-culture and another and between subcultures and the dominant culture as shown in Exhibit 6.2.

Exhibit 6.2

CULTURAL CLASHES

Here are two cases of clashes between corporate culture and subunit culture.

- The marketing department of Smithkline Beechem in India has, for many years, hired only the toppers from the best business schools in the country. Consequently they have a very competent and result-oriented team capable of ideation, conceptualisation and planning of superb market-entry packages. Unfortunately, the R&D and production departments, more rigorously controlled by the head office, had not developed the same values in their hiring processes. Obviously, the knowledge gap between these two departments had become so unbridgeable that Smithkline Beechem in India ended up with a greater number of new product failures than the market average.
- It was the late 1980's and HP was putting up its operation in India and at Bangalore. The building was ready and at the main entrance was a cubicle with some railings installed inside. The chief of the Asia Pacific region, who was incidentally the person in charge of the Indian operations, was curious to know why the cubicle and railings were put up at the entrance of the plant. When confronted, he was politely told that the cubicle was meant for security staff and railings were meant for frisking employees when they were leaving the plant after completing their shifts. Frisking was to be carried out in order to detect any smuggling of valuable components, he was told. The chief, a Singaporean by nationality, was aghast at these answers. For him, frisking of employees was something new, never practised in HP operations anywhere in the world. Everywhere, HP stood by its credo-'Respect and Trust People'. Here, you are expected to respect and trust people and at the same time frisk employees, suspecting them to be thieves. He felt particularly saddened when he was told that frisking was to be done only for one section of employees.

Now the time came to letter the wall in the main hall with HP credo-'Respect and Trust People'. The chief put his feet down, "You will not letter the wall with the credo unless you pull out railings. You will not frisk anyone over here", shouted the chief. Finally, he had his say and way. The railings were dismantled and the credo appeared on the wall.

Strong, Weak, and Unhealthy Cultures Distinction is also made between strong and weak cultures. In a strong culture, the core values of the organisation are widely shared and eagerly embraced by large number of employees who are deeply committed to them.

A *strong culture* will have a significant influence on employee behavior manifesting in reduced turnover, lower absenteeism, increased cohesiveness and positive attitudes. This is so because there is a high agreement among members about what the organisation stands for. The result is the variation of internal atmospheres of high behavioural control. Behavioural control brought in by strong culture is much more powerful than the one that results from formal rules and regulations. In addition, organisations sharing strong culture tend to perform better than those without such a culture. In recent years, as organisations have created flatter structures, introduced team systems of working, reduced bureaucratic control and empowered employees. Some would argue that the shared meaning generated by a strong culture ensures that everyone is moving in the same direction (See also opening case).

Strong culture has dysfunctional consequences. It tends to lead to groupthink, collective blind spots, and resistance to change and innovation. It tends to discourage diversity as strong culture would not accommodate the diverse behaviours and strengths that people of different backgrounds can bring to the organisation.

Weak Cultures A weak culture is characterised by the presence of several sub-cultures, sharing of few values and behavioural norms by employees and existence of few sacred traditions. In weak-culture organisations, there is little cohesion across the organisation-top executives do not repeatedly expose any business philosophy or exhibit commitment to particular values or extol the use of particular operating practices. Because of the lack of shared values, organisational members have no deeply felt sense of identity. The lack of corporate identity tends to result in few employees viewing the company as a place to work and hence a way to make a living.

Unhealthy Cultures There are organisations which have unhealthy cultures. One unhealthy trait is a politicised internal environment that allows influential manager to operate autonomous 'fiefdoms' and resist needed change. In politically dominated cultures, many issues get resolved on the basis of turf, vocal support or opposition by powerful executives, personal lobbying by a key executive and coalitions among individuals or departments with vested interests in a particular outcome. What is best for the organisation plays second fiddle to personal aggrandisement.

Another feature of unhealthy cultures is that of prompting managers who are good at staying within their budgets, exerting close supervisory control over their units and handling administrative detail as opposed to managers who understand vision, strategies and culture-building and who are good leaders, motivators and decision makers. While the former are adept at internal organisational manoeuvring, they may lack the entrepreneurial skills an organisation needs among its senior executives to introduce new ideas, reallocate resources, build new competitive abilities and fashion new culture.

EFFECTS OF CULTURE

LO 3
Outline the effects of culture

Culture effects may be both functional, as well as dysfunctional. Talking about the latter, it may be stated that culture leads to groupthink, collective blind spots, resistance to change and innovation.

As was mentioned earlier, culture makes an organisation a clan. The clan forming an industry possesses a few potentially disabling weaknesses. A clan always tends to develop zenophobia, a fear of outsiders. Another problem from well-knit culture relates to the management of diversity. Strong cultures put considerable pressure on employees to conform. But modern organisations are known for diversity of workforce. Workforce diversity is being accepted and even encouraged. Obviously, there develops conflict between the need for conformity and the advantage of having employee's diverse behaviours and strengths.

Culture acts as a barrier to mergers and acquisitions. Historically, financial matters were alone considered to decide which company should acquire which company or which unit would merge with which firm. In recent years, cultural compatibility has become the primary concern. While a favorable financial statement or product line may be the initial attraction of an acquisition company, whether the acquisition actually works seems to have more to do with how well the culture of the two organisations jell with each other. Where there is a mismatch, acquisitions are likely to fail, as happened to the takeover of Poysha Industries Ltd. by Tinplate Co. of India Ltd. The latter acquired the former in 1991, but the big-bother attitude of the acquirer was too much for the acquired and the marriage broke down in 1994.

A well developed and sustained culture offers several benefits to the organisation. First, culture serves as a control mechanism that shapes performance of employees. As culture seeps through the organisation, people register do's (e.g., perform effectively and keep a firm grip on quality) and don'ts (e.g., engage in poor team work or be disrespectful to employers). When employees do not act in accordance with the norms of culture, managers and peers try to intervene and initiate corrective actions.

Second, culture promotes innovation. By developing and supporting alluring processes, culture promotes innovation and creativity. Innovation and creativity is the key to competitive advantage of an organisation. Third, culture wields considerable influence on strategy formulation and implementation. It provides inputs to the company to adopt a particular strategy. Motorola for example, is built around high investment in R&D, quality and customer care. This culture has bolstered the strategy of the company, providing the impetuses for the development of new products.

Culture energises people in the company to do their jobs in a strategy-supportive manner and helps execute strategies. A culture where frugality and thrift are values shared by organisational members, is conducive to successful execution of low-cost leadership strategy. Similarly, a culture where creativity, change acceptance and challenging the status quo are pervasive themes, it is conducive to successful implementation of a product innovation and technological leadership strategy.

Fourth, culture provides a sense of identity to members and enhances their commitment to the organisation. When employees internalise the values of the company, they find their work intrinsically rewarding. Motivation is enhanced and morale gets a boost.

Finally, by ensuring organisation-person fit, culture brings about organisational commitment and job satisfaction among employees. Satisfied employees do not exit the organisation and even bring in new talent too.

ELEMENTS OF CULTURE

LO 4
Categorise the different elements of culture

Culture is a very complex and multifaceted concept comprising many elements. All these elements have evolved over time, sometimes through revolutionary and sometimes through peaceful means and are themselves products of a number of factors affecting a society. They interact in a complex manner to determine the totality of a given culture. The elements of a culture provide the basis of comparison made between cultures and are used to assess the likely impact of culture and cultural changes on international business.

Though the elements of culture are many, we focus here on languages, religion, education, aesthetics, attitudes, customs and manners and supernatural beliefs. (See Fig. 6.2). It needs no emphasis to state that these elements impact all levels of culture.

Language and Culture

Which influences what? In other words, does culture influence language or does language impact culture? The debate continues. However, the safest way of concluding the debate is to state that there is a close inter-relationship between the two. It is generally held that it is not possible to understand a culture without taking into account its language; and it is equally difficult to understand a language outside of its cultural context. Yet, despite the close connection between language and culture, it is not advisable to think that the relationship between the two is complete and absolute. Some societies, for example, share common cultural traditions but speak mutually unintelligible languages. On the other hand, societies with quite different cultures may speak mutually intelligible languages. Nevertheless, culture influences language and language impacts culture in several ways.

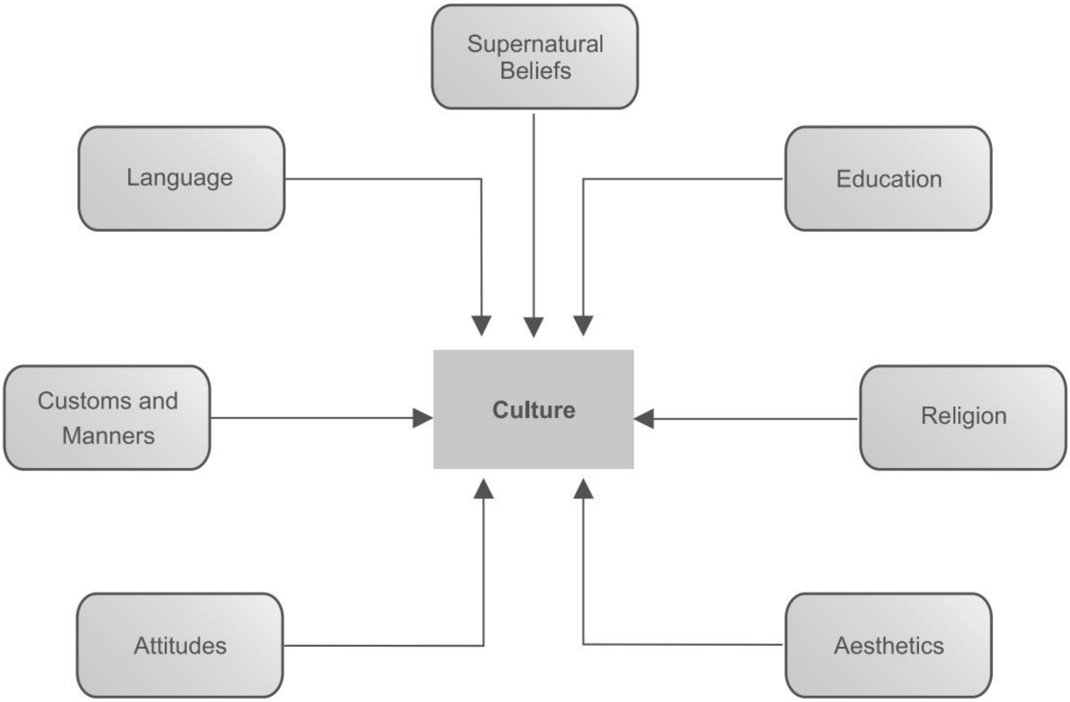


Fig. 6.2 Elements of Culture

The Influence of Language on Culture Language refers to an abstract system of word meanings and symbols for all aspects of culture. Language includes speech, written characters, numerals, symbols and gestures of non-verbal communication. How does language influence culture?

First, language establishes the categories on which our perceptions of the world are organised. Obviously, language is more than a system of communication that enables people to send and receive messages. More importantly, it establishes categories in our minds that force us to distinguish those things that we consider as similar from those that are not. As every language is unique, the linguistic categories of one language will never be identical to the categories of any other. Consequently, speakers of any two languages will not perceive reality in exactly the same way.

Second, besides reflecting its world view, a language reveals a culture's basic value structures. Some societies are collectivists culturally while others are individualistic. Individualism is deep rooted in Americans. For the Americans, it is the individual, not the group, that is important. This individual orientation is reflected in the language used by the Americans. American English is rich with words focussing on self. Roughly, there are no fewer than 150 such words, including self-absorbed, self-esteem, self-appointed, self-centered, self-actualisation, self-confident and self-supporting.

The above hypothesis that language determines cultural patterns is not acceptable to several experts. Many anthropologists argue that the language fails to capture nuances of human thoughts and behaviours. For example, humans possess the ability to make millions of colour distinctions, yet languages differ in the number of colours that are represented by their respective vocabularies. The English language distinguishes between yellow and orange, but some other languages cannot. The word *punya* is popular in Indian languages but there is no equivalent of that in the English language.

The Influence of Culture on Language The impact of culture seems to be more significant than vice versa. The vocabularies of all languages reflect cultural nuances of the societies. If a society is endowed with highly advanced technology (as it happens in rich countries), the language of that society contains such technical jargon as computers, laptops, BPO, call centres, e-mails, internet, iPods, software, websites, and the like. Similarly, professional occupations such as software engineer, accountant, professor, philosopher and scientist find their place in the language of a society that is rich in specialised occupations. Thus, any standard language enables its users to adapt most effectively to their environment by providing a conceptual lexicon most suited to its culture.

In some societies of the world, the influence of culture on language is a deliberate and political process. In France, the Academic Franchise has been serving as a forum of language police, protecting the French from having to accept foreign words into their language. High-tech words, which sprung up after the Internet revolution (such as www, spam, virus), have entered many other languages, but the 'language police' has succeeded in preventing such intrusions. The French, for more than 350 years, have supported Academic Franchise whose mission is to keep non-French words out of their language.

High and Low-context Languages The world's languages can be classified, based on whether the message conveyed is explicit or implicit, into two groups. Languages in which people state things directly and explicitly are called low context. The words provide the meaning. There is no need to interpret the situation to understand the import of the words. Languages in which people state things indirectly and implicitly are called high context. In the high context language, communications have multiple meanings that can be interpreted only by reading the situation in which they occur. So important are the ideas of high and low context that many people refer to the whole culture as being high and low context.

Most northern European languages, including German, English and the Scandinavian dialects, are low context. People use explicit words to communicate direct meaning. In contrast, Asian and Arabic languages are high context. In Asian languages, often what is left unsaid is just as important as what is said. Silent periods and the use of incomplete sentences require a person to interpret what the communicator does not say, by reading the situation. Arabic introduces interpretation into the language with an opposite tack. Extensive imprecise verbal and non-verbal communication produces an interaction where reading the situation is essential for comprehending intent.

A clear understanding and effective use of language is essential for the success of any international business practice. It helps determine success in the following ways:

- It provides a clearer understanding of a given situation. Having the ability to communicate in the host language enables an international manager to conduct business directly with his / her hosts without the need for an interpreter. There is no need for a third person to explain the situation or what is being discussed. Thus, the manager is able to assess a situation instantly and act accordingly. This obviously saves time and adds spontaneity to social intercourse.
- Language establishes one of the most effective and flattering bridges to local people. To speak the host's language means having direct access to hosts who are more willing and delighted to communicate openly in their own diction. In many instances, this is how friendships develop and prosper; as in most cultures speaking the host's language is one of the most flattering ways to pay compliments to the host culture and those who belong to it.
- Even the most competent interpreter could have difficulty conveying hidden, implied meanings of words and nuances, phrases, or slang. Speaking directly with the host in his / her language gives the speaker a feel of the emotions and significance with which the host communicates.
- Language, properly and effectively learned and practised, provides one of the most practical means of understanding another culture. When learning a foreign language, one is not just acquiring a means of communication but also developing a deeper understanding and appreciation of the

host's history, politics, social life, and other cultural aspects.

- Learning a language, understanding all the nuances and clichés, and enjoying ways of socialising with a host are some of the most practical and rewarding experiences for an international manager. It builds confidence and earns the respect and admiration of local people. In short, they help make a manager more effective.

Among all languages, Chinese is most widely used across the globe (see Table 6.1). But in the corporate world, it is English which is prima donna. Naturally, countries go out of the way to promote teaching and learning of the language among their citizens (see Exhibit 6.3). Infact, one of the competitive strengths of India is the capability of her citizens to converse in English.

Exhibit 6.3

'SINGLISH' TO MAKE WAY FOR ENGLISH

An expatriate, working in globalised Singapore or a tourist may take some time to get used to "Singlish"—English mixed with Malay words, Chinese grammar, and local slang.

Sweet as it may sound, Singlish is not seen as good enough for an interconnected world; a world where standardised English is seen as a must for business and commerce.

So, in a bid to ensure that more and more Singaporeans speak standard English and are understood better by the rest of the world, the government launched a "speak good English movement".

Launching the movement, Singapore's Deputy Prime Minister, Mr Lee Hsien Loong, stressed the importance of English: "According to BBC News Online, March 23, nine out of ten computers connected to the Internet are located in English speaking countries and more than 80 per cent of all home pages on the Web are written in English. More than four-fifths of all international organisations use English as their main, or one of their main, operating languages."

Mr Lee said standard English, as opposed to Singlish, would allow Singaporeans to plug into the global economy, develop the city state into an attractive hub for multinational corporations, and link up with the rest of the world through trade and investment.

"Because our language habits are in transition, we must make a special effort to get people to speak standard English. The younger generation is switching from speaking Chinese, Malay or Tamil, to speaking English. We have to make a choice either to switch to English, or switch to Singlish.

"If we give up our mother tongues, only to learn and speak English, we will be worse off. Our mother tongues carry with them values, ancient cultural heritages and a sense of identity. To lose some of this, because we need to speak standard English, an international language of business and science, is painful, but it is rational trade-off to make………" Mr Lee said.

Mr Lee said Singaporeans must make the effort to learn English grammar, sentence structures and pronunciation. "We need to speak with a British or American accent; a Singaporean accent is fine. But Singaporeans must speak a form of English that is readily understood by people all over the world." He said the "speak good English movement" was off to a promising start.

"Through the Encouraging the Use of Standard English (ENTHUSE) Committee, the Ministry of Education has taken the lead to improve the standard of English teaching in schools.

Our schools have many programmes activities…MOE is also working to upgrade the standard of English teaching in schools.

"But government effort alone is not enough. The home environment is very important. As a child spends a larger part of his early formative years at home, this is where he picks up his language skills. Parents can get their children to speak good English only if they try to speak good English themselves," Mr Lee said. The government, it is clear, will spare no effort in helping Singaporeans master standard English. A major battle with Singlish lies ahead.

Table 6.1 Language Distribution of the World

Rank	*Language*	*Primary Country*	*Population*
1	Chinese, Mandarin	China	885,000,000
2	Spanish	Spain	332,000,000
3	English	United Kingdom	322,000,000
4	Bengali	Bangladesh	189,000,000
5	Hindi	India	182,000,000
6	Portuguese	Portugal	170,000,000
7	Russian	Russia	170,000,000
8	Japanese	Japan	125,000,000
9	German	Germany	98,000,000
10	Chinese, Wu	China	77,175,000
11	Javanese	Indonesia, Java, Bali	75,500,800
12	Korean	South Korea	75,000,000
13	French	France	72,000,000
14	Vietnamese	Vietnam	67,662,000
15	Telugu	India	66,350,000
16	Chinese, Yue	China	66,000,000
17	Marathi	India	64,783,000
18	Tamil	India	63,075,000
19	Turkish	Turkey	59,000,000
20	Urdu	Pakistan	58,000,000

(*Source*: Adapted from Barbara F. Grimes (ed.); *Ethnologue Languages of the World,* 13th edition (Dallas: SIL International, 1996)

It is not countries alone, corporates too are active in training employees to become linguists. IBM, Microsoft, Logica, Capgemeni and Cognizant are companies that are active in organising language training programmes for their employees.

Logica India has its presence in 40 countries, the UK, France, Sweden, the Netherlands and Germany being big clients. The company provides training in Dutch, German, French and Swedish and also in Kannada for people form other states working in Bangalore.

Capgemeni has clients in 60–80 countries and has language options in German, Italian, Spanish and Dutch. The company hires external trainers from respective embassies and firms who can teach these languages. Trainers also come from Alliance François, Max Muller Bhavan and similar other bodies.

Cognizant has a Cognizant Academy for Training and Development of Employee Skills. The Academy trains technicians in Japanese, German, Spanish, French, Mandarin and Dutch as the company has significant presence in the Netherlands, UK, US, Germany, France, Spain and Japan, with a development centre in China.

Managers have realised that more the languages they know, more benefits they enjoy. Some prominent benefits from such proficiency are:

- Learning the host language builds rapport and sets the proper tone for doing business abroad.
- Learning a second language facilitates learning other languages.
- To provide the best medical care for oneself and one's family, communicating clearly the nature of a medical problem to local medical professionals who do not speak English is vital.
- With the increasing threat of terrorism, knowledge of the local language might prevent involvement, injury or death.

- Learning the local language can play a major role in adjusting to culture shock because efficient communication can (1) minimise the frustration, misunderstandings and aggravations that face the linguistic outsider, and (2) provide a sense of safety, mastery and self assurance.

Religion and Culture

Religion refers to a specific and institutionalised set of beliefs and practices generally agreed upon by a number of persons or sects. There are nearly 1,00,000 religions across the globe, but the major ones among them are Hinduism, Christianity, Islam, Buddhism, and Confucianism. Each has its own distinct characteristics and followers.

Religion has considerable impact on one's life, irrespective of the country to which he or she belongs. People go to any extent and practise abnormal activities in the name of religion. Animals and human beings are sacrificed to propitiate god, heads are tonsured, cheeks and tongues are pierced, sex and food are given up for days, dipping in rivers and rolling over around places of worship—all in the name of religion. People are compelled to change their religious faiths, places of worship are destroyed and pillaged, people are beheaded, and battles are fought over religious issues. In modern democracies, elections are fought on issues relating to religion. Religion has its impact on the economy of a country too. (See also Exhibit 6.4 and Table 6.2)

Exhibit 6.4

THE NEW WARS OF RELIGION

A religious fanatic feels persecuted, goes overseas to fight for his God and then returns home to attempt a bloody act of terrorism. Next week, as Britons celebrate the capture of Guy Fawkes, a Catholic *jihadist* under the Houses of Parliament in 1605, they might reflect how dismally modern the Gunpowder plot and Europe's wars of religion now seem.

Back in the 20th century, most Western politicians and intellectuals (and even some clerics) assumed religion was becoming marginal to public life, faith was largely treated as an irrelevance in foreign policy. Symptomatically, State Department diaries ignored Muslim holidays until the 1990s. In the 21st century, by contrast, religion is playing a central role. From Nigeria to Sri Lanka, from Chechnya to Baghdad, people have been slain in God's name, and money and volunteers have poured into these regions. Once again, one of the world's great religions has a bloody divide (this time it is Sunnis and Shias, not Catholics and Protestants). And once again, zealotry seems all too relevant to foreign policy, America would surely not have invaded Iraq and Afghanistan (and be thinking so actively of striking Iran) had 19 young Muslims not attacked New York and Washington.

It does not stop there. Outside Western Europe, religion has forced itself dramatically into the public square. In 1960, John Kennedy pleaded with Americans to treat his Catholicism as irrelevant; now a born-again Christian sits in the White House and his most likely Democrat replacement wants voters to know she prays. An Islamist party rules once secular Turkey; Hindu nationalists may return to power in India's next election; ever more children in Israel and Palestine are attending religious schools that tell them that God granted them the whole Holy Land. On present trends, China will become the world's biggest Christian country, and perhaps its biggest Muslim one too. President Mahmoud Ahmadinejad of Iran, not usually a reliable authority on current affairs, got it right in an open letter to George Bush, "Whether we like it or not," he wrote, "the world is gravitating towards faith in the Almighty."

(*Source: The Economist,* Nov. 3, 2007)

Table 6.2 Major World Religions

	1900		1970		1990		2000	
Christians	558.1	(34.5%)	1,236	(33.5%)	1,747	(33.2%)	1,999	(33.0%)
Muslims	199.9	(12.3%)	553.5	(15.0%)	962.3	(18.3%)	1,188	(19.6%)
Hindus	203.0	(12.5%)	462.5	(12.5%)	685.9	(13.0%)	811.3	(13.4%)
Buddhists	127.0	(7.8%)	233.4	(6.3%)	323.1	(6.1%)	359.9	(5.9%)
Jews	12.3	(0.8%)	14.7	(0.4%)	13.1	(0.3%)	14.4	(0.2%)
Non-religious	3.0	(0.2%)	532.0	(14.4%)	707.1	(13.4%)	768.1	(12.7%)

Note: Numbers in millions, followed by percentage of the world's population (in brackets)

(*Source*: Barrett, D., Durian, G. and Johnson, T. (eds)(2001) *World Christian Encyclopedia*, 2nd edn (New York: Oxford University Press)

Hinduism With nearly 500 million adherents, Hinduism is found mainly in India. Critics argue that by emphasising *moksha, dharma,* renunciation, and asceticism, Hinduism negates entreprenurialism and the wealth acquisitive nature of its followers.

This perception is not all that correct. India has produced hundreds of entrepreneurs who have made it big at home and abroad. India is probably the only country in the world where wealth is worshipped in the form of Goddess Lakshmi, unlike in the West where richness is merely respected.

Looking at the past, in most Indian literature, the world is viewed from the eyes of the well-to-do. Poverty, it is often said, is a living death; to serve another for one's keep is a dog's life, and not worthy of an Aryan. From the time of the Rig Veda, which contains many prayers for riches, worldly wealth was looked upon as morally desirable for the ordinary man, and indeed essential to lead a full and civilised life. The ascetic who voluntarily abandoned his wealth performed and assured himself of spiritual advancement, as well as the way to salvation *(moksha)*. The fourth and ultimate aim of existence, the ascetic's life, was not that of an ordinary man. The theoretical classification of the four stages of life (1) *Brahmacharya*—student life, (2) *Grihstha*— married and householder, (3) *Vanaprastha*—hermit in a forest, and (4) *Sanyasin*—old man and a homeless wanderer with all earthly ties broken. This scheme gave ample scope in the second stage to the householder, who was indeed encouraged to build up the family fortunes, and to spend, part of them at least, on the pleasures of the senses. Thus, the ideals of ancient India, while not perhaps the same as those of the West, by no means excluded money-making. India had not only a class of luxury-loving and pleasure-seeking dilettante but also one of wealth-seeking merchants and prosperous craftsmen, who, if less respected than the Brahmins and warriors, had an honourable place in society.

The followers of Hinduism believe in palmistry, astrology, numerology, *vaastu* and other beliefs, often bordering on superstition. Which business to start and when, what name should be given to the plant and to the product, when to buy cars or jewellery, when to visit a foreign country and the like are decided not on rational thinking but on superstitious beliefs as Exhibit 6.5 shows.

Christianity is the most widely practised religion in the world. About one billion people, approximately 20 per cent of the world's population identify themselves as Christians. The vast majority of Christians live in Europe and America, although their numbers are growing in Africa.

Protestantism (one branch of Christianity, the other being Catholicism) has considerable implications for business. Capitalism, which is the most dominant economic philosophy today, has grown out of Protestantism which advocates hard work and encourages wealth acquisition. Hard work and wealth are essential requisites for capitalism to grow.

Exhibit 6.5

IT IS ALL IN THE STARS

Business tycoon Anil Ambani is rumoured to consult an astrologer before making any major decision. Bharati Airtel Chairman, Sunil Bharti Mittal has a fixation on the Number 23. And liquor baron Vijay Mallya doesn't ever forget a trip to Tirupati with his new jets. Forget competitive rivalry, these billionaire business magnates have at least oneside common to them—a superstitious streak. And that's something that they share with a large majority of Indians as well.

It is not just business tycoons, Bollywood's fixation with 'K' is only well-known with soap queen Ekta Kapoor and director Karan Johar endorsing it. India's iconic superstar Amitabh Bachan allegedly made his daughter-in-law Aishwarya Rai perform a host of rituals because she was a *manglik,* a term used to denote the Mars influence.

Railway Minister Mamata Banerjee preferred retaining her old residence near Ram Manohar Lohia Hospital as against a bungalow on Akbar Road. Mamata did not wish to stay there as senior Congress leader and former Union Minister, Mani Shankar Aiyar had lost in 2009 Lok Sabha polls while living in that bungalow.

So what do the planets foretell? In a country that takes superstition seriously, it is not uncommon to find that such 'beliefs' are leveraged as a big business opportunity.

Take a look at the astrology market itself. Roughly, it is estimated at around Rs 200–300 crore for services such as financial astrology. And if you combine elements such as vaastu, rudraksh, feng shui and mantras, then it amounts to a whopping Rs 800 crore. These figures are themselves indicative of the steady demand that the market attracts.

And no one knows this better than celebrity numerologist Sanjay B Jumaani who boasts of an illustrious clientele. "They want advice on numerous occasions like before launching a product or brand, name consultations, colours for clothes, cars, shares they want to buy or name of the company which helps them change their outlook. Almost about 90% of cricketers follow lucky numbers," he says with a great degree of confidence.

If Jumaani has a long list of celebrities as clients, financial astrologer Col. Ajay Jain has a loyal set of HNIs and banks who consult him. "At least 40–45% of my business comes from HNIs and NRIs. Whenever the market faces higher volatility and fluctuation, the client consultation goes up by 30–40%." Jain says that HNIs don't mind paying anywhere between Rs 50,000–Rs 11 lakh for consultation! "If a client is paying me Rs 50,000 but earning back Rs 2 lakh based on my advice, then would he mind it?" asks Jain assertively.

Needless to say, professionals such as Jumaani and Jain have kickstarted a business which is finding many takers. And sectors such as real estate, automobiles, stocks, travel and tourism and jewellery are making hay out of the 'superstition' business. In jewellery, for instance, sales of gold every year go up by at least 15–20% during Akshaya Tritiya, a day considered auspicious for the Hindus.

(*Source*: *The Economic Times*, August 16, 2009)

Islam is the second largest religion with followers spread over more than 50 countries and inhabiting an almost contiguous stretch of land from the north west coast of Africa through the Middle East, to China and Malaysia in the Far East.

Islam prohibits receipt or payment of interest which is considered usury. To the devout Muslim, as stated in the previous chapter, receipt of interest is considered to be a grave sin. This principle has been codified in certain numbers. In 1992, for example, Pakistan's Federal Shariat Court, the highest Islamic law making body in the country, declared interest to be un-Islamic and therefore illegal.

Fearing that rigid adherence to the above principle could wreak havoc with a country's banking and financial system (thereby driving away international business), Islamic banks have been experimenting with a profit-sharing system. Under this system, when a bank lends money to a businessman, the lending bank takes a share in the profit earned by the business person instead of demanding interest payment. Similarly, a depositor of money will not get interest from the accepting bank, but takes a share of the profit earned by it.

Some critics argue that Islam discourages profit. This is not true. The Quran speaks approvingly of free enterprise and of earning legitimate profit through trade and commerce. Islam also advocates market based systems. Given this proclivity, Muslim countries tend to attract international businesses so long as they behave in a manner that is consistent with Islamic ethics.

There has been an upsurge of fundamentalism in some Islamic countries. This fundamentalism is being associated in the media with militants, terrorists, and violent upheavals such as the bloody conflict occurring in Algeria or the killing of foreign tourists in Egypt (see also Exhibit 6.6). This characterisation is not true. Fundamentalism is not peculiar to Islam; it may be noticed in Hinduism or Christianity as well.

Most Islamic countries are being governed by dictators. Turkey is the only muslim country which has democracy. Certain tenets of Islam, for example, stoning to death for adultery, do not sync with democratic principles. One of the fundamental norms of democracy is protecting human rights. Going by the endless killing of innocent people, it is hard to believe that Islamic countries guarantee protection of human rights.

Compassion for poor and strict adherence to the religious principles are some of the virtues of Islam. A thousand years ago, the great cities of Baghdad, Damascus and Cairo took turns to race ahead of the Western world. Islam and innovation were twins. The various Arab caliphates were dynamic super powers – beacons of learning, tolerance and trade. But today, the Arabs are in a wretched state. Even as Asia, Latin America and Africa are marching ahead, the Middle East is held back by despotism and convulsed by war, in spite of the oil wealth they have in abundance. Fault lies squarely on the wrong interpretation of Islam.

Exhibit 6.6

LAW OF GOD VERSUS LAW OF MAN

A Saudi surgeon has just pioneered a new, minimally invasive technique for replacing defective heart valves in children as young as three years old. Yet, she is not allowed to drive a car. The kingdom produces long-haired devotees of heavy-metal music, junk food and Harley-Davidson motorbikes. It also contributes the lion's share of suicide-bombers in Iraq. It boasts a truly independent judiciary, and its sharpest lawyers carry degrees from the world's top schools. But, they practise in a system with few codified laws, run by a coterie of ultra-puritanical judges who believe their rulings, based on their own interpretation of religious texts, represent the will of God.

Of all the institutions that perpetuate such contradictions and stop the kingdom from evolving much like other prosperous societies, perhaps the most obstructive is the judiciary. Saudis tend to find excuses for things that strike outsiders as odd. The absoluteness of the Saudi monarchy, they tend to say, is a product of history and tradition. Extreme segregation of the sexes results from adherence to a 200-year old revivalist version of Islam, Wahhabism, that is part of the Saudi national identity. Besides, as the owners of Mecca, Saudis have a duty to uphold orthodoxy.

Yet, even the most reform-resistant Saudis have long bemoaned the capriciousness of their courts. In theory, the Koran is held to be the Saudi constitution, and Islamic sharia its law. In practice, a patchwork of royal decrees frames the way the monarchy functions. A few ministerial committees regulate important commercial disputes, but it is a body of some 700 clerics, chosen by each other from a pool of Wahhabi scholars, that defines sharia as they see it, and chooses how to apply it. Its rulings are often harsh, including beheading for the crime of witchcraft, but sometimes also lenient, as in cases of rape or wife-beating. Sometimes it is slow, leaving thousands of abandoned women unable to secure a divorce.

This is why a recently announced overhaul of the legal system has been greeted with general relief. When the new rules go into effect, the country will have three tiers of courts, instead of the current two. Instead of applying their understanding of sharia to any case brought before them, judges will now preside over courts specialising in criminal, commercial and labour or family issues. The judiciary council that used to act as the highest court and was controlled by the most reactionary clerics in the kingdom, has been relegated to administration. A new ten-man Supreme Court will be filled mostly with royal appointees, presumably of a more diverse pedigree. The changes will be sweetened with an extra $2 billion in state funding for the judiciary.

Yet, they may be slow to take effect if past experience is any guide. Several years ago, a new code of criminal procedure was proclaimed, stipulating such things as the need to keep court records and lawyers to represent defendants. Some judges still ignore such rules, for example, by ordering uppity lawyers out of their courts. Some, as a matter of principle, refuse to recognise another recent initiative, granting women their national identity cards. These judges still insist on women being identified by a male 'guardian'. In any case, a woman's testimony still carries only half the weight of a man's.

Besides, the reforms do not touch on how judges are chosen. While most Saudis are proud of their faith and believe in the justice of Islamic law, many would like their legal system to accept currents other than Wahhabism in interpreting it. Some 10% of the 24 million Saudis are Shias and many of the rest adhere to the less rigid Sunni schools. Liberal Saudis even suggest that judges should be trained, not only in sacred texts but also in other aspects of life.

The changes do not meet another demand often voiced by lawyers, that the laws be codified. This is no easy task since sharia consists of only a limited number of specific injunctions, with the bulk of accepted texts being traditions of exemplary behaviour by the Prophet Muhammad and his companions. Yet, as law experts argue, there is a basic need, in a complex modern society, for predictability in how the law should be interpreted. In answer to such arguments, Saleh Lahidan, the grizzled, long-standing head of the just-demoted supreme judicial council says that there is no need to copy other countries; codification would 'separate us from our culture'.

But Mr Lahidan, derided by a commentator on a popular Saudi website as 'a dinosaur who ought to go extinct', may be fighting a losing battle. Reform in the kingdom is slow but public opinion is shifting. Among recent examples, one of the most fiery of preachers who advocated jihad in Iraq, Salman Awda, recently penned a Ramadan message to the al-Qaeda leader, Osama bin Laden, decrying the waste of life and damage to Islam caused by terrorism. And Saudi women activists, quiescent since a crackdown 15 years ago stripped several of government jobs, have now launched a national campaign to win the right to drive.

(*Source: The Economist*, Oct. 13, 2007)

Buddhism has 250 million followers in Central and Southeast Asia, China, Korea, and Japan. Buddhists stress spiritual achievement and obviously wealth creation is not encouraged. In Buddhist societies, we do not see the same kind of cultural stress on entrepreneurial behaviour that we see in the Protestant West. It is regretable that Buddhism, known for *Ahimsa*, is resorting to violence and killings. In sectarian clashes between Buddhists and Muslims in Myanmar resulted in over 240 deaths in the past two years. Most of the victims were Muslims.

Confusians numbering over 150 million are found in China, Korea, and Japan. The religion teaches the importance of attaining personal salvation through right action. Confusianism is built around a comprehensive ethical code that sets down guidelines for relationships with others. The need for high moral and ethical conduct and loyalty to others are central to Confusianism.

Confusianism has economic tenets too. It teaches the followers to lower the costs of doing business and this has largely contributed to the economic success of Japan, South Korea, and Taiwan.

Three principles are central to Confusianism—loyalty, reciprocal obligations, and honesty. Loyalty to one's boss is considered to be essential for salvation. This belief helps organisations maintain cordial employer–employee relations. Loyalty to one's superior brings the concept of reciprocal obligations to the centrestage. The principle of reciprocal obligations enjoins the superior to bestow "blessings" on subordinates for their loyalty. The employees of a Japanese company are loyal to the leaders of the organisation and in return the leaders bestow on them the "blessings" of lifetime employment. Honesty is the third principle of Confusianism. The religion points out that dishonest behaviour fetches only shorterm benefits. Ethical conduct is vital for long term benefits of organisations. Ethical conduct begets trust, which in turn eliminates expensive layers to resolve disputes and contractual obligations are discharged without hassles.

In general, all religions impact international business in the following ways:

- Specific religious laws
- Clothing requirements
- Religious festivals during which work may be curtailed or forbidden
- Foods that are forbidden
- Ban or restrictions on consumption of alcoholic drinks
- Weekly day of religious observance
- Facilities for daily prayers
- Segregation of men and women at workplaces
- Restrictions on electronic and print media
- Restriction on business and trading hours.

Education and Culture

In its broad sense, education is the lifelong process of learning through which members of a society acquire knowledge and develop skills, ideas, values, norms, and attitudes which they share with other members of the society. In this sense, education may be understood as the transmitter of culture. In the formal sense, education refers to the number of years an individual spends and the examinations he or she passes in schools, colleges, and university. But all education does not take place in classrooms. Much of it takes place at home under the tutelage of parents and other members of the family. Both types of education are pivotal to the formation of attitudes and development of social skills.

Education has considerable economic implications as well. As noted earlier, economic progress of a country depends on the education of its citizens. This being a broad statement, specific economic implications are as follows:

1. Countries rich in educational facilities attract high-wage industries. By investing in education, a country can attract (nay, create) the kind of high-wage industries that are often called "brain power" industries.
2. The market potential of a country depends on education. Educationally advanced countries such as England, France, and Germany are more likely to be markets for computers and high-tech equipment than are less educated countries such as Poland, the Czech Republic, and Romania. It is also likely that MNCs doing business in these countries will find it easier to hire and train local managers in Western Europe than in Eastern Europe.
3. The level of literacy and educational attainment determines the nature of advertising, packaging, quality of marketing research, and distribution systems available or prevalent in a country.

Aesthetics and Culture

Aesthetics relates to the artistic tastes of a culture. Aesthetic values of Indians, for example, are different from those of Canadians as reflected by the art, literature, music, and artistic tastes. One important manifestation of aesthetics is the behaviour of people. International managers should understand aesthetic local values if he or she has to appreciate another culture and the way in which business must address these values in the international arena.

Another aesthetically related area is colour. In many Western countries, the colour black is associated with mourning, while white is with joy and purity. In many Asian countries white is the colour for mourning. Green is the favoured colour in Islam but it is associated with sickness across much of Asia.

Music is deeply embedded in culture and should be considered while promoting goods and services. It can be used in clever and creative ways or in ways that are offensive to the local population. The architecture of buildings and other structures should also be researched to avoid making cultural blunders due to the symbolism of certain shapes and forms.

Attitudes and Culture

Attitudes are positive or negative evaluations, feelings, and tendencies which make an individual behave in a particular way towards people or objects. Attitudes include opinion about individual freedom, democracy, truth and honesty, the role of sexes, justice, love, marriage, and sex. Of particular interest to us in this context are the attitudes towards work, business, time, change and the future.

Attitude towards work is important as it has significant impact on motivation, morale, job satisfaction, productivity, and other aspects of human resource management. Positive attitude towards one's work, also called work ethic, makes a worker a more productive and a more satisfied employee. Compensation and reward systems are critical elements in determining work attitudes. An international business firm has to devise a system of compensation and reward that would help promote works ethic and of course, is congruent with the host country's culture.

Japanese workers are supposed to have a strong work ethic. On the other hand, Indian ethos such as detachment from work, *nirvana*, and renunciation are said to be inconsistent with the positive work attitudes of workers. This observation is not true, for, it is only in India that an average worker takes work as worship. For him or her, work is everything. No worker touches his or her tools, wheel, mouse or button in the morning without closing his or her eyes for a few seconds worshipping the almighty and expressing gratitude for having bestowed his blessing in the form of work. The Indian worker has earned appreciation from everywhere for his or her sincerity, hard work, loyalty, and honesty.

The culture of the land determines its people's *attitude towards business*. Business systems are a product of beliefs, mores, and customs of the society in which they exist. In fact, their very existence depends upon social philosophies which conduct and support various kinds of business functions. Business people must have some basic set of philosophies to guide their actions. Beliefs and value systems concerning what is right and what is wrong are basic to all business activities and serve as a justification for doing or not doing something by which actions of business persons and other groups are judged.

In capitalist systems an individual perceives business basically as a profit-seeking organisation producing goods and services in response to market demand. In Islamic social systems, business is an all-important institution based on personal relationship, trust and respect. Business firms are viewed not just providers of goods and services but as partners in progress and prosperity. Attitudes towards profit-making and business in general are an important part of the decision of an MNC to expand into a particular country.

French culture is known for its emphasis on elegance, elitism, and concern for form. Not only does this get reflected in its 1200 museums, 5000 varieties of wine (which are classified, like the French society, from superior to ordinary table wine), more than 50,000 drama performances every year, but also in the fact that France has always been the capital of the fashion industry.

On the other hand, Mexican culture is known for its "pro-death" values. Mexicans celebrate 'The Day of the Dead', have folk art forms which feature skeletons, have museums of mummies, adorn the graves as a work of art, and even have a popular magazine called La Calavera (meaning The Skeleton)!! Not surprisingly, life insurance industry is not a flourishing business in Mexico. In the mid 1990s, less than 20 per cent of the employed population had life insurance cover, and the insurance premium formed just about 1.5 per cent of the GDP (as compared to 5.5 per cent in Brazil and close to 9 per cent in the US).

People's *attitudes toward time* depend on culture. Most Western and capitalist societies believe that time is money. To waste time is to waste money. For most Westerners, punctuality is a must. Being late for a meeting or appointment is not only considered rude but also offensive. Every business activity is timed in terms of hours, minutes, days, months, and years. Long-term strategic plans are prepared to ensure targets are met on time. Time seems to control every aspect of human endeavour. Pay and productivity are measured in terms of the time it takes to complete a given task. But in some other societies time is viewed as something not to be taken seriously and punctuality is rarely observed.

Attitude to *change* is equally significant. The international manager must understand the aspects of culture that resist change, how those areas of resistance differ among cultures, how the process of change takes place in different cultures, and how long it will take to introduce change. There are two conflicting forces within a culture regarding change. People attempt to protect and preserve their cultures with an elaborate set of sanctions and laws invoked against those who deviate from their norms. Differences are perceived in the belief that 'my method is right; thereby the other must be wrong'.

The fact is that cultural environment does change and the culture should also change in order to ensure its own continuity. The international manager can bring in change successfully when he or she is able to relate the new idea with the conventional one. Usually cultures with centuries old traditions that have remained closed to outside influences are more resistant to change than other cultures. The level of education in a society and the exposure of its people to knowledge and the experience of other cultures is an extremely important determinant of its attitude towards change. The influence and nature of religious beliefs in a society also influence attitudes about change.

Another dimension of time is people's perception towards the future. In some societies, the prevailing belief is that people can influence and even control the future. Educational systems offer a variety of training and self-development courses to help individuals develop strong internal locus of control—the ability to carve out one's own future. In an Islamic society and in India the belief is that the future is pre-ordained and no one can alter it. This attitude often manifests itself in an almost total absence of forward business planning, with each day taken as it comes. What is not finished today can be continued tomorrow.

Culture vis-á-vis Customs and Manners

Customs are common or established practices. Manners are behaviours that are regarded as appropriate in a particular society. Customs dictate how things are to be done; manners are used in carrying them out. Further, manners are pointers of an individual's character whereas customs are what society collectively expects its members to do. The international manager should understand the manners and customs of host country citizens. Failure to understand and respect local customs and manners may land the manager in trouble, besides losing business.

Customs and manners differ from country to country. In Arab countries, for example, it is considered bad manners to attempt to shake hands with a person of higher authority unless this individual makes the first gesture to do so, unlike in the US where a person would not hesitate to offer his or her hand regardless of the person's rank. Similarly, shaking hands with the opposite sex is not appreciated in India, though the practice is prevalent in some other countries. Table manners vary from culture to culture, ranging from precise placement of eating implements to using fingers instead. Understanding customs and manners is particularly important during discussions and negotiations. Bodily expressions may contradict what is being said or implied. Observing manners and respecting customs are essential ingredients of successful negotiations in far and near Eastern cultures.

Supernatural Beliefs

The final dimension of culture refers to the supernatural beliefs. All societies have a certain degree of control over their physical and social environments. People in all societies can understand and predict a number of things. Things like car cannot run without petrol, Sun always rises in the east and sets in the west and apple falls on the earth are predictable. But, there are certain other things which are not predictable: why a person dies on the spot in an accident when the person sitting next to him/her is unscathed? Why your hand always stumbles on a wrong object whenever you want to pick up an article? Why does a child get polio-attacked, but the child's playmate next door is not? Such questions have no clear answers because they cannot be explained by our conventional systems of justice or rationality. Obviously, societies must develop **supernatural belief systems** for explaining these unexplainable happenings. The people explain the unexplainable by relying on various types of supernatural explanations, such as magic, religion, witchcraft, sorcery and astrology.

Supernatural belief systems affect the conduct of business by shaping attitudes about work, savings, consumption, efficiency, individual responsibility and decision making. Followers of Hinduism believe in **vastu**. ***Vastu*** decides the direction of the factory gate, main entrance of the premises, place where CEO should sit, and whether or not the company should diversify/acquire another business. The Islamic religion, although not hostile to capitalism, places greater emphasis on the individual's responsibility to the society, including charity to the poor and ensuring that profits are made only through fair business dealings rather than through fraud, deceit, or usury.

IMPLICATIONS FOR INTERNATIONAL BUSINESS

LO 5
Analyse the implications of culture for international business

Global businesses are the repositories of multicultures. Multiculturalism means that people from many cultures (and frequently many countries) interact regularly.[17] An MNC is just another world. It has a home country and has several host countries where the head office and subsidiaries are, respectively, located. The scenario is highly complex with several national cultures and subcultures interacting regularly.

Managing multiculturalism is essential for every international firm. Four tasks are crucial: spreading cross-cultural literacy, culture and competitive advantage, managing diversity and strategy-culture fit (see Fig. 6.3).

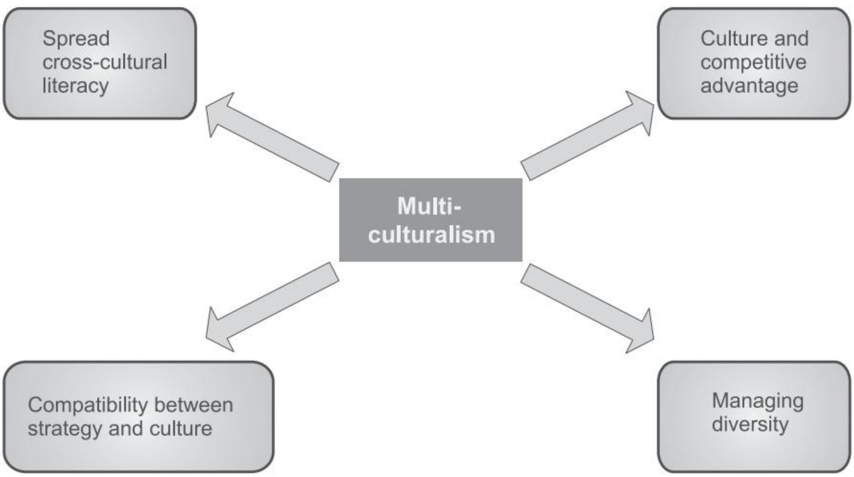


Fig. 6.3 Multiculture and International Business

Spreading Cross-cultural Literacy

One of the biggest dangers confronting a firm that enters a foreign market for the first time is the problem of being ill-informed. International businesses that fail to understand host-country cultures are likely to fail. Doing business in different cultures requires adaptation to conform with the nuances of that culture. No firm has the right to expect changes to be made in the local culture to suit its needs and expectations. An international manager has to bear in mind that local people often expect higher standards of behaviour and tolerate far less deviation from local manners and customs from foreign companies than from a native firm.

Removing Cross-cultural Illiteracy One way is to appoint local citizens to do business in a particular culture. Firms should 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. Hitachi is now taking this approach as it transforms itself from a Japanese into a global firm. For a long time Hitachi was a typical Japanese company. With globalisation, along with many other enterprises, Japanese society also has realised that monoculture firms will not survive. In 1991, Hitachi had set up a department to educate executives about other cultures. This department downplays the old notions of harmony and consensus decision-making. Hitachi is also sending increasing numbers of its executives for prolonged postings overseas, and it is starting to bring foreign managers back to Japan. The foreign experience has encouraged senior managers to seek firmer leadership in Japan—to shift away from the old consensus decision-making—and Hitachi's top executives have encouraged this trend.

An international business must also be constantly on guard against the dangers of ethnocentric behaviour. The ethnocentric person sees his or her own group as the center or defining point of culture and views all other cultures as deviations from what is normal. Hand-in-hand with ethnocentrism goes a disregard or contempt for the culture of other countries.

It was ethnocentrism that led China's Emperor Chien Lung to dispatch the following message to Great Britain's George III in reply to the latter's request that the two nations establish trade ties:

> *Our Celestial Empire possesses all things in prolific abundance and lacks no produce within its own borders. There is, therefore, no need to import the manufactures of outside barbarians in exchange for our own produce. But as the tea, silk and porcelain, which the Celestial Empire produces, are absolute necessities to European nations and to yourselves, we have permitted, as a signal mark of favour, that foreign business houses (at Canton) be supplied and your country thus participate in our beneficence —. As your ambassador can see for himself, we possess all things. I set no value on objects strange or ingenious and I have no use for your country's manufactures —. I do not forget the lonely remoteness of your island, cut off from the world by intervening wastes of sea, and I overlook your excusable ignorance of the usages of our Celestial Empire, I have consequently commanded my minister to enlighten your ambassador on the subject.*

Unfortunately, ethnocentrism is all too prevalent; many Indians are guilty of it, as are many Americans, French, Japanese, Britishers, and so on. Ugly as it is, ethnocentrism is a fact of life and the international businesses must be on continual guard against it.

How do international managers learn to live with other cultures? The first step is to realise that there are cultures different from their own. They must then go on to learn the characteristics of those cultures so that they may adapt to them.

Culture and Competitive Advantage

Culture may sound abstract but the norms and values prevalent in a society do influence the costs of doing business in that country. These costs influence the ability of enterprises to establish a competitive advantage in the global marketplace. Japan presents us with an example of how culture can influence competitive advantage. The country'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 workers and management for the good of the company. In addition, the availability of a pool of highly skilled labour, particularly engineers, has helped Japanese companies develop cost reduction techniques.

A different picture is found in Britain. Here, the class-based conflict between workers and management has disrupted industrial relations, raising the cost of doing business.

Similarly, the ascetic principles of Indian culture have not been highly supportive of its business growth. Also, Islamic laws banning interest payments may raise the cost of doing business by constraining a country's banking system.

For international business, the connection between culture and competitive advantage is important for two reasons. First, the conjunction suggests which countries are likely to produce the most viable competitors. The Pacific Rim nations (South Korea, Taiwan, Japan, and China), for example, are likely to produce cost-effective competitors because of the combination of free market economies, Confucian ideology, group-oriented social structures, and advanced education systems.

Second, the relationship between culture and competitive advantage has important implications for the choice of countries in which to locate production facilities and do business. Obviously, a country that has strong cultural support attracts a vast inflow of FDI.

Managing Diversity

Managing diversity means establishing a heterogeneous workforce to perform to its potential in an equitable work environment where no member (or group of members) has an advantage or a disadvantage. Managing diversity is a challenge for an international manager. The challenge is to create a work environment in which each person can perform to his or her full potential and therefore compete for promotions and other rewards on merit alone. Success in international arena is greatly determined by an MNC's ability to manage diversity. (See also Exhibit 6.7)

Exhibit 6.7

MATSUSHITA GOES GLOBAL

In recent years, a growing number of multinationals have begun to expand their operations, realising that if they do not increase their worldwide presence now, they will be left behind in the near future. In turn, this has created a number of different challenges for these MNCs, including making a fit between their home organisational culture and those at local levels in the different countries where the MNC operates. Matsushita provides an excellent example in how they have handled this challenge with their macro / micro approach. This huge, Japanese MNC has developed a number of guidelines that it uses in setting up and operating its more than 150 industrial units. At the same time the company complements these macro guidelines with on-site micro techniques that help create the most appropriate organisational culture in the subsidiary.

At the macro level, Matsushita employs six overall guidelines that are followed in all locales. They include: (1) be a good corporate citizen in every country, among other things, by respecting culture, custom and languages; (2) give overseas operations the best manufacturing technology the company has; (3) keep the expatriate head count low and groom local management to take over; (4) let operating plants set their own rules, fine-tuning manufacturing processes to match the skills of the workers; (5) create local research and development to tailor products for markets; and (6) encourage competition between overseas outposts and plants back home.

Working within these macro guidelines, Matsushita then allows each local unit to create its own culture. The Malaysian operations are a good example. Since 1987, Matsushita has set up 13 new subsidiaries in Malaysia, and employment there has more than quadrupled, to approximately 25,000 people. Only 230 of these employees, however, are Japanese. From these Malaysian operations, Matsushita currently produces 1.3 million televisions and 1.8 million air-conditioners annually and 90% of these units are shipped overseas. To produce this output, local plants reflect Malaysia's cultural mosaic of Muslim Malays, ethnic Chinese and Indians. To accommodate this diversity, Matsushita cafeterias offer Malaysian, Chinese and Indian food and to accommodate Muslim religious customs, Matsushita provides special prayer rooms at each plant and allows two prayer sessions per shift.

How well does this Malaysian workforce perform in the Japanese MNC? In the past, Malaysian plants' slogan was "Let's catch up with Japan". Today, however, these plants frequently outperform their Japanese counterparts in both quality and efficiency. The comparison with Japan no longer is used. Additionally, Matsushita has found that the Malaysian culture is very flexible, and the locals are able to work well with almost any employer. Commenting on Malaysia's multiculturalism, Matsushita's managing director notes, "They are used to accommodating other cultures, and so they think of us as just another culture. That makes it much easier for us to manage them than some other nationalities".

Today, Matsushita faces a number of important challenges including remaining profitable in a slow growth, high cost Japanese economy. Fortunately, this MNC is doing extremely well overseas, which is buying time to get its house in order back home. A great amount of this success results from the MNC's ability to nurture and manage overseas organisational cultures (such as in Malaysia) that are both diverse and highly productive.

(*Source*: Hodgetts and Luthans, *International Management*, p. 181)

Both domestically and internationally, organisations find themselves leading workforces that have a variety of cultures (and sub-cultures) and consist of a largely diverse population of women, men, young and old people, blacks, whites, Indians, Latins, Asians, Arabs, lesbians, physically challenged, and even people who are significantly overweight. Days were when a typical Indian firm was manned with Shettys, Reddys, Nairs, Raos, Patels, Mehtas, or Singhs. A typical firm today is an amalgam of a diverse workforce in terms of gender, race, and ethnicity. One can find a Shastri rubbing shoulders with a Khan, both jostling with a Gowda, and all shaking hands with a Singh.

Interaction helps bring employees together, thus leading to diversity. Most companies encourage interaction and therefore go in for exchange programs. Wipro introduced exchange programs so that American Management System (AMS) employees could come to Bangalore and vice versa. HCL in its first three months sent 20 employees each on both sides for an exchange program so that the two sides could work together as a team. MphasiS encouraged its Chinese engineers to work alongside MphasiS engineers on its US accounts. Similarly, for a Japanese project, the development is co-located in Shanghai and Mumbai, involving travel, coordination and knowledge sharing across both locations. All this goes a long way in buildings a rapport between teams. WIPRO has come out with an interesting concept of 'buddies'. This means that for every five employees of AMS, there is one WIPRO employee as their buddy who would guide them on WIPRO rules and regulations.

Most Indian managers perceive diversity in its restricted meaning. For them, diversity means having women as employees. HUL's management team comprises 11 per cent women, up from six per cent four years earlier. At Kodak India, 70 per cent of the company's marketing staff and 85 per cent of the workforce at its Bangalore factory are women.

So much for women participation as employees in Indian firms. India remains a male dominated workplace, if one goes by an interesting happening in the recent past. When Arundhati Bhattacharya became the CEO of State Bank of India (first woman to become so in the 208 years history of the premier bank), her elevation created a problem – how to print her business card. She could not be called Chairperson as the bank had provision only for Chairman and not for Chairperson. She now calls herself as Chairman and not Chairperson.

Infosys has gone beyond appointing women. 40 per cent of Infoscions are non-Indians. At HSBC, half the employees worldwide are women. In terms of race, 30 per cent are Asian and nearly 70 per cent are Latin American.

Another important aspect of diversity is **generational diversity**—differences in values, aspirations, and beliefs that characterise the present generation. Today's youth measure success in terms of sales volume, quantifiable results, and swelling bank balances. For them, ends justify means. Older people have no tolerance for the youth.

Diversity—Advantages and Disadvantages Diversity, though a challenging task to manage, carries with it certain advantages. One main benefit of diversity is the generation of more and better ideas. Because group members come from a host of different cultures, they are often able to create unique and creative solutions and recommendations. A second major benefit is that culturally diverse groups can prevent *groupthink*, which is social conformity and pressures on individual members of a group to conform and reach a consensus. When this occurs, group participants believe that their ideas and actions are correct and those who disagree with them are either uninformed or are deliberately trying to sabotage their efforts. Multicultural diverse groups are able to avoid this problem, because the members do not think similarly or feel the pressure to conform. As a result, they typically question each other, offer opinions and suggestions that are contrary to those held by others, and must be persuaded to change their minds. Therefore, unanimity is achieved only through a careful process of deliberation. Decision-making may be very slow, unlike in a homogeneous group, but the decisions reached tend to be very effective.

There are problems associated with diversity, nevertheless. Diversity may cause a lack of cohesion that results in the firm's inability to take concerted action, be productive, and create a work environment that is conducive to both efficiency and effectiveness. These problems are rooted in people's attitudes.

There are perceptual problem too. When culturally diverse groups come together, they often bring preconceived stereotypes with them. A related problem is inaccurate biases. Japanese firms, for example, depend on groups to make decisions. Entrepreneurial behaviour, individualism, and originality are downplayed.

Yet another potential problem with diverse groups is inaccurate communication, which could occur for a number of reasons. One is misunderstandings caused by words used by one but not clear to others. Another problem is the way in which situations are interpreted. Many Japanese nod their heads when others talk, but this does not necessarily imply their approval. They are merely being polite and attentive. Different uses of time may also lead to communication problems. For example, many Japanese will not agree to a course of action on-the-spot. They will not act until they have discussed the matter with their own people because they do not feel empowered to act alone. Many Latin managers refuse to be held to strict timetables, because they do not have the same time-urgency that US managers do.

Managing Diversity—Some Practical Measures Having discussed the diverse workforces, and their benefits and potential problems, it is appropriate to list out some practical steps that managers can take to manage diversity. Here are some such steps:

- Focus on bringing in the best talent, not on meeting numerical goals. Geocentric policy towards staffing should be the guiding principle
- Hold managers accountable for meeting goals of diversity
- Establish monitoring programmes among employees of same and different races
- Develop career plans for employees as part of performance reviews
- Develop an age, gender, and race/ethnic profile of the present workforce
- Promote minorities and other disadvantaged sections to decision-making positions, not just to staff jobs

- Diversify the company's board of directors
- Provide extended leaves, flexible scheduling, flexi time, job sharing, and opportunities to telecommunicate, particularly for disadvantaged workers.

Culture-Strategy Compatability

A culture and strategy fit is essential for the success of an international business. (See Exhibit 6.8) But achieving the balance between strategy and culture is extremely difficult because an MNC operates in different parts of the globe, each country being culturally different from the other. Cultural differences provide challenges to international managers in marketing products, managing workforces, and dealing with host-country governments. But fortunately, similarities do exist among many cultures, thereby reducing some of the needs to customise business practices to meet the demands of local cultures. Countries that share cultural similarities form a cultural cluster or simply called the *convergence*. Several developments account for convergence.

- Customers' needs across societies are similar. In order to meet identical needs, companies need to produce similar goods. Similar production processes are needed to produce such products.
- Growing industrialisation and economic development enable organisations to have the technical and financial capability to use similar technologies.
- Global competition and global trade contribute to convergence. International competition raises

Exhibit 6.8

STRATEGY—CULTURE FIT

Name of Company		*Strategy—Culture Fit*
P&G	-	During 1980s, modified its bulky diapers in Japan to 'trim-fit' which helped regain 30 percent market share. Trim-fit became best sellers in the US.
McDonald's	-	Created for Indian veg palate Maharishi burger and for non vegetarians, the company introduced lamb mince instead of beef mince in burgers.
Asian Paints	-	Became APCO in Australia, as Australians are averse to the terms Asia.
Coca-Cola	-	Labels on bottles supplied to gulf to contain 'no-alcohol'.
Nokia	-	Introduced Hindi SMS for Indian users of cellphones.
McDonald's	-	'Meat prepared after halal' is printed on the label before exporting meat to Saudi Arabia.
Domino's Pizza	-	Pizzas in Bangalore to contain Indian curry as paste instead of the usual one. It also offers Tandoori pizzas.

managerial awareness of what people in other societies are doing. Japanese competition with other countries for example, enabled companies elsewhere to initiate such managerial practices as Just-in-Time (JIT) inventory, Kaizen, open offices, and common uniforms.

- International strategic alliances contribute to clusters. With international cooperative arrangements among competitors, an increasing number of firms from diverse nationalities combine with one another to form one organisation. These joint ventures or alliances provide a wealth of information on the organisational practices of other societies. Later, parent organisations use this knowledge to change and improve their own organisations.
- Business education also serves to harmonise organisational practices. In particular, the large number of international students in US and European MBA programmes helps spread common business techniques. Many students return to their home countries with the intent of adopting management practices that best fit their national cultures. For example, many of the high-tech firms in India, Korea, and Taiwan are staffed with top executives who were educated in the US and stayed on to work for a decade or more. Now they are returning to their homelands with technical and managerial expertise.

Tackling the Culture Factor—Strategies Many international businesses utilise the country-clustering approach in formulating their international strategies. Many firms from New Zealand focus their first exporting efforts on Australia. Similarly, Hong Kong firms have been very successful in exploiting China's markets.

As stated earlier, firms use either a worldwide integration strategy or local (national) responsive strategy. In the **worldwide integration strategy**, standardised products are developed and are sold throughout the world with few alterations.

National Responsive Strategy A national **responsive strategy** allows subsidiaries to enjoy substantial latitude in adopting products and services to suit the particular needs and cultural realities of the countries in which they operate.

Types of National Responsiveness There are three general categories of national responsiveness: (1) product adaptation, (2) individual adjustment, and (3) institutional adaptation.

Product Adaptation This refers to the differentiation of a firm's product to capture a particular niche in the market. Product differentiation also means adapting the product to suit cultural differences in the host-culture by modifying its characteristics, as for example, Coca Cola changing the name of its Diet Coke to Coke Light in Japan because the word 'diet' has a disagreeable connotation; the McDonald's menu is revised in different parts of the globe depending on tastes, customs and religious beliefs. In the Philippines, Tide is sold in three forms: powder, liquid and bar. The detergent bars used for washing clothes by hand in areas that do not have washing machines. Rolls Royce came into the Indian market the first time with bells instead of horns with the assumption that Indians would respond better to the bells (See also Exhibit 6.9).

Individual Adjustment This is sought to be accomplished through training. Training should be provided to all personnel and their families going on international assignments, as they would be exposed to a cultural environment which may be very different from their own. The managers and their families will face daily challenges, excitement, frustration, uncertainty, and anxiety. The degree of success with which they respond to these feelings and emotions and their ability to handle them effectively will depend on the success of their training and more importantly, on their skills, stamina, linguistic and

Exhibit 6.9

CULTURAL NUANCES AND MOBILE PHONES

Technologies tend to be global, both by nature and by name. Say 'Television', 'Computer' or 'Internet' anywhere and chances are you will be understood. But not with the ubiquitous instrument called the cellphone. For North and South Americans, it is *cellular*. For Britons and Spaniards the same mobile phones are *moviles*. Germans and Finns refer to them as *Handys* and *Kannykat* respectively, because they fit in your hand. The Chinese too, make calls on a *sho Ji*, or 'hand machine'. In Japan the term of art is *keitai*, which roughly means 'something you can carry with you'.

This distinction is revealing for an object that, in the space of decade, has become as essential to human functioning as a pair of shoes. Mobile phones do not share a single global moniker because the origins of their names are deeply cultural. 'Cellular' refers to how modern wireless networks are built, pointing to a technological worldview in America. 'Mobile' emphasises that the device is untethered, which fits the roaming, once imperial British style. *Handy* highlights the importance of functionality, much appreciated in Germany.

Germans are not avid users of cellphones. On average Germans—who are found of saying that 'talk is silver, silence is golden'—spend only 89 minutes each month calling others for *Handy* based conversation. This may be a result of national telephone companies on both sides of the Berlin Wall having exhorted subscribers for years to 'keep it short' because of under-investment in the East and rapid economic growth that overtaxed the network in the West. Germans are also thrifty, for longer calls they resort to much cheaper landlines.

Americans are talkative. Their average monthly talk-time is a whopping 788 minutes, though some of this is a statistical illusion because subscribers also pay for incoming calls. Yet talk is cheaper: there is no roaming charge within the US. Americans are often talking in their cars, an ideal spot for phone call, especially in many states where driving and talking without headsets is still legal.

Most talkative in the world are Puerto Ricans, who have by far the highest monthly average in the world of 1,875 minutes, probably because operators on the American island offer all-you-can-talk plans for only $40, which includes calls to the mainland. This allows Puerto Ricans to chat endlessly with their friends in New York, but may also have arbitrageurs routing cheap international phone calls through the island.

It is not that only the talk-time and names of the mobiles have cultural background, just how people behave when talking on a mobile phone is also a question of culture too. Parisians and Madrilenians, for example, feel free to talk in the street, even in the middle of the pavement. Londoners, by contrast, tend to gather in certain zones to talk. In both London and Paris people tend to separate phone and face-to-face conversations by retreating to a quite corner. But subscribers in Madrid often mix them and even allow others to take part in their phone conversations. The Spanish, most of the times take a call and most turn off voicemail, as they consider it rude to have a call unanswered, even if it is inconvenient. This may be the result of a strong sense of social obligation towards friends and family.

Elsewhere too, culture and history may help determine whether people talk in public or take a call. The Chinese often let themselves be interrupted, fearing that otherwise they would miss a business opportunity. Uzbeks use their mobiles only rarely in public, because the police might be listening. Germans can get aggressive if people disobey the rules, even unwritten ones. In 1999 a German died in a fight triggered by his ill-mannered *Handy* use.

In some countries it is common that people carry more than one handset. Japanese workers often have two: a private one and a work one. Having several phones is often meant to signal importance. Latin American managers like to show how well connected they are: some even have dedicated one for the boss.

Cultural adoption is common in Africa and Asia. In poorer countries, people handle handsets differently as they lack money to use them in the way others do. When designing a phone, cultural orientation is a must.

Ugandans are beneficiaries of handsets in unique ways. There is Farmer's Friend which provides weather forecasts, rice farmers are receiving farming tips, and human experts offer advice on 'Chicken's eyes are bulging' type of complaints. There is also the Google Trader, a text-based system that matches buyers and sellers of agri products and commodities.

Services to help farmers have been most widely adopted in China, where China Mobile offers a service called Nong Xin Tong in conjunction with the agriculture ministry, as a part of its push in rural areas. Mobile phones are also being used in health care. One-way text alerts, sent to everyone in a particular area, is used to raise awareness of HIV. Camera-phones are used to send pictures to remote specialists for diagnosis.

Mobile phones have unique adaptations in India. The country is a huge market for any mobile brand and the rate at which the handsets are penetrating is amazing. Every second Indian has a 'Cell' (in India mobile is known as cell), cutting across all sections of society. More than the professionals, academics, business people and political leaders, it is the college going students, priests, servant maids, vegetable vendors, barbers, plumbers, masions and rickshaw drivers who are more active users of cellphones.

Many have more than one phone, and more numbers an individual has more important the person is. In fact, mobile phone, carry snob value in India, rather than the functional value. Ladies carry handsets in colourful pouches and men usually have small pockets in their shirts to accommodate cells.

Companies provide unique features to meet needs of Indians. Many brands, for example, double up as torches. Nokia has launched a set of services called 'Life tools', which ranges from agricultural information for farmers such as prices, weather data and farming tips. There is also educational service like the language tuition.

Purchase of a cellphone is marked by great fanfare in India. Auspicious day and time are chosen in advance. On the said day and time, the new cell is brought home, kept in pooja room, flowers are spread, coconut is broken and camphor is burnt. Then the set is formally inaugurated.

Mobile technology has made even illiterate Indians use jargons such as sim card, currency, SMS, post-paid, pre-paid, network and the like. Thanks to cellphones, Indians already known for talking loud, have become more talkatactive and more noisy.

(*Source: The Economist*, Oct. 2, 2009 and Jan 2010)

communicative competence, intelligence, level of interest and knowledge of the host-culture, and their ability to empathise with members of the host-culture. A successful manager is one who communicates in the host's language, behaves in an appropriate manner, observing all the local manners and customs, and relates to everyone in a manner that enables the local people to accept him or her as one of them.

Institutional Adaptation An international firm seeks *institutional adaptation* by adopting an appropriate organisational structure and policies to fit into the host-culture. An organisational design in one culture may be totally inappropriate in another. Human resource practices need to be modified to take into account the differences in remuneration, employment, promotion, and training methods. In Islamic countries, for instance, work scheduling would have to allow sufficient time and provide suitable facilities for employees to pray at certain times of the day. Recruitment policies would have to recognise class and ethnic distinctions in order to avoid causing offence to employees and customers from different class and ethnic backgrounds.

CULTURE AND PERFORMANCE

LO 6
Assess culture and performance

Towards the end, we focus on the impact of culture on performance of organisations. The correlation between norms and values and performance of companies was brought out earlier too in different contexts. However, we focus on four factors that reiterate the impact of culture on organisational performance:

- Corporate culture can have a significant impact on a firm's long-term economic performance.
- Corporate culture will probably be an even more important factor in determining the success or failure of firms in the next decade.
- Corporate cultures that inhibit strong long-term financial performance are not rare; they develop easily, even in firms that are full of reasonable and intelligent people.
- Although tough to change, corporate cultures can be made more performance enhancing.

Taylor Cox of the University of Michigan is more specific in bringing out a correlation between culture and organisational performance. Table 6.3 contains the six arguments of Taylor Cox.

The *cost argument* posits that organisations failing to manage multi-cultures tend to pay heavy cost. Employees tend to be uncomfortable on their jobs, spend time and energy discussing issues relating discrimination and harassment. Skilled employees tend to quit their jobs. When employees leave, organisations lose money invested on such employees.

The *resource acquisition* argument says that organisations successful in handling multi-cultures are in a better position to attract employees rich with multi-cultural backgrounds. Organisations flush with multi- cultures tend to be vibrant and innovative.

Table 6.3 Six Arguments for Managing Cultural Diversity

1.	Cost Argument	As organisation become more diverse, the cost of a poor job in integrating workers will increase. Those who handle this well, will thus create cost advantages over those who don't.
2.	Resource-Acquisition Argument	Companies develop reputations on favourability as prospective employers for women and ethnic minorities. Those with the best reputations for managing diversity will win the competition for the best personnel. As the labour pool shrinks and changes composition, this edge will become increasingly important.
3.	Marketing Argument	For multinational organisations, the insight and cultural sensitivity that members with roots in other countries bring to the marketing effort should improve these efforts in important ways. The same rationale applies to marketing to subpopulations within domestic operations.
4.	Creativity Argument	Diversity of perspectives and less emphasis on conformity to norms of the past (which characterise the modern approach to management of diversity) should improve the level of creativity.
5 .	Problem-solving Argument	Heterogeneity in decision and problem solving group potentially produces better decisions through a wide range of perspectives and more thorough critical analysis of issues.
6 .	System Flexibility Argument	An implication of the multicultural model for managing diversity is that the system will become less determinant, less standardised, and therefore more fluid to react to environmental changes (i.e., reactions should be faster and at less cost).

(*Source*: Jamest A.F. Stoner, etal, *Management* P.198)

The *marketing argument* says that organisations that are successful in handling multi-cultures understanding markets better. Markets themselves are diverse. Diverse cultures can understand diverse markets better.

The *creativity* and *problem-solving* arguments maintain that people from diverse cultures tend to be more creative and shall be good at problem solving.

The *system flexibility* argument posits that the ability to manage diversity increases the adaptability and flexibility of an organisation. Such a firm tends to be proactive in responding to changes in both external as well as internal environmental forces.

Summary

- Culture may sound an abstract expression. But it has significant effect on what an individual does and behaves (LO1)
- Levels of culture, dominant and sub-cultures, participative and authoritarian, and the like are the cultural dimensions (LO2)
- Cultural effects may be functional or dysfunctional. On the positive side of culture it may be stated that it regulates behaviours of people. It becoming clannish is the negative side of culture (LO3)
- Language, education, religion, attitudes, customs and manners are the different components of culture (LO4)
- For international business cultural implications include: Competitive advantage, diversity, cross-cultural illiteracy and strategy and culture (LO5)
- Extending beyond its impact on individual behaviours, culture impacts organisational performance also.

Review Questions

1. What is culture? Describe the levels of culture. (LO1 and LO2)
2. Bring out the elements of culture, together with the impact of each of them on business. (LO4)
3. What are the implications of culture for international business? (LO5)
4. What is diversity? How to manage it? What are the benefits of managing diversity? (LO5)

Discussion Questions

1. What are the challenges faced by international manager in managing multiculturalism? (LO5)
2. 'Most MNCs need not enter foreign markets to face the challenges of dealing with multiculturalism.' Yes or No? Argue. (LO5)

Reinforcing Exercises

Max Weber's views on Protestantinism and Hinduism speak about the functional and dysfunctional sides of religion. The German sociologist drew a connection between protestant ethics and "the spirit of capitalism" that has since become famous. Weber observed that capitalism flourished in Western

Europe, where "business leaders and owners of capital, as well as the higher grades of skilled labour, and even more the higher technically and commercially trained personnel of modern enterprises, are over whelming protestant."

Weber's perception of Hinduism is that its ascetic principles such as salvation, enough is enough, life after death and the like go against the spirit of capitalism. This explains the reason why India, being one of the oldest civilised nations, has not bee able to produce many enterprises which have run for more than hundred years.

What is your comment about Weber's views?

- Language can have derailing effect on international transactions. Consider the following: Chrysler Corporation was nearly laughed out of Spain when it translated its U.S. theme that advertised "Dart is power". To the Spanish, the phrase implied that buyers sought but lacked sexual vigour.

The Bacardi Company concocted a fruity bitters with a made-up name, Pavame, suggestive of French chic. Bacardi wanted to sell the drink in Germany, but Pavane is perilously close to *Pavin*, which means "baboon".

A company marketing tomato paste in the Middle East found that in Arabic the phrase "tomato paste" translates as "tomato glue".

Comment on the above.

- Tatas and Starbucks have entered a 50-50 joint venture recently. The two companies offered Indian Expresso Roast, sourced locally through the coffee sourcing and roasting agreement with Tata Coffee. The Indian Expresso Roast will be a hallmark feature of all Starbucks stores in the market and highlights the quality expresso available in India. As part of the agreement, Starbucks and Tata Coffee Ltd., will work for developing and improving the profile of the Indian-grown Arabica Coffee around the world by elevating the status of Indian coffee, as well as improving the quality of coffee through sustainable practices and advanced agronomy solutions.
  Name and illustrate other MNCs which have custemised their products to suit local markets.
- In its recent ad released by Maruti Suzuki reads thus:

  "When two great cultures come together, you can move an entire nation".

  Read the ad carefully and make your own observations.
- Entrepreneurial spirit runs deep in the minds of Indians. They have the knack of discovering ingenious solutions to problems turn an adversity into opportunity. One such story (among several) is narrated by Navi Padjou, Jaideep Prabhu and Simone Ahuja in their book *Jugaad Innovation.*

"Kanak Das is from Assam and like many Indians; he rides his bicycle to work. And the roads he travels are full of potholes and bumps. Those gave him back problems and slowed him down considerably. On introspection, Das struck on a brilliant idea and put it into practice. He retrofitted his bicycle, a shock absorber compresses and releases energy to the near wheel. By converting the energy in the shock absorber into a propulsive force, his bicycle can run faster on bumpy roads".

The spirit of Das and his ilk is called by the authors as *Jugaad culture*, which has come to Indians because of culture.

Make observations on the above.

- If there is any religion in India which has a deep impact on business, it is Parsi. Two aspects, among others are striking. One is the pursuit of excellence. Doing your best work and expecting the same from others yields superior results. This was Jamsetji's mindset as he worked to build his companies and his country. While hiring managers or other key personnel, he invariably searched for the best, most talented he could find and paid them well. He even went overseas in search of talent.

Second is the belief of Parsis that creating organisations whose ultimate purpose is to fight poverty and sickness is the god's work. Jamsetji set out to start and then to grow profitable enterprises capable of generating revenues that could be invested in helping hapless people.

As of now, two-thirds of Tata is owned by philanthropic trusts. Tata is one of the biggest charities in the world.

Can you draw parallels any where?

CLOSING CASE

Seventh Heaven

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

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

The Pickney affair with India started in late 1997, when Amway sent them for a typical look-see, to decide whether they could contemplate living here for some two-odd years. They spent a week in Delhi just 'getting a feel for living in the capital city'.

"Before I came here, I had heard a lot of stories, and none of them were good." What didn't help matters was the number of vaccinations he had to take before coming to India; "I had never had as many shots in my life before," says the only expat on the rolls of the Rs. 600-crore Indian operations of Amway.

Cleanliness and health were two issues the Pickneys were concerned about. But, to their immense relief, it turned out to be far better. "We have not taken any malaria pills in the last five years."

People were the first thing Pickney noticed on his arrival in India. "In Sydney, you don't find people on the roads just outside the city. Here, they are everywhere." What's impressed him most about Indians is the level of education, dedication and commitment, which he says is 'the best and the highest in the world'.

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

Another interesting observation he made was regarding performance appraisal. "People here equate hard work with high performance. Just because you spent as many hours, it does not make you a high achiever."

Pickney himself works almost every Saturday, if he is in town, and dislikes taking work home to his lovely house in the plush Sainik Farms locality in the outskirts of Delhi. While both husband and wife tend to stay in more, dining out with friends is one of the few entertainment options available in India. He has got more Indian friends than expats, mostly people he met through business, like Kanwar Bhutani of Tupperware.

Both, however, try to find time to play golf at the ITC Golf Course in Gurgaon. It's a game Mrs. Pickney took up in India, since she found free time on her hands for the first time in her life. A certified chartered accountant, Mrs. Pickney used to run her own business in Australia. Some of that time has been used to learn to cook typical Indian fare, butter chicken, aloo palak.

rogan josh and dal makhani.

It's no wonder then that half their meals are Indian. They've adjusted to the spice factor in Indian food. What was hot when they first came is nothing compared to hot today. "When we travel abroad, we really miss the spice."

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

"Family ties are much stronger here, as is respect for elders and their wisdom. For instance, girls in our office who talk and dress in a Western way, have no problems accepting arranged marriages," says Pickney, whose daughter is getting married in Australia in November this year. Papa Pickney is planning to throw an Indian reception after the Australian wedding, including traditional attire for the bride and the groom.

"Yet another occasion to break a coconut, Mr. Pickney?" we wonder.

Questions

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

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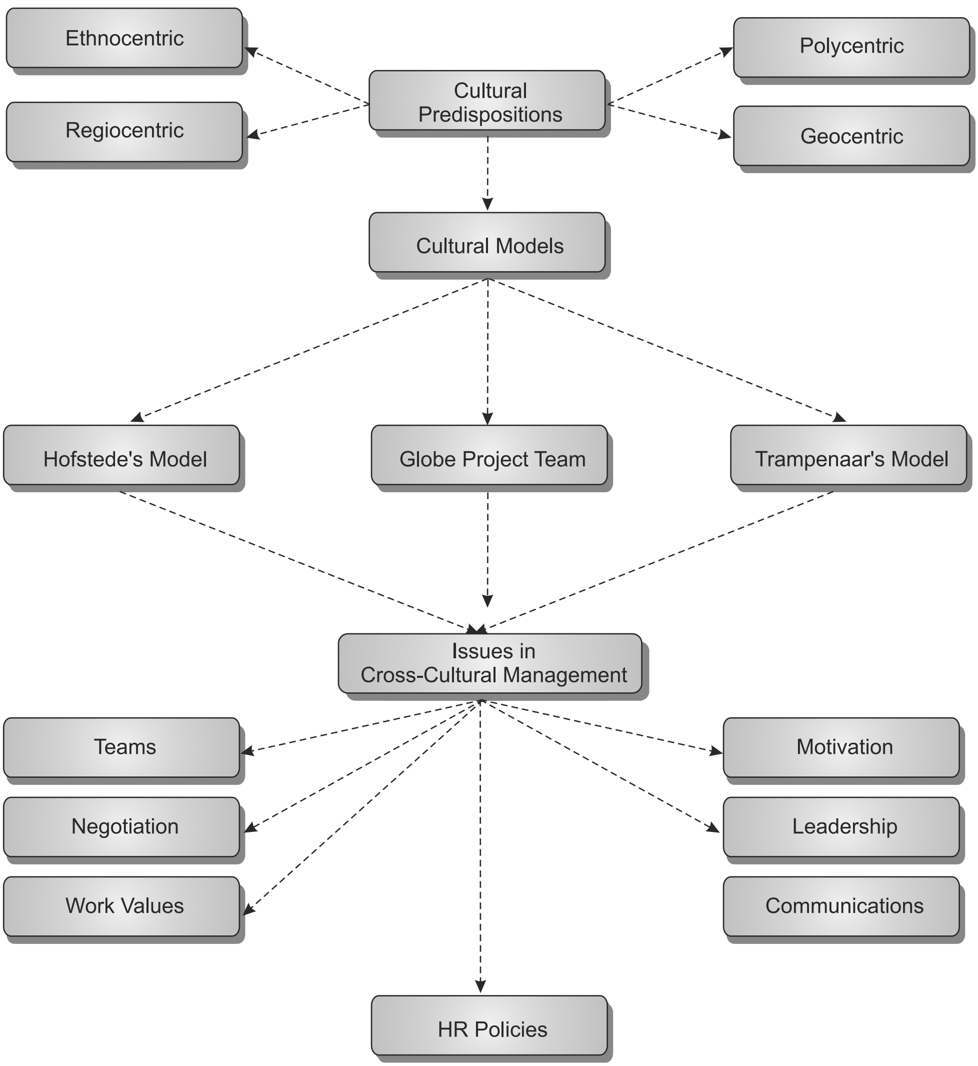
CHAPTER


Ethnocentric
Polycentric
Cultural Predispositions
Regiocentric
Geocentric
Cultural Models
Hofstede's Model
Globe Project Team
Trampenaar's Model
Issues in Cross-Cultural Management
Teams
Motivation
Negotiation
Leadership
Work Values
Communications
HR Policies

7

Managing Across Cultures

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Identify the need for greater awareness of multi-cultures
- **LO 2:** Analyse and evaluate different cultural predispositions
- **LO 3:** Subdivide different cultural models
- **LO 4:** Relate and evaluate the issues in cross-cultural management

Opening Case

Missed Sensitivities

An US fertilizer manufacturer headquartered in Minneapolis decided to venture into the vast potential of third-world markets. The company sent a team of agricultural researchers into an East African country to test soils, weather and topographical conditions in order to develop locally effective fertilizers. Once the research and manufacturing of these fertilizer products had been completed, one of the initial marketing strategies was to distribute free of charge, 100-pound bags of the fertilizer to selected areas of rural farmers. It was thought that those using the free fertilizer would be so impressed with the dramatic increase in crop productivity that they would spread the word to their friends, relatives and neighbours.

Teams of salespeople went from hut to hut in those designated areas, offering each male head of household a free bag of fertilizer along with an explanation of its capacity to increase crop output. Although each head of household was very polite, they all turned down the offer of free fertilizer. The marketing staff concluded that these local people were either uninterested in helping themselves grow more food and eat better, or so ignorant that they couldn't understand the benefits of the new product.

In the previous chapter, we had examined the nature of culture. We propose to discuss in detail the cultural dimensions of international business in this and in the next chapter.

NEED FOR GREATER AWARENESS OF MULTICULTURES

LO 1
Identify the need for greater awareness of multi-cultures

When an oranisation internationalises itself, it needs to globalise its culture too. In other words, the manager of an international business should imbibe multiculturalism. How fast and how well the international manager can understand and adapt to the local culture determines his or her success in a host country.

All segments of international business are impacted by culture. Strategy formulation and implementation, accounting, human resources management, marketing, organisational behaviour processes, and management of supply chain, greenfield investment or acquisition and the like are subject to cultural impact. Culture also plays a key role in international alliances and mergers.

Often erroneous assumptions are made about culture resulting in avoidable consequences. The international manager believes that what has succeeded in home country will equally work in host country's cultures.

There are many instances to demonstrate the fact that cultural insensitivity leads to disastrous consequence. To illustrate, an airline service to Brazil advertised that it had comfortable 'rendezvous lounges' in its business-class section. Unfortunately, it failed to realise that the word rendezvous in Portuguese refers to room for illicit sexual encounters.

Insensitivity to the cultural realities of foreign workforces can lead to unpleasant results. An American businessman rewarded the most outstanding member of a Japanese marketing team by promoting him to head the group. Rather than being proud and grateful, however, the top performer seemed ashamed, and the others in the group were uncomfortable and demoralised. Contrary to what the American businessman had anticipated, performance in the group quickly deteriorated. What the American had not realised was that Japanese feel most comfortable working in teams, with all sharing equally in decisions, work loads and responsibility for outcomes.

CULTURAL PREDISPOSITIONS

LO 2
Analyse and evaluate different cultural predispositions

Most international businesses tend to have predispositions while managing multicultures. These orientations make MNCs adopt specific steps in managing cross-cultures. Four orientations have been identified: ethnocentricism, polycentricism, regiocentricism and geocentricism (See Fig. 7.1)

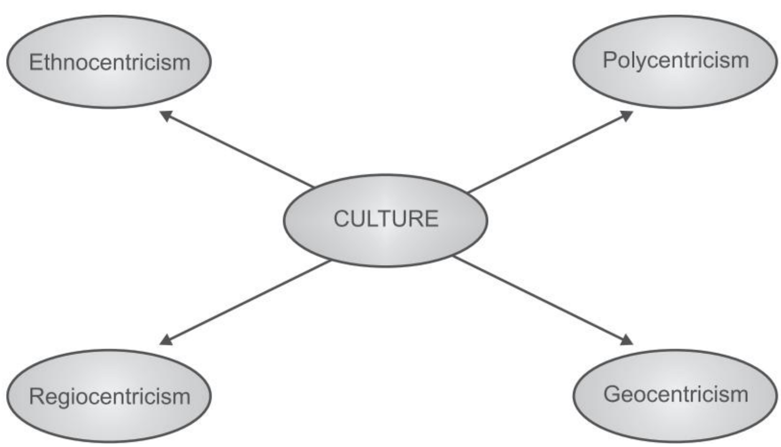


Fig. 7.1 Cultural Predispositions

Ethnocentricism Ethnocentricism is the tendency of people to evaluate a foreigner's behaviour by the standards of their own culture, and to believe that their own culture is superior to all others (See the opening Vignette). Because our own culture is usually the only one we learn, we take our culture for granted, assuming that our behaviour is correct and all others are wrong, or atleast very strange. Ethnocentricism is a strong obstacle to promoting multiculturalism and without being an exception, every culture is ethnocentric to a lesser or larger extent.

A fundamental assumption of ethnocentric people is that their way of doing things is right, proper and normal, and that of other cultures is wrong and inferior. Such a blanket condemnation of cultural differences prevents us from seeing that other people view our customs as equally strange and irrational. For example, people in the US think of themselves as being particularly conscious of cleanliness. They tend to criticise hygiene practices of others. Little do they understand that there are societies that are critical of the hygiene practices of the Americans. East Africans, for example, think that Americans have no sense of hygiene because they defecate in rooms (the bathroom) that are frequently located adjacent to that part of the house where food is prepared (the Kitchen).

Besides being an obstacle to true multiculturalism, ethnocentricism can contribute to prejudice, contempt for outsiders and intergroup conflict. On the functional side, ethnocentricism enhances group solidarity by legitimising existing cultural groups.

As stated earlier, ethnocentricism prevails in all societies. What is to be realised is that ethnocentric orientation should not blind the international manager from accepting good things in other cultures. It is vital for him or her to refrain from comparing his or her way of life with those of the international business partners. Each individual should be understood with an open mind in the context of his or her unique historical, social and cultural backgrounds.

Ethnocentricism can be seen in MNCs. Ethnocentric MNCs are home-country centered. Strategic decisions in these companies are made at headquarters and passed on to subsidiaries. Key positions at both domestic and foreign operations are held by home office personnel, and subsidiaries are managed by expatriates from the parent country. Profits earned at the subsidiaries tend to be repatriated to headquarters.

Polycentricism If ethnocentricism exhibits intolerance to other cultures, polycentricism advocates tolerance to beliefs and values of other societies. If locals are hired to head strategic positions in subsidiaries, if a management policy is originated to suit local needs, or if a product is customised to meet local tastes, it is polycentricism in practice.

Polycentricism is more pronounced in the context of human resource practices. In polycentric staffing, operations outside the home country are managed by individuals from the host country. Firms can implement a polycentric approach for top and middle level managers, for lower-level staff or for non-managerial workers. In other HR policies relating to appraisals and promotions too local needs outweigh other considerations.

Polycentric approach does not bestow absolute freedom to subsidiary heads to run their business as stand-alone units. MNCs usually conduct extensive training programmes in which host-country managers visit home offices for extended periods. They are trained in the company's culture and are taught how to protect nuances of corporate culture, respecting, of course, the host country's beliefs and values.

As with ethnocentric approach, polycentric orientation carries with it certain merits and gets dented because of some drawbacks. Talking about the advantages, it may be stated that polycentric approach seeks to eliminate the high cost of relocating expatriate managers and families. Second, this approach offers a degree of autonomy in decision making to subsidiary heads. Subsidiary heads are in a better position to adapt to local needs and tastes. Third, since host country citizens are used, training costs may not be high. Fourth, host country nationals are less expensive than deputing home country citizens as expatriates to work in subsidiaries.

The major drawback of polycentric approach is the tendency to lose control over subsidiaries. Subsidiaries tend to become stand-alone companies. Another limitation is that home country managers may lose the benefit of gaining exposure to overseas markets.

Regiocentricism

Regiocentric approach operates in the same way as polycentricism. But they differ in that polycentric company adapts IHRM practices to countries and the geocentric to regions. Regiocentricism has similar features, advantages and limitations like the polycentric orientation.

The formation of regional trading blocks has increased the popularity of regional headquarters (e.g., for NAFTA and the European Union). Region-wide products and brands become feasible. Manufacturing, marketing and other scale economies take advantage of regional commodities in demand. Planning is done regionally through country level strategic priorities that emphasise national responsiveness.

Geocentricism

In geocentric orientation, subsidiary operations are managed by the best qualified individuals, regardless of their nationality. Subsidiaries may choose managers from the host country, from the home country or from a third country. The only criterion for selection is the merit of the applicant. The capable managers adapt easily and well to different cultures and are usually bilingual or multilingual.

Among the advantages of geocentricism is that the company becomes truly cosmopolitan. Second, global managers are able to adjust to any business environment, particularly to cultural differences. The major drawback of geocentricism is the additional costs incurred on training and relocation of expat managers. Compensation of expatriates is higher than for host country employees.

Table 7.1 brings out the salient features of the four predispositions more clearly.

Table 7.1 Cultural Predispositions

	Ethnocentric	*Polycentric*	*Regiocentric*	*Geocentric*
Strategy	Global integration	National	Regional integration and national responsiveness	Global integration and national responsiveness
Culture	Home country	Host country	Regional	Global
Decision-making	Headquarters	Subsidiary	Regional Headquarters	Subsidiaries around the world in collaboration with headquarters
State of internatio-nalisation	Early	Middle	Middle	Late
HRM Strategy	Top positions in subsidiary are occupied by home country nationals	Locals occupy key positions	Regional people occupy key positions	Best people anywhere in the world are hired to occupy key positions
Finance	Profits repatriated to home country	Profits retained with subsidiary	Profits redistributed within the region	Profits redistributed globally
Complexity of organisation	Complex in home country, simple in subsidiaries	Varied and independent	Independent on a regional basis	Highly complex and highly interdependent on a global basis

CULTURAL MODELS

LO 3
Subdivide different cultural models

We propose to discuss three cultural models: Globe Project Team, Hofstede's model and Trompenaars' 7d cultural dimensions model. Understanding of these models equips international managers with the basic tools necessary to analyse the cultures in which they do business. The three approaches also provide useful theoretical concepts to help understand the nuances of different cultures better.

Globe Project Team

The GLOBE (Global Leadership and Organisational Behaviour Effectiveness) project team comprises 170 researchers who have collected data, over seven years, on cultural values and practices and leadership attributes, from 17,000 managers in 62 countries, covering as many as 825 organisations. The research team identified nine cultural dimensions that distinguish one society from another and have important managerial implications: assertiveness, future orientation, performance orientation, human orientation, gender differentiation, uncertainty avoidance, power distance, collectivism/societal, and in-group collectivism.

Assertiveness This aspect is defined as the degree to which individuals, in organisations or societies, are expected to be tough, confrontational and competitive as against modest and tender.

Future Orientation This dimension refers to the level of importance a society attaches to future-oriented behaviours, such as planning and investing in the future, and delaying immediate gratification.

Performance Orientation This measures the performance and excellence in society and whether people are encouraged to strive for continued improvement and excellence.

Human Orientation Human orientation is the means to understand the degree to which individuals in organisations or societies encourage and reward people for being altruistic, generous, caring and kind to others.

Gender Differentiation This is an understanding of the extent to which an organisation or society resorts to role differentiation and gender discrimination.

In-group Collectivism This refers to the degree to which individuals express pride, loyalty and cohesiveness in their organisations or families.

Collectivism/Societal This refers to the degree to which organisational and societal practices encourage and reward collective distribution of resources and collective action.

Power Distance This refers to the degree to which organisational members or citizens of a society expect and agree that power should be unequally distributed.

Uncertainty Avoidance This refers to the extent to which members of an organisation or society strive to avoid uncertainty by relying on social norms, rituals and bureaucratic practices, to minimise the unpredictability of future happenings.

Table 7.2 contains GLOBE's ranking of countries on the nine variables.

Obviously, GLOBE's ranking is highly helpful to international managers who are seeking to be successful in cross-cultural settings. Anticipating cultural similarities and differences allows multicultural managers to develop the behaviours and skills necessary to act and decide in a manner appropriate to the host country's norms and expectations.

GLOBE Project is also discussed in the section on leadership across cultures.

Table 7.2 GLOBE Cultural Variable Results

Variables	*High Ranking*	*Medium Ranking*	*Lowest Ranking*
Assertiveness	Spain, US	Egypt, Ireland	Sweden, New Zealand
Future Orientation	Denmark, Canada	Slovenia, Egypt	Russia, Argentina
Performance Orientation	US, Taiwan	Sweden, Israel	Russia, Argentina
Human Orientation	Indonesia, Egypt	Hong Kong, Sweden	Germany, Spain
Gender Differentiation	S. Korea, Egypt	Italy, Brazil	Sweden, Denmark
Collectivism/Societal	Denmark, Singapore	Hong Kong, US	Greece, Hungary
Power Distance	Russia, Spain	England, France	Denmark, Netherlands
Uncertainty Avoidance	Austria, Denmark	Israel, US	Russia, Hungary
In-group Collectivism	Egypt, China	England, France	Denmark, Netherlands

Hofstede's Cultural Dimensions

In the discussion on multicultures, reference should be made to the pioneering work of Dutch scientist, Geert Hofstede. He identified four cultural dimensions around which countries have been clustered, with people in each group exhibiting identical behaviours. The four dimensions are: power distance, uncertainty avoidance, individualism and masculinity (see Fig 7.2).

The more recent fifth dimension of time orientation is not well known, but it was added to help describe the long versus short-term orientation of cultures. The East Asian countries were found to have long-term orientations while the US and the UK were found to have relatively short-term orientations. While such time orientations are important to our understanding of culture, the original four dimensions have received the most attention and have been elaborated here.

Hofstede's study preceded the GLOBE Research Project. But we have taken the GLOBE study first because of its comprehensiveness and wide spread research base. If Hofstede focussed on the employees of only IBM, GLOBE study covered as many as 825 organisations selected from the financial, food

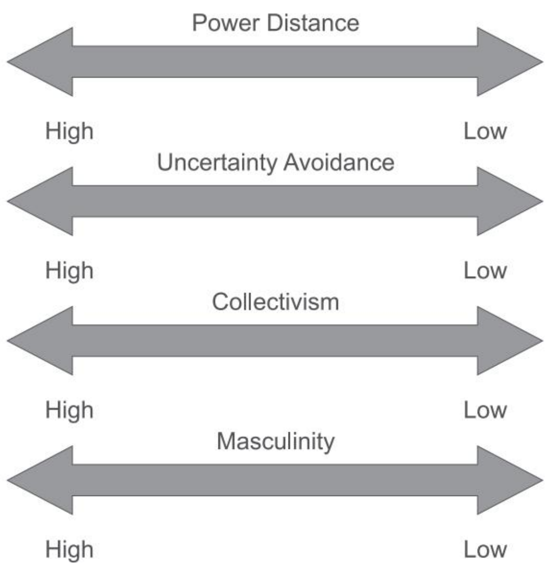


Fig. 7.2 Hofstede's Cultural Dimensions

processing and telecommunications industries. However, the usefulness of Hofstede's study cannot be undermined.

Power Distance (PD) Power distance is the extent to which the less powerful members of institutions and organisations accept that power is distributed unequally. Countries in which people blindly obey the orders of superiors have high power distance.

High PD countries have norms, values and beliefs, such as:

- inequality is fundamentally good,
- every one has a place; some are high, some are low,
- most people should be dependent on a leader,
- the powerful are entitled to privileges, and
- the powerful should not hide their power.

The dimension of power distance can be measured in a number of ways. For example, the basic motivational assumption in high power distance countries is that people dislike work and try to avoid it. Consequently, managers believe that they must adopt Theory X leadership style, that is, they must be authoritarian, must force workers to perform, and must supervise their subordinates closely.

Organisational structures and systems tend to match the assumptions regarding leadership and motivation. In high PD countries, decision making is centralised. Those at the top make most of the decisions. Organisations tend to have tall structures. They will have a large proportion of supervisory personnel, and the people at the lower levels will often have low job qualifications. Such structures encourage and promote inequality among people at different levels. On the other hand, organisations in low PD countries tend to be decentralised and have flatter structures. They will have a smaller proportion of supervisory personnel and the lower level of workforce will be highly qualified.

Fig 7.3 contains country and organisational examples.

Low PD Countries Austria, Israel, Denmark, Sweden, Norway	India, Philippines, Mexico, Venezuela, Brazil *High PD Countries*
Low centralisation	High centralisation
Flat structures	Tall structures
Small wage differentials	Large wage differentials
Leadership less directive-more participative	Crafted to support the power elite or government
Varied strategy issues	Work disliked, coercive motivation
Performance-linked promotions	Compliance and trust worthiness based promotions
Work is a powerful motivator	More supervisory personnel
Fewer supervisory personnel	Authoritarian leadership
Structures in which manual and clerical works are equally valued	Structures in which white-collar jobs are valued more than blue-collar jobs.

Fig 7.3 Power Distance Countries and Organisational Examples

Uncertainty Avoidance Uncertainty avoidance (UA) is the extent to which people feel threatened by ambiguous situations, and create beliefs and institutions that try to avoid them. Some countries have high uncertainty avoidance while some are characterised by low uncertainty avoidance.

Countries with citizens who do not like uncertainty tend to have a high need for security, and a strong belief in experts and their knowledge. Countries with low UA have people who are more willing to accept that risks are associated with the unknown, and that life must go on inspite of this.

Specifically, high UA countries are characterised by norms, values and beliefs which accept that:

- conflict should be avoided,

- deviant people and ideas should not be tolerated,
- laws are very important and should be followed,
- experts and authorities are usually correct, and
- consensus is important.

Low UA societies tend to represent the opposite of the above characteristics.

The effect of uncertainty avoidance has several manifestations. Countries with high UA cultures have high structuring of organisational activities, more written rules, less risk-taking by managers, low labour turnover and less ambitious employees.

Low UA societies have organisation settings with less structuring of activities, fewer written rules, more risk-taking by managers, higher labour turnover and more ambitious employees. The organisation encourages employees to use their initiative and assume responsibility for their actions (see Fig. 7.4).

Low UA Countries Denmark, Sweden, UK, US, India			Greece, Portugal, Japan, Peru, France *High UA Countries*
	Less structuring of activities	More structuring of activities	
	Fewer written rules	More written rules	
	More generalists	More specialists	
	Variability	Standardisation	
	Greater willingness to take risks	Risk aversive	
	Less ritualistic behaviour	More ritualistic behaviour	
	Performance-linked promotion	Seniority based promotion	
	Non-directive flexible leadership	Task-oriented leadership	

Fig. 7.4 Uncertainty Avoidance Countries and Organisational Practices

Figure 7.5 shows categorisation of countries based on their PD and UA scores. While PD is manifested in behavioural traits such as respect for elders, corruption, polarisation and violence in national politics, UA is manifested by religiosity, xenophobia, identity, obligation and fast driving.

SMALL POWER DISTANCE, WEAK UNCERTAINTY AVOIDANCE NORDIC COUNTRIES, ANGLO COUNTRIES, USA, NETHERLANDS	**LARGE POWER DISTANCE, WEAK UNCERTAINTY AVOIDANCE** CHINA, HONG KONG, SINGAPORE, INDIA, BANGLADESH, INDONESIA, MALAYSIA
SMALL POWER DISTANCE, STRONG UNCERTAINTY AVOIDANCE GERMAN SPEAKING COUNTRIES, HUNGAY, ISRAEL	**LARGE POWER DISTANCE, STRONG UNCERTAINTY AVOIDANCE** TAIWAN, THAILAND, PAKISTAN, LATIN COUNTRIES, E. EUROPE, JAPAN, KOREA

Fig. 7.5 Country Classification

Individualism/Collectivism (IC) Individualism is the tendency of people to look after themselves and their family only. Opposite of this is collectivism which refers to the tendency of people to belong to groups and to look after each other in exchange for loyalty.

Specifically, countries high on individualism have norms, values and beliefs which accept that:

- people are responsible for themselves,

- individual achievement is ideal, and
- people need not be emotionally dependent on organisations or groups.

In contrast, collectivist countries believe that:

- one's identity is based on one's group membership,
- group decision making is best, and
- groups protect individuals in exchange for their loyalty to the group.

The effects of individualism/collectivism can be seen in organisations also. Organisations in collectivist societies tend to promote nepotism in selecting managers. In contrast, in individualistic societies, favouritism shown to friends and relatives is considered to be unfair and even illegal. Further, organisations in collectivist cultures base promotions mostly on seniority and age, whereas in individualist societies, they are based on one's performance. Finally, in collectivist cultures, important decisions are made by older senior managers as opposed to individualist cultures, where decision making is an individual responsibility (see Fig. 7.6).

Low Individualism Countries Venezuela, Colombia, Taiwan, Mexico, Greece	US, Australia, UK, Canada, Netherlands *High Individualism Countries*
Organisation as 'family'	Organisation is more impersonal
Organisation defends employee interests	Employees defend their own interests
'We' attitude	'I' attitude
Promotion with group seniority 'based'	Promotion linked to individual performance
Leader appeals to duty and commitment	Leader rewards or punishes based on individual performance
Group decision-making, preference organisations	Individual decision-making, preference for large for small organisations

Fig 7.6 Individualism/Collectivism Countries Organisational Practices

Masculinity/Feminity (MF) Masculinity refers to a situation in which the dominant values in society are success, money and other material things. Hofstede measured this dimension on a continuum, ranging from masculinity to femininity.

High masculine cultures have norms, values, and beliefs that:

- gender roles should be clearly distinguished,
- men are assertive and dominant,
- machismo or exaggerated maleness is good,
- people, especially men, should be decisive,
- work takes priority over other duties, such as family, and
- advancement, success and money are important.

In highly masculine societies, jobs are clearly defined by gender. There are men's jobs and women's jobs. Men usually choose jobs that are associated with long-term careers. Women usually choose jobs that are associated with short-term employment, before marriage.

Figure 7.7 is a categorisation of countries based on their individualism and masculinity scores. While individualism is manifested in GNP per capita, faster walking, weak family ties, and frequency of using the word 'I', masculinity is seen as assertiveness, performance versus solidarity, fewer women elected and homophobia. (see also Fig. 7.8)

Criticisms Hofstede's cultural dimensions have been criticised on six counts. First, as we stated

COLLECTIVIST, FEMININE THAILAND, KOREA, VIETNAM, INDONESIA, MALAYSIA, SINGAPORE, COSTA RICA, CHILE, PORTUGAL, RUSSIA	**COLLECTIVIST, MASCULINE** HONG KONG, CHINA, JAPAN, PHILIPPINES, INDIA, BANGLADESH, MEXICO, VENEZUELA, GREECE, ARAB WORLD
INDIVIDUALIST, FEMININE SPAIN, FRANCE, NETHERLANDS, NORDIC COUNTRIES	**INDIVIDUALIST, MASCULINE** CZECHOSLOVAKIA, HUNGARY, POLAND, ITALY, GERMAN SPEAKING COUNTRIES, ANGLO COUNTRIES, USA

Fig. 7.7 Country Classification

Low Masculinity Countries Sweden, Denmark, Thailand, Finland, Yugoslavia		*High Masculinity Countries* Japan, Austria, Venezuela, Italy, Mexico
Sex roles are minimised	Sex roles are clearly differentiated	
Organisations do not interfere with people's private lives	Organisations may interfere to protect people's interests	
More women in qualified jobs	Fewer women in qualified jobs	
Soft, intutive skills are rewarded	Aggression, competition and justice are rewarded	
Social rewards are valued	Work is valued as a central life interest	
Leadership style more participative	Leadership is authoritarian	
Smaller organisations prefered	Larger organisations prefered	

Fig. 7.8 Masculinity/Feminity Country Examples and Organisational Practices

earlier, Hofstede's observations were made based on the responses from employees of only IBM. The Dutch scientist interviewed an awesome 100,000 IBM employees for his study. But, findings based on responses from only one company have been the major drawback. IBM employees may not fully represent the cultural nuances of people in different countries.

Second, findings of Hofstede are quite outdated. It may be recalled that he conducted the study between 1967 and 1973 and the data were analysed in the late 1970s. Much water would have flown by now in the rivers of countries studied by Hofstede. A smilar study conducted during contemporary period might give different results.

Third, several scholars have argued that Hofstede's cultural dimensions, at best, reflect cultures of business, but not values of life in general. Fourth, it is argued that Hofstede's dimensions do not cover the entire spectrum of the cultural phenomenon. Fifth, Hofstede's coverage of countries is partial geography of the world, missing other dimensions underlying culture. Finally, the meanings of items used in Hofstede's instrument seem to carry cultural bias towards the Western countries.

Trompenaars' 7d Model

Trompenaars, an European researcher, conducted an extensive research with 15,000 managers from 28 countries, representing 47 national cultures. He describes cultural differences using seven dimensions (the theory is therefore called 7d cultural dimensions model): (i) universalism versus particularism, (ii) individualism versus collectivism, (iii) specific versus diffuse, (iv) neutral versus affective,

CULTURAL DIMENSION	CRITICAL QUESTION
Relationships with People:	
Universalism vs. Particularism	Do we consider rules or relationships more important?
Individualism vs. Collectivism	Do we act mostly as individuals or as groups?
Specific vs. Diffuse	How extensively are we involved with the lives of other people?
Neutral vs. Affective	Are we free to express our emotions or are we restrained?
Achievement vs. Ascription	Do we achieve status through accomplishment, or is it part of our situation in life (e.g., gender, age, social class)?
Perspective on Time:	
Sequential vs. Synchronic	Do we do tasks in sequence or several tasks at once?
Relationship with the Environment:	
Internal vs. External Control	Do we control the environment or does it control us?

Fig. 7.9 The 7d Cultural Dimensions Model

(v) achievement versus ascription, (vi) past versus present, and (vii) internal versus external control (See Fig.7.9). The first five dimensions deal with how people relate to each other. The two final dimensions deal with how a culture manages time, and how it deals with nature. Each dimension is a continuum or a range of cultural differences.

Universalism versus Particularism (UP) In cultures with universalistic orientation, people believe in abstract principles such as the rules of law, religion or cultural principles. The basic premise is that these principles can be applied everywhere without modification. UK, USA and Czech represent universalistic culture. Particularism, on the other hand, is the belief that circumstances dictate how ideas and practices should be applied. South Korea, Mexico and Nigeria follow particularistic culture. In universalistic culture, the focus is more on formal rules than on relationships, business contracts are adhered to very closely, and people believe that a 'deal is a deal.' In a particularistic culture, legal contracts are often modified, and the way deals are executed also changes, depending on the situations. In particularistic culture too, there exist rules, but people expect exceptions to be made for friends, family relations and others. Managerial practices under universalistic cultures include formalisation of business practices, treating all cases similarly and announcing any change publicly. Particularism entails such managerial practices as the use of informal norms, and introducing changes in a subtle way (see also Fig.7.10).

	UNIVERSALISM	PARTICULARISM
Countries following the cultural dimension	USA UK Czech Republic	Nigeria Mexico South Korea
Orientations	Rule bound Contracts upheld	Relationship bound Contracts are subject to modification
	Business deals are sacrosanct	Business deals are flexible to the situation and the person

Fig. 7.10 Universalism versus Particularism

Individualism versus Collectivism (IC) This dimension is almost identical to Hofstede's value dimension. In individualistic societies, the focus is on 'I' or 'me' and the orientation is on one's own growth. In collectivist societies the focus is on groups including family, organisation and community. Responsibility, achievement and rewards are group-based. In individualistic societies, people are trained from childhood to be independent, and each person assumes individual responsibility for success or failure. Figure 7.11 brings out the facets of individualism and collectivism into sharp focus.

	INDIVIDUALISM	COLLECTIVISM
Countries following the cultural dimension	Czech Republic UK	Nigeria Egypt Japan
Orientations	Focus on 'me' or 'I' Individual decision making Individual responsibility Individual achievement	Focus on 'We' Group decision making Group achievement Group responsibility

Fig. 7.11 Individualism versus Collectivism

Neutral versus Affective (NA) In this dimension, Trompenaars focuses on the appropriateness of expressing emotions in different cultures. In neutral cultures, the tendency of the people is to control one's emotion so that it will not interfere with judgement. In contrast, affective cultures encourage expression of emotions. Expressions of anger, laughter, gesturing and a range of emotional outbursts are considered normal and acceptable. But in neutral societies, emotions are considered to be messy interferences in achieving objectives. Achieving objectives is more important than emotional nature of the interaction (See also Fig. 7.12).

	NEUTRAL	AFFECTIVE
Countries following the Cultural Dimension	Sweden Czech Republic UK	Norway Mexico China
Orientations	Focus is on task and not on expressing emotions Control over emotions admired Physical contacts avoided	Expressions of emotions in any situation is accepted Gesturing and touching are common

Fig. 7.12 Neutral versus Affective

Sweden, Czech Republic and UK seem to practise cultural practices which are neutral. Affective culture is being practised in Norway, Mexico and China. Neutral countries keep dialogue to the point. But affective countries expect strong commitment and tolerate emotional outbursts.

Specific versus Diffuse (SD) This cultural dimension focuses on how a culture emphasizes notions of privacy and access to privacy. In specific cultures, individuals have large public spaces and relatively small private ones. While the public space is open, private is guarded carefully and shared with only close friends and associates. A diffuse culture does not allow any distinction between public and private spaces. In diffuse cultures, an executive's office and home are not divided as clearly as they are in specific cultures, and work relationships often extend into personal relationships (see also Fig. 7.13).

	SPECIFIC	DIFFUSE
Countries following the Cultural Dimension	Sweden Czech Republic UK	Norway Mexico China
Orientations	Business is separated from other parts of life	Business is mixed up with personal life
	Precision in communication	Vague communication
	Principled moral reasoning	Situation based moral

Fig. 7.13 Specific versus Diffuse

Cultures of Sweden, Czech Republic and UK are specific whereas those of Norway, Mexico and China are diffuse. Culture specific countries use objectives and standards, and give clean and precise directions. But diffuse cultures mix private and business lives.

Achievement versus Ascription (AA) This dimension describes the methods used to acquire status. In achievement culture, an individual is accorded status based on how well he/she performs his/her functions. Status depends on achievement. An ascription culture is one in which status is attributed based on who or what a person is, his or her age, gender or social connections. Achievement is not the criterion to accord status. Figure 7.14 gives a brief description of the features and managerial implications of achievement versus ascription dimension.

	ACHIEVEMENT	ASCRIPTION
Countries following the Cultural Dimension	Norway Ireland Austria	Japan Hong Kong Argentina
Orientations	Status depends on performance and accomplishment	Status depends on one's pedigree
	Titles are used when relevant Mixture of age and gender in management	Titles are invariably used Background and age main qualification for management

Fig. 7.14 Achievement vs Ascription

Achievement and ascription cultures have their own followers. Norway, Ireland and Austria practise achievement oriented cultures, whereas ascription followers include Japan, Hong Kong and Argentina. These countries believe in seniority and respecting chain of command. Achievement cultures, on the other hand, emphasise merit and competence.

Time Dimension Time orientation has two dimensions. The first dimension of Trompenaars' is similar to Hofstede's: there are different emphases on the past, present and future. The second refers to sequential versus synchronic culture. This dimension is unique to Trompenaars. In sequential culture, time is viewed as linear and is divided into segments that can then be divided and scheduled. The followers of sequential culture tend to do only one activity at a time, keep appointments strictly, and show a strong preference for following plans as they are laid out, and not deviating from them. US, Mexico and France tend to follow sequential cultures. In synchronic cultures, such as Portugal and Egypt, time is viewed as circular and indivisible, and relationships are more important than schedules. Activities are not scheduled with definite starting or ending times, and individuals move from event to event, notwithstanding whether an event is completed or not (See Fig. 7.15).

	PAST	FUTURE
Countries following the Cultural Dimension	Hong Kong Israel	Korea Hong Kong
Orientations	Stability is respected Past guides every action, any change is looked at with suspicion Strategic planning has no relevance	Strategic planning is important Change is considered necessary and beneficial Assumption that individuals can influence future Hard work now shall lead to future success

Fig. 7.15 Past versus Future

Internal versus External Control (I/E) The final cultural dimension of Trompenaars relates to one's locus of control, a belief one entertains that he or she is the master of his or her own destiny. Where individuals (read managers) believe that they have control over outcomes, they are said to be followers of internal locus of control. Instead, if they believe that they have no control over the outcomes, such people (managers) deem to follow the tenets of external locus of control. Believing in outcomes is, according to Trompenaars, dealing with environment. Poland and Greece are two countries whose citizens possess strong internal locus of control, whereas, Ethiopians and Chinese are said to be externals. Internals emphasise authority and tend to dominate subordinates. But externals tend to exhibit patience and prefer win-win relationships (See Fig.7.16).

	INTERNAL CONTROL	EXTERNAL CONTROL
Countries following the Cultural Dimension	Poland Brazil Greece	Ethiopia China Greece
Orientations	Managers tend to be proactive Dominate the nature Focus on self or own group	Emphasis on compromises Harmony and adjustment is good Adaptation to cycles Managers tend to be fatalistic

Fig. 7.16 Internal Control versus External Control

(*Source*: Figures 7.9 to 7.16 are adapted from John B. Cullen's *Multinational Management*)

ISSUES IN MANAGING CROSS-CULTURAL MANAGEMENT

LO 4
Relate and evaluate the issues in cross-cultural management

Managing multiculturalism, or cross-cultural management, is of considerable significance as it offers the following potential benefits:

- increasing creativity and innovation,
- demonstrating more sensitivity in dealing with foreign customers,
- hiring the best talent from anywhere,
- demonstrating a global perspective,
- creating a 'superorganisational culture', using the best of all cultures,
- greater flexibility within the organisation, both to adapt to a wider range of environments, and to change within these environments.
- evolve universally acceptable HR policies and practices.

The international manager needs cross-cultural competence to manage multiculturalism. Cross-cultural competence includes skills, awareness and knowledge.

In order to be culturally competent, an individual needs to:

1. possess a strong personal identity,
2. have knowledge of and felicity with the beliefs and values of the culture,
3. display sensitivity to the effective processes of the culture,
4. communicate clearly in the language of the given cultural group,
5. perform specially sanctioned behaviour,
6. maintain active social relations within the cultural group,
7. negotiate the institutional structures of that culture.

MNCs across the globe are building cross-cultural capabilities in their employees as Exhibit 7.1 indicates.

Exhibit 7.1

GLOBAL IT COS ON A CULTURE MAKE OVER

Multinational IT companies are in for a make over. Hiring staff is not a problem for the MNCs but a cultural overhaul in the manner in which they do business is the new focus for them. The reasons are not far to see: deal sizes are smaller, their competitors like TCS, Wipro and Infosys are more nimble, and despite the MNC credentials, traditionally MNCs have had a country specific business strategy rather than a global one.

The culture make over is taking shape in terms of learning foreign languages, understanding how to deliver services from low-cost destinations and encouraging staff to think in terms of a more globally integrated organisation.

Take, for instance, Atos Origin India (AOI), part of the $6.6 billion European IT major, Atos Origin. After office hours, about 100 odd staff at AOI head for French classes. This does not help them master the language but is good enough to help them comprehend the specification document (spells out the work that the client is sending) of the client. At IBM, employees are being encouraged to think in terms of a more globally integrated organisation, and tap into a programme called 'shades of blue' to understand business nuances of any other country.

And at Accenture and IBM, there is a shift from a country specific strategy to a more global sourcing one. For MNCs, this is a huge shift in how they work. For instance till recently, IBM used to process purchase orders in 300 destinations. Now, it does it in just three places, Bangalore, Shanghai and Budapest.

Big Blue also recently shifted Asia headquarters from Tokyo to Shanghai in a bid to fathom its new growth markets, China and India, more closely. Says Michael J. Cannon Brookes, vice-president, business development, China and India, IBM, "MNCs are going through cultural shift of operating in a flat world." Interestingly, Mr. Brookes' role was carved out just about a year back to look at the India and China opportunity more closely. Atos Origin sees a savings upwards of 50% for client work, if done from India.

To take the benefit of India sourcing, it is sending down a team from French car maker Renault to AOI to bridge cultural gaps. Says Partha Iyengar, vice-president, research, Gartner India, "For multinationals, hiring staff in destinations like India is least of the problems. But, they are not used to doing small deals and delivering services out of low cost destinations. This does require cultural change in how they work."

In fact, hiring people has been the least of their worry. In just a few years, IBM India moved from a 4,000 people outfit to over 40,000 employees. Accenture moved from 1,000 to over 17,000 and Atos Origin has about 1,500 people from less than 400 employees a couple of years back. The bigger problem is the cultural overhaul they have to do to deliver services from India.

In another instance, from doing everything from pay-roll, to developing software, to shipping servers as a country specific strategy, IBM is now going for best offshore options. For instance, for IBM Japan, the HR is done in Manila, pay-roll in Shanghai, procurement in Schenzen, accounting in Kuala Lumpur, technology support in Australia, and so on.

Its 'shades of blue' cultural orientation programme is targeted towards helping employees understand the needs of staffers across locations easily. The faster they do that the easier it will be for the global giants to catch up with their smaller but more nimble competitors.

Cultural make-over is at its best in Korean companies like LG, POSCO, Samsung and CISCO. Koreans working in these companies in India not only learn Hindi, Kannada and Oriya, but adopt local names too (for example, Anurag is the adopted name of Chang Chyone Jung).

POSCO, which has 30–35 expats working in India, has made it mandatory for its expat employees to learn Oriya for a better understanding of the local environment. Oriya classes were introduced for Korean employees of POSCO India during the first half of 2006, and are held every week by an in-house resource person.

Koreans have also been introduced to local traditions, customs and celebrations and socio-economic elements in the region through guest lectures every month. Simultaneously, for the new Indian employees, the HR induction programme has a special session on Korean tradition and ethics. It's a two-way process in the integration of cultures.

Expats coming to India, on their part, are interested in exploring a new country and India being one of the fastest growing economies, it only adds to their enthusiasm. LG India's experience establishes the point. Yasho Verma, director HR & MS, LG India, says, "We have Korean interns who do their research projects with us, and they have even shown cultural adaptation to the extent of adopting Indian names like Pragya or Ashim. Some of them had also volunteered for a Sanskrit learning course arranged by LG India. "LG India has 20 expats working in India."

CISCO is another example of facilitating such an adaptation process. All its expat employees come primarily from four places. Europe, Singapore, Beijing and US. In at least two of these places, the first language is not English. Expats are made to go through a cultural orientation before they leave, and after reaching here, they have a two-day orientation for the employees, spouse and children. CISCO also has a language course of 160 hours. Syed Hoda, senior director, operations globalisation centre, at CISCO elaborates, "It could be a combination of 80 hours in Hindi and 80 in Kannada, or 120 hours in Kannada and 40 in Hindi. It depends on the individual's need." CISCO is planning to relocate over 20% of its senior team, in the next three years, to its globalisation centre.

(*Source: The Economist*, April 15, 2007)

The previous sections in this chapter covered the nature of culture and cultural dimensions. With this background in view, one should take a look at how to manage multicultures. Seven dimensions pose themselves as indicators of cross-cultural management. They are: motivation, leadership, communication, HR practices, teams, negotiation and work values (see Fig.7.17).

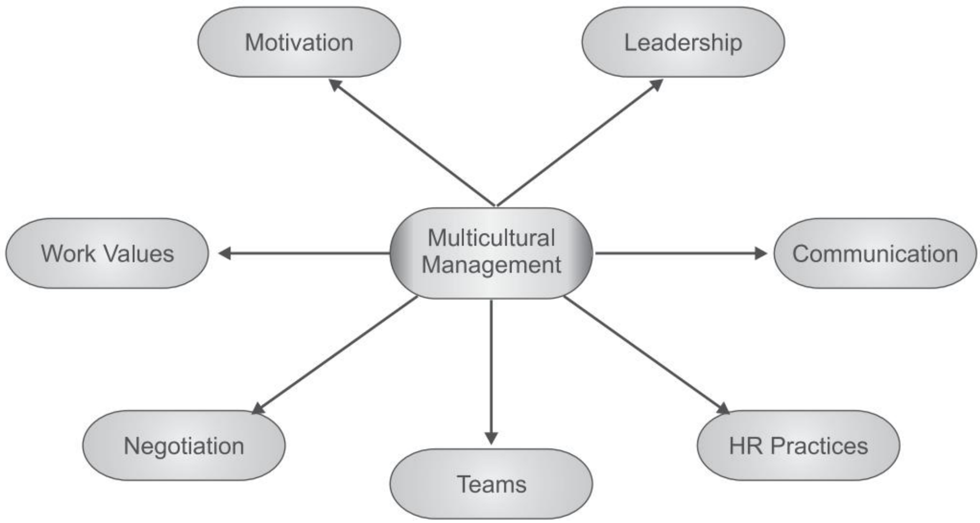


Fig. 7.17 Cultural Dimensions

Motivation Across Cultures

Motivation refers to the way an individual engages himself or herself in need fulfilling activities. At the heart of motivation are felt needs which drive the individual to act. The individual may have several ways to satisfy his or her needs. He or she selects the best course, and engages in a behaviour that begets rewards which help satisfy the felt needs. Thus, motivation takes place.

Which needs activate the individual to act, what course of action he or she engages in and what rewards the person expects, vary from culture to culture. Rich country citizens tend to be more motivated by higher order needs like achievement, growth and realising one's potential than spend energy and time on fulfilling lower level needs, such as food, clothing and shelter. It is the other way round in the developing countries where base level needs are the main motivators.

With regard to the goal directed behaviour at work, the impact of national cultures is striking. A Japanese worker, for instance, is not expected to boast about his or her work performance. For an Indian, work is not just a means of living, it is worship. For a US citizen, work is only a means of living. National culture and social institutions also influence the levels of satisfaction workers expect to receive in an organisation, and how committed workers are to their organisation and its social goals (see also Table 7.3).

Management Styles Management styles are effective motivators in each culture. American styles are characterised by professionalism and friendliness. Japanese managers motive employees through continuous counsel and persuasion. The Arab manager will be most effective in a parenting-type role that includes coaching and personal attention.

Table 7.3 Cultural Contrasts in Motivation

	American	*Japanese*	*Arab*
Management Styles	Leadership; Friendliness	Persuasion; Functional group activities	Coaching; Personal attention; Parenthood
Control	Independence; Decision-making; Space, Time, Money	Group harmony	Of others/parenthood
Emotional Appeal	Opportunity	Group participation; Company success	Religion; Nationalistic; Admiration
Recognition	Individual contribution	Group identity; Belonging to group	Individual status; Class/ Society; Promotion
Material Awards	Salary; Commission; Profit sharing	Annual bonus; Social services; Fringe benefits	Gift for self/family; Family affair; Salary increase
Threats	Loss of job	Out of group	Demotion
Cultural Values	Competition; Risk-taking; Material possession; Freedom	Group harmony; Achievement; Belonging	Reputation; Family security; Religion; Social status

(*Source:* Farid Elashmawi, *et al, op.cit,* p.144)

Control All people are motivated by the power of being in control of their own lives or work space. Americans feel good about being independent and in control of their own destinies. Japanese motivation comes through group harmony and consensus, whereas the Arab manager strives for control of others through a parenting relationship.

Emotional Appeal Americans respond to available opportunity. Sentiments may not evoke response. The Japanese are motivated by reputation and company success, which are allied with their cultural values of belonging and group achievement. Arab motivation comes from an appeal to the sense of self within the authority structure.

Recognition Americans want to be directly recognised for their individual contributions and achievements. Japanese recognition comes through identification with the group. Recognition in Arab cultures generally results from the individual's status in the hierarchy. When a department reaches its goal, the recognition will first go to the head and then percolate down to the lowest level employees.

Material Reward The American rewards that are culturally appropriate reflect the values of the macro culture. Americans measure individual success more in terms of material possessions. Monetary rewards motivate Americans. The Japanese are motivated by rewards shared among the group, such as bonuses, social services and fringe benefits available to group members. Arabs are motivated by gifts for the individual and family, which reflect admiration or appreciation for the individual's achievement.

Threats Threats motivate people for the wrong reasons. Since the Americans' identities are often directly linked to their jobs, the threat of being fired is significant to them. For the Japanese, the greatest threat is the fear of exclusion from the group. To the Arab, a demotion is a threat to one's reputation and status.

Cultural Values As stated earlier, motivational tools and processes reflect each unique culture. In the American culture, competition, risk-taking, material possessions, self-reliance and freedom are all motivational values. In contrast, group harmony, belonging and achievement are important and valued tools in motivation of Japanese employees. The Arab workers value reputation, authority and social status, and respond to these values in their motivation process.

Leadership Across Cultures

Leadership is the ability to influence others in order to work towards achievement of shared goals. It is too well known that leadership is the critical factor determining success or failure of an organisation.

To be a successful leader, one must possess certain traits which, in the context of an international business, need to be different. To be specific, the leader of an MNC needs to be endowed with the following skills and abilities:

Cosmopolitan Sufficiently flexible to operate comfortably in pluralistic cultural environments.

Skilled at International Communication Knows at least one foreign language and understands the complexities of interaction with people from other cultures.

Culturally Sensitive Uses experience in different national, regional and organisational cultures to build relationships with culturally different people while understanding his or her own culture and cultural biases.

Capable of Rapid Acculturation Rapidly acculturates or adjusts to strange or different cultural settings.

Knowledge about Cultural and Institutional Influences on Management Understands how national culture and a country's social institutions affect the entire management process.

A Facilitator of Subordinates' Intercultural Performance Uses a deep understanding of cultural differences in work and living to prepare subordinates for successful overseas experiences.

User of Cultural Synergy Takes advantage of cultural differences by finding a synergy that combines the strengths of each cultural group, and by using performance standards understandable across cultures. This results in higher levels of organisational performance than that produced by culturally homogeneous companies.

A Promoter and User of the Growing World Culture Understands, uses and takes advantage of the international advances in media, transportation and travel that support the globalisation of international business.

A Commitment to Continuous Improvement in Self-awareness and Renewal Understanding and questioning oneself.

It is not enough if an individual possesses the needed traits. What is more important is that he or she should be able to fine-tune the skills to meet country specific needs. A multicultural leader is the person with the skills and attitudes to relate effectively to and motivate people across race, gender, age, social attitudes and life styles. Successful leadership in MNCs requires that managers adjust their leadership styles to fit different situations, more specifically, in cultural contexts of different countries.

The recent research on cross-national differences in leadership is the GLOBE. The GLOBE study contains insights regarding leadership that can help the multinational manager develop a leadership style to navigate successfully through cultural settings. Led by Robert House, nearly 200 researchers from 60 countries are looking at what makes a leader successful, and to what extent are a leader's behaviours and traits contingent on the national context.

The purpose of the GLOBE study is to understand the patterns of leadership that are universally accepted, and those that are subject to the unique influences of local cultures. Findings show that certain traits, both positive and negative, are common to all cultures, and certain other behaviours are culture-specific. Positive behaviours such as trustworthy, encouraging, effective communication, bargaining capabilities and team building abilities are universally acceptable. Negative traits that have universal rejection are egocentricism, non-cooperation, ruthlessness and authoritariacism. Culture specific leader attributes include group orientation, self-protectiveness, participative skills, humanness, autonomy and charisma. Table 7.4 shows the different skills and their acceptability.

Table 7.4 Leadership Behaviours and their Acceptability from 60 Countries

Universally acceptable and rejectable traits and behaviours		*Culture specific traits and behaviours*
Positive	*Negative*	
Trustworthy	Loner	Group orientation
Just	Asocial	Self-protectiveness
Honest	Non-cooperative	Participative skills
Plans ahead	Non-explicit	Humanness
Encouraging	Egocentric	Autonomy
Positive	Ruthless	Charisma
Good bargaining	Dictatorial	Humility
Dynamic		
Motivator		
Confidence builder		
Dependable		
Intelligent		
Decisive		
Win-win problem solver		
Skilled administrator		
Communicator		
Informed		
Team builder		

Some highlights of the GLOBE study findings are:

- Participative leader is more acceptable in Canada, Brazil, and Australia.
- Americans like two kinds of leaders—those who provide employees with empowerment and autonomy, and those who are bold, fearless, confident and risk takers.
- Malaysians expect their leaders to be humble, modest, dignified and group oriented.
- Arabs treat their leaders as heroes and worship them as long as they remain in power.
- Iranians expect their leaders to exhibit power and strength.

- The French expect their leaders to be appreciative of the finer aspects of French culture and arts, and to have a good knowledge of mathematics.
- The Dutch are not favourably inclined to terms like 'leader' and 'manager'. The Dutch value equality.

The GLOBE project is an ongoing one. It is highly useful to multinational managers in as much as the study offers insights into traits and behaviours that a leader should exhibit while managing multicultures.

Table 7.5 shows the leader's roles in his or her parent unit, in a subsidiary and how far host country's culture impacts his or her behaviour.

As shown in the Table 7.5, where leadership role is energising and driving for results, local cultures do influence leader traits and behaviours. The impact of local cultures is not felt significantly in other roles.

Table 7.5 Leader's Role and Cultural Impact

Leader's Role	*Headquarters*	*Subsidiary*	*Cultural impact*
Visioneering	Sets the corporate vision and mission	Enforces the corporate vision and mission and sets unit goals	Not influenced by host culture
Energising	Establishing enabling environment to achieve organisational objectives	Ability to emulate similar energy and have the host unit achieve its objectives	Largely influenced by the host country's culture particularly with reference to directive, participative and charismatic styles
Efficiency	Initiating the use of necessary tools and practices that drive productivity	Ability to emulate and, where necessary, deviate from parent company's tools and practices	Local culture does have impact on leadership styles
Results	Driving for results	Driving for results	Highly culture sensitive
Rules and procedures	Country and industry specific	Ensuring coordination and control as desired by the head office	High degree of local dependence as well as integrate globally for corporate parity and sense of equity

Building a Multicultural Organisation

One of the tasks of a leader is to make his or her firm a truly multicultural and cosmopolitan organisation. Towards this end, he or she needs to pursue seven characteristics that will make a multicultural organisation (See Fig.7.18).

Creating Pluralism When both majority and minority group members are able to establish behavioural norms, values and policies in an organisation, there exists pluralism. Diversity training helps establish pluralism.

Achieving Leadership Diversity Leadership diversity represents the presence of heterogeneous group of leaders in the organisation. Many global firms have heterogeneous leaders. P&G, for example, has leaders from across the globe. The MNC has 300 Indian managers in international assignments. Uniliver, too, has trained 110 managers at HUL and all of them are posted to different countries, ranging from South America to South Africa to the Far East. More than 300 Citigroup senior managers posted globally were hand-picked from the company's Indian operations.

Ethnicity is one way of achieving diversity. Sex is another key area for leadership diversity, with many firms today having women in top executive positions. Indira Nooyi is the CEO of Pepsi and she is

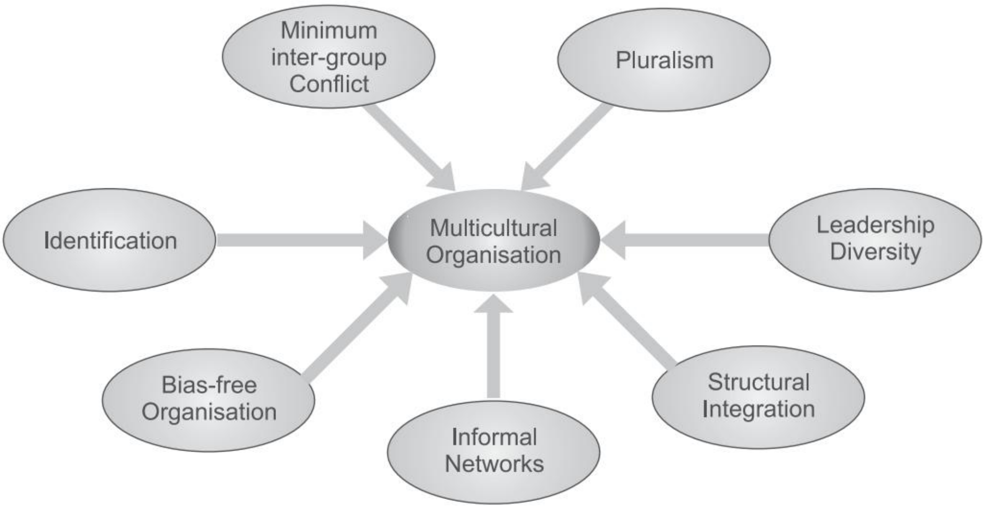


Fig. 7.18 Dimensions of Multicultural Corporation

no exception. Diversity is not just at senior positions. Diversity of leadership should percolate to middle level and lower level positions.

Structural Integration Structural integration takes place when individuals are assigned to jobs based on merit and not on ethnicity or gender. Performance becomes the basis for effecting promotions and awarding rewards.

Integration of Informal Networks Disadvantaged people are often excluded from informal networks, making it difficult for them to achieve career advancement. Affirmative actions, such as company sponsored mentoring programmes targeting disadvantaged sections, and company sponsored social events where such less privileged people are encouraged to participate, can help achieve integration of informal networks. Xerox's Hispanic Professional Association is an example aiming at such an integration.

Bias-free Organisation Biases and prejudices are the antithesis of multiculturalism. Multiculturalism demands global mindset, openness to accept what is best and broad mindedness to encourage diversity. Firms must take steps to eliminate biases and prejudices.

Wipro is a typical organisation which is free from biases and prejudices. Nearly seven per cent of its employees are non-Indians. The company has sales offices in 14 countries, and has software, hardware engineering and BPO centres in nearly as many countries. In addition to its vast engineering factories in India, Wipro taps the brain power and expertise of people in Japan, China, Taiwan, Dubai, Australia, Canada, US, UK, Germany, Sweden, Rumania and Vietnam. It has mastered the art of global collaboration. Its thousands of software programmers work in teams whose individual members are scattered across continents.

Organisational Identification Organisation needs to have its own identity and every member should align himself or herself with it. All the steps discussed till now shall help a company achieve such identification and alignment.

Minimising Inter-group Conflict Conflict in organisations is inevitable and often has functional consequences. Conflict encourages creativity and enhances productivity. Benefits occur when conflict is at the optimum level. When it reaches above optimum levels, steps need to be initiated to minimise the conflict. The most effective approach to minimising conflict among cultural groups is to collect and share data about sensitive issues.

Communicating Across Cultures

Successful international management requires effective cross-cultural communication. Additionally, in global businesses, activities such as leading, motivating, decision making, problem solving and exchanging information and ideas depend on the ability of managers and employees from one culture, to communicate successfully with colleagues, clients and suppliers from other cultures.

Communication is the process of transmitting meanings from sender to receiver. On the surface, this appears to be a fairly straight forward process. But there are several problems in the international scenario that can result in the failure to transfer meanings correctly.

Mistakes in cross-cultural communication often go unnoticed by the communicators, but these mistakes have the potential to cause damage to international relationships and negotiations. Mistakes or misinterpretations of subtle gestures of the hands and face, the use of silence, what is said or not said, and the intricacies of dealing with age and status often provide pitfalls for international managers.

Communication Dimensions Crucial issues in inter-cultural communication are: language and culture, differences between high and low context cultures, use of interpreters, linguistic styles, social context, and non-verbal communication. If these are taken care of, inter-cultural communication will be effective.

Language and Culture Language is the foundation of every culture. It is an abstract system of word meanings and symbols related to all aspects of culture. Language includes speech, written characters, numerals, symbols and gestures of non-verbal communication.

The inter-relationship between language and culture was discussed in the previous chapter.

High and Low Context Languages As explained in the previous chapter, languages are either high context or low context placed. Languages in which people state things directly and explicitly are called low context. The words provide the meaning and there is no need to interpret the situation to understand the import of the words. Languages in which people state things indirectly and implicitly are called high context. In the high-context language, communications have multiple meanings that can be interpreted only by reading the situation in which they occur. So important are the ideas of high and low context, that many people refer to the whole culture as being high or low context.

Most northern European languages, including German, English and the Scandinavian languages are low context. People use explicit words to communicate direct meanings. In contrast, Asian and Arabic languages are high context. In Asian languages, often what is left unsaid is just as important as what is said. Silent periods and the use of incomplete sentences require a person to interpret what the communicator does not say, by reading the situation. Arabic introduces interpretation into the languages with an opposite tack. Extensive imprecise verbal and non-verbal communication produces an interaction where reading the situation is essential for comprehension (also see Fig. 7.19).

Communication between high context and low context people is a challenge for international managers. Translated words for a low context speaker have explicit meanings but the same may have a

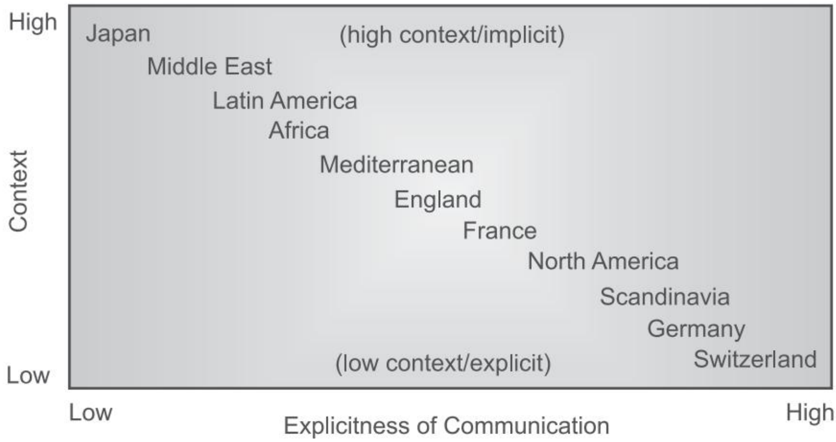


Fig. 7.19 Contrasting Patterns of Communication in Low versus High Context Cultures

multitude of meanings for a high context speaker. In international negotiations, the negotiators should realize that communication will have errors. Moreover, even good translations may require contextual interpretations for effective communication.

Use of Interpreters In cross-cultural communication, use of a language foreign to both parties, is common. The international manager is at an advantage if he or she speaks more than one language fluently. US Americans speak only English but their European counterparts are generally bilingual, or even multilingual.

Most Indians are at an advantage from this perspective. They are comfortable in their respective vernacular languages, Hindi and English.

Increasingly, companies are making use of the services of interpreters in international negotiations. The interpreter's role is to provide a simultaneous translation of a foreign language while a person speaks. This requires greater linguistic skills than speaking a language or translating written documents. Good interpreters are not only bilingual but also have the technical knowledge and vocabulary to deal with technical details common in business transactions. (More on negotiation in the next chapter).

To simplify the increasing diversity of languages in business, some MNCs use one language as corporate language. Increasingly, this language is English, as it is being used in majority of countries. Using English allows companies a more consistent culture while dealing with the linguistic diversity of their employees and customers. However, even companies which have a corporate language, have permanent translators on their rolls to manage such issues as interaction with the international press, translation of local product information and negotiations with other companies. (See Exhibit 7.2)

Linguistic Styles In addition to having different structures (grammar, vocabulary and syntax), languages possess different linguistic styles. Knowledge about these is desirable for an international manager. For example, cultures vary in terms of how explicitly they transmit and receive verbal messages. Good communicators in some societies are supposed to be precise and straightforward. Emphasis in some societies is placed on using words powerfully and accurately while silences, even short ones are anxiety-producing. Communication patterns in some cultures are ambiguous, inexact and implicit. In some Eastern cultures, such as Japan and China, where there is less emphasis on words, people tend to derive more meanings from non-verbal cues and the general social context. It is not that words are

Exhibit 7.2

GETTING LOCAL FOR GLOBAL LEAP

Cross-cultural marriages are a tough call. And Laxmi Mittal isn't the only one who managed to crack that code. Indian corporate groups looking for a global footprint are doing everything from taking language lessons in Chinese and Korean, to bonding with the local farmers in Bangladesh, to maintaining cordial relations with the Masai tribesmen, in an effort to go 'local'. Corporate honchos, from TCS to BILT, Cormpton Greaves to GHCL, Tata Chem to M&M, call it 'cultural sensitivity' and increasingly, it is turning into India Inc's most important deal drill.

Take the Tata group, which has a business footprint in various industries, spanning every region from Latin America to South Africa, China to Bangladesh, and has recently been engaged in a number of cross-border M&A deals. The key to managing these diverse cultural cues, says Alan Rosling, executive director, Tata Sons, is to go local with a vengeance. Take Tata Motors' Daewoo venture in Korea. "The principal way is to get locals to do most of the work," says Rosling. "So, we are heavily using locals in Daewoo, and the few Indians we have gone there are learning to speak Korean."

This is also the mantra for Bilt which has recently announced the deal to acquire Malaysia's biggest paper and pulp company, Sabah Forest. Says B.Hariharan, Director Finance, at Bilt, "Jobs are an issue and one has to be very conscious of not displacing people from their current jobs in Malaysia". Adds Nikhil Sen, who is looking after finance and strategy at GHCL, which has recently announced three M&A deals in the US and Europe, "In emerging economies like Romania where we acquired the soda ash company, one needs to stay clear of asset stripping, post acquisition."

Sometimes, just language skills are a big plus. The TCS representative in Latin America, for instance, speaks Spanish, Portuguese, Hungarian, and has recruited a senior management team that's mostly local, though the backbone is Indian.

Sometimes, this local sensitivity is vital just to stay in business. Take Tata Chemicals, which last year acquired Brunner Mond having Kenyan operations in Masai tribal areas. "The local management has to be on good terms with the chiefs of the tribes," says Rosling. Cultural connect becomes even more important when the company's foray is in a politically sensitive area. Take the Tata group's $2.5 billion investment in Bangladesh's energy, steel and fertiliser sectors.

Despite the detailed feasibility study, the group encountered hiccups for the choice of the steel plant site. "There was a ground swell of opinion from local farmers who demonstrated against the project to the district officer," says Rosling. But the situation turned positive when it was explained to them that the group in question was the Tatas, and any compensation due to them would be paid.

Sometimes, a deal can depend upon the dinner spread and table talk. When the M&M team started negotiating with the Chinese tractor maker, Jangling, a crucial aspect of their pow-wows was 'dinner diplomacy'. M&M's crack deal masters realised that more business happens across the dinner table in China than in the board room. Says an M&M source, "Food is an integral part of their culture. Unfortunately, few things appealed to the Indian palate. But that did not deter them from responding to their Chinese partners with the same zeal with which they hosted these meals." Result: they managed to swing the deal in just 90 days.

Of course, India's own brand equity in specific business prompts locals to go the extra mile to connect. Take the TCS experience in China. There, the mayor of the town solved the Indian team's biggest problem in China, finding vegetarian food. He set up a 'Tam Brahm vegetarian restaurant' for the TCS crowd. Now that's connecting.

(*Source: The Economic Times*, June 29, 2006) unimportant in Eastern cultures, but rather that the words are inseparably interrelated to social relationships, politics and morality. Given this more holistic approaches to communication, its purpose in many Eastern cultures is not to enhance speaker's individuality through oratorial skills but rather to promote harmony and social integration. In such societies one is expected to be sensitive to subtle contextual cues and not to assume that critical information will always be verbalised.

Direct and indirect styles of communication often lead to misunderstandings and miscommunications.

North Americans view an indirect person as tricky, deceptive and of questionable integrity. At best, Westerners consider indirect communication to be a waste of their time. On the other hand, those from implicit cultures view the explicit communication styles of North Americans to be rude, coarse and insensitive (See also Exhibit 7.3).

Yet another dimension of linguistic styles deals with turn-taking between speakers. The differences in timing can cause problems as revealed in the following passage:

> Brazilians frequently have two people talking at once in a conversation, with almost no pauses. Americans sometimes have brief pauses between speakers and sometimes have a little overlay of speakers. If you are speaking with people from a culture that has many verbal over-lays, such as the Brazilians, you may have to be more assertive if you want to participate in the conversation. If you are speaking with people from a culture with more verbal pauses, you may have to learn to pause more often to make sure others get a chance to speak. When talking with a Japanese, it is typical for Americans to wait just long enough to become uncomfortable and then begin speaking again. The Japanese, however, remains silent to show respect for the speaker or the comment, and by the time he feels it is appropriate to say something, the American is already speaking again. The result is that we end up monopolising conversations.

Exhibit 7.3

WHERE INCONVENIENCE MEANS IMPOSSIBLE

Chinese scholar Robert Kapp describes the indirect style of communicating found among the Chinese, which can affect business negotiations between US and Chinese businesspeople.

The indirection that permeates Chinese speech even in English translation can be particularly disconcerting to Americans. 'Perhaps' and 'may be' are cultural stock-in-trade. "Maybe I will come with you" usually means "I'm Coming". "Perhaps it is too far for you to walk" means "There's no way I'll let you walk". When something is 'inconvenient', it most likely is impossible. But more than verbal indirection is at work here. The absence of a categorical statement implies that 'perhaps' some room for discussion remains; and, in any case, a subsequent reversal will not represent a clear backing-down. Despite the firm signal that conditional speech often implies, negotiation is never totally foreclosed and dignity is maintained, at the expense of American patience.

(*Source*: Gary P. Ferraro, op.cit p. 60)

Language and Social Context Language in the international context has yet another dimension: People frequently speak several different languages or different forms of the same language, depending on the social situation. A person may speak one language at home (called the mother tongue), one language at office and a totally a different language in the market place. But people, who speak only one language, switch its styles. A student speaking a language in his or her hostel is different from the form of expression the student uses while speaking with parents or professors. Levels of formality between speakers, relative status, sex and age of the speakers can frequently determine what is said and how it is said. A professor's name starts with an honourable prefix, like Professor, and a husband or wife carry different prefixes. If an elderly person has one prefix, a respectable individual in a society is addressed differently. The prefixes generally used are Dr, Sir, Mr, Mrs, Miss, Professor and the like. The speaker in Parliament or a legislative assembly is addressed as 'honourable', while a judge in a court is invariably called Mr. Justice.

Linguistic differences can be found between men and women. Gender differences are visible in subtle areas of language, such as intonation, loudness, assertiveness and style. Women in some societies are less assertive while talking but men tend to be assertive; women in some other societies tend to use self-disclosure as a way of learning about others, whereas men tend to avoid self-disclosures; women's discourse strives for equality in social relationships, whereas men's discourse attempts to establish status and power; women will often match experience with others for the sake of showing and empathy ("I know how you feel"), whereas men match experience for the sake of gaining attention ("I can top that"); finally, women show their support by expressing their understanding, whereas men show their support by giving advice or wanting to solve a problem.

Non-verbal Communication Non-verbal communication includes facial gestures, voice intonation, physical distance, smile, battling of eyelid, kiss, handshake, walking (gait), posture, touching, colour symbolism, clothing, hair styles, graphic symbols and even silence. Non-verbal communication supplements or enhances spoken communication.

It is easy to misinterpret the meaning of non-verbal communication of another culture. Take, for example, body language. In the US, when a manager keeps his or her feet on the desk, it means the boss is relaxing and others can also do the same. But such gestures are frowned upon in India.

Take another non-verbal communication medium-touching. In greeting one another, people may shake hands, embrace or kiss. In routine interaction, people may touch or pat each other in a variety of ways. The type of touching deemed appropriate is deeply rooted in the society's cultural values. Russian men, for example, often kiss other men outside their family as a form of greeting; Brazilian men hug in greeting.

At times, touching may prove embarrassing as the late S. Radhakrishnan realised. It was 1956 when S. Radhakrishnan, the then Vice President of India, visited China. He called on Mao Zedong, the then Chairman of Communist China at his residence. Mao had his hand in a bandage because his finger had been crushed while he was getting into a car at Phnom Penh. Mao put his hand out and Radhakrishnan touched it. Then he patted Mao on the cheek. The Chinese supremo was a bit taken aback and those around him were startled. It was Radhakrishnan who saved the situation. He said, "Mr Chairman, don't be alarmed. I did the same thing to Stalin and the Pope." The tension disappeared and everyone laughed.

All modes of non-verbal communication possess five salient features, and it is desirable that the international manager is aware of them:

1. Several of non-verbal cues (for example, expression of emotions through smile, shedding tears, frowns or eyebrow flashes) are universal in their meaning. But there are also modes of non-verbal communication whose meanings vary from culture to culture.
2. Unlike spoken language, many non-verbal cues are sent and received despite our best intentions to do otherwise. In other words, many non-verbal modes cannot be controlled, though spoken language

can be. We can smile when we are unhappy, and to that extent we can purposefully control some non-verbal cues, but we cannot control blushing when embarrassed, perspiring when nervous or pupil dilation when frightened.

3. Because some non-verbal communication is beyond an individual's control, it is not uncommon to find a noticeable lack of fit between a person's words and his or her non-verbal messages. For example, in response to the question "How are you?" a person might respond "Fine", while at the same time sending a number of non-verbal messages (such as downcast eyes, and a frown) that totally contradict the upbeat verbal response. When a discrepancy occurs between the verbal and the non-verbal, the observer will most likely believe the non-verbal.

4. Non-verbal behaviour is, by and large, unconscious. We send non-verbal messages spontaneously without giving much thought about what hand gestures we choose to punctuate our words, or how long we maintain eye contact. Because much of our non-verbal behaviour is operating on the unconscious level, seeking clarification of a misunderstood non-verbal cue becomes almost impossible. Although we can ask someone to repeat a sentence, we are unlikely to ask someone to explain what he or she meant by a half-smile, a particular posture, or a sudden movement of the head.

5. Women tend to be better readers of non-verbal cues than men.

Barriers to Effective Cross-cultural Communication

Because of several verbal and non-verbal differences in communication, people from different cultures often misunderstand each other. Misunderstandings arise because of culture, perception, and experience.

Culture becomes a barrier when people from two different cultures have different ways of reacting to the same situation. For example, an American can, in his or her class, admit his or her ignorance about a concept openly, but the students often appreciate such a gesture. If the same admission is made in India, students view the professor as incompetent. Students expect a professor to know everything.

Perception refers to the process of seeing what is there to be seen. Problems arise because people rarely see what is to be seen. In international communication, a potential perceptual barrier is stereotyping. A person under the influence of stereotyping slots another person in a group and understands him or her from group's characteristics. Stereotyping acts as a barrier to communication when it sets up expectations that may be untrue. However, if a person is able to use a stereotype as an initial expectation of how someone from another culture might behave, it could be helpful. When the person actually meets someone from the other culture, then he or she needs to gain an understanding of this individual to make communication more effective.

Experience barrier arises due to differences in life events between two individuals. When two people are form different cultures, it is likely that their life experiences are varied. The type of homes, how they worship, their educational systems, what they eat, and how they spend their leisure time tend to be different. Lacking a common body of experience is likely to make communication more difficult.

Tips for Effective Communication Across Cultures Communication is critical in managing multi- cultures. International managers need to possess effective communication skills while negotiating with overseas suppliers/buyers, making presentations and motivating and leading subordinates who represent diversity. The following tips might help the multicultural manager improve his or her communication skills.

Learn the Language of the Host Country The inter-cultural manager should learn to communicate with subordinates and employees in their own language. Nothing gives the manager more acceptance than talking to people in their own mother tongue.

Learn to Neutralise Language Accents People pronounce English words in the manner which symbolises their own language. For many Indians, for example, school becomes ‘i school’, statistics becomes ‘i statistics’, ‘whose’ becomes ‘hose’, ‘which’ becomes ‘wuch’, Ravindra becomes ‘Rabindra’, Canara Bank becomes ‘Kanara Bank’ and Mahatma becomes ‘Magatma’. Angularities as these need to be neutralised if one should communicate with international managers.

Be Aware of the Fact that Cross-cultural Barriers do Exist The most significant thing the international manager should do is to avoid committing cultural mistakes. For instance, Britishers expect privacy and it is a mistake to ask a Briton any personal questions. Similarly, Koreans do not wish to be told ‘No.’ They want their visitors to leave with good feelings. Soliciting feedback helps minimise cross-cultural barriers to communication.

Use Straight Forward Language and Speak Clearly Using apt words without verbose makes communication effective. Minimising the use of idioms and analogies helps a lot. Facing the preen of another culture directly also improves communication as facial expression and lip movements add to comprehension.

Be Sensitive to Non-verbal Communication Non-verbal communication means different things to different people. Thais, for example, tend to speak softly and do not use gestures. Thais usually employ eye contact, but intense eye contact, which is accepted in the Middle East and Latin America, is not appreciated by the Thais. Singaporeans often smile to cover anxiety or embarrassment rather than to express amusement. Their smile should not be misconstrued. French display unusual contact behaviour among friends and relatives. A study of comparative touch behaviour at the cafes in Paris and London showed that within the space of an hour, French couples touched each other over one hundred times while the British couples did not touch each other at all. High-contact behaviour of French should not be taken as their acceptance of a business deal.

Develop Cultural Sensitivity Learning host country language is no doubt essential but what is desirable is to become sensitive to local cultures. TCS, Wipro and Infosys, as was stated in Exhibit 7.1, train their employees in cultural sensitivities. Asians, as stated above, tend to smile to cover up their severe stress or embarrassment. Their smile should not be taken as being rude or insensitive (also see Exhibit 7.4).

Human Resource Practices in the National Context

Human resource practices such as employee hiring, training and development, compensation and performance management should differ from country to country. A separate chapter (Chapter 22) in this book explains the general principles that govern international human resource management activities. The fact that these practices are culture-specific and the reasons for the same are discussed here.

Why do HR Practices Vary Cross-national differences in HRM and the pressure to adapt to local conditions depend on several national context factors. The national context includes social institutions, business culture, factor conditions and their combined effects on the business environment.

Social institutions are the principal institutions through which essential tasks of living are organised, directed and executed. Five basic institutions can be found in any society, that is the family, religion, economy, education and the state. The main function of **family** is progeny, that is contribution of members to society. Families also teach the new members what is expected of them, as well as try to motivate them to fulfill those expectations. **Religion** motivates members of a society to comply with their responsibilities and obligations by assigning meaning and purpose to such activities. The **economy** includes corporations, organised markets, international trade associations and consumer

Exhibit 7.4

MISCOMMUNICATION ACROSS CULTURES

The strong East Asian concern for covering negative emotions can be confusing to outsiders from deal-focused cultures. When we moved from Germany to Singapore in 1988, my wife and I decided to try learning Mandarin on weekends. We hired Stefanie, a pleasant young woman, who had recently immigrated from Taiwan, to tutor us.

My lessons were interrupted late that year when my mother passed away and I had to fly to Wisconsin to attend the funeral. Unfortunately, I had barely returned to Singapore when my brother phoned again to break the sad news that our father had passed away. As you might imagine, this was very difficult time for me.

It happened to be a Saturday when I got back from this second funeral, and Stefanie dropped by to enquire why I had missed over a month's worth of lessons. Suffering from grief compounded by jet lag and exhaustion, I blurted out that both of my parents had just died.

A stricken look flashed across the young woman's face for just a fraction of a second, and she gasped. Stefanie suddenly laughed out loud, right in my face, and proceeded to giggle for several seconds.

Now, intellectually I was quite aware that people from some Asian cultures hide their nervousness, embarrassment or severe stress with a laugh. I also knew I should have broken my sad news much more gently. After all, Stefanie was a Chinese person raised in the Confucian way, she revered her parents. For her the sudden realisation that she could perhaps lose both of them, almost at the same time, must have come as a terrible shock.

Nevertheless, my immediate reaction to her laugh was visceral. I felt as though I had just been hit very hard in the stomach. Even though I understood rationally what had happened, I had difficulty relating to Stefanie as I had before the incident. A few weeks later she stopped coming and we had to find a new Mandarin tutor.

(*Source:* Richard R. Gesteland, *op.cit.*, pp. 37–38)

organisations. The purpose of economic institutions is mainly to produce and distribute goods and services throughout society. **Education** seeks to transmit abilities and skills so that all members of society become productive members of the economy as adults. Finally, the **state** is an institution designed to protect society's members from internal and external threats. The state also establishes penal and civil codes to lay down standards of acceptable and unacceptable behaviours, responsibilities and obligations, and it specifies sanctions for violation of these standards. The role of the state in shaping, directing and promoting economy is not to be undermined.

What is interesting is that these social institutions are closely linked with national and **business cultures**. Institutions, such as the family and the educational systems, pass on cultural traditions. The state reflects the norms and values of the society. Organisations must identify and implement HRM practices that meet the demands of a society's social institutions. Social institutions help define correct ways of doing business in any country. In India, for example, state expects businesses to adopt affirmative actions. In Japan, the family system relies on women raising children so that men can work long hours at night, or be away from home for long periods. Obviously, there are unwritten biases against women holding managerial positions after they beget children.

The national context also includes the **factor conditions** prevalent in a country. The factor conditions (the five as stated below) determine the resource pool available for a firm. The resource pool represents all the physical and human resources available in a country. The five factor conditions are:

- The quality, quantity and accessibility of raw material.
- The quantity, quality and cost of human resource available.
- The scientific, technical and market-related knowledge available to firms.
- The cost and amount of capital available to firms for operations and expansion.
- The type, quality and costs of supporting institutions such as education, transportation and communication facilities.

Now, these factor conditions are abundant in some countries and scarce in others. Again, abundant countries are not rich in all factors and certain countries do not lack in all of them. Germany, for example, has large pools of technically trained workers who support the development of industries, but German workers are the highest paid in the world. Japan and the US have strong R&D bases but Korean electronics companies do not have the same level of knowledge resources. Factor conditions coupled with social institutions and business culture determine a country's **business environment**. The business environment, in turn, determines the type of HR policies and practices to be followed in the host country.

The specific HR practices that are country specific are: employee selection, training, compensation, performance appraisal and industrial relations.

While selecting employees, companies need to follow local hiring practices. Ignoring locals amounts to offending local cultural norms. But, best talent may not be available locally. Thus, multinational managers are expected to assess the trade-off between following home practices and hiring locals against the costs and benefits of following local traditions.

Cross-national differences do exist in training and development needs. Such needs may be less intense in countries where educational facilities are available. Germany has strong technical education programme. India too has large number of engineering colleges producing technically qualified people in large numbers. Life-time employment practice, mainly prevailing in Japan, too, has an impact on determining training and development needs. Training is slow and less significant in countries which practise life-time employment. Managers pick up new skills through extensive job rotations. They learn by doing.

If there is one element of HRM, that is common to all cultures, it is performance appraisal. Performance review is extensively used in all countries so as to identify performers for promotion, and to assess training needs. In individualistic societies, it is treated as the most objective and reliable tool to effect pay hike or promote achievers. In collectivist societies, on the other hand, personal background characteristics, and not achievement, are the determining factors to reward employees. According to Hofstede, managers in collectivist societies often avoid direct performance appraisal feedback. An open discussion of performance may clash with the society's norm of harmony, which takes precedence over other values. Koreans prefer seniority-based promotions to appraisal-based upgradations.

Cultural differences also wield their influence on industrial relations. In Japan, management-labour strike is rare because of traditional and structural factors that blur distinctions between workers and management. Union leadership is a stepping stone to management, nearly 15 per cent of union officials rise to serve as executives of the company. Obviously, union leaders have little incentive to assume labour positions against those responsible for their advancement. Labour laws are generally inoffensive.

A number of countries require substantial employee representation on the corporates' boards of directors. Such countries mandate a two-tiered board, a large supervisory board and a management board. The former has employee representatives. In Germany, the Netherlands and Luxembourg, employees have direct representation in supervisory boards.

Employee dismissal practices too vary. In the US, the popular perception is that no one is entitled to a job. Once an individual ceases to be productive, his or her future employment is in jeopardy. Europeans, on the other hand, feel that employees acquire a proprietory interest in their jobs over time. The traditional Japanese view is that one's job is the central part of his or her place in society, and that a job largely defines the person. An individual is expected to hold a job for the same company for a life time. In Japan, the focus is not on the conditions of dismissal but on the propriety of dismissal itself.

Need for Synergy

This section focused mainly on the need for varying HRM practices to suit different cultures. But the trend emerging now is that MNCs are transferring HRM practices from the respective home offices to their subsidiaries. In other words, synergy is emerging in HRM practices. Three approaches support synergy: rational, culturalist and political.

The Rational Approach This approach posits that best employment practices, wherever they originate from, need to be transmitted to the subsidiaries in order to enhance efficiency. This is what Japanese MNCs did during 1980s and 1990s. The Japanese firms transferred their employment practices as they expanded into Europe and North America. Such practices, as the common uniform, shared canteens and open offices, now prevalent in India, have been borrowed from Japan.

The Culturalist Approach This approach argues that it is the legacy of national culture that forces transfer of practices, more than the demands of competition. It is too well known that MNCs take many aspects of national culture with them when they go abroad. In other words, their corporate culture is influenced by the national culture in the parent country. Obviously, along with national culture, MNCs unwittingly carry HRM practices across sites in different countries. GE's culture of contention rather than collaboration transmits to all its subsidiaries, wherever they are located. Wipro is emerging as an Indian MNC. As stated earlier, the Bangalore based software giant has sales offices in 14 countries and scouts for talent in as many countries. The core value of Wipro is honesty which it has imbibed from Indian ethos. In emerging markets, where some of the biggest revenue opportunities lie, corruption is routine, and contractual obligations are rarely upheld. There is temptation for any MNC to play by local rules. But Wipro resists such temptations.

The Political Approach The political approach portrays that there are always certain actors who have their own stakes in transfer of practices to subsidiaries. A range of actors in the head office seek to protect or advance their own positions by initiating or engaging in the transfer of practices. They project themselves as indispensable or atleast as key players in the transfers. Even the individuals holding key positions in subsidiaries seek to protect their turf by sharing practices with their counterparts in other sites.

Multicultural Teams

Multicultural teams comprise members coming from more than one culture. Multicultural teams can be divided into three types:

- *Token teams*, in which only one member is from another culture. An example would be a group of Japanese retailers and a British attorney who are looking into the benefits and shortcomings of setting up operations in Bermuda.
- *Bicultural teams* have members from two cultures. An example would be a team of four Mexicans

and four Canadians who have formed a team to investigate the possibility of investing in Russia.

- *Multicultural teams* have members from three or more cultures. An example is a group of three Americans, three Germans, three Uruguyans, and three Chinese managers who are looking after mining operations in Chile.

Managing Culturally Diverse Teams Cultural diversity can be an important source of energy in enhancing organisational effectiveness. More and more organisations are realising the virtues of cultural diversity, but surprisingly, they know little about how to manage it. There is a significant amount of learning that every organisation goes through in understanding and accommodating for cross cultural corporate challenges. What organisations can do is to create awareness of the cultural differences and sensitivity to the work values, prevalent in countries that the MNC's require to interact with, either as a customer or as a host unit. Organisations that adopt a multinational strategy can become more than a sum of their parts. Operations in each culture can benefit from operations in other cultures through an enhanced understanding of how the world looks and works.

On the flip side, multicultural teams often generate frustrating management dilemmas. Cultural differences can create substantial obstacles to effective teamwork, but these may be subtle and difficult to recognise until significant damage has already been done. But, by intervening, leaders tend to create more problems than they resolve. The challenge in managing multicultural teams effectively is to recognise underlying cultural causes of conflict, and to intervene in ways that not only get the teams back on track but empower their members to deal with future challenges effectively.

Strategies for Managing Teams Four strategies have been suggested to tackle problems of multicultural teams:

- *Adaptation:* Acknowledging cultural gaps openly and working around them.
- *Structural intervention:* Changing the shape of the team.
- *Managerial Intervention:* Setting norms early, or bringing in a higher level manager.
- *Exit:* Removing a team member when other options have failed.

Table 7.6 shows the four strategies together with representative problems, enabling situational conditions and complicating factors under each strategy.

The other ways of managing culturally diverse teams are : selection, visioneering, power and respect.

- *Task-related selection:* Leaders should select team members based on their task-related abilities rather than on ethnicity. Team members should be homogenous in ability levels but heterogenous in attitudes. Such members help maximise team effectiveness.
- *Establishing a vision:* Members of diverse teams have more difficulty agreeing on their purpose and task than do members of homogenous groups. Global alliances often become troubled because partners from different cultures do not clearly understand each other's intent, their purpose, goals, and strategy, because they are initially unable to communicate with each other. The main task of a leader is to help teams agree on his or her vision or superordinate goal that cuts across individual differences. Superordinate goals give general direction and focus to the team's activities. Such goals, requiring collaboration and cooperation, generally decrease prejudice and increase mutual respect.
- *Equalizing power:* Teams generally produce more and better ideas if all members participate. Cultural dominance (disproportionate power vested in members of one culture over those from other cultures) is, therefore, counterproductive because it stifles non-dominant team members' contributions. In multicultural teams, leaders must guard against vesting disproportionate power in host country members, members of the home country, members from the most technologically

Table 7.6 Strategies for Managing Multicultural Teams

Representative Problems	*Enabling Situational Conditions*	*Strategy*	*Complicating Factors*
• Conflict arises from decision-making differences • Misunderstanding or stone-walling arises from communication differences	• Team members can attribute a challenge to culture rather than personality • Higher-level managers are not available or the team would be embarrassed to involve them	**Adaptation**	• Team members must be exceptionally aware • Negotiating a common understanding takes time
• The team is affected by emotional tensions relating to fluency issues or prejudice • Team members are inhibited by perceived status differences among teammates	• The team can be subdivided to mix cultures or expertise • Tasks can be subdivided	**Structural Intervention**	• If team members aren't carefully distributed, sub-groups can strengthen preexisting differences • Subgroup solutions have to fit back together
• Violations of hierarchy have resulted in loss of face • An absence of ground rules is causing conflict	• The problem has produced a high level of emotion • The team has reached a stalemate • A higher-level manager is able and willing to intervene	**Managerial Intervention**	• The team becomes overly dependent on the manager • Team members may be sidelined or resistant
• A team member cannot adjust to the challenge at hand and has become unable to contribute to the project	• The team is permanent rather than temporary • Emotions are beyond the point of intervention • Too much face has been lost	**Exit**	• Talent and training costs are lost

advanced or economically developed countries, or members with ideologies most consonant with their own. Team leaders should manage the distribution of power according to each member's ability to contribute to the task, and not according to some preconceived gradient of relative cultural superiority.

- *Creating mutual respect:* For most teams to work effectively, members must respect each other. Prejudice is the antonym of mutual respect. Equal status, close contact, and cooperative efforts towards a common goal decrease prejudice. Team leaders can enhance mutual respect by selecting members of equal ability, making prior accomplishments and skills known to all team members, and minimising early judgement based on ethnic stereotypes.

Work Values

Work values, yet another dimension of multicultural management, are the aspects of a job that bring satisfaction. The framework in Table 7.7 helps understand the work related implications of Geert

Hofstede's cultural dimensions. The work values that would manifest themselves while at work are discussed along with examples.

The work values of a nation are as uniquely identifiable as the national cultural dimensions.

Table 7.7 Framework of Work Values

Independence ⟷	***Conformity***
• Flexible work hours • Choosing alternative career paths	• Cleary defined work schedules • Well identified career paths with limited flexibility
Individualism ⟷	***Collectivism***
• Individual accountability for work assigned • More focus on self in addressing concerns, 'I' focus	• Building and encouraging interdependencies at work • Tendency to form groups and collate through identifying some factor of commonality, like gender and religion
Authority ⟷	***Equality***
• Ability to assert authority when something needs to be done • Position, title and status are important and determine the degree of influence	• Lack of relevance for designations/titles, hierarchy • Similar benefits and privileges across the organisation
Compliance ⟷	***Empowerment***
• Acceptance of policies and rules as organisational limitations • Non-adherence merits reprimand and corrective action	• Scope to propose changes to policies and processes • Participatory approach to decision making on work-related aspects

Independence Vs Conformity Arises from the cultural dimension of power dimension, where the belief is more on theory X leadership and management style than theory Y. Organisational structures and systems reflect a highly flexible framework for work related behavior where the power distance scores are low and significantly rigid in the high power distance countries. Work values are evident in a more authoritative way of working, an unconscious respect for people in power and position of authority, and benefits and perks restricted to certain levels within the organisation. The low ranking of long-term orientation reflects freedom in the American culture, which is reflected in work values of greater flexibility, and the freedom to react quickly to new opportunities and challenges.

Individualism Vs Collectivism Similarly, work values that convey 'time is money and punctuality is highly regarded' are derived from high culture scores on individualism, where the 'self' is important and everything else has a time and place in life, which is evident in the American workplace.

Authority Vs Equality In Japan, the high scores for uncertainty avoidance imply a work value of security and conformity to rules and policies, speaking-up or voicing individual opinions are neither appreciated nor encouraged.

Compliance Vs Empowerment Correlated to cultural scores on masculinity, the male are naturally empowered, by virtue of their gender.

Work values are a derivative of the country's cultural dimensions, and are key determinants of how decisions are made, providing a framework that enables the individuals to protect/defend what they believe in. Common work values propel outstanding performance, and when work values clash, conflict occurs and performance is impacted adversely. Knowledge of work values prevalent in a country helps MNC's respect and build a tolerance for how work gets done in each of its subsidiaries. Vendor behaviour in a country like India, where timeline commitments are 'made to be broken', would be very difficult to comprehend for an American firm where vendors are genuinely committed to contractual terms which are legally enforceable.

Work values can be a source of stress, especially during the time of entry of an organisation into a host location, when the impact of diversity in the values is most severely experienced by individuals of the parent as well as the host country. Awareness and acceptance of the work values in various countries where an MNC operates, especially among managers and those who interact extensively with individuals in the host location, and vice versa, are critical for facilitating a more collaborative approach to problem solving and decision making in a multinational context. It also ensures that the expectations are balanced and realistic.

The speed and ease of acclimatisation to work values are also dependent on the degree of cultural distance between the parent and the host cultures. Therefore, countries with somewhat similar scores on Hofstede's cultural dimensions would be able to get into a working relationship with the least amount of effort and acclimatisation, as compared to countries which are more wide apart on the scores.

The World Values Survey

The World Values Survey (WVS) is an ongoing, large-scale study of sociocultural and political change that is investigating basic values and beliefs of people in more than 65 countries on all six continents, containing almost 80% of the world's population. Researchers from around the world are collecting data from a sample of at least 1000 people in their own societies under the guidance of an international steering committee. There have been four waves of data collection: 1981, 1990–91, 1995–96, and 1999–2001.

The two most important dimensions of societal values according to the WVS are traditional versus secular orientation towards authority and survival versus self-expression values.

Traditional Versus Secular Orientation towards Authority Societies with a traditional orientation towards authority have values that reflect early times and the centrality of the family. These values include the importance of God, the importance of obedience, and religious faith over independence and determination, and views against abortion, euthanasia, and suicide. Further, traditional cultures emphasise social conformity rather than individuality, believe in absolute standards of good and evil, support deference to authority and have high levels of national pride and nationalistic outlook. South Asian countries, Turkey and Philippines come under this category.

Societies with secular or rational values have values opposite to those described above. Most ex-communist countries, earstwhile USSR, Bosnia, Romania and Georgia are some of the countries that are guided by secular values.

Survival versus Self–Expression Values Survival inspired societies place priority on economic and physical security over self-expression and quality of life. These societies also have low levels of subjective well-being, report relatively poor health, are low on inter-personal trust, emphasise materialist values and have relatively high levels of faith on science and technology. Such societies include mainly African countries.

US, Australia, New Zealand, Britain, Canada and European countries fall into the category of societies inspired by self-expression. Societies with high self-expression values tend to have the quite opposite preferences, for example, they are trusting and tolerant of others, politically active, happy and place priority on self-expression and quality of life.

Negotiating

The final dimension of cross-cultural management relates to negotiating. The next chapter deals exclusively with cross-cultural negotiations.

Summary

- International manager needs to imbibe multi-cultures. He or she should acclimatise culture of the host country (LO1)
- Multinational businesses have four orientations before them: ethnocentric, polycentric, geocentric, and regocentric approaches. A full blown MNC needs to follow geocentric orientation (LO2)
- Globe Project Team, Hofstede's, and Trompenaars cultural dimension are the most popular and have wide applications. The later identifies 7 dimensions, Hofstede has identified 4 of them and Globe Team has identified nine of them (LO3)
- For an international manager, multicultural management involves managing motivation, leadership, communication, teams, negotiation and work values (LO4)

Review Questions

1. Explain the four cultural predispositions MNCs tend to have towards managing in a global context. (LO2)
2. What are the challenges in communicating across cultures? (LO4)
3. Explain Hofstede's cultural dimensions that enable an understanding of cultures across countries. (LO3)
4. Explain Trompenaar's framework of cultural dimensions. (LO3)
5. Describe Globe project's leadership dimensions. (LO3)

Discussion Questions

1. Dovetail Hofstede's cultural dimensions with Globe project's framework. Bring out the similarities and dissimilarities. (LO3)
2. Discuss the motivational techniques relevant across cultures. (LO4)

Reinforcing Exercises

- Philips, a Dutch firm, is an example to be mentioned when we talk about ethnocentricism. 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. Japanese companies too are known for ethnocentricism to the core. Maruti Suzuki is only one example. According to the Japanese Overseas Enterprise Association, only 29% of the Japanese subsidiaries of foreign companies had presidents who were not Japanese. In contrast, 66% of the Japanese subsidiaries of foreign companies had Japanese presidents.

  Can you extend this write up by citing more examples?
- India is known for high power distance cultural orientation. Telengana is the state to be stated first. Inequality is accepted and respected in this state. In fact, if any agricultural labourer should see his landlord, he must remove his chappals, take-off his towel and tie it around his waist and address the land owner as "I am your servant". The worker should address his boss as "I am your servant" before every sentence he speaks. Where else do you find this phenomenon?
- Bill Hewelett and David Packard, founders of Hewlett-Packard, propagated a set of values known as the "HP Way". These values, which shape the way business is conducted, have an important ethical component. "HP Way" is applicable to all subsidiaries of HP. Do you think such ethical principles made applicable across the board in all subsidiaries will work?

CLOSING CASE 1

Troubled Team

When a major international software developer needed to produce a new product quickly, the project manager assembled a team of employees from India and the United States. From the start the team members could not agree on a delivery date for the product. The Americans thought the work could be done in two to three weeks; the Indians predicted it would take two to three months. As time went on, the Indian team members proved reluctant to report setbacks in the production process, which the American team members would find out only when work was due to be passed to them. Such conflicts, of course, may affect any team, but in this case they arose from cultural differences. As tensions mounted, conflict over delivery dates and feedback became personal, disrupting team members' communication about even mundane issues. The project manager decided that he had to intervene with the result that both the American and the Indian team members came to rely on him for direction regarding minute operational details that the team should have been able to handle itself. The manager became so bogged down by quotidian issues that the project careened hopelessly off even the most pessimistic schedule, and the team never learned to work together effectively.

Questions

1. What mistakes did the project manager commit while constituting a team?
2. Which of the strategies (see Table 7.6) do you recommend to bring the team back on track?

CLOSING CASE 2

Waiting in New Delhi

Richard was a 30-year-old American, sent by his Chicago-based company to set up a buying office in India. The new office's main mission was to source large quantities of consumer goods in India: cotton piecegoods, garments, accessories and shoes, as well as industrial products such as tent fabrics and cast iron components.

India's Ministry of Foreign Trade (MFT) had invited Richard's company to open this buying office because they knew it would promote exports, bring in badly-needed foreign exchange and provide manufacturing knowhow to Indian factories.

Richard's was, in fact, the first international sourcing office to be located anywhere in South Asia. The MFT wanted it to succeed so that other Western and Japanese companies could be persuaded to establish similar procurement offices.

The expatriate manager decided to set up the office in the capital, New Delhi, because he knew he would have to frequently meet senior government officials. Since the Indian government closely regulated all trade and industry, Richard often found it necessary to help his suppliers obtain import licenses for the semi-manufactures and components required to produce the finished goods his company had ordered.

Richard found these government meetings frustrating. Even though he always phoned to make firm appointments, the bureaucrats usually kept him waiting for half an hour or more. Not only that, his meetings would be continuously interrupted by phone calls and unannounced visitors as well as by clerks bringing in stacks of letters and documents to be signed. Because of all the waiting and the constant interruptions, it regularly took him half a day or more to accomplish something that could have been done back home in 20 minutes.

Three months into this assignment, Richard began to think about requesting a transfer to a more congenial part of the world, 'somewhere where things work'. He just could not understand why the Indian officials were being so rude. Why did they keep him waiting? Why didn't the bureaucrats hold their incoming calls and sign those papers after the meeting, so as to avoid the constant interruptions?

After all, the Government of India had actually invited his company to open this buying office. So didn't he have the right to expect reasonably courteous treatment from the officials in the various ministries and agencies he had to deal with?

Questions

1. Why is Richard not able to jell with local conditions?
2. If you were Richard, what would you do?

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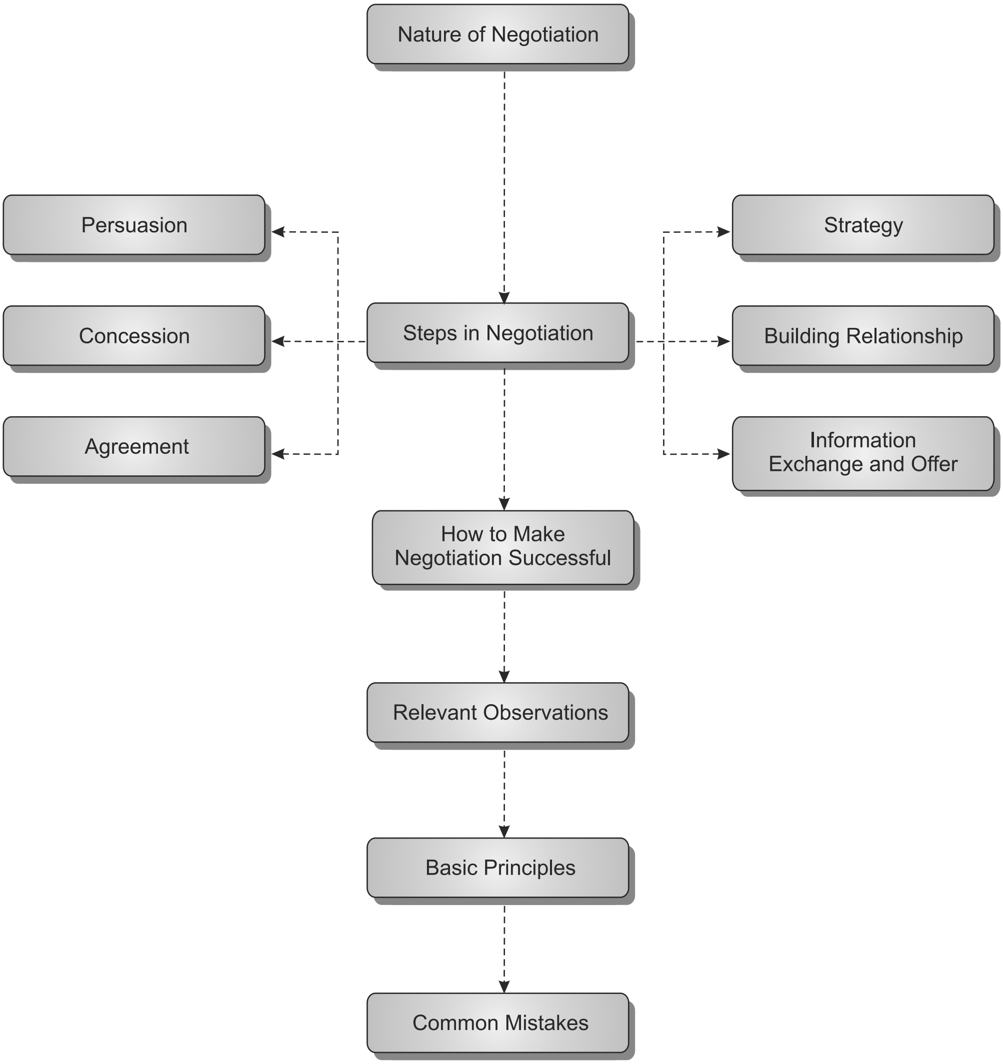
CHAPTER



Nature of Negotiation
Persuasion
Concession
Agreement
Steps in Negotiation
Strategy
Building Relationship
Information Exchange and Offer
How to Make Negotiation Successful
Relevant Observations
Basic Principles
Common Mistakes

8

Negotiating Across Cultures

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Define the nature of negotiation
- **LO 2:** Illustrate the steps in international negotiations
- **LO 3:** Examine the environmental factors impacting negotiations
- **LO 4:** Use important tips to make negotiation successful
- **LO 5:** Relate to relevant observations
- **LO 6:** List the basic principles
- **LO 7:** List the common mistakes

Opening Vignettes

What Went Wrong?

Roger Brown, marketing vice president for a Seattle-based lumber company, was making a sales presentation to a plywood wholesaler in Tokyo. Roger had just proposed what he considered to be a fair price for a large shipment of first-quality plywood. Much to his amazement, the three Japanese executives did not respond immediately but rather sat across the table with their hands folded and their eyes cast downward, saying nothing. Fifteen seconds passed, then thirty, and still no response. Finally, Roger became so exasperated that he said with a good deal of irritation in his voice, "Would you like me to repeat the offer?" From that point onward, the talks were stalled, and Roger never did successfully negotiate a contract for plywood.

***

It was in the early days of Tata Consultancy Services (TCS). A delegation from the company went to the US to negotiate for a deal with an American firm. In spite of the most competitive terms quoted by TCS, it failed to bag the project. On being probed, the reason for not securing the order was interesting: "the Indian delegation compressed only men".

***

In 2009, Ambani tried to buy Cyondell Basell global chemicals firms then in bankruptcy. The deal would have catapulted Reliance Industries onto the world stage, putting it into the same multinational bracket as Tata or Samsung and positioning it as a possible rival to big Western firms such as BASF and Shell. If it had come off, the deal would also have made Ambani richer.

The deal, however, came to a naught. A former Lyondell executive says Reliance was out of its depth. Though it conducted extensive due diligence it had a "nickel-and-dime" approach to negotiations that might have worked in India but appeared naïve and arrogant abroad. Lyondell managers found Ambani tough and charming, but felt his underlings were not up to snuff. "Their style….would not even get them services consideration in the boardroom of Exxon or Chevron," says the executive.

NEGOTIATING is a basic human instinct. When a child cries and obtains what he/she wants from his or her father, the child has negotiated successfully. If a wife convinces and makes her husband buy a necklace for her as an anniversary gift, she proves to be a successful negotiator. Why, then negotiating in international business? Negotiating is at the heart of global business. International managers travel around the world seeking business relationships. These are the days of investments, mergers and acquisitions. At every stage, the global manager is required to negotiate with his or her counterparts across the globe.

This chapter describes the nature, process, tips for successful negotiation and other related issues.

NATURE OF NEGOTIATION

LO 1
Define the nature of negotiation

Negotiation refers to a process in which two or more entities come together to discuss common and conflicting interests in order to reach an agreement of mutual benefit. What needs emphasis is that there is no scope in negotiation for intimidation, or bludgeoning the other party into submission. Rather, it involves the more subtle art of persuasion, whereby all parties feel as though they have benefited. Negotiation should result in a win-win situation for all the parties involved.

Two types of negotiation are in practice: distributive and integrative. Distributive negotiations occur when two parties with opposing goals compete over a set value. Take the example of a road side vendor vending a product. The intention of the seller is to strike a lucrative bargain – sell the product at the most attractive price. But the buyer's motive is to strike a deal advantage to him – buy the product at the lowest price possible. When the deal is finely struck, one tends to lose and the other to gain. This results in a win-lose situation.

Integrative negotiation aims at a win-win situation – both the parties stand to gain. This negotiation involves cooperation between the two groups to integrate interests, create value, and invest in the agreement. Both groups work towards maximising benefit for both sides and distributing those benefits. When we say both the parties stand to gain, it does not mean that everyone receives exactly what they wish for, but instead that the compromise allowed both sides to keep what was most important and still gain from the deal. We focus here on the integrative negotiation.

In international business, negotiation involves handling cross-cultural nuances. In American and several European cultures, negotiations tend to assume an aggressive, adversial manner. Negotiations in these societies view contracting as a win-lose proposition, taking pride in having driven the hardest bargain.

In Asian countries, negotiations take a much different form. The role of a contract in Asian societies is influenced by three aspects of local cultures. First, every person must strive to maintain harmony and accord in society. From childhood, individuals are taught to avoid disputes and acrimony in their personal and business relationships with others. Second, the maintenance of harmony and the importance placed on personal dignity stress the importance of not embarrassing others. The considerable social pressure to avoid dishonour works in all aspects of life, including negotiating contracts and resolving contract disputes. Third, most Asians attach utmost importance to the social group to which one belongs, particularly to one's school or company. Thus, business people may be characterised by their group loyalty, and their desire for group harmony and consensus.

Thus, negotiation is—

- a voluntary activity in the sense that either party can break away or refuse to enter discussion at any time.
- a win-win situation. Each negotiating party feels that he or she has won in the hardest way.
- implies that both the parties are serious about the deal and are willing to enter a contract after the deal is struck.
- the process that is influenced not just by hard facts but by the personal values, skills, perceptions, attitudes and emotions of the parties at the bargaining table.
- time bound activity. Timing is a critical factor in negotiation. It plays an important role in influencing the overall climate, and directly affects the ultimate outcome of the discussions.

STEPS IN INTERNATIONAL NEGOTIATIONS

LO 2
Illustrate the steps in international negotiations

Experts on international negotiation agree that it involves atleast seven steps: preparation, strategy, building the relationship, exchanging information and the first offer, persuasion, concessions and agreement (see Fig. 8.1).

Preparation

Successful negotiation demands elaborate preparation. Specifically, preparation involves the following activities:

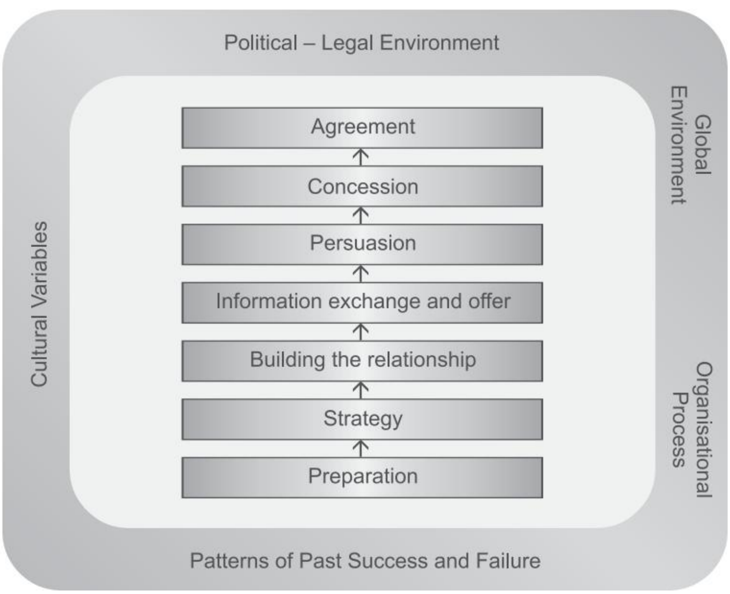


Fig. 8.1 Negotiating Process

Setting bargaining objectives In negotiation, it is vital to understand that 'if you don't know where you are going, you are liable to end up at some place else'. The objective of negotiating should be made clear.

Know the other side Can the counterpart sitting across the table deliver what your company wants? What are the goals of the other side? Is the other side dealing with any competitors, and do the competitors have any advantage?

Place of negotiation The selection of a site for negotiation is of critical importance as the location has impact on bargaining and its outcome. Several issues present themselves in this context. First, the negotiator must adjust to an unfamiliar environment during the days, weeks, or even months of the negotiations. Second, the negotiator is exposed to the deleterious effect of jet lag. Third, the negotiator has little or no control over the setting in which the discussions take place. The size of the conference room, the seating arrangements and the scheduling of times for both negotiating and socialising are the decisions made by the host negotiating team. The side that controls these details of the process tends to use them to its advantage. Fourth, the negotiator, working in a foreign country, is hampered by being physically separated from his or her firm and its various support personnel. Finally, negotiators walking on foreign soil are under pressure to conclude the deal as soon as possible.

Send a proper team A typical negotiating team consists of a business leader or a pursuit leader, who is usually responsible for developing the business and structuring the transaction; a contract specialist, who brings experience with outsourcing contract terms and conditions; and the proposed client manager, who will be responsible for delivery.

Irrespective of the number of the team members and their designations, it is essential that they possess knowledge, skills, communication and experience. In addition, the negotiating team should be adequately authorised. A negotiator without authority is a little more than a messenger, who is unlikely to earn trust or build working relationships with counterparts.

Agenda Is there an agreed-upon agenda? Can it lead to somewhere the company does not want to go?

Developing a Strategy

Developing a strategy is vital in negotiation. Have a situation but also be flexible. The key questions that need to be addressed while developing a strategy are shown in Exhibit 8.1.

Exhibit 8.1

KEY POINTS IN STRATEGY

- What questions should we ask in the first session?
- What questions are they likely to ask?
- How will we answer these questions?
- What is our opening position?
- Do we have enough factual data and information to support this position?
- If not, what extra information could be available?

When you are negotiating as a team, also consider the following questions:

- Who will lead the discussion?
- Who will check understanding (verify facts)?
- Who will ask what questions?
- Who answers the other side's questions?
- Who will work to reduce tension and show concern for people?

(*Source:* Jean-M. Hiltrop and Sheila Udall, *The Essence of Negotiation*, 1997, p. 23)

Building the Relationship

Building the relationship means exchange of pleasantries between the parties. Negotiation partners get to know each other personally. They develop opinions regarding the personality characteristics of the negotiators: what they are really like, what are their goals and whether they can be really trusted.

Generally, building of relationship occurs at a place other than the one fixed for formal negotiation. Bars, restaurants and cultural tours are ideal spots for relation building.

The duration and the relationship building vary across cultures. US business people, for example, are eager to get down to formal discussion straight away. For them, socialising is not very important. So also are Germans. Japanese, on the other hand, believe in socialising. The first step in a Japanese negotiation often occurs by drinking tea in a room outside the formal office.

Cultural differences notwithstanding, relationship building plays a critical role in laying the foundation for an eventual deal.

Exchange of Information and the First Offer

Exchange of information constitutes the fourth step in negotiation. At this stage, both parties exchange information and their needs for the agreement. Parties exchange information that is task-related. It pertains to the actual details of the proposed agreement. Typically, both sides make a formal presentation of what they desire out of the relationship. They present issues such as the quantity, characteristics and price of the product. Both sides usually present their offer. This is their first proposal of what they expect from the deal.

National and business cultures play their role in deciding what information is to be given; how the information is presented; and how close the initial offer is to the actually expected or hoped-for specifications in the agreement.

Being insensitive to cultural nuances often results in the negotiation being aborted in the initial stage itself as the opening vignette shows.

Figure 8.2 shows a comparison among different nations regarding information exchange and

	Arabs	*Japanese*	*Mexicans*	*Russians*	*US Americans*
Information Exchange	Focus is more on information about the relationship and less on technological details	Extensive requests for technical information	Focus is more on information about the relationships and less on technical details	Great attention to detail	Information is given directly and briefly, often with a multimedia presentation
First-Offer or Counteroffer	20 to 50% off goal	10 to 20% off goal	Fair for both parties and close to goal	Extreme and purposefully unfair	5 to 10% off goal

Fig. 8.2 Information Exchange and First-Offer Strategies

(*Source*: Adapted from Chaney and Martin, 1995) first-offers. Note that the Arabs insist more on relationship-related information whereas Japanese insist on task-related information.

Persuasion

The fifth step in the negotiation process relates to persuasion. Persuasion is the heart of the negotiation process. At this stage, each party tries to get the other side to agree to its proposition. There is no single formula for success; each situation needs to be assessed within its own unique set of circumstances. The successful negotiator must choose the appropriate strategy, project the correct personal and organisational images, do the right type of homework, ask the most relevant questions, and offer and request the appropriate types of concessions at the right time.

What is interesting is that no party wants to give away more than it has to, but each knows that without giving some concessions, it is unlikely that an agreement is reached. The success of persuasion depends on (i) how well the parties understand each other's position; (ii) the ability of each to identify areas of similarity and differences; (iii) the ability to create new options; and (iv) the willingness to work towards a solution that allows all parties to experience a win-win situation.

Concessions

Persuasion being successful, final agreement must emerge. Before that, negotiating parties need to offer and receive concessions. Concession making requires that each side relax certain demands to meet the other party's needs.

Two approaches to making concessions are in use—sequential and holistic. **Sequential** approach requires that each party reciprocates concessions made by the other side. Most North Americans follow this approach. In contrast, Asians follow the **holistic** approach. In this, the negotiating parties make very few concessions during discussions of each point in a potential agreement. Only after all participants discuss all issues can concession making start.

Agreement

The final stage in the negotiating process is to hammer out a final agreement. Three steps present themselves in the agreement stage: (i) formulating an agreement; (ii) ensuring implementation; and (iii) reviewing one's negotiating experience.

Formulating an agreement refers to signing the contract agreeable to all sides. The contract must be consistent with the legal system or systems. What is important is that people from different national and business cultures must understand the contract in principle. The signing partners must have a true commitment to the terms of the agreement.

An agreement is not successful until it has been **effectively implemented**. It is therefore useful to include an implementation clause in the contract. Such a clause shall stipulate what needs to be done, when, and by whom.

Implementation demands a totally different mindset from the negotiators. They generally carry a mindest of deal-making. This should be converted into implementation.

After closing the negotiation, the negotiating party should **review own experience**. Following questions are pertinent in this context:

- How satisfied are you with the outcome of the negotiations?
- Who was the most effective negotiator? Who conceded most?
- What strategies and actions helped the discussions most?
- What actions hindered the discussion?
- Did you trust the other party? What affected this feeling most?

- How well was time used? Could it be used better?
- How well did people listen to each other? Who talked most?
- Were creative solutions suggested? What happened to them?
- Did you have a good understanding of the underlying issues and concerns of the other party? Did the other party understand yours?
- How adequate was your preparation? How did this affect the negotiation?
- What were the strongest arguments put forward by the other party? How receptive was the other party to your arguments and ideas?
- What are your main learning points from this negotiation? What would you do differently next time?

ENVIRONMENTAL FACTORS

LO 3
Examine the environmental factors impacting negotiations

As shown in Fig. 8.1, the negotiating process is impacted by cultural, political, and global factors. Of these, cultural variables are the deciding factors. A society's culture plays a decisive role in determining the effectiveness of a negotiating approach. This is particularly true when the negotiating parties come from different cultures, such as an ascription society and an achievement society. As noted in the previous chapter, in an ascription society, status is attributed based on birth, kinship, gender, age and personal connections. In an achievement society, status is determined by accomplishments. Such cultural perceptions do impact the outcome of the negotiating process. Consider the following:

"Pierce Howard, a California winemaker, was making a sales presentation to a large distributor in Shanghai, China. As part of his presentation, Pierce mentioned that he thought that his wines would be well received in China because they were very popular in Japan, and after all, the two countries had a great deal in common. From this point on in the presentation, the Chinese lost interest in Pierce and his line of California wines."

What Pierce did not realise was that the Chinese were resentful of the Japanese who bombed and brutally occupied Shanghai during World War II. These Chinese businessmen did not appreciate being compared to the Japanese, whose culture they believe is derivative of their own.

Government policies influence international negotiations considerably. No negotiations can be held with business people of a country on which economic sanctions are being imposed, Cuba, for example. Current US policy bans the sale of any technology or services to organisations located in countries that support terrorism or build nuclear weaponry.

International business deals occur with multiple currencies that fluctuate daily. Currency fluctuations can affect business negotiations considerably, as is happening to Indian IT and BPO firms in the wake of Rupee emerging stronger against the US dollar.

TIPS TO MAKE NEGOTIATION SUCCESSFUL

LO 4
Use important tips to make negotiation successful

Start reading this section after having a second look at the opening vignette. Here are explained certain tips to make an international negotiation successful. The list is only suggestive and not comprehensive. We explain these tips with a reminder: in the international arena, it is how you handle the client, above all else, that can make or break a deal.

- Focus on long-term relationships, not short-term contracts.
- Avoid over-reliance on cultural generalisation.
- Time is of essence.

- Be a good listener, not a speaker.
- Use interpreters.
- Act ethically and with integrity.
- Avoid use of dirty tricks.
- Have patience.

Focus on Long-term Bondage than on Short-term Contracts

The single most crucial factor in international negotiations is the concern for building long-term relationships. Negotiations succeed when the focus is on building relationship, but not when the focus is on winning the deal. International negotiating is not about winning big, humiliating the opponent, making a killing and gaining all the advantages. Rather, successful negotiation is conducted in a cooperative climate in which the needs of both the parties are met, and in which both sides can emerge as winners. Where both sides feel they have won, there will be motivation to repeat the business dealings.

Building relationships requires that negotiators take time to get to know one another. Frequently, this involves activities such as eating, drinking, visiting national monuments, playing golf, and the like. This type of socialising is vital because it represents an honest effort to understand the needs, goals, values, interest, and opinions of negotiators on the other side. When initiation is earnest, response from the other side is positive.

Avoid Over-reliance on Cultural Generalisation

Knowledge about the cultural environment in which one is operating is vital for making the deal come through. Simply put, the more knowledge people have of the culture of their international business partners, the less likely they will be to misinterpret what is being said or done, and the more likely their business objectives will be met. Communication patterns, both verbal and non-verbal, need to be mastered as well as the myriad of other culture-specific details that can get in the way of effective inter-cultural business communication.

Being knowledgeable of the cultural environment is no doubt highly desirable, but overdependence on such details and the tendency to stereotype cultures are equally counterproductive. Not all Middle Easterners engage in verbal overskill, and not all Japanese are reluctant to give a direct answer. There are exceptions amidst patterns. We may chuckle when we hear heaven defined as the place where the police are British, the cooks are French, the mechanics are German, the lovers are Italian, and it is all organised by the Swiss, conversely, hell is defined as the place where the cooks are British, the mechanics are French, the lovers are Swiss, the police are German, and it is all organised by Italians. Such cultural stereotypes can be offensive to those being lumped together uncritically, but they can be particularly harmful in international business negotiations as they can be wrong. At times, negotiators on the other side of the table do not act the way the generalisations would predict.

Another dimension is the need to be aware of the fact that international negotiations, involving parties representing different cultures, will exhibit extra sources of tension. Cultural dissimilarity reduces interpersonal attraction. Communication problems are the potential causes. Differences in language, non-verbal behaviours, values and patterns of thought lead to frustrations in international negotiators. General differences in negotiation scriptors across cultures cause a variety of negotiative consequences, including negotiative emotions during cross-cultural commercial interactions. (Also see Exhibit 8.2)

Exhibit 8.2

TIPS IN CROSS-CULTURAL NEGOTIATIONS

With Arabs: Junior managers enter first, followed by senior executives; take time to establish rapport and relationships; anticipate efforts to make you feel comfortable by flattery and accommodation; expect to mix business and personal information to establish individual support, trust and commitments; utilise a go-between in the negotiation; to gain concessions, they may try to make you feel guilty and then obligated; they like to bargain and are skilled at making deals; be patient, enjoy the process, and be willing to compromise; their senior managers may withhold a decision until consulting their technocrat.

With Americans : Prepare an agreed-upon agenda; be prompt in starting time; prepare and pass on minutes of the meeting afterwards; the chairperson presents first; focus on issues one at a time; solicit input form all attendees; expect open discussion and debate; share problem-solving ideas; assign individual action items; be direct, assertive, involved and action oriented.

With Chinese: Hire your own interpreter and use to maximum benefit; arrive promptly and prepared with handouts in English and a listing of your team members, titles and responsibilities; initial meetings will go slowly and formally in which background information is exchanged and small talk, but no jokes; only senior members on both sides are expected to talk, unless junior members are invited to provide input; do not interrupt, even if a mistake is made (take notes and share corrections in private); avoid surprises, secretiveness, and generalisations; be prepared to provide details, take notes of their observations and answer questions ; recognise the hierarchy present and seek to gain their trust; expect a large negotiating team and long two-hour lunch breaks; 'face' is important and it can be given, earned, taken away or lost; expect silences; reciprocation is important in teams of referrals, favors and entertaining; realise that the power of the negotiator with mainland and overseas Chinese.

With Japanese: Expect to deal with a homogeneous group of up to 4, junior and middle mangers; establish harmonious, cooperative relationships, giving time to lunch and/or evening dinner and entertainment; follow their rule of 'etiquette', such as, token gifts called 'persenta' which are exquisitely wrapped- use holiday to exchange greetings; seek more information than you initially give; focus on middle managers who make recommendations to senior managers making the decisions; maintain communication by telephone calls, faxes, electronic mail, letters and visits.

(*Source*: Philip R. Harris, *Managing Cultural Differences,* pp 72-73)

Be Sensitive to Timing

We had stated in the beginning of this chapter that international negotiations are time sensitive. It is imperative that negotiations are conducted without wasting time. But, in reality, negotiating is time-consuming, frustrating and involves unanticipated postponements.

Patience often pays in international business negotiations. McDonald's was engaged in negotiations for nearly a decade before it began selling hamburgers in Moscow. Similarly, a high-level salesperson for US office furniture company spent months negotiating a deal in Saudi Arabia. He made frequent courtesy calls, engaged in long discussions on a large number of topics other than office furniture, and drank enough coffee to float a small ship. But the months of patience paid off. His personal commission was in excess of $2 million!

On the other hand, any attempt to hasten negotiation is likely to result in aborting the talk. In a well publicised case involving a subsidiary of the then Enron Corporation, a negotiated contract to sell electricity to a state-run electricity board was eventually cancelled by the government on the grounds that it was conducted too hastily.

Another dimension to time in international negotiations is that some months in a year are inappropriate to conduct negotiations in certain cultures. **Ramzan**, festive month in Islamic countries and Golden Week (in Japan most people take a vacation) are to be avoided.

Still another consideration of time has to do with the different time zones between one's home office and the country in which the negotiations are taking place. Owing to these different time zones, an American negotiating in Manila cannot fax the home office in New York and expect an immediate response, as might be expected if the negotiations were taking place in Boston. Obviously, attempting to operate between two distinct time zones can be frustrating because it tends to slow the pace of negotiations.

Learn to Listen

Listening is vital for the success of negotiations. It helps in atleast two ways. First, the knowledge gleaned through listening can convince the negotiating partners that you are knowledgeable, and thus worthy of entering a long-term relationship. Second, the very fact that you made the effort to hear what they were telling will enhance the rapport and trust between the two parties.

Though listening plays such a vital role, people in general spend only 30 to 40 per cent of their time listening, thus leading to several communication errors.

Listening requires attention, energy and skill. Exhibit 8.3 lists the keys to effective listening. A good listener finds areas of interest, is flexible, works hard at listening and uses thought speed to mentally summarise, weigh and anticipate what the speaker says. Good listening means shifting from thinking about self to empathising with the other person and thus requires a degree of emotional intelligence. The international negotiator does well to look at the tips for effective listening listed in Exhibit 8.3.

Exhibit 8.3

GOOD LISTENER

- Asks questions, paraphrases what is said.
- Looks for opportunities, new learning.
- Avoids distractors, tolerates bad habits, knows how to concentrate.
- Challenges, anticipates, mentally summarises, weighs the evidence, listens between the lines to the tone of voice.
- Nods, shows interest, provides positive feedback.
- Judges contents, skips errors.
- Does not judge until comprehension is complete.
- Listens to central themes.
- Works hard, exhibits active body state, eye contact.
- Listens to the whole message before responding.
- Concentrates more on the message than on the style of presentation.
- Is conscious of staying in the present. Is not carried away by baggage from the past.

Use Interpreters

Services of an interpreter may be used when a party to a negotiation is not comfortable with the language of bargaining. Little knowledge about the language of negotiation is not enough. Unless one is extremely well versed in a foreign language, it is not advisable to negotiate in that language directly, instead one should rely on the services of a competent interpreter. Use of interpreter has its own problems, however. There will be more number of people involved in negotiation, cost of negotiation will increase, and it is a barrier to the two sides really getting to know one another.

A few considerations in selecting and engaging the services of interpreter are in order. First, the person should possess intimate knowledge about the respective languages of the negotiating parties and technical expertise in the area being negotiated. Second, having selected, sufficient time should be given to the interpreter and the negotiator to get to know each other. The interpreter should know the goals and expectations of the negotiator. Third, since negotiation is a testing job, the interpreter should be given breaks periodically to recharge his/her intellectual batteries. Fourth, the negotiator needs to avoid ambiguities, slang, or other forms that do not translate well. Finally, interpreters should be treated with respect and acknowledged as highly qualified professionals.

Exhibit 8.4 contains some more tips on the use of interpreters.

Exhibit 8.4

TIPS ON THE USE OF INTERPRETERS

- Brief the interpreter in advance about the subject.
- Select an interpreter who is knowledgeable about the product or subject.
- Explain to the interpreter major idea in two or three different ways, as the point may be lost if discussed only once.
- Avoid talking more than a minute or two without giving the interpreter a chance to speak.
- While talking, allow the interpreter time to make notes about what is being said.
- Do not lose confidence if the interpreter uses a dictionary.
- Permit the interpreter to spend as much time as needed in clarifying points whose meanings are obscure.
- Interrupting the interpreter as he or she translates may cause misunderstandings.
- It is unwise to expect an interpreter to work for over two hours without rest.
- Consider using two interpreters if negotiation is to last an entire day or into the evening so that when one tires the other can take over.
- Don't be concerned if a speaker talks for five minutes and the interpreter covers it in half a minute.
- Be considerate if the interpreter commits a mistake
- Ask the interpreter for advice, if there are problems.

(*Source*: Philiph R. Harris, et al, *Managing Cultural Differences,* Bufferworth-Heinemann, 2007, p. 80)

Act Ethically and with Integrity

As days go by, the world is becoming more hetrogeneous, fast-paced and complex. Ethical conduct is essential to survive in such a world. Business people, both at-home and abroad, are constantly challenged with ethical dilemmas. Are employees treated fairly? Are organisations preserving ecology? Are businesses paying taxes regularly and honestly? Are business people bribing government officials to procure out of turn favours? These and other related conflicts keep cropping up. A firm stand to remain ethical, notwithstanding consequences, shall help a negotiator to strike a deal to his or her advantage.

Dirty Tricks

Often, negotiators employ dirty tricks to win the deal for their company. Dirty tricks are tactics that pressure opponents to accept unfair or undesirable agreements or concessions. We list the dirty tactics with a caution that they do not pay in the long-run. Some commonly practised tricks are:

Deliberate deception Negotiators present flagrant untruths either in the facts they offer or in their intentions for the negotiation.

Stalling Negotiators wait until the last minute before the negotiating team plans to go home. They then push for quick concessions to close the deal.

Escaping authority Negotiators make an agreement, then reveal that it must be approved by senior managers or the government. The objective is to put the other team under psychological pressure to make more concessions.

Good-guy, bad-guy routine One negotiator acts friendly, while his or her partner makes unreasonable demands. The 'good guy' suggests that only a small concession will appease the unreasonable 'bad guy'.

You are wealthy and we are poor Often used by negotiators from developing countries, this tactic attempts to make concessions seem trivial. Small companies may also use this tactic when dealing with larger firms.

Old friends Negotiators act as if the companies and their negotiators have long enduring friendships. They feign hurt feelings if their counterparts disagree or do not agree to their requests.

Have patience Negotiating is not a quick-fix game. The process of negotiating may stretch over a couple of years. Often tempers are frayed and talks get deadlocked. Merger negotiates between Bharti Airtel Ltd and South Africa's flagship MTN Group Ltd, for example, collapsed in acrimony a year ago. But the talks have resumed and everybody is hoping that the merger deal would be through. Unfortunately, the deal fell through.

RELEVANT OBSERVATIONS

LO 5
Relate to relevant observations

Here are the major points to remember while preparing and negotiating international deals:

1. Few negotiations succeed without extensive preparation, both for the technical details of the potential relationship and for dealing with people who bring different cultural backgrounds to the negotiating process.
2. Building personal relationships is a key step in negotiation for most of the world. US managers, in particular, must work harder on this step.
3. First offers may differ by cultural background, and managers must be aware of how their offers are viewed by people from other cultures.

4. There are many tactics in persuasion. Some of these may be considered dirty tricks. Good negotiators are prepared to deal with all tactics.
5. The processes surrounding giving and receiving concessions may be viewed quite differently by people from different nations. A good international negotiator knows how his or her counterpart views the concession-making process.
6. Culture and legal traditions influence the content and force of law regarding business contracts. An international negotiator should not assume that a signed contract means the same thing in all countries.
7. Competitive negotiation, with its use of dirty tricks and rigid positions, seldom leads to long-term relationships.
8. Problem-solving negotiation is more flexible, and probably a more successful strategy for the international negotiator.
9. Individuals who engage in international negotiations must be flexible, empathic and physically tough.

Before concluding this chapter, we propose to add two more sections—principles and mistakes in negotiation.

BASIC PRINCIPLES

LO 6
List the basic principles

While negotiating, it is important to consider the following:

- Negotiation is a voluntary activity in the sense that either party can break away from or refuse to enter discussion at any time.
- A negotiation usually starts because at least one of the parties wants to change the status quo and believes that a mutually satisfactory agreement is possible.
- Entering negotiations implies acceptance by both the parties that acceptance between them is required (or is desirable) before a decision will be implemented. If the matter can be decided unilaterally by one of the parties, there may be no point in committing oneself to the negotiating process.
- Timing is a critical factor in negotiation. It plays an important role in influencing the overall climate and directly affects the ultimate outcome of the discussions.
- A successful outcome in negotiation is not always winning at any cost or even 'winning', but getting what both sides want.
- The progress of all types of negotiation, even when it is conducted through third parties, is strongly influenced by the personal values, skills, perceptions, attitudes and emotions of the people at the bargaining table.

COMMON MISTAKES

LO 7
List the common mistakes

The mistakes generally committed while negotiating are:

- Entering negotiations with a preset mindset
- Not knowing who has final negotiating authority
- Not knowing precisely what power they posses and how to use it effectively
- Entering a negotiation with only a general goal to be obtained upon the final outcome of the negotiation
- Failing to advance positions and arguments of substance
- Losing control over seemingly unimportant factors such as timing and ordering of issues
- Failing to let the other side make the offer

- Ignoring time and location as a negotiating weapon
- Giving up when negotiation seems to have reached a deadlock
- Not knowing the right time to close

Needless it is to say that negotiations in general will be successful when bargaining parties follow the steps: Consider the environmental factor, observe the principles, follow the tips and take care to avoid the mistakes that might collapse the negotiations.

Summary

- Negotiation is a process in which two or more parties discuss deals and agree upon them. Negotiation can be distributive or integrative (LO1).
- Negotiation passes through several stages before a deal is clinched (LO2).
- Cultural variables, political-legal, and globalisation are the factors which wield influence on negotiations (LO3).
- Several tips have been suggested to make negotiation successful (LO4).
- More important requisite is the pre-negotiation preparations (LO5).
- Negotiation process should be conducted keeping certain principles in mind (LO6).
- By observating negotiations across the globe, experts have identified common mistakes which need to be avoided (LO7).

Review Questions

1. What is international negotiation? Bring out the tips that can make a negotiation successful. (LO1)
2. How do cultural variables influence international negotiation? (LO3)
3. Explain the different steps in international negotiation. (LO2)
4. Why are negotiations difficult to conduct in international business? List as many factors as you can think of from cultural, national, and organisational influences that affect the outcome of negotiations. (LO4)

Discussion Questions

1. Pick two countries and discuss the cultural differences in the ways people might use verbal negotiating tactics. (LO3)
2. Discuss the significance of negotiation involving cross-border and cross-cultural transactions. Give examples. (LO3)

Reinforcing Exercises

Ford is one company which takes negotiations seriously. As is well known, Ford does more business with Japanese companies than any other firm. Ford has made a large investment in training its managers with Japanese responsibilities. Over 2000 of its executives have attended a three-day programme on Japanese history and culture and the company's Japanese business strategies. In addition, more than

1000 Ford managers who work face-to-face with Japanese have attended a three-day programme called "Managing Negotiations: Japan". The company also conducts similar programmes on Korea and China.

Any parallels can you draw?

CLOSING CASE

Offers Turned Down

Frank Mcdougal had been chosen to set up a branch office of his engineering consulting firm in Seoul, Korea. Although the six engineering consultants who would eventually be transferred to Seoul were Americans, Frank was interested in hiring local support staff. He was particularly interested in hiring a local person with excellent accounting skills to handle the company's books. He was confident that he would be able to find the right person for the job because his company was prepared to offer an excellent salary and benefits package. After receiving what he considered to be several excellent leads, he was surprised to be turned down by all four prospective candidates. They were very appreciative of being considered for the position, but all preferred to stay with their current employer. Frank just couldn't understand why all four Koreans chose to pass up an increase in salary and fringe benefits.

How would you explain this situation to Frank?

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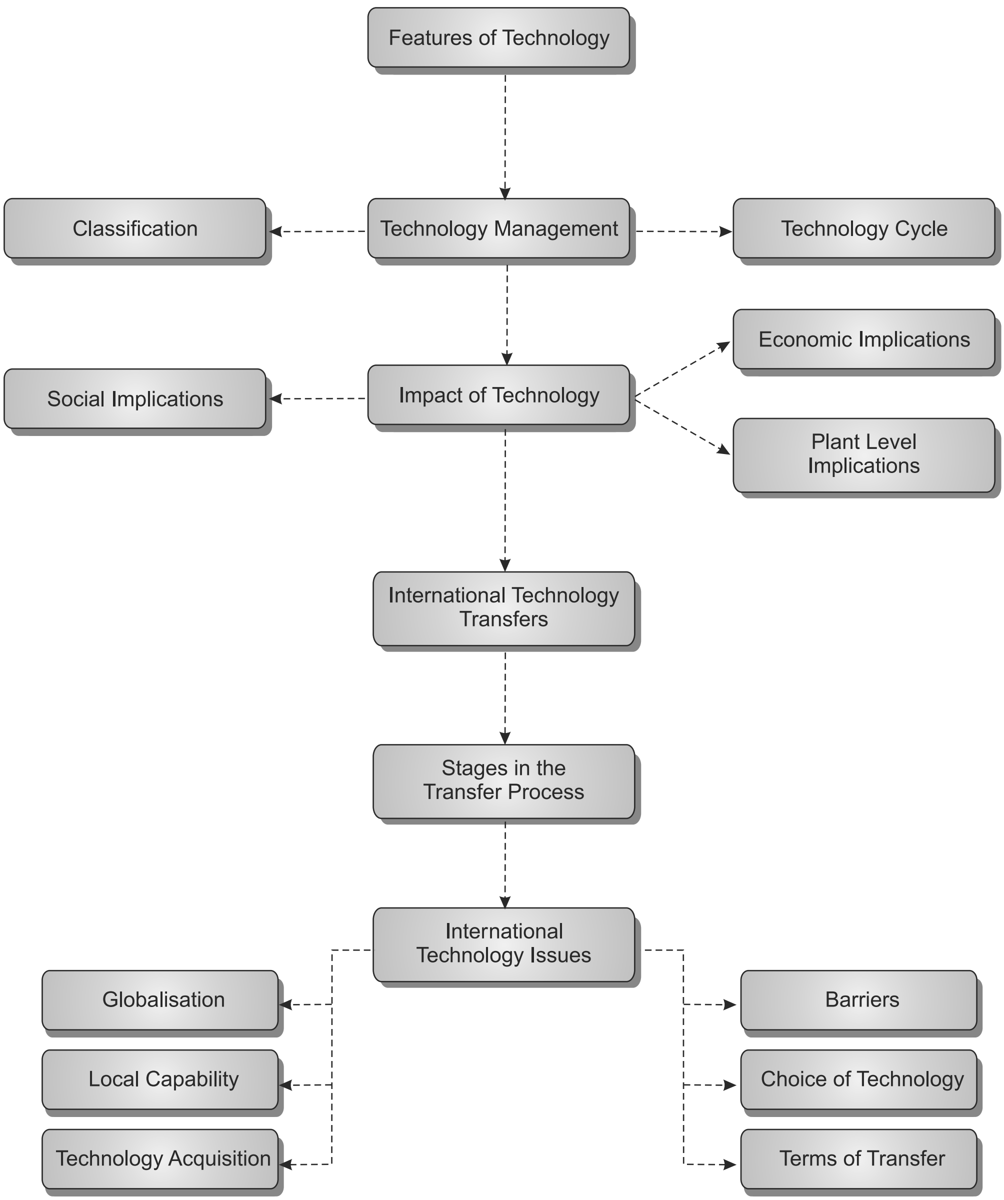
CHAPTER



Features of Technology
Technology Management
Classification
Technology Cycle
Economic Implications
Social Implications
Impact of Technology
Plant Level Implications
International Technology Transfers
Stages in the Transfer Process
International Technology Issues
Globalisation
Local Capability
Technology Acquisition
Barriers
Choice of Technology
Terms of Transfer

9

Technological Environment

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Recall the nature of technology
- **LO 2:** Outline the features of technology
- **LO 3:** Examine management of technology
- **LO 4:** Interpret the impact of technology
- **LO 5:** Relate to the international technology transfers and its stages
- **LO 6:** Evaluate international technology issues

Opening Case

India-Hub of R&D

There were times when Indian companies were doling out large sums of money in importing technology. In 2006, for instance, Corporate India spent 2.5 times more in paying for technological know-how than in developing their own. For two years before that they paid close to 10 times for technology/IP than for developing their own.

Compare India's situation with its nearest rival China and the difference is huge. China has seen four times the number of patents filed than India. Taiwan meanwhile, has improved its focus on innovation and has even set up a central agency for the purpose.

Things are changing now. As Indian companies are globalising, they realise that they should have long product pipelines. This is not possible without an in-house research programme. Years ago, Videocon for instance had a 'commodity' approach to the market, but with margins moving towards the high-end technology differentiating market, the company has changed tack. The company has set up R&D centres in Japan, Italy, China and India of course. In fact, Videocon has raised its R&D budget from 1% to 4% on its turnover.

Indian companies have been trying out a variety of ways to gain the technological edge. There is no one approach but different companies are developing their own models to do research that will make them gain edge over rivals.

Consider large conglomerates, for example, the Tata Group or for that matter the Reliance Industries—both are focusing on technologies that might be fairly big but nobody is sure when the technology will come to fruition. Take Tata Group's desire, for instance, to develop advanced building materials. These materials might mitigate the usage of steel in construction. But one needs builders and customers to use such materials. This is clearly a long-term plan and the group is spending close to Rs. 300 crore on this research.

Reliance Life Sciences, set up in 2001 (a subsidiary of Reliance Industries) is working on novel proteins and is still in early stages of development. The company is also developing a wide range of cell-based therapies for regenerative medicine. Its research programme focuses mostly on embryonically and hematopoietic stem cell tissue engineering, cell-based vaccines and immunotherapy.

MNC's are eyeing India as a hub for R&D activities. Microsoft has its research centre in Bangalore. Staffed with around 60 fulltime researchers, many of them are Indians with PhD's from top universities in the US. The centre is at the cutting edge of Microsoft's R&D. It covers seven areas of research, including mobility and cryptography.

Its success, including developing a popular tool for Microsoft's new search engine Bing, underscores the potential of R&D in India at a time when cost-conscious firms are keen to offshore to save money by using talented researchers abroad. Bing tool, which enables searches for locations with incomplete or even incorrect addresses, the innovation would never have taken root if the R&D had been done in the US.

While India might seem like a natural location to expand off-shoring into R&D, it is hampered by some serious structural problems that range from inadequate home-grown researchers to a lack of government support. India produces around 300,000 computer science graduates a year. Yet, it produces only around 100 computer science PhDs, a small fraction of the 1,500-2,000 that get awarded in the US or China every year.

Students here are not exposed to research from an early age, faculties are not subject to research and there's no career path for innovation because there's a lot of pressure to get a 'real' job.

The small numbers of PhD's and the lack of government incentives for India's fledgling R&D sector are blunting the country's edge.

Rival China has already pulled ahead with at least 1,100 R&D centres compared with less than 800 in India, despite lingering concerns about rule of law and intellectual property rights. Aside from providing funding to encourage students to complete their PhD's, China also offers fiscal incentives such as tax breaks for R&D centres and special economic zones provide infrastructure for hi-tech and R&D industries. India is also losing out in the patent stakes. In 2006-07, just 7,000 patents were granted in this country of 1.1 billion people, compared with nearly 160,000 in the US.

R&D in India is cheaper than in China. But salaries in India have been rising by around 15% every year and may soon reach parity with China. R&D centre costs in Shanghai are currently just 10-15% higher than those in India.

Cisco Systems Inc., International Business Machines Corp; Intel Corp., Nokia Corp., Telefon AB, LM Ericsson and Suzuki Motor Corp have all gone beyond low-end coding and tweaking products for the local market, with heafty investments and recruitment. Their success shows India's potential if the government starts supporting such ventures and building high-tech parks and incubators.

Texas Instruments Inc. and San Francisco based Cadence Design Systems Inc. were among the first to set up R&D in India in the mid-1980s, drawn by the legions of English-speaking software engineers who could be hired at around 20% of the cost of engineers in the US.

The opening of the economy in the early 1990s and the establishment of the software services industry drew more foreign firms looking to cut costs and tap emerging markets.

Firms first focused on the development only, but research has grown in importance in recent years, and many of the facilities in India are now the largest, outside their home base.

Half of Cisco's core R&D work, including innovations in WIMAX and optical networks, and around 40% of business software firm SAP AG's ideas for processes and product development come from India.

WIMAX, short for worldwide interoperability for microwave access, is a telecommunications technology that provides wire-less data transmission.

The Indian units are more tuned to the needs of customers in emerging markets. Besides, Bangalore is only a five-hour flight away form three strategic regions; South-East Asia, East Asia and the Middle East.

IBM's India Research Labs do a 'fair share of patenting', helping swell the parent's record numbers every year. Its new $100 million mobile communications research, Mobile Web, is the first time a big project has been driven form outside the US.

NATURE OF TECHNOLOGY

LO 1
Recall the nature of technology

TECHNOLOGICAL environment, like its counterparts—political and legal, and cultural—wields considerable influence on international business.

J K Galbraith defines technology as a 'systematic application of scientific or other organised knowledge to practical tasks'. During the last 150 years, technology has developed substantially. Science and technology (see Exhibit 9.1 for the difference between the two terms) enabled man to conquer distances; control birth rate; save lives; generate, preserve, and distribute energy; discover new materials and substitutes to existing ones; introduce machines to do the work of human beings; substitute mental work with computers; probe deep into the seas and space in search of new treasures; provide himself with lot of leisure and comfort, ad infinitum.

Exhibit 9.1

SCIENCE AND TECHNOLOGY—THE SEMANTICS

It is useful to place the two words—science and technology in their proper perspective. It may be noted that the word science refers to a systematised body of knowledge and when this knowledge is put into practice, it becomes technology.

There are similarities and dissimilarities between the two terms. With regard to similarity, it may be stated that the two are inter-dependent. Advances in science help develop new technologies while at the same time, the need for new technologies and products provide the drive for new scientific discoveries. The difference between science and technology may be brought out as follows:

	Features	Science	Technology
1.	In pursuit of	Knowledge	Socio-economic gains
2.	People involved	Scientists	Engineers
3.	Agencies involved	Research institutions and universities	Industrial establishments
4.	Funding	Mostly government	Industry
5.	Motivation	To satisfy curiosity	To bring out need satisfying products
6.	Domain	Public	Private/secret
7.	Impact	Discontinuous	Continuous
8.	Time span	Uncertain	Evolutionary

As years roll by, new discoveries have been added. 1983 was particularly considered by scientists as the year of scientific success. In this year, scientists put a billion-dollar technology into space;

produced the world's first test-tube triplets and obtained evidence of another solar system. In the field of medicine, Japan marketed the much-awaited artificial blood system. A major breakthrough was achieved in the field of genetic engineering to cure dwarfism. The US physicists stripped off all the electronics from the uranium atom thus exposing the bare nucleus. It was also the year when the doctors were confronted with a baffling disease, namely, AIDS (Acquired Immune Deficiency Syndrome) also named 'Grey Plague' that has taken a heavy toll of human lives.

The year 1998 belonged to the nuclear scientists of India—they shook the world with serial underground nuclear blasts at Pokhran, resurrected a dead atomic reactor in Rajasthan, and concluded negotiations with Russia on building a 2000 megawatt power station in Tamil Nadu.

Globally the year witnessed an array of events: construction of an international space station, a lamb delivered by the world's first cloned sheep Dolly, the block-buster anti-impotency pill Viagra, teleportation and the discovery that a strange force is pushing the universe apart.

Technology is the most dramatic force shaping the destiny of people all over the world. Some of the technological inventions man feels, are wonders (see Exhibit 9.2), some others are horrors, and yet others have mixed blessing. Automobiles and television for example have evoked mixed reactions. Hydrogen bomb, nerve gas, and submarine guns have proved to be horrors. Penicillin, open heart surgery, and birth control pills are wonders.

In Iran, protestors use twitters, facebook, instant messaging and cell phones for destructive purpose. China uses electronic gadgets to quell protestors. Beijing employs cyber police to regulate websites, patrol cyber cafes, monitor cell phone text messaging and track down Internet activities. The same devices were used recently to overthrow dictators in many of the Middle-East and North-African countries.

Whether one is enthralled or appalled by a technological invention depends on one's outlook.

Exhibit 9.2

MAGNIFICENT AND MOVING

The rescue of miners trapped in the bowels of the earth in Chile's San Jose mine in Copiapo has inspired awe and admiration round the world – for the way humanitarian values fused with state-of-the-art technology to score an unparalleled and moving triumph. To keep 33 miners trapped in gold and copper mine 700 metres under the earth's surface and in reasonably good physical and mental health for 69 days was a challenge with few precedents. On Oct 13, 2010, the world exulted as 31-year-old Florencio Avalos, who had done wonders for the morale of his comrades, emerged from a special rescue capsule. The workers whose bare-chested images in their sweltering dwelling had become familiar to people worldwide were reborn, thanks to the modern-day secular miracle. Those who were reunited with their families naturally felt that life meant much more to them now. Some wanted more attention devoted to safety. The operation was executed with tremendous preparation, precision, and orderliness, without which there would have been no question of success. There are heart-warming stories such as those of 19-year-old Jimmy Sanchez, the youngest member of the group who preserved himself with thoughts of his two-month-old daughter, and 63-year old Mario Gomez, who has been working in the mines from the age of 12 and was thinking of retiring when the world seemed to come down around him. Happily, they have won their freedom weeks earlier than was thought possible.

(Source: *The Hindu*, dated Oct 14, 2010)

FEATURES OF TECHNOLOGY

LO 2
Outline the features of technology

Before we describe the impact of technology on business, we propose to bring out the salient features of technology. The first feature of technology is its change and then more change. Technology forces change on people whether they are prepared for it or not. In the modern society, it has brought so much change that it creates what is called future shock, which means that change comes so fast and furiously that it approaches the limits of human tolerance and people lose their ability to cope with it successfully.

More ideas are being worked on the time gap between idea and implementation but the time between introduction and production is shortening considerably. Experts have estimated that 80 to 90 of all the scientists who ever lived are still alive today. Business leaders must always watch out for changes and developments taking place around. New developments must be adopted and new ideas explored, else the business units would perish at the earliest.

Disruption is the substitute word for technology change. Technology disruption refers to the replacement of old technology by a new one. Steam power replaced animal and hydropower. Then electric power and the combustion engine largely replaced the stream technologies. Among the computer mainframe companies, only IBM survived and others disappeared. The mainframe companies were then replaced by mini-computer companies where only HP survived as an independent firm—the other main players, Digital and Tandem, were acquired by HP and Sun by Oracle. The mini computer was then replaced by the personal computer, which, in turn, may be replaced by mobile phones and tablets. At every technological transition, old players were left behind and new ones emerged, though it can take decades for such a transition to take place.

Another feature of technology is that its effects are widespread, reaching far beyond the immediate point of technological impact. Technology ripples through society until every community is effected by it. The shock waves push their way into even the most isolated places. People cannot escape it. Even if they travel to remote places as in Far East, technology is still represented by vapour trials from airplanes flying overhead, microwave communication signals from satellites moving fast, and a haze from air pollution often preventing a view of the afar side.

An additional feature of technology is that it is self-reinforcing. As stated by Alvin Toffler, “Technology feeds on itself. Technology makes more technology possible.” This self-reinforcing principle implies that technology acts as a multiplier to encourage its own faster development. It acts with other parts of society so that an invention in one place leads to a sequence of inventions in other places. Thus invention of the wheel led rather quickly to a dozen or more applications. These applications, in turn have affected 50 other parts of the system and led to several additional inventions that similarly influenced society as technology multiplies.

Yet another feature of technology is that it is a complete set of knowledge, ideas, and methods and is likely to be the result of a variety of activities—both internal and external. Technological process, tends to be a gradual process consisting of a sequence of small increments lying along a continuous path.

From a micro perspective, technology refers to the level of sophistication with which a factory uses inputs such as labour, finance, machines, and raw materials to produce output. Viewed from this perspective, technology may be compared to a black box (see Fig 9.1). Several inputs enter the box on the one side and product Y comes out at the other side. In this chapter we discuss technology from both macro and micro perspectives.

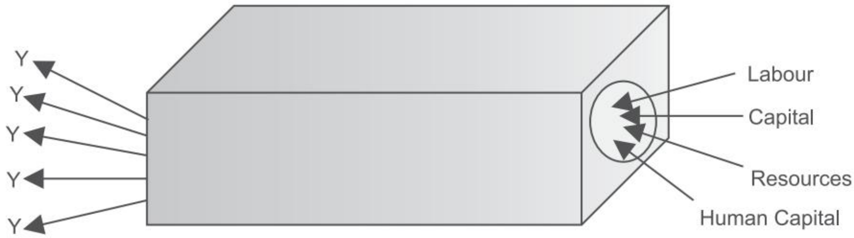


Fig. 9.1 Black Box

MANAGEMENT OF TECHNOLOGY

LO 3
Examine management of technology

Management of technology involves its categorisation and managing the systems that enable the awareness, acquisition, adaptation, advancement and abandonment.

Classification of Technology

Technology can be classified according to any of the following categories:

- *State-of-the-art-technologies*: Technologies that equal or surpass the competitors.
- *Proprietary technologies*: Technologies protected by patents or secrecy agreements that provide a measurable competitive advantage.
- *Known technologies*: Technologies that may be common to many organisations but are used in unique ways.
- *Core technologies*: Technologies that are essential to maintain a competitive position.
- *Leveraging technologies*: Technologies that support several products, product lines, or classes of products.
- *Supporting technologies*: Technologies that support the core technologies.
- *Pacing technologies*: Technologies whose rate of development controls the rate of product or process development.
- *Emerging technologies*: Technologies that are currently under consideration for future products or processes.
- *Scouting technologies*: Formal tracking of potential product and process technologies for future study or application.
- *Idealized unknown basic technologies*: Technologies that, if available, would provide a significant benefit in some aspect of life.

The Technology Cycle

Following classification, technology management involves carefully implementing five stages—awareness, acquisition, adaptation, advancement and abandonment (see Fig. 9.2).

1. Awareness phase This is the first phase of the technology cycle in which a company has a formal mechanism to become aware of emerging technologies relevant to the company's needs. Some companies form 'think tanks' with engineers and scientists, who research from around the world, and gather information through computer bulletin services, journals, magazines, books, conferences and international product exhibitions. This information is synthesized and put in short internal report form for the benefit of corporate strategic planners and technology policy markers.

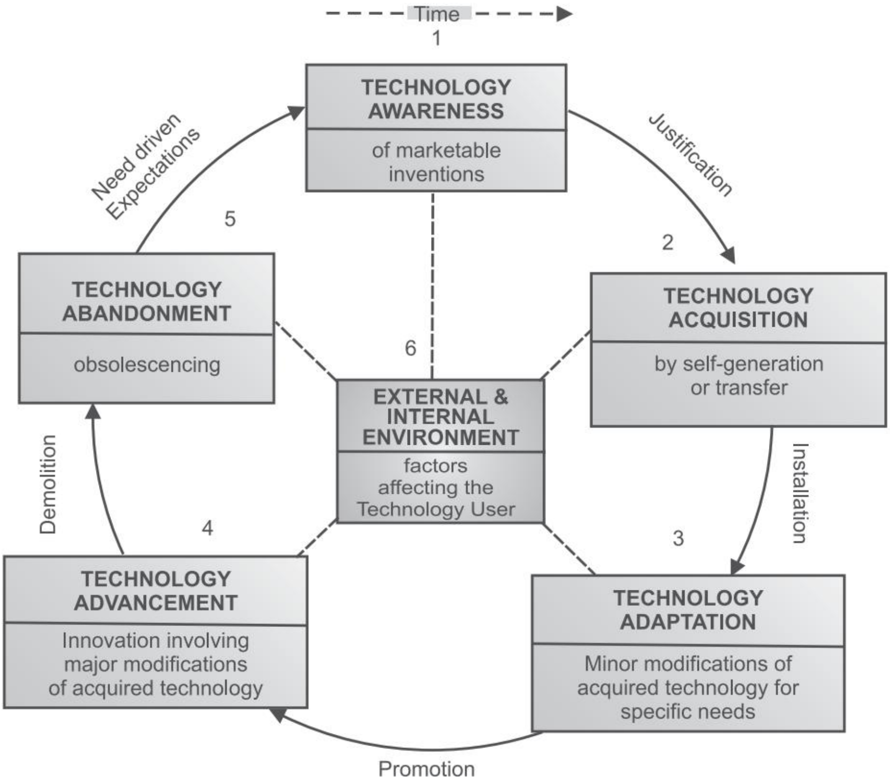


Fig. 9.2 The Technology Cycle, showing the five basic elements of technology management at any given level (product, service, function, work centre, plant/division, corporation, industry, national or international) applicable to deal with an existing or new technology. The dashed lines represent 'analysis.'

(*Source*: Gerard Gayner, *op.cit*., p. 3.5)

2. Acquisition phase This phase involves the actual acquisition of a particular technology. To go from the awareness phase to the acquisition phase, the company's technology group, in collaboration with the industrial engineering group, would conduct technical feasibility study, as well as an economic feasibility study, before justifying and acquiring a new technology.

3. Adaptation phase Virtually every enterprise ends up adapting an acquired technology for its particular needs. If the homework is done correctly, the transition from acquisition to adaptation becomes much smoother and less expensive. Conversely, if sufficient time and effort have not gone into studying the relevance of a particular technology to the company's present needs, a great deal of rework and adaptation result. This not only frustrates the people acquiring the technology but also slows down the assimilation rate, causes major productivity losses, and results in severe quality problems.

4. Advancement phase When capital is limited one cannot indiscriminately purchase and abandon technologies with scarce money. It becomes imperative to improvise the acquired technologies for one's home needs. Companies like Lincoln Electric have taken this thinking to a new height. It is the world leader in electric arc-welding equipment, and generates most of the process technologies internally, eventually patenting them because it cannot find equipment among the vendors. For the most part, it advances its technologies through the efforts of its design and development engineers.

5. Abandonment phase This last phase of the technology cycle is the most critical because decisions are made concerning the obsolescence of a particular technology. With the rapid discarding of existing technologies, timing for new technologies is critical for survival, let alone for winning in the business game. Bad timing in prematurely abandoning a product could result in lost revenues, and on the other hand, waiting too long to abandon might also result in lost revenues because a customer may find a better alternative in competition. There does not seem to be an easy formula to make the selection, but it can be done with greater input of information from different areas of the company, such as research and development, marketing and production.

IMPACT OF TECHNOLOGY

LO 4
Interpret the impact of technology

We propose to discuss the impact of technology in general, under three heads: (a) technology and social change, (b) economic effects of technology, and (c) technology and plant level changes (see Fig. 9.3).

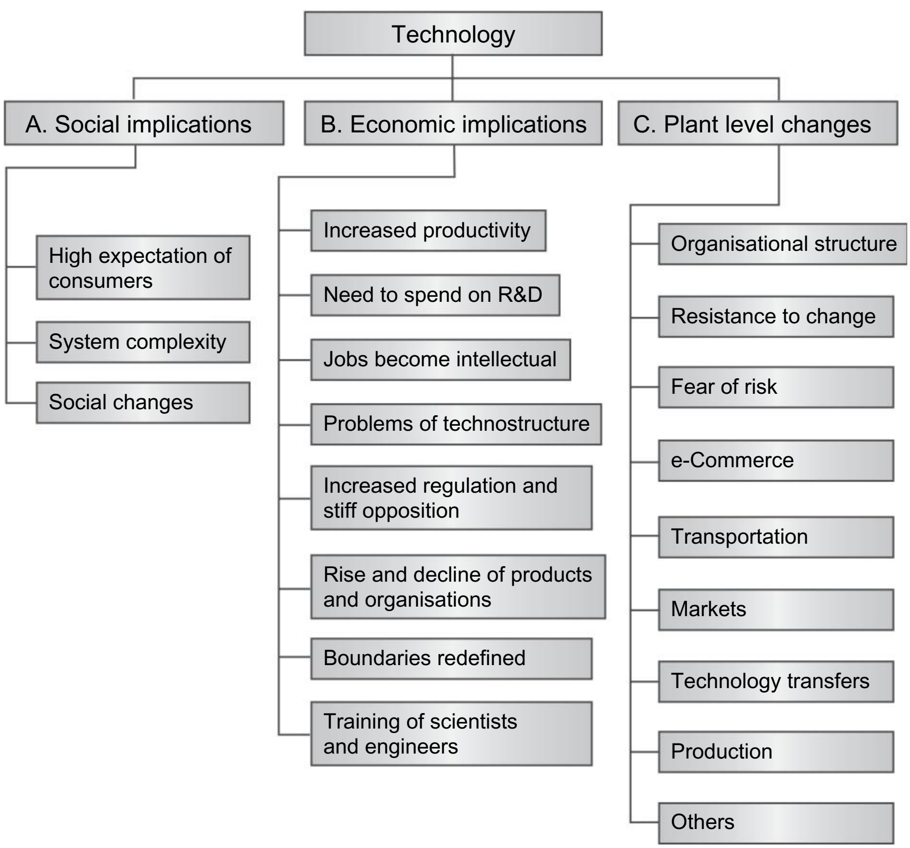


Fig. 9.3 Impact of Technology

Social Implications

Perhaps the most striking influence of technology is found on society. Practically every area of social life and the life of every individual has been, in some sense or the other, changed by the developments in technology.

High Expectations of Consumers Technology has contributed to the emergence of affluent societies. Affluent citizens want more of many things than more of same things. New varieties of products, superior in quality, free from pollution, more safe, and more comfortable, are produced and supplied to the affluent sections. This calls for substantial investments in R&D. One important compulsion for investing in technological advances in Japan is its customer's high expectations regarding design sophistication, quality, delivery schedules, and prices. Industry owners in Japan swear by the dictum—the customer is a god who is always right. High expectations of consumers pose a challenge and an opportunity to the owners of business institutions.

System Complexity Technology has resulted in complexity. Modern machines work better and faster no doubt. But if they fail they need the services of experts for repair. They fail often because of their complexity. A machine or a system is composed of several hundred components. All parts must work in tandem to accomplish a desired task. Reliable performance of each part therefore assumes greater significance.

Also there is interdependence of systems. Failure of power supply, for example, will cause dry water taps, closed petrol bunks, suspended elevators between floors, dark streets, dark houses, no television and radio broadcasts, closed retail establishments, and so on. A localised problem in a power house balloons into a regional problem affecting thousands of people. It is possible that technology might eventually lead to simplicity and small independent operational units. Such a possibility still remains a distant dream. Meanwhile more complexity in work and product systems is expected. Management is, therefore, under pressure to keep the whole system working all the time.

Social Change The role of technology on social change may be observed in more than one way. *First*, there is the change in social life, which results from a change in a technological process. Thus an invention may destroy the economic basis of a city, displace thousands of workers, yet the same invention may result in the creation of a new city somewhere else and create even more jobs than it originally destroyed. Technological changes of this sort create a turmoil in society, with socially uprooted, mobile populations drifting about in search of new centres of employment. Sometimes this drifting may result in a new geographical distribution of population; an example is provided by constant drift of population centres of electronic or aerospace industries.

Secondly, besides uprooting population, technology directly changes the patterns of their social life, for instance the family, the sensitive recorder of all types of change, alters with technological development. An invention may open new employment opportunities to women, radically change hours spent at work and in the family, increase available leisure time, open jobs to youth, and deny them to middle-aged or old workers. Technological development may basically change the stratification system of community. Skilled jobs carrying great prestige may be destroyed. Jobs may be opened to underprivileged members of the society. Technological advancement tends to smoothen out differences, if strategically targeted at the potential workforce. Technology creates a more freer and an egalitarian society.

Thirdly, though social differences tend to be ironed out, status differences are likely to be created by technological advancement in developing countries. Technology flows to less developed countries mainly through multinational companies. With vast resources at their command, multinational corporations have carved out places and images for themselves distinct from local companies. Along with MNCs, people associated with them directly or indirectly behave like a class apart by themselves. Such people are better paid than their counterparts in local companies. With higher incomes, the standard of living enjoyed by these people is fairly high. They form exclusive clubs and are culturally more at home with the industrial West. In fact, the cultural integration of these neo-rich people with the industrial West is so complete that they read the same books, see the same films and TV programmes, have similar fashions, similar groups or organisations of family and social life, similar styles of decorating the home, building furniture and urban designs. Despite linguistic barriers, they have a far greater capacity for communication among themselves than is possible between illiterate and managerial persons in the same country speaking the same language. This international community that has the same patterns of consumption, must have similar patterns of income as well. In India, the employees in foreign collaborations are paid much more than are paid in other local Indian companies, though they do the same job in the same field.

Fourth, the way we cook, communicate, use media and work are affected by technology. Even the language we use is changing, terms that until recently were not even part of our lexicon such as superconductivity, computer engineering, robotics, unmanned factories, miracle drugs, space communications lasers, fiber optics, satellite networks, e-business and electronic funds transfer have become common place. New terms continue to emerge as new products are introduced or improved—always with the anticipation that there will be a newer, faster, and better innovation in the market any day. Social changes are also reflected in our vocabularies. Concepts like house-husband, surrogate mother, and domestic partner all represent changes in society. It is therefore rightly said that the words are the bugles of social change. When our language changes, behaviour will not be far behind.

Fifth, technology has its impact on religion in atleast two ways. First, religiosity has declined in importance as consumers have come to rely on technology rather than on benevolent deities for their well- being. Technology has modernised countries and provided consumers with increased product varieties, new media, alternative view points and new activities. Second (on the negative side), modernisation pressures have produced notable backlashes ranging from movements against genetically modified foods to wholesale rejections of western technologies by certain religious fundamentalists.

Sixth, technology has revolutionalised the education system. The Internet makes vast knowledge bases available to a large number of people electronically. The diffusion of knowledge is occurring at faster rates, making proprietory technologies and ideas more difficult to maintain. At the consumer level, exposure to new lifestyles and behaviours is slowly educating individuals out of parochial perspectives, into broader and more tolerant mindsets.

Technology has virtually democratised education by enabling students in the very poor and remote countries to access the world's best libraries, instructors and courses available through the Internet. A digital learning environment provides students with skills to rapidly discover and access information needed to solve complex problems.

Seventh, technology has transformed attitudes of Indians largely. Old mindsets are demolished, religious shibboleths are destroyed, and status differentials have been levelled up. Weaker sections no more accept suppression and the poor are no more starving. People are becoming pro-change, pro-business and pro-growth. Youths are educated and skilled, ambitious and hardworking. Connectivity has improved. It is a sight to see boys and girls walking up to the colleges and men travelling in city buses talking over mobile phones, often disturbing the fellow walkers and co-travellers.

Another dimension of the impact of technology is on jobs that have become fewer in number with the adoption of new technology. *The Economic Times* dated July 16, 2014 reports that jobs per billion dollar earnings fell over the last four years. In FY03, for an earning of one billion dollar employee addition were 40,000, in FY12 it was 20,000, went up to 26,500 in FY13, and fell drastically to 13,000 in FY14.

Some more examples are worth recollecting here. An American firm – Instagram – was sold to Facebook for about $1 bn in 2012. At the time of sale Instagram had 30 mn customers but only 13 employees. The same Facebook took over WhatsApp in 2014 for $19 bn but the number of employees of the taken over company was only 30. On the other hand, Kodak, which filed for bankruptcy a few months earlier, employed 1,45,000 people in its heydays. A recent study by academics at Oxford points out that 47% of today's jobs could be automated in the next two decades.

While revenues have increased from $8 bn at the turn of the century to $118 bn now, the pace of change in technology and processes has accelerated in the recent past. Infosys and Cognizant have partnered with automation specialists of IP Soft while TCS and HCL have built automatic tools in-house. BPO firms are also increasingly moving to automate their processes.

Finally, technology facilitates wealth creation. More than wealth creation, technology aids human endeavours and satisfies consumer needs. Technology, whether created or acquired, facilitates conversion process and through the conversion process society's and market needs are met. (See Fig. 9.4)

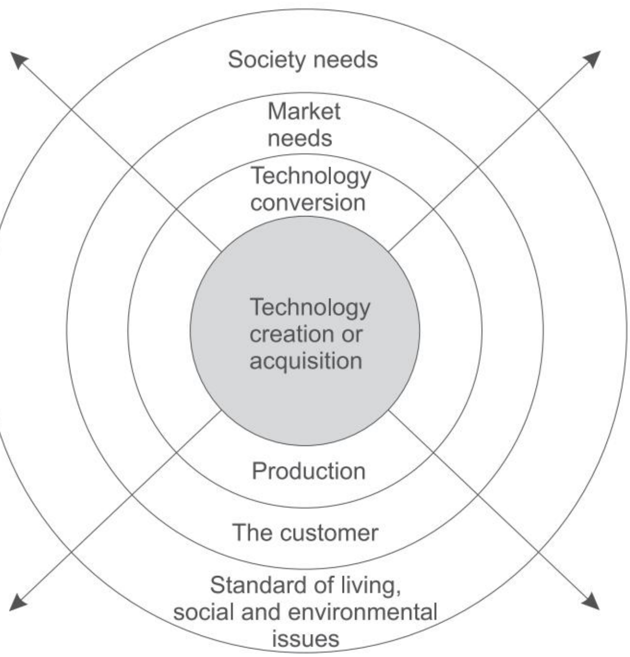


Fig. 9.4 Spinningout Technology

(*Source*: Tarek Khalil, *Management of Technology*, McGraw-Hill, 2000, p. 8)

Technology and Economy

Developments in technology also have significant economic implications.

Increased Productivity The most fundamental effect of technology is greater productivity in terms of both quality and quantity. This is the main reason why technology at all levels is adopted. In a hospital the objective may be qualitative, such as maintaining life with electronic monitoring equipment regardless of costs. In a factory, the objective may be quantitative in terms of more production at less cost.

As a result of productivity improvements, real wages of employees tend to rise and prices of some products decline, which spreads the beneficial economic effects of technology throughout the whole social system. The result is that employees and citizens are motivated to want more technological advancement, thereby putting major responsibilities on business to introduce it with the due concern for its social and environmental effects.

Need to Spend on R&D Research and Development (R&D) assumes considerable relevance in organisations as technology advances. In this context, firms are required to consider, decide and take action on at least six issues. *Firstly*, the allocation of resources to R&D. A firm must make the required resources available for effective R&D. A company's R&D intensity (its spending on R&D as a percentage of sales revenue) is a principle means of gaining market share in global competition. Besides consistence in resource allocation to R&D across lines of business improves corporate performance by enabling the firm to better develop synergies among product lines and business units.

Secondly, technology transfer, the process of taking new technology from the laboratory to the market place is equally important. This transfer takes longer time as organisations grow in size. The US based chemical giant Du Pont has long been known for its excellence in basic corporate research. In the early 1990s, for example, it led US chemical companies in patents applied for and granted. The company spent more than $13 billion on chemical and related research during the 1980s but the management admitted that the company failed to develop much in the way of major innovations.

Thirdly, time factor is important in R&D. Companies can no longer assume that competitors will allow them the time needed to recoup their investment. Time to market, therefore, is an important consideration because 60 per cent of successful potential innovations are imitated within four years at 65 per cent of the cost of innovation. In the 1980s, Japanese auto manufacturers gained incredible competitive advantage over US manufacturers by reducing new products' time to market to only three years. US auto companies needed five years.

Fourthly, as new technology comes in, the old technology needs to be abandoned. The process of old replaced by new is called technological discontinuity. Such discontinuity occurs when a new technology cannot be used simply to enhance the current technology but actually substitutes for that technology to yield better performance. The R&D manager must determine when to abandon present technology and when to develop or adapt new technology.

Fifthly, the firm must also decide on its own R&D or to outsource technology. The make or buy decision can be important to a company's R&D. Although in-house R&D has been traditionally an important source of technical knowledge for companies, firms can also tap the R&D capabilities of competitors, suppliers and other organisations through contractual agreements or strategic alliances, such as licensing, R&D agreements, and joint ventures. When product life-cycles were longer, a company was more likely to choose its own R&D, not only because it gave the firm a longer lead time before competitors imitated it, but also because it was more profitable in the long run. In today's world of shorter life-cycles and global competition, a company may no longer have the luxury of waiting to reap a long-term profit. As a rule, it may be stated that a company should buy technologies that are commonly available but make (and protect) those that are rare, valuable, hard to imitate, and have no close substitutes. In addition, outsourcing technology may be appropriate when:

- The technology is of little significance to competitive advantages;
- The supplier has proprietary technology;
- The supplier's technology is better and/or cheaper and reasonably easy to integrate into the current system;
- The technology development process requires special expertise; and
- The technology development process requires new poeple and new resources.

The *sixth* and the final issue relates to the decision on product innovation or process innovation. In the early stages, product innovations are most important because the product's physical attributes and capabilities affect financial performance considerably. Later, process innovations such as improved manufacturing facilities, increasing product quality, and faster distribution become important in maintaining the product's economic returns. German and Japanese firms have been most successful in process innovations.

Organisations are spending huge sums on R&D every year. The latest R&D scoreboard, published annually by the UK Department of Trade and Industry (DTI 2006) showed a 7% increase in spending by the top 1,250 companies undertaking R&D globally in 2005 – 06. The total amount spent on R&D was $249 billion, with the hundred most active companies contributing 61% of the total. US companies increased their R&D spending at the rate of more than twice the average, while European and Japanese companies showed below-average gains in spending. The strongest gains were made by firms from Taiwan and South Korea, both of which are now among the top 15 countries in terms of their proportion of the R&D spending by the top 1250 firms. (See also opening case).

Jobs Tend to Become more Intellectual and Knowledge-oriented With the advent of technology, jobs tend to become more intellectual or upgraded. A job hitherto handled by an illiterate and unskilled worker now requires the services of an educated and competent worker. A clerical post in an office now demands the services of an expert in computers.

Introduction of new technology dislocates some workers unless they are well-equipped to work on new machines. This makes it obligatory on the part of business houses to retrain its employees and to rehabilitate those displaced and untrainable. Equal is the responsibility of the government to provide training and educational facilities to its citizens. Government and businessmen should boldly demonstrate and convince the people that economic growth is more an insurance against unemployment than opposition to technological advancement.

But for those who pick up and acquaint themselves with the new technology, the job will be rewarding. The new job will be more challenging and rewarding. Working class, in general, stands to gain through increased productivity, reduced prices, and increased real wages—all by-products of technological advancement.

Along with upgrading jobs, technology has its impact on human relations. Technology lays down the requirements for much of the human interaction in organisations. The arrangement of a production set-up determines who will be near whom. The work flow determines who needs to talk to whom. And since interaction and activity affect sentiments, technology indirectly determines what individuals in large groups will feel and think about one another and about their work situation.

Problem of Technostructure Not only jobs become more intellectual and knowledge-oriented, even the incumbents tend to become highly professional and knowledgeable. An organisation that has adopted the latest technology is flush with scientists, engineers, MBA's, college graduates, and knowledge workers as teammates. Though such an organisation can boast of a progressive and modern outlook of its personnel complement, the problems such an enterprise has to face on this account are serious, to say the least. Motivation of such employees, for instance, is a difficult task. Such mundane incentives as attractive remuneration, job security, and just treatment, hardly inspire the enlightened employees to work more. They are instead motivated by opportunities which offer challenges or growth or achievement. Secondly, retaining such employees for long is a difficult job. Being cosmopolitan in their outlook, these professional employees are known for organisational rootlessness and job-hopping. Flighting and not sticking to one company is their culture. The company has to make several exceptions to discourage rootlessness of its professional employees. Regular attendance and punctuality have to be relaxed; dual promotion ladders have to be established so that distinguished technical people can rise in rank; profit-sharing to be provided to give creative persons a financial stake in the ideas they create; attendance at professional get-togethers has to be sponsored; writing professional articles has to be encouraged; and special assignments and part-time teaching may be allowed. Thirdly, scientific and professional workers constitute, what Galbraith calls, the technostructure of a modern organisation. The technostructure tries to control the organisation through influencing management's decision-making. While there may be nothing wrong in making decisions prompted by the technostructure, the problem lies in the social effect that is involved. People constituting technostructure are experts, no doubt. But they are more action-oriented and are yet to learn social problems of business decisions. Management is, therefore, in a tight position to balance the ruffled feelings of technocrats and the social consequences of business decisions.

Increased Regulation and Stiff Opposition A by-product of technological advancement is the ever-increasing regulation imposed on business by the government of the land and stiff opposition from the public. The host government has the powers to investigate and ban products that are directly harmful or hurt the sentiments of a section of society. Import of animal tallow has been banned by the Government of India because the alleged mixture of tallow with vanaspati oil hurt the feelings of Hindus.

Rise and Decline of Products and Organisations Change of technology, therefore, is a norm and not an exception. This poses another problem to business. A new technology may spawn a major industry but it may also destroy an existing one. Transistors, for example, hurt the vacuum-tube industry and xerography hurt the carbon-paper business. Television affected the business of radio broadcasting companies and movies and synthetic fibres reduced the demand for cotton fabrics. It is for this reason that Schumpter saw technology as a force for 'creative destruction'. And it is precisely for the same reason that the saying, 'today's growth product is tomorrow's earthen pot', becomes relevant. Products, like mortals, have life-cycles. A typical product, today, is subject to a cycle: introduction, growth, maturity, decline, and abandonment.

An organisation that is associated with a particular technology is influenced by it and will have the same life pattern as of the technology. Such an organisation will go in sequence through the introductory, growth, maturity, and decline phases. The life of such an organisation may be composed of the following stages: (i) birth, (ii) growth, (iii) policy, (iv) procedure, (v) theory, (vi) religion, (vii) ritual, and (viii) last rites (see Fig. 9.5). In this eight-step sequence, an organisation is born and then its

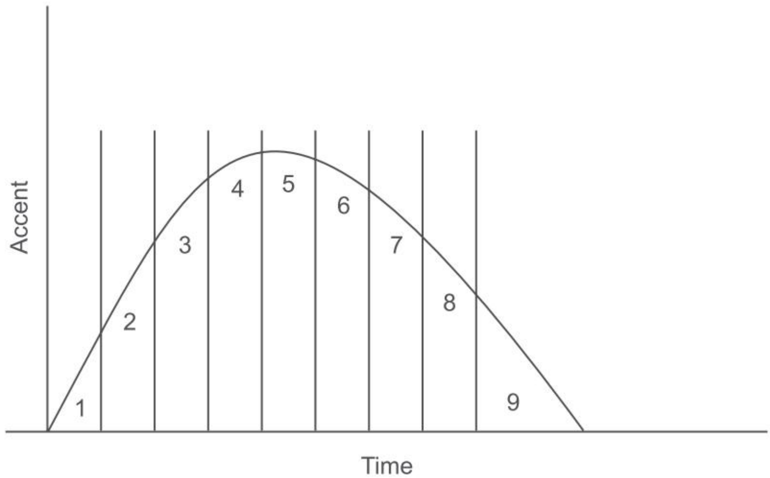


Fig. 9.5 Life Cycle of an Organisation

growth. Policies are developed to guide decisions, and these are carried out through procedures. These procedures are refined and made more efficient with theories about efficiency. In time, the organisation may develop characteristics of a religion, it may worship the way it does things. Performance is by ritual; things are done by ha bit without questioning. The death and last rites of the organisation will ordinarily follow.

Business Boundaries Redefined Technological changes have significant consequences for industries:

- Technological change is a potent force in the reconfiguring of industry boundaries, it may broaden or narrow generally accepted industry boundaries. For example, advances in information technologies have rendered old conceptions of the financial services industry obsolete: insurance firms, banks and brokerage houses can now all be interconnected to provide new financial services, thus blurring long-held distinction among the services offered by these industries.
- As a consequence of its impact on whole industries, technological change can have a significant impact on the prevailing business definition of individual companies. Companies may find themselves in a different business due to technological changes that they or others have effected. For example, Xerox (in the US) landed itself in such position in its copier business, thanks to the success of Japanese firms in miniaturising products. Because Japanese firms introduced smaller-sized copiers, Xerox found itself selling to different customers with different needs through different distribution channels and competing for different bases (price was much more important).
- Technological change is one of the important factors giving rise to product substitution and product differentiation. For example, plastics have replaced many uses of steel, and microwave ovens are now frequently substituted for conventional ovens. Similarly in videotape recorders, companies have sought to differentiate their products through the introduction of technologically based features; longer recording time, longer recording time setting, sharper picture reproduction, clearer sound and so on.

The above examples suggest that technological change is a dominant force in shaping competitive dynamics in many industries. It influences industry boundaries and structure, product substitution and differentiation, and the price and quality relationships between products.

- Technological change in the form of process (as opposed to product) and materials innovations may contribute to many of the impacts noted above. For example, process innovations such as automation, robotics, and CAD/CAM have bestowed cost and quality advantages on many companies. Japanese automobile manufacturers have gained a significant competitive edge on their rivals elsewhere through the adroit use of this form of technological change.
- *Finally,* for multi-product companies (preceding discussion applies to single-business units), technological change may have multiple impacts. For example, technological change can create new synergies across business or obsolete existing ones. Advances in telecommunications and computer technologies have made new synergies possible across business dealings with computers, television sets and communications.

Training of Scientists and Engineers The number of engineers and scientists a country possesses is an indication of its status in innovation. As stated in the opening case, the number of scientists and engineers India possesses, particularly Ph D's in computer technology, is not encouraging.

In one particular dimension, India's standing is better than China: employability of engineers by MNCs. It is said that only 10% of Chinese engineers are fit to work in MNCs. But about 25% other graduates in India are suitable for work in export-oriented IT and business service sectors.

With regard to the number of doctoral graduates across natural sciences, mathematics, computer science, agriculture, social and behavioural science and engineering, US produced (in 2002) almost twice as many Ph Ds as Germany, while the combined graduates of China, India and Russia exceeded the number of US graduates. What is significant is that while the number of first-degree graduates gives an indication of the current knowledge and skills available in the workforce, doctoral degrees reflect a country's ability to engage in cutting edge research. It is cutting edge research that lays foundation for further innovation.

Plant Level Implications

The impact of technology at the plant level is also significant.

Technology and Organisational Structure Technology has considerable influence on organisation structure, length of the line of command, and span of control of the chief executive. Where companies use technology, which is fast changing, matrix structures are more common. Some companies use a matrix even though the rate of technological change is not fast. Besides technology, other factors that have their influence on organisation structure are history and background of a company and the personalities of the people who founded the firm and managed it subsequently, but the impact of technology is considerable.

The length of line of command is determined by whether production process is mass-process based (routine) or customised (non-routine). Line of command tends to be lengthy where the production is routine and process based. Decision-making is highly centralised. It tends to be short if the production activities are customised. The use of specialists will be more and hence decision-making gets delegated.

Technological factors seem to explain the wide variations in the span of control of chief executives, the people responsible to the policy-forming body for the conduct of their firm's business. In mass production technologies, the number of people whom an executive controls tends to be larger than when the production is unit based (See also Figure 9.6).

Technology has its impact on other areas of an organisation. Any technological advancement will

Low Technical Complexity High

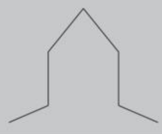
Structural Characteristics	Small-Batch Technology	Mass Production Technology	Continuous Process Technology
Levels in the hierarchy	3	4	6
Span of control of CEO	4	7	10
Span of control of first line supervisor	23	48	15
Ratio of managers to nonmanagers	1 to 23	1 to 16	1 to 8
Approximate shape of organisation	 *Relatively flat, with narrow span of control*	 *Relatively tall, with wide span of control*	 *Very tall, with very narrow span of control*
Type of structure	Organic	Mechanistic	Organic
Cost of operation	High	Medium	Low

Fig. 9.6 Technical Complexity and Organisational Design

(*Source*: Gareth R. Jones, *Organisational Theory*, p. 366)

result in (a) the expanded availability of a range of products and services; (b) substitution of capital for labour, leading to higher productivity and lower costs; (c) increases in sales or power for the innovating organisation relative to its competitors; (d) initiation of changes in behaviour among customers, suppliers, employees, or society; and (e) side-effects on the quality of physical environment.

Fear of Risk There is always the fear of risk. Take the case of DuPont's Corfam, an intended substitute for the forecasted shortage of shoe leather. After an investment of $3000 million, the company abandoned the project in 1971 because of quality and cost problems. Even a research-oriented company like DuPont, which was responsible for adding totally new dimensions to the textile industry with its introduction of synthetic fibers beginning in 1939, was unable to manage technology without great risks and some subsequent failures.

Resistance to Change The manager of a given business unit shall face resistance to change. New technology poses new problems which may not be to the liking of the organisational men. The resistance to change is often psychological.

A typical businessman himself is opposed to new technology. He does not encourage new technology. Reasons are not purely psychological. Adopting new technology is expensive and risky. When he is making enough money with obsolete technology why must he worry about new technology? Take the case of Telco (now Tata Motors) for example. Telco's trucks are still antiquated models only found in developing countries. But the turnover of Telco was Rs 1,969 crores during 1989–90. Another example is Bajaj Auto Ltd. The company claims to be number two in the world in the manufacture of two-wheelers. But during the last two decades the company could not develop a self-starting scooter. Or take the case of Indian Telephone Industries (ITI), which was till recently manufacturing strowger crossed switching equipment that became outdated 10 years ago with the development of electronic switching system.

Specifically, resistance to change stems from the following reasons:

1. Psychological and social commitments to existing products, process, and organisation,
2. Sizable capital investments in long-life single-use facilities,
3. Low profits and reduced rate of growth,
4. Small size or fragmented activities,
5. Complacent top management,
6. Industry norms and associations or cartels that perpetuate industry-bound thinking,
7. Lack of successful entrepreneurial models to emulate, and
8. Powerful labour resistance to changes in methods.

E-commerce The phenomenal growth of the Internet and the associated World Wide Web has made e-commerce possible. E-commerce is contributing to a growing percentage of cross-border transactions. Viewed globally, the Web is emerging as the great equaliser. It rolls back some of the constraints of location, distance, scale, and time zones. The Web allows, both small and large, to expand their global presence at a lower cost than ever before. The Web makes it much easier for buyers and sellers to find each other, wherever they may be located, and whatever their size.

Modern factories are now able to produce goods in a shorter period of time (to produce one car it takes less than 10 seconds) and with fewer defects, thanks to the introduction of "Six Sigma" quality programs. These programs are designed to increase quality and eliminate defects, thus enabling firms to compete in any international market. Six Sigma is a statistical term that means 3.5 errors per million, effectively eliminating performance problems and ensuring that products conform to standards. As a result of such programs, Nokia has been able to dominate the international cellular telephone business and HP has become the world leader in printers.

While e-commerce focuses on marketing and sales proceses, E-business emphasises integration of systems, processes, organisations, value chains, and markets. Integration operates through Internet and helps build new relationships between businesses and customers.

The Internet and e-business provide a number of benefits in global business, including the following:

1. Convenience in conducting business worldwide; facilitating communication across borders which brings markets closer
2. An electronic meeting and trading place, which adds efficiency in the conduct of business
3. Power to consumers as they gain access to limitless options and price differentials
4. Efficiency in distribution (More details on e-commerce and e-business in Chapter 25).

Transportation Technology In addition to developments in computers and telecommunications, several major innovations in transportation 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 containerisation, which simplifies trans-shipment from one mode of transport to another.

While the advent of commercial jet has reduced the travel time of businessmen, containerisation has lowered the costs of shipping goods over long distances.

Huge containers are built, each of which is almost 400 m long, or the length of four football pitches, and another half pitch across. As many as 30,00 parts go into making of a ship. The ship can carry 7,500 or so 40-foot containers, each of which can hold 70,000 T-shirts.

Each ship is equipped with the largest internal-combustion engine ever built, as powerful as 1,000 family cars. This engine turns the longest propellor shaft (130m) ever made, at end of which is the largest propeller, at 130 tonnes. Yet the container is so automated that it requires a mere 13 people to crew it. Each ship costs $200 m and they are manufactured in Singapore and South Korea. Called the triple E-class (economy of scale, energy efficiency and environment cleanliness) these are the largest container ships ever built and carry such a huge cargo that for shipping one T-shirt from China to Netherlands, it costs only 2.5 cents.

Container ships have facilitated world trade immensely. More than 900 bn tonnes of goods and services were transported by sea in 2012, with trade helping to boost global growth rate. An ever expanding web of links connects rich and poor; developing countries now account for around 60% of sea borne trade.

Globalisation of Production Technological breakthroughs have facilitated globalisation of production. A worldwide communications network has become essential for any MNC. Texas Instruments (TI), the US electronics firm, for example, has nearly 50 plants in 19 countries. A satellite based communications system allows TI to coordinate on a global scale, its production planning, cost accounting, financial planning, marketing, customer service, and human resource.

Globalisation of Markets Along with the globalisation of production, technological innovations have facilitated the internationalisation of markets. As stated earlier, containerisation has made it more economical to transport goods over long distances, thereby creating global markets. Low-cost global communications networks such as the World Wide Web are helping to create electronic global market places. In addition, low-cost jet travel has resulted in the mass movement of people around the world. This has reduced the cultural distance between the countries and is bringing about convergence of consumer tastes and preferences. At the same time, global communications networks and global media are creating a worldwide culture. Worldwide culture is creating a world market for consumer goods. Signs of a global market are already visible. It is now easy to find a McDonald's restaurant in Tokyo as it is in New York, to buy a Sony Walkman in Mumbai as it is in Berlin, and to buy Lewis's jeans in Paris as it is in San Francisco.

Others

A few more trends are equally significant. The new trends are reflected in collaborations, social networking, unified communication, data mining and analytics, mobile computing, cloud computing and teleworking.

Collaboration is a process where two or more people or organisations work together with a shared purpose. A collaborative working environment supports people in both their individual and cooperative work thus giving birth to a new class of professionals (called e-professionals), who can work together irrespective of their geographic locations.

Social Networking is a social structure made up of individuals or organisations (called nodes) which are tied by one or more specific types of interdependency, such as friendship, kinship, financial exchange, dislike, knowledge or prestige. The social network can be used to measure social capital—the value an individual gets from the social network. Examples of social networks include Linked In, Orkut, Twitter and Scispace.net.

Unified Communication refers to a set of products that provides a consistent unified user interface and user experience across multiple devices and media types. It is the integration of real-time communication services such as instant messaging (chat), IP technology and video conferencing with non real-time communication services such as e-mail, SMS and fax. Unified communication seeks to optimise business processes and reduce the response time, manage flows and eliminate device and media dependencies.

Data Mining is the process of extracting patterns from data. Data mining is becoming an increasingly important tool to transform the data into information. It is commonly used in a wide range of profiling practices such as marketing, surveillance, fraud detection and scientific discovery. *Analytics* encompasses a variety of techniques from statistics, data mining and game theory that analyse current and historical facts to make predictions about future events.

Mobile Computing is a generic term that describes one's ability to use technology while moving, as opposed to portable computers, which are only practical for use while deployed in a stationary configuration. A few concerns are:

- **Insufficient bandwidth**: Mobile internet access is generally slower than direct cable connections
- **Security standards**: When working mobile one is dependent on public networks, requiring careful use of VPNs
- **Power consumption**: When a power outlet or portable generator is not available, mobile computers must rely entirely on battery power.
- **Transmission interferences**: Weather, terrain and the range from the nearest signal point can all interfere with signal reception. Reception in tunnels, some buildings and rural areas is often poor.

Cloud Computing refers to anything that involves delivery of hosted services over the Internet. Stated differently, cloud computing refers to the delivery of computing as a service, over the Internet, from vast warehouses of shared machines. Three categories of services are delivered: Infrastructure-as-a-Service (IaaS), Platform-as-a-Service (PaaS) and Software-as-a-Service (SaaS). A cloud service has three distinct features that differentiate it from the traditional hosting: (i) it is sold on demand, typically by the minute or the hour, (ii) it is elastic—a user can have as much or as little of a service as he/she wants at any given time, (iii) the services is fully managed by the provider (the customer needs only a personal computer and an Internet access).

Teleworking includes telecommuting, e-commuting, e-work, telework, working from home (WFH), or working at home (WAH). Teleworking is an arrangement in which employees enjoy flexibility in working locations and hours.

Daily commuting to work places is replaced by telecommunication links. Many work at home, while others, occasionally referred to as nomad workers or web commuters who utilise mobile telecommunication technologies, work from coffee shops or myriad other locations.

Technology Transfers As technology transfers have considerable significance for international business, we propose to discuss them in greater detail.

Technology transfer covers various activities, including the internal transfer of technology from the R&D or engineering department to the manufacturing department of a firm based in a country.

It also includes the same transfer of technology from a laboratory or operations of an MNC in one country to its laboratory or operations in another country. Finally, it includes the transfer of technology from a research consortium supported by many firms to one of its members. Simply told, technology transfer is a process that permits the flow of technology from a source to a receiver. The source is the owner or holder of the knowledge and it can be individual, a company, or a country. The receiver is the beneficiary of the transferred technology.

What is it that is transferred in the name of technology? Technology is transferred through published material (such as journals, books); purchase and sale of machinery, equipment and intermediate goods, transfer of data and personnel; and interpersonal communication.

Technology transfer comprises six categories:

1. **International Technology Transfer**, in which the transfer is across national boundaries. Generally, such transfers take place between developed and developing countries. The focus of this chapter is on international technology transfers.
2. **Regional Technology Transfer**, in which technology is transferred from one region of a country to another.
3. **Cross-industry or Cross-sector Technology Transfer**, in which technology is transferred from one industrial sector to another. An example is the transfer of technology from the space programme to commercial applications.
4. **Interfirm Technology Transfer**, in which technology is transferred from one company to another. An example is the transfer of computer-aided design (CAD) expertise and computer-aided manufacturing (CAM) machines from a machine tool manufacturing firm to a furniture making firm.
5. **Intra-firm Technology Transfer**, in which technology is transferred within a firm, from one location to another. Intrafirm transfers can also be made from one department to another within the same facility.
6. **Pirating or Reverse-Engineering**, whereby access to technology is obtained at the expense of the proprietary rights of the owners of technology.

INTERNATIONAL TECHNOLOGY TRANSFERS AND STAGES

LO 5
Relate to the international technology transfers and its stages

As stated earlier, our focus in this chapter is on the transfer of technology between countries.

Mention technology transfer and what comes to one's mind immediately is that technology generally flows from developed nations to developing countries. This is not always true. Technology transfers take place among rich countries too. In the recent past, some UK companies, such as GEC, have purchased high-technology companies in the US. Similarly, Japanese firms expanded their foreign investments in research-intensive countries such as the US and West Germany in order to improve their access to technology flows after companies from these countries had become more reluctant to license technology to Japan to avoid further strengthening of Japanese competition. But technology transfer is needed more in developing countries, as it is they who do not or cannot develop an indigenous one.

That the developing countries are meant only to import technology may not be true. The developed countries may have something to learn from the small-scale (recollect what E F Schumacher always emphasised—"Small is Beautiful"), labour-intensive, and natural or organic technologies developed in the third world countries such as Argentina, Brazil, Mexico, and Korea, which are emerging as exporters of technology to less developed third world countries.

Technology transfers are justified whether they flow between two rich countries or between a rich country and a developing country. As the resources and skills are unevenly distributed among nations, it is natural that different inventions are made in different countries. When an invention is made in some part of the globe, it is desirable that others should borrow or buy the same instead of wasting their efforts on repeating the whole life history of the new technology.

Countries stand to gain in importing technology. The former socialist countries had shed their inhibitions and were only too willing to import technology. Kosygin, the Soviet Premier, had acknowledged, in 1968, the need for import of technology thus: “It would be near-sighted of us not to make use of the latest achievements of foreign science and technology—we must use every opportunity to purchase (foreign) licences and improve our use of licences to speed up the technical process in our economy”.

What Kosygin said about the erstwhile USSR applies to India too. For nearly five decades, India had adopted a self-reliant and import substitution policy resulting in shunning foreign technology. Consequently, the country paid a heavy price in the form of greater inefficiency and high cost. From 1991 onwards, thanks to the liberalisation policy introduced by the then government, import of technology is made much simpler and the benefits are there for everyone to see and enjoy. In global ranking in terms of technology transfers, India stands two and China twenty-nine.

Parties in the Transfer Process

International technology transfer has both horizontal and a vertical dimension, each with its own elements. From the horizontal perspective, the three basic elements in technology transfer are the home country, the host country and the transaction. The vertical dimension of technology transfer refers to the issues specific to the nation state, or to the industries or firms within the home and host countries.

We focus on both the dimensions.

Home Country’s Reactions to Technology Transfers

Home countries express apprehensions about the export of their technology. They have reasons to oppose the export of technology. They argue that the establishment of production facilitates by MNCs in subsidiaries abroad decreases their export potential. Additionally, they claim, because some of the MNCs imports stem from their subsidiaries, the volume of imports of the home country tends to increase. Given the decrease in exports and increase in imports, the balance of trade tends to be adverse to the home country. Besides, technology transfer tends to affect adversely competitive advantage of the home country. Labour unions in the home country too oppose technology transfer on the ground that the jobs generated from the new technology will benefit the host country citizens.

Host Country’s Reactions to Technology Transfers

More serious are the reactions of the host country to technology transfer. The subject of technology transfers is highly sensitive, often evoking strong reservations against it from the host country citizens. The criticisms against technology transfer are based on economic and social factors.

Economic Implications Economic implications include payment of fee, royalty, dividends, interest, and salaries to foreign technicians and tax concessions resulting in loss to the national exchequer. All these are payable to the transferring country and might prove very expensive to the host country. In addition to the payments just stated, the technology supplier often succeeds in extracting payments through various other techniques like over-pricing and buying intermediates at high prices. There are malpractices too, for example, tie-up purchases, and restriction on exports, and charging excessive prices.

Many times, the type of technology transferred by international business is not appropriate to developing countries. The technology that is developed is inevitably the one most suitable for industrial countries, that is, designed to produce the types of goods that a rich country needs and to do so by methods, which are appropriate to resources endowment of developed nations. This means that the technologies tend to be designed for the production of high-quality sophisticated goods on a large scale, using as much as possible capital and higher-level professional skills in place of sheer labour and replacing natural resources by synthetics. Such technologies are not in the interest of developing countries.

Social Implications The social and cultural implications of technology transfer are more serious than the economic significance. Along with the transfer of technology, there is the transmission of culture from the exporting countries. The upper and middle class Indians are a case in point. Majority of these neo-rich people are totally Westernised and Americanised in their attitudes, behaviours, food habits, and dress accustomedness. This is because, we import technology from the United States and European countries. The Indians who work in firms using such imported technologies get influenced and accustomed to the skills, concepts, policies, practices, thoughts, and beliefs. The influence of alien culture on Indian soil is so visible, that some voluntary organisations in the country have started campaigns against cultural invasion.

Then there are social problems like pollution, urbanisation, congestion, depleted natural resources, and similar other evils.

Apprehension of technology importing countries may be justified but it does not mean that the host countries should be denied the benefits of new technologies. Host countries should initiate actions to minimise the adverse effects and maximise benefits from imported technologies. Figure 9.7 contains the action plan.

Strategies before Host Countries

A host country has the following strategies relating to the technology transfer:

- *A host country might do nothing towards technology transfer*. This attitude stems form atleast two assumptions. First, the host economy is strong and vibrant enough and is capable of absorbing technology. Second, the economy and the government are incapable of evolving policies towards the import of technology.
- *A government might limit certain sectors* to domestic ownership and throw open other sectors for overseas technology. This has been the policy of the Government of India too. Category 'A' industries in the Industrial Policy 1991 are reserved for domestic ownership.
- *A host government might limit the amount of inward investment*. As stated in chapter 4, FDI (along with technology) is permitted by the Government of India upto 24%, 26%, 49%, 51% and 74% in different sectors of the economy.
- *A Government might specify performance requirements for foreign investors*. The performance

- Identify and set entry conditions for new and/or existing foreign investors.
- Reserve certain sectors for local producers.
- Specific performance requirements form MNE: affiliates.
- Try and eliminate restrictions on use of technology supplied by MNEs.
- Limit technology payments (royalties) to foreign firms.
- Improve understanding of costs and benefits of technology: improve negotiating abilities.
- Solicit competitive bids from alternative technology suppliers.
- Encourage MNEs to sell technology on contractual basis.
- Limit duration of technology contracts.
- Encourage indigenous production of technology.
- Encourage market structure most conducive to an efficient inflow and dissemination of technology.
- Impose training obligations on MNEs.
- Give more incentives to MNEs to set up R&D facilities in host countries.
- Encourage development of state-owned enterprises (as in Brazil and India).
- Provide fiscal and other incentives to encourage privately financed R&D to the point where its marginal social benefits equate with its marginal costs.
- Reconsider macro-economic and macro-organisation policies so as to remove structural distortions in cross-border technology markets.
- Encourage development of clusters of supporting or related activities, and also interaction between universities, cooperative research associations and private firms.
- Support industrial restructuring and by general educational and other policies facilitate the upgrading of indigenous human capital.
- Liberalise technology and other markets which distort terms of technology transfer and diffusion.

Fig. 9.7 How to Maximise Benefits from Technology Transfer: Some Options Available to Host Governments

requirements might include indigenisation of production processes, adding to the exchange reserves and creating jobs to locals.

- *A government could discourage restrictive clauses on technology transfer.* MNC's are allowed to freely transfer technology to their subsidiaries located in the host country.
- *A government might influence terms and conditions of technology transfer*. The host country invites FDI, no doubt but desires to have the discretion to decide the extent and type of technology it needs to serve its long-term interest.
- *A government might encourage indigenous technological development*. Instead of importing technology, the host government may encourage domestic R&D. Popularly called import substitution, this strategy is adapted when indigenous capabilities are weaker, and where overall coordination of policies to improve own competitiveness is not likely to succeed. The emphasis of this strategy is to encourage exports and upgrade skills in the import-substituting industries. For a long time till 1991 India followed import substitution strategy. It is only since 1991, that foreign technology is allowed liberally in Indian industries.
- *The host government might encourage cross-border collaborative R&D.* Investment in R&D is so expensive that strategic alliances prove beneficial to alliance partners. Competition from MNCs might also encourage governments to engage in cross-border technological cooperation. Among many of these arrangements was the European Strategic Project on Information Technology (ESPRIT), which was initiated in 1984. The purpose of this 10 year research programme was to

target the R&D intensive sectors of the IT industry, where the challenge from US and Japanese firms was intense.

- *Finally, the government might attempt to obtain knowledge through alternative routes.* The recipient county may buy technology in the open market by-passing the convential routes. This route has atleast two advantages for the host country: technology may be available at much cheaper rates and terms; and dependence on MNCs for technology is minimal.

Transaction

This element focuses on the nitty-gritties of the transfer. The issues here relate to the terms and conditions of technology transfer. The terms and conditions are covered towards the end of this chapter.

STAGES IN THE TRANSFER PROCESS

The transfer of technology between countries, particularly from rich to developing nations, proceeds in five different, but coordinated stages. The steps are summarised as follows (see also Fig. 9.8).

1. Assignments, including sale and licensing agreements covering all forms of industrial property including patents, inventor's certificates, utility models, industrial designs, trade marks, service names, and trade names.

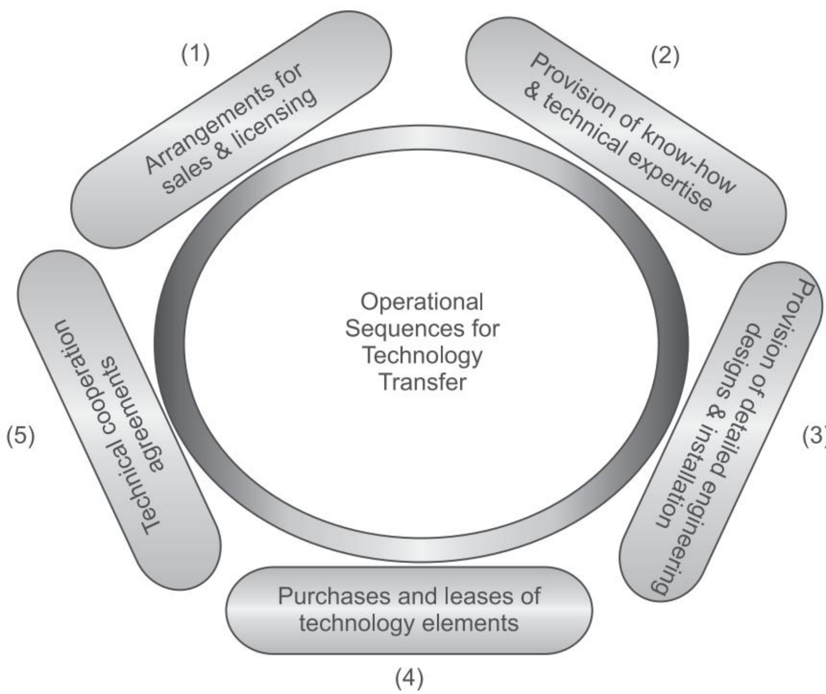


Fig. 9.8 Operational Sequences for Technology Transfer

2. Arrangements, covering the provision of know-how and technical expertise in the form of feasibility studies, plans, diagrams, models, instructions, guides, formulations, service contracts and specifications, and /or involving technical, advising, and managerial personnel, personnel training, and equipment for training.
3. Arrangements, covering the provision of basic or detailed engineering designs, and the installation and operations of plant and equipment.
4. Purchases, including leases and other forms of acquisition of machinery, equipment, intermediate goods and/or raw materials, insofar as they are part of transactions involving technology transfers.
5. Industrial and technical cooperation agreements of any kind, including turnkey agreements, international subcontracting, as well as provision for management and marketing services.

Technology is not a homogeneous phenomenon. There are different types of technology, each posing fundamentally different problems and demanding different solutions in the international transfer process.

INTERNATIONAL TECHNOLOGY ISSUES

An international business faces a number of technology-related issues. The more important of them are ways of technology acquisition, choice of technology, terms of technology transfer, and creating local capability (see Fig 9.9).

LO 6
Evaluate international technology issues

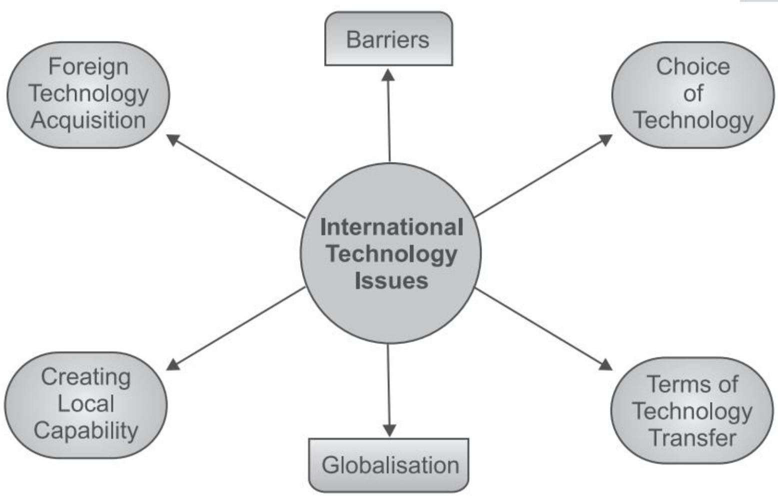


Fig. 9.9 Technology Issues

Foreign Technology Acquisition

One of the major issues in technology relates to the mode of acquisition. Developing new technology may conjure up visions of scientists and product developers working in R&D laboratories. In reality, new technology comes from many different sources, including suppliers, manufactures, users, other industries, universities, government, and MNCs. While every source needs to be explored, each firm has specific sources for most of the new technologies. For example, because of the limited size of most farming operations, innovations in farming mainly come from manufacturers, suppliers, and government agencies. In many industries, however, the primary sources of new technologies are the organisations that use the technology.

Essentially, the question of how to acquire new technology is a make or buy decision. In other words, should the firm develop the technology itself or acquire it from an outside source? However, the decision is not that simple. There are several alternatives, each having its own advantages and shortcomings.

Broadly, the acquisiton routes are three: (i) internal, (ii) external, and (iii) combination (see Fig. 9.10). These routes take their direction in the six categories of technology transfers discussed earlier.

	Purely Internal				Purely External		
Seizing Tacit Knowledge	X						
Internal R&D	X						
Internal R&D with Networking		X					
Reverse Engineering		X					
Covert Acquisition with Internal R&D							
Covert Acquisition			X				
Technology Transfer and Absorption			X				
Contract R&D				X			
R&D Strategic Partnership				X	X		
Licensing						X	
Purchasing						X	
Joint Venture							X
Acquisition of Company with Technology							X

(*Source*: UNIDO: International Centre for Science and High Technology, *Technology Acquisition,* p. 151)

Fig. 9.10 Technology Acquisition Routes

Internal Technology Acquisition This is the result of technology development efforts that are initiated and controlled by the firm itself. Internal acquisition requires the existence of a technological capability in the company. This capability could vary from one expert who understands the technological application well enough to manage a project conducted by an outside research and development (R&D) group to a full blown R&D department.

Internal technology acquisition options have the advantage that any innovation becomes the exclusive property of the firm. In addition, the resulting technology will be tailored to meet the firm's needs. However, internal development has risks. The development takes longer time than acquiring already developed technology from external sources. In addition, internally generated technology is more expensive than the one acquired from outside sources.

External Acquisition External technology acquisition is the process of acquiring technology developed by others for use in the company. External technology acquisition generally has the advantage of reduced cost and time to implement and lower risks. However, technology available from outside sources was generally developed for different applications. Therefore, external acquisition should contain an aspect of adaptation to the acquiring company's application. The acquiring company must realise that this adds to the cost, time, and risks to the project.

Combined Sources Many forms of technology acquisition are combinations of external and internal activities. Combined acquisitions seek to overcome the limitations of internal and external sources, taking advantages of both the actions at the same time.

Table 9.1 shows the comparative advantages of the three broad sources of technology acquisition.

Making Decision

Table 9.1 does give generalities about the three sources of technology acquisition. But generalities do not apply to every situation. Each case must be considered by itself. The technology manager must, therefore, weigh the advantages and limitations of each specific route of technology acquisition and then make a decision about its choice. A brief description of each follows.

Table 9.1 Comparative Advantages of the Internal, External and Combined Sources

Factors	*Internal source*	*Combination of Internal and External*	*External source*
1. Company technological growth	Highest potential	Medium potential	Lowest potential
2 Exclusivity/competitive advantage	Highest potential	May maintain exclusivity	Generally do not have an advantage
3 Company capability	Must be relatively strong technically	Technical strength is required, but it can be weaker	Technical strength is an asset, but not essential
4. Time to market	Generally longest	Can be reduced due to added information	Should be shortest
5. Risk of failure	Highest	Medium risk	Lowest
6. Cost and affordability	Highest cost	Medium cost	Lowest cost

Seizing Tacit Knowledge Taking advantage of the knowledge available in-house is least expensive and has no risks. It will not leave when the knowledgeable person leaves the firm. Every firm will have employees who are knowledgeable and it is up to the company to identify and make use of the know-how.

Internal R&D Technology acquisition via internal R&D consists of having a research and development group within the firm. The group is responsible for creating the technology that the firm uses. This source of technology acquisition enables the firm to become stronger, has the advantage to exclusivity, and may entail tax or other government incentives. Long time required, high cost, and risk of failure are the demerits of this internal route of technology acquisition.

Internal R&D with Networking Internal R&D networking has all the same advantages and disadvantages discussed under internal R&D. The main difference is the fact that the R&D staff make a fairly concerted effort to keep abreast of the state of development of the technologies affecting their products. They network with technology creators at conferences and trade shows. They also follow technological developments published in papers, magazines, and journals. They follow the developments made by their competitors by reading magazines, journals, and sales literature where competing products are discussed. They attend meetings, demonstrations, and trade shows where competing products are on display.

The networking approach improves the firm's external technology acquisition capabilities. Its R&D staffs are familiar with options that are available in the market. This unfolds technology acquisition options that might not be considered by a purely internal R&D firm.

Reverse Engineering Reverse engineering is the determining of the technology embedded in a product through rigorous study of its attributes. It entails the acquisition of a product that the firm believes would be an asset, disassembling it, and subjecting its components to a series of tests and engineering analysis to ascertain how it works and studying the engineering design criteria used in the product's creations.

Reverse engineering is common in the automobile and machinery industries. Before designing their own products, companies reverse their competitors' products to ascertain their strength and weakness. New designs maintain the strength and solutions are developed for the weaknesses resulting in a competing product that is better than the original. Reverse engineering is less costly, less risky, and takes less time to market compared to internal R&D route. It enables the development of a product that meets the competition in all its areas of strength and has a competitive advantage in the competitor areas of weaknesses. On the negative side, it has the potential to develop a me-too product. There is also the possibility that the reverse engineering team does not properly understand the original design and the new product is actually poorer than the one studied. There are also the legal risks of infringing on the patent rights of the owners of the original product.

Reverse Brain Drain This involves attracting expatriate entrepreneurs and experts who have gained adequate experience abroad to set up or develop enterprises in their countries of origin. Taiwan and China are known for this type of technology transfer.

Covert Acquisition with Internal R&D This route of technology acquisition sounds less above board. It entails finding out the technology developments being conducted by a competitor that are not open to the public. Most businesses do this to some extent by questioning suppliers about components being sold to the competitors or by socialising with the competitor's employees. The less scrupulous firms even become involved in industrial espionage using cameras, binoculars, and break-and-enter techniques to learn about the happening inside the competitor's plant.

Using internal R&D along with the covert acquisition has the same benefits as reverse engineering. It can result in a product that is similar, but not exactly a me-too product. Internal R&D can improve upon the competitors products by adding value and solving technical problems they may have.

Costs, risks, and time to market can be reduced. However, risks include being sued and developing a reputation of being an unscrupulous firm.

Covert Acquisition This, without internal R&D, guarantees that the product will be a copy (generally a poor one) of the competitor's product. The firm can introduce it at a lower price because there are no development costs to recover. However, with the exception of the price, the product will have no other competitive advantage. Without internal R&D, it is likely that the product will not be copied accurately and that it will be worse than the original. A firm with this technology acquisition strategy is likely to have inferior products, an inability to improve its products, an inability to deal with technical problems the products may have, a poor image, and high legal costs.

Technology Transfer and Absorption This route is similar to internal R&D with networking. The difference is that there is much more effort put into searching for, learning about, and translating, no-cost technology to the firm's applications. Internal technical ability is necessary to understand the technologies found and to develop them into solutions for the firm's application.

Technology transfer and acquisition is most often used with process technologies. An example would be where the firm finds a process technology that has been invented by a government or educational institution, and applies the same to its own production line by acquiring components and attaching them to the existing equipment.

Contract R&D Firms resort to contract R&D for more than one reason. This is the ideal option for those that lack the necessary facilities and expertise to conduct the required work but still want to mai tain control over the development and own the results exclusively. It is also a good choice for those that need a specialised set of equipment or expertise for occasional short-term projects. This avoids the i vestment in these facilities and the on-going commitment to staff that would be underutilised. It allows short-term access to world-class personnel and facilities for specialised projects that would otherwise be completely beyond the company's means.

Some firms have strong in-house R&D, still choose on contracting out R&D projects. One reason is to maintain internal strength in technologies crucial to the firm's business. R&D needs in other areas are contracted out. Another reason is to occasionally contract R&D in core technology as well. This exposes the company's R&D personnel to experts in other environments. Staff enrichment is the by-product of this route of technology acquisition.

The advantages of this route are no investment in facilities, and low investment in staff. The disadvantages are: no hands-on-knowledge in-house and difficulty in keeping information confidential.

R&D Strategic Partnership R&D strategic partnerships are almost the same as contracting R&D. They generally consist of a group of companies with a common need that collectively contract a research institution to conduct the work for them. This allows the firms to share the risk and costs. It also creates a situation where they can learn from each other as well as from the experts conducting the research.

The partners in this route are often competitors. Therefore, the kind of projects that are most conducive to this type of technology acquisition are competitive research. These are usually applied research projects that are too risky and too expensive for any one firm to handle, but if certain results were achieved the whole industry would benefit. As a result, the company must have either an internal R&D or contract R&D capability to translate the results of the applied research into technology the firm can use.

R&D strategic partnerships can be initiated by one firm inviting others to join, by informal group of firms, by formalised association of firms in an industry, or by the R&D institution itself. The last model is the most common. R&D strategic partnerships are becoming relatively common with large companies in electronics/computers, automobiles, oil and mining, but are rare with small companies.

The advantages of this route of technology acquisition are: shared risks, reduced cost, and possibility of learning from others. Need to share knowledge with others and the necessity of adopting research results to own application are the drawbacks of this route.

Licensing Yet another route of technology acquisition is licensing. Its major benefit is a significant reduction in time to market relative to other forms of technology acquisition that require development. It also enables the acquiring firm to share the financial risks of acquiring the technology with the provider because the bulk of the payments are generally in the form of royalty—a percentage of sales of product made using the new technology.

A frequent argument against licensing is that the licensee might become a competitor to the provider of technology. This argument assumes a simple and discrete relationship between the licensor and the licensee. But licensing can be a part of a multifaceted strategy that permits the licensor to take an ownership interest in the foreign venture. In addition, trademarks remain the property of the licensor in perpetuity, whereas licensees normally have a finite tenure.

The circumstances under which licensing may be a preferred strategy are the following:

Where host countries restrict imports and/or direct investment.

Where a specific foreign market is small.

Where prospects of technology feedback are high.

Where licensing is a way of testing and developing a market that can be later exploited by direct investment.

Where the pace of technology change is sufficiently rapid that the seller can remain technologically superior.

Where opportunities exist for licensing auxiliary processes without having a license of basic product technologies.

Where small companies have limited resources and expertise for direct foreign expansion.

Among the advantages of licensing technologies are: costs and risks are less than internal R&D and time required to commercialise is less. The disadvantages are: exclusivity may be lost and internal capability may not be developed.

Purchasing A common and effective external technology acquisition method is purchasing. This is normally done in the form of buying a piece of production machinery with embedded technology. This is the quickest form of technology transfer because the technology is already packaged and is ready for use. It is low risk because the equipment has been proven to be technically competent and there are already users to evidence the machine's capability. In addition, the providing firm can also provide implementation support in the form of set-up and training. The costs will be lower than developing the technology because the providing company is generally in the business of providing the machines containing the technology to many users thereby spreading the development costs over several customers.

However, care must be taken not to overlook the costs of internal activities such as staff time spent on training and disruption of the present production that will happen during the installation of the new equipment. It is also necessary to understand that the provider sells the technology to many buyers thus making exclusivity highly unlikely. In addition, there could be resistance from employees within the acquiring company.

There is yet another form of purchasing the technology—to pay for the know-how behind the technology and the right to use it in the firm's application. This is very similar to licensing, except it is a one-time purchase rather than an ongoing relationship.

Joint Venture Entering a joint venture agreement with a technology provider is another form of external acquisition that can be very effective. Typically, this is a partnership between two firms, one with a technology and another with market access. It can take the form of the creation of a new firm with each of the partners owning shares in the new firm in proportion to the value of their contribution to the new firm. In this case production facilities are installed in the new firm with the partners bringing technology and market know-how along with capital investment into the new firm. The distribution and marketing of the product may use the system that the firm with market access has in place, or that firm's know-how may be used to create a dedicated system for the new firm.

Another version of this is very similar to licensing. The providing and acquiring firms form a contractual agreement describing who provides what and how the revenues are to be shared. The main difference between this and licensing is the fact that the technology provider has an expanded relationship with the acquiring firm. They make joint decisions about production and marketing even though the acquirer actually produces the product and provides it to the market. The advantage is that both firms learn from each other. The disadvantage is that either company cannot make decisions on its own, the partners have to agree on any major issue.

Irrespective of the form, joint venture route of technology acquisition offers several advantages and benefits. The technology can be implemented immediately, as it is already proven. Risk involved is less and there are possibilities of learning from the provider of technology. There are disadvantages too. Market risks are high and there are no chances of developing technical strengths.

Acquisition of a Technology Rich Firm The final form of external technology acquisition is the acquisition of a firm that has the know-how, which the acquiring firm desires. This can happen when one firm has a technological innovation that is impacting another company's innovation (which would take time and may not have the desired results), the second company negotiates to purchase the entire company. This can result from a defensive action or it can be deliberate strategy to acquire technology.

The outright purchase has advantages and disadvantages. On the positive side are: short time to market, low risks, and probability of buying good image. The problems are: possibility of acquiring negative baggage and merger problems.

While the routes of technology acquisition discussed till now are comprehensive, they exclude one mode of transfer of technology, that is, personnel. This route includes employment of nationals by foreign firms; employment of foreign technicians (see Exhibit 9.3); migration of trained personnel; internal training programmes of professional bodies, educational institutions, and research institutions. This route of technology transfer is very common. In both joint ventures and acquisitions, there is the flow of FDI. FDI brings, along with it, technology.

Choice of Technology

The second major issue relating to technology transfer is its choice. It is argued that it is the industrialised countries that develop technology, and the know-how thus developed will be mainly useful to them. This means that the rich countries become monopolists in developing, using, and managing technology. This also means that the technologies tend to be designed for the production of high quality sophisticated goods on a large scale, using as much as possible capital and higher-level professional skills in place of sheer labour, and replacing natural resources by synthetics. It would be unwise to criticise the industrial countries for creating a technology suitable for themselves. But what needs to be criticised is the big gap in the world of technological system—that there is no equally scientific, equally efficient technology designed to produce the kind of goods needed to satisfy the basic needs of the great majority of mankind living in developing countries. There is also no technology to produce such goods by methods suitable to resource endowment of developing countries, that is, fully utilising their labour and natural resources. The transfer of industrial country technology, modified and adopted to the different needs and conditions of the developing countries, can do more harm than good. Specifically, when a capital-short economy uses

Exhibit 9.3

A "MOONLIGHTING" STRATEGY FOR TECHNOLOGY TRANSFER

Seoul—every Friday evening, dozens of young and middle-aged men leave their offices in Tokyo, head for the airport, and arrive here in South Korea a few hours later. They are Japanese engineers who have come to spend the weekend quietly moonlighting at Korean companies.

Among them are engineering professionals, partners in technical firms, and employees of major Japanese corporations. Some are exporting their skills on the sly without the consent of their bosses. "Some of these engineers are working at big personal risk", says Nabuhiro Nakamura, whose Tokyo consulting firm last year recruited 250 Japanese technical experts for part-time work in Korea for various lengths of stay.

Their Korean sponsors range from small auto-parts makers to the biggest conglomerates. They typically meet the Japanese at the airport, put them up in good hotels, provide interpreters, and pay them the equivalent of US $250 a day. Some even lend the Japanese money to help buy houses back in Japan.

The moonlighting engineers are just a small part of larger Korean strategy. South Korea desperately wants to go high-tech but is badly lacking in the plans, people, and processes needed to get there alone. "We're very weak in design technology", says Yu Hee Yol, the head of technology transfer at the Ministry of Science and Technology, "So we import what we can't create".

(*Source:* Roback and Simmonds, *International Business and Multinational Enterprises,* p. 484)

a capital-intensive technology in certain sectors of the economy, this inevitably means a dualistic structure in which access to scarce capital is unequally distributed and which is likely to result in unequal income distribution and high unemployment.

On the other hand, the alternative technologies available from within the developing countries from the earlier economic history of industrial countries or deliberately created as "intermediate", tend to be inefficient since they are not backed by the full force of modern science. For this reason, the developing countries are highly suspicious of and often antagonistic to attempts to emphasise the question of suitably transferred technology. They want to modernise and share in the benefits of modern science. Attempts to preach alternative technologies to them sound like paternalistic or neocolonialistic conspiracies to condemn them to something second best—"good enough to them". They see the rich countries wielding power and enjoying high-income levels and using the 'modern' technology. It is easy and tempting for the less developed countries to argue that the industrial countries must be rich because they are using the modern technology—and by implication, if the developing nations want to become developed, they must also acquire modern technology. The arguments can, thus go on. But what needs to be stressed is that the technology that is transferred to developing countries needs to be appropriate—labour-intensive and preferably smaller-scale.

The appropriate technology controversy raises several key questions for the international manager. To what extent are commercially feasible alternative technologies readily available? If not available, can the cost of developing more appropriate technology be justified? And, what mix of factors other than differences in the relative cost of labour and capital should influence the managerial decision?

Terms and Conditions of Technology Transfer

The issue relating to terms and conditions of technology transfer and the question of the suitability of the transferred technology are related to each other. Some of the restrictive conditions, for example, make the technology less suitable than it would otherwise be. This clearly applies to such restrictions as prohibitions on the adaptation of the imported technology, preventing the use of imported technology as a basis for local R&D development, and clauses stipulating that the results of local technological research and development based on the imported technology must be transferred to the owner or supplier of the technology. Such restrictive clauses clearly reduce the suitability of the technology and it should be the effort of all concerned to remove such conditional provisions.

Cost of technology transfer is a very serious issue for developing countries. Much of the cost of imported technology is concealed because import of technology often takes place as part of a package as in embodied form, that is, embodied in machinery and equipment. Though actual figures are difficult to come by, the estimates made by UNCTAD suggest that the annual payments by developing countries alone towards import of technology amount to $10 billions. Such high costs of technology defeat the very spirit of modern science and technology which are expected to be "the common property of mankind", and subject to proper protection and payments to the inventor and are freely available. But, unfortunately 90 per cent of the modern technology transferred to developing countries is controlled by MNCs who are essentially interested in getting highest returns from their inventions.

The developing countries reacted in their own way to face the restrictive clauses imposed by international businesses on their exports of technologies. Exhibit 9.4 for example, tells how the Government of India put its own guidelines to govern technology transfers.

Exhibit 9.4

TECHNOLOGY TRANSFERS—GUIDELINES

In order to ensure that foreign technical (and/or financial) collaboration proposals conform to government priorities, domestic enterprises have been advised to adhere to the following guidelines:

(a) The Indian company should fully explore alternative sources of technology and furnish reasons for preferring the particular technology and the source of import.

(b) The agreement should not prohibit sub-licensing of the know-how to other Indian parties.

(c) No restrictions should be placed on the licensee regarding the procurement of capital goods, components, spares, raw material, pricing policy, selling arrangements, and so on.

(d) The agreement should place no export restrictions except when the collaborator has a sub-licensing arrangement.

(e) The use of foreign brand names on products for the domestic market is prohibited, although there is no objection to their use on products to be exported. A foreign firm may, however, provide its trademark free of charge or use it with a suffix or prefix (e.g. Lehar-Pepsi, Hero Honda).

(f) Any consultancy required to execute the project should be obtained from an Indian firm. If a foreign consultant is required, an Indian firm should still be the prime consultant.

(g) Provisions for training Indians in production and management should be included where applicable.

Collaboration agreements are normally approved for a period of five years, plus, in some cases, an additional three-year start-up period. An extension for another five years may be granted if the government is satisfied that the technology transferred needs more time to be properly assimilated, or the licensor is going to make available new technology, or the agreement relates to an export-oriented industry. Moreover, Indian regulations allow former licensees to continue production after the licensing contract expires without making new payments to the licensor, even though the product continues to be protected by Indian patents.

The royalty depends on the nature of technology and is generally allowed at 3–5 per cent over the period of five years. Higher rates of royalty are permissible on exports and products involving the import of sophisticated technology. The government views unfavourably royalty agreements that provide only the right to exploit a patent and do not permit continuing access to technical know-how and new research and development.

(*Source*: United Nations Centre on Transactional Corporators, *Foreign, Direct Investment And Technology Transfer in India,* United Nations, New York, 1992)

It is a different matter that most of these restrictive guidelines have been lifted, particularly with the advent of economic liberalisation since the 1990s.

Creating Local Capability

Creating local technological capability is essential to absorb imported technology. This stems from several reasons. Technology, it may be stated, is not simply a matter of blueprints, which can be transferred without any local effort, to any part of the world. Each time some technology is installed, some local adoption is required, which demands local technological capability. The greater the capacity, the more efficient the resulting operations. The need for local adaptation arises from the fact that the environment in which any technology operates is unique in any situation when it is installed and may even differ radically from the environment for which the know-how was developed in the first place. This is especially true when technology is transferred from MNCs to developing countries. Difficulties are often found in the availability of skilled labour, the dexterity, training, education and experience, availability and quality of material and other parts; and infrastructural facilities, including energy, transport, and water. In some situations local technological efforts may be needed to permit the technology to work at all. In others, it may add to productivity and international competitiveness.

Japan provides the most spectacular example of a country that deliberately fostered the process of building up local technological capability on the basis of imported technology, devoting considerable local resources of R&D to adapting imported technology to local conditions. Korea is another example. The country's strategy for gaining technological mastery has relied heavily on indigenous efforts through capitalising on experience and emphasising the selective use of technology transfer. Foreign products are copied and then improved, as in the case of the semi-automatic looms for weaving fabric, which were initially copied and then adapted to suit local conditions. Exporting provided a considerable source of local learning as buyers transmitted information about product requirements and other factors.

L&T in India is a striking example for developing local capability. F L Smidth, a Danish firm, gave L&T technology to make spherical seating for self-aligning bearings for supporting rotary kilns. The technology was time-consuming and cumbersome. L&T engineers came up with a totally innovative method of manufacturing the part which was faster and far superior in quality. This design impressed

F L Smidth so much that the Danish conglomerate adopted it as SOP throughout their plants across the globe and the firm was generous in its appreciation of L&T. The local technological capability is needed in order to adapt technologies to local conditions, to improve productivity in the operation of any given technology, and to permit the attainment of international competitiveness and growth of exports.

The above argument is very interesting but the difficulty lies in developing capabilities, particularly because technological competence does not emerge overnight, nor can it be bought off the shelf as if acquiring a new company or a key scientist or engineer. It has to be learned the hard way, by a process of accumulation over time, and one which involves mistakes and blind alleys as well as success.

In the wake of globalisation of business, technology is available for any country which wants to acquire and assimilate it. But the receiving nation needs to have appropriate infrastructure, proper administrative reforms and accountability, and transparent decision-making process in order to attract foreign investment. Just receiving is not enough.The recipient nation should also develop local capabilities to adopt and assimiliate this technology.

Building local capabilities and willingness of the transferring countries are essential for technology transfer to take place as shown in Fig. 9.11. If local capabilities are not developed and if transferring countries (mostly developed) are willing , then the technology transferee countries (mostly developing) suffer from syndromes of technological dependency (see quadrant 2), a typical outcome of a zero-sum game. In quadrant 3, developing countries stand to gain as they have absorptive capabilities. Technology transfer does take place notwithstanding unwillingness of rich countries to pass on their technologies through formal routes— typical of piracy or reverse engineering as practised by Japan. Quadrant 1 results in a win-win situation. Transfer of technology takes place and both transferring and transferee countries stand to gain. It is opposite in quadrant 4. Technology transfer does not take place and no country stands to gain.

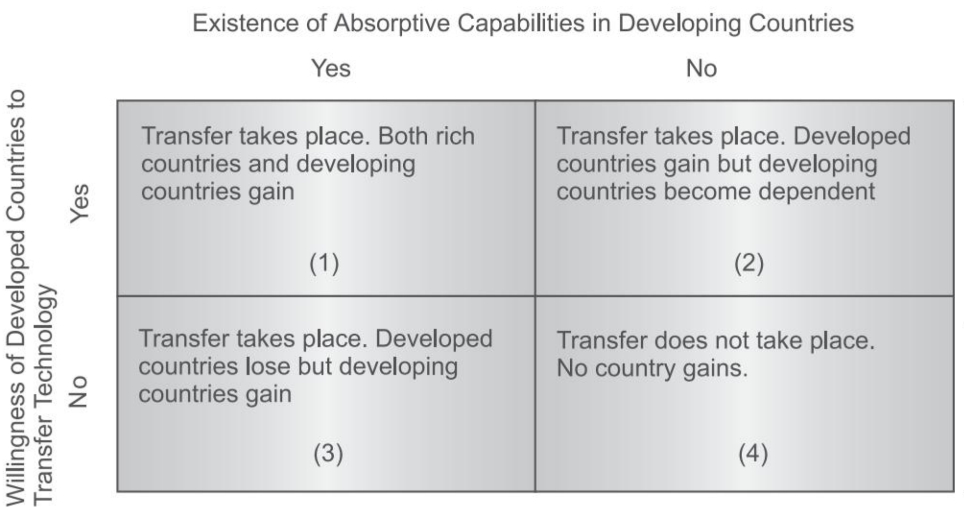


Fig. 9.11 Pros and Cons of Alternative Possibilities of Technology Transfers

(*Source*: Adapted from Tamir Agman and Mary Ann Von Glinow, p.237)

Globalisation

The world economy is passing through structural changes. These changes are driven by globalisation of business as well as by the revolution in information, communication, and transportation technology. Nations now have powerful technology in their hands, fundamentally transforming the way in which business is conducted around the globe.

The World Trade Organisation (WTO) is contributing to globalisation by removing trade barriers between countries and evolving mechanisms for smooth conduct of trade among nations. The WTO has also evolved a mechanism to manage technology better. The main provisions of the WTO that influence technology transfer are included under the following sections:

- Trade Related Aspects of Intellectual Property Rights (TRIPs)
- Trade Related Investment Measures (TRIMs)
- Subsidies and Countervailing Measures (SCMs)
- The Information Technology Agreements

Barriers to Technology Transfers

The final international technology issue relates to barriers. The problems encountered in transfer of technology are:

- A limited general understanding of the concept of technology, and the lack of a consistent framework for its study.
- Lack of systematic planning for technology transfer in developing countries or misunderstanding of its underlying philosophy.
- Lack of bilateral scientific/technology advantages in the process of technology transfer (mutual benefits).
- Lack of systematic and integrated engineering and socio-economic approach to the technology transfer process.
- Lack of a relevant quantitative framework/approach to the analysis and evaluation of technology transfer to developing countries.
- Failure to include ergonomic aspects in technology transfer or to accord sufficient value to the human-machine interface variable of the transferred technology, or the failure to adjust the technology to the existing socio-cultural system.
- Lack of attention to environmental considerations and assessment of technological impact.
- Failure to determine whether a national consensus and orientation exist for a transfer.
- Failure to recognise the local potential (cultural and economic) for adoption of technology (that is, failure to determine the availability of social and economic infrastructures).
- Failure to determine if the existing national productive capacity is adequate to support the application of the transferred technology (technical and technological potential and infrastructures).
- Restricting the feasibility study of technology transfer to financial assessments (mostly cost-benefit analysis).
- Lack of any universally accepted perspective on relevant socio-economic as well as technological infrastructures in the process of technology transfer (commercial, legal, transportation, utilities, and communication networks).
- Absence of any substantial effort to review and utilise the potential of technological interchange and socio-technical collaboration for technology transfer between developing countries.

- Misunderstanding of the concept of technology appropriateness, hitherto confined to only small and non-capital-intensive technologies.
- Presence of ethical problems within the technology transfer process.
- Failure to evaluate or consider 'conflict causing' factors pertaining to the transferred technology. These factors can be categorised into:
  1. 'sector conflict factors': conflicts that can arise within the techno-economic system.
  2. 'rural-urban conflict factors' arising because of spatial (that is, regional) imbalances in the distribution of physical resources needed for specific industry in the long term (for instance, sacrificing the existing production institutions in an area in order to initiate to new, imported, mostly large-scale technology), leading to.
  3. factors 'disturbing the socio-cultural balance' that operate with in the social system:

     due to the nonconformity of the transferred technology with the available potential, and with the inherent objective of development policies and national techno-economic plans in developing countries; and due to the lack of specific software and any other sophisticated supportive tools for technological planning and technology assessment within the technology transfer framework.

It should be noted that the policies on technology transfer have changed. Most governments have moved from controls and restrictions to market-friendly approaches improving the business and FDI environment, strengthening legal and other institutions and enhancing the skills and raising the capabilities of local businesses. Market-friendly approaches are themselves shifting from providing an enabling environment to stronger pro-innovation (technology seller) regimes, while continuing to encourage technology transfers. In the international arena, national market friendly approaches are complimented by TRIPS, restrictions on performance requirements and a number of other agreements.

Summary

- Technology refers to the process of converting an invention into useful products. Science refers to invention and technology is its conversion into goods and services (LO1).
- Technology is characterised by several features. Major of them are its constant change, widespread effects and the like (LO2).
- Technology management involves its classification, and its systems (LO3).
- Impact of technology is widespread. Specifically, technology has its impact on society, plant and the economy as a whole (LO4).
- Technology transfers evoke reactions from home country as well as host country. Transfer passes through five sequences (LO5).
- International technology transfers confront several issues (LO6).

Review Questions

1. What is technology? How does it differ from science? (LO1)
2. Describe the different phases of technology management. (LO2)
3. Bring out the impact of technology on: (a) Society, (b) Economy, and (c) A plant. (LO3)
4. What is technology transfer? What are the directions of such transfers? (LO5)

5. Bring out the stages in technology transfer. (LO5)
6. Explain the issues involved in international technology transfers. (LO6)
7. State and explain a recipient country's strategies for imposting technology. (LO6)

Discussion Questions

1. Why do home countries oppose technology transfer? (LO6)
2. 'One of the major issues in technology transfer relates to the mode of acquisition.' Evaluate this statement. (LO6)
3. 'Impact of technology has been a subject of immense discussion.' Why? (LO4)

Reinforcing Exercises

- Indians firms are known for using outdated technology, believing it is ok as long as money flows in. For a long time Telco's (Tata Motors) truck models were antiquated only found in developing countries. Bajaj was unable to develop a self-starting scooter, for decades. Or take the case of Indian Telephone Industries (ITI) which was still recently manufacturing strowger crossed switching equipment that became outdated decades ago.
  Why this phenomena?
- The technology transferce company should develop own capability to absorb the new ideas. L&T is an example for developing local capability. F L Smidth, a Danish firm, gave L&T an order to make spherical seating for self-aligning bearings for supporting rotary kilns. The technology was cumbersome and time-consuming. L&T engineers came up with a totally innovative method of manufacturing the part which was faster and far superior in quality. The Danish firm started buying it from L&T.
  Collect more such examples.

CLOSING CASE

The Incredible Journey of Google

In its history of 10 years, what the US based technology firm has achieved is incredible. Few firms have risen like Google, from total obscurity to being part of many people's lives and also their vocabulary. The company's search engine has become the prime tool for most people seeking information on any topic. In July 2006, over 49 percent of all Internet searches were conducted on Google, as against less than 25 percent for its nearest rival, Yahoo. From a turnover of $6.1 billion in 2005, the revenues shot upto $21.7 billion in 2008.

Google Inc. (the name is a play on the mathematical name for 1 followed by 100 zeros) came into being in 1998, as the fruit of a project by two computer science PhD students at Stanford University, Sergei Brin and Lawrence Page. The search engines in use at that time were not good at understanding user queries and the answers they delivered typically included many irrelevant links. Users either had to shift through pages of results to find what they really wanted to be skilled in putting together sophisticated queries to limit the volume of responses. Brin and Page's (the duo are still 'on leave' from the Stanford PhD Programme) PageRank algorithm, however, prioritised the results of an enquiry according to how many other sites linked to them, allowing web users to vote for sites that had the most useful content. As Google's website proudly claims, 'Democracy on the web works': Google users are typically able to locate what they want amongst the first few results of a search.

Online advertising, which generates 96 percent of the firm's revenue, is kept separate from the search results. The 'sponsored search' allows the customer to click on sites related to the particular search-advertisers pay for each 'click' that the consumers make on their websites. The price is determined by advertisers bidding against each other in real-time online auction for the privilege of having their messages displayed when certain key words are entered in the search engine.

Google has its presence in India but revenue contribution from Indian operations was a measly $200 million in 2008. However, Google pins great hopes on India. With a head count of 1000 people, its second largest employee base globally after the US, Google is of the view that it is sitting on top of a veritable goldmine of online advertising.

With only 6.6 million broadband users, this goldmine might seem a long way off. But Google's numbers in India are actually not too shabby. Its social network, Orkut, has an estimated 13 million active monthly users as of May 2009. Along with the search page, video service YouTube and its free e-mail (Gmail,) Google India claims to have four of the five leading web properties in India (the fifth being Rediff). With an active Internet base estimated to be around 50-60 million users, recent price cuts on broadband offerings as well as cheaper mobile-data access plans have given connectivity a big boost. Auctions for next-generation data-rich 3G-mobile networks and Broadband Wireless Access expected by the end of the year will improve things further. Not surprisingly, global research firm Forrester Research estimates that India will be the world's third-largest broadband Internet base by 2013. This is the market that Google is gunning for.

The business of selling ad space to companies can only thrive as long as Internet users keep flocking to Google's sites. To retain and attract new users, the company has been integrating services like railway information, bus schedules, local business listings, movies, reviews, and geographic information into their search.

Google also provides language support for people who use Gmail and Google's blogging service, Blogger. This service allows users to write a passage in the Roman script and the software created by Google will convert it into Hindi and seven other Indian languages.

Google takes great care while hiring people. The company has fancy for puzzles and the prospective hires are subject to series of puzzle tests. Those who survive will find entry into the company. There is a flourishing entrepreneurial environment in the company. Employees are allowed to bring their pets and kids to the office. They are encouraged to innovate and be creative all the time.

Googlies on the Way

Google may be sitting pretty as of now. But it must bat firmly as there are googlies on the way. Microsoft's new search engine Bing has entered the market already and is poised to cut into Google's market. Second, the company has launched too many products, not all profitable. Further, such proliferation has dented the image of Google as a company known for focus and simplicity. Third, some products are released unfinished. While some are explicitly under the Google Labs umbrella, as new ideas that users are invited to help the company develop, more mature one (such as Froogle) may spend three or more years as 'beta' products, the industry's term for unfinished software that users are helping to refine for final release.

Fourth, Google has not always anticipated how others might view its projects. A plan announced in 2004, but conceived much earlier to digitise books in the collection of major libraries encountered serious opposition from publishers and authors concerned about infringement of copyrights.

Fifth, a serious concern is that the growing internationalisation of the Internet makes it more difficult for the one-size-fits-all search engine to satisfy consumers. Google's international advertising revenues are a growing proportion of its total revenues. This reflects the fact that more than half its user traffic is outside the US. The number of internet user's outside the US is estimated to grow at 13 percent per annum, twice the rate of growth within the US. While Google's service is provided in 97 languages worldwide, the growth in international usage offers opportunities for internet start-ups to provide services in local markets which the 'one-size-fits-all' approach cannot satisfy.

Sixth, Google is getting into avoidable controversies from different quarters. It was with China to start with, and it was over the internet censorship. For a number of years, Google refused not to locate its Chinese language server within the Chinese firewall. The result was the lose of China – a huge market. Finally, Google agreed to the government's rules and launched its censored China – based site 'google.in' in 2006, arguing that providing restricted information was still better than no information.

Then came 2013. Google found itself under sharp attack from politicians in Europe when it was revealed that the company had adopted strategies to avoid paying corporate income tax on the bulk of its earnings outside the US, the majority of which was generated in Europe. Estimates suggest that in 2011 Google avoided above $ 2bn in worldwide corporate income tax by shifting $9.8 bn in revenue into a shell company in Burmuda where there is no income tax. Google's tax rate on profits earned overseas was just 3.2 percent, even though most of its foreign sales were made in European countries with corporate income tax rates ranging from 26 to 34 percent.

Incidents of the above type are likely to dent the image of any otherwise successful company.

All things considered, Google's strength cannot be underestimated. It has an excellent team of executives comprising Eric Schmidt, Larry Page, Sergey Brin and Nikesh Arora, guiding the destiny of Google. The company has a treasure trove of trial and error lessons learnt from world across over time. Atleast in India, Google has unique strength to rule over the market. The fact is that Google has excelled in devising products for one category likely to soar above others in India namely the mobile phone simultaneously with PC. This is sure to attract even more consumers to its sites for some more time to come and continue Google's reign as the well entrenched king of the Indian Internet domain.

Google's top brass is proactive. Having remained a private limited company for seven years, Google went public in 2005. The company has huge financial resources at its command. In the US market, Google's share of video sharing fell behind the leader- YouTube. Google decided to acquire YouTube for $ 1.65 billion.

Questions

1. Analyse Google's architecture. How well is it suited to the company's present competitive situation?

2. What is Google's expectation from India? Why is it pinning so much hope on India?

3. What are the weaknesses of Google? What are its strengths?

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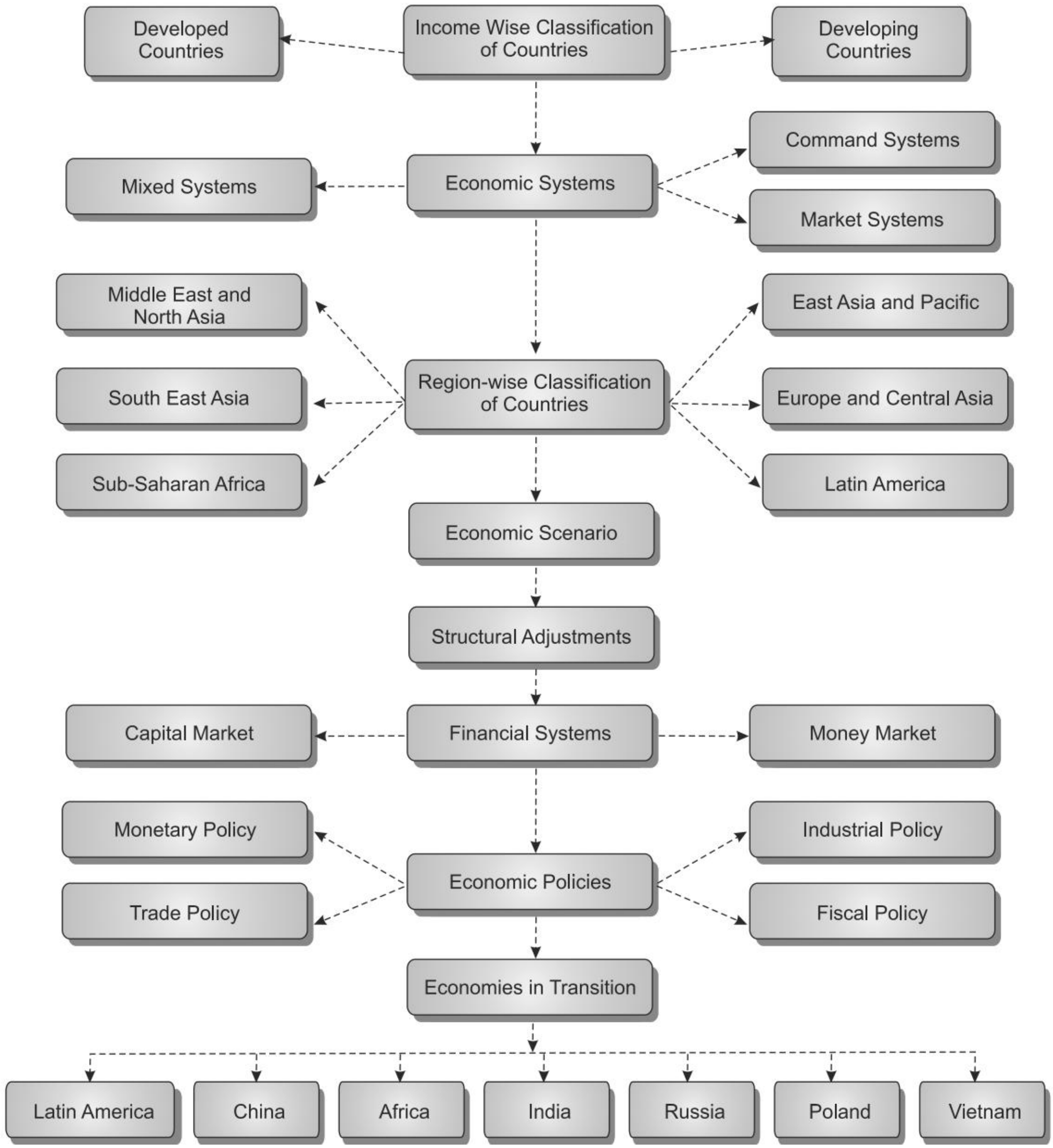
CHAPTER


Developed Countries
Income Wise Classification of Countries
Developing Countries
Command Systems
Mixed Systems
Economic Systems
Market Systems
Middle East and North Asia
East Asia and Pacific
South East Asia
Region-wise Classification of Countries
Europe and Central Asia
Sub-Saharan Africa
Latin America
Economic Scenario
Structural Adjustments
Capital Market
Financial Systems
Money Market
Monetary Policy
Industrial Policy
Economic Policies
Trade Policy
Fiscal Policy
Economies in Transition
Latin America
China
Africa
India
Russia
Poland
Vietnam

10

Economic Environment

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Formulate income-wise classification of countries
- **LO 2:** Analyse countries classified by economic system
- **LO 3:** List classification of countries by region
- **LO 4:** Analyse the economic scenario
- **LO 5:** Assess the financial system
- **LO 6:** Outline the economic policies
- **LO 7:** Examine the structural adjustments required
- **LO 8:** Identify the economies in transition

Opening Case

Resurgent India?

India is a land of large numbers: a place of over a billion people, a million mutinies, and a thousand different tongues.

The country achieved Independence in 1947 after a long struggle against the British rule. The former colony was divided into India and Pakistan, the Eastern part of which eventually became Bangladesh. For many years, India was a socialist democratic republic with a federal government inspired by the British Parliamentary System. However, in the late 1980s and early 1990s, India began to move away from its socialist economic and political orientation and aggressively adopted market capitalism.

This shift has benefited the economy considerably. And the results present themselves clearly. The GDP, which registered an average growth rate of 5.3 percent in the 1980s has gone past 9 percent in 2006, 2007 and 2008. It is hovering around 5 percent as of now. Due to global economic melt-down, the growth rate has fallen slightly, but is sure to pick up in the near future. Exports are soaring (see Table 10.1), with engineering doing particularly well, helped by Special Economic Zones, which are free of red tape and account for 22% of exports.

Many controls that crippled industrial growth in the past have been discontinued, though

Table 10.1 Indian Economy

	1990	2010
Population, mn	839	1186
GDP, $ bn (2010 prices)	433	1538
GDP per person $ (2010 prices)	503	1265
GDP world ranking (current $)	12	10
Exports, as % of GDP	6.9	21.5
Gross savings as % of GDP	21.9	34.7
Adult literacy rate %	48.2	68.3
Poverty rate %	45.3	32.2
Urban population, % of total	26	30
Share of world market capitalisation	0.4	2.88
Number of billionaires in Forbes rich list	1	49

it may take some more years to call India a totally market driven economy. Tortuous, bribe-laden procedures have been abolished or pruned. Industrial licensing, import permission, technological tie-ups, capital issues, foreign investment, and much else have been liberalised. As on today, captains of industries are free to decide and implement. The country has become robust in the industrial sector, and is the centre of attraction for the entire world in software and information technologies. Panchayatraj governance, spread of NGOs, and civil societies and the Right to Information Act have added to the acceleration of economic growth.

Agriculture continues to be the major economic activity accounting for 28 percent of the GDP. After the Green Revolution of the late 1960s and early 1970s, agricultural production started increasing at an annual rate of three percent plus. As a result, India became self-sufficient in grain production.

There are hundreds of millions of poor people. But the poverty ratio has declined from 56.1% in 1973 to 32% today. People have everything to pick and choose. They no longer have to queue up for years for a telephone, car or scooter. They are no longer at the mercy of Indian Airlines, government bus service, LIC, GIC or other ex-monopolies.

Over a decade and odd, reforms have brought obvious gains for Indians. Some of them are physical. A study in the National Medical Journal of India in 2011, looking at children among India's wealthier population, found that at the age of 18, boys are 4.5cm taller and 45kg heavier than they were in 1992. This is because of better food and less disease. Census 2011 revealed interesting developments. The country's 247mn households, 2/3 of them rural, have seen literacy rates rise to 74% from 65% in 2001; 63% have now phones, up from just 9%; nearly 60% have a bank account; 93% of these in towns and cities have atleast access to electricity, 2/3 cooking gas, and the like.

Economic reforms have ensured ample supplies of everything, ending the perennial scarcities of the bad old days. Low import duties have ended the smuggling of gold, synthetics and consumer electronics. The black market premium on foreign exchange has gone.

Financial reforms have empowered consumers with access to housing loans, personal loans, credit and debit cards and mutual funds. ATMs have revolutionised access to cash, and computerisation has improved the speed of the bank staff. The delivery of financial services has vastly improved.

New technology has spread fast. It has revolutionised the capital market, facilitating de-materialisation of shares and giving India an electronic exchange (NSE), superior to London Stock Exchange. Mobile phones have taken technology to the grass roots, street hawkers, rickshaw pullers and construction workers own them. E-governance initiatives like *Bhoomi* (Karnataka) and *e-Seva* (Andhra Pradesh) have improved the access of villagers to land records and market information. ITC has launched e-Choupals. Computerisation has facilitated micro-finance organisations.

Particularly during the last two decades, the country has transformed. 'New India' is one of the world's fastest growing economies, triggered by sectors like software, services, telecom, pharmaceuticals, retail, real estate and automobiles. Global investors have taken note of it and terms like FDI and foreign institutional investors have become household phrases. Thousands of MNCs have set up shops, even as hundreds of Indian companies have made a beeline to foreign shores.

More pleasant sight is the PSUs which were looking dowdy for decades. They are unrecognisable today compared to 20 years ago. They are on an overseas acquisition spree and have become leaner, efficient, vibrant, innovative and competitive. Their ownership is diffused and their shares are now listed.

The country's savings rate has shot up from 22% to 34-36% in two decades. With a moderate foreign capital inflow, India can sustain an investment rate of 36-38% of GDP which can generate 8-9% of growth rate. Per capita income has shot up from $300 to $1700 in two decades. Salaried people are earning higher incomes and wages of casual labourers have shot up by 40%.

High GDP growth rates have made the government very rich—central revenues are rising by over Rs. one lakh crores per year. This has helped spend hugely on welfare and social sectors.

India has become world leader in frugal engineering. Frugal engineering helps cut costs enormously. One example is Nano, the world's cheapest car. Indian telecom has the cheapest call rate of one rupee per minute.

Indian business leaders, unlike their Chinese counterparts, are at home in global markets; many of them are fluent in English and are graduates.

Better days are ahead for India and its economy. First, we have a new party with enough numbers on its own in the Parliament and change in thinking of the leading business schools in the US and Europe. With increasing confidence, CEOs of India's leading companies are venturing overseas, making headlines with high profile acquisitions. Indian software giants like TCS, Wipro and Infosys have emerged as global technology leaders, thanks partly to the skills of the thousands of world-class engineering graduates that the country produces each year. Indian companies are thriving in other key sectors such as pharmaceuticals, petrochemicals, and steel, demonstrating a capacity for efficiency and innovation that is changing the global competitive landscape. India's banking system and equity markets are well regulated and far more open to foreign participants than China's.

Table 10.2 Delays at Ports and Airports in India

Transaction	Location	Norm
Air freight	*Delhi Airport*	
Export	2.5 days	Less than 12 hours
Import	15 days	Less than 12 hours
Containerised sea freight	*Mumbai*	
Ship waiting time	3-5 days	Less than 6 hours
Export dwell time	3-5 days	Less than 18 hours
Import dwell time	7-14 days	Less than 24 hours

(Source: Roy and Bagai (2005))

Thus, the positives of Indian economy are many and varied. No wonder, in the days to come, India is prophesied to play a much bigger role in the world economy.

However, take a look at the nagging negatives that have the potential to drag the economy two steps backwards, while it wants to go one step ahead. Infrastructure continues to be a nightmare as Table 10.2 shows. Alongwith all the talk about IT and BPO revolution, hunger continues to stay. On Global Hunger Index, India ranks 94 (out of 118 countries researched), one rank behind Ethiopia. Pakistan has done much better with 88th rank and China with 47th place.

More than 1,50,000 farmers have committed suicide, one suicide every 30 minutes. Thanks to market-friendly measures; sensex is rising but increasingly poor are getting isolated and the rich are aggrandising themselves. The digital divide has further worsened the gap between the poor and the rich.

We have a lousy civil rights record. The police refuse to register complaints, *Khap Panchayats* kill social dissents, mobs intimidate minorities, and fake encounters are common. Court cases last decades. Over a million cases are pending. There is no equality in practice, in social or economic relations, for *dalits*, tribals and other minorities.

The quality of the public services remains pathetic. A typical doctor at a primary health care centre in Delhi is less competent than in

Tanzania, and the chances of his recommending harmful treatment are 50:50. Teacher absenteeism is rampant, and half of standard V children in five states cannot read class II texts. Water supply is just four hours a day in Delhi, six hours on alternate days in Bangalore, against round-the-clock supply in Jakarta or Colombo. Electricity supply is erratic, with 30 percent of it being pilfered with impunity.

Bangalore may be the hub of software industry and earner of foreign exchange worth billions per annum through export of software services, but it is also a place having many badly maintained roads. The civic body seems to be a big sadist. It takes pleasure in digging up the passable roads for repair and then abandoning them for months and years. Consequences are traffic congestion and floating dust. Whenever a vehicle manages to pass through these roads, it raises huge dust that settles on the following vehicles, pedestrians, and road-side shops and houses. In another ten years, Bangalore will have the highest incidence of lung diseases in the country and it is because of the corrupt and slothful civic body as well as the indifferent state government.

Fear haunts people, particularly those in deprived sections. Dalits and tribals fear upper caste oppression and insurgency is rampant in 160 districts out of 600. Across the country, fear of crime is rising. Before Independence, the police seemed capable of catching criminals, and the courts of convicting them speedily. Today, few people are caught and fewer are convicted beyond appeals.

We have six million new phone connections every month, but we also have 30,000 villages that have never heard the ring of a telephone. There is also the danger that over time, without another bout of reforms, scherosis will set in. Indian companies mostly thrive inspite of the weak state; they need to make sure that they do not thrive because of it. Two worrying signs are evident: the slow down in new entrepreneurs breaking into the established order; and endemic corruption. Both clash with the aspirations of the masses, who want India to be a land of opportunities.

On Gender Gap Index too (compiled by the Word Economic Forum), ranking of India is disappointing. (Gender Gap Index is a composite score covering such dimension as opportunities available for women, economic empowerment of fair sex and health and survival accessibility for ladies). The following is the ranking of India:

2011	Out of 135 countries covered	113 rank
2010	Out of 128 countries covered	112 rank
2009	Out of 127 countries covered	114 rank
2008	Out of 125 countries covered	113 rank
2007	Out of 128 countries covered	114 rank
2006	Out of 122 countries covered	115 rank

Yet India is on the move. It is a resurgent country as Suman Bery, an economist, speaks of the "old Indian formulation that at the end of every two-year period it seems as if you have got nowhere but in each seven-year period you look back and things have been transformed."

THE opening case above gives a brief account of the economic environment prevailing in India. This input is necessary for an international business seeking to invest in India. Nay, any MNC seeking to invest in any country should analyse and understand the local economic environment. In addition, understanding the economic environment of foreign countries can help international managers predict how trends and events in those environments might affect performance of businesses there. In this chapter, we propose to discuss all those forces which constitute the economic environment of a country. For the purpose of convenience, we propose to include the following forces: (See Fig. 10.1)

- Classification of countries on the basis of income
- Region-wise classification of countries
- Economies in transition
- Economic scenario

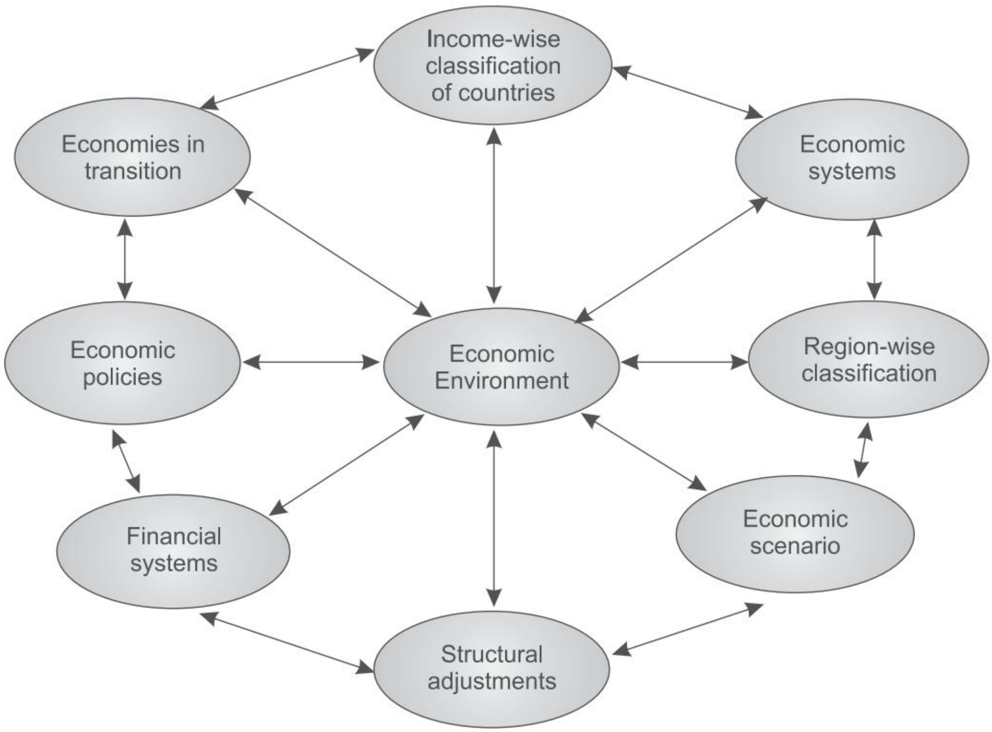


Fig. 10.1 Elements of Economic Environment

- Economic systems
- Financial system
- Economic policies
- Structural adjustments

INCOME-WISE CLASSIFICATION OF COUNTRIES

LO 1
Formulate income-wise classification of countries

Several international agencies including the Organisation for Economic Cooperation and Development (OECD) and the United Nations classify countries by their economic status. But the best known system of classification is the one recommended by the World Bank in which 211 economies with a population of at least 30,000 are ranked by their levels of gross national income (GNI) per capita. These economies are then classified as low-income (LIC), lower-middle income (LMC), upper-middle income (UMC), high-income OECD, and other high-income countries.

LIC countries are defined as those having a per capita GNI in 2011 of $ 995 or less; LMC countries have incomes between $996-3945; UMC countries between $3946-12195; and high income countries of $12196 or more (see Table 10.3 and Map. 10.1). Generally, LIC, LMC and UMC countries are called the developing countries and the rest are the developed ones. Traditionally all the countries were classified as first world (high income) second world (middle income) third world (low income).

Developing Countries

Most developing countries share a set of common and well-defined goals. These include a reduction in poverty, inequality, and unemployment; the provision of minimum levels of education, health, housing, and food to every citizen; the broadening of economic and social opportunities; and the forging of a cohesive nation-state. Related to these economic, social, and political goals are the common problems shared in varying degrees by most developing countries: widespread and chronic absolute poverty, high levels of unemployment and underemployment, wide and growing disparities in the distribution of income, low and stagnating levels of agricultural productivity, sizeable and growing imbalances between urban and rural levels of living and economic opportunities, serious and worsening environmental decay, antiquated and inappropriate educational and health systems, severe balance of payments and international debt problems, and substantial and increasing dependence on foreign technologies, institutions, and value systems.

Developing countries include many nations in Africa, the Middle East, and the poor formerly communist nations in Europe and Asia. Some of these countries (for example India and China) have the potential to emerge as superpowers in the near future.

Developed Countries

Those countries that are highly industrialised, highly efficient, and whose people enjoy a high quality of life are the developed countries. People in these countries usually receive excellent healthcare and benefit from the best educational systems in the world. Most developed nations also support programmes for helping poorer nations improve their economies and standards of living. Countries in this category include Australia, Canada, Japan, New Zealand, the US, all Western European nations and Greece. The IMF now includes 11 former emerging economies as developed economies. Among them are Hong Kong, S. Korea, Czech Republic and Estonia.

Geographically, developing countries are found in all parts of the globe (Map 10.1) whereas developed countries are clustered in a few areas. In terms of the numbers and population, developing countries far exceed those of developed countries (see Figs. 10.2 and 10.3).

Figures 10.2 and 10.3 indicate that there is a wide disparity between where the world's income is produced and where the world's people live. The low-income countries are the areas where population growth is highest, while their proportion of the world's income is stagnant. The population is increasing but their share of the world's income is not growing. In the middle- and high-income countries the phenomenon is opposite. High-income countries are contributing to higher proportion of world's GDP, while the proportion of the population is decreasing. The middle-income area is showing both population growth and a growing proportion of the world's production of GDP.

Table 10.4 presents interesting phenomena. The table contains percentage shares of India, China, Japan, US and UK in world population and world economy. One thousand years back, India enjoyed a premier place with a population share of 28% and a share in the economy of 28.9 percent. Other countries, particularly US and UK were no where near India. As decades went by India lost its supremacy. In 2006, India's share in the world population stood at 17.4% but its share in the economy was just 6.3%. Other countries have scored better than India.

This illustrates the difficulties international managers face. The high-income countries are a natural place to do business because of high demand, but the developing countries exhibit (as for example, India) tremendous potential because of the sheer size of the population—74.3 per cent of the total number of countries and 84.1 per cent of the total population. It might be safer to focus on the high-income

Table 10.3 Economic Status of Different Countries

Classification of economies by region and income, FY 2011

East Asia and Pacific

American Samoa	UMC
Cambodia	LIC
China	LMC
Fiji	UMC
Indonesia	LMC
Kiribati	LMC
Korea, Dem. Rep.	LIC
Lao PDR .	LIC
Malaysia	UMC
Marshall Islands	LMC
Micronesia, Fed. Sts	LMC
Mongolia	LMC
Myanmar	LIC
Palau	UMC
Papua New Guinea	LMC
Philippines	LMC
Samoa	LMC
Solomon Islands	LIC
Thailand	LMC
Timor-Leste	LMC
Tonga	LMC
Tuvalu	LMC
Vanuatu	LMC
Vietnam	LMC

Europe and Central Asia

Albania	UMC
Armenia	LMC
Azerbaijan	UMC
Belarus	UMC
Bosnia and Herzegovina	UMC
Bulgaria	UMC
Georgia	LMC
Kazakhstan	UMC
Kosovo	LMC
Kyrgyz Republic	LIC
Lithuania	UMC
Macedonia, FYR	UMC
Moldova	LMC
Montenegro	UMC
Romania	UMC
Russian Federation	UMC
Serbia	UMC
Tajikistan	LIC
Turkey	UMC
Turkmenistan	LMC
Ukraine	LMC
Uzbekistan	LMC

Latin America and Caribbean

Antigua and Barbuda	UMC
Argentina	UMC
Belize	LMC
Bolivia	LMC
Brazil	UMC
Chile	UMC
Colombia	UMC
Costa Rica	UMC
Cuba	UMC
Dominica	UMC
Dominican Republic	UMC
Ecuador	LMC
El Salvador	LMC
Grenada	UMC
Guatemala	LMC
Guyana	LMC
Haiti	LIC
Honduras	LMC
Jamaica	UMC
Mexico	UMC
Nicaragua	LMC
Panama	UMC
Paraguay	LMC
Peru	UMC
St Kitts and Nevis	UMC
St Lucia	UMC
St Vincent and the Grenadines	UMC
Suriname	UMC
Uruguay	UMC
Venezuela, RB	UMC

Middle East and North Africa

Algeria	UMC
Djibouti	LMC
Egypt, Arab Rep.	LMC
Iran, Islamic Rep.	UMC
Iraq	LMC
Jordaa	LMC
Lebanon	UMC
Libya	UMC
Morocco	LMC
Syrian Arab Republic	LMC
Tunisia	LMC
West Bank and Gaza	LMC
Yemen, Rep.	LMC

Sub-Saharan Africa

Afghanistan	LIC
Bangladesh	LIC
Bhutan	LMC
India	LMC
Maldives	LMC
Nepal	LIC
Pakistan	LMC
Sri Lanka	LMC

Sub-Saharan Africa

Angola	LMC
Benin	LIC
Botswana	UMC
Burkina Faso	LIC
Burundi	LIC
Cameroon	LMC
Cape Verde	LMC
Central African Republic	LIC
Chad	LIC
Comoros	LIC
Congo, Dem. Rep.	LIC
Congo, Rep.	LMC
Coted'Ivoire	LMC
Eritrea	LIC
Ethiopia	LIC
Gabon	UMC
Gambia, The	LIC
Ghana	LIC
Guinea	LIC
Guinea-Bissau	LIC
Kenya	LIC
Lesotho	LMC
Liberia	LIC
Madagascar	LIC
Malawi	LIC
Mali	LIC
Mauritania	LIC
Mauritius	UMC
Mayotte	UMC
Mozambique	LIC
Namibia	UMC
Niger	LIC
Nigeria	LMC
Rwanda	LIC
Sao Tome and Principe	LMC
Senegal	LMC
Seychelles	UMC
Sierra Leone	LIC
Somalia	LIC
South Africa	UMC
Sudan	LMC
Swaziland	LMC
Tanzania	LIC
Togo	UC
Uganda	LIC
Zambia	LIC
Zimbabwe	LIC

High income OECD

Australia
Austria
Belgium
Canada
Czech Republic
Denmark
Finland
France
Germany
Greece
Hungary
Iceland
Ireland
Israel
Italy
Japan
Korea, Rep.
Luxembourg
Netherlands
New Zealand
Norway
Poland
Portugal
Slovak Republic
Slovenia
Spain
Sweden
Switzerland
United Kingdom
United States

Other high income

Andorra
Aruba
Bahamas, The
Bahrain
Barbados
Bermuda
Brunei Darussalam
Cayman Islands
Channel Islands
Croatia
Cyprus
Equatorial Guinea
Estonia
Faeroe Islands
French Polynesia
Gibraltar
Greenland
Guam
Hong Kong SAR, China
Isle of Man
Kuwait
Latvia
Liechtenstein
Macao SAR, China
Malta
Monaco
Netherlands Antilles
New Caledonia
Northern Mariana Islands
Oman
Puerto Rico
Qatar
San Marino
Saudi Arabia
Singapore
Taiwan, China
Trinidad and Tobago
Turks and Caicos Islands
United Arab Emirates
Virgin Islands (U.S.)

Map 10.1 Income-wise Classification of Countries

Map not to scale

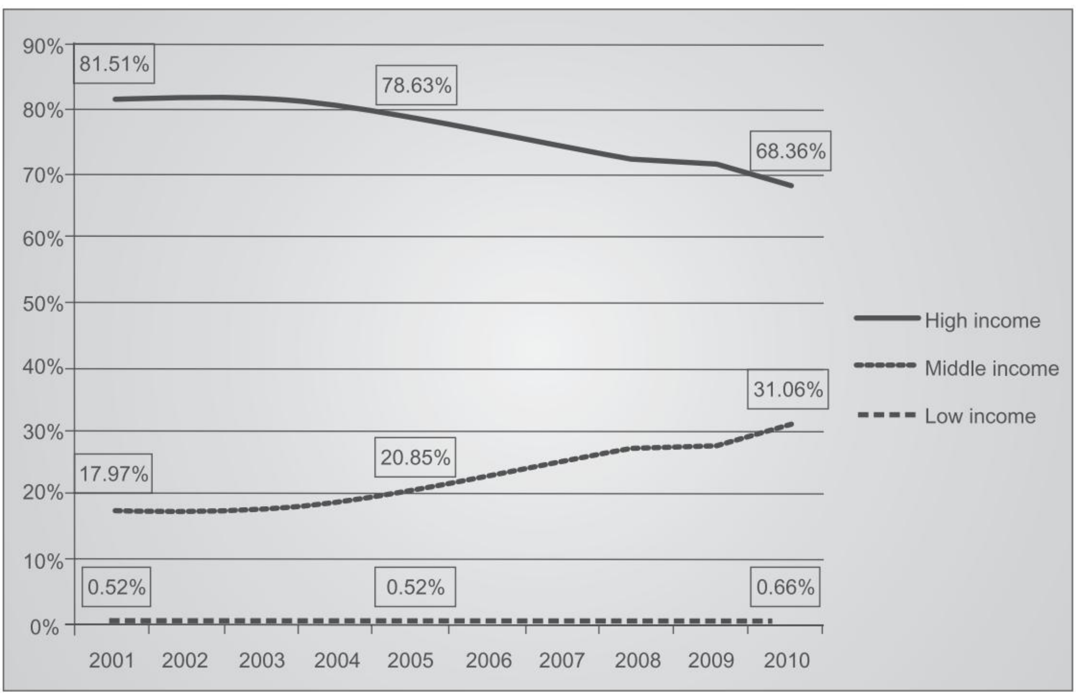


Fig. 10.2 World GDP, 2001-2010

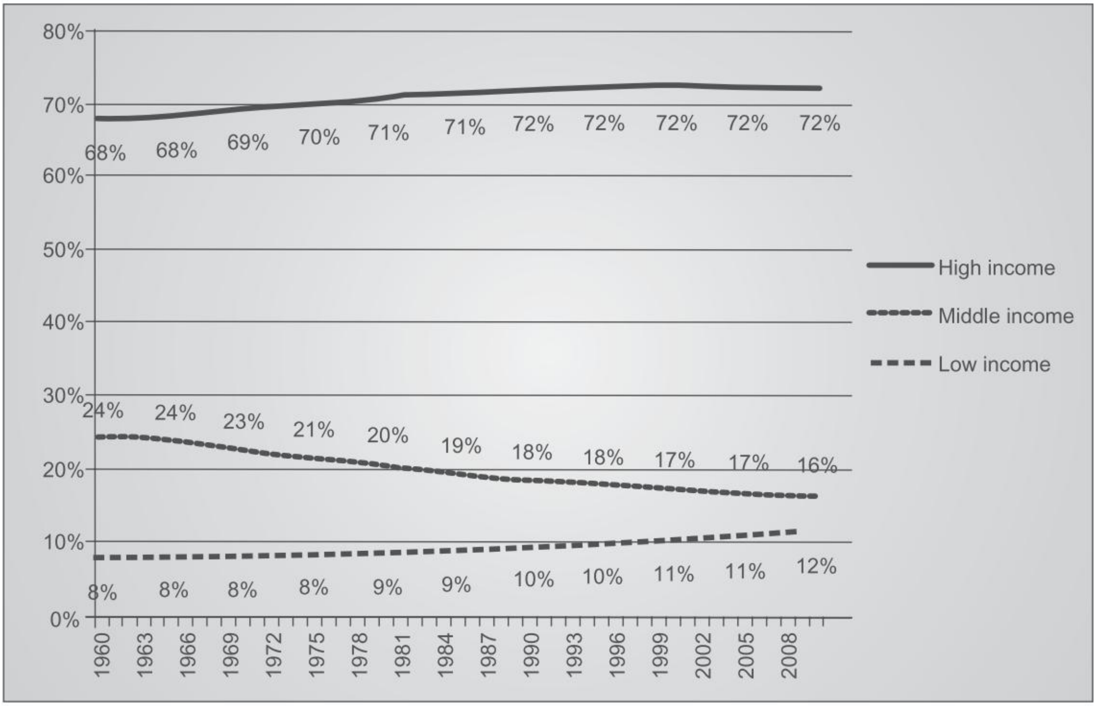


Fig. 10.3 World Population, 1960-2010

Source: Figs. 10.2 and 10.3 are based on *International Business* by Raid A. Ajmi, et al, Pp 79-80

Table 10.4 Percentage Share of World Population and Economy

	India		*China*		*Japan*		*US*		*UK*	
	Population	*Economy*	*Population*	*Economy*	*Population*	*Economy*	*Population*	*Economy*	*Population*	*Economy*
1000	28.0	28.9	22.1	22.7	2.8	2.7	0.5		0.7	
1500	25.1	24.4	23.1	24.9	3.5	3.1	0.5	0.3	0.9	1.1
1600	24.3	22.4	28.8	29.0	3.3	2.9	0.3	0.2	1.1	1.8
1700	27.3	24.4	22.9	22.3	4.5	4.1	0.2	0.1	1.4	2.9
1820	20.1	16.0	36.6	32.9	3.0	3.0	1.0	1.8	2.0	5.2
1910	17.0	7.5	24.4	8.2	2.9	2.6	5.4	18.9	2.6	8.2
1950	14.2	4.5	21.7	4.5	3.3	3.0	6.0	27.3	2.0	6.5
1970	14.8	3.1	22.5	4.2	2.8	7.8	5.4	22.1	1.4	4.2
2000	16.6	5.4	20.7	12.3	2.1	7.1	4.6	27.4	1.0	3.2
2006	17.4	6.3	20.5	15.1	4.7	6.3	2.0	19.7	0.9	3.2

(*Source*: *The World Economy*, OECD, 2006)

countries because of their relative political and economic stability, but the potential of developing countries to emerge as developed economies should not be lost sight of by international managers.

The Subterranean Economies The subterranean economies cut across all high-income, middle-income and low-income countries and are not counted in the official data of the World Bank. In all these countries, called black market economies, there exists an underground economy whose transactions do not enter official records at all. Unofficial sales and purchases of goods and services, even those exchanged on barter system, make the official GNP figure somewhat lower than what is actually shown. Poor countries are the victims of black market activities. Their economic growth is stymied and their polities are subverted.

COUNTRIES CLASSIFIED BY ECONOMIC SYSTEM

LO 2
Analyse countries classified by economic system

Another way of classifying countries is by their economic system. Keeping this in view, countries are classified as market economies, command economies, and mixed economies. The system of economy a nation follows depends on its political ideology. In countries where individual goals are uppermost over collective goals, market economies do find their place. In contrast, in countries where collective goals are given prominence, state interventions and restricted markets do exist (see Fig. 10.4).

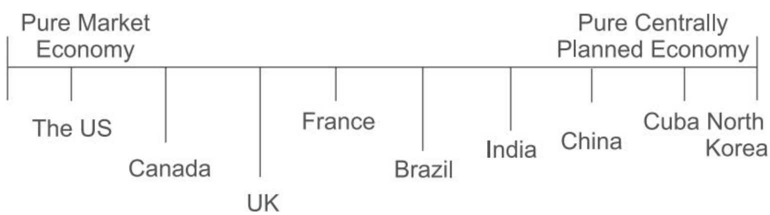


Fig. 10.4 Continuum of Economic Systems

Market Economy

In a market economy, also called capitalism, all productive functions are privately owned. Production of goods and services is not planned by individuals. Rather production is determined by the interaction of supply and demand forces. Whether to produce more or less depends on the price factor. If demand for a product exceeds its supply, price tends to rise prompting producers to produce more. If supply exceeds demand, prices will fall, signaling producers to produce less. In a market economy consumers are sovereign. Consumers decide what the producers should produce and supply.

The system of capitalism stresses the philosophy of individualism believing in private ownership of all agents of production, in private sharing of distribution processes that determine the functional rewards of each participant, and in the individual expression of consumer choice through a free marketplace.

Mention should be made of the welfare state which has developed in recent years. This is a modification of capitalism that provides for an increasing degree of state regulation when certain deficiencies occur in the economy. State interventions include workers' compensation law, provision for social security, laws regulating industrial relations, direct state financial aid to housing and agriculture, and the like. State interventions of this type are necessary to provide flexibility for market economy, otherwise it might become static and be destroyed because of certain faults.

Market economy requires fulfillment of certain conditions, if it were to function effectively. Failure to fulfill the requisites may destroy capitalism. The requisites include:

1. Trust (in banks, insurance companies, suppliers, etc.)
2. Law and order (enforcement of contracts)
3. Security of persons and of property
4. Balancing competition with cooperation (for a safe workplace and a cleaner environment)
5. Division of responsibility and diffusion of power (an independent judiciary)
6. Community altruism (a social "safety net" for the impaired, chronically unemployed, the elderly, etc.)
7. Social mobility, legitimation of ambition, and toleration of competitiveness
8. Materialistic values as a stimulus to greater production
9. Deferring gratification to generate private saving
10. Rationally unconstrained by tradition
11. Honesty in government
12. Efficient forms of competition, as opposed to monopolistic control
13. Freedom of information (along with protection of privacy)
14. Flow of information without restrictions or favoritism

Capitalism which ruled the roost for nearly three decades may not sustain itself for long. True, market economy created enormous wealth across the globe till now, but its potential to generate prosperity in future is at stake. Exhibit 10.1 brings out interesting arguments.

Exhibit 10.1

CAPITALISM AT RISK

Fragility of the Financial System Trillions of dollars move around the world daily, at high velocities. The financial crisis of 2008 showed that if these flows are not managed and unregulated, transparency can be reduced and risk compounded, with devastating consequences.

Global Trade Breakdown The financial crisis of 2008 also demonstrated how trade can breakdown with dire consequences. The freeze in trade finance and collapse in demand for goods was reflected in a 2.8 percent drop in global trade in 2009, the first fall since the Second World War.

Inequality and Populism Within countries and across regions, income and wealth disparities are increasing. The growing gap makes a mockery of the idea that economic growth benefits all. Governments are likely to resort to populist politics forcing them to resort to harmful government interventions, such as over regulation of market transactions, confiscation of property, and abrogation of property rights.

Migration Massive migration, either domestically (from rural areas to cities) or across national boundaries, is often a consequence of inequality. Cross-border movements of people tend to trigger protectionism and anti-immigrant political reactions, which frustrate would-be immigrants, undermine potential solutions to labour needs in developed countries, and generate social conflict.

Environmental Degradation Industrial growth is associated with climatic change, which affects the availability of water, health of crops, air quality and sea levels. The consequences could be seen in migration, the disruption of manufacturing and trade, and political instability.

Failure of Law The rise of corruption, extortion, thuggery, terrorism, fundamentalism, expropriation in some parts of the world make it difficult to operate capitalist system that respects property and human rights and uphold contracts. When bribes rather than competition determine winners, investment in innovation ceases to be a worthwhile.

The Decline of Public Health and Education The size of the labour force depends in part on its health, and its productivity depends on its education as well as its wealth. In parts of the developed world, the quality of education is on decline, and health care costs have become unmanageable everywhere.

The Rise of State Capitalism For centuries, developing nations have adopted variations of mercantilist policies to accelerate economic growth. But in the 21st century, some developing countries are giants. To the extent Russia, China and India play by their own rules, they have the potential to disrupt market capitalism as it is practised in the developed world.

Radical Movements, Terrorism and War The increasing challenge of maintaining sufficient peace and security for capitalism to prosper threatens the system. Substantial conflicts could disrupt the flows of goods, services, and capital necessary for the functioning of global markets.

Evolution and Pandemics The development of resistant pathogens and the unwillingness of some governments to address pandemics and to engage in cooperative efforts to curb the spread of disease pose another threat. An outbreak of untroubled infectious disease could quickly disrupt trade and financial markets worldwide.

The Inadequacy of Institutions Governmental and international institutions seem inadequate to deal with the scale and complexity of these varied challenges. Too often, international cooperation consists of adhoc agreements, such as those meant to address climatic change, trade and migration. Worse, the disruptive forces interact in negative ways so that problems in one area, stimulate new ones in others. It is the systemic character of the challenges that makes them especially hard to address them. Neither governments nor the few international institutions currently in place are set up to deal with systemic failure.

(*Source: Harvard Business Review*, Sept. 2011)

Command Economy

Also called socialism, in a command economy planning is a must. Decisions relating to all economic activities—what to produce, how to price—are determined by a central government plan. In fact, in a pure command economy the tools of production are organised, managed, and owned by the government, with the benefits accruing to the public. Consistent with collective ideology, the objective of a command economy is for government to own and run business for the good of society.

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 economy nations has fallen drastically.

Mixed Economy

This falls midway between a market economy and a command economy. Largely followed in France, India, Italy, and Sweden, mixed economies admit existence of private sector along with government ownership. The economic set-up under this philosophy is split into three parts:

- Sectors in which both production and distribution are entirely managed and controlled by the state to the complete exclusion of private enterprise;
- Sectors in which the state and private enterprise jointly participate in production as well as in distribution, and
- Sectors in which the private enterprise has complete access subject only to the general control and regulation of the state.

Merits and Demerits of Market, Command and Mixed Economies

Market Economy Each economic system has its own strengths and weaknesses. Capitalism, for example, encourages individual initiative, allows market forces to have free play, promotes a competitive spirit, and directs the scarce resources to most profitable uses. The weakness of market economy stems from the fact that it results in gross inequities of income, recurrence of trade cycles because of the free play of market forces, and exploitation of the poor by the rich. Capitalism tends to have a devasting effect on environment. People in capitalist societies earn more and consequently indulge in excessive and wasteful expenditure on consumer durables and luxuries.

Command Economy The great October Revolution of 1917 saw, for the first time, the emergence of a state based on Marxist principles. It was Lenin who set up a Communist state in Russia and from here, the ideology spread to Czechoslovakia, Poland, Hungary, Romania, Yugoslavia, and China. Firmly entrenched in these countries, socialism appeared to have answers for all the ills associated with capitalism. But cracks developed within the edifice built over a period of more than six decades. The structure started crumbling all of a sudden. We recently witnessed country after country going back on socialism and almost embracing capitalism. Several reasons have contributed to the reversal of the socialist economy. These reasons, incidentally, testify to the inherent weakness of socialism.

The major weakness of socialism is the denial of individual freedom. One of the essential requirements of human organism is freedom—to work, to earn, to express, to choose, and to indulge in expenditure of one's choice. This freedom is denied to people. The followers of socialism believed that the ideology would guarantee individual freedom. This expectation was belied as it became clear in the communist countries. Individual freedom did not exist in these countries, contrary to the theoretical claims made about it.

Second, socialism assumes total commitment of people to work and to contribute to the country's welfare. This has not been forthcoming from people in the socialist countries. People worked more or less as they work under capitalism, being driven by the twin forces of the carrot and the stick. In fact, there was more slackness and more pilfering on the part of the workers and probably more corruption on the part of the management than in capitalist societies.

Third, the socialist economies failed to achieve significant economic growth. The rate of growth of these economies has been markedly lower than that of the economies relying on market forces. One of the most striking failures of state or collective ownership has been in agriculture where a superpower like the Soviet Union, possessing one-sixth of the land surface on earth, found itself unable to feed its people even after 70 years of revolution.

Fourth, equality, which was the main plank of socialism, did not succeed in the Communist countries. The basic principle that every organised society is subject to stratification very much applied to Communist societies also. Years back, therefore, the communist motto of *for each according to his ability*, to *each according to his need* was changed in the Soviet Union, without fanfare and almost surreptitiously to *from each according to his work*. The Stakhanovites made a big dent in the Communist theory by being given economic rewards for their work and the differentiation that has been subsequently introduced consists not so much in the money wage but payments in kind and in privilege to those who occupy higher positions in the hierarchy; this, if translated into money, would show a very substantial difference.

Fifth, the rulers themselves did not set fine examples for the followers to emulate. Lenin lived, till the end of his life, in one room in Kremlin whereas Brezhnev lived in the equivalent of many palaces and owned a fleet of the most expensive of the world's cars. The late Caucescu and his wife of Romania lived in style and led a pompous life. Public anger against the couple was so intense that together they died being shot mercilessly by prosecutors. More than 300 bullets were found on the dead bodies of Caucescu and his wife. The number of bullets bear testimony to the public wrath against the leaders who proclaimed equality but did not practise it.

Finally, communism collapsed because of its inherent weakness—lack of flexibility and the absence of resilience. Capitalism survives because of its flexibility. It abandons the market where the survival of people is at stake.

Mixed Economy Mixed economy also has its share of criticisms. It has, for example, not enabled its followers to become either Americans or Russians. Mixed economy has been approximately compared to the amber colour on a signal post which keeps the driver of a vehicle guessing about what the next move should be.

The international manager needs to know the system of economy prevailing in a country where he or she intends to do business. Obviously, countries with market economies are good places to locate business units. Many managers complain about the bureaucracy in China and the degree of influence of the Chinese government in economic decision-making. But things have changed in China and so is true in India. Managers would do well to understand these developments.

CLASSIFICATION OF COUNTRIES BY REGION

LO 3
List classification of countries by region

A final way of classifying countries is by the region to which a nation belongs. The major regions are—(also see maps appended to Chapter 1)

- East Asia and Pacific
- Europe (East and Central Europe) and Central Asia
- Latin America and the Caribbean
- Middle East and North Africa
- South Asia
- Sub-Saharan Africa
- High income countries—which are widely scattered

These designations are important to international businesses, which tend to organise their activities along geographical lines. For example, IBM has its operations in Africa, America, Asia Pacific, Europe, and the Middle East. Siemens discloses its sales by region—Africa, Middle East and CIS, Asia Pacific, the Americas, Europe and Germany. Managers can use the data compiled and disclosed by the World Bank to discover trends in key markets. Investors too can use the data to analyse where potential growth and risks exist in the regions where their firms operate.

ECONOMIC SCENARIO

LO 4
Analyse the economic scenario

Macro economic scenario determines the attractiveness or otherwise of a country as an investment destination. Such a scenario is characterised by the size of economy, income levels and distribution, consumption, population, inflation, external financial status, banking and financial markets and tax system. India's status on the above parameters in growing positive and hence India is receiving attention from MNCs around the world.

Size of the economy Size of an economy is a primary concern for an MNC to venture into a given country. Obviously, the bigger is the size of the economy, the larger is the market and that attracts foreign investment. Size of an economy is generally measured using two criteria: GNI and GDP. Gross National Income (GNI) refers to the sum total of goods and services produced in a country, including the net income derived from external sector. Gross Domestic Product (GDP) indicates the gross amount of goods and services produced within a country. The GDP does not take into account income earned from external sector.

In tandem with the size of the economy is its growth rate. It needs no emphasis to state that high growth rates bring in their wake increased jobs, rising incomes, and vibrant business activities. Quite the opposite happens during periods of low growth rates.

As of now, India stands next to China in terms of growth rates. China registers around 7% where as India has 5.5% growth. All other countries are hovering around 2 to 4%.

Income Levels

Going by the income levels, countries are classified into three categories: First world, second world and third world. All those can be either developed or developing economies (More on these was explained earlier in this chapter).

Income Distribution

Per capita GNI is no doubt a good measure of a country's prosperity but fails to reveal the income distribution within a country. For an MNC, income distribution is more significant than the per capita GNI. Besides, GNI provides no information about the size of the market which is a vital piece of information for an MNC. For example, Qatar has the highest GNI per capita in the world, but its total population is a fraction of that of Delhi. Obviously, Qatar is not a big market for automobiles. On the other hand, low per capita GNI of a country clouds its potential as a market. Hence, does exist the relevance of income distribution. In most developing countries, incomes are more unevenly distributed than those of the rich nations. India, China and Russia top the list of countries having unequal income distribution. Consider India as an example. Though described by many as a poor country, the country is a home for 100 billionaires. Wealth acquired by the top ten is shown in Table 10.5.

It looks as if India's total wealth is accumulated by these elite people, while for the vast majority of people, life is a struggle. Eating twice a day may not be a problem for them, but things like better schooling for children, timely medical attention and the like are still luxuries. Situation in China and Russia is no less striking.

Now the elite people with whom vast wealth is accumulated have high purchasing power thus attract MNCs. This situation is particularly true in countries where the low per capita GNI occurs because of a very large low-income population. Thus, a country may have a large GNI, but its per capita GNI is low because of its large population.

More to the income distribution lessons for MNCs. Income distribution provides important clues to the economy in general and different market segments within it in particular. A more even income distribution would generally be found in rich countries, which would offer large potential

Table 10.5 India's Super Rich

(Wealth in Rs. crore)

	2012	*2013*
Mukesh Ambani	111,464	117,161
Azim Premji	69,322	94,667
Sunil Mittal	82,733	85,662
Dilip Shanghvi	49,814	78,759
Anil Agarwal	54,236	57,221
Shiv Nadan	27,658	51,564
Anil Ambani	34,318	37,245
Kumar Mangalam Birla	26,661	27,642
Uday Kotak	22,161	25,119
Ashwin Choksi Ashwin Dari Abhay Vakil	22,013	25,079

(Source: *Economic Times*, dated March 1, 2014)

for standardised mass-consumption products. The size of the very high-income group in the total population would reveal the country's potential as a market for luxury goods, such as designer clothes and luxury automobiles.

Developing countries would show a very large proportion of low-income groups that usually would not offer an immediate market for most products promoted by MNCs. The size of the wealthy segments, instead, would determine the market size.

MNCs need to keep in mind the presence of middle-income groups within the overall income distribution. In the rich countries, the middle-income groups are usually the largest proportion of the population, which implies the existence of big markets for a wide range mass-produced consumer goods. The middle class is relatively small in developing countries (India is an exception) which limit their potential as a market for a wide variety of consumer products.

Personal Consumption

Personal consumption patterns – how people spend their income and what items they buy – are significant determinants of a country's potential as a market for MNCs. While income distribution data provide information on how and when income accrue, statistics on personal consumption indicate how this income is spent on goods and services. A country in which people spend major portion of their income on food and shelter offers little scope for luxury products. The same country is an attractive market for inexpensive goods that meet the basic necessities of life. Many MNCs develop their marketing strategies based on the consumption patterns prevailing in each country.

Population

"India is the cradle of the human races, the birthplace of human speech, the mother of history, the grandmother of legend and the great grandmother of tradition. Our most valuable and most instructive materials in the history of the man are treasured up in India only" said Mark Twain. India, not only for him but also, for several foreign investors and MNCs is a destination. Who is who of any MNC has its presence in India; foreigners have invested in over a thousand Indian companies via the stock markets;

750 MNCs have R&D centres in India; and 390 of the Fortune 500 companies outsourced software development or business process to India. This is all because of the country's vast population of 1.2 bn as of today, standing next to China.

Population of a country has several dimensions. First is the growth rate. Growth rate is the result of both birth and death rates. According to the Census 2001, the growth rate was 1.97% and it came down to 1.64% as per the Census 2011. Moderate growth rates have resulted in demographic dividend for the country. This implies that by 2025 India will be the supplier of human resource to the rest of the world. This is so because growth rates in other countries are declining or are stagnant causing shortage of teachers, professionals, nurses, and doctors.

Second dimension is the density of population. This is calculated as a ratio of the number of persons per sq.km of land area. According to the 2011 Census, density in the country is 382 earning the country the distinction of being one of the densely populated countries in the world. A high density has both positives and negatives. Negatively speaking first, high density means overcrowding, over population, and pressure on the resource base of a country. On the positive side, high density means reduced transportation costs, better reach, and an easily accessible pool of labour.

Third, age structure of the population is yet another dimension. In developed countries, the proportion of elderly citizen tends to be higher than youth. Trend is likely to be opposite in developing countries. Relatively young populations imply possibilities for higher growth over the next few years, particularly in countries where birth control is not in place. Such countries may have more number of people depending on the income-earning members. Dependency burdens have important economic implications, in as much as they affect the amount of discretionary income people may or may not have after meeting expenses on the maintenance of dependents and themselves. Most countries with high dependency burdens have low levels of discretionary incomes, which limit their attractiveness for MNCs.

Fourth and final population dimension relates to the educational level of the population. Literacy levels have implications on consumption patterns and standards of living. A country with a high level of literacy is likely to attract MNCs products because individuals tend to have broad outlook over them and are likely to have open minds towards new products. For products like books, software, laptops, smart phones and the like, literacy levels are crucial. Literacy levels also indicate the potential of finding local skilled labour and local managers for an MNC's subsidiary.

India should have, by now, achieved 100 percent literacy but efforts towards that are underway. For example, from 64.83% in 2001, literacy level shot up to 74.04% in 2011.

Inflation

Inflation is understood as a situation characterised by a sustained increase in the general price level. Inflation can be moderate or galloping. It is moderate when price rises slowly at a single-digit percentage (5 to 7 percent) and is galloping when prices touch sky with rates varying from 200 to 300 percent. A fall in the price level leads to deflation which is generally unwelcome.

Economists believe that inflation is an essential condition for growth. They contend that growth without inflation is a dream. For a developing economy, inflation serves two important purposes—increased savings and encouragement to invest.

Inflation tends to shift real income away from people who save little to those individuals who have the habit of saving more from their income. Inflation thereby encourages savings. Similarly, inflation can be used as a means to encourage investment. Zero rate of inflation deters investors from taking up new investment opportunities. A moderate rate of inflation attracts investments as profit margins tend to be attractive. Inflation carries negative effects too. For one thing, it may lead to increased consumption, thus checking savings. Inflation may also adversely affect the balance of payments position both on current and capital accounts.

Economists trot out a number of reasons for inflation. 'Demand-pull' and 'cost-push' arguments are two of the most commonly advanced causes. The demand-pull argument holds that excess demand in the economy, which may be the result of cheap borrowings or tax cuts, encourages producers to raise price, which lead to a rise in wage demands as workers strive to maintain their standard of living. The cost push argument holds that excessive costs drive prices up. As significant element of costs is accounted for by wages, this argument becomes linked with the demand-pull argument. Rising wage costs tend to be passed on to consumers in the form of higher prices, thus creating what is popularly known as the 'wage-price inflationary spiral'.

In many developing countries, inflation is measured by the wholesale price index (WPI) and consumer price indices (CPI). In India, WPI is preferred for the reason that its coverage is far wider and more uniform than that of the four available CPIs. Of the four available CPIs, the index for industrial workers is most commonly used. Of late, there is a talk about 'core inflation' which can be more conveniently measured with the help of the WPI for manufactures.

An MNC needs to observe inflationary trends in host countries. High inflation will result in severe economic consequences. Generally, income levels do not keep pace with inflation, which reduces the purchasing power of consumers and erodes their potential as a market segment, especially for products that have relatively high income elasticity, such as non-essential goods and services. High inflation also pushes up local manufacturing costs because of high input costs. Further, high inflation in a host country pushes up the prices of products manufactured there. This will erode the competitive edge of the MNC, particularly when it seeks to export the products to overseas markets. Moreover, local inflation would devalue the local currency against the MNCs' home currency. As a result, value of the profits repatriated to the MNCs' home country would go down as per home country terms. High inflation in overseas locations also could prompt restrictive measures by the governments, which could hamper economic viabilities of MNCs in such host countries.

External Financial Status

External financial position of a country deserves serious consideration by any MNC. Any country's status on external sector depends on its balance of payments, popularly called by its acrimony BOP. BOP is the summary of all external transactions of the country in a given year. BOP can be favourable or unfavourable.

A favourable BOP means several positives. First, it indicates that the country is in a strong position to meet its external obligations. Second, it is likely to be lenient towards imports, as it is able to pay for imports through forex reserves built up. Third, the country is positive towards FDI because it is able to generate the necessary forex reserves to permit conversion of local currencies into foreign currencies for repatriation of MNCs' profits. No surprise, any MNC bats for such a country as an investment destination.

Unfavourable BOP will result in high import controls (conserve forex reserves) and restrictions on repatriation of profits. Such a country obviously deters FDI inflow.

Banking and Financial Markets

More than any other facility, an MNC needs adequate and timely finance in a host country. The banking sector of the host country must be well developed and be able to provide the needed working capital and term leaves to the MNC in order to meet its operational requirements. Moreover, the financial market structure must provide opportunities for raising funds to meet the cost of operations. The MNC must also evaluate the costs of funds in local markets and assess whether it would be cheaper to raise funds locally or to bring them from abroad. The host country may, however, have regulations that prohibit, restrict, or require the sourcing of funds from abroad or the local market.

Tax System

Any government has the right to tax income earned by an MNC in the host country. This right is unquestionable, but negotiable. The host country's tax system and tax rates either deter an MNC or invite it to invest money. For an MNC, host country's tax policies have wider implications as stated below:

- Location of operations
- Choice of entry form – exporting, licensing, management contract or greenfield investment
- Legal form of the new venture, such as subsidiary or branch
- Possible facilities in tax-haven countries to raise capital and manage cash
- Method of financing, such as internal or external sourcing and debt or equity
- Capital budgeting decisions
- Method of setting transfer prices.

FINANCIAL SYSTEM

LO 5
Assess the financial system

The financial system comprises two segments; money market and capital market.

Money market is the market in which short-term funds are borrowed and lent mainly through monetary assets. It does not deal with cash or money but transacts in financial assets like trade bills, promissory notes and treasury bills with short maturity periods. These financial assets are also called 'near money'.

Money market is of great help to an economy as it helps enhance liquidity, stabilises interest rates and helps financial and commercial institutions and commercial banks earn attractive interest.

While money market deals with short-term funds, its counterpart 'capital market' deals with long-term funds. *Capital markets*, also called stock exchanges, constitute a vital element of an economy. Corporate sector raises its long-term funds through capital markets. Well developed stock exchanges obviously add to attractiveness of a country for FDI inflow.

Indian capital markets have grown in maturity and they are in no way less efficient than their counterparts in developed countries. Over time a few positive developments have taken place adding to the vibrancy of capital markets in India. *First*, two new institutions OTCEI and NSE have come into being in addition to the already functioning BSE. *Second*, foreign institutional investors (FIIs) emerged as significant players adding to the agility of stock markets. *Third,* along with the new institutions, certain new instruments have also been added in the recent past. The new instruments include commodities, currency, derivatives, futures and options. *Fourth,* buy-back of shares by corporate has been permitted. *Fifth,* disclosure of end use of funds raised through public issues is mandated. *Sixth,* demutualisation of stock exchanges has been permitted. This enables the capital markets to convert themselves into corporate entities from members-owned ones. In short, the Indian capital market has witnessed metamorphic changes in the recent past and is poised well to meet the needs of the liberalised economic environment (for a contrast see Exhibit 10.2).

Exhibit 10.2

MARKET MIDGETS (2011)

Stock-exchange indicators

Country	Companies listed	Market cap. # bn
Cambodia	nil	nil
Mozambique	2	0.4
Laos	2	0.7
Cameroon	3	0.2
Maldives	4	0.1
Cape Verde	4	0.3
Swaziland	5	0.3
Namibia	6	7.6
Libya	12	3.1
Armenia	13	0.1
Tanzania	16	3.7
Syria	20	2.0
Zambia	20	5.5

Sources: African Securities Exchanges Association; Federation of Euro-Asian Stock Exchanges; World Federation of Exchanges; stock exchanges

ECONOMIC POLICIES

LO 6
Outline the economic policies

Economic policies of a country determine its position in the international arena. Broadly, the policies include industrial policy, trade policy, monetary policy and fiscal policy. These policies prevail in all the countries. Our focus here, however, is on India.

Industrial Policy

The term 'industrial policy' refers to the government's policy towards industries with regard to their establishment, functioning, growth and management. The policy will indicate the respective areas of the large, medium and small-scale sectors. It will also spell out government's policy towards foreign capital, labour, tariff, and other related aspects. Naturally, the industrial development of a country will be shaped, guided, fostered, regulated and controlled by its industrial policy.

Industrial policy is probably the most important document which indicates the relationship between government and business. The document is helpful to planners and administrators in the government, in as much as it give clear guidelines for promoting and regulating industries. It is equally helpful to captains of industries and others for deciding areas and priorities of their investments. Needless it is to state that an international manager should be knowledgeable about a country's industrial policy.

The industrial policy has no legal sanction and as such its violation cannot be challenged in a court as is possible in the case of Fundamental Rights guaranteed by the Constitution. However, it has certain broad guidelines for the government's administrative action and deals with only the qualitative aspects thereof. There are no physical targets to be fulfilled, no time-span, no financial commitment as in the case of an industrial plan. There is only a moral commitment on the part of the government to implement the policy in word and spirit.

Yet, industrial policy has strong justification for its existence. For example, it can:

- *Correct* the imbalances in the development of industries and help bring about a desirable balance and diversification in them.
- *Direct* the flow of scarce resources in the most desirable areas of investment in accordance with national priorities.
- *Prevent* the wasteful use of scarce resources and ensure their conservation and judicious utilisation.
- *Empower* the government to regulate the establishment and expansion of private industry in accordance with the planned objectives.
- *Demarcate* areas among the public, private and joint sectors of the economy, as well as large, medium and small-scale industries.
- *Prevent*, through fiscal and monetary policies, the formation of monopolies and concentration of wealth in a few hands so that the evils associated with monopolies can be effectively curbed.
- *Give guidelines* for importing foreign capital and the conditions on which such capital should be permitted to operate.

Monetary Policy

Monetary policy refers to the measures taken by a central bank (RBI in India) to ensure price stability in the economy. The measures generally used are: money supply, interest rates and inflation. Besides, the policy provides a platform for the apex bank to announce norms for governing financial bodies such as banks, financial institutions, NBFCs, primary dealers in the money market and authorised dealers in the foreign exchange market. The RBI announces new monetary policy every year.

The Central bank has been minting coins, managing the exchange rate, acting as the banker for the government and supervising banks and the bond market.

The RBI's monetary policy has been characterised as controlled expansion, i.e., adequate financing of economic growth and at the same time ensuring price stability. In other words, extra money is pumped in to sustain economic growth. Money circulation is controlled when there is a tendency for prices to rise.

RBI's monetary policy has been criticised from several angles. It is alleged that the policy neither succeeded in controlling inflation, nor in fuelling economic growth. Critics also allege that the RBI has been an appendage to the government. The government has used the RBI to bail out whenever the former lived beyond its means.

RBI became its own after 1991. It rediscovered itself and performed functions as it should. As of today RBI is among the world's best central banks. Its record on balancing growth and inflation is encouraging. Since 1995 wholesale prices have risen by an average of 6% a year, and growth has averaged 7%. As the protector of the safety of financial system, its record has been significant. Despite a current account deficit that leaves India vulnerable to global jitters, the country steered itself away from the 1997 Asian crisis, and the West's banking crisis in 2008. The RBI also managed the potentially destabilising capital inflows before the Wall Street crash, and has avoided a domestic financial crisis despite fast growth in banks' assets for many years.

Destination for any central bank is managing financial stability and interest rates. RBI has reached this stage and is sitting pretty. Being the only institution in the country free of graft, RBI enjoys enormous clout overseas and at home it stock is very high.

Fiscal Policy

Fiscal policy refers to the policy of the government regarding taxation, public expenditure and public debt. There is a general belief, from Keynes in the thirties, that the governments can influence businesses through fiscal measures. Inspired by this belief, governments all over the world have been using fiscal measures to regulate and promote their economic and business activities in order to achieve such objectives as: (i) acceleration of rate of investment; (ii) promoting socially desirable investment; (iii) achieving full employment; (iv) achieving rapid economic growth; (v) promoting foreign trade; (vi) reducing inequality of income, and (vii) establishing a welfare state.

The fiscal policy operates through budget. The Constitution of India provides that: (1) no tax can be levied or collected except by authority of law; (ii) no expenditure can be incurred from public funds except in the manner provided in the Constitution, and (iii) the executive authorities must spend public money only in the manner sanctioned by the Parliament in the case of the union and by the state legislature in a state.

In deference to the provisions of the Constitution, the government has been preparing annual budgets, placing them before Parliament, obtaining its approval and spending and raising revenues as stipulated in the yearly budgets.

The budget will be a balanced one if revenues match with expenses. A balanced budget is a dream. What governments everywhere have are the deficit budgets.

Trade Policies

Trade policy refers to all the procedures and practices that have a bearing on the trade movement of a country. At the international level, trade policy of a country may be inward-looking or outward-looking (read also chapter 3). An inward-looking approach advocates that a country should not trade with other nations, whereas an outward-looking strategy calls for easy movement of goods and services among nations. Trade, in this context, needs to be viewed from a broader perspective, involving not only movement of goods and services but of capital, labour, enterprises and students as well.

There are proponents for both the approaches. Advocates of an outward orientation argue that free trade encourages learning by trade and implies achievements of dynamic transformation of the economy to higher standards of living. Free trade is a win-win situation as all the trading partners stand to gain through productivity improvements, notwithstanding diversities in their domestic institutions and policies. The other name for an outward-looking approach is export promotion strategy.

By contrast, an inward-looking policy stresses restrictions on trade, people and communications. The rationale behind this policy is that countries (developing) should evolve their own style of development and control their own destiny. This means policies should encourage indigenous ‘learning by doing’ in manufacturing and develop indigenous technology appropriate to the country’s resource endowment. An inward-looking strategy is alternately called import-substitution approach to international trade.

In practice, the distinction between inward-looking and outward-looking approaches gets blurred. Most of the less developed countries have employed both strategies with different degrees of emphasis at one time or another. For example, in the 1950s and 1960s, the inward-looking industrialisation strategies of the larger Latin Americans and Asian countries such as Chile, Peru, Argentina, India, Pakistan and the Philippines were heavily import substitution-oriented. By the end of the 1960s, some of the key sub-Saharan African countries like Nigeria, Ethiopia, Ghana and Zambia began to pursue import substitution strategies and some smaller Latin American Asian countries also followed suit. However, since the mid 1970s, the export promotion strategy has been increasingly adopted by a growing number of countries. The early followers of export promotion strategy-South Korea, Taiwan, Singapore and Hong Kong-were joined by Brazil, Chile, Thailand and Turkey which switched for import substitution approach.

STRUCTURAL ADJUSTMENTS

LO 7
Examine the structural adjustments required

Since July 1991, the Government of India has initiated a series of radical changes in its policies relating to industry, trade, finance, foreign investments and fiscal aspects. The various changes, also called structural adjustments, when put together constitute an economic policy which marks a total departure from the policy pursued earlier.

Background to the New Policy

The new economic policy was necessitated by the worst economic crisis witnessed by the country after Independence.

The most visible sign of the crisis was its extremely low foreign exchange reserves of Rs 2400 crore, witnessed in 1991. The reserves were just enough to buy from abroad only three weeks requirements. The situation became even more precarious when international agencies lowered the county's credit rating.

The second major aspect of the economic crisis was the rapidly increasing burden of national debt which exceeded 60 percent of GNP in 1991. The fiscal deficit of the previous five years forced the government to borrow increasingly to meet shortfall in the revenue account. Borrowing added to the already prevailing debt burden.

The third and the most damaging feature of the 1991 crisis was the high price level. During 1985-1990, the GDP grew at an average rate 5.7 percent but money supply increased at 15.7 percent per annum. This excess liquidity led to high price rise which touched 17 percent.

Together called the structural adjustment programme (SAP), the new policy envisages the measures as shown in Table 10.6.

Thanks to the new economic policy, the economy has become vibrant. Captains of industry are buoyant and not deterred by the entry of MNCs. There is an overall increase in productivity, quality and competitiveness of goods and services. For an economy which was under the grip of controls for nearly four decades, the new economic policy has not been a big jolt. It has absorbed the shocks of the structural adjustments with remarkable resilience and is looking ahead for more reforms. This has been realised by all political parties and hence the talk about the irreversibility of economic reforms.

There are problems nevertheless:

1. The pace of economic reforms, though fast during the first three years, slowed down from 1994 onwards.
2. Though economic reforms are announced by the Central Government, their implementation is in the hands of state governments resulting in conflicts.
3. The Central Government's fiscal deficit continues to be high and this is reflected in continuing inflationary pressure.
4. The reforms have hit the labour hard. Emboldened by the new economic policy, both public and private sector enterprises have resorted to voluntary retirement schemes to get rid off surplus labour. (See also opening case)

Table 10.6 Model of Economic Management in India

Old	*New*
Pre-reform strategies	Economic reform strategies
Closed economy	Open economy
Self reliance	Integrate with world markets
State-led economic growth	Market determined economic growth
Import substitution strategies	Export oriented strategies
License dominated regime	Delicensing, deregulation, debureaucratisation
Frequent state interventions	Selective and effective state interventions
Political administered prices	Market determined prices at large.
Not much concern for deficits	Contain all kinds of deficits
Development by inflationary process	Deflationary monetary and fiscal policies
PSUs as engines of growth	Private investment as growth engine
Dominance of PSUs	Withdrawal from the area of private interest
Philosophy of natural monopoly	Minimise gap between public and private sector.
Restriction of FDI and MNCs	Inducement to FDI and MNCs
Restriction on currency movement	Liberalisation of restrictions
State controlled interest rates	Deregulation of interest rates
State controlled credit	Credit policy reforms
Underdeveloped capital market	Reforms in capital market
Huge public sector budgetary resource (PSBR) liability on the government	Minimise PSBR
High tax rates	Tax reforms

Structural adjustments, though largely successful in India, have not been so elsewhere. Infact, structural adjustments, also called economic prescriptions, were advocated by the IMF for any country that went to the world body for financial help. India did approach the IMF for assistance for the reasons stated above. But in several countries such as Bolivia and several Latin American countries, the measures were not highly successful. The blame for their ineffectiveness was thrown on the IMF itself. The one-size-fits-all approach followed by the IMF was held responsible for failure. Economic prescriptions should be country-specific. Instead, IMF advocated similar measures for all assistance seeking countries.

ECONOMIES IN TRANSITION

LO 8
Identify the need for greater awareness of multi-cultures

During the past two decades, many countries with command economy orientation have been remaking themselves to emerge as market friendly economies. This process, called economic transition, involves changing a country's fundamental economic organisation and creating entirely new market institutions. Some countries tend to take transition further than others, but the process typically involves five reform measures:

1. Macroeconomic stabilisation to reduce budget deficits and expand credit availability.
2. Liberalisation of economic activity that is decided by prices reflecting supply and demand.
3. Legalisation of private enterprises and privatisation of state-owned enterprises in accordance with an effective system of individual property rights.

4. Removal of trade and investment barriers in goods and services, and removal of controls on convertibility of the nation's currency.
5. Development of a social-welfare system designed to ease the transition process.

The transition process has not been without its difficulties. The move from a command economy and political system to a market economy with the development of democratic political institutions is a slow and painful process. But, most of these countries exhibited a remarkable speedy reform process. During the initial stages, the progress was phenomenal. By 1992, the Communist empire had ceased to exist, with democratic governments replacing the communist parties. East Germany had been reunited with West Germany, and Hungary, Czechoslovakia and Poland had all been accepted as associate members of the EU. The Soviet Union had disappeared with its former republics declaring their independence, but realigned in the Commonwealth of Independent States (CIS).

As part of economic reforms, extensive programmes of privatisation were introduced with devastating consequences, particularly in wide-spread unemployment. Far from achieving rising living standards, most citizens in Eastern Europe saw their living standards plummet, and the rising popular discontent with the reforms meant that the communist parties in many countries gained support in the 1993 elections.

We focus on some of the countries in transition in this section.

India

From 1950 to 1991, India (*see Map 10.2*) had a mixed economy. There are arguments for the achievements made during this long period and there are counter arguments challenging these claims. While it is out of context to go into all the details, suffice it is to say that the economy has accepted open market operations. The opening case to this chapter throws enough light on the present status of India's economy.

Map not to scale

Map 10.2 India

China

China is a country which is attracting the attention of all nations, and the attention is justified. There is possibly no other country on earth that has done more for its people economically in the last 20 years than China. (see Map 10.3)

Map 10.3 China

Map not to scale

China has one-quarter of the world's population and one of the world's largest economies despite its Communist-dominated government and centrally planned economy. As a Communist player in world markets, China represents a special area of interest to those studying international business. In the modern period, it was not until the 1970s that China began to open its doors to outside trade and investment. Since that time, China has made many changes in its economic and legal systems to facilitate doing business with the West. It has opened up opportunities for collectively- and privately-owned enterprises and made it easier to set up joint ventures with foreign firms. China has increased imports of technology (the country ranks 29th in terms of technology transfers), modernised its banking system and other service industries, encouraged Chinese companies to adopt modern management techniques and international accounting standards, and hastened the development of quality control programs in manufacturing.

China is one of the most attractive markets for foreign direct investment (FDI) by MNCs from around the world. Major investors have come from Taiwan, Japan, and the US. In fact, over one-third of all investments flowing into developing countries worldwide has gone to China. In 2000 alone, over 12,000 foreign companies set up wholly owned subsidiaries in China for a total of US $53.6 billion in FDI. China has also undertaken legal reforms needed to attract foreign firms.

Speeding of democratic reforms is very much in place. The country's Parliament recently agreed on landmark changes to the Constitution. The Chinese are now permitted to own property for the first time since the 1949 revolution. Besides, human rights are enshrined in the Constitution. The country also announced its plans to lift restrictions on foreign investment in retailing, including those on foreign ownership and number of branches. The move would help China fulfil its commitments of opening its markets as per the WTO regulations.

Though Chinese economy is moving in the right direction, political and social problems pose serious threat to the future of the country. At the social front, the gap between the urban rich and rural poor is huge. Three decades of 'get rich quick' advice from party council has left the country divided between a richer coast and an impoverished interior, between upwardly mobile city dwellers and stagnating rural communities. These days, the income disparity between China's richest few (the country has the second largest number of Forbes billionaires) and poorest many (peasants, migrant workers, pensioners) would make many a modern capitalist turn blue.

China's fast economic growth is clouding a multitude of problems, ranging from rampant corruption and devastating pollution to a frail banking system, and the lack of independent courts to uphold the rule of law.

A country which ruled the root for three decades is suddenly facing problems from all sides. Growth rate is flagging and costs are rising and these seem to have triggered other problems. China's government has made life difficult for MNCs. It has denied access to banks and blocked interned firms. Hardware firms such as Cisco, IBM and Qualcomm are expecting trouble; GlaxoSmithKline is ensued in a corruption problem; Apple was forced to apologise for offering inadequate warranties and Starbucks has been accused of price-gouging. A sweeping consumer protection law which has come into force recently will pose further challenges to the MNCs. Government's efforts to stop extravagant spending by officials is likely to hit foreign suppliers of luxuries.

Some foreign companies are leaving. Revlon, Best Buy, and Media Market and Yahoo are the exits till now and some more are likely to follow.

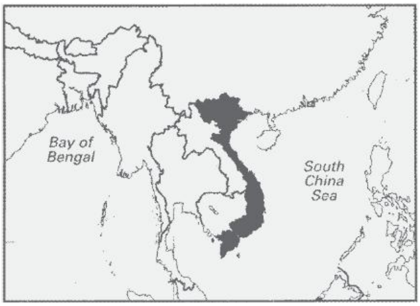
Another problem confronting the Chinese leaders relates to lack of internal democracy. No one speaks against leaders. None has the courage to question and debate. None of the 1.3 billion ordinary Chinese gets a vote in the party's secretive conclaves. The country's rulers seem to be caring too much for their welfare and too little for the many poorest.

Most recently, a law was passed to enshrine private party rights. But, like much else in China, such property rights will benefit mostly city-dwellers; a growing urban middle class will now be able to buy and sell their homes or businesses. In the country side, where peasants are able to only lease their land and not own it, the new law will not benefit them in anyway.

Thus, unrest continues in China. But not on the scale and magnitude of the Tiananamen Square incident in 1989.

Vietnam

Located in Southern Asia and bordering China, the Gulf of Tonkin, the South China Sea, the Gulf of Thailand, Cambodia, and Laos, Vietnam (*see Map 10.4*) is a country with a population of 80 million, spread over an area of 331,041 sq. km. From being a Communist country for a long time, Vietnam almost became a free economy when the Communist Party's top decision makers decided in 2002 to pursue policies necessary to boost the role of private sector and permit its members to engage in private business for the first time. Like China, Vietnam is one of the new investment darlings in Asia, and several MNCs are rushing to penetrate this potential market. The country has vast natural resources such as gas, gold, and timber.



Map not to scale

Map 10.4 Vietnam

Crime, corruption, bureaucracy, poor infrastructure, and an archaic legal system are impeding the flow of investment into Vietnam. Of the $23 billion pledged by Western investors, only one-third has actually been spent. Vietnam's human rights and religious practices have also attracted all-round criticism. But the newly emerging entrepreneurs are a big hope for an economy which has a per capita income of just $93.

Russia

Russia's marriage with Communism dates back to 1917. For the next 75 years, factories, distribution, and all other economic activities, as well as the price of labour, capital, and products were controlled by

Map 10.5 Russia Map not to scale

the government. While China was experimenting with private farm ownership and a limited market-price system, the Soviet Union (*see Map 10.5*) remained staunchly Communist under a system of complete government ownership. This total absence of market institutions has badly impaired transition in Russia today. Unlike China, Russia is enduring massive political and economic reforms at the same time.

Russia as an entity came into being following the dissolution of the USSR in 1991 and, as of today, it is the leading member of the Commonwealth of Independent States (CIS).

The transition from government ownership and central planning has been challenging for ordinary Russians. Except for criminals and wealthy business people, citizens are having difficulty maintaining their standard of living and affording many basic items such as food and clothing. In fact, in the winter of 1998–99, the Russian government requested food from Western Europe and the US to help its people avoid starvation. These hard times are causing increased alcohol abuse and depression among Russians.

Despite difficult times, some MNCs are doing business in Russia and others have plans to do so. Table 10.7 provides a list of major US firms conducting business in Russia.

As in Vietnam, entrepreneurs are doing pretty well for themselves in Russia. Rising oil prices helped eight new Russian entrepreneurs enter the select list of the world's extremely rich people. The Forbes magazine list of world billionaires also states that Moscow is the third city to house the world's rich people, first and second being US and China respectively.

Poland

Poland (see Map 10.6) is located in Central Europe and has the Baltic Sea, Russia, Lithuania, Belarus, Ukraine, Slovakia, the Czech Republic, and Germany as neighbours. Stretching over a land area of

Table 10.7 Major US Firms doing Business in Russia

Abbott Laboratories	Control Data	IBM	Polaroid
American Express	Cooper Industries	Johnson & Johnson	Procter & Gamble
Anderson (Arthur)	Corning*	Lilly (Eli)	Radisson Hotels*
Archer-Daniels-Midland	CSX*	Litton Industries	Ralston Purina
AT&T	Dow Chemical	McDermott	RJR Nabisco
BankAmerica Corp.	Dresser Industries	McDonald's*	Holdings
BP Amoco*	DuPont	Minnesota Mining &	Strauss (Levi)*
Cargill	Emerson Electric	Manufacturing	Texaco*
Caterpillar	Ernst & Young	Mobil*	Union Carbide
Chase Manhattan	Exxon*	Monsanto	United Telecomm.*
Corp.	FMC	Occidental Petroleum	Upjohn & Pharmacia
Chevron*	General Motors	Pepsi Co	US West*
Coca-Cola	Hewlett-Packard	Pfizer	Xerox
Conoco*	Honeywell	Philip Morris	Young & Rubicam

*Established business in Russia after 1986

(*Source*: Alan M. Rugman and Richard M. Hodgetts, *International Business*, p. 562)

312,685 sq. km, Poland has a population of 38 million. The country was ruled by Stalinist Communists for a decade after World War II, but by the late 1950s, a more independent Polish Community Party began to emerge—collectivisation of farms was ended and religious freedom was permitted. But the rigorous economic reforms in the early 1990s put Poland on the right track. Market-oriented reforms included removing price controls, restraining pay hikes, slashing subsidies and balancing the budget. The country joined EU in 2004 and this gave a further boost to the economy. Since 2004, the economic growth averaged 4% a year, and GDP per capita is now 67% of the EU average. The country has redirected much of its trade from its communist neighbours to the EU, started to modernise its transport infrastructure and restructured some of its ailing state-owned industrial units.

Map 10.6 Poland

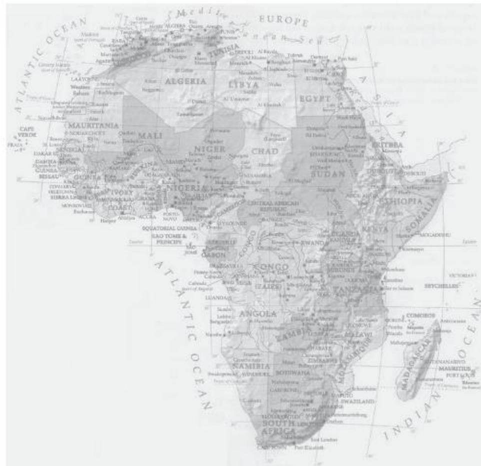
Poland was the only country in Europe to avoid a recession during the financial crisis, thanks mainly to a mixture of deft fiscal and monetary policies, flexible exchange rate for its currency, and exposure to international trade and a low household and corporate debt.

The solid economic performance has given Poland extra weight in the EU, both economically and politically. It is now seen as one of the six big member countries, alongside Germany, Britain, France, Italy and Spain. German-Polish ties have become the second most important bilateral relationship in the EU, after the Franco-German axis.

Yet, Poland has its own problems. Instability in the East is one of them. Economic reforms are unfinished, with more reforms needed in agriculture and income disparities are widespread. The most urgent task is to slim down Poland's gloated public sector. Successful private companies are being held back by the public sector. Bureaucracy and corruption are widespread, exiting some of the best and brightest Poles. Demography is another problem. Poland has one of the lowest fertility rates in the EU and remains an emigration country. Poland has huge surplus of coal piled up but the country is importing it from Russia, resulting in revenue deficit. Main reason for this paradox is that the coal in Poland is of high quality but costlier. Hence, cheap coal is imported from Russia.

Africa

Most African countries (*see Map 10.7*) were under the control of European colonial powers. They, however, gained independence between the late 1940s and the mid 1960s. Soon these countries adopted communist economic policies. During the Cold War, the former USSR and the US struggled against one another for political influence across much of the dark continent. The situation was extreme and blatant in Angola, where each nation provided weapons and other supplies to different sides in a civil war.



Map 10.7 Africa

Many African countries believe in exercising control over their economy. The most prominent countries are Tanzania and Zambia which influenced other African nations in adopting socialist principles. It is no surprise that most African countries are witnessing low GNP, unemployment, high inflation, low quality of life, and overall economic stagnation.

In the last ten years, many African nations have initiated a transition towards free-market economies and governments are loosening their control. Uganda, for instance, has introduced several measures to privatise its agricultural sector which was under state control for a long time. Nearly 30 countries are switching towards market economies. Malawi, Mozambique, and South Africa have already held democratic elections and Mali, Tanzania, and Zambia are experiencing peaceful democracies.

But in countries such as Algeria, Nigeria and Sierra Leone, political and economic instability continues. In some of these countries corrupt political leaders have amassed huge wealth at the cost of poor citizens.

Chiluba, the former President of Zambia, for example, was arrested in February 2003 and charged with corruption and looting the state treasury. In May 2002, a national disaster was declared in the country and appeal was made for international aid when food shortages threatened more than 2.5 million Zambians with starvation.

Africa's population was reaching one billion in 2009, up from 110 million in 1850. By 2050, the population is projected to double to 1-9 billion creating a human tide that would put an unbearable burden on food, jobs, schools, housing and health care. Africa's population has doubled in the past 27 years, with Nigeria's and Uganda's numbers climbing the fastest. Whereas in 1950, there were two Europeans for every African, by 2050, there will be two Africans for every European. Even China's projected population of 1.4 billion in 40 years will be shrinking, while India will be adding only 2 million a year to its 1.2 billion people.

A significant shift from the country side towards urbanisation is taking place in Africa, leading to expansion of cities such as Lagos and Cairo. But with urbanisation comes urban poverty in slums such as those of Kiberia in Kenya and Cape Flats in South Africa. The continent has the most lethal roads in the world. It is predicted that by 2020, more people would die in traffic accidents than from HIV/AIDS, TB and malaria combined.

Heart attacks, strokes, cancers, diabetes, asthma and other chronic diseases caused by smoking tobacco are expected to account for 46 percent of deaths by 2030, up from 24 percent in 2004.

Africa has 53 mini states, with poor communication, bad roads and bad markets. But there are signs of promise. Africans are buying mobile phones at a world record rate, with take-up soaring by 550 percent in five years. The Internet has empowered civil society to hold governments accountable. Renewable energy technologies, including wind and solar power, rain water tanks and bio-fuel cookers, promise to transform lives in rural areas.

Unless and until market based economic reforms and democratically elected governments are put in place, Africa remains a gamble for many MNCs.

But for India, Africa has potential to become what vast tracts of South East Asia have become to China. India’s trade with Africa has increased from $893 million in 1991–92 to $4.75 billion plus during 2003–04, an increase of 14 per cent.

Given the oil-rich states of the continent, it is natural for the ONGC to have a presence there. But many other companies, too, have set up operations in African continent. Software services firms Infosys and I-Flex have interests in Africa. Similarly, Dr Reddy’s Labs, Cipla, Ashok Leyland, Tata Motors, BSNL, L&T, and a host of others have presence in the dark continent.

Three reasons account for the mutually beneficial relationship existing between India and Africa.

The first is historical. Parts of Africa are inhabited by Indians, a legacy of the days, when the British shipped Indian labourers to work in the plantations there. Along with Indians, Indian companies are also accepted in Africa.

Second, the Government of India is keen on boosting Africa as a big export destination for Indian goods and services.

Third, throughout the continent, Indian products are recognised for their quality and low cost.

No more a gamble

Africa is no more a gamble for MNCs. It is rising from dark. Over the past decade, six of the world's fastest growing countries were in Africa. In eight of the past ten years, Africa has grown faster than East Asia, including Japan.

From Ghana in the west to Mozambique in the South, Africa's economies are consistently growing faster than those of almost any other region of the world. Ethiopia is growing by 7.5%, without a drop of oil to export. Once a byword for famine, it is now the world's tenth-largest producer of livestock.

Labour productivity has been rising by 2.7% per year. Trade between Africa and the rest of the world has increased by 200% since 2000. Inflation has dropped from 22% in the 1990s to 8% in the past decade. Foreign debt declined by a quarter, and budget deficits by two-thirds.

Several positives have contributed to the prosperity of the "lion economies". Commodities boom is one such favourable factor. In 2000-08, around a quarter of Africa's growth came from natural resources. Favourable demography is another cause, with the fertility rates falling in Asia and Latin America, half of the increase in population over the next 40 years will be in Africa. The continent has a fast growing middle class and the rate of foreign investment has jumped around ten-fold in the past decade. China has improved Africa's infrastructure and the countries's enthusiasm for technology is adding to the rising prosperity. It has more than 600 mn mobile phone users more than America or Europe.

Political stability is yet another contributing factor for Africa's new found prosperity. The Africa of a generation ago was a sad place. Apartheid isolated its largest economy, South Africa. Only seven out of more than 50 countries held frequent elections. Dictators have now fallen, civil wars ended, elections are being held and stability is gradually creeping in.

MNCs can now eye Africa for investment.

Latin America

Latin America (*see Map 10.8*) is a rapidly growing region and a virtual destination for FDI. The region comprises several nations, prominent among them being Chile, Argentina, Brazil, and Peru. For much of the 1970s, Argentina, Brazil, Chile, and Peru had economies under repressive government control, and all the four countries suffered from rapid inflation, rising unemployment, and low quality of life. Chile was the first to loosen government control and implement sweeping economic reforms, and other countries slowly followed suit. Most of Latin America is now characterised by growing market economies.

Map 10.8 Latin America

Latin American countries rely heavily on the US as their major export market. At the same time, the size and scale of cooperation within Latin American trading groups is increasing.

The biggest challenge facing MNCs entering Latin countries is political and economic instability. Economic reform in Mexico, for example, was jeopardised when the Mexican peso tumbled steeply in 1994. In the long run, however, the outlook for Mexico and of the entire region is promising. Financial aid and other assistance from developed countries has helped to revive the Mexican economy and kept the nation, and indeed the entire region, on the track of economic reform. Continued economic and political reforms are boosting Latin America's appeal to MNCs.

Economic reforms initiated by formerly controlled economies are having a profound effect on international business. Free markets are spurring major shifts in manufacturing activity. Lured by incentives such as low wages and growing markets, MNCs are forging ties in newly industrialised countries and exploring opportunities in developing nations. World capital markets are making it easier for these companies to set up factories abroad and some newly industrialised countries are even producing world-class competitors of their own.

Summary

- Keeping incomes as basis, countries can be classified as low income, middle income and high income. They can also be categorised as first world (high-income), second world (middle-income) and third world (low-income) economies (LO1).
- Economic systems across the globe fall into any of the three: market, mixed, and command. Countries across the globe can be fit into any of these categories (LO2).
- Region-wise classification of countries also helps international manager to get a macro view of them. Broadly, we have Asian, African, Latin American, North American and European countries (LO3).
- Economic scenario of a country comprises such elements as size of the economy, income levels, income distribution, personal consumption, population, inflation, financial markets and tax system (LO4).
- Money markets and capital markets constitute the financial system of a country (LO5).
- Economic policies of a country include industrial policy, monetory policy, fiscal policy, and trade policy (LO6).
- Structural adjustments were implemented by all transition economies, including India. Critics point out that such adjustments were imposed by the IMF. But India's experience has been positive (LO7).
- Several countries are identified as transition economics – economists which are converting themselves from command economy to market economy. India, China, Poland are among them (LO8).

Review Questions

1. What is economic environment? How is the economic environment of host country important for an international manager? (LO1)
2. Explain the rationale of classifying countries on the basis of income. (LO1)
3. What are the main features of: (i) Developed countries, (ii) Developing countries, (iii) Transition economies? (LO1)
4. Describe atleast three economies that are in transition. (LO8)
5. What is new economic policy? Why was it needed? (LO6)
6. Describe, in brief, all the components of economic environment? (LO1)

Discussion Questions

1. As an international manager, which country do you prefer, and why, to locate a plant among:
   (i) developed countries, (ii) developing countries, (iii) transition economies. (LO1 & LO8)
2. Referring to the opening case, make a SWOT analysis of the Indian economy. (LO1 & LO8)
3. Imagine that you are the director of a major international lending institution supported by funds from member countries. What one area in the developed and developing economies

would be your priority for receiving development aid? Do you suspect that any member country will be politically opposed to aid in this area? Why or why not? (LO1)

Reinforcing Exercises

- When economies are hit by hyperinflation, the (as it happened in Brazil in the early 1990s and Turkmenistan in mid – 1990s) citizens need to spend at the earliest. Next day means currency becomes worthless.

  Zimbabwe should be mentioned here. Prices here were rising at 1 to 20 percent per day, and by mid – 2007, the inflation rate hit 3714 percent. Upon reflection, the Chairman of the Combined Harare Residents Association in Zimbabwe noted, " There is surrealism here that is hard to get across to people. If you have cash you spend it today, because tomorrow it is going to be worth 5 percent less. Normal horizons do not exist here".

  Is the above case an exception?
- "Countries that have transitioned from closed to open economies have prospered substantially. For example, China's transition has generated great economic success. It has been the fastest growing economy over the past 30 years. Ditto India which is ranked as the third largest economy in the world. Ireland and Brazil have also joined the bandwagon. Now, is the transition inevitable to become prosperous? Command and mixed economies have lost their relevance totally?

CLOSING CASE

A Charismatic and Benign Dictator

Yet another country which remained isolated, not tasted fruits of democracy and accompanying world trade benefits is Cuba. Fedel Castro has ruled the country for five decades under his firm grip but took care of his people through his paternalistic outlook. He poured resources into social programmes that reached from cradle to grave, providing free world-class health care and education as well as free pensions and funerals. Child malnutrition and adult illiteracy were eliminated. Life expectancy and many other social indicators rose above those of the United States. Every Cuban household had a ration book entitling to a monthly supply of food and other staples, provided at a nominal cost. Many other services too were (and are) similarly subsidised. Compared with the rest of Latin America, Cuba seemed to be achieving greater racial and sexual equality. So much was his concern for people that Fedel Castro evoked admiration from his 11.2 mn who did not mind economic sanctions from the US and who put up with grave natural calamities such as hurricanes with equanimity.

Across Cuba small businesses are proliferating. There are no wholesalers, and all supplies come from state owned super markets. The biggest growth has come from oil and gas, nickel mining, and sugar. People have been so much fed by government that they have become lazy. They stand around chatting or in long telephone conversations with their mothers. They also routinely pilfered supplies from their workplace: that is what keeps the informal economy going.

Cubans hardly produce anything. Between 2007 and 2009, Cuba imported around 80% of the food, at a cost of over $1.7 bn per year.

The global financial crisis in 2007-08 took its toll, however isolated Cuba stayed unconnected. Tourists stayed away, the oil price plunged, and the aid from Venezuela dried up. Having repeatedly defaulted on its foreign debt, Cuba has little access to credit.

Cuba follows state farming, which is its main stay. Farms held by the state account for 70%

of Cuba's 6.7 mn hectares of agricultural land. State farming, like the estuarial USSR, has been disasterous. To rectify the damage, government allowed private farmers and co-ops in 2008 to lease idle state land for 10 years to be extended upto 25 years.

Raud Castro, brother of Fedel Castro, became the president of Cuba in 2008 and since then several reforms have been initiated to transform communist-ridden moribund economy by privatising all economic activities. The reforms, set out in 313 "guidelines" are being implemented slowly. Non-state actors and co-operatives will be given importance to the reforms.

In 1991, a sort of miracle had happened to the Cuban economy, but short-lived. That was the year when Soviet Union collapsed which also meant a big blow to Fedel Castro. Soviet subsidies suddenly stopped. The overnight withdrawal of Soviet subsidies and trade links caused Cuba's economy to contract by 35% between 1989 and 1993. Fedel Castro declared a national emergency, opened the island for foreign investment and mass tourism and legalised small family business and the use of dollar. Then came Venezuela which began to supply Cuba cheap oil as a swap for the services of some 20,000 Cuban doctors, sports instructors and security advisers working in Venezuela. China too pitched in. Thus bolstered, businesses, and foreign ventures were shut down; and the dollar ceased to be a legal tender in 2004.

Cuba, the geographically horizontally spread island, is a country which you hate or love it. Love it because there are no bombings, no terrorist attacks, no overthrow of governments, no killings, no springs and no political instability. You love it also because people are generally happy and contended. You hate Cuba because you do not know any other Cuban, except the Castro brothers. You have another reason to hate – that Cuba does no go by democracy, is not pro-capitalist, no member of WTO, no pro-US and no pro-Europe, does not attend world economic forums and is not at the mercy of the IMF and the World Bank. And Cubans are no big users of internet and intranet. At the end of 2010, there were only 724,000 computers on the island, giving 1.8 mn users access to a state-run intranet. The 434,000 who could connect to the internet are mainly professionals using it at their workplaces.

Questions

1. What is your take on Cuba? Do you love or hate? Why?
2. Do you recommend Cuban's model of economy to any other country?

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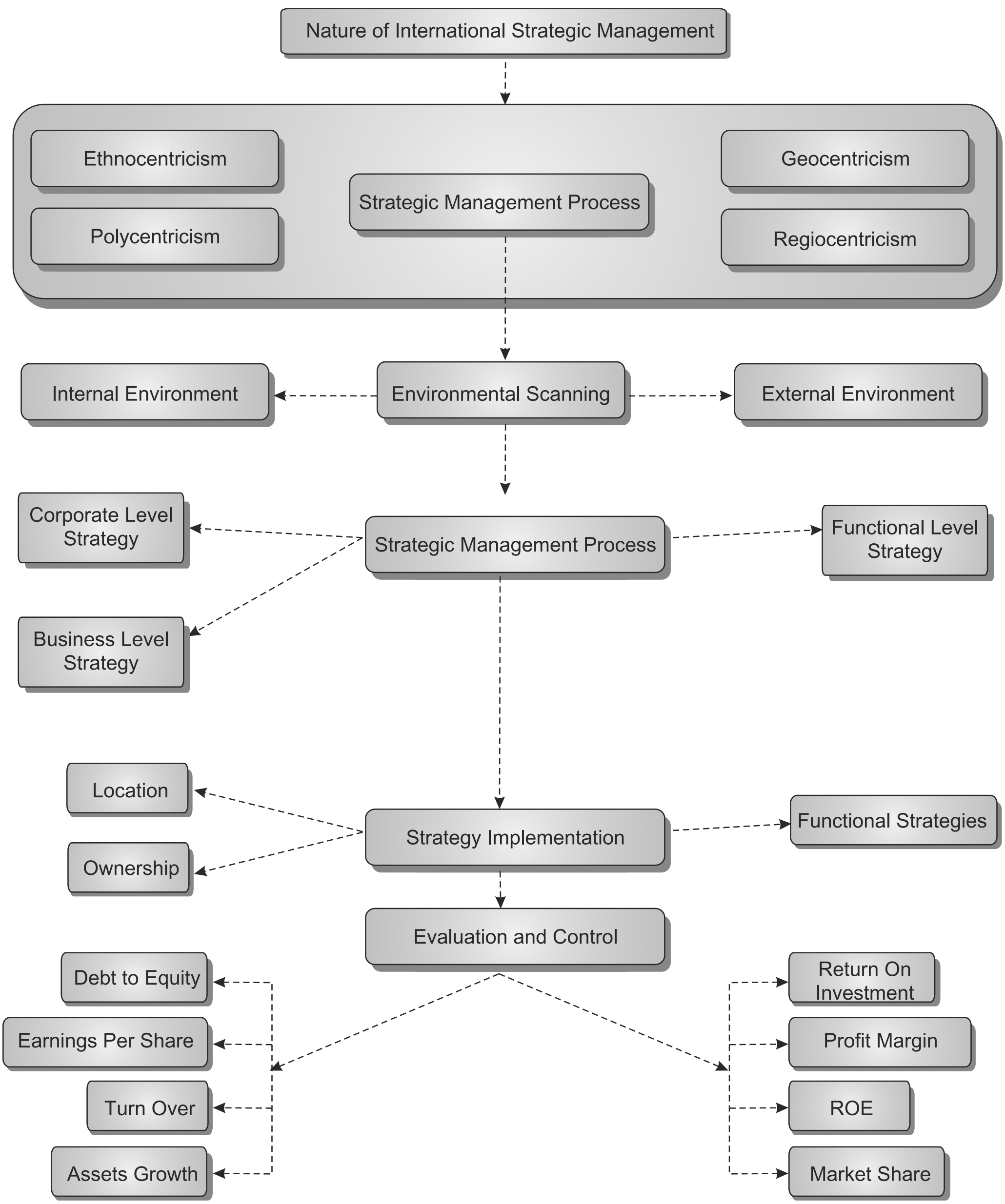
Suggested Readings

Riad A. Ajami and Jason Goddard, *International Business*, Jainco, 2014

PART 3

CHAPTER


Nature of International Strategic Management
Ethnocentricism
Polycentricism
Strategic Management Process
Geocentricism
Regiocentricism
Internal Environment
Environmental Scanning
External Environment
Corporate Level Strategy
Strategic Management Process
Functional Level Strategy
Business Level Strategy
Location
Ownership
Strategy Implementation
Functional Strategies
Evaluation and Control
Debt to Equity
Earnings Per Share
Turn Over
Assets Growth
Return On Investment
Profit Margin
ROE
Market Share

11

International Strategic Management

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Understand the nature of international strategic management
- **LO 2:** Identify avenues of profitability available for an MNC
- **LO 3:** Understand the strategic predispositions of an MNC
- **LO 4:** Examine the strategic management process

Opening Case

The Emperor Strikes Back

Frederick Upcott must be spinning in his grave on hearing the news about Tata Steel's acquisition of Corus, an Anglo-Dutch company, in 2006. It was in the beginning of the 20th century and Upcott was the Chief Commissioner of the Indian Railways. "Will Tatas be able to manufacture steel in India? If they succeed, I will undertake to eat every pound of steel they succeed in making," prophecied the knighted Upcott.

Rare it is that a company succeeds in acquiring another that is four times as large. But Tata Steel did it when it bought Corus for £4.3 billion. Tata Steel has the capacity to make five million tonnes of steel a year and Corus nineteen million tonnes, together they will become the world's sixth largest steel maker, as shown in Table 11.1. In Fortune Global ranking, Tata-Corus will get 268th rank. At this place, the combine will be positioned next to Coca-Cola in total turnover.

Tata's acquisition of Corus has only fit into a pattern prevailing in steel industry. The steel industry has been on a consolidation spree. First came the Areclor-Mittal deal, resulting in the merger of the two largest players in the business. Then came the Tata-Corus deal. Weaker players,

Table 11.1 Steel Makers in Fortune 500 Global Ranking

Company	*Global 500 Ranking*	*Revenues ($m)*	*Profits ($m)*
Arcelor-Mittal	62	68,653	8,144
Nippon Steel	168	34,502	3,037
JFE Holdings	218	27,366	2,879
Norsk Hydro	222	27,033	2,427
POSCO	236	25,678	3,916
Tata Corus	268	23,002	1,665
Baosteel Group	296	21,501	1,395

(*Source:* www.cnn.com)

all over the world have been gobbled up and strong players have been merging to increase their clout. In the last couple of years, there have been 305 deals of M&As in steel, touching a whopping $64.5 billion. This figure does not include several deals, big and small, for which deal values are not disclosed. This also does not include the 136 plus deals that are pending, that further amount to $18 billion roughly.

Steel makers across the globe realise that consolidation will result in scales which further help in sourcing raw materials, better utilisation of marketing and sales network and flexibility in production schedules.

Corus gains by joining Tata. Financial stability stemming from association with Tata Sons, prospects of sourcing hot metal from Tata Steel's facilities in India and access to markets in India and Asia-Pacific region are some of the strengths that Corus would be richer from its association with Tata Steel.

Tata Steel belongs to Tatas, the most widely admired business group in India, flush with managerial and technical resources. The tea-to-trucks conglomerate, with 100 firms in its stable, began emerging as a force in the global market place in 2000 when it bought Tetly Tea, Britain's top tea bag brand, in a deal which the newspapers headlined, "The Emperor Strikes Back".

Including the $407 million purchase, Tata has spent at least three billion dollars on 19 acquisitions in five continents, from the Eight 0'Clock Coffee Co. in the US to Daewoo in South Korea.

The total turnover of Tata companies was ₹ 379675 bn in 2010–11, with 58 percent of the revenue coming from businesses outside India. Tata companies employ over 425,000 people worldwide. The group operates in more than 80 countries across six continents, and its companies export products to 85 countries.

There is no other corporate group that is such a familiar part of Indian lives. Indians sport Tata watches, sip Tata tea, ride to work in Tata buses, drive Tata cars, telephone using Tata networks, keep their homes airconditioned with Tata-supplied power and holiday in Tata luxury hotels.

The group harks back to the British colonial era when it was founded in 1869 by Jamshedji Tata, who began a textile trading business in Bombay, and went on to construct the country's first hydroelectricity plant and steel mill.

Tata Steel helped underpin the group's fortunes. It is now India's biggest private steel company and the world's most cost-efficient steel producer.

Tata Steel is no loser either. It would diversify risk in terms of accessing newer markets and expanding the product mix. It would also get high-end capacities in auto, engineering and construction grade steel. It would get access to the technical know-how and steel making techniques of Corus. The most important benefit for Tata Steel would be the reaching of critical mass in one shot rather than the long drawn process of organic growth. Corus will also help Tatas focus on the growing auto sector in India with a possible $300 million investment in Jamshedpur or Orissa, where a greenfield Tata Steel Plant is planned.

A civilian coup of sorts was staged by a core group that helped Tata take over Corus. Inside

Bombay House, the Tata group headquarters in Mumbai, a top level Tata team, including M.D. Muthuraman, Noshir Soonawala, Koushik Chatterjee and Arun Gandhi, along with a set of bankers from ABN Amro and Deutsche Bank had kicked off Project Colour, the code name for the Tata Bid.

Within Camp Tata, the roles were clear-cut. Gandhi would handle the UK Takeover Panel and Laws, while Chatterjee and his treasury team including Sandeep Biswas, the head of treasury, would work in tandem. Along with the Tatas' treasury team, its financial planning team was also involved, while Mr. Muthuraman provided the steel and industry specific perspectives to back up the financial whizkids.

IN Chapters 5 to 10, we examined issues relating to the larger environment in which firms compete. This environment includes political, economic, technological, and cultural factors. Our focus now shifts from the environment to the firm, and in particular, to the actions that managers can take to compete more effectively in international business. We propose to discuss the different strategies that firms pursue when competing globally, consider the pros and cons of these strategies, explain the various factors that affect a firm's choice of strategy, and look at the tactics firms adopt when competing in the international arena.

NATURE OF INTERNATIONAL STRATEGIC MANAGEMENT

LO 1
Understand the international strategic management

Strategic management is concerned with the process of formulating, implementing, and evaluating strategies to achieve a firm's objectives. In concept, strategic management process in an MNC is similar to that in any other form of organisation, the main complicating factors being the numerous country and regional environments it has to analyse and understand before considering the various strategic options. More time and efforts are required to identify and evaluate external trends and events in MNCs. Geographic distances, cultural and national differences, and variations in business practices, often make communication between home offices and overseas operations difficult. Strategy implementation can be more difficult because different cultures have different norms, values, and work ethics.

Strategic management is critical to international business. An MNC needs to keep track of its increasingly diversified operations in a continuously changing international environment. This need is particularly obvious when one considers the amount of FDI that has taken place in recent years. FDI has outgrown trade across the globe and this development necessitates the need to coordinate and integrate diverse operations with a united goal. There are examples of firms that are precisely doing this, classic example being Tata group (see opening case). Also, take the case of Ford Motor, which has re-entered the market in Thailand and, despite a shrinking demand for automobiles there, is beginning to build a strong salesforce to garner market share. The firm's strategic plan is based on offering the right combination of price and financing to a carefully identified market segment. In particular, Ford is working to bring down the monthly payments so that customers can afford a new vehicle. This is the same approach that Ford used in Mexico, where the currency crisis of 1994 resulted in serious problems for many multinationals.

Toyota is another multinational company which has benefited vastly from strategic management. The company is going beyond the automotive market. (See the closing case to this chapter.) In the process, Toyota is assessing environmental opportunities and threats and examining its internal strengths and weaknesses so that the firm's strategic thrust can exploit its strengths and sidestep any shortcomings.

Strategies to increase profitability:

An MNC is able to increase its profitability in ways often not available to a domestic firm. For example, a global firm is able to:

1. Earn a greater return from its distinctive skills and core competencies.
2. Realise location economies by dispersing operations to those locations where they can be performed most efficiently.
3. Realise greater experience curve economies, which reduces the cost of production.
4. Acquire and/or develop widely known brands.

However, the MNC's ability to increase its profitability by exploiting the four strategies stated above depends on how well it formulates its production, marketing, and finance strategies and implements them in differing national environments.

AVENUES OF PROFITABILITY

LO 2
Identify avenues of profitability available for an MNC

Acquiring and/or Developing Brands Nestlé is the best example to be mentioned in this context. As is well known, Nestlé is the world's largest food company, with sales of $48 billion in 1997. The corporation employed over 226,000 people in 1997, 97 per cent of whom worked outside Switzerland. In 1997, Nestlé operated 495 factories in 70 countries. One-half of its sales were in Europe, and 25 per cent came from North America.

Nestlé has been highly successful in its global operations. It has adopted several strategies to achieve the success. Through aggressive acquisitions, it has expanded its sales with new, high-margin, sophisticated products. Paralleling this is the strategy of acquiring and/or developing widely known brands. Another important strategy is to continuously improve traditional products. For instance, Nestlé produces over 200 types of instant coffee, all tailored to meet the requirements of specific countries. The final strategy is that the company has given local managers substantial autonomy. However, basic strategy, brand policy, and financial decisions are controlled at company headquarters in Vevey, Switzerland.

Reaping Experience Curve Benefits The *experience curve* refers to the systematic reductions in production costs over the life of a product. Figure 11.1 illustrates the relationship between production costs and output.

The experience curve has greater strategic relevance. Moving down the experience curve allows a firm to reduce its cost of creating value. The firm that moves down the experience curve rapidly will have a cost advantage compared to its competitors. Thus, Firm A in Fig. 11.1, because it is further down in the experience curve, has a clear cost advantage over Firm B.

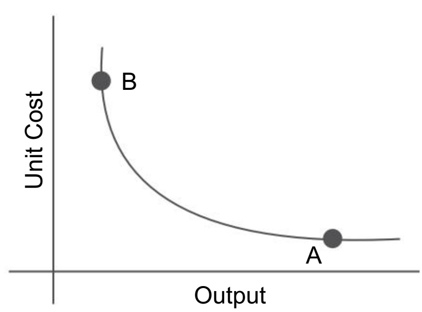


Fig. 11.1 The Experience Curve

Experience-based cost savings come from company personnel learning how to perform their tasks more efficiently. Other sources of cost savings are improvements in plant layout and workflows, product design modifications that enhance manufacturing efficiency, redesigning of machinery and equipment to gain increasing operating speed, and tailoring of parts and components in ways that streamline the assembly process. Experience can also reduce the cost of constructing and operating websites, new retail outlets, new plants, or new distribution facilities. There are also benefits associated with getting samples of a rival's products and having design engineers study how they are made, benchmarking company activities against the performance of similar activities in other companies, and interviewing suppliers, consultants, and ex-employees of rival firms to tap into their wisdom.

The reasons behind experience curve are mainly plant-specific. Therefore, the key to progressing downward on the experience curve, as fast as possible, is to increase the volume produced by a single plant as rapidly as possible. Since 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.

One firm that has exploited the strategy of experience curve to its advantage is Matsushita, a Japanese company. 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 got its VHS format accepted as the world standard and reaped enormous experience curve-based cost economies. This cost advantage constituted a formidable entry barrier to new competitors. Matsushita's strategy was to build global volume as rapidly as possible. To ensure that 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 realised considerable experience curve advantages.

Realising Location Economies We know that countries differ along a whole range of dimensions, including the economic, political, legal, cultural and that these differences can either increase or decrease the costs of doing business. We understand from the theory of international trade that because of differences in factor costs, certain countries have a comparative advantage in the production of certain products. For example, Japan excels in the production of automobiles and consumer electronics. The US excels in the production of pharmaceuticals, biotechnology products, and financial services. Switzerland excels in the production of precision instruments and pharmaceuticals. India excels in the production of computer software.

What does all these mean? They imply that, trade barriers and transportation costs permitting, a firm does benefit by basing each of its value creation activities at that location where economic, political, and cultural conditions are most conducive to the performance of that activity. Firms that pursue such a strategy are said to be reaping *location economies*. Advantages of location economies help a firm lower its costs of production and/or help it differentiate its product from those of competitors.

General Motors (GM) did precisely the same thing. Design of its Pontiac Le Mans car was done in Germany, key components were manufactured in Japan, Taiwan, and Singapore; assembly was performed in South Korea; and the advertising strategy was formulated in Great Britain. Each of these countries was best suited to perform a particular value creation activity.

Core Competencies The term core competence refers to skills within the firm that competitors cannot easily imitate. The skills may exist in production, finance, R&D or marketing, but they are the bedrock of the firm's competitive advantage. For example, Toyota has a core competence in the production of cars; McDonald's has a core competence in managing fast food operations; P&G has core competence in developing and marketing consumer products; and Wal-Mart has core competence in information systems and logistics. The list is only illustrative.

For such firms, global expansion is a way to exploit their core competencies and offer products of high quality at low prices. Firms with unique and valuable skills can realise enormous returns by applying those skills, and the products they produce, to foreign markets where indigenous competitors lack similar skills and products.

INTERNATIONAL STRATEGIC PREDISPOSITIONS

LO 3
Understand the strategic predisposition of an MNC

Before describing strategic management process of international business, it is useful to understand its strategic predisposition towards doing things in a particular way. This predisposition helps determine the specific decisions the firm will implement. There are four such predispositions: ethnocentric, polycentric, regiocentric, and geocentric. Table 11.2 lists each predisposition and its characteristics (Read also Chapter 6).

Ethnocentric Orientation An MNC with an ethnocentric orientation will rely on the values and interests of the parent country in formulating and implementing a strategic plan. Primary emphasis is on profitability and the firm will try to run its operations overseas in the same way they are run at home.

Polycentric Disposition An MNC with a polycentric predisposition will tailor its strategic plan to meet the needs of the host country culture. If the firm operates in more than one country, an overall plan will be adopted to meet specific needs of the host country. Each subsidiary will decide on the objective it wants to pursue depending on local needs. Profits will be ploughed back to the host country for expansion and growth of business operations.

Regiocentric Predisposition An MNC with a regiocentric predisposition will be interested in both profit as well as public acceptance—an acceptance of both ethnocentric and polycentric orientations. The firm will use such a strategy that allows it to address both local and regional needs. For example, an MNC doing business in the EU will be interested in all its member countries.

Geocentric An MNC with a geocentric approach will view operations from a global perspective. Such firms offer global products with local variations and their employees belong to different parts of the globe. They hire the best people, notwithstanding their region or religion.

The predisposition of an international business greatly influences its strategic management process. Some MNCs, for example, are more interested in profit and/or growth than they are in developing a comprehensive corporate strategy that exploits their potential. Others are more interested in large-scale manufacturing that will allow them to compete on price across the country or region, as opposed to developing a high degree of responsiveness to local demand by tailoring a product to meet local needs. Some prefer to sell in countries where the cultures are similar to their own so that the same basic marketing orientation can be used throughout the regions. These orientations or predispositions greatly influence corporate strategies.

Table 11.2 Orientation of an MNC under different Profiles

	Orientation of the Firm			
	Ethnocentric	*Polycentric*	*Regiocentric*	*Geocentric*
Mission	Profitability (viability)	Public acceptance (legitimacy)	Both profitability and public acceptance (viability and legitimacy)	Same as regiocentric
Governance	Top-down	Bottom-up (each subsidiary decides on local objectives)	Mutually negotiated between region and its subsidiaries	Mutually negotiated at all levels of the corporation
Strategy	Global integration	National responsiveness	Regional integration and national responsiveness	Global integration and national responsiveness
Structure	Hierarchical product divisions	Hierarchical area divisions, with autonomous national units	Product and regional organisation tied through a matrix	A network of organisations (including some stakeholders and competitor organisations)
Culture	Home country	Host country	Regional	Global
Technology	Mass production	Batch production	Flexible manufacturing	Flexible manufacturing
Marketing	Product development determined primarily by the needs of home country customers	Local product development based on local needs	Standardise within region, but not across regions	Global product, with local variations
Finance	Repatriation of profits to home country	Retention of profits in host country	Redistribution within region	Redistribution globally
HR Practices	People of home country developed for key positions everywhere in the world	People of local nationality developed for key positions in their own country	Regional people developed for key positions anywhere in the region	Best people everywhere in the world developed for key positions everywhere in the world

(*Source*: Hodgetts and Luthans, *International Management*, 2003, p. 259)

STEPS IN STRATEGIC MANAGEMENT PROCESS

LO 4
Examine the strategic management process

Strategic management process is necessary both at the headquarters of an MNC as well as at each of the subsidiaries.

The global strategic management process duplicates the process followed in domestic companies. However, the variables and, therefore, the process itself are far more complex in international business because of the difficulty in obtaining accurate and timely information; the diversity of geographic locations; and the differences in political, legal, cultural, and economic forces. Typically, the strategic management process of an international business comprises four major steps, viz.,

- Scanning of global environment;
- Formulation of strategies;
- Implementation of strategies; and
- Evaluation and control. (see Fig. 11.2)

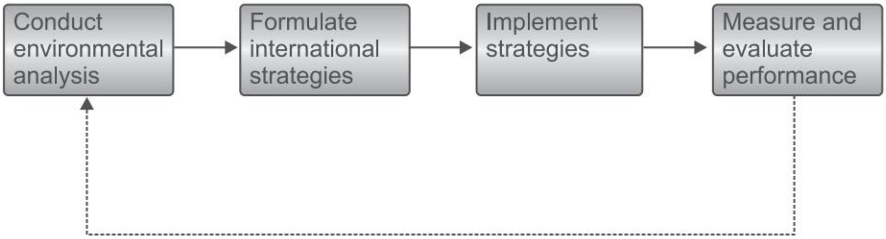


Fig. 11.2 International Strategic Management Process

Environmental Scanning

The first step in strategic management process is scanning of internal and external environments.

External Environment Scanning of external environment provides management with accurate forecasts of trends that affect the fortunes of businesses.

External environment comprises economic forces, politico-legal forces, cultural, and technological forces (all these were considered in the earlier chapters). These forces, together, will decide the types of products to be developed, the nature of positioning and market segmentation strategies, the types of services to be provided, and the choices of business to acquire or sell. Forces external to the firm directly affect suppliers and distributors. Identifying and evaluating external opportunities and threats enable organisations to define objectives and evolve strategies to achieve these objectives. Specifically, scanning of external environment focuses on the following trends:

1. What are the dominant economic features that affect the firm?
2. What is competition like and how strong are the competitive forces?
3. What is causing the firm's competition and business environment to change?
4. Which firms are in the strongest/weakest positions?
5. What strategic moves are rivals likely to make?
6. What are the key factors for competitive success?
7. Is the industry (of which the firm is one unit) attractive and what are the prospects of profitability?

The most desirable approach to external assessment is to pursue two perspectives: SBU and regional. The purpose is to identify those SBUs and geographic regions where the firm is strong, and those where corporate performance is weak.

SBU assessment Strategic business units (SBUs) are carved by splitting the firm into distinct business units. External assessment is best done by assessing the performance of such units. The first step is to identify SBUs that contribute positively to group performance (i.e., the above-and below-average financial performers) and those that are competitive within their industry sectors (above and below-average performers in their respective industries). Figure 11.3 shows a hypothetical international firm with eight SBUs, with contributions to group-performance and industry-performance levels graphed against each.

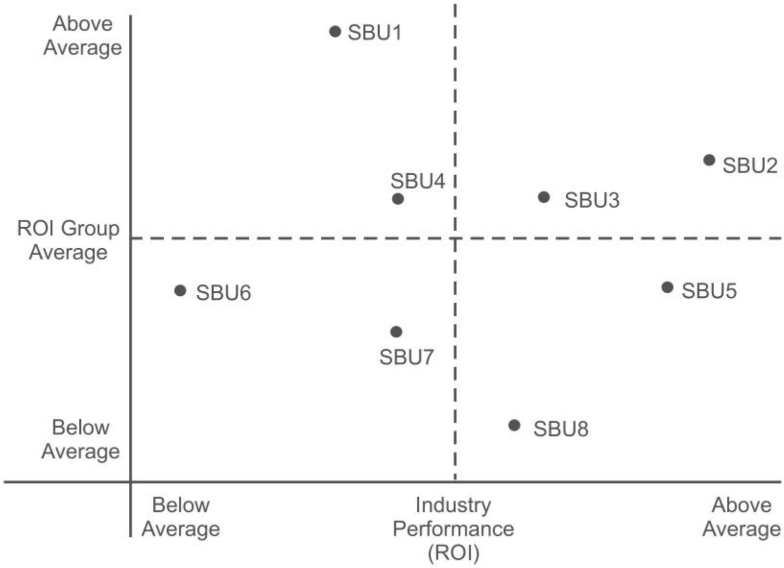


Fig. 11.3 Group Assessment of SBUs

- Thus, SBU2 and SBU3 are clear 'winners', above average performers in their industries and outstanding contributors to group profits.
- SBU1 and SBU4 contribute strongly to group profits but lag in industry performance. These SBUs would be benchmarked against industry rivals to determine ways to improve their performance.
- SBU5 and SBU8 are well placed within their industries, earning above-average return-on-investments (ROIs), but pull down the group performance.
- SBU6 and SBU7 are a drag, both on industry and group performance. These are fit candidates for divestment. Before placing them for sale, their past performance may be recollected, future prospects may be forecast and strategic usefulness may be analysed. Assessment of internal and external factors is highly relevant.

Regional Evaluation The assessment of regions is desirable before formulating strategies. The process begins with plotting regional corporate performances on two indices: market size and market growth. Figure 11.4 illustrates typical plotting of regions.

The relative size of each regional circle indicates the proportion of corporate sales emanating from that region—bigger the circle, greater the proportion of total sales occurring in that region. In Fig.11.4, Western Europe and North America account for major proportion of worldwide sales. The bay in each circle indicates the company's market share. The market share of the company is greater both in Western Europe as well as North America. The horizontal axis shows regional growth rates for individual regions. Latin America and Asia show highest growth rates.

Several alternatives present themselves:

- Slow growth in Western Europe would likely result in highly competitive markets. Sales would mainly come at the cost of rivals, from cost cutting measures, or from acquisitions.
- The company's position in North America is strong, with a dominant market share in a moderately expanding market.

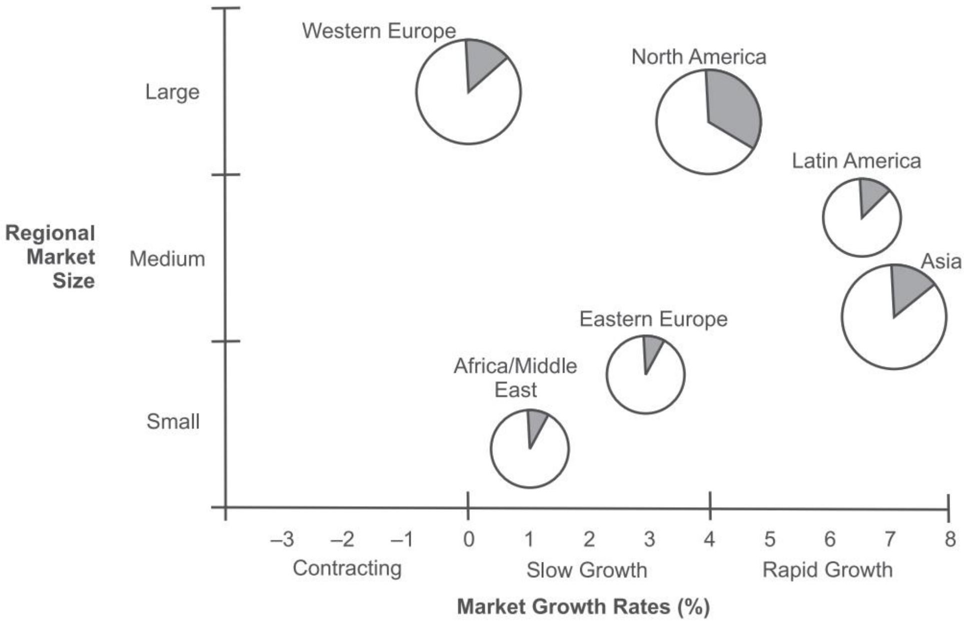


Fig. 11.4 Evaluating Corporate Regional Performance on a Market Size-Growth Matrix

(*Source:* Fig. 11.3 and 11.4 are based on *World Business* by John S. Hill, pp 241 and 242 respectively)

- Sales might be pursued in the Latin American and Asian regions to take advantage of the expanding markets.
- The African, Middle East and Eastern European regions show slow growth in relatively small markets. Cautious approach would be appropriate in these regions.

Internal Environment After examining the external forces, the management needs to turn to internal environment. Scanning of internal environment should focus on three specific areas:

(1) Mission statement, (2) physical resources and personnel competencies, and (3) the way in which value chain analysis can be used to bring these resources together in the most profitable manner.

As part of the assessment of internal environment, the strategist should take a close look at the company's vision and mission statements. The vision statement seeks to answer the question, "What do we want to become, ten years hence?" Many vision statements are one liner each. The vision statement of an eye clinic can be, "Our mission is to take care of your vision."

Mission Statement. A mission statement is an enduring statement of purpose that distinguishes one business from similar other businesses. It identifies the scope of a firm's operations in product and market terms.

MNCs mission statements generally contain one or more of the following features:

- Strategic elements such as how organisational strengths are being leveraged in the market place to realise the vision.
- Description of business in terms of customers, products and geographic locations.
- Perceived organisational strengths, customer satisfaction levels, corporate culture, technology, supply-chain strength, quality orientation, and the like.

The importance of vision and mission statements to effective strategic management is too obvious to need any emphasis. Firms do well to have written vision and mission statements for the following reasons:

- To ensure unanimity of purpose within the organisation
- To provide a basis, or a standard, for allocating organisational resources
- To establish a general tone or organisational climate
- To serve as a focal point for individuals to identify with the organisation's purpose and direction, and to direct those who are, for some reason unable to participate in the organisational activities
- To facilitate the translation of objectives into a work structure involving the assignment of tasks to responsible elements in the firm
- To specify organisational purposes, and then to translate these into objectives in such a way that cost, time and performance parameters can be assessed and controlled.

Physical Resources and Personnel Competencies Physical resources are the assets that the international business has with it to carry out its strategic plan. Many of these assets are reflected in the firm's balance sheet, being listed as building, machinery, inventory, cash, and the like. However, a balance sheet does not reveal the whole picture. The location and disposition of these resources is also important. An MNC, for example, having facilities located in different parts of the globe is in a much better position than a company that has only one plant.

Personnel competencies are the abilities and talents of people. An international business needs to take cognisance of these as they decide its strengths and weaknesses. In fact, the real strength of a firm lies with its people and not in its physical resources and their location.

Several MNCs have profited from astute environmental scanning. For example, Alcatel Alsthom of France, after a careful analysis of macroenvironment, made a series of acquisitions and alliances and now is the world's largest telephone equipment company. This has put Alcatel in an ideal position to garner market share in the rapidly growing telecommunications market. US MNCs Ford and General Motors have been positioning themselves carefully in Europe and are now two of the major automakers there.

Value Chain Analysis A complimentary approach to internal environmental assessment is the examination of the firm's value chain. A *value chain* is the way in which primary and support activities are combined in providing goods and services and in increasing profit margins. Figure 11.5 illustrates a value chain. The primary activities in the chain include—

1. inbound logistics such as receiving, storing, materials handling, and warehouse activities;
2. operations in which inputs are put into final product form by performing activities such as machining, assembling, testing, and packaging;
3. outbound logistics that help distribute the products to the customers;
4. marketing and sales which are used to encourage buyers to purchase products; and
5. service for maintaining and enhancing the value of the product after the sale through activities such as repair, maintenance, and parts supply.

The support activities in the value chain include:

1. The firm's infrastructure, which is made up of its general management, planning, financing, accounting, legal, governmental, and quality management areas;
2. Human resource management, which is made up of the selection, placement, appraisal, promotion, training, and development of the company's personnel;
3. Technology in the form of knowledge, research and development, and procedures that can result in improved goods and services; and
4. Procurement, which involves the purchasing of raw materials, supplies, and similar goods.

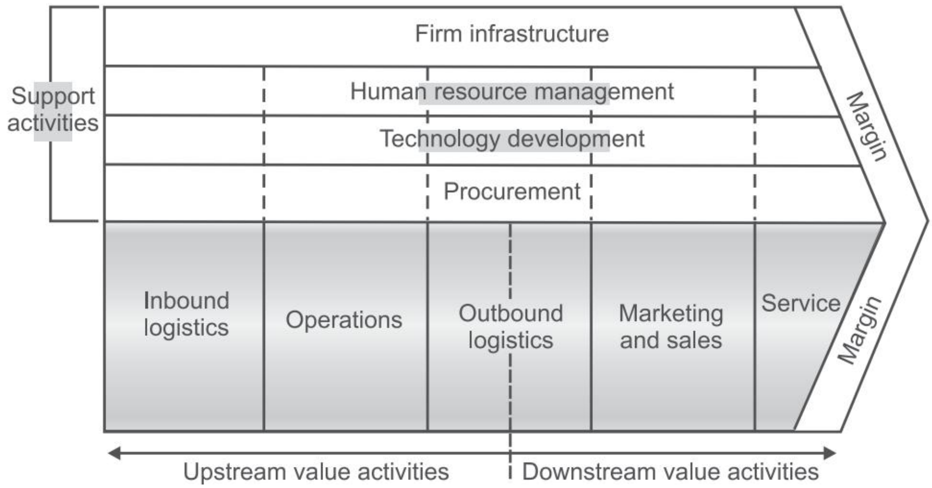


Fig. 11.5 Value Chain

The value chain stipulates that the total revenues minus total costs of all activities undertaken to develop and market a product or service yields revenue. A firm will be profitable as long as total revenues exceed the total costs incurred in creating and delivering the product or service. Every firm will have its own value chain. The management of any business should understand not only its own value chain operations, but also of their competitors', suppliers', and distributors' value chains.

Strategy Formulation

A typical MNC is often caught between two extremes: need to standardise products to achieve scale economies or customise all activities to suit specific local needs. Such a dilemma between pressure for global integration and pressure for local responsiveness is often daunting.

Let us first examine the case for global integration and that for local responsiveness. Pressure for global integration stems from sound economic reasons. *First*, integration of the world economies is the trend which is going to be much stronger in the years to come. It is said that at present global markets produce and consume more than 20 percent of the world output and are projected to multiply 12-fold, to more than 80% of world output by 2025. Likewise, more economic integration will take place in the next 30 years than occurred in the past 100 or more.

Second, MNCs often face pressure for cost reduction. Responding to pressure for cost reduction, a firm requires to lower the costs. A manufacturer, for example, might mass-produce a standardised product at the optimal location anywhere in the world to realise economies of scale, learning effects, and location economies. Alternatively, an MNC might outsource certain functions to low-cost foreign supplier in an attempt to reduce costs. *Third*, consumers all over increasingly demand and accept highly standardised products whether they are Apple iPods, Samsung plasma screens or Starbuck's expresses. MNCs naturally go with the consumers' preferences.

Reasons for local orientation are equally strong. *First*, there are differences in customer tastes and preferences. Naturally, one-size-fits-all product policy is not acceptable. An MNC should customise its offerings to suit local needs and preferences. *Second* relates to differences in traditional practices, creating a need to customise products accordingly. Fulfilling this need may require delegation of manufacturing and production functions to foreign subsidiaries. *Third* refers to the host government's demands. Economic and political demands imposed by host-country governments may require local responsiveness.

Balancing these two positives results in formulating one of the four alternative strategies: international, multi-domestic, global and trans-national. (See Fig. 11.6).

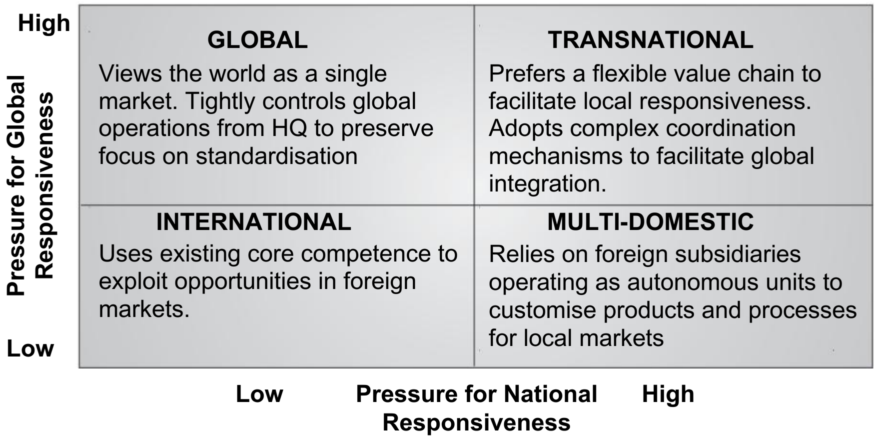


Fig 11.6 Strategy Types

(*Source:* John Daniel, et al, *International Business*, Pearson 2013, p.430)

International Strategy McDonald's, Kellog's, Google, Haier, Wall-Mart and Microsoft adopt international strategies. What is unique about these MNCs is that they possess core competencies and seek to leverage them by expanding into overseas markets. The international model expects subsidiaries to administer businesses as instructed by headquarters. Some subsidiaries may have operational freedom to adapt products to local conditions as well as to set up some light assembly operations or promotion techniques. But ultimate control rests with the head office.

Multi-domestic Strategy Multi-domestic strategy permits subsidiaries to act independently. The company's subsidiaries in their respective local markets have the authority to design, make, and market products that meet local customers' needs and preferences. Each subsidiary almost functions as a profit centre. Johnson & Johnson is the best example for multi-domestic strategy. The DNA of J & J is decentralised decision making. Managers close to customers and competitors are allowed to make decisions. With few exceptions, each subsidiary is managed by citizens of the country where it is located. This approach enables J & J to behave like 250 small, innovative, entrepreneurial firms, responding to the unique opportunities and threats in their local markets yet still benefiting from the resources commanded and expertise generated by global operations.

Multi-domestic strategy makes companies customise their products, marketing and service programmes to local conditions. It also makes managers hold a polycentric view that people who are close to the markets should manage businesses.

Global Strategy This strategy asserts that there exists a single global market for many consumers and industrial goods. People everywhere want to buy the same products and live the same way. Obviously, global strategy compels companies to think in terms of creating products for a world market, manufacturing them on a global scale in a few efficient plants, and marketing them through a few focussed distribution channels.

A global strategy can help organisations reap efficiencies by standardising product designs and manufacturing, using common suppliers, introducing products around the world faster, coordinating prices, and eliminating overlapping facilities. Ford 2000 initiative built a single global automotive operation. By sharing technology, design, supplies, and manufacturing standards worldwide, Ford saved $5 bn during the first three years.

Trans-national Strategy A trans-national strategy seeks to achieve both global responsiveness and national responsive pressures. A true trans-national strategy is difficult to achieve as one goal requires close global coordination while the other goal requires local flexibility. However, many firms are finding that, although increased competition means that they must achieve global efficiency, growing pressure to meet local needs demands national responsiveness. One company that uses trans-national strategy effectively is Caterpillar, a heavy equipment manufacturer. It achieves global efficiencies by designing its products to use many identical components and centralising manufacturing of components in a few large-scale facilities. However, assembly plants located in each of Caterpillar's major markets add certain product features tailored to meet local needs.

Goal Setting for Strategy Formulation Whatever may be the type, strategy formulation should be preceded by goal setting. MNCs pursue a variety of goals; Table 11.3 provides a list of the most common ones. These goals typically serve as an umbrella beneath which the subsidiaries operate.

Profitability and marketing usually dominate the strategic plans of today's MNCs. Profitability, as shown in Table 11.3, is of a very high significance because MNCs generally need higher profitability from their overseas operations than they expect from domestic activities. The reason is obvious. Setting up overseas operations involves greater risk and effort. Further, a firm that has done well domestically with a product or service usually has done so because the competition is less severe. Firms with such an advantage often find additional lucrative opportunities beyond their borders. Moreover, the more successful a firm is domestically, the more difficult it is to increase market share without strong competitive response. International markets, however, offer an ideal alternative to the desire for increased growth and profitability.

Another reason why profitability and marketing top the list of goals is that these tend to be more externally environmentally responsive, whereas production, finance, and personnel areas tend to be more internally controlled. Thus, for strategic planning, profitability and marketing goals are given higher importance and deserve closer attention.

Having decided upon the focus and specific goals, the next logial step is to formulate strategies. Strategies may be intended, deliberate, unrealised, emergent, imposed or realised strategies (see Fig. 11.7).

Strategies that are decided in advance by the top leadership of the firm are *intended strategies*. Those that are put into operation are *deliberate strategies*. Those intended or deliberate strategies that do not happen become *unrealised strategies*. Strategies which are not intentionally planned, and which can come about from lower levels in an organisation, are *emergent strategies*. Those that are *imposed* on an organisation are strategies about which the members of an organisation have little effective choice. The imposed strategies, plus some emergent strategies, plus those intended strategies that are deliberately adopted, together constitute the *realised strategies,* i.e, what the organisation as a whole does in practice.

The above strategies are formulated at corporate, business and functional levels.

Table 11.3 Areas for Formulation of MNC Goals

Profitability
Level of profits
Return on assets, investment, equity, sales
Yearly profit growth
Yearly earnings per share growth
Marketing
Total sales volume
Market share—worldwide, region, country
Growth in sales volume
Growth in market share
Integration of country markets for marketing efficiency and effectiveness
Production
Ratio of foreign to domestic production volume
Economies of scale via international production integration
Quality and cost control
Introduction of cost-efficient production methods
Finance
Financing of foreign affiliates—retained earnings or local borrowings
Taxation—minimising tax burden globally
Optimum capital structure
Foreign exchange management—minimising losses from foreign currency fluctuations
Personnel/Human Resources
Development of managers with global orientation
Management development of host country nationals

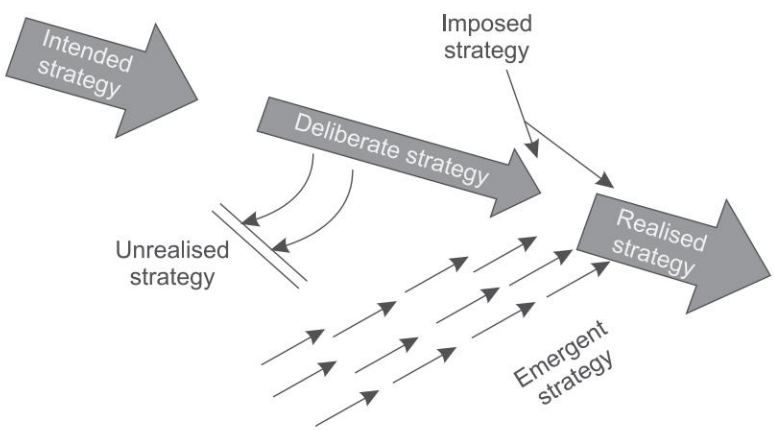


Fig. 11.7 Different Strategies

(*Source*: Adrain Haberberger and Alison Rieple, *Strategic Management,* Oxford, 2008, p. 50)

Corporate Level Strategy

Corporate level strategy seeks to define the domain of businesses the firm intends to operate. The focus is on questions related to business portfolio, including patterns of diversification and risk-return issues. The four key approaches to corporate strategy are growth, retrenchment, stability and combination.

A **growth strategy** is designed to increase the scale or scope of the MNC's operations. While **scale** refers to the size of the MNC's activities, **scope** means the types of its activities.

Growth is sought to be achieved through organic ways or inorganic routes.

Organic growth refers to the MNC's strategy of relying on greenfield projects. Microsoft is one example that generates much of its growth organically. Bharat Heavy Electrical Ltd, the Government of India behemoth, grew organically. **Inorganic growth** includes mergers or takeovers. Tata Steel (read opening case) rose to the status of sixth largest steel producer thanks to its acquisition of Corus.

A **retrenchment strategy** is designed to reduce the scale or scope of the MNC's business. Downturn economic conditions or heightened competition force the MNC to cut its scale of operations. The MNC seeks to reduce the scope of its activities by selling unprofitable business units or those units that carry no sync with the core business.

A **stability strategy** is designed to guard against change. An MNC that is content with what it has accomplished, generally pursues stability strategy. The MNC has no desire to expand sales, increase profits, enhance market share, or expand customer base. It is simply interested in maintaining the present status.

When an MNC seeks to have a mix of growth, retrenchment and stability strategies across its subsidiaries, it is said to pursue a **combination strategy**. For example, the MNC can invest in subsidiaries that demonstrate potential, retrench in those for which less exposure is desired, and stabilise others. Combination strategies are common as MNCs rarely follow identical strategies in each of their business units.

Business Level Strategies

Whereas corporate strategy deals with the overall organisation, business strategy focuses on specific subsidiaries or operating units within the firm. Where the MNC is engaged in just one line of business, it needs to have a single strategy which is common to both the subsidiary as well as for the entire organisation. For other international businesses, business-level strategy means crafting anywhere from two to dozens of strategies.

Before formulating a business-level strategy, the MNC needs to decide on its general competitive strategy in the market place. The general competitive strategy may be low-cost leadership, differentiation or focus. These three strategies, according to Michael Porter, offer competitive advantage to a firm.

Cost leadership strategy A strategy in which a company exploits economies of scale to achieve the lowest cost is called the low-cost leadership strategy. A number of cost elements deserve pruning to achieve low cost. Such elements include economies of scale, learning and experience curve effects, extent of capacity utilisation, linkages with suppliers and distributors, R&D costs, labour, taxes, energy and shipping costs.

Cost leadership strategy can be effective when the market is composed of many price-sensitive buyers, when buyers do not care about differences from brand to brand, or when there are a large number of buyers with enough bargaining power. The idea behind the low cost strategy is to underprice competitors and thereby gain market share and sales, driving some of the competitors out of the market entirely.

Differentiation strategy The differentiation strategy is an integrated set of actions taken to produce goods or services that customers perceive as being different. Through the differentiation strategy, the firm produces non-standardised products for customers who value differentiated features more than their value cost.

The differentiation strategy should be pursued only after a careful study of buyers' needs and preferences to determine the feasibility of incorporating one or more differentiating features into a product. A successful differentiation strategy allows a firm to charge a higher price for its product, and to gain customer loyalty because consumers may become strongly attached to the differentiation features. Special features that differentiate one's product can include superior service, spare parts availability, engineering design, product performance, useful life or ease of use.

Focus strategies Firms choose a focus strategy when they desire to use their core competencies to serve the needs of a particular industry segment or niche, to the exclusion of others. Examples of specific market segments that can be tageted by a focus strategy include (a) a particular buyer group (e.g., youth or senior citizens), (b) a different segment of product line (e.g., products for professional painters or those for 'do-it-yourselves'), or (c) a different geographic market (e.g., North or South in India).[13] Thus, focus strategy is an integrated set of actions taken to produce goods or services that serve the needs of a particular competitive segment. Focus strategies prove to be effective when consumers have distinctive preferences or requirements, and when rival firms are not attempting to specialise in the same target segment.

Functional Level Strategies

Corporate and business strategies are implemented through functional strategies. Functional strategies involve management of all functional areas, production, marketing, finance and HR, in such a way that they subserve the interests of corporate and business strategies. For example, financial strategy of an MNC deals with such issues as the firm's desired capital structure, forex-holdings, risk-reduction techniques, debt policies and working capital management. Typically, an international business develops a financial strategy for the overall business, as well as for each SBU. International marketing strategy concerns the selling and distribution of the firm's products or services. Likewise, international operations strategy deals with the creation of the firm's products or services. Similarly, international human resource strategy focuses on the people who work for the organisation. All these functional areas will be covered in detail in subsequent chapters.

Strategy Implementation

The strategy formulated needs to be implemented. Strategy implementation is the process of attaining goals by using the organisational structure to execute the strategy formulated. Three issues deserve serious consideration for strategy implementation: (i) location, (ii) ownership decisions, and (iii) functional area implementation.

Location An MNC must decide the location of its subsidiary. Core consideration in choosing a country is the size of its market. Industrialised countries score over others and obviously, MNCs have traditionally invested in the rich countries. Another consideration in choosing a country is the extent of government control. Earlier, MNCs refused to do business in Eastern European countries and to some extent even in India. The recent liberalisation of economy in India and shift towards free market in the republics of the former Soviet Union and the other Eastern European nations, however encouraged MNCs to change their perception, and they are now making moves in this largely untapped part of the global market.

Still another consideration in selecting a country is restriction on foreign investment. Traditionally, countries such as China and India have required that control of the operation be in the hands of the local partners. MNCs that are reluctant to accept such conditions will not establish operations there.

MNCs will also look at the specific benefits offered by host countries before selecting locations. Such benefits include tax laws, interest rates, subsidies, infrastructure and the like. Table 11.4 outlines the considerations which a multinational manager keeps in mind while selecting a country.

Location is important for an MNC for a number of reasons. Facilities in a host country contribute to the competitive edge to the MNC. This is particularly true when materials, labour, and other inputs

Table 11.4 Indicators of Market Potential

1. Demographic characteristics	
	Size of population
	Rate of population growth
	Degree of urbanisation
	Population density
	Age structure and composition of the population
2. Geographic characteristics	
	Physical size of the country
	Topographical features
	Climatic conditions
3. Economic factors	
	GNP and its per capita
	Rate of growth of GNP
	Ratio of investment to GNP
	Income inequalities
4. Technological factors	
	Level of technical skills
	Existing manufacturing technology
	Amount spent on R&D as percentage of GNP
5. Socio-cultural factors	
	Dominant values
	Life style patterns
	Ethnic groups
	Linguistic fragmentation
6. National priorities	
	Industry priorities
	Infrastructure priority plans

can be obtained inexpensively. Location is also important because host country citizens prefer locally produced products. Indians, for example, prefer to "be Indian and buy Indian". Imported goods may be subject to tariff restrictions. Besides, an MNC may already be doing so much business in a country that the local government will insist that it set up local operations and begin producing more of its goods internally. This is one of the reasons why Japanese auto manufacturers have started to establish operations in the US. Finally, competitors in a host country may not exist, or competition may be less intense. In either case, an MNC finds it more advantageous to do business in a foreign country.

Although the benefits are many, there can be serious drawbacks associated with locating operations overseas. An unstable political climate may leave an MNC vulnerable with low profits, bureaucratic red tape, and even expropriation as happened in Liberia and Kuwait. MNCs confront alien cultural, social, demographic, political, economic and competitive forces when doing business internationally. These forces can make communication difficult between home office and subsidiaries. Finally, weaknesses of competitors in foreign lands are often overestimated, and strengths are frequently underestimated. Keeping informed about the number and nature of competitors is more difficult when doing business in overseas countries.

Ownership Ownership of international operations has become an important issue in recent years. There are a number of forms of ownership in international operations. The most common ownership patterns are joint ventures, alliances, mergers and acquisitions, and new facilities. Depending on the region of the world, some patterns are more popular than others. In Australia and New Zealand, for example, alliances are more popular while in China, joint ventures are widely used. However, the most widely recognised approaches are wholly owned subsidiaries acquired through mergers and acquisitions, joint ventures, licensing agreements, franchising, and basic export and import operations.

Functional Strategies Functional strategies are used to coordinate operations and to examine that the strategies are implemented effectively. While the specific functions in MNCs vary, they typically fall into five major areas: marketing, manufacturing, finance, technology, and human resources. These functional strategies are considered in detail in the latter part of this book.

Evaluation and Control

The final phase in international strategic management is evaluation and control. The strategy formulation and implementation process are a prelude to evaluation and control. Evaluation (control is implied) involves an examination of the MNC's performance for the purpose of determining (1) how well the organisation has done, and (2) what corrective actions should be taken in the light of this performance.

Strategy evaluation includes two basic activities: (1) assessing the actual results and comparing them with the expected ones, and (2) taking corrective actions to ensure that performance conforms to plans.

Strategy evaluation can be a painful and sensitive task. Too much emphasis on evaluating strategies may be expensive and counter productive. No one wants to be evaluated too closely. At the same time, too little or no evaluation can create even worse problems. Strategy evaluation is essential to ensure that stated objectives are being achieved. It is also important because MNCs face dynamic environments in which forces change quickly and dramatically. Success today is no guarantee for success tomorrow. An organisation should never be lulled into complacency with success. Firms experience demise as swiftly as they taste success. For example, IBM's profits dropped in 1993 to negative \$7.99 billion. Other companies that experienced net losses in the excess of \$1 billion in 1993 were Fort Howard and Eagle-Picher Industries.

Quantitative criteria are mainly employed to evaluate the performance of a firm. Quantitative criteria are mainly financial ratios that are used to make three critical comparisons: (1) comparing the firm's performance over different time periods, (2) comparing the firm's performance to competitors, and (3) comparing the firm's performance to industry averages. Some key financial ratios that are particularly useful as criteria for evaluation include:

1. Return on investment
2. Return on equity
3. Profit margin
4. Market share
5. Debt to equity
6. Earnings per share
7. Sales growth
8. Assets growth

Summary

- Strategic management refers to the process of scanning environment, formulating strategies, implementing the strategies, and evaluating their effectiveness. When this is done by an MNC, it becomes international strategic management. (LO1)
- An MNC can seek to achieve profitability through either or all of the four ways: acquiring or developing brands reaping experience curve benefits; realising location economies; and leveraging core competencies. (LO2)
- MNCs have four strategies predispositions: ethnocentricism, polycentricism, regiocentricism and geocentricism. They can pursue anyone of those. (LO3)
- Strategic management is a four step sequential process. The steps are: environmental scanning, strategy formulation, strategy implementation and evaluation and central. (LO4)

Review Questions

1. What is strategic management? How is it important for an international business? (LO1)
2. Describe the international strategic management process. (LO4)
3. Describe how international businesses formulate their strategies. (LO4)
4. Describe how international businesses evaluate and control effectiveness of their strategies. (LO4)
5. How is environmental scanning useful to international business? (LO4)

Discussion Questions

1. What are the basic differences between a domestic strategy and an international strategy? (LO1)
2. Should the same managers be involved in both formulating and implementing international strategy, or should each part of the process be handled by different managers? Why? (LO4)
3. Study mission statements from several international businesses. How do they differ, and how are they similar? (LO4)

4. Identify products you use regularly that are made by international firms which use the three different business strategies. (LO1)

Reinforcing Excercises

- N. Chandrasekaran's (CEO of TCS) initiative has paid off handsomely. At his instance, TCS was split into 23 SBUs, each unit with a HR, finance and other functions attached to it. Each SBU is headed by a leader, who is responsible for its profits. Each unit runs as a profit centre but draws on the strength of TCS's scale.
  This strategy turned managers into entrepreneurs, and ensured that TCS remained nimble even though it is the largest among Indian IT firms. There is a clear mandate to all 23 SBUs to embrace and embed digital into the industries they serve. Find parallels to the strategic initiative taken by TCS.
- Samsung Electronics is one MNC which swears by ethnocentrism in its policies and actions. Yet it is the most successful company and is striving to become more competitive to beat the likes of Google, Microsoft and Apple.
  In a few years Samsung has become the world's most valuable and largest consumer electronics firm. It has done this through an unrelenting focus on execution and being the "fastest follower". The Korean national traits of discipline, observance of protocol, competitive spirit, long term orientation and suspicion of foreigners have created a formidable and focused company. It is highly insular, with virtually all senior executives and board members being Korean albeit many with extensive international experience.
  Why then praise geocentric approach when ethnocentricism has proved successful in Korea? Japan and China?

CLOSING CASE 1

Late Mover Advantage?

Though a late entrant, Toyota is planning to conquer the Indian car market. The Japanese auto major wants to dispel the notion that the first mover enjoys an edge over the rivals who arrive late into a market.

Toyota entered the Indian market through the joint venture route, the partner being the Bangalore based Kirloskar Electric Co. Known as Toyota Kirloskar Motor (TKM), the plant was set up in 1998 at Bidadi near Bangalore.

To start with, TKM released its maiden offer—Qualis. Qualis is not a newly conceived, designed, and brought out vehicle. Rather it is the new *avatar* of Kijang under which brand the vehicle was sold in markets like Indonesia.

Qualis virtually had no competition. Telco's Sumo was not a multi-utility vehicle like Qualis. Rather, it was a mini-truck converted into a rugged all-purpose van. More importantly, Toyota proved that even its old offering, but decked up for India, could offer better quality than its competitor. Backed by a carefully thought out advertising campaign that communicated Toyota's formidable global reputation, Qualis went on a roll and overtook Tata Sumo within two years of launch.

Sumo sold 25,706 vehicles during 2000–2001, compared to a 3 per cent growth over the previous year, compared to 25,373 of Qualis. But during 2001–2002, it was a different story. Qualis had been clocking more than 40 per cent share of the market. At the end of Sept 2001, Qualis had sold over 25,000 units, compared to Sumo's 18000 plus.

The heady initial success has made TKM think of the future with robust confidence. By 2010, TKM wants to make and sell one million vehicles per year and garner one-third share of the Indian market.

The firm is planning to introduce a wide range of vehicles—a sub-compact, a sedan, a luxury car and a new multi-utility vehicle to replace Qualis. A significant percentage of the vehicles will be exported.

But Toyota is not as lucky in China. Its strategy of 'late entry' in China seems to have back fired. In 2005, it sold just 1,83,000 cars in China, the fastest growing auto market in the world. Toyota ranks ninth in the market, far behind Volkswagen, General Motors, Hyundai and Honda.

Toyota delayed producing cars in China until 2002, when it entered a joint venture with a local company, the First Auto Works Group (FAW). The first car manufactured by Toyota-FAW, the Vios, failed to attract much of a market, as, despite its unremarkable design, it was three times as expensive as most cars sold in China.

Late start was not the only problem. There were other lapses too. Toyota assumed the Chinese market would be similar to the Japanese market. But Chinese market, in reality, resembled the American market.

Sales personnel in Japan are paid salaries. They succeeded in building a loyal clientele for Toyota by providing first-class service to them. Likewise, most Japanese auto dealers sell a single brand, thereby ensuring their loyalty to it. Japan is a relatively a well-knit country with an ethnically homogeneous population. Accordingly, Toyota used nationwide advertising to market its products in its home country.

But China is different. Sales people are paid commissions and most dealers sell multiple brands. Obviously, loyalty plays little role in motivating either the sales staff or the dealers, who will ignore a slow selling product should a more profitable one turn up. Besides, China is a large, diverse country. A standardised ad campaign will not do. Luckily, Toyota is learning its lessons.

Competition in the Chinese market is tough, and Toyota's success in reaching its goal of selling a million cars a year, by 2010, is uncertain. But, its chances are brighter as the company is able to transfer lessons learned in the American market to its operations in China.

Questions

1. Why has the 'late comer's strategy' of Toyota failed in China, though it succeeded in India?
2. Why has Toyota failed to capture the Chinese market? Why is it trailing behind its rivals?

CLOSING CASE 2

Huge and Eternal!

Certain features look outlandish with this Korean Chaebol – Samsung. It forays into dozens of unrelated industries, from microchips to insurance. It is family controlled and hierarchial; prizes market share over profits; and has an opaque and confusing ownership structure. The CEO, Lee-Kun-Lee, has built a personality cult around himself. The man believes in keeping things shaken up. "Change everything, but your wife and children" he exhorted managers in 1993. Three years later, he lit a bonfire of 150,000 gadgets because some were defective. Samsung has exited older managers and restructured its divisions over the past two years despite posting record profits even amidst global financial crisis. Samsung is one of the conglomerates which first prospered in part, thanks to their close ties with an authoritarian government.

But facts speak differently and loudly. Started as a small noodle business in 1938, Samsung swelled into a network of 83 companies that account for a staggering 13% of South Korea's exports. Last year' sales revenues stood at $135 bn. From stylish phones to semi-conductors, from

DRAM to digital TVs, Samsung encompasses a variety of businesses that harness speed, creativity and efficiency to invent, develop and market the products that are defining how we live today. With more than a quarter of Samsung employees engaged in research and development, each vertical is focused on discovering new technologies, products and services that will open a new world of possibilities for the people who use them.

Affiliated companies: Samsung is comprised of the following affiliates:-

Electronic: Samsung Electro-Mechanics; Samsung SDI; Samsung Corning Precision Materials; Samsung SDS; Samsung Mobile Display; Samsung LED

Machinery & Heavy Industries: Samsung Heavy Industries; Samsung Techwin

Chemical: Samsung Total Petrochemicals; Samsung Petrochemicals; Samsung Fine Chemicals; Samsung BP Chemicals

Financial Services: Samsung Life Insurance; Samsung Fire & Marine Insurance; Samsung Card, Samsung Securities; Samsung Investment Trust Management; Samsung Venture Investment

Other Affiliated Industries: Samsung C&T Corporation; Samsung Engineering; Cheil Industries; Samsung Everland; The Shilla Hotels & Resorts; Cheil Worldwide; S I Corporation; Samsung Medical Centre; Samsung Economics Research Institute

Affiliated Organisations: Samsung Human Resources Development Centre; Samsung Lions; The Ho-Am Foundation; Samsung Foundation of Culture; Samsung Welfare Foundation; Samsung Life Public Welfare Foundation

Star of Samsung is Samsung Electronics, which started out making chunky transistor radios, but is now the world's biggest technology firm, measured by sales. It makes more televisions than any other company. Whatever and wherever Samsung lays its hands, it shall be the world number one.

Samsung is an admirable company packed with full of individual successes. Any practitioner or an academic should read and emulate what Samsung thinks and does. No wonder, China sends emissaries to study what makes Samsung tick in the same way that she sends her bureaucrats to learn efficient governance from Singapore. To some, Samsung is the harbinger of a new Asian model of capitalism. It ignores the Western conventional wisdom, in terms of ownership pattern, product-focus, organisational structure and boss-subordinate relationship.

Samsung is prodigiously creative, atleast in terms of making incremental improvements to other people's ideas: only IBM earns more patents in America. Having outstripped Japanese conglomerates like Sony, Samsung is rapidly becoming prototype of GE, the American monolith so beloved of management gurus.

Is Samsung sitting pretty? No. It wants to be huge and eternal. Towards this end, the conglomerate is strategising several things. Mr. Lee Kun-Lee is clear and has told his executives—"The majority of our products today will be gone in ten years". To survive, he said, the company must not only go into the new businesses it has identified, but open itself to work with partners and even make acquisitions.

Samsung's success comes from spotting areas that are small but growing fast. Ideally, the area should also be capital-intensive so that rivals wouldn't catch up. The firm believes in scaling up so as to gain price advantage and become key customer for equipment manufacturers. Samsung believes in buying and not owning technology. This makes it assume execution risk and not innovation risk.

Samsung has a foot in both rich and poor countries. While it has also produced products for Western consumers, it has aimed products at poor countries also. This not only gave Samsung scale, but also market shares in the world's fastest growing economics. Whereas Western firms reeled in the recent recession, Samsung flourished, buoyed by sales in markets that never stopped growing.

Samsung intends foray into five new businesses (see the table below) and by 2020, these five verticals are expected to generate \$150 bn revenue. It is an ambitious plan and a brash goal indeed, but 10 years ago the turnover was \$23 bn but aimed at \$100 bn in eight years hence and this has been accomplished.

Probably, Samsung needs to tread cautiously. Guts and luck have favoured the Korean firm till now. But everything Samsung has tried has not been successful, for example, cars. The greatest danger for any family-controlled business is the transfer of leadership to the next generation. Samsung passed this test in 1987 when the founder handed over to his son, Lee Kun-Lee. Now Lee's son, Jay Y. Lee, has been appointed COO of Samsung Electronics and a new transition looms. If Lee, the third has business acumen Samsung prospers. If not, the whole country could suffer.

Reliance on infotainment is not what other giants are doing. Many of today's computer and electronics giants are getting out of manufacturing business altogether. IBM has shifted to services, while Philips and Siemens both sold their IT businesses to focus on other areas. Getting out at the right time is not in the DNA of Samsung. This is one of the lessons Samsung needs to learn and practice.

Some of the proposed five new businesses are me-too lines and not unique and distinct. Its experience in semi-conductors and flat-screen televisions fits easily with solar cells and LED lighting: the technology, materials and production processes are similar. Likewise, its expertise in batteries for gadgets smooths the way for making car-sized ones. Samsung wants to apply the magic of ever cheaper chips to medical services as did in mobile phones. Even drugs are not so far a-field when one looks at them in business process terms: high-volume manufacturing with low defect rate. Samsung firmly believes it can be a leader in all of these. Is optimism backed by past success real or misplaced vim.

Fresh fields
Samsung's new business areas

			Targets for 2020		
Sector	**Invest., $bn**	**Ownership**	**Sales, $bn**	**Jobs**	**Status**
Solar panels	5.1	100% Samsung SDI	8.5	10,000	Production began in January
LED lighting	7.3	50% Samsung Electronics,	15.2	17,000	Already selling in South Korea
		50% Samsung Electro-Mechanics			
E-vehicle batteries	4.6	40% Samsung Electronics	8.7	7,600	Initial operations began in November 2010
Biotech drugs	1.8	40% Samsung Everland,	1.5	1,000	Factory to begin in 2013; developing biosimilars now for patents expiring in 2016
		10% Samsung C&T			
		10% Quintiles			
Medical devices	1.0	100% Samsung Electronics	8.5	10,300	Blood-testing unit available, X-ray machine ready in 1-2 years, acquired Ultrasound maker

Questions

1. Are Samsung's strategies to foray into the five businesses sound?
2. Is Samsung's optimism to sit at the top in the proposed businesses backed by past success or misplaced vim?

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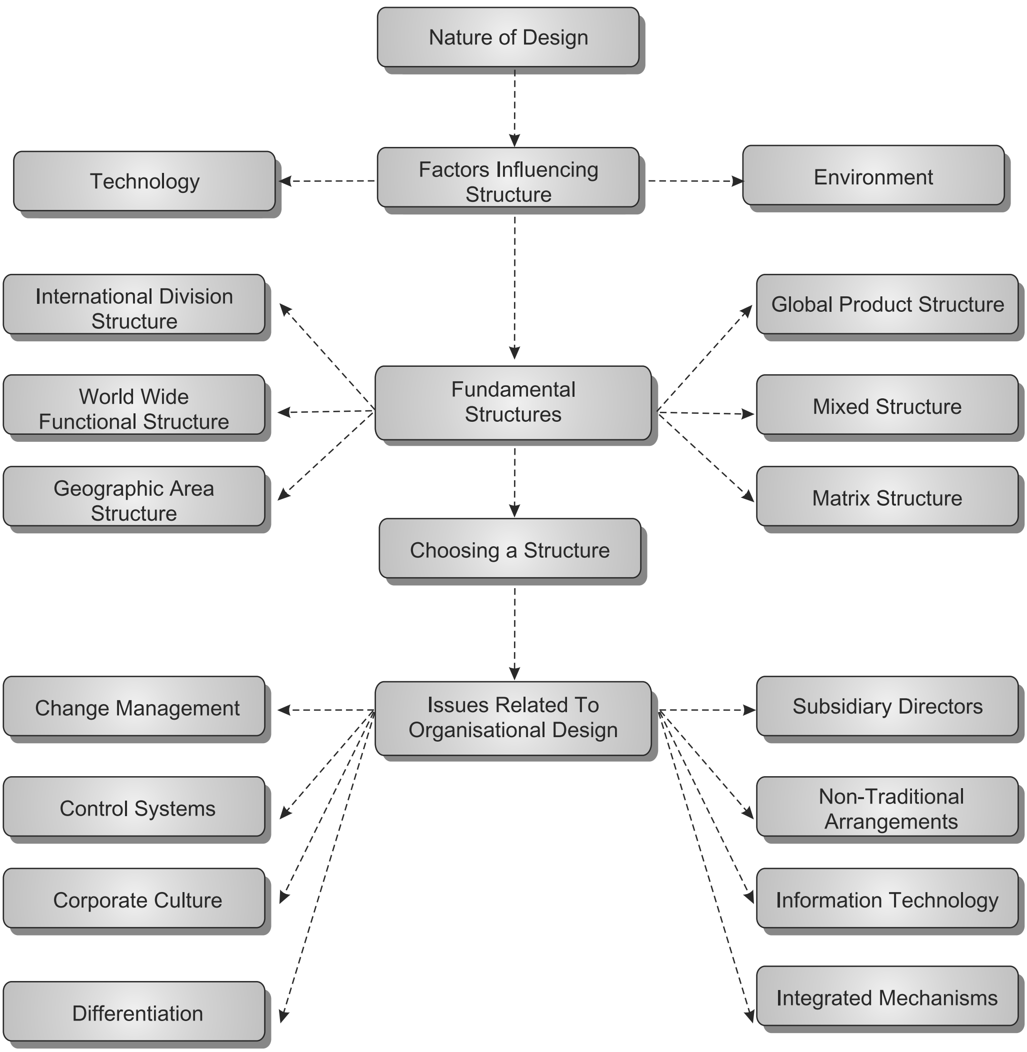
CHAPTER


Nature of Design
Factors Influencing Structure
Technology
Environment
Fundamental Structures
International Division Structure
World Wide Functional Structure
Geographic Area Structure
Global Product Structure
Mixed Structure
Matrix Structure
Choosing a Structure
Issues Related To Organisational Design
Change Management
Control Systems
Corporate Culture
Differentiation
Subsidiary Directors
Non-Traditional Arrangements
Information Technology
Integrated Mechanisms

12

International Organisational Structure

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Recognise the nature of international organisational design
- **LO 2:** Classify the factors influencing organisational structure
- **LO 3:** Identify the basic organisational structures
- **LO 4:** Assess the choices made while choosing a structure
- **LO 5:** Interpret the related issues in global organisational design

Opening Case

The More it Wants to Change, the More it Remains the Same

Here is a 150-year old company, going strong. Business lines and structures might have changed over a long period, but its culture almost remains the same. We are referring to Siemens AG of Germany founded in 1847. As of now, the company has 360,000 employees in 190 countries manufacturing everything from hearing aids and medical scanners to giant power generation turbines, wind system, and locomotives. The engineering behemoth counts among the top 30 companies worldwide in the Fortune 500 index in terms of sales. Siemens also has a record of sort of paying a fine of $800 mn to the US government on a bribery scandal. It was against this background that Peter Loscher was brought in from outside in 2007 to clean up the organisation.

Structurally, Siemens was organised into 12 operating groups, which were further subdivided into 70 business divisions. Although each division had its own product focus, such as wind power or molecular imaging, Siemens worked hard to deliver integrated solutions to customers. This required the divisions to cooperate with each other on large projects.

Typical of German corporate culture, Siemens has been following decentralisation and compartmentalisation. Compared with American or Japanese MNCs which often centralise key functions and use foreign subsidiaries just for a limited set of tasks, German multinationals tend to give a lot of autonomy to local executives – the argument being that they usually sell complex technical products with a need for a high level of customer – for specific local adaptation.

The countries where the company was most active had their own executive managers. These individuals acted as the country managers for all of Siemens' business in specific geographies, and were also the CEOs of the respective local companies. The operating group and business division structure was often replicated within the local company. This resulted in a matrix structure, with the head of the power generation business in Argentina, for example, reporting to the local country CEO and to the global head of the business division.

It was the responsibility of the local CEOs and their staff to manage relations with local customers, bid for new projects, and ensure that business divisions cooperated on the execution of the projects. Local companies were given significant discretion over product specifications for local clients. Thus, the local company in Argentina might bid on a subway project in Buenos Aires, tailor that bid to the needs of the local client, and if the bid was accepted, make sure that there was sufficient cooperation between the different business divisions in order to successfully complete the project.

Locher felt that the arrangement was good but complex. He felt that there were too many direct reports to the HQ, resulting in information overload. Plus, there was the problem of accountability. Suppose a project is not executed in time, who is to be held accountable – the local managers or the managers in the business divisions? Loscher believed that country managers had too much power in the structure, and the business divisions had too little and were not accountable enough.

Having understood the problem, Loscher started fixing it. In 2008, he changed the structure. The operating groups were consolidated into three main sectors – energy, industry and healthcare. He then placed business divisions within their respective sectors. Then the 190 country units were organised into 17 regional clusters and he gave them primary responsibility to develop a cost-effective regional infrastructure, focusing on customers and managing local sales organisations. Profit and loss responsibility was assigned to the sectors and business divisions. Previously, each operating group and national subsidiary had maintained their own separate profit and loss statements. This change sent shock waves to the local executives around the world, who were told that their goal was to contribute towards the global profit and loss accounts for a sector and business division. While not doing away with local responsiveness, Loscher had effectively reduced the power of country managers within the Siemens structure, making them directly responsible for boosting the profitability of the global business.

Loscher went further, instituting a management review process that led to the replacement of half of the company's top 100 managers. He is now directly involved in the appointment of the top 300 management positions in the company. He also took out two layers of top management that had no operational accountability in the previous structure. His aim in doing all these seems to have been to replace managers who did not buy into a new way of doing things, and to increase the performance accountability of the people who ran sectors and business divisions.

Peter Loscher set an ambitious target for himself to increase annual revenue of Siemens to $135 bn. Siemens began accepting orders it could not complete on time and on budget, and began missing profit targets. In July 2013, Loscher was removed and in his place came in Kaeser. Unlike Loscher, Kaeser is a long-time *Siemensianer*. On assuming office, Kaeser faced three challenges: to slim the company's bureaucracy, fine-tune its portfolio and executive projects better. He has made a good start on the first and some progress on the second. The third will take time.

At times, Siemens conforms to a German stereotype of valuing processes at the expense of results. In keeping the pattern, Kaeser began a reorganisation. This will affect 11,600 jobs. He hopes to redeploy many of the workers concerned, though some will have to go. Laying off is a part of the reorganisation plan.

Long-lived companies change fast overtime. Nokia, for example, began in 1865 as a pulp mill, recently it sold its mobile-phone business to Microsoft, and now it mainly makes network equipment. But Siemens goes by the saying – the more one changes, the more it remains the same. When asked to sum up his business in one word, Kaeser says "electrification". However, he desires to add two more – automation and digitisation. But the reconfiguration of Siemens is a huge project and its position at the heart of Germany's industrial economy makes change at home sensitive.

MOTOROLA'S share in the worldwide cellular market has been, of late, declining. In an effort to reverse the trend, the MNC has now committed itself to an increased presence in Europe and Asia. For example, the company recently decided to build a \$150 million plant in Germany. The company has also decided to expand operations in Asia, notably in China, Korea, the Philippines, and Taiwan. Simultaneously, Motorola has been restructuring its overall worldwide operations in order to increase efficiency and cut down costs. The company has recently merged half dozen separate businesses into two huge divisions, one focusing on consumers and the other on infrastructure equipment. Motorola hopes that this new organisational arrangement will help it better adapt to the global market which is becoming more competitive.

Xerox is another example of worldwide reorganisation of operations. It intended to cut 9000 jobs by the begining of 21st Century with a view to trim costs. It has plans to replace traditional copiers by less expensive digital ones. If the company continues to manufacture high cost traditional copiers, it will definitely lose out to its competitors.

Shell, Motorola and Xerox are not isolated instances but are indicative of the trend to show how MNCs are reorganising their operations to compete more effectively in the international arena.

Nearer at home, several companies are restructuring themselves in a big way. Hindalco, the flagship of the AV Birla group took over Indo Gulf recently in order to restructure itself and build a global non-ferrous metals company. With the augmented balance sheet, Hindalco has plans to bid for National Aluminium Company (NALCO). Grasim and Indian Rayon, in the same group, have also undergone restructuring.

NATURE OF INTERNATIONAL ORGANISATIONAL DESIGN

LO 1
Recognise the nature of international organisational design

As stated above, an MNC needs an appropriate organisational structure to implement its strategies. Organisational structure (often called organisational design) is its basic vehicle through which strategy is implemented and through which the work of the organisation is actually implemented. In fact, strategy, determines the structure needed for implementation.

A firm cannot function unless its various structural components are appropriately assembled. Through its design, the firm shall:

- allocate organisational resources;
- assign tasks to its employees;
- instruct employees about the firm's rules, procedures, and expectations relating to their jobs; and
- collect and transmit information necessary for problem solving and decision making.

The last task is particularly important for a large MNC, which needs to share vast amounts of information between corporate headquarters and subsidiaries worldwide.

Prominent MNCs such as IBM, General Motors, Mercedes, Mitsubishi, Xerox, and Royal Dutch/ Shell have sophisticated global structures. Some of these firms also have subsidiaries or affiliates that are integrated into the overall structure. For example, Mitsubishi has 28 core groups that are bound together by cross-ownership and other financial ties, inter-locking directorates, long-term business relationships and social and historical ties. Among these are Mitsubishi Bank, Mitsubishi Heavy Industries, Ashai Glass, Tokyo Marine and Fire Insurance, Nikon Corporation, and Kirin Brewery. Mitsubishi obviously needs a carefully designed global structure that allows it to integrate and coordinate the activities of these operations.

FACTORS INFLUENCING ORGANISATIONAL STRUCTURE

LO 2
Classify the factors influencing organisational structure

Several factors—popularly called contingency factors—influence organisational structure. The most significant of them are environment and technology (see Fig. 12.1).

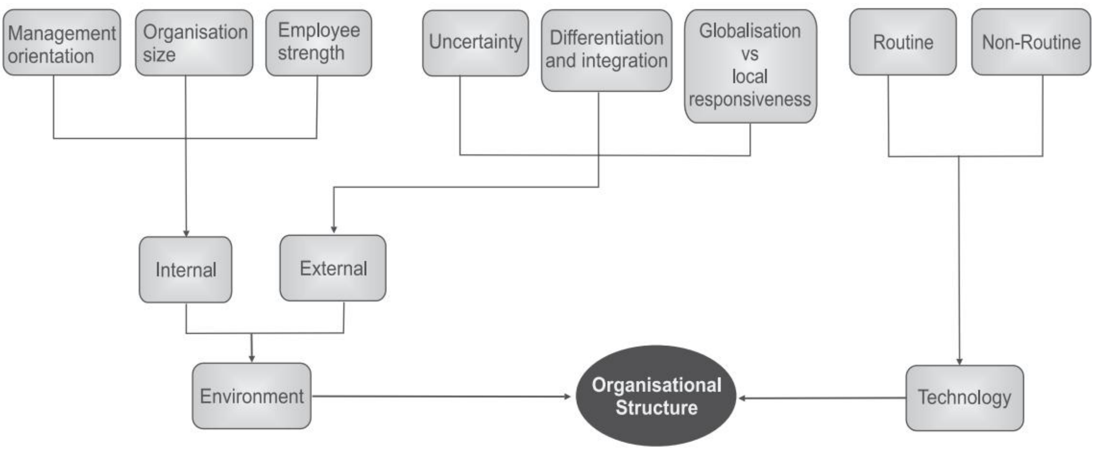


Fig. 12.1 Factors Influencing Organisational Structure

Environment

A structure needs to be so designed that it can accommodate both internal and external factors in the environment.

Internal Environment One internal factor that has its impact on organisational structure is its management orientation. *Ethnocentric* management orientation is characterised by strong control by the parent company. Its structure reflects strong centralisation in decision-making, and most of the managers are parent country nationals. *Polycentric* management allows decentralisation of authority and decision-making.

Managers in subsidiaries are mainly nationals of the host country. In *geocentric* management, the organisational design is cosmopolitan, with little concentration of decision-making or personnel with any particular nationality.

Size is another internal factor which has an impact on organisational structure. Regarding the impact of size on structure, four trends have been identified:

1. As organisations grow, they tend to add more departments and levels, making their structures increasingly complex.
2. Growing organisations tend to take on an increasing number of staff positions in order to help top management cope with the expanding size.
3. Additional rules and regulations tend to set in along with the increase in size. While such guidelines help achieve better coordination, the unchecked proliferation of rules and regulations may lead to excessive bureaucracy and reduced efficiency.
4. As organisations grow larger, they tend to become more decentralised.

Because of the potential effects of size, many companies try to ensure that their sub-units do not grow unwieldy.

Another internal factor that impacts organisational structure is the employee strength. When the number of employees increases, the company is likely to resort to more formalised ways of doing things. It becomes necessary to introduce policies, procedures, and systems, because one can no longer expect people to relate informally on a face-to-face basis in the efficient execution of tasks.

External Environment External environment comprises a host of forces such as customers, suppliers, shareholders, competitors, regulatory agencies, financial markets, human resources markets, physical resources, and cultural influences. It would be impracticable for an organisation to explore every minute aspect of its environment. The preferred course of action is for the organisation to monitor carefully those aspects of its environment that are significant, and respond accordingly. The response could include modification or change in organisational structure.

The following deserve serious consideration when we talk about external environment:

- Environmental uncertainty.
- Differentiation and integration.
- Pressure for globalisation or local responsiveness.

Environmental Uncertainity The environment of a firm can be uncertain or may fit into a stable pattern. This characteristic of the environment has the most profound effect on organisational structure. A firm that operates in a highly unstable and uncertain environment tends to have *organic characteristics* such as decentralised decision-making, fewer rules and regulations, and both hierarchical and lateral communication channels. Much of the emphasis is on horizontal coordination, with considerable delegation from one level to the next. These features are necessary as the fast changing environment makes it necessary for individuals at any level to monitor the external forces and help decide how to respond.

In contrast, a firm operating in a stable environment tends to have relatively *mechanistic characteristics*, such as highly centralised decision-making, many rules and regulations, and mainly hierarchical communication channels. Much of the emphasis is on vertical coordination but with very little delegation down the line.

Figure 12.2 compares the structural dimensions of the mechanistic and organic designs. It may be noted from the figure that the two structures—organic and mechanistic—represent opposite ends of a continuum of organisational design possibilities. But in reality, a firm must make adjustments for the realities of its environment while designing its structure.

Differentiation and Integration The impact of environment on organisational design can be extened from the firm as a whole to its different units. Viewed from this perspective, two features of organisation emerge—differentiation and integration.

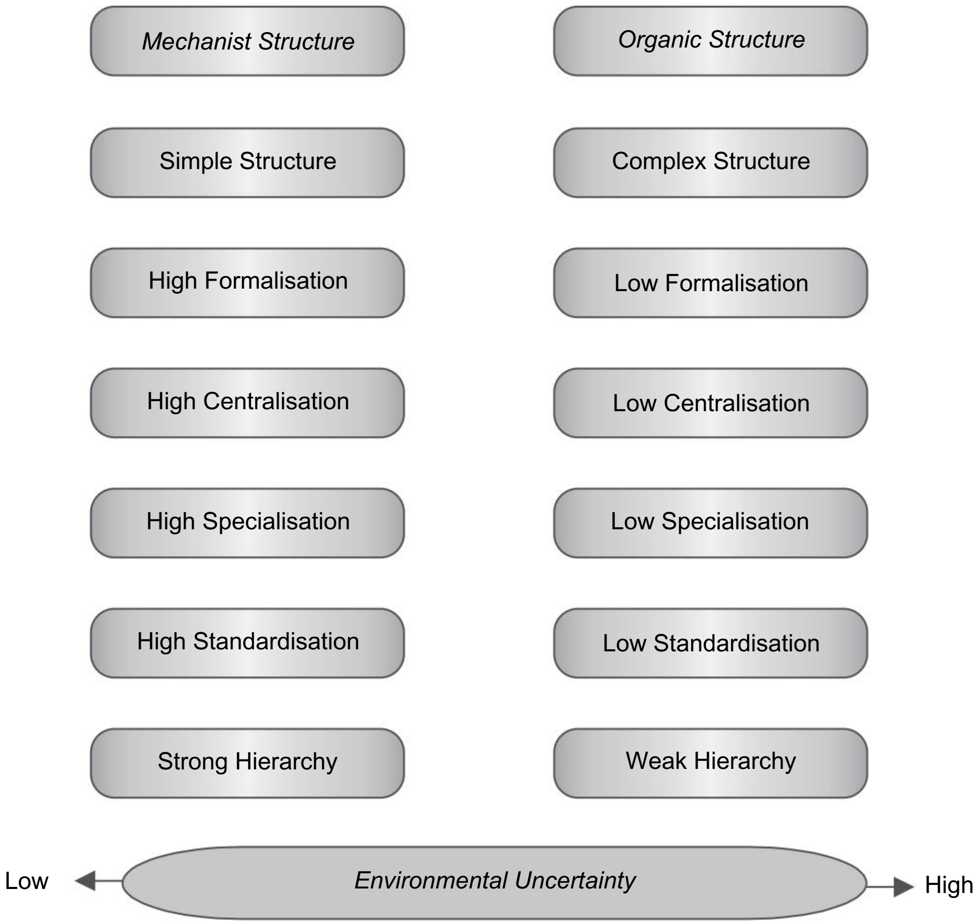


Fig. 12.2 Relationship between Environmental Uncertainty and Organisational Structures

Differentiation means that within an organisation, there are departments, each of which positions itself with respect to its own relevant external environment. A finance department looks at the environment from the perspective of cash inflows, interest rates, exchange rates, financial markets, and the like. The sales department is worried about sales volumes, collections, customers, products, and the like. A danger with highly differentiated organisation is that departments might become independent islands and function in ways detrimental to the achievement of overall objectives. Hence there is need for co-operation and collaboration.

Where there is insufficient co-operation, integration becomes necessary. Integration ensures co-operation among different departments. In conditions where environments are unstable there is a greater differentiation among departments. Greater the differentiation, greater the need for integration. This is what most successful international businesses do. General Motors, for example, was formed with twenty five different companies. Each company operated in its own way, made its own decisions, and made its own range of cars. A high level differentiation, obviously. When Alfred P. Sloan took over as president of GM, the first thing he did was to bring about integration, a strategy which proved to be successful.

Pressure for Global Integration or Local Responsiveness There are pressures for globalisation and also compulsions to respond to local needs. Based on these two dimensions—global integration and local responsiveness—four strategies emerge: multi-domestic strategy, international strategy, global strategy, and transnational strategy.

Implications of each strategy were explained in the previous chapter. Suffice it is to state that firms pursuing multi-domestic strategy tend to adopt worldwide area structure, international strategy that of product division structure, trans-national strategy that of matrix structure, and global strategy that of worldwide product division structure.

Technology

Another factor which has profound impact on the organisational design of an MNC is technology. In Chapter 9, we discussed how technology facilitate internationalisation of business. Here the focus of discussion is on the impact of technology on organisational designs of international businesses.

Within an organisation, technology exists at three levels: individual, departmental, and organisational. At the *individual level*, technology is the personal skills and knowledge employees possess. At the functional or departmental level, the procedures and techniques that groups use to perform their work and create value constitute technology. At the *organisational level*, technology refers to the efforts and machinery used to convert inputs to outputs.

An international business takes inputs from the environment and creates value from the inputs by converting them into output through a conversion process (see Fig. 12.3). Generally, technology

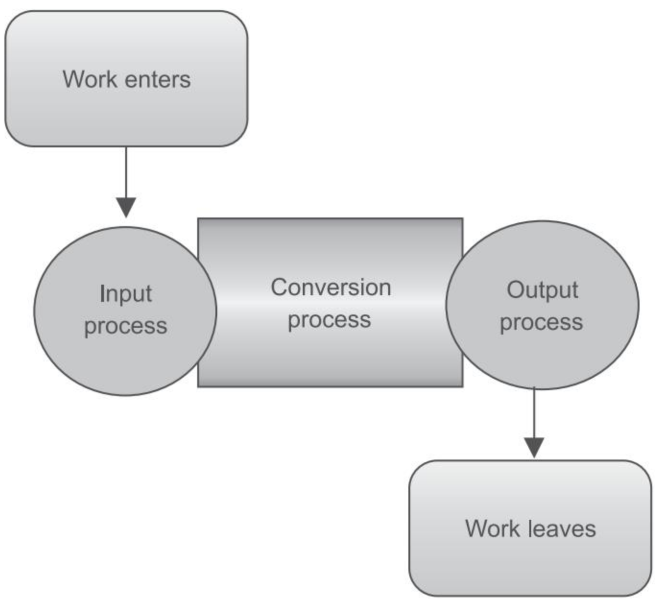


Fig. 12.3 Input Conversion and Output Process

is perceived to exist only at the conversion stage. This is not true. It is present in all organisational activities: input, conversion, and output.

At the *input stage*, technology—skills, procedures, and techniques—allows each department to handle relationships with outside stakeholders so that the firm can manage its specific environment. The human resource department, for example, has techniques such as interviewing procedures and psychological testing that it uses to hire the right people for the right jobs. The finance department has techniques for obtaining funds at lower costs.

At the *conversion stage*, technology—a combination of machines, techniques, and work procedures—transforms inputs into outputs. The best technology adds value to the conversion process, in addition to completing the process.

At the *output stage*, technology allows an organisation to effectively dispose of finished goods and services to customers. To be effective, a firm must possess techniques for testing the quality of the end product, for marketing it, and for rendering post-sale service.

Dimensions of Technology In the context of the impact of technology on organisational design, two dimensions of technology are observed: routine technology and non-routine technology.

Routine Technology When technology is *routine*, employees perform clearly defined tasks according to set rules and procedures. The work process is programmed in advance and is highly standardised. Because of the standardised work process, employees only need to learn the procedure for performing the task effectively. Decision-making is centralised and routine technology tends to have mechanistic structure.

Non-Routine Technology Firms operating with *non-routine technology* face a different set of factors that affect the design of the organisation. Here tasks become less routine and more complex. Consequently firms need to develop a structure (mostly organic) that allows employees to quickly respond to and manage an increase in the number and variety of exceptions and develop new procedures to handle new problems. Decision-making is decentralised. Organisational structures tend to be flat.

Till now we have examined the impact of environment and technology on organisational design. Do the same factors influence the organisational design of an international business? The answer is 'yes'. MNCs, in general, tend to organise their international operations in the same way as they do for domestic functions. If the MNC tends to have high formalisation, specialisation, and centralisation at its home-based headquarters, these organisational characteristics may occur at its overseas subsidiaries as well. Rarely does, organisational structure of a foreign subsidiary converge with local customs. In fact, the major challenge for international managers in the years to come is to bring synergy between the organisational structure of an overseas subsidiary with local customs and cultures.

BASIC ORGANISATIONAL STRUCTURES

LO 3
Identify the basic organisational structures

Coming to specific organisational structures, it may be stated that an MNC can adopt any of seven fundamental structures. These are international division structure, worldwide functional organisation, geographic area organisation, product organisation, matrix structure, and networked structure.

International Division Structure In the international division structure, the overseas unit is an adjunct to the parent company. It handles all the international activities, which may be organised by function, product or geographic area. All of the overseas subsidiaries are under the authority of the international division head (usually vice-president), who coordinates the overseas activities. The international division allows the MNC to concentrate resources and create specialised programmes and activities targeted on international operations, while simultaneously keeping such activities segregated from the firm's on-going domestic activities. As the overseas activities are under one head, control and communication are easy. The structure can also respond quickly to the changes in the international business environment. Use of this structure has drawbacks too. The structure separates the domestic and international managers, which can result in two different camps with divergent objectives. As overseas operations expand and diversify, this design fails to cope with the new demands. Finally, most research and development efforts are domestically oriented, so ideas for new products and process in the international market are given low priority. Figure 12.4 illustrates the international division structure.

Until recently, Coco-Cola used an international division design through which the soft drink giant conducted its bottling plant all over the world. Brazil's Banco Economico SA, the oldest private bank in Latin America also uses the international division approach. Nearer at home, Titan has divisional structures.

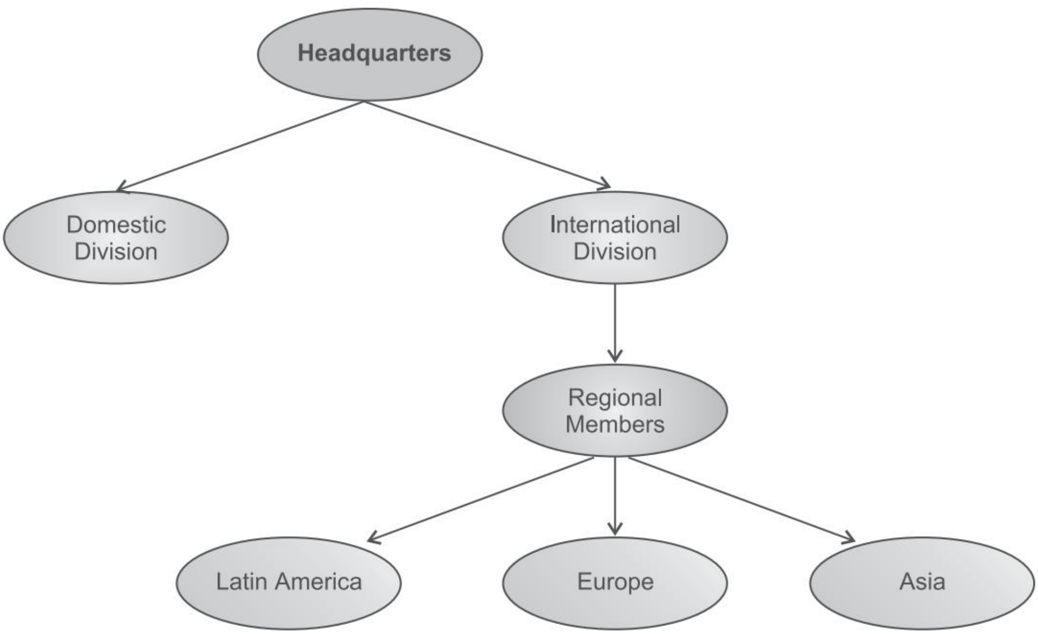


Fig. 12.4 International Division Structure

Worldwide Functional Structure In this, each functional department or division is responsible for its activities around the world. For example, the manufacturing department is responsible for worldwide manufacturing activities, so also with finance, marketing, R&D, and human resource management. This design is used by MNCs that have narrow or similar product lines. It results in what is often called a U-form organisation, where U stands for 'Unity'. Figure 12.5 illustrates the functional structure. British Airways is the best example for the U form of organisation design.

British Airways is essentially a single business firm (it provides air transport services) and has companywide functional operations dedicated to marketing and operations, public affairs, engineering, corporate finance, human resource, and other basic functions.

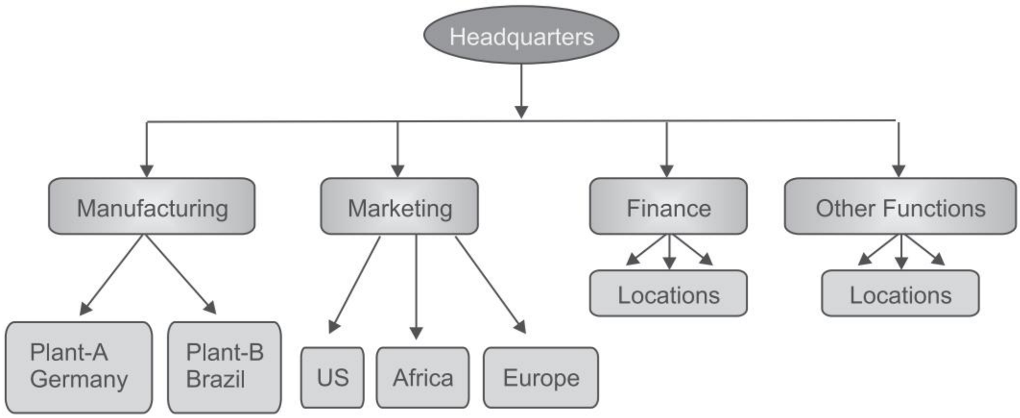


Fig. 12.5 Worldwide Functional Structure

Since each functional area deals with global market, specialisation and concentration of functional expertise can be taken advantage of. Control of various functions can be exercised relatively easily. The global functional design focuses attention on the key functions of the firm. Managers can easily isolate a problem in marketing and distinguish it from activities in other functional areas.

Geographic Area Structure In this, worldwide activities are organised by dividing the globe into different geographic areas. The regional manager, as the vice-president of each area is responsible for all business activities within that geographic area. (See Fig. 12.6)

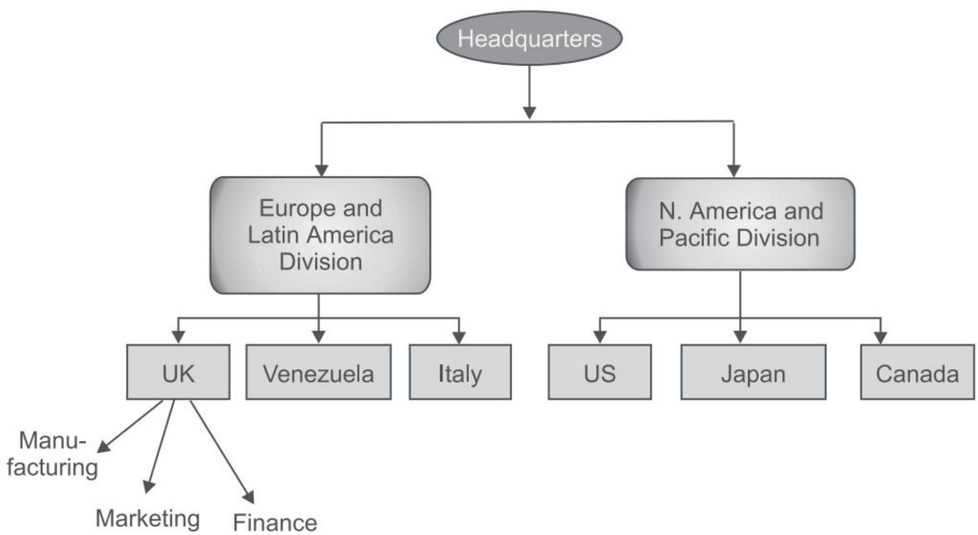


Fig. 12.6 Geographic Area Structure

A geographic division can respond to the market conditions of a particular area much more effectively than any other structure. In the US, soft drinks have less sugar than in South America, so the manufacturing process must be slightly different in these two locales. Similarly, in England, people prefer bland soups, but Indians enjoy soups with lots of spices. In Turkey, Italy and Spain, and Portugal, people prefer a milder and sweeter blend. Geographic division can respond to these preferences in tastes easily.

However, as there are different divisions covering different areas, there may be duplication of functions. There is also the problem of lack of communication among divisions. Diffusion of technology is slow as innovations generated in one division (area) may not be adopted quickly by others. Hence, this arrangement is not suitable for products undergoing rapid technological changes. It is because of these disadvantages, Ford abandoned its global area structure in favour of a global function design.

A geographic area structure is most likely to be used in a firm whose products are not easily transferable across regions. This approach is particularly useful for firms with a polycentric corporate philosophy as is the case with Nestle. Cadbury Schweppes PLC, a British soft drink and confectionary firm, also uses the global area division. Cadbury owns brand names such as McRobertsons, Pascall, Tarax, Canada Dry, Barons Table, Cadbury Chocolate, and Ped Tulip. The firm has five basic divisions, each representing a different area of the world—the UK, Europe, the Pacific Rim, North and South America and other countries. Executives in each division handle distribution, promotion, advertising, and other functions for all Cadbury. Ranbaxy in India has a geographic area structure. The company has divided the world into four regions—India and the Middle East, Europe CIS and Africa, the Asia Pacific and America. Schweppes products that fit their particular markets.

The geographic area structure is particularly suitable for a firm whose strategy is marketing-driven rather than dependent on manufacturing efficiencies or technological innovation, or a firm whose competitive strength lies in the reputation of its brand. In particular, this structure is said to find more acceptance among European MNCs, such as Nestle, than among transnational firms of the US, because of the dominance of the US domestic market.

Product Organisation This is the most common organisational structure followed by an MNC. The product design assigns worldwide responsibility for specific products or product groups to separate operating divisions within a firm. As Fig. 12.7 shows, the manager who is in charge of product division has authority for this product line on a global basis.

The global product divisions operate as profit centres. Managers of product divisions run the operations with considerable autonomy. They have the authority to make important decisions. But, corporate headquarters usually maintain control in terms of budgetary constraints and home-office approval for key decisions.

Product structure works best when the firm has diverse product lines or its product lines are sold in diverse markets, as for example, Daimler-Chrysler (See Exhibit 12.1 for details), or even Motorola. HUL is an Indian firm which has product structure.

A number of benefits are associated with the global product design. If the firm produces a large number of diverse products, the structure allows each major product line to focus on the specific needs of its customers. This would be difficult to achieve if the firm were trying to sell all their products out of one centralised marketing department. This approach also helps develop a cadre of experienced well-trained managers who understand a particular product line. A third benefit of the product structure is that it helps the company match its marketing strategy to the specific needs of the customer. For instance, in some areas of the world a product may be in the introduction stage, while in other parts, it may be the growth, maturity, or decline stage. These differing life-cycles require close technological and marketing coordination between the home market and the foreign market, and this can be best achieved by a product division approach. Fourth, the product division facilities efficiencies in manufacturing as

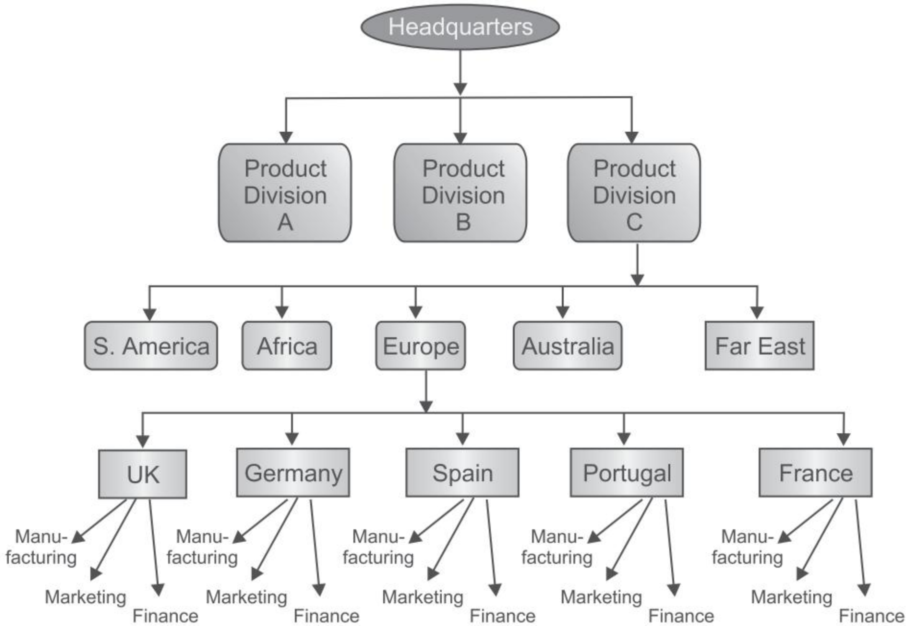


Fig. 12.7 Global Product Division

Exhibit 12.1

DAIMLER—MORE THAN MERCEDES

Daimler-Chrysler is Germany's largest firm. Many people associate it with its line of luxury vehicles, the Mercedes. However, today Daimler-Chrysler is far more than just a vehicle manufacturer, it is a worldwide diversified firm with business in everything from aerospace to insurance to software and mircoelectronics.

As Germany's economy boomed after the Second World War, demand for the firm's vehicles grew rapidly. Daimler-Chrysler exported vehicles and engines to virtually every market in the world. Further, its pricing strategy and the luxury image of its products largely protected it against economic downturns. However, Daimler-Chrysler also has encountered some problems. Motor vehicles have become more complicated. Managers realised that if they were to maintain the Mercedes image, they needed to look beyond mechanical excellence. They also had to contend with the growing threat posed by Japanese vehicle manufacturers.

Accordingly, Daimler-Chrysler manager developed a strategy that called for diversification. Mr Edzard Reuter, then chairman of the firm, spearheaded the formulation and implementation of this strategy. Starting in 1985, the firm bought several major new businesses, including Dornier (aerospace), AEG (electrical equipment), MTU (propulsion systems), and several others in the aerospace and services industries including an interest in Fokker, the Netherlands based aircraft manufacturer.

After this period of rapid acquisition, Daimler-Chrysler faced another challenge—how to bring the new businesses under the existing corporate 'Umbrella'. Managers quickly realised they couldn't do this. Instead, they had to restructure the entire organsiation to make it work more efficiently and effectively. After careful analysis, Reuter and his associates decided to organise Daimler-Chrysler into four basic groups. Under German law, Daimler-Chrysler AG became holding company consisting of four legally independent product groups.

One product group, called simply Mercedes-Benz is responsible for making passenger cars and commercial vehicles. Another product group, called AEG, handles industrial automation, rail systems and transportation technology, electrotechnical systems and components, electrical consumer products, microelectronics, and office and communications technology. The third product group, called Deutsche Aerospace, is responsible for the firm's aircraft, space systems, defence systems, and propulsion system operations. The fourth group, called Debis (for Daimler-Benz Inter Services), handles software, financial services, insurance, trading, and marketing services.

Unfortunately, the grand vision held by Edzard Reuter to create an integrated technology organisation has been plagued by a string of problems in recent times. This has included company scandals, structural difficulties, and massive losses for 1995–96 of DM 6 billion (about $4.8 billion). Daimler's estimated loss far exceeded even the most dire analyst's forecasts and is the biggest in German corporate history. These losses in part can be attributed to the poor growth of the German economy, but more specifically, about one-third of the loss was attributable to Fokker, which has been hard hit by falling demand for its smaller type of aircraft. The controlling interest in Fokker acquired in 1994 led to losses of over $500 million over a two-year period. The new chairman of Benz, Mr Schrempp, said the shareholders could no longer bear the brunt of keeping the company afloat and withdrew all support from the ailing company which effectively led to the collapse of Fokker and the loss of more than 7000 jobs in the Netherlands and a further 1200 in Germany. The chairman underscored the tensions between the Netherlands and Germany by saying that the reason for pulling out of Fokker was the lack of financial commitment from the Dutch Government. While Daimler-Chrysler's problems seem to stem more directly from poor investment strategies, its structure seems appropriate for an integrated technology organisation of this type.

(*Source*: Darrell Mahoney, et al, *op. cit*, p. 511)

managers are free to produce the products wherever manufacturing costs are the lowest. Finally, because managers possess extensive product knowledge, they are more able to incorporate new technologies into their product(s) and respond quickly and easily to technological changes that affect their market. (See also exhibit 12.2)

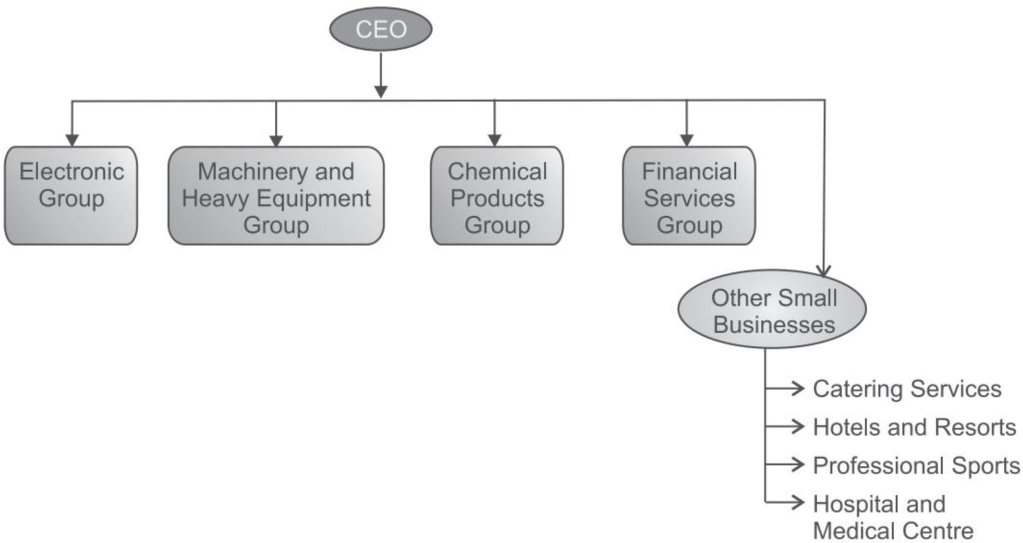
The potential drawbacks of the global product structures should not be lost sight of. First is the necessity of duplicating facility and staff personnel within each division. A second is that products that sell well are often given primary attention and those that need special handling and promotion are sidelined, even though this may result in loss in the long run. A third is that an effective product division requires executive who are knowledgeable about the worldwide demand for their products. Most managers know local markets more clearly than overseas markets. Finally, coordination among product groups becomes difficult, for example, the electronics division may decide to subcontract components to a plant in Germany, while the computer division is outsourcing from a company in France. If the two divisions had coordinated their activities, it would have been possible to subcontract to a single source at a lower price. Finally, lack of cooperation among the various product lines can result in lost sales, given that each division may have information that can be of value to another.

Exhibit 12.2

SAMSUNG'S CAMPUS

Samsung group is the largest business in Korea, with annual revenues of $133 billion and 220,000 employees. The electronics major has a global product structure as shown in the figure below.

The group is organised into five major divisions: electronics group, the machinery and heavy equipment group, chemical products group, financial services group and another group of small businesses. Each of these groups is independent and has little in common with others.



Mixed Structure Seldom will companies have all their activities organised on the structures described till now. Most firms follow a hybrid design which best suits their purpose as dictated by size, strategy, technology, environment, and culture. A company's managers start with the basic prototypes discussed till now, merge them, eliminate some pieces, and create new elements unique to their firm as they respond to changes in the organisation's strategy and competitive environment. This is the reason why the famous saying "Structure follows strategy" has emerged.

Most MNCs are known to follow hybrid structures. Philips, Sanyo, and Unilever are but only three instances. Unilever, the consumer products giant, uses a classical regional structure with local managers in three areas of the world: Africa/Middle East, Latin America, and East Asia/Pacific. But in Europe and North America, where consumer preferences are identical, the structure is different. The president of Lever Brothers in New York, for example, reports to the Unilever worldwide detergents products coordinator in London. Figure 12.8 illustrates the hybrid structure.

The primary advantage of the mixed structure is that it allows the firm to create the specific types of design that best meets its needs.

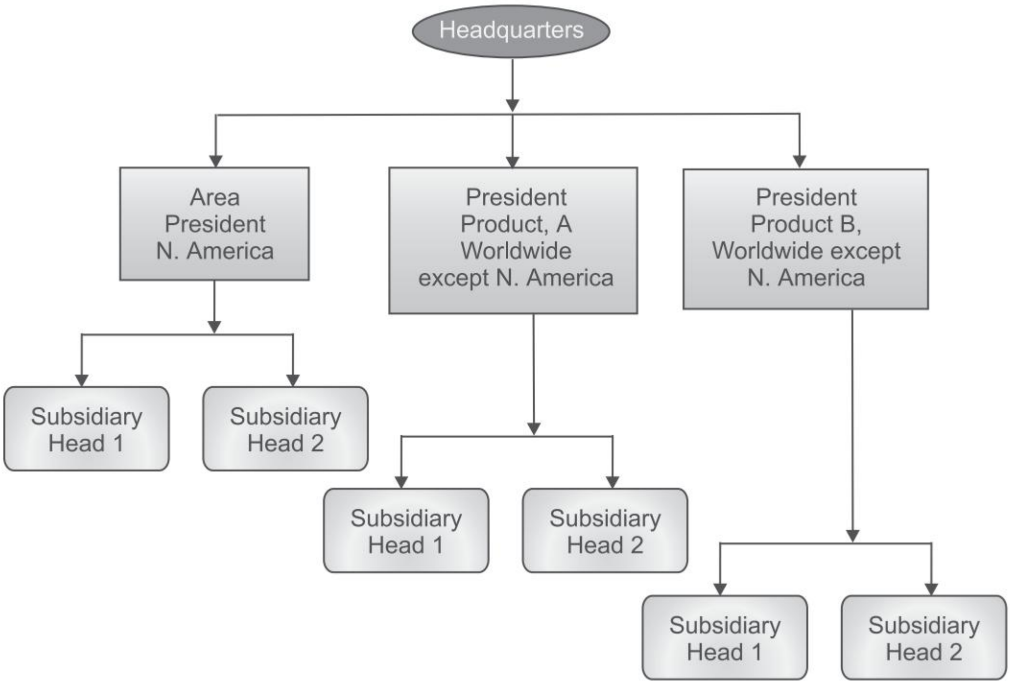


Fig. 12.8 Mixed Structure

But, problems emerge with communication flows, chains of command, and groups going their own way.

Matrix Structure The most complex form of international organisational design is the matrix structure. The matrix design emerges when one design is superimposed on top of an existing, but different form. The resulting design, is quite fluid, with new matrix dimensions being created, escalated or reduced, and eliminated as needed. For example, the global matrix design as shown in Fig 12.9 was created by superimposing global product design (shown down the side) on an existing global functional design (shown across the top).

The global matrix design permits a firm to form specific product groups using members from existing functional departments. These product groups can then plan, design, develop, produce, and market new products with appropriate input from each technical area. In this way the firm can draw on both the functional and the product expertise of its employees. After a given product development task is completed, the product group may be dissolved. Its members will then move on to new assignments. Other matrix arrangements are also possible. For example, an area design could be overlaid on a functional design, allowing area specialists to coordinate activities with functional experts.

There are three roles in a matrix organisation that differ from those in single dimension structures. First, there are managers who report to two different matrix bosses (see Fig. 12.10); secondly, there are the matrix managers who share the subordinates; and thirdly, there is the top manager who is expected to head the dual structure and balance and adjudicates disputes.

Matrix structure is mainly utilised by technology firms, turnkey firms, and construction firms such as TRW, Bechtel, NEC, and Siemens. Dow Chemical is another firm that has matrix structure. L&T,

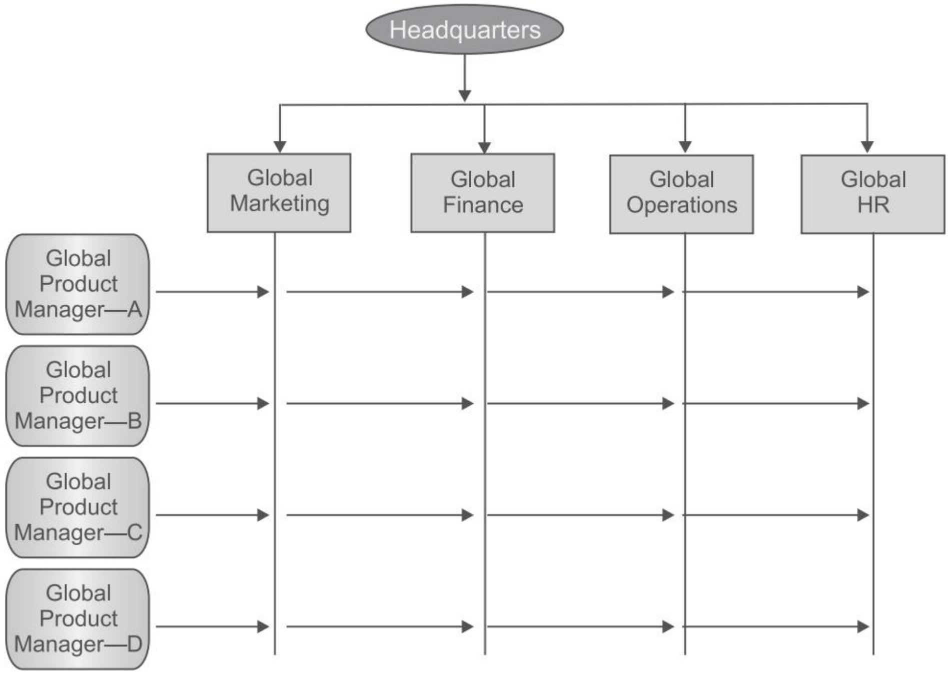


Fig. 12.9 Matrix Structure

(*Source*: Darrell Mohoney, et al, op. cit, p. 514)

the Indian engineering giant follows matrix structure when it undertakes turnkey projects. IBM has a dozen business entities in India. Each unit is a company by itself with strong local business heads who report directly to global heads and to the local managing directors as well.

WIPRO has a matrix structure. The entire business of WIPRO is divided into three divisions, viz; Wipro Technologies, Wipro Infotech and Wipro Consumer Care and Lighting. Each division has its own functional heads.The headquarter at Bangalore too has functional executives. A functional head of a division will have two matrix bosses—head of division and functional executive at headquarters. For example, finance head of Wipro Technologies shall report to his divisional head and to the finance executive at the headquarters. Similarly, other divisional functional heads. And the arrangement is working well. Most MNCs have adopted matrix structures in the last two decades.

Coming to the strengths and weaknesses, it may be stated that each matrix pattern will have its own merits and demerits according to the combination of dimensions adopted. There are, however, general strengths and weakness of the matrix approach.

In the first place, matrix design will facilitate the flow of communication throughout the organisation because of the dual interaction. Before key decisions are made, the structure brings to bear the two intersecting perspectives. Secondly, the global matrix design promotes organisational flexibility. It allows firms to take advantage of functional, area, customer, and product organisation designs as needed, while minimising disadvantages of each.

The disadvantages are equally strong. The matrix structure is not suitable for a firm that has few products and operates in a relatively stable market. Second, the structure often is clumsy and bureaucratic. It may require so many meetings that it is difficult to get any work done. Often, the need to get an area and

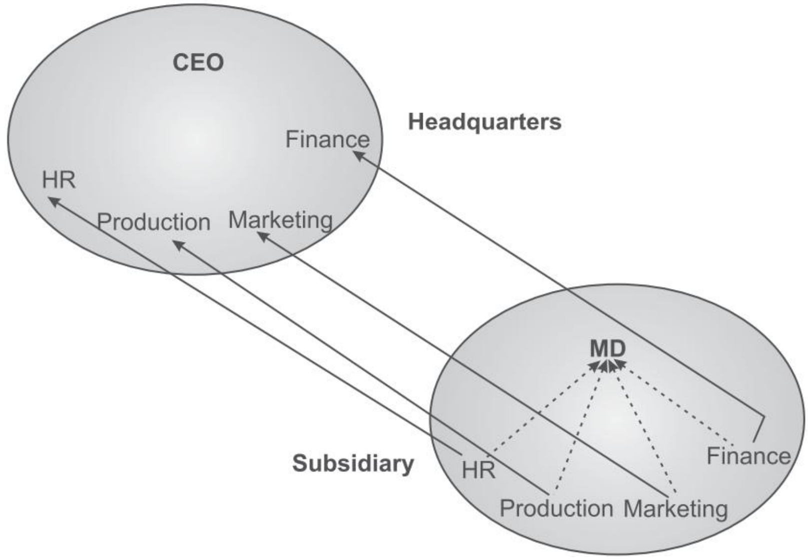


Fig. 12.10 Subordinates Reporting to Dual Heads

a product division to arrive at a decision slows decision-making and produces an inflexible organisation unable to respond quickly to market needs or to innovate. Finally, the dual hierarchy structure can lead to conflict and perpetual power struggles between the areas and the product divisions.

In the light of these problems, many firms are rethinking about the use of matrix design. Siemens, for example, found the structure less suitable for its global operations and has developed a hybrid structure, which the company believes will make it more competitive in the international market (See also opening case). Dow Chemical, instead of abandoning the matrix, is trying to build 'flexible' matrix structure. (See Exhibit 12.3 for details).

ABB had a complex matrix structure under Barnevik, in which companies reported to a country head as well as the headquarters. His successor, Goram Lindahl dismantled the structure to a great extent, having the country managers responsible only for environment scanning. GE dismantled matrix structure three years ago. Earlier, when GE India had a matrix structure, local business heads reported directly to their counterparts at HQ, with a 'dotted line' connection to the local head. With the matrix structure being dismantled, a first for GE globally, every one reports to the local head.

Networked Structure The networked structure is a form of organisation in which many functions of an MNC are contracted out to other independent firms and coordinated through the use of information technology networks to operate as if they were within a single corporation. This type of structure is often called the virtual corporation because it performs as if it were virtually one single corporation. Though networked structure permits flexibility in adjusting to market needs, the need for sharing proprietary information with the networked firms may create potential competitors. But, given the rapidly expanding communication facilities, networked structure may be feasible for companies wishing to engage in global business that requires a great deal of flexibility and are able to contract out certain functions while still retaining control over core competencies associated with their competitive advantage. Benetton is a well-known example of a firm that uses a networked structure. (see Exhibit 12.4 for more details)

Exhibit 12.3

DOW CHEMICAL'S MATRIX STRUCTURE

The chemical industry is a global industry in which six major players compete head to head around the world. These companies are Dow Chemical and DuPont of the United States, Great Britain's ICI, and the German trio of BASF, Hoechst AG, and Bayer. The barriers to the freeflow of chemical products between nations largely disappeared in the 1970s. This along with the commodity nature of most bulk chemicals and a severe recession in the early 1980s ushered in a prolonged period of intense price-competition. In such an environment, the company that wins the competitive race is the one with the lowest costs. And in recent years that has been Dow.

Dow's managers insist that part of the credit must be placed at the feet of its maligned "matrix" organisation. Dow's organisational matrix has three interacting elements: functions (e.g., R&D, manufacturing, marketing), business (e.g., ethylene, plastics, pharmaceuticals), and geography (e.g., Spain, Germany, Brazil). Managers job titles incorporate all three elements—for example, plastics marketing manager for Spain—and most managers report to at least two bosses. Thus, the plastics marketing manager in Spain might report to both the head of the worldwide plastics business and the head of the Spanish operations. The intent of the matrix was to make Dow operations responsive to both local market needs and corporate objectives. Thus, the plastics business might be charged with minimising Dow's global plastics production costs, while the Spanish operation might be charged with determining how best to sell plastics in the Spanish market.

When Dow introduced this structure, the results were less than promising; multiple reporting channels led to confusion and conflict. The large number of bosses made for an unwieldy bureaucracy. The overlapping responsibilities resulted in turf battles and a lack of accountability. Area managers disagreed with managers overseeing business sectors about which plants should be built and where. In short, the structure didn't work. Instead of abandoning the structure, however, Dow decided to see if it could be made more flexible.

Dow's decision to keep its matrix structure was prompted by its move into the pharmaceuticals industry. The company realised that the pharmaceutical business is very different from the bulk chemicals business. In bulk chemicals, the big returns come from achieving economies of scale in production. This dictates establishing large plants in key locations from which regional or global markets can be served. In pharmaceuticals, regulatory and marketing requirements for drugs vary so much from country to country that local needs are far more important than reducing manufacturing costs through scale economies. A high degree of local responsiveness is essential. Dow realised its pharmaceutical business would never thrive if it were managed by the same priorities as its mainstream chemical operations.

Instead of abandoning its matrix, Dow decided to make it more flexible so it could better accommodate the different businesses, each with its own priorities, within a single management system. A small team of senior executives at headquarters now helps set the priorities for each type of business. After priorities are identified for each business sector, one of the three elements of the matrix—function, business, or geographical area—is given primary authority in decision-making. Which element takes the lead varies according to the type of decision and the market in which the company is competing. Such flexibility requires that all employees understand what is occurring in the rest of the matrix so that they can cooperate rather than act individually. Although this may seem confusing, Dow claims this flexible system works well and credits much of its success to the quality of the decisions it facilitates.

(*Source*: Charles WL Hill, *op. cit*, p. 413)

Exhibit 12.4

BENETTON MAKES UNIQUE IDEAS WORK WORLDWIDE

Sometimes called "the McDonald's of fashion", Italy's Benetton group now has about 7000 sportswear shops, featuring brightly coloured knit clothing, in over 120 countries. The development of Benetton is a rags-to-riches story about four siblings, one sister and three brothers. Together, they built a $2 billion empire after the sister, Giulianna, began designing attractive knitwear in the early sixties.

The basic idea behind the company's success is to make clothing that not only is fashionable but also can be produced on a major scale so that prices are affordable. To boost affordability, the Benettons have eliminated the wholesaler and all the intermediaries. They rely mainly on independent licensees who sell Benetton merchandise directly to customers in specially designed stores with the now-famous kelly-green fronts. Benetton licensees pay no fees or royalties. Instead, they commit to selling only Benetton-made goods. Although it can cost more than $100,000 for a licensee to set up a Benetton store in the United States, profits can be sizeable if the sales volume is high. The profits come from the markup on the clothing purchased from the Benetton Group.

Benetton goods are manufactured mainly in Italy, where the company has several factories as well as subcontracting arrangements with many small Italian firms. In addition, the company has wholly owned manufacturing facilities in other countries, such as France, Spain, the United Kingdom, and the United States. A US facility in North Carolina helps meet domestic demand for cotton and denim goods, shortens ordering time, and shelters US licensees from the impact of the failing dollar, which on occasion has pushed up the prices of Italian made Benetton goods.

Part of the company's success is attributable to a special technique for making sweater in undyed wool and dyeing them a short time before shipping. This approach has enabled the company to react rapidly to fashion trends and fill orders from licensees quickly. To make the system work, Benetton has invested in a computerised inventory system and a huge $20 million computer controlled warehouse that is bigger than a domed sports arena. The warehouse has 16 robots and a complex conveyer to help handle the massive volumes.

At one point, licensees in the United States complained that Benetton was licensing too many stores in close proximity. Since that time, Benetton has reduced the number of stores by almost two-thirds to about 200, but many of them are double the square footage to enable better displays and a wide selection of offerings. The company has also been branching into other areas, such as children's wear under the Benetton 012 label and trendier sportswear under the Sisley name. Their recent attempts to launch fragrance and cosmetic lines were not successful and Benetton has licensed the lines to a joint venture between Jacques Bogard SA and Fragrance Marketing Group.

CHOOSING A STRUCTURE

LO 4
Assess the choices made while choosing a structure

A multinational corporation has several organisational structures before it. Which to choose becomes difficult as each approach has strengths and weaknesses. Clearly, there is no one single way to organise, no ideal organisation structure, and no organisation form that can remain static when once adopted. Successful firms are using different organisational patterns to manage their overseas operations effectively.

Although there are no standard requirements, a relatively small number of variables can help in choosing an organisational form that best fits the needs of a given firm in a given set of circumstances.

1. The relative importance in the present and future of foreign and domestic markets to the firm's competitive strategy.
2. The historical background of a firm and its evolutionary stage in global operations.
3. The nature of a firm's business and its product strategy.
4. The management traits and management philosophy of the firm.
5. The availability of and willingness to invest in internationally experienced management personnel.
6. The capacity of a firm to adjust to major organisational changes.
7. The degree of centralisation and the extent to which the firm wants to decentralise its power of decision-making and grant autonomy to its subsidiaries.

RELATED ISSUES IN GLOBAL ORGANISATIONAL DESIGN

LO 5
Interpret the related issues in global organisational design

Global enterprises face a number of related organisational issues that must be carefully managed. We consider eight major issues here: (See Fig. 12.11)

1. Differentiation.
2. Role of subsidiary directors.
3. Non-traditional organisational arrangements.
4. Changing role of information technology in organising.
5. Need for integrating mechanisms.
6. Control systems.
7. Managing corporate culture.
8. Managing change.

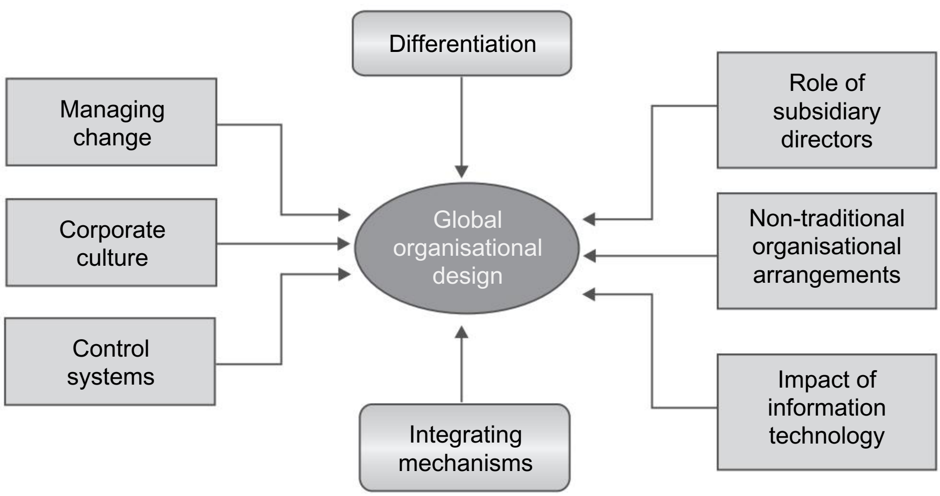


Fig. 12.11 Issues in Organisational Design

Differentiation Two alternatives present themselves in the context of differentiation: vertical differentiation and horizontal differentiation.

Vertical differentiation refers to the decision making hierarchy in an organisation. Decision making authority may be centralised or decentralised. All companies must address who has what authority to make which decisions.

Now, if decision making power is vested with the head office, it is called centralised decision making. Instead, if the decision making authority is delegated to the subsidiary managers, it is called decentralised decision making. Decentralisation allows subsidiary managers to make decisions which serve host country needs best, but overall interests of the firm tend to be compromised. Centralisation of decision making helps the firm retain control at headquarters and protect the overall interests of the company, but the abilities of subsidiary managers to respond quickly and effectively to changes in their local markets are curbed.

Often it makes sense to centralise some decisions and decentralise offers, depending upon the type of decision and the company's strategy. Decisions relating to major financial expenditures, legal issues, manufacturing, R&D and the like, tend to be centralised. However, operating decisions such as those rotating to HR and marketing are decentralised.

Which decision making hierarchy matches with which firm's strategy is the relevant question. It may be stated that centralised decision making aligns well with international or global strategy, and decentralised decision making goes well with the multi-domestic strategy.

Horizontal differentiation is concerned with how the company decides itself into sub-units. The decision is generally made on the basis of function, product or area. In many MNCs, one of these predominates, but more complex solutions are adopted in others. Typical structures of MNCs were explained in the previous pages.

Use of Subsidiary Board of Directors

Subsidiary of any international firm, particularly fully owned, will have its own board of directors to oversee the activities of the top level managers in that subsidiary. The issue before any MNC is whether to view the creation of a subsidiary board of directors as a proforma exercise and give the board little authority, or to empower the board with substantial decision-making power.

Vesting the subsidiary board of directors with the authority of decision-making amounts to decentralisation of power, which is welcome in as much as the subsidiary can act quickly and decisively without having to seek parent's approval. Further, if the MNC decentralises authority to local levels, an active board provides a clear accountability and reporting link back to headquarters.

A potential disadvantage of empowering a subsidiary's board is that the subsidiary may become too autonomous and may fail to maintain the desired accountability with the parent firm.

In the meanwhile, four major areas in which MNCs use subsidiary boards have been identified. One is to advise, approve, and appraise local management. A second is to help the unit respond to local conditions. A third is to assist in strategic planning, and a fourth is to supervise the subsidiary's ethical conduct. These are spelt out in detail in Table 12.1, where samples of survey responses from US, Canada, Japan, and Europe are provided.

A close look at the table shows that the Japanese and the Swedes tend to place greater importance on these boards than Europeans and Americans, although all countries report important benefits from the use of these boards. The trend is likely to continue in the coming years.

Non-traditional Organisational Arrangements

In recent years, MNCs have increasingly expanded their operations in ways that differ from those used in the past. These include acquisitions and joint ventures. These organisational arrangements do not

Table 12.1 Importance of Subsidiary Boards over the Next 5 to 10 Years—Mean Ratings (1= Low; 5 = High)

	United States (n = 31)	*Canada (n = 9)*	*Japan (n = 14)*	*Europe excluding Sweden (n = 28)*	*Sweden (n = 8)*
Local Management					
Advising local management	3.50	3.67	4.15	3.43	4.00
Approving budgets and short-term plans of the subsidiary	2.48	3.00	4.36	2.75	3.13
Monitoring operating performance and corrective measures in the subsidiary	2.81	3.00	4.00	2.71	3.38
Appraising the subsidiary's top management performance and top officer's compensation.	2.10	2.33	3.64	2.46	2.63
Deciding the amount to remit as dividends	2.39	2.33	3.57	2.18	2.00
Local Country Contact and Conditions					
Facilitating the establishment of contacts with local leaders and institutions	2.90	3.56	3.62	3.32	3.88
Identifying and responding to concerned stakeholders (e.g., environmentalists and consumer groups)	2.10	1.44	3.50	1.68	1.00
Ensuring compliance with local legal requirements	3.50	2.67	4.23	3.00	3.75
Providing knowledge of local economic, political, and social conditions	3.48	3.44	4.00	3.39	4.25
Strategic plan					
Participating in drawing up the subsidiary's strategic plan	2.52	3.00	4.29	2.54	2.88
Ethical issues					
Supervising the subsidiary's ethical conduct	2.94	2.67	3.64	2.82	2.75

(*Source:* Hodgetts and Luthans, *International Management*, McGraw-Hill, 2000, p. 319)

use traditional hierarchical structures and, therefore, cannot fit into any design described earlier in this chapter. The following paragraphs describe how they work.

Organisational Designs for Acquisitions Acquistions are common with MNCs. For example, in the past British Petroleum acquired Amoco for $48.2 billion. Daimler-Benz bought the Chrysler Corporation for $40.5 billion and LG Electronics took over Zenith for a sizable amount. In other cases, MNCs have taken an equity stake but not bought the entire company. For instance, Ford Motors owns 75 per cent of Aston Martin Legenda of Britain, 49 per cent of Autolatina of Brazil, and 34 per cent of Mazda of Japan.

Acquisitions are not confined to only international businesses. Indian firms too are actively taking over companies in a big way. There were a total of 49 overseas acquisitions by Indian companies in 2003 as against 28 in 2002. The total value of the overseas acquisition deals in 2003 stood at Rs 8049 crore, compared to ₹ 941 crore, in 2002. Acquisitions took place within the country also. The total value of Indian firms being acquired stood at ₹ 21,432 crore, in 2003. The value was ₹ 41,798 crore, in 2002[11].

In each of these cases, the buying MNCs have fashioned a structural agreement that promotes synergy while encouraging local initiative by the acquired firm. The result is an organisation design that draws on the traditional structures that have been described earlier but still has a unique design specifically addressing the needs of the two firms.

Organisational Arrangement for Joint Ventures Joint venture agreements are also common with MNCs. In joint ventures all parties contribute to the undertaking and coordinate their efforts for the overall good of the enterprise. For example, Samsung has a joint venture agreement with Motorola to develop the next generation digital assistants; with AT&T to create Pen-based computers; with Toshiba to make 64-megabyte flash memory chips; with USA Video to create video file servers; and with General Instrument to develop digital television.

Any joint venture requires carefully formulated structure that allows each partner to contribute what it can and efficiently coordinate their efforts. All the co-venturers should meld their different values, management styles, action orientation, and preferences in favour of the joint venture. This is the main objective that the origanisational design should seek to realise.

Alliances and acquisitions, though common in the corporate world, can ultimately be bad for the partners themselves. In the long run, as a result of changes in technology, cheap sources of labour, and changes in government policy, new entrants will enter the industry, and the existing companies that have struck joint-venture or acquisition deals will find themselves ineffective players. Having been insulated from competition (alliances or acquisitions are basically made to thwart competition), the existing monopolistic organisations will have developed tall, centralised, mechanistic structures weighed down by overly complex bureaucratic rules and procedures. Their decision-making will be slow and cumbersome, and in the short run, they will be unable to meet the challenges of the rapidly changing environment. GM, IBM, and Xerox are companies that controlled their competitive environment for a long time and suffered greatly when the environment changed and allowed more agile foreign and domestic competitors to enter and beat the established companies at their own game.

Role of Information Technology

International businesses rely heavily on information technology (IT) because it lends competitive advantage to them. In fact, it is the search for competitive advantage that is driving the rapid development and adoption of IT. For one thing, IT reduces the need for hierarchy and this helps bring down bureaucratic costs. Second, IT enables an international business become responsive to local needs faster. It also enables companies to create virtual products—products that are customised to the needs of individual customers—without additional cost. (See Exhibit 12.5 for more details on customisation.)

True, IT enables MNCs do business differently. At the same time, problems associated with IT should not be lost sight of. First, there will be opposition within the firm to the introduction of IT. As stated above, IT makes organisations flatter. Many managers find their powers, authority, or even their job security being jeopardized. Mid-level managers may worry that the adaptation of computer-based MIS may be followed by widespread management lay-off. Managers, obviously, resist the introduction of IT. Departmental heads, too, fear IT because their hold on information flows into and out of the departments gets diluted.

Exhibit 12.5

LEVI'S DIGITAL JEANS

In 1994, Levi Strauss & Company began introducing a system that could change the face of apparel retailing. Levi's had long been aware that women often complained about the difficulty of finding off-the-rack jeans that fit properly. Now advances in information technology may be allowing Levi's to do something about it. Using the new technology, a sales clerk at an original Levi's Store can use a personal computer and the customer's vital statistics to create what amounts to a digital blue jeans blue print. A touch-screen software system leads a sales clerk through the fitting process and requires no special computer skills. The software allows for 4,224 possible combinations of four basic measurements: hips, waist, inseam, and rise. The sales clerk takes these coordinates by tape measure and enters them into the personal computer, along with other desired features such as colour and style.

Once completed, a customer's order can be sent electronically to the company's factory in Mountain City, Tennessee, where the denim for the jeans will be cut to specification by a computer-driven cutting machine. The pieces are then tagged with bar codes and sent through the regular mass-production washing and sewing process. At the end of the assembly process, scanning equipment separates out the jeans, which are then sent to the store where they were ordered, or, if the customer prefers, by Federal Express to the customer's home.

The total additional cost to the customer is $10, well worth it, according to one satisfied customer, Beth Gilmore, who paid $56 for a pair of digitally tailored Levi's from a store in Cincinnati. "I'm tall", she said. "In the past, there's always been a compromise—they're either too big or too little somewhere." Her digital jeans, in contrast, "fit like a glove."

Levi Strauss will not disclose how many jeans it has sold this way, but the company notes that sales of women's jeans at the Cincinnati store where the system is being tested rose by 300 per cent compared with the prior year. By the end of 1995, the company was offering the service on an experimental basis to some 30 Original Levi stores. Levi Strauss adopted the technology worldwide in the late 1990s and currently has over 30 locations operating in the United States. In 1999, it also experimented with a megastore in San Francisco that contains a hot tub in which customers can shrink their jeans to fit and afterward dry off in a waist-high glass booth that is filled with warm air.

(*Source*: Gareth R. Jones, *Organisation Theory*, p. 322)

Second, computer-based information system tends to eliminate the human element of communication. There are some kinds of information that cannot be aggregated and summarised by computers. Certain details which are rich in colour and content and which cannot be quantified and aggregated by electronic means, are often required for crucial decision making. Only human beings can provide such details and no electronic media can substitute that.

Integrating Mechanisms

One of the issues relating to international business relates to the need for coordination among different subsidiaries and all of them with the parent company. The need for coordination is not felt much in multidomestic companies as they are basically concerned with responding to local needs. Such firms are likely to operate with a worldwide area structure in which each area has considerable autonomy and its own set of value creation functions. Since each area is established as a stand alone entity, the need for coordination among areas is minimised.

As the company goes global, the need for coordination increases. Coordination in an MNC can be achieved through tight centralisation. But, if the coordination task is complex, centralisation may not be very effective. Top-level executives responsible for achieving coordination can soon become overwhelmed by the volume of work required to coordinate the activites of various divisions, particularly if such units are diverse, many, and are geographically widely dispersed. When this is the case, firms look towards integrating mechanisms, both formal and informal, to help achieve coordination.

Formal Integrating Mechanisms The formal mechanisms for integrating subsidiaries vary in complexity ranging from simple direct contact to matrix structure (see Fig. 12.12).

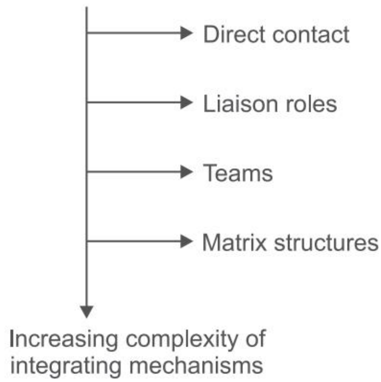


Fig. 12.12 Formal Integrating Mechanisms

The *direct contact* mechanism is the simplest form of coordination. Here managers of subsidiaries simply contact each other whenever they have a common concern. This mechanism works well when all the managers have a common orientation. *Liaison roles* are a bit more complex. When the volume of contacts among subsidiaries increases, coordination can be improved by giving a person in each division responsibility for coordination with other subsidiaries on a regular basis. Through these roles, a permanent relationship is established among the people involved.

When the need for coordination is greater still, firms tend to *use teams* (or task forces), temporary or permanent, comprising individuals from the subsidiaries that need to achieve coordination. They are typically used to coordinate new-product development, but they are useful when any aspect of operations or strategy requires the harmony of two or more divisions. New product development teams are typically composed of personnel from R&D, production and marketing. For example, GM Holden's Australia and Toyota Motor Company Australia used a taskforce when they collaborated on the design of the commodore.

When the need for coordination is very high, firms may use *matrix structure*, in which all roles are viewed from a holistic perspective. The structure is designed to facilitate maximum integration of all subunits.

But matrix structure, instead of facilitating coordination of subunits, may create conflict. By nature, the matrix structure tends to be inflexible and bureaucratic. Decisions in bureaucratic structures tend to get bogged down. More problems are created than solved in matrix structures. However, as in the case of Dow Chemical, matrix structure needs to be somewhat flexible and supported by informal integrating mechanisms.

Informal Integrating Mechanisms Many international firms also rely heavily on informal coordination mechanisms. *Informal management networks* can be very effective. This is simply a group of managers from different parts of the world who are connected to another in someway. These connections are often formed as a result of personnel contact, mutual acquaintances, and interaction achieved through travel, training programmes, conferences, taskforce experiences, and joint meetings.

Informal management networks can be very powerful for short-circuiting bureaucracy that may delay communication and decision-making. Firms make use of computer and telecommunications networks to provide the physical backup for informal networks, E-mail, video-conferencing, and high-speed data systems make it easier for managers scattered across the globe to get to know each other.

Control Systems

A major task of an MNC's leadership is to control the various subsidiaries whether they are defined on the basis of function, product division, or geographical area to ensure their actions are consistent with the firm's overall strategic and financial objectives.

The task becomes daunting for an international businesses because of the following factors:

1. **Distance** The geographical distance and cultural disparities separating countries increase the time, expense and possibilities of errors in cross-national communications. The advent of e-mail and fax transmissions has replaced the human element in communication. And communications can be best handled not by machines but by face-to-face or voice-to-voice contacts.

2. **Diversity** Each subsidiary of a firsm needs to be locally responsive—adjusting to the needs of the country in which it operates. When market size, type of competition, nature of the product, labour cost, currency, and a host of other factors differentiate operations among countries, the task of setting standards and evaluating performance to improve it becomes extremely complicated.

3. **Degree of Uncertainty** Control implies setting goals and developing plans to meet these goals. Data relating to business operations are much less complete and accurate in some countries than others. Besides, political and economic conditions are subject to rapid changes in certain countries. These factors impede planning and controlling.

4. **Too much of Independence** When Ratan Tata became the Chairman of Tata Group, he faced the challenge of unifying all its companies which were functioning almost as stand-alone firms. JRD delegated powers to unit managers, as is the wont of Tata tradition. Independence though welcome, too much of it can be counterproductive and difficult especially when a new chairman endeavours to introduce new policies and procedures. Ratan Tata did face resistance from the unit heads, but he overcame it by handling situations carefully.

5. **Differences in Approach** Global businesses themselves are not at par so far as approaches to controls are concerned. For example, how British firms monitor their overseas operations is often different from how German or French firms do so. Similarly, US MNCs tend to have their own approach to controlling and it differs from both the European and Japanese approaches. The following observations are revealing:
    1. Control in US MNCs focuses more on the quantifiable and objective details of an overseas subsidiary, whereas European firms tend to emphasise on the qualitative aspects. British firms, too, tend to emphasise on financial data. The US approach allows comparative analysis between domestic units and foreign subsidiaries. The European parameters are more flexible and allow control to be exercised on a unit-by-unit basis.
    2. British overseas firms tend to focus on major problems, sidelining detailed matters of control. Control in European MNCs require a high level of company-wide understanding and agreement regarding what is appropriate in parent and subsidiary units.
    3. Control in US MNCs requires large central staff and centralised information processing capability. Control in European MNCs requires a larger cadre of capable expatriate managers who are willing to spend long periods of time abroad.
    4. Control in European firms requires more decentralisation of operating decisions than control in US MNCs.

5. Control in British firms is used more for general guidance than for surveillance. German firms use control as a policing and surveillance instrument. Control systems in France tend to follow the German model, but the French control system is less systematic and sophisticated.

Control systems employed by an MNC include personal, bureaucratic, and output checks. *Personal control*, also called *direct control* is a control by personal contact with subordinates. For example, Jack Welsh, CEO of GE, had regular one-to-one meetings with the heads of all GE's major businesses, most of which were international. He used these meetings to probe the managers about the strategy, structure, and finacial performance of their operations. In doing so, he had essentially exercised personal control over these managers and their strategies. Another example of direct control is the International Telephone and Telegraph (ITT), which holds monthly management meetings at its New York Headquarters. These meetings are presided over by CEO of the company, and reports are submitted by each ITT unit manager throughout the world. Problems are discussed, goals are set, evaluations are made, and actions are taken that will help the unit improve its effectiveness.

Bureaucratic controls include rules and procedures that direct the actions of the subsidiaries. Budgets are popular bureaucratic checks used by MNCs. Budgets are essentially a set of rules for allocating a firm's financial resources. A sub unit's budget specifies with precision how much the sub unit can spend. Headquarters use budget to regulate the behaviour of units.

Output controls involve setting goals for subsidiaries to achieve; expressing these goals in terms of relatively objective criteria such as profitability, productivity, growth, market share, and quality; and then judging the performance of subunit management by their ability to achieve the goals. Goals are normally established through negotiations between subsidiaries and headquarters.

Output controls foster a system of "management by exception". As long as subsidiaries meet their goals, they are left alone. If a subsidiary fails to attain its goals, CEO is likely to ask some tough questions. If satisfactory answers are not forthcoming, headquarters management intervenes to improve the sub unit's efficiency.

Output controls reward suitably the performance of subsidiaries. For example, if a worldwide product division achieves its profitability goals, its managers may receive a significant bonus. The size of the bonus might reflect the extent to which a division exceeds its goals so that subsidiary management has an incentive to optimise performance.

TCS uses unique system of control. The company has implemented an internal real time management tool called 'Ultimatix' to track and improve productivity across the length and breadth of TCS operators.

MNCs use a variety of control techniques (apart from those discussed till now) to improve their efficiencies as Exhibit 12.6 shows.

Exhibit 12.6

GETTING BACK TO BASICS

While Japan's economy has been in the doldrums for the past few years, some experts believe that the problems facing many Japanese corporations are not related to economic woes, but rather to poor management. "Ninety percent of the Japanese economy is made up of domestic companies that are low-tech and low-productivity," claims consultant Masao Hirano. However, a few pioneering firms are starting to demonstrate that "by becoming better focused, (Japanese companies) can survive and even prosper," says analyst Satoru Oyama.

Cosmetics maker Shiseido held too much inventory and had overly high expenses, leading to a

$550 million loss over two years. But rather than call for a government bailout, Shiseido executives focused on fundamental improvements. Better technology allowed them to control and forecast inventory more effectively. They cut costs throughout the corporation and curtailed their product line. After Shiseido returned to profitability, chief logistics officer Seiji Nishimori boasted, "We're showing other Japanese companies that it's possible to reverse a slide."

Canon, the world's leading maker of copiers and laser printers, has also taken a disciplined approach to performance improvement. CEO Fujio Mitarai replaced every manufracturing line at the firm's 29 Japanese factories with small, self-directed teams of half a dozen workers that do the work previously done by 30 labourers. The teams discovered more efficient inventory management techniques, and Canon was able to close 20 of its 34 parts warehouses. "Manufacturing is where most of the costs lie," Mitarai claims. Canon earnings improved by 53 percent, enabling Mitarai to conclude, "We're much more profitable today because of these changes."

The success of notable high performers such as multinational Toyota has caused Japanese firms to realise the benefit of global cost competitiveness. High-tech companies are abandoning manufacturing and switching attention to R&D to counteract an influx of inexpensive electronics from China, Taiwan, and Korea. For example, NEC has reduced its commitment to the unprofitable semiconductor chip-making business, and focused on more lucrative cell phones and software. Sharp, too, has given up on low-margin PC monitors and refocused its operations on innovative products such as liquid crystal displays for PDAs. Sony is working on revolutionary new computer chips while reducing its investment in consumer electronics.

All three companies say they now listen to their consumers more closely. "We were proud of our great technology, and (we) just pumped out products without thinking of our customers' needs," says NEC director Kaoru Tosakar. "Now, we're emphasising efficiency, profits, and clients".

These companies are an exception in Japan, where so-called zombie firms are bailed out over and over again by a government that fears unemployment and chaos if businesses fail. But the zombies need to hear the lessons these stellar firms have learned: Watch inventory. Cut costs where possible. Use information technology more effectively Simplify product lines. Experiment with new ways of organising. Shut down money-losing businesses. Choose areas where the firm can add value. Listen to customer feedback. If the zombies could adopt these suggestions, the Japanese—and the rest of the world—would surely benefit.

(*Source:* Clay Chandler, "Japan's Horror Show," *Fortune*, November 10, 2002, pp. 114–118; "Quick Studies," *Business Week*, November 18, 2002, pp. 48-49)

Culture in International Business

Corporate culture is the set of shared values that defines for its members what the organisation stands for, how it functions, and what it considers important. Culture helps bring about coordination among different subsidiaries of a firm, in as much as the firm's culture overrides differing subsidiary orientations. In addition, culture acts as a control variable too. Culture controls exist when employees "buy into" the norms and value systems of the firm. When this occurs, employees tend to control their own behaviour, which reduces the need for direct supervision. A firm enjoying strong culture obviates the need for any other control system (see also Exhibit 12.7).

How to create corporate culture? The creation of corporate culture for an MNC usually starts with the firm's mission statement. The mission statement, spells out the firm's values, goals and the basic operating philosophy. Having spelt out the mission of the firm, the management should have:

(a) symbols, for example, a corporate logo;
(b) heroes, usually successful and distinctive managers;

Exhibit 12.7

CULTURE AS CONTROL

GE has long had a strong corporate culture, which helps unify behaviour among its personnel. This culture is partially based on US cultural norms, such as pride and optimism, and partially on the styles and practices of GE's top managers, such as the use of massive layoffs and quick sale of under performing businesses.

During 1990–91, GE proceeded cautiously with changing the inherited corporate culture at Tungsram. One reason was GE's unfavourable experiences in France after its 1988 acquisition of a medical equipment manufacturer. GE has tried quickly to integrate the manufacturer into the US division and to impose its corporate culture on the French facility. The experiment met strong resistance and prompted unfavourable publicity. However, in 1922, following the appointment of a new CEO at Tungsram, GEL decided to introduce the GE corporate culture at Tungsram more decisively and quickly. The new CEO was an American with much experience in managing GE subsidiaries abroad; thus GEL expected his managerial style and practices to reflect GE's headquarters norm. Further, GE translated a 50-page manual, *Integrity: Code of Conduct in the Workplace*, into Hungarian and required all Tungsram employees (as it does in the United States) to pledge observance of its contents. The manual describes behaviour to try to eliminate corruption, instructs that one must deal fairly with co-workers (regardless of nationality, gender or creed), and requires absolute fairness in dealing with competitors and suppliers.

Many aspects of GE's culture are almost opposite to those that existed at Tungsram. For example, the norm in the United States is to be inner-directed—believing that it is up to each individual to succeed and that outside constraints can be overcome if only one tries hard enough. However, the norms in Hungary (perhaps brought about by long periods of foreign domination when there was no self-determination) is to be outer-directed—believing that uncontrollable outside forces, rather than the will of the individual, are decisive in determining outcomes. In addition, GE's use of layoffs and selloff's to improve performance contrasts sharply with the experience at Tungsram, where there is a history of paternalism. For example, from the start many Tungsram employees lived in company housing and vacationed at company resorts. Their children attended company schools. During evenings and weekends, employees and their families rooted for Tungsram sport teams. The best way to get a job at Tungsram was to be recommended by a current employee; however, once employed, satisfactory work performance led to lifetime job security. Further, even the manual contradicted Hungarian norms. Because of foreign rule, Hungarians learned to survive by pretending to accept foreign mandates, which they circumvented while avoiding direct confrontation. For example, under communist rule—during which there was no legal certainty, standards were not absolute, and power was exercised arbitrarily—people became masters of finding back-door approaches to solving problems. Personal relationships and reciprocal favours were much more important than formal rules. Thus, GE has tried to enforce a universal code in a culture that believes in ethical relativism.

On the one hand, GE is quite satisfied with what it has accomplished in the transfer of its corporate culture to Hungary. Tungsram's CEO said that GE is not seeking a complete eradication of cultural differences, but is working towards a degree of homogeneity that is like " a pea soup, not a stew". Several aspects of GE's efforts to bind together the separate national and corporate cultures have been those common to many MNCs, such as extensive training in language and business skills and the rotation of employees among geographic locations. On the other hand, the leader of the union at Tungsram said, "GE's (Corporate) strategy is to make everyone insecure. The owner assesses us from the United States, where the sturcture of the economy and industrial relations are different. GE tries to employ here overseas methods, which causes conflict". Further, a *Financial Times* article said, "By comparison with some multinationals, which try to cultivate a reputation for cultural sensitivity, GE risks being accused of arrogance in its approach....Those employees who find (this) difficult tend to leave".

(c) legends, including stories about successes and failures that get passed from employee to employee;
(d) Shared experiences, such as working together towards shared goals.

Akio Morita, Sony's chairman, typifies how the founding father can build culture. His personal beliefs and values permeate the entire organisation. He is given credit for much of Sony's success today and is revered by the firm's employees, who look to him for leadership and guidance.

McDonald's is another example to show that a firm can build strong culture through conscious efforts. McDonald's refers to its franchisees and suppliers as partners and emphasises its long-term commitment to them. This commitment is not just a PR exercise; it is backed by actions including willingness to help suppliers and franchisors improve their operations by offering capital and or managerial assistance when needed. In response, the firm's franchisees and suppliers are integrated into the parent company's culture and are committed to helping McDonald's succeed. One result is that McDonald's can devote less time than would otherwise be neccessary to controlling its franchisees and suppliers.

Other names to be stated in this context are Daimler-Chrysler and Honda. Honda has a culture that stresses teamwork and togetherness. Each Honda employee understands that he or she should take responsibility for doing whatever is necessary to enhance quality. Daimler-Chrysler's culture centers around technology. The firm and its managers have always focussed on applying technology as efficiently and effectively as possible. As a result, Daimler-Chrysler's managers put a premium on technological innovation and refinement.

After building a strong culture, the MNC must take every opportunity to communicate its cultural contours to its subsidiaries across the globe, so that they keep them at the forefront while making decisions and taking actions. Culture can be spread to subsidiaries in other ways too. Frequent contact and interaction between managers and other employees are useful in transmitting and reinforcing corporate culture. Frequent transfer of key managers to different units also serves the purpose.

Not all firms require identical cultural norms and behaviours. It depends on the strategy the firm has chosen to pursue. For example, the firm implementing a global strategy aims to develop a strong culture that helps everyone around the world understand and accept a standard set of goals, priorities and practices. Instead, a company adopting multi-domestic strategy cannot have standardised norms and practices. Each subsidiary is required to interpret corporate goals in the way that suits local needs. Subsidiary managers are bestowed with authority to have their own cultural nuances, of course, not clashing with the corporate culture. Figure 12.13 indicates specific cultural requirements of each corporate strategy.

Managing Change in International Business

Change is common in any business, more so in overseas business. Change takes place because of environmental changes, and change in technology and cultural values and mores.

Environmental changes force change on an MNC with considerable force. As new markets open or existing markets decline, the firm needs to develop appropriate responses. Consider the opening up of the EU's internal market in 1992. Literally thousands of firms changed their strategy for doing business in the market. For example, some rearranged their manufacturing locations, hoping to benefit from economies of scale. Unilever restructured its detergent product line by replacing autonomous, nearly independent national operations with a new subsidiary, Lever Europe, which was charged with treating Europe as one market.

Change in technology compels firms to redefine work roles and reporting relationship among

Pressure for National Responsiveness

Pressure for Global Responsiveness	Low	High
High	**GLOBAL** Strategic objectives: Productivity and efficiency Strategic emphasis: Integration, competitive advantage Dominant attribute: Standardised goal achievement, global competitiveness Leadership style: Production and achievement oriented, decisive control orientation Bonding: Goal orientation, production, competition	**TRANSNATIONAL** Strategic objectives: Integration responsiveness, learning Strategic emphasis: Innovation ideas and growth Dominant attribute: Innovation, creativity, dynamism, flexibility Leadership style: Innovator, risk affirmative, congruence between individual values and company goals Bonding: Flexibility, risk, entrepreneurship
Low	**INTERNATIONAL** Strategic objectives: Leverage core competencies Strategic emphasis: Control, stability, predictability Dominant attribute: Formal order, rules, uniformity Leadership style: Director, administrator, enforcer Bonding: Rules, policies and procedures clear expectations	**MULTI DOMESTIC** Strategic objectives: Local responsiveness Strategic emphasis: Team spirit, commitment, consensus Dominant attributes: Cohesiveness, trust, affiliation Leadership style: Mentor, facilitator, coach, adaptability Bonding: Loyalty and tradition

Fig 12.13 Strategy and Organisational Culture

(*Source:* John D. Daniels, etal, International Business, Pearson, 2013, p.608)

employees. For example, the spread of personal computers in the workplace has reduced the need for mainframe computers, altered the role of corporate MIS staff, and offered customer service employees far more information than their counterparts possessed decades ago. This raised their status as well as their training requirements.

Changes in cultural values and mores also trigger organisation change. For example, reduced consumption of tobacco products has caused producers of such products to diversify into other product areas. Philip Morris purchased General Foods in 1985 and Kraft in 1988. It is now aggressively attacking the European market, acquiring the chocolate and coffee house, Jacob Suchard, as well as the leading cigarette company in former East Germany. Similarly, WD & HO Wills have bought sporting goods companies throughout Asia, particularly in India and Pakistan.

More than products and work practices, change has its impact on organisational structure too. In the recent years, many companies that struggled to stay competitive, responded by reducing the size and basic configurations of their organisational charts. The process of reducing the number of employees required to operate effectively is known as downsizing. Downsizing is not just laying off people to save money. It is directed at adjusting the number of employees needed to work in newly designed organisations (which is why it is also called rightsizing).

Another way organisations are restructuring is by completely eliminating parts of themselves that focus on non-core sectors of the business and hiring outsider firms to perform those functions instead – a practice called outsourcing. The practice of using outsourcing services of overseas companies is known as offshoring. Downsizing, outsourcing or offshoring will have significant impact on the firm's strategies and structures.

Summary

- Organisational design represents the vehicle through which strategy of a company is implemented and through which the work of the organisation is put in place. (LO1)
- Several factors (can be broadly categorised into two) impact the organisational design. They are technology and environment. (LO2)
- MNCs can choose among several structures available. The basic structures include: international division structure, functional structure, area structure, product structure, matrix structure and hybrid type. Each has its own pluses and minuses. (LO3)
- Overall philosophy of the organisation, control systems that are in place, organisational culture, nature of business, product strategy and the like are of the cues that help select an appropriate structure. (LO4)
- Several issues go with structures. They include: differentiation, technology impact, control systems, corporate culture and the like which are connected with organisational structures. (LO5)

Review Questions

1. Explain the nature of international organisational design. Bring out the factors that affect organisation structure. (LO1 & LO2)
2. Write notes on:
(a) International Division Structure (LO3)
(b) Worldwide Functional Structure
3. Explain the following, highlighting their merits and demerits:
(a) Geographic Area Structure (LO3)
(b) Product Organisation
4. What is matrix structure? How is it suitable for international business? (LO3)
5. Write notes on: (LO3)
(a) Mixed Structure
(b) Networked Structure
6. State and explain the various issues related to an organisational design. (LO5)

Discussion Questions

1. Do managers of international firms need to approach organisation design differently from their counterparts in domestic firms? Why or why not? (LO2)
2. How do the global product, area, functional, and customer approaches to organisation differ? How are they similar? (LO3)
3. Why do international firms need to develop a unique organisational design rather than simply model themselves on other firms? (LO4)
4. Why is coordination important in international business? (LO5)
5. What role might IT play in designing an organisational structure? (LO5)

Reinforcing Excercises

- Walmart is one example which follows international division model to oversee its planned international operations. Located at Arkansas, the division overseas operations in 27 countries that collectively generate more than $135bn in sales. In terms of reporting structure, the division is divided into three regions – Europe, Asia and the Americans – with the CEO of each region reporting to the boss of the international division, who in turn reports for the CEO of Walmart. We too have stated some examples in the text. Can you find some more names of the firms?
- Most western corporators have a preference for consolidation, for lumping business units and divisions together under one banner to make it clear as to who is accountable. In many cases, the businesses are disparate and unrelated, but they are nevertheless force-fitted into the corporate hierarchy. Decision-making comes from the above and trickles down to the various companies, whether a particular direction and rationale truly makes sense for all or not. Many times it will not. Eager to make sure everyone understands who is the boss, CEOs create direct-reporting relationships and matrices, all of which are designed to reduce independence. Tata sons does precisely the opposite.

  Who is right? Who is wrong?

CLOSING CASE

Organisational Change at Unilever

Unilever is a very old multinational with worldwide operations in the detergent and food industries. For decades, Unilever managed its worldwide detergents activities in an arm's-length manner. A subsidiary was set up in each major national market and allowed to operate largely autonomously, with each subsidiary carrying out the full range of value creation activities, including manufacturing, marketing, and R&D. The company had 17 autonomous national operations in Europe alone by the mid-1980s.

In the 1990s, Unilever began to transform its worldwide detergents activities from a loose confederation into a tightly managed business with a global strategy. The shift was prompted by Unilever's realisation that its traditional way of doing business was no longer effective in an arena where it had become essential to realise substantial cost economies, to innovate, and to respond quickly to changing market trends.

The point was driven home in the 1980s when the company's archrival, Procter & Gamble, repeatedly stole the lead in bringing new products to market. Within Unilever, "persuading" the 17 European operations to adopt new products could take four to five years. In addition, Unilever was handicapped by a high-cost structure from the duplication of manufacturing facilities from country to country and by the company's inability to enjoy the same kind to scale economies as P&G. Unilever's high costs ruled out its use of competitive pricing.

To change this situation, Unilever established product divisions to coordinate regional operations. The 17 European companies now report directly to Lever Europe. Implicit in this new approach is a bargain: The 17 companies are relinquishing autonomy in their traditional markets in exchange for opportunities to help develop and execute a unified pan-European strategy.

As a consequence of these changes, manufacturing is now being rationalised, with detergent production for the European market concentrated in a few key locations. The number of Euopean plants manufacturing soap has been cut from 10 to 2, and some new products will be manufactured at only one site. Product sizing and packaging are being harmonised to cut purchasing costs and to pave the way for unified pan-European advertising. By taking these steps, Unilever estimates it may save as much as $400 million a year in its European operations.

Lever Europe is attempting to speed its development of new products and to synchronise the launch of new products throughout Europe. Its efforts seem to be paying off: A dishwasher detergent introduced in Germany in the early 1990s was available across Europe a year later—a distinct improvement.

But history still imposes constraints. Procter & Gamble's leading laundry detergent carries the same brand name across Europe, but Unilever sells its product under a variety of names. The company has no plans to change this. Having spent 100 years building these brand names, it believes it would be foolish to scrap them in the interest of pan-European standardisation.

Questions

1. What strategy was Unilever pursuing before its early 1990s reorganisation? What kind of structure did the company have? Were Unilever's strategy and structure consistent with each other? What were the benefits of this strategy and structure? What were the drawbacks?

2. By the 1990s, was there still a fit between Unilever's strategy and structure and the operating environment in which it competed? If not, why not?

3. What kind of strategy and structure did Unilever adopt in the 1990s? Is this appropriate given the environment in which Unilever now competes? What are the benefits of this organisational and strategic shift? What are the costs?

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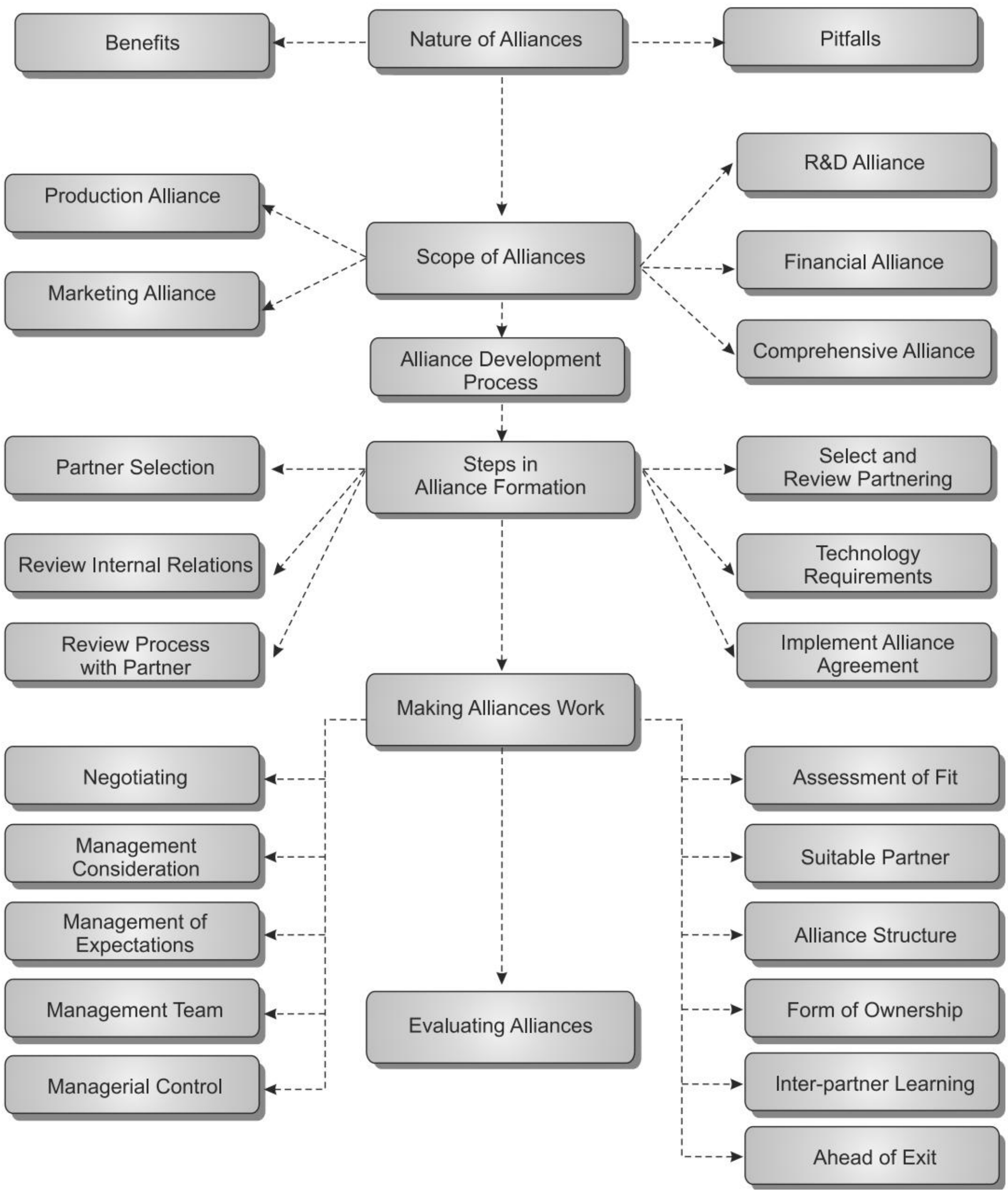
Suggested Readings

The Economist, July 26, 2014.

CHAPTER


Benefits
Nature of Alliances
Pitfalls
R&D Alliance
Production Alliance
Scope of Alliances
Financial Alliance
Marketing Alliance
Comprehensive Alliance
Alliance Development Process
Partner Selection
Steps in Alliance Formation
Select and Review Partnering
Review Internal Relations
Technology Requirements
Review Process with Partner
Implement Alliance Agreement
Making Alliances Work
Negotiating
Assessment of Fit
Management Consideration
Suitable Partner
Management of Expectations
Alliance Structure
Management Team
Evaluating Alliances
Form of Ownership
Managerial Control
Inter-partner Learning
Ahead of Exit

13

International Strategic Alliances

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Define the nature of strategic alliances
- **LO 2:** Discover the scope of strategic alliances
- **LO 3:** Analyse the benefits of strategic alliances
- **LO 4:** Analyse the pitfalls of strategic alliances
- **LO 5:** Deconstruct the processes of forming alliances
- **LO 6:** Outline the efforts which go into making an alliance Work
- **LO 7:** Examine the economic considerations for strategic alliances
- **LO 8:** Evaluate alliances

Opening Case

Alliances in the Airline Industry

There are an estimated 500 airlines alliances around the world. Many of these are between international and regional or local airlines. There are also a number of links between major international airlines. The four largest of these alliances are Star Alliance (United Airlines of the US, Lufthansa of Germany, Scandinavian Airlines System, Air Canada, Varig of Brazil, Thai Airlines, Air New Zealand, and Ansett Australia); Oneworld (British Airways, American Airlines, Cathay Pacific of Hong Kong, Canadian Airlnes, and Quantas of Australia, joined by Iberia of Spain and Finnair during 1999); Wings (KLM of the Netherlands, Continental Airlines of the US, and Alitalia); and an alliance between Delta Air Lines of the US, Swissair, Austrian Airlines, and Sabena of Belgium. The Oneworld alliance was formed after its two leading members, British Airways and American Airlines, became impatient with the US, UK, and EU competition authorities for failing to approve their proposed trans-Atlantic link-up unless they were willing to give up a large number of airport slots.

Among all the alliances in airlines industry, Star Alliance launched on May 14, 1997, is the largest in the world that runs about 18,100 daily flights to 975 airports in 162 countries, having a total fleet of 3,360 aircraft carrying about 510 million passengers annually.

The alliance developed the regional concept in 2004 which helps it penetrate individual markets through regional carriers. Star Alliance was voted the best airline alliance in the 2005 World Airline Award for the second time in three years.

Alliances enable airlines to code-share (selling tickets to destinations served by their alliance partners,) cooperate on fares, share each other's frequent flyer schemes and airport lounges, share information, purchase airport services jointly, and coordinate aircraft use. Oneworld is at present unable to code-share or cooperate on fares as they have not yet received regulatory approval. Cooperation of this kind can bring benefits to passengers by way of cost savings and the convenience of through-tickets, extended frequent flyer schemes, shared information, and other facilities. However, airline alliances increase the market power of the major airlines, which they may use to raise fares or keep smaller airlines out of the market. Alliances are often fragile, lasting only a short time, though recent evidence suggests that airlines are beginning to settle down with their preferred partners. Although alliances are generally a loose arrangement, equity stakes are sometimes involved and the management of such alliances is becoming more formal. In the airline industry, alliances provide evidence of worldwide industry consolidation as global competition intensifies.

STRATEGIC alliances among international businesses are common. Globalisation of business is the order of the day. But internationalisation can be a very expensive process, particularly where a firm must coordinate R&D, production, marketing, human resource, and financial decisions to succeed. A firm may discover that it is short on some of the internal resources necessary to effectively compete against its rivals internationally. The high costs of research and development of new products alone often stretches corporate budgets. Therefore, a firm may seek partners to share these costs. For example, Boeing has enlisted the support of Japanese partners to help offset the high development costs of the next generation of jumbo jets. Likewise, a firm may develop a new technology but lack a distribution network or production facilities in all the national markets it seeks to serve. Strategic alliances are answers to all such issues, as the opening case shows.

NATURE OF STRATEGIC ALLIANCES

LO 1
Define the nature of strategic alliances

Strategic alliances are cooperative agreements between firms that go beyond normal company to company dealings. Alliances and/or cooperative agreements can involve *joint research efforts, technology sharing, joint use of production facilities, marketing one another's products, or joining forces to manufacture components or assemble finished products.*

Strategic alliances can be grouped into three broad categories: non-equity alliances, equity alliances, and joint ventures. (See Fig. 13.1). In a **non-equity** alliance, cooperating firms agree to work together to carry on activities but they do not take equity positions in each other or form an independent organisation to mange their cooperative efforts. These non-equity alliances are managed through contracts. *Supply agreements* (where one firm agrees to supply to others), and *distribution agreements* (where one firm agrees to distribute the products of others) are examples of non-equity strategic alliances.

In an **equity alliance**, cooperating firms supplement contracts with equity holding in alliance partners. For example, when GM began importing small cars manufactured by Isuzu, not only did these partners have supply contracts in place, but GM also bought 34.2 per cent of Isuzu's stock. In a **joint venture**, cooperating firms create a legally independent firm in which they invest and share profits, if any.

The use of all types of alliances has grown substantially over the last several years. By the early 1990s, for example, IBM had over 400 strategic alliances with various companies in the US and overseas. One of these alliances, DOW Corning (a joint venture with Dow Chemical) is listed in the *Fortune* 500. Over 450 alliances have been established between pharmaceutical and biotechnology firms in the late 1990s. Overall, the rate of joint venture formation between US and international firms has been growing at an annual rate of 27 per cent since 1985. Not to be forgotten are the airline alliances discussed in the opening case. Nearer home, ICICI and HUL have launched a 'partnership project' for contract farming in wheat and basmati rice in Haryana and Madhya Pradesh. Similarly, Rallis and ICICI have tied up with big retail chains like Food World and Nilgiris for contract farming of fruits and vegetables in Karnataka. Last year, Hero Motors entered licensing agreement with Aprilia (Europe's second largest two-wheeler maker) to manufacture and sell 'motoscooters' in India. The agreement, valid for eight years, permits Hero Motors to use the brand name and technical expertise of Aprilia, which is to be paid royalty on every vehicle. Twenty one oil and gas companies, recently decided to have a joint pool of scarce equipment and services to save cost and time overrun. The players include BP, ENI, BG, Cairn, Hardy, RIL, and ONGC. Their ultimate aim is to create enabling environment for rig-sharing. Rigs are scarce and cost between \$5 lakh and \$7.5 lakh per day. Bharti Airtel, Vodafone and Idea Cellular have formed 'Indus Towers' to share towers. BSNL and Aircel have a ten-year understanding (effective from 2009) to share towers of BSNL. Ericsson and Philips are working together on projects in which mobile phones antennae are embedded in streetlights in European cities. Hershey and Ferrero, two confectioners are sharing warehouses and vehicles in North America. American Express is marketing Bluebird, a low cost current account, through Walmart stores.

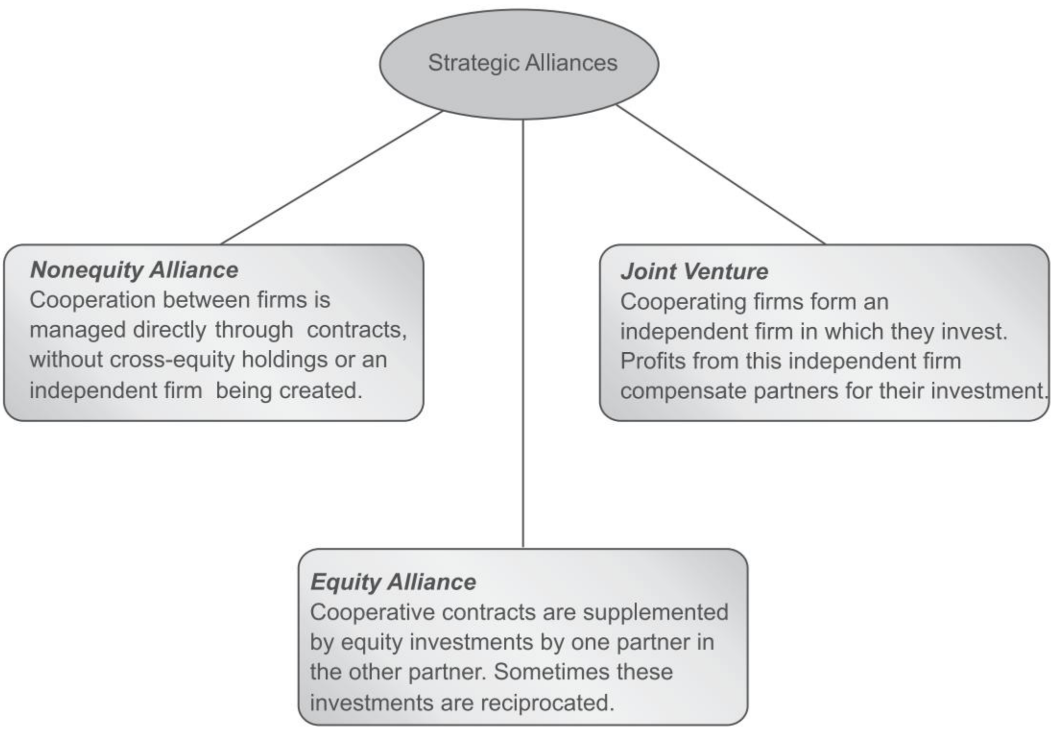


Fig. 13.1 Types of Strategic Alliances

(*Source:* Jay B. Barney, *Gaining and Sustaining Competitive Advantage,* PHI, 2004, p. 270)

Mahindra partnered with Ford to learn low to design the next generation SUVs which resulted in Scorpio. Bajaj Auto partnered with Kawasaki and Toyota R&D to transform itself from an old line scooter supplier to new age motor cycle company. Tata Motors partnered with leading global suppliers like Bosch to design their Nano. Exxon Mobil signed a strategic partnership with Rosneft, a Russian state-controlled oil company—together they propose to explore energy reserves in Russia's Arctic region. Strategic alliances have entered even education. Recently, Hong Kong Polytechnic University invited tenders to enter strategic alliances for leadership development in their MBA programme.

SCOPE OF STRATEGIC ALLIANCES

LO 2
Discover the scope of strategic alliances

The scope of cooperation between firms varies significantly as shown in Fig. 13.2. An alliance may be comprehensive that is one in which the partners participate in all facets of conducting business. On the other hand, an alliance may have a more narrowly defined focus concentrating on any element of the business such as R&D. These latter alliances are called functional alliances. The degree of collaboration will depend on the basic goal of each partner.

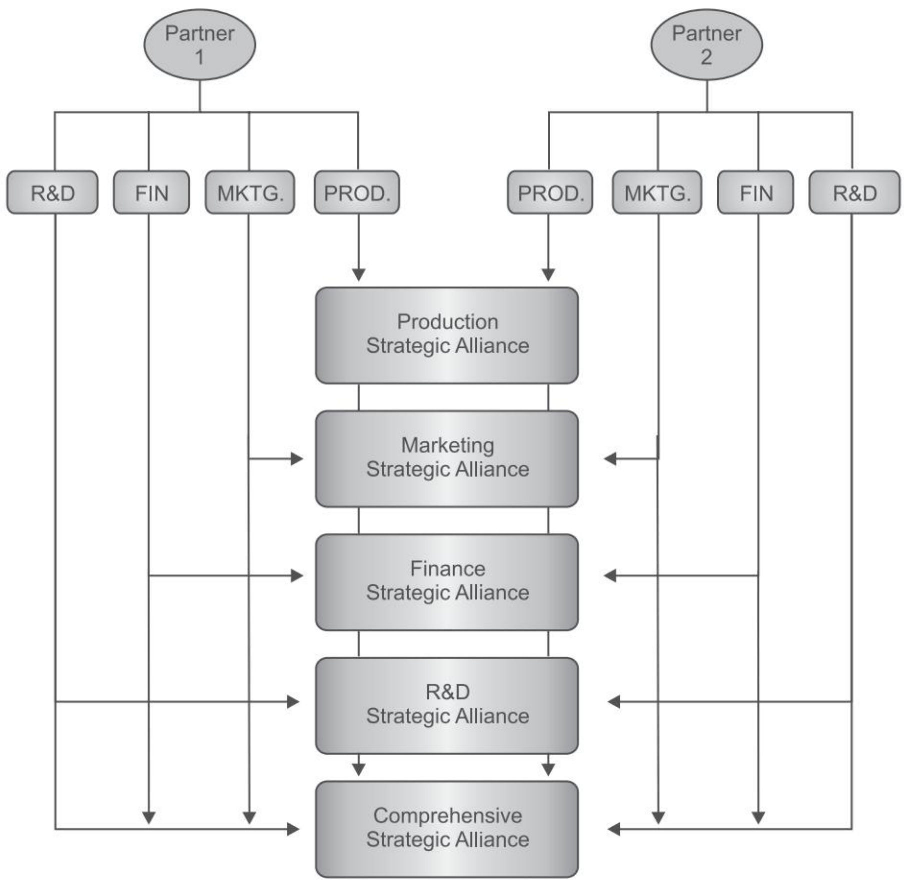


Fig. 13.2 Scope of Strategic Alliance

Comprehensive Alliances

These include collaborative agreements that cover all stages of manufacture, such as R&D, design, production, marketing and distribution. These alliances mainly assume the form of joint ventures. A joint venture is an ideal form of organisation to handle a comprehensive alliance. As an independent entity, the joint venture can handle all operations without giving scope for incompatible partners to interfere in the day-to-day activities.

Obviously, comprehensive alliances are very difficult to form. This difficulty arises from the numerous areas of collaboration that must be addressed and negotiated. Consequently, joint venture alliances often involve only two MNCs and may evolve over time.

Functional Alliances

These are alliances which have narrow scope and cover production, marketing, finance, or R&D activities. These do not take the form of joint ventures.

A *production alliance* is a functional alliance in which two or more firms join, each manufacturing products or providing services in a shared or common facility. Production alliances may use a facility already owned by one partner, or may involve the construction of a new facility altogether.

A *marketing alliance* is a functional alliance in which two or more firms share marketing services or expertise. In most cases this involves one partner introducing its products or services into a market in which the other partner already has a presence. The established firm helps the newcomer by promoting, advertising and/or distributing its products or services. The established firm may negotiate a fixed price for its assistance or may share in the newcomer's profits. Marketing alliances are common in book publishing though they are not uncommon in other areas also. For example, the alliance between Titan and the Timex US watchmaker was for marketing watches. But the arrangement was shortlived. Under an 8-year-old agreement, Titan handled the marketing and distribution of watches made by Timex. But the firm reneged on its commitment with effect from April 1, 1998, when Titan suddenly stopped its offtake of Timex watches. This was not the only problem. Under the agreement, Titan was not allowed to launch watches under ₹ 1000; that segment was to be left open for Timex. However, just before the break-up of the alliance, Titan launched two new brands—Sonata (₹ 375 and above) and Dash (Rs 250 plus). The alliance between P&G and Godrej was a marketing alliance (read closing case to this chapter). A *financial alliance* is a collaborative arrangement of firms that wish to reduce the financial risks associated with a project. Partners may equally share finance or one partner may contribute the bulk of the finance while the other partner(s) provides special expertise or make other kinds of contributions. In *R&D alliance* the partners agree to undertake joint research to develop new products or services. These alliances are not usually formed as joint ventures. Since forming a separate legal organisation and staffing it with teams of researchers drawn from the staff of each partner might disrupt ongoing scientific work in the respective laboratories, each partner may instead singly agree to cross-license whatever new technology is developed thereby allowing its partner(s) to use its patents as well. Therefore each partner has equal access to all technologies developed by the alliance, an arrangement that guarantees that the partners will not fall behind each other in the technological race. Oflate, weak demand, overcapacity, and severe environmental regulations are forcing automakers to form alliances in order to save billions that each would otherwise have to invest on R&D.

BENEFITS OF STRATEGIC ALLIANCES

LO 3
Analyse the benefits of strategic alliances

Strategic alliances are beneficial for the reasons stated in the opening paragraph. In addition, an alliance can offset the competitive disadvantages of firms. It can also help allied companies direct their competitive energies more towards mutual rivals and less towards one another. Who partners with whom affects the pattern of industry rivalry. Many runner-up companies, wanting to preserve their independence, resort to alliances rather than mergers in order to close the competitive gap. They rely on collaboration with others to enhance their own capabilities, develop valuable new strategic resources, and compete effectively. Industry leaders pursue cooperative alliances in order to better fend off ambitious rivals and open up new opportunities.

Strategic alliances are much favoured, indeed essential, in industries like electronics, semiconductors, computer hardware and software, and telecommunications where technological developments are changing at a furious pace along many different paths, and advances in one technology spill over to affect others, often blurring industry boundaries. Whenever industries are experiencing high velocity technological change in many areas simultaneously, firms find it essential to have cooperative relationships with other enterprises to stay on the leading edge of technology and product performance even in their own areas of specialisation. They cooperate in technology development, in sharing R&D information of mutual interest, in developing new products that complement each other, and in building networks of dealers and distributors to handle their products.

> Competitive advantage emerges when a firm acquires valuable resources and capabilities through alliances and cooperative agreements that it could not otherwise obtain on its own, and this requires real collaboration between the partners to create new value together, not just exchange of ideas and information.

Matsushita, for example, has tied up with Microsoft to work on digital convergence projects that involve integration of digital, audio visual, and personal computer technologies. Texas Instruments aligned with Hitachi in 1988 to conduct joint research and later manufacture memory chips.

Collaborative agreements facilitate enter foreign markets. Motorola, for example, initially found it very difficult to gain access to the Japanese cellular telephone market. In the mid-1980s the firm complained about Japanese trade barriers. The turning point for Motorola came in 1987 when it allied itself with Toshiba to build microprocessors. As part of the deal, Toshiba provided Motorola with marketing help, including some of its best managers. This helped Motorola secure government approval to enter the Japanese market and getting radio frequencies assigned for its mobile communications systems. Similarly, Mobil entered strategic alliance with BP to penetrate into European markets.

Yet another rationale for forming strategic alliances is risk sharing. Major industries today are so competitive that no firm has a guarantee of success when it enters a new market or develops a new product. Cooperative agreements can be used to either reduce or control an individual firm's risks. An example that can be cited in this context is Boeing, the world's most successful commercial aircraft manufacturer. It formed a strategic alliance with three Japanese firms—Fuji, Mitsubishi, and Kawasaki—to develop the Boeing 777. Designing and developing a wide body jet costs billions of dollars, which no one firm can risk, and Boeing sought to minimise the risk through strategic alliance.

One of the most often cited reasons for forming strategic alliances is the exploitation of economies of scale. Alliance partners will be able to reap economies of scale in partnership rather than when they act independently. In this context, the complementary assets and resources that alliance partners possess are their development, manufacturing, and distribution activities. The cost of these activities, when combined in a strategic alliance, can be less than the cost of the activities separately.

Firms can also use strategic alliances to learn important skills and abilities from their competitors. The joint venture between GM and Toyota has been cited for its potential to help GM learn about manufacturing high quality small cars. To take advantage of this learning potential, GM rotates managers between its own manufacturing facilities and those of the joint venture.

Alliances are formed among firms of developed and developing countries for mutual motivations. The partner from the developing country seeks the technology, know-how, or capital from the developed country. The partner from the developed country seeks an opportunity to benefit from comparative advantages of the lesser-developed country. These advantages often include low cost labour and untapped reserves of raw materials.

Usually, these alliances take the form of a joint venture. Many US firms use joint ventures with companies from Mexico to take advantage of low cost labour. Both US and Japanese firms often find joint ventures in Southeast Asia attractive for the same reason. The numerous untapped oil and mineral reserves in Russia make joint ventures in that country attractive to many US and European companies.

Strategic alliances have become fashionable, besides serving sound economic reasons. The 1980s and 1990s have seen an explosion in the number of strategic alliances and there seems to be no reversal of the trend. Historically, export-minded firms in industrialised countries sought alliances with firms in less-developed countries to import and market their products locally—such arrangements were often necessary to win local government approval to enter a less developed country's market or to comply with governmental requirements for local ownership. More recently, firms from different parts of the world have formed strategic alliances and partnership arrangements to strengthen their mutual ability to serve whole continents and move towards more global market participation. Both Japanese and American companies are actively forming alliances with European companies to strengthen their ability to compete in European Community and to capitalise on the opening up of East European markets. Many US and European companies are allying with Asian companies in their efforts to enter markets in China, India, and other Asian countries. (See also Exhibit 13.1)

Thus, strategic alliance can provide or attain[6]—

- cost reductions;
- access to complementary skills;
- cooperation in supplying a range of products into opportunity markets that would not be available to a small volume supplier;
- joint contributions to marketing and promotion costs to enter new markets;
- access to capital and grants;
- access to required plant and equipment;
- increased bargaining power;
- cooperation in undertaking training;
- improved performance and efficiency and thus the chances of survival. (Also see Exhibit 13.2)

PITFALLS OF STRATEGIC ALLIANCES

LO 4
Analyse the pitfalls of strategic alliances

There are potential pitfalls from collaboration agreements that need to be stated in this context. Figure 13.3 summarises seven fundamental sources of problems that often threaten the viability of strategic alliances.

Exhibit 13.1

TOSHIBA'S USE OF STRATEGIC ALLIANCES AND JOINT VENTURES

Toshiba, Japan's oldest and third largest electronics company (after Hitachi and Matsushita), over the years has made technology licensing agreements, joint ventures, and strategic alliances cornerstones of its corporate strategy. Using such partnerships to complement its own manufacturing and product innovation capabilities, it has become a $37 billion maker of electrical and electronics products—from home appliances to computer memory chips to telecommunications equipment to electric power generation equipment.

Fumio Sato, Toshiba's CEO, contends that joint ventures and strategic alliances are a necessary component of strategy for a high-tech electronics company with global ambitions:

"It is no longer an era in which a single company can dominate any technology or business by itself. The technology has become so advanced, and the markets so complex, that you simply can't expect to be the best at the whole process any longer."

Among Toshiba's two dozen major joint ventures and strategic alliances are:

- A five-year-old joint venture with Motorola to design and make dynamic random access memory chips (DRAMs) for Toshiba and microprocessors for Motorola. Initially the two partners invested $125 million apiece in the venture and have since invested another $480 million each.
- A joint venture with IBM to make flat-panel liquid crystal display in colour for portable computers.
- Two other joint ventures with IBM to develop computer memory chips (one a "flash" memory chip that remembers data even after the power is turned off).
- An alliance with Sweden-based Ericsson, one of the world's biggest telecommunications manufacturers, to develop new mobile telecommunications equipment.
- A partnership with Sun Microsystems, the leading maker of microprocessor-based workstations to provide portable versions of the workstations to Sun and to incorporate Sun's equipment in Toshiba products to control power plants, route highway traffic, and monitor automated manufacturing process.
- A $1 billion strategic alliance with IBM and Siemens to develop the next generation DRAM—a single chip capable of holding 256 million bits of information (approximately 8,000 typewritten pages).
- An alliance with Apple Computer to develop CD-ROM-based multimedia players that plug into a TV set.
- A joint project with the entertainment division of Time Warner to design advanced interactive cable television technology.

Other alliances and joint ventures with General Electric, United Technologies, National Semiconductor, Samsung (Korea), LSI Logic (Canada), and European companies like Olivetti, SCS-Thomson, Rhone-Poulenc, Thomson Consumer Electronics, and GEC Alsthom are turning out such products as fax machines, copiers, medical equipment, computers, rechargeable batteries, home appliances, and nuclear and steam power generating equipment.

So far, none of Toshiba's relationships with partners has gone sour despite potential conflicts among related projects with competitors (Toshiba has partnerships with nine other chip makers to develop or produce semiconductors). Toshiba attributes this to its approach to alliances: choosing partners carefully, being open about Toshiba's connections with other companies, carefully defining the role and rights of each partner in the original pact (including who gets what if the alliance doesn't work out), and cultivating easy relations and good friendships with each partner.Toshiba's management believes that strategic alliances and joint ventures are an effective way for the company to move into new businesses quickly, share the design and development costs of ambitious new products with competent partners, and achieve greater access to important geographic markets outside Japan.

(*Source*: Thomson and Strickland, *Strategic Management*, p. 195)

Exhibit 13.2

SOME REASONS FOR CONCLUDING CROSS BORDER STRATEGIC BUSINESS ALLIANCES

- To capture economies of synergy (e.g., by pooling resources and capabilities and by rationalising production)
- To lower capital investment; to disperse or reduce fixed costs; to better exploit scale and/or scope economies; to lower unit costs by using the comparative production advantage of each partner
- As a consequence of the convergence of technologies and interdependencies among innovation processes and as a response by firms to growing competition, a shorter product cycle and a faster rate of technological obsolescence:
    (a) To spread R&D costs; to gain speedy access to new technologies; and
    (b) As a means of promoting joint R&D and design efforts with suppliers and/or customers.
- To obtain reciprocal benefits from the combined use of complementary assets; to exchange patents and territories
- To overcome government-mandated trade or investment barriers
- To assist the entry process of small firms into high-risk, entrepreneurial ventures, especially in emerging technology sectors
- To gain new knowledge about, or achieve quicker access to, markets and/or to spread marketing and distribution costs; to widen market sources
- To pre-empt or neutralise the strategy of competitors or to advance monopoly power; as a defensive strategy to reduce competition
- To better secure contracts from foreign governments who favour local firms; to better deal with local suppliers and/or labour unions
- As an initial entry strategy to unfamiliar markets
- To reduce cross-border political risks

(*Source*: John H. Lunning and Sarianna M. Lundan, *Multinational Enterprises and the Global Economy*, p. 283)

Adverse Selection

One serious problem with alliances is the adverse selection of partners. Potential cooperative partners can misrepresent the skills, abilities, and other resources that they will bring to an alliance. The partner may promise to bring to the alliance certain resources that it either does not control or cannot acquire. For example, a local firm engages in adverse selection when it promises to make available to alliance partners a local distribution network that does not currently exist. Firms engaging in adverse selection are not competent alliance partners.

Moral Hazard

Partners in an alliance may possess resources and capabilities of high quality and of considerable value but fail to make them available to alliance partners. For example, a partner, in an engineering strategic alliance may agree to send only its most talented and best trained engineers to work in the alliance but

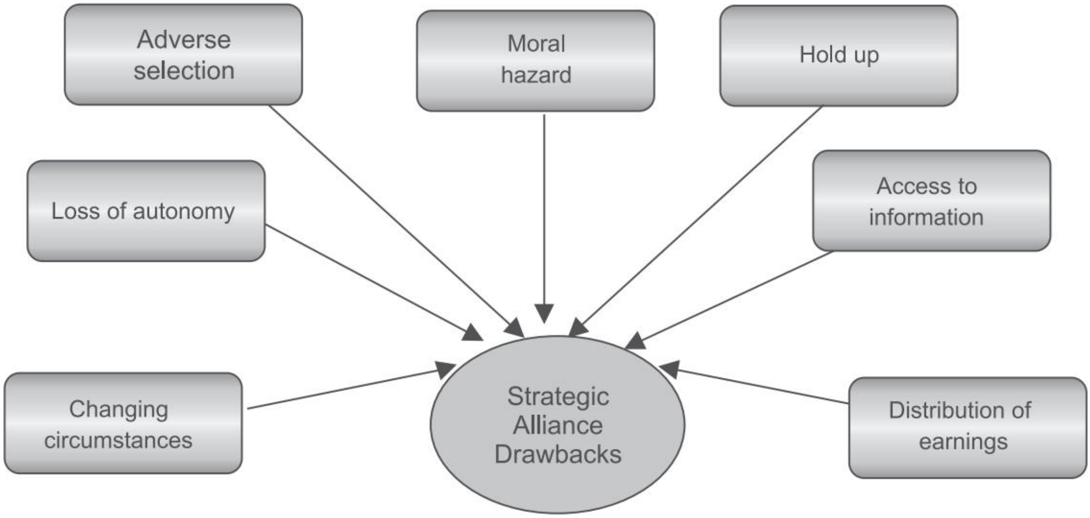


Fig. 13.3 Drawbacks of Strategic Alliances

then actually send less talented, poorly trained ones. These engineers may not be able to contribute a great deal to the success of the alliance, but may learn from more qualified and talented personnel sent by other partners. In this way, the less qualified engineers effectively transfer wealth from other alliance partners to their own firm. Such a situation is considered a moral hazard.

Hold Up

A hold up may take place even without an adverse selection or moral hazard occuring. Once a strategic alliance has been formed, partners may make investments that have value only in the context of that alliance and in no other activities. For example, managers from one alliance partner may have to develop close and trusting relationships with managers from other partners. These close relationships are valuable in the context of the alliance but have limited value in other activities. Also, one partner may have to customise its manufacturing equipment, distribution network, and key organisational policies to cooperate with other partners. These modifications have significant value in the context of the alliance but do not help the firm, and may even hurt it, in activities outside the alliance.

When one firm makes more activity-specific investments in an alliance than other partners make, the investing firm is subject to a hold up. Hold up occurs when a firm that has not made investments demands returns from the alliance that are higher than what the partners agreed to when they formed the alliance.

Access to Information

Access to information is another drawback of strategic alliance. For collaboration to work effectively, one alliance partner (or both) may have to provide the other with information it would prefer to keep secret. It is often difficult to identify information needs ahead of time. Therefore, a firm may enter an agreement not anticipating the need to share certain information. When the reality of the situation becomes apparent, the firm may have to reveal that information, or compromise the effectiveness of the collaboration.

Distribution of Earnings

This is the most serious problem between alliance partners. As the partners share risks and costs, they also share profits. This amounts to over-simplification of the issue. There are other financial considerations that can cause conflict. For example, the partners must also agree on the proportion of the joint earnings that will be distributed to themselves, as opposed to being reinvested in the business. In addition, they must agree on the accounting of earnings or profits, and how transfer pricing will be handled is also crucial.

British Airways is reconsidering a number of its strategic alliances because of financial issues. In 1993, the firm invested several hundred million dollars in the US Air as part of strategic alliance between the two carriers. After British Airways made its investment, US Air suffered major losses because of increased competition from low-fare carriers in its core Northeastern US markets. British Airways became concerned about the increased risk to its investment and the viability of US Air as a partner. In 1994 it announced that it was suspending further investment in the US Air until that carrier returned to profitability. Late in 1996 US Air signaled its effective withdrawal from the alliance. British Airways has warned other partners in strategic alliances that their respective agreements are in danger of termination unless profits begin to increase.

Potential Loss of Autonomy

Loss of autonomy is another potential drawback of a strategic alliance. The alliance between Hero and Honda that lasted 27 years finally broke down for this season. Honda, the Japanese partner, wanted greater say in decision—making, particularly in sourcing parts from original equipment manufacturers (OEMs), which the Munjals family was not willing to concede. The other disagreement related to expansion: Munjals wanted to expand overseas, but Honda wished to keep it to India only. Because of the loss of autonomy, the late Dhirubhai Ambani never countenanced the idea of an alliance. He bought technology for his PFY plant at Patalaganga from DuPont but refused their equity participation. Like Rahul Bajaj, Ambani did not take partners because he could never play second fiddle. Just as firms share risk and profits, they also share control, thereby limiting what each can do. Most attempts to introduce new products or services change the way the alliance does business. The introduction of new products or services, or any other significant organisational change, must first be discussed and negotiated. As part of the alliance contract many organisations include a clause that stipulates that if ever the joint venture terminates, the partners cannot enter each other's markets for a set period of time. Fuji-Xerox, the long lived and successful joint venture, for example, was originally limited to selling copies only in Indonesia, Japan, S Korea, the Philippines, Taiwan, and Thailand, although that restriction was later eliminated.

There is also the danger of the strategic alliance being the first step towards a takeover. One survey of 150 terminated strategic alliances found that over three quarters ended because the Japanese firms had taken over their non-Japanese partners.

Changing Circumstances

Changing circumstances may also affect the viability of a strategic alliance. The economic conditions that motivated the cooperative arrangement may no longer exist, or technological advances may render the alliance obsolete. For example, in the 1980s the Daewoo group and GM initiated a joint venture. Daewoo Motors would build vehicles in S Korea for export to the US and would be given operating control over the project. In addition, Daewoo group hopes to use GM’s marketing power to promote the sales of the joint venture’s vehicles. GM hoped to take advantage of low labour costs in S Korea. However, rising wages in S Korea and declining value of the US dollar eroded the cost savings GM hoped to gain from Korean production. Faced with its own quality problems in the US market, GM was unhappy at the prospect of selling defect ridden cars off Daewoo’s assembly lines to US consumers who were already sceptical of GM products. Conflict continued as the Daewoo group lobbied GM to incorporate the latest technological advances into the Daewoo vehicles, but GM was unwilling to invest more money in the joint venture until the quality of its purchases improved. Trust between the partners was not strengthened when Daewoo Motors signed an agreement to acquire technology from the Suzuki Motor Company. As it turned out even the decision-making styles of the two firms clashed. The Daewoo Group, a tightly knit, family-owned Chaebol, was used to making decisions quickly, while GM’s elaborate bureaucracy is fully capable of studying even the simplest problem for years.

In the first place, collaboration between independent firms, each with different motives and perhaps conflicting objectives, is not easy. It requires many meetings of many people working in good faith over a period of time to iron out what is to be shared, what is to remain proprietary and how the cooperative arrangements will work. Cross-border allies typically have to overcome language and cultural barriers; the communication, trust building and coordination costs are high in terms of management time. After years of functioning, partners discover they have deep differences of opinion about objectives and strategies. Tensions build up, working relationships cool, and the much expected results never materialise. Many times, allies find it difficult to collaborate effectively in competitively sensitive areas, thus raising questions about mutual trust and forthright exchanges to information and expertise. There can also be clashes of egos and cultures. The key people on whom success or failure depends may have little personal chemistry. They may be unable to work closely together or form a partnership, or be unable to come to consensus.

There are other reasons too. It has been proved that alliances have short life. The life of a JV is what is called the 'seven year itch', beyond which there develop many cracks between the partners. Often differences in aspirations and approaches cause a collapse. A case in point is HDFC-Chubb General Insurance. In 2007, the Indian outfit called off its JV with Chubb Corporation, the world's largest non-life insurance company, after five years owing to differences on the pace of growth.

JV flop appears to be in the DNA of some companies. Godrej, for example, has a history of broken JVs. In the nineties, Godrej Soaps broke its JV with P&G after four years as it felt its brands like Cinthol were receiving a short shrift. In the early 2000s, Godrej & Boyce and GE Appliances parted ways; and a tie up with Pillsbury to market wheat flour was also called off. And more recently, Godrej Consumer Products bought Sara Lee's 51.1 in Godrej Sara Lee, ending a 15-year J.V.

STEPS IN FORMING AN ALLIANCE

Alliance Development Process

LO 5
Deconstruct the processes of alliance development and steps in forming alliance

Alliances do not occur overnight. It takes time to crystalise the thoughts and efforts and to see the outcome. A typical alliance process involves three phases, as shown in Fig.13.4.

Alliances are formed, as stated earlier, for such purposes as to organise joint R&D, technology sharing, marketing other's products, and the like. Prior to forming the strategic partnership, the status of the alliance partners is that of uncertainty and instability, often deepening into crisis. But the partners seek to overcome the crisis that might abort the efforts to form the alliance. They employ short-term strategies and save the intended alliance from collapsing. These efforts are represented by a broken line running above the crisis point, before and after time zero. The short-term interventions might help convert the crisis into an opportunity. The task of converting the crisis into opportunity may take atleast one year.

The alliance partners shall consolidate with the same short-term interventions. With consolidation stems the possibility of alliance partners becoming complacent and even slipping back to the comfort zone, the stage at which the alliance partners were placed prior to the efforts to entertain strategic partnering. This is indicated by another dotted line (see Fig.13.4) that starts just after the second year.

Visionary leadership and strong commitment are needed to prevent the possibility of slipping back. Creating a more attractive and achievable goal shall help carry the proposed alliance to the second phase. Here, too, consolidation takes place but there is yet another possibility of losing the momentum, as the third dotted line indicates. The proposed alliance has, by now, reached the take-off stage and from here, marching to the third phase tends to be swift and fairly smooth. The whole process of conceiving the idea and operationalising the alliance is likely to spread over atleast five years.

Steps in Forming an Alliance

The three phases shown in Fig.13.4 involve several specific and detailed steps. They are: select a partner, identify drivers for alliancing, review internal relationships, review process with partner and share information, select and review partnering and alliance team members, discuss technology requirements and implement and review strategy action plan.

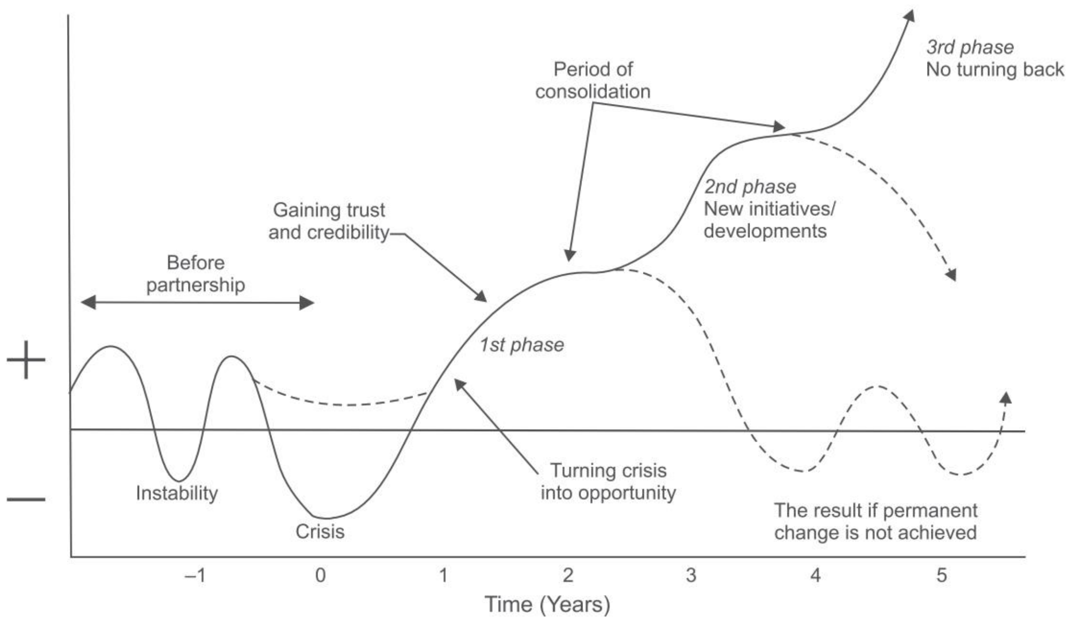


Fig. 13.4 Alliance Process Curve

(*Source:* Tony Lendrum, *The Strategic Partnering Handbook,* TMH, 2004, p. 49)

Partner Selection Strategic partnering is like marriage. The pre-condition for success in married life is the synergy between the husband and wife. Any mismatch would result in frequent quarrels, tension and unhappiness, often leading to separation. The alliance partner should also be selected after careful consideration of such factors as drive, trust, commitment and sincerity (More details on partner selection in the next section).

Drivers for Alliance The strategic partners need to spell out the drivers of the proposed alliance and the likely outcomes of such an alliance after it has been operationalised. Telecom New Zealand, the largest telecommunications provider in New Zealand and Alcatel, one of the world's largest builders of communications equipment, formed an alliance in 2002 to develop Telecom's trans-Tasman 'Next Generation Network'. This alliance is likely to enable Telecom to:

- combine voice and data on the same line,
- deliver multiple services with ease,
- roll out new services much faster and more cost effectively,
- continue to provide integrated solutions for voice, video and data,
- simplify Telecom's network and achieve substantial efficiencies.

And, for Telecom's customers, the alliance means:

- end-to-end service management to the desktop,
- greater data speeds for many customers,
- a flexible 'plug and play' IT and T environment,
- lower overall costs for IT and T services.

Review Internal Relationships A review of internal relationships needs to be carried out to ensure that the alliance partners are capable of sustaining partnerships. Earning trust, sharing information, resolving conflicts, removing roadblocks and improving internal communication will be the key requisites.

Review Process with Partner and Share Information The purpose of reviewing at this stage is to share the principles, processes and associated practices of strategic partnering and alliancing. The alliancing partner should be equally committed and supportive of the process if success were to be achieved.

Select and Review Partnering and Alliance Team Members Successful alliances are about equally successful teamwork and good governance. It is essential to develop a core group of people, picked up for their skills, commitment and ability to meet and exceed expectations.

Discuss Technology Requirements Technology should be developed and supplied selectively to reduce costs and enhance value. Technology should also add to the competitive advantage.

Develop, Implement and Review Action Plan As part of the strategic alliance process, there will be an action plan that brings together the strategy and activities of the previous steps. With the plans being implemented, review of the progress needs to be monitored.

MAKING AN ALLIANCE WORK

LO 6
Outline the efforts which go into making an alliance work

Many international alliances are ending up in failure. This has prompted a critic to point out that alliances are like Trojan horses that should be avoided. For example, one study of 49 alliances found that two-third run into serious financial and managerial troubles within two years of their formation, and that although many of these problems are solved, 33 per cent are ultimately rated as failures by the parties involved. It is because of this, discussion on managing alliances assumes relevance. The partners in an alliance must address eleven issues:

- Exercising Managerial Control
- Managing Inter-partner Learning
- Thinking Ahead of Exit
- Assessment of Fit with Strategy
- Partner Selection
- Alliance Structure
- Form of Ownership
- Negotiating Process
- Joint Management Consideration
- Management of Expectations
- Management Team

Exercising Managerial Control

Management team having been constituted for the alliance business, effective control needs to be exercised over its activities. Managerial control may be parent control or managerial control. *Parent control* is the process through which a parent company ensures that an alliance is managed in a way that conforms to its own interest. *Managerial control* is the process in which an alliance partner influences alliance activities or decisions in a way that is consistant with its own interests through various managerial, administrative or social tools.

Managing Inter-partner Learning

Strategic alliances bring companies with different and varied skills, competencies, strengths, knowledge and technologies together. Here is a unique opportunity for each partner to learn from others and together strengthen themselves. Learning from others can take place at two levels: operational and managerial. *Operational learning* includes knowledge about technology, processes (including quality control), production, marketing skills, and operational expertise (e.g. relationship—building expertise). *Managerial learning* comprises organisational expertise (e.g. leadership, human resources management, organisational structure, managerial efficiency, and employee participation); market (international and host country); industrial and collaborative experience; and financial management (e.g. cost-control, tax-reduction, risk-reduction, and asset management).

Inter-company learning becomes possible where there is an open mind with the alliance partners. The imparting partner needs to have willingness to share the knowledge with the alliance partners and the receiving firm shall accept the learning as an opportunity to enrich self without entertaining the thought it is inferior to the others.

Openness being assumed to obtain, the alliance partners should observe certain safeguards. First, the design, development, manufacture and service of a product manufactured by an alliance company needs to be structured so as to protect the most sensitive technologies. Second, the alliance firms can agree in advance to exchange specific skills and technologies that ensure equitable gain. Finally, avoiding undue dependence on an alliance partner shall help mitigate the leakage risk.

Thinking Ahead of Exit

It is truism that alliances do not last long and the alliance partners are well aware of this. It is advisable that the alliance exits after its object has been achieved. It will be painful when the alliance is wound up before the stated purpose has been realised.

Whatever the stage for exit, an alliance terminates for the following reasons:

- Failure to manage expectations
- Differences in operational or strategic objectives
- Differences in managerial styles
- Inability to predict partner's competenance
- Inability to predict regulatory policies

Assessment of Fit with Strategy

Any collaborative arrangement involves the combining of assets of two or more companies. If the strategic alliance can better achieve the firm's strategic objective than 'going-it-alone', then it should not have any doubt about becoming a partner. However, situations change, thus decisions need to be reassessed. For example, a firm's resource base may change relative to that of other companies, making strategic alliance more or less advantageous. Further, the external environment changes, such as the riskiness of or the types of operations permitted in certain locales. Because of these changes, a firm needs to continuously reexamine the fit between collaboration and strategy.

Partner Selection

The major key to making a strategic alliance work is to select the right ally. A good ally or partner is the one which has three characteristics: (i) A good partner helps the firm achieve its strategic goals whether they are market access, sharing the costs and risks of new products development, or gaining access to critical core competencies. The partner must have capabilities that the firm lacks but it values, (ii) A good partner shares the firm's vision for the purpose of the alliance. If the two firms do not share the common purpose of the alliance, the business will collapse. (iii) A good partner is unlikely to try to exploit the alliance for its own ends that is to exploit the firm's technological know-how while contributing little in return. To select a partner with these three characteristics a firm needs to conduct a comprehensive research on potential alliance candidates.

The research should cover the following areas:

1. Collect all relevant information publicly available on potential allies.
2. Collect data from informed third parties. These include firms that have had alliances with potential partners, investment bankers who had dealings with them, and former employees.
3. Have face-to-face meetings with the senior managers of the potential partner to ensure that the chemistry is right.
4. Look at the products that the potential partner is currently offering. Most experts believe that a firm should align itself with a partner whose products or services are complementary but not directly competitive with its own.
5. Assess the potential to learn from each other. Areas of learning can range from the very specific, for example how to manage inventory more efficiently or how to train employees more effectively to the very general—how to modify corporate culture and how to manage more strategically.

6. View the alliance as temporary (5 to 10 years); continue longer if it is beneficial but do not hesitate to terminate the alliance and go alone if the payoffs run out.
7. Avoid the 'anchor' partners. An anchor partner holds back the development of a successful strategic alliance because of the inability to provide its share of funding.
8. Be cautious of the "elephant-and-ant" complex. This occurs when the alliance partners are of unequal size. In alliances of unequal size, the larger firm will dominate the smaller firm. Corporate cultures between the two also differ.

Alliance Structure

Having selected a partner 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. Figure 13.5 depicts the four safeguards against opportunism by alliance partners. *Firstly*, alliances can be designed to make it highly difficult 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 leakages to the partner.

Secondly, contractual safeguards can be written into an alliance agreement to guard against the risk of opportunism by a partner. *Thirdly*, 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. For example, in the alliance between Motorola and Toshiba, the former has licensed some of its microprocessors technologies to Toshiba and in return Toshiba has licensed some of its memory chip technology to Motorola. *Fourthly*, the risk of opportunism by one 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 is a case in point. Rather than enter an informal agreement or a licensing arrangement (which Fuji initially wanted), Xerox insisted that Fuji invest in a 50/50 joint venture to serve Japanese and East Asia. This venture constituted such a significant investment in people, equipment, and facilities that Fuji Photo was committed from the outset to making the alliance work in order to earn a return on its investment by agreeing to the joint venture. Fuji essentially made a credible commitment to the alliance.

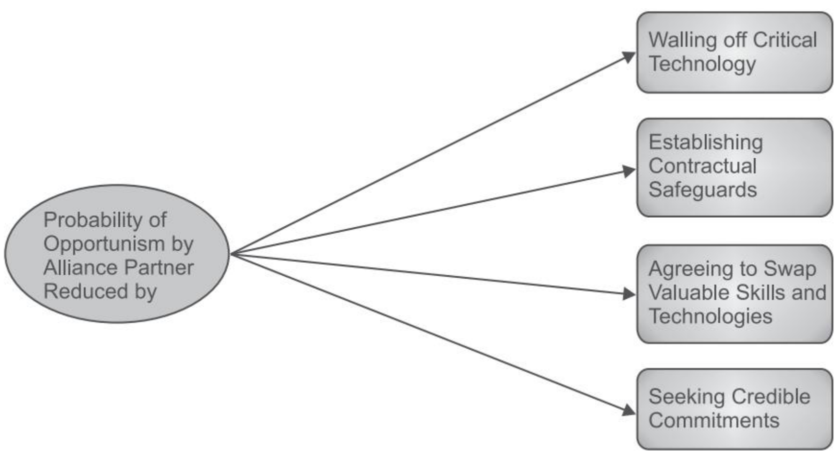


Fig. 13.5 Structuring Alliances to Reduce Opportunism

(*Source:* Charles W L Hill, *International Business,* p. 447)

Given this, Xerox felt secure in transferring its photocopiers technology to Fuji. The checklist given in Fig. 13.6 will be highly useful in selecting a partner entering an agreement and making the alliance work.

Form of Ownership

Another issue in establishing a strategic alliance is the form of ownership that is to be used. As stated earlier, joint venture is the most common form of strategic alliance. A joint venture almost takes the shape of a limited company and is located in the country in which it will be doing most of the business or may be located in a third country that offers tax and legal advantages.

The partners in joint venture are usually a private firm and a government, for example, Maruti-Suzuki, an erstwhile joint venture between the Government of India and the Suzuki of Japan. When Central and Eastern Europe were under communist control, public-private ventures were the primary method of investment by Western firms. And this entry mode is popular despite the opening up of the economies.

Then there are *turnkey operations*. These are the projects that involve a contract for construction of operating facilities that are transferred for a fee to the owner when they are ready to commence operations. Companies performing turnkey operations are frequently industrial-equipment manufacturers that supply some of their own equipment for the project. Usually, such firms are into construction activities. One popular example to be cited in this context is the alliance between ABB and Companhia Brasiheira de Projectos e Obras to construct a turnkey dam for the government of Malaysia.

A public-private venture may be created in any one of three ways:

(a) when the government of a land controls a resource and wants it to be exploited with the assistance of a foreign private firm that has the expertise, for example, exploitation and development of oil fields,

(b) when a particular country does not permit wholly owned foreign subsidiaries, and

(c) a firm entering a centrally planned economy has no choice except enlisting the support of the government as for example, China.

1. **Understanding your capabilities and needs**
   - Do you really need a partner? For how long?
   - How big is the payoff? How likely is its success?
   - Is a joint venture the best option?
2. **Choosing an appropriate partner**
3. **Designing the joint venture**
   - Define the venture's scope of activity, and its strategic freedom vis-a-vis its parents.
   - Layout each parent's duties and payoff to create a win-win situation.
   - Establish the management role of each partner.
4. **Doing the deal**
   - How much paper work is enough? Trust versus legal considerations?
   - Agree on an end game.
5. **Making the venture work**
   - Give the venture continuing top management attention.
   - Manage cultural differences.
   - Watch out for inequities.
   - Be flexible.

Fig. 13.6 Alliance Checklist

(*Source*: Paul W Bearnish, et al, *International Management,* Irwin, 1994, p. 130)

Negotiating Process

Any collaborative arrangement involves transfer of technology and funding of the alliance. Often, technology transfer is a contentious issue. The value of many technologies would diminish if they were widely known or understood. Historically, agreements have included provisions that the recipient will not divulge this information. In addition, some sellers have held onto the ownership and production of specific components so that recipients will not have the full knowledge of the product or the capability to produce an exact copy of it. Secrecy is an issue when firms are negotiating agreements to transfer process technology. Many times, a firm wants to sell techniques it has not yet used commercially. A buyer is reluctant to buy what it has not seen. It has become common to set up preagreements in order to protect all parties. Exhibit 13.3 shows major issues included in a typical JV agreement (Also see Exhibit 13.4).

Exhibit 13.3

ISSUES AND TERMS IN A TYPICAL JOINT-VENTURE AGREEMENT

1. Joint venture name and its legal nature (e.g. limited company or not)
2. Scope and scale of production or operations
3. Investment amount, unit of currency, and equity (ownership distribution)
4. Forms of contribution (e.g. cash, technology, land or equipment)
5. Responsibilities of each party
6. Technology or knowledge transfer
7. Marketing issues (e.g. focussing on export market or local market)
8. Composition of the board of directors (in equity joint ventures)
9. Nomination and responsibilities of high level managers
10. Joint venture project preparation and construction
11. Labour management (e.g. various human resource issues)
12. Accounting, finance, and tax issues (e.g. the currency unit of accounting)
13. Alliance duration
14. Disposal of assets after expiration
15. Amendments, alterations, and discharge of the agreement
16. Liabilities for breach of agreement
17. *Force majeure* (e.g. force or power that cannot be acted or fought against)
18. Settlement of disputes (e.g. litigation or arbitration)
19. Obligations of the contract (e.g. when it will take effect) and miscellaneous issues

(*Source:* Oded Shenkar and Yadong Lao, *International Business*, Wiley India, 2004, p.323).

Exhibit 13.4

EVAPORATED EUPHORIA

Bajaj had tempestuous relationship with scooter maker, Piaggio, owned by the Agnellis of Italy. The powerful Turin-based family runs an industrial empire which, according to David Lomax, author of *The Money Makers*, is 'so big and influential that no Italian government would dare either to ignore it or to adopt policies which would damage its overall interests'.

Piaggio and the Bajaj group tied up in early 1960 to assemble scooters in India. Vespa in India was as loved as Vespa in Europe, the first wheels alike of the rich and the poor. A young Sir Terence Conran, the British designer, scooted round London on his. In New Delhi, the college-going Bajaj found that his Vespa boosted his popularity. The technical collaboration ended in 1971 when the Indira Gandhi government refused permission to extend its term. Some analysts felt this was a blessing in disguise. 'With Rahul's tough and disciplined approach, the company soon found its footing in the market and Bajaj Chetak and Super became legends,' commented one.

On the day the collaboration officially, ended, Piaggio wrote to Bajaj, thanking him for years of 'really friendly cooperation' and wishing Bajaj Auto 'the most successful future'. It was dated April 1—All Fool's Day—an unintended irony. A decade later, Piaggio would accuse Bajaj of pilfering Piaggio designs in a California district court.

Piaggio's move appears to have been a knee-jerk reaction to Bajaj's export thrust. Pune's scooter king had started dreaming of becoming a global player. Between 1978 and 1981, Bajaj Auto's export sales jumped from Rs 63.5 m to Rs 133.2 m. A euphoric Bajaj even ran a campaign in *Time* magazine, perhaps the first Indian advertiser to do so. But he was still just a country cousin, Piaggio's production in 1981 was 905,000 vehicles, that of Bajaj Auto, 173,000. Piaggio's sales were L626bn (about Rs 4.7 bn at the then current rates). Bajaj Auto's were Rs 1.16 bn.

Bajaj's euphoria evaporated as Piaggio initiated legal action against him in the USA and West Germany. The Italians claimed that Bajaj had violated the terms of their collaboration, had not returned Piaggio's original drawings and so had no right to manufacture scooters.

Bajaj claims he had Piaggio's tacit permission. 'How else could it have been? We couldn't be expected to invest crores of rupees in plant and equipment and then one fine day cease to manufacture and let our investment go to seed. And, if Piaggio had not acquiesced in our action, it should have taken legal action then, not ten years later.' Piaggio's lawyers—Indian—took a rather dim view of this attitude. 'It's a matter of national importance that Indian companies abide by the agreements that they enter into with foreign companies. We want a greater inflow of foreign technology. How can we inspire confidence if we violate agreements?'

Bajaj brushes aside the argument. 'I remember a whole week in Genoa with four of my colleagues in 1975. A deal was about to be finalised. Everything was done. Without charging any royalty and fees, without any equity in our company, Piaggio would give the plans of their scooters and three-wheelers. In return we would give them the worldwide right for exporting our vehicles. We fixed the minimum value they would export each year for the next ten years. It got stuck on one small point. We wanted R&D cooperation. They wouldn't agree to that. But we broke amicably as we had done in 1971. Later our exports increased a little bit. They were still chicken feed. But Piaggio thought it was a threat.'

Hiring Baker-Mckenzie, one of the largest international law firms in the world, Bajaj poured $1m into his defence. It was a huge figure for an Indian company at the time.

The great scooter war ended on a whimper. In the USA, Piaggio offered an out-of-court settlement. The millions of dollars compensation demand was scaled down to $50,000. Bajaj 'refused to budge and in the final settlement only gave a promise that he would not sell Bajaj scooters of Piaggio design in the US. By then there was no demand for the scooters in the US anyway.' In Germany, Bajaj Auto lost in the lower courts but won in the supreme court.

(*Source*: Gita Piramal, *Business Maharajas*, Viking, 1996 pp. 99-100)

Another controversial area is the degree of secrecy surrounding the financial terms of agreements. In some countries, for example, governmental agencies must approve royalty contracts. Often, these authorities consult with their counterparts in other countries regarding similar agreements in order to improve their negotiating position with MNCs. Many MNCs object to this procedure because they believe that contract terms are proprietary information with competitive importance and that market conditions usually dictate the need for very different terms in different countries.

Joint Management Considerations

How to manage an alliance is another issue that needs to be addressed. In general, there are three ways to jointly manage a strategic alliance (see Fig. 13.7):

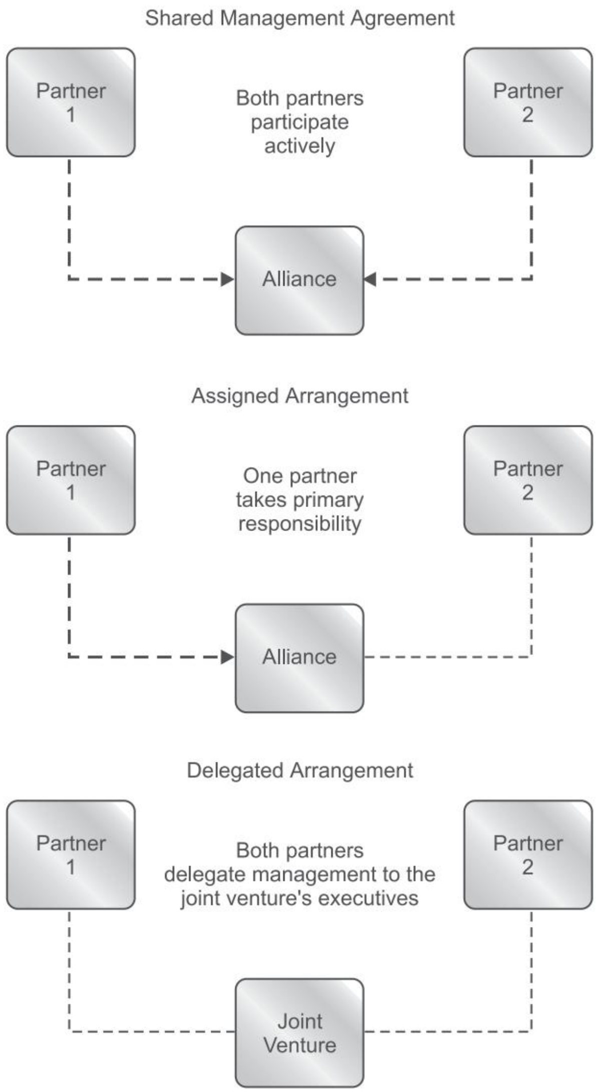


Fig. 13.7 Managing Strategic Alliances

(*Source:* Darell Mahoney, et al, p. 485)

- shared management agreement,
- assigned arrangement,
- delegated arrangement.

Shared Management Agreement Under this, each partner fully and actively participates in managing the alliance. The partners run the alliance, and their managers regularly pass instructions and details to the alliance managers. Managers in these alliances have limited authority and must defer most decisions to managers from the parent firms. This type of agreement requires a high level of co-ordination and near perfect agreement between the partners. Obviously, it is the most difficult type of agreement to maintain and the one most prone to lead to conflict between the partners.

Assigned Arrangement Under an assigned arrangement, a partner holding the majority of a joint venture's shares assumes primary responsibility for the operations of the strategic alliance. For example, Boeing controls the overall operations of its strategic alliance with Fuji, Mitsubishi, and Kawasaki for the design and production of the new 777 commercial aircraft.

Delegated Arrangement Under a delegated agreement that is reserved for joint ventures, the partners agree not to get involved in on-going operations and so delegate management control to the executives of the joint venture itself. These executives may be specially hired to run the new operation, or may be transferred from the participating firms. They are responsible for day-to-day decision-making and management of the venture and for implementing its strategy. The executives have real power and the autonomy to make significant decisions themselves.

Management of Expectations

Management of expectations is a critical issue in strategic alliances. When the expectations are too high, problems are bound to occur, leading to disappointment and frustration as the closing case to this chapter demonstrates. Wrong expectations often arise because the alliance partners may view the alliance differently. One may perceive the alliance as a target for acquisition, whereas the other may look at it as an equal partner. Often, different time horizons of the alliance partners can lead to wrong expectations. One partner may expect quicker returns while the other may be looking for long-term benefits. It is essential that the alliance partners do not entertain wrong expectations, and should they arise, they need to be subdued in the beginning itself.

Management Team

Alliance needs a management team whose members are devoted to the venture's success rather than representing the interests of the partners. Therefore, the team must be empowered and trusted by both sides, no one should be considered 'our man', all should be the venture's men and women. Their loyalty should be principally to the vision, and secondarily to their parent organisations. Using a cliche, the team should be concentrating on increasing the size of the pie, rather than quarreling over their parents' share of the pie. (Also see Exhibit 13.5)

ECONOMIC CONSIDERATION FOR STRATEGIC ALLIANCES

LO 7
Examine the economic considerations for strategic alliances

In this content, we propose to explain some economic bases for creating strategic alliances—economy of scope and transaction-cost theory. By describing the models at the end of the chapter, we do not intend to lower their significance.

Exhibit 13.5

STRUCTURING AND ADMINISTERING THE ALLIANCE

Putting appropriate governance structures in place for the alliance Is as important as finding the right partner. These include:

- A clear agreement as to which resources are going to be committed to the alliance on either side, and how access to them will be regulated;
- The appropriate legal form-license, informal alliance, separate jointly owned organisation for the alliance. Each form tends to have its own needs and suitable management styles depending on the number of partners involved. The management of a complex consortium, which brings together multiple partners to work on multi stranded problems, in order to develop a complicated new product, is likely to be more difficult to manage than a simple collaboration between two partners with a specific focus, such as a distribution agreement;
- What performance goals should be set for the alliance and how precisely they are to be measured? This can be particularly important to specify when the alliance embraces a variety of cultures and accounting conventions. It may be desirable to appoint outside auditors;
- How often, and through which medium, the various parties should communicate. These may be a combination of informal norms established during the 'courtship' phase and formal meetings. This may be particularly important if partners come from different countries and located thousands of miles apart;
- How disputes will be resolved; for example, which legal or arbitration regime should apply. In the case of a joint-venture, it may be desirable to appoint outside directors to oversee fair dealing between the parties;
- What will happen at the end of an alliance, which may be set up with specific time frames and goals in mind? Toshiba attempts to minimise the risk of any problems by setting up what are in effect prenuptial agreements which detail what each partner would do in the case of the alliance not working out;
- How the alliance can be restructured during its life if performance falls short of expectations or if the environment changes. Research has found that alliances that are periodically restructured are twice as likely to be considered successful as those that are not.

(*Source*: Adrian Haberberg and Alison Rieple, *Strategic Management*, p. 388)

Economy of Scope In general, firms form strategic alliances when the combined value of their resources and assets is greater than the value of them considered separately. This notion of resource complimentarity is the essence of economy of scope and exists as long as the inequality in the following equation holds:

$$\text{NPV (A+B)} > \text{NPV (A)} + \text{NPV (B)}$$

Where: NPV(A+B) = the net present value of Firm A's and Firm B's assets combine

NPV (A) = the net present value of Firm A's assets alone

NPV (B) = the net present value of Firm B's assets alone

Transaction-Cost Theory Firms cooperate to form alliances owing to the difference in transaction and control costs involved. Alliances are created to eliminate the control costs of inhouse development and also to avoid the costs involved in a market transaction.

CHOICE AMONG ACQUISITIONS, ALLIANCES AND GREENFIELD INVESTMENTS

Generally an MNC has two choices: between greenfield investment and acquisition; and between strategic alliance and acquisition.

The determinants of choosing between a greenfield investment and an acquisition are six: (i) R&D intensive units prefer a greenfield investment; (ii) units that produce a product but do not produce it at home go in for acquisition; (iii) acquisitions are also favoured when the industry is experiencing either very low or very high rates of growth, due to the need of entry without adding to the industry capacity; (iv) follow the leader attitude; (v) preference for an acquisition over greenfield investment is more pronounced when there is an inertia following a period of organic growth, and there is a need to get over the languor; and (vi) need for balancing between global integration and local responsiveness. MNCs pursuing global strategy tend to prefer greenfield investment to M&As. Instead, firms pursuing local responsiveness strategy prefer the M&A route of entry.

Likewise, the choice between strategic alliance and acquisition is influenced by the motivating factor. When knowledge acquisition is the primary motivation, the choice facing an MNC is clearly acquisition, since an alliance always suffers from opportunism.

EVALUATING ALLIANCES

LO 8
Evaluate alliances

Alliances once formed, need to perform well to realise their objectives. Assessment helps ascertain whether or not the objectives have been met.

Assessment of alliances cannot be done in the usual way. In other words, profitability indices cannot be used to assess performance of alliances. This is so because alliances are formed not with the purpose of generating additional sales and profits but for gaining indirect benefits to the partnering firms. Such indirect benefits include breakthrough inventions, penetration of risky markets or overcoming local political barriers. A classic example to be cited in this context is Boeing. Boeing's ventures with Japanese companies are designed to serve as a defensive strategy. These alliances prevent Airbus, the main competitor, from working with Japanese firms. It is a different matter that strategic alliances enhance profitability of partnering companies, but by themselves alliance firms are not expected to earn profit.

Obviously, measures used to evaluate alliances include:

- Good partner relationships
- High employee morale
- Culture compatibility
- Social responsibility obligations
- Rapport with host governments
- New inventions
- Gaining new markets
- Preventing competitors

Besides helping assess effectiveness of alliances, evaluation facilitates timely interventions to remedy situations. When Appliance Motor Company (AMC) discovered after a few months that its first alliance partner was not meeting expectations in terms of investment in quality control, company executives initiated to remedy the situation. In a research and development alliance, within the first few meetings of research personnel from both the firms, one partner felt that the other firm was not committing its best researchers to the joint effort. The alliance manager took up the issue with his counterpart in the alliance, and they finally resolved it quickly within a few weeks.

Learning from alliances is valued highly, but learning about alliances can also yield dividends. Assessing alliance performance adds to firm's knowledge base regarding alliances: what they can and cannot achieve, under what circumstances they are likely to succeed or fail, what managerial actions are most effective in what types of alliances, and the like.

When a strategic alliance fails to meet its objectives, partnering parents can negotiate an end to the agreement. Partnering managers are expected not only to know when to invest time and resources in building alliances but should also understand when to end the agreements.

End of an alliance does not mean that relationships between partnering firms are soured. Respective businesses of both the alliance partners are more important than agreements which are never intended to be long lasting.

SUMMARY

- Cooperative agreements between firms that go beyond normal business deals are called strategic alliances. Cooperative deals are very popular and no company worth a name is free from them. (LO1)
- Alliances can be comprehensive or functional. Comprehensive alliances are more meaningful but difficult to form and even survive. (LO2)
- Alliances are beneficial to the partners. There will be economies of scale, optimum resources utilisation, better direction to industry and even avoiding unhealthy competition. (LO3)
- Pitfalls of alliances are several. Improper selection of alliance partners is the major one. Because of the pitfalls, alliances do not survive for long. (LO4)
- Partner selection, identify drivers for alliance, share information, discuss technology arrangements and others constitute the steps in alliance formation. (LO5)
- Alliance partners must initiate measures that avert break up of cooperative deeds. For example, partner selection, alliance structure, and form of ownership. (LO6)
- Economic rationale should be the strong driver behind alliance formation. Combined value of partners' resources and assets should be greater than the value of them considered separately (LO7)
- Assessing performance of an alliance is equally important. Cultural integration, new inventions discovered, gaining new markets and the like are a few of the cues that help assess performance. (LO8)

REVIEW QUESTIONS

1. What is a strategic alliance? Bring out its benefits and pitfalls. (LO1, LO3 and LO4)
2. Describe the scope of strategic alliances. (LO2)
3. How to make alliances work? (LO6)
4. What are the common types to functional alliances? Briefly explain each. (LO2)
5. What are the basic differences between a joint venture and other types of strategic alliances? (LO1)
6. Why have strategic alliances grown in popularity in recent years? (LO3)
7. What factors need to be considered in selecting an alliance partner? (LO8)
8. How do you evaluate an alliance? (LO8)

Discussion Questions

1. What are the relative advantages and disadvantages of joint ventures compared to other types of alliances? (LO1)
2. Could a firm undertake too many strategic alliances at one time? Why or why not? (LO3)
3. What are some of the issues between forming a strategic alliance with a firm from the same country and forming one with a firm from a foreign country? (LO1)
4. What kinds of companies stand to gain the most from entering strategic alliances with potential competitors? Why? (LO1)

Reinforcing Exercises

- One benefit for a company from an alliance is that it helps enter a foreign market. In 2004, Warner Brothers entered a joint venture with two Chinese partners to produce and distribute films in China. Without this it would be extremely difficult for Warner Brothers to enter Chinese market.

  Examples of the above type are aplenty, as strategic alliances are highly common in the corporate world. You name atleast 10 of them – both successful and botched up-ventures.
- A marketing alliance between Titan & Timex was broken. Titan alleges that Timex reneged on its alliance conditions. Get more details and analyse causes for the fiasco. What could the partners have done to make the venture successful?
- The successful alliance between Fuji and Xerox can be an illustration for others to emulate. Rather than enter an informal or licensing arrangement (which Fuji initially wanted), Xerox insisted that Fuji invest in a 50-50 venture to serve Japan and East Asia. This venture involved investment in people, equipment, and facilities that Fuji was committed to make the alliance work.

  Besides investment, what other measures can you suggest to make an alliance work?

CLOSING CASE

The P&G Fiasco

The break-up of the alliance between the American FMCG (Fast Moving Consumer Goods) giant, Procter and Gamble (P&G) and the leading Indian business group, Godrej in 1996 is a case that goes down in the history of corporate India as an event few would like to forget.

It was a shortlived marriage. The year was 1992 and the two firms announced the formation of a strategic alliance that seemed to hold great promise for both companies. As part of the deal, the two companies set up a marketing partnering venture, P&G-Godrej (PGG). David Thomas, P&G's country manager was appointed the CEO while Adi Godrej, the head of the Indian company became the chairman.

To begin with everything looked bright and promising for the alliance. Both the partners were well-known names in the consumer goods industry.

Modalities were worked out very well. P&G paid Godrej nearly Rs 50 crore to acquire its detergent brands—Trilo, Key, and Ezee. P&G, on its part, gave a commitment that it would utilise Godrej's soap making capacity of 80,000 tpa. Godrej was allowed to complete its existing manufacturing contracts for two other MNCs, Johnson and Johnson and Reckitt and Coleman, but could not take up any new contracts. P&G, on its part, would not appoint any other supplier until Godrej's soap making capacity had been fully utilised. Godrej transferred 400 of its salespeople to the alliance venture. P&G acted quite fast in finalising the alliance lest arch rival Hindustan Lever would move in, if it did not.

P&G gained access to the manufacturing facility of Godrej. It would have taken a couple of years to set up to implement a project on its own. Godrej also had expertise in vegetable oil technology for making soaps. Vegetable oils like palm oil and rice bran oil can only be used in India for making soaps as beef tallow is banned. Godrej also had a network of retail outlets which were thrown open for P&G. Even though P&G was not a stranger to India, its Indian operations were essentially those of the erstwhile Richardson Hindustan, which was mainly known for the famous Vicks, a pharmaceutical product. The non-pharma distribution network of Godrej was of immense benefit to P&G. Godrej had excess manufacturing capacity, which proved to be a burden and the company was struggling to find ways of utilising the excess facility. Godrej also hoped to access superior technology and managerial skills of P&G.

The alliance became operational in April 1993. As soon as the alliance became operational, P&G engineers introduced new systems such as Good Manufacturing Practices and Materials Resource Planning in Godrej plants. The two companies seemed to show a considerable amount of sensitivity to the cultural differences between them. For about a year, it looked as though things were going fine. Thereafter, elements of distrust began to surface and the two firms found the differences in management styles too significant to be brushed aside. By December 1994, rumours were rife that P&G and Godrej did not see eye to eye on many key issues.

One reason why the relationship soured was that the performance did not match expectations. In 1992, Godrej had sold 29,000 tonnes of soap. This increased to 46,000 in 1994 but fell sharply to 38,000 tonnes in 1995. While sales did not rise as expected, costs were increasing. Due to the cost plus agreement, Godrej had little incentive to cut costs. Informed sources were of the opinion that Godrej was charging Rs 10,000 more per tonne than the expected processing costs.

To compound the problem, Godrej expressed its dissatisfaction on the ground that P&G did not promote brands like Trilo and Key. It was also unhappy with P&G's methodical and analytical approach as opposed to its own intuitive method of launching brands at great speed. P&G, on its part, felt that there was little logic or coordination in Godrej's brand building exercises. By mid-1994, differences became sharp between the partners, and a senior executive, HK Press, on deputation to the joint venture, was quietly eased out and sent back to the Godrej group company.

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

Questions

1. What according to you, are the factors that favoured the alliance between P&G and Godrej?
2. What went wrong with the joint venture? Why did it break up within four years of its formation?

   What signals does this joint venture fiasco send to other foreign investors?

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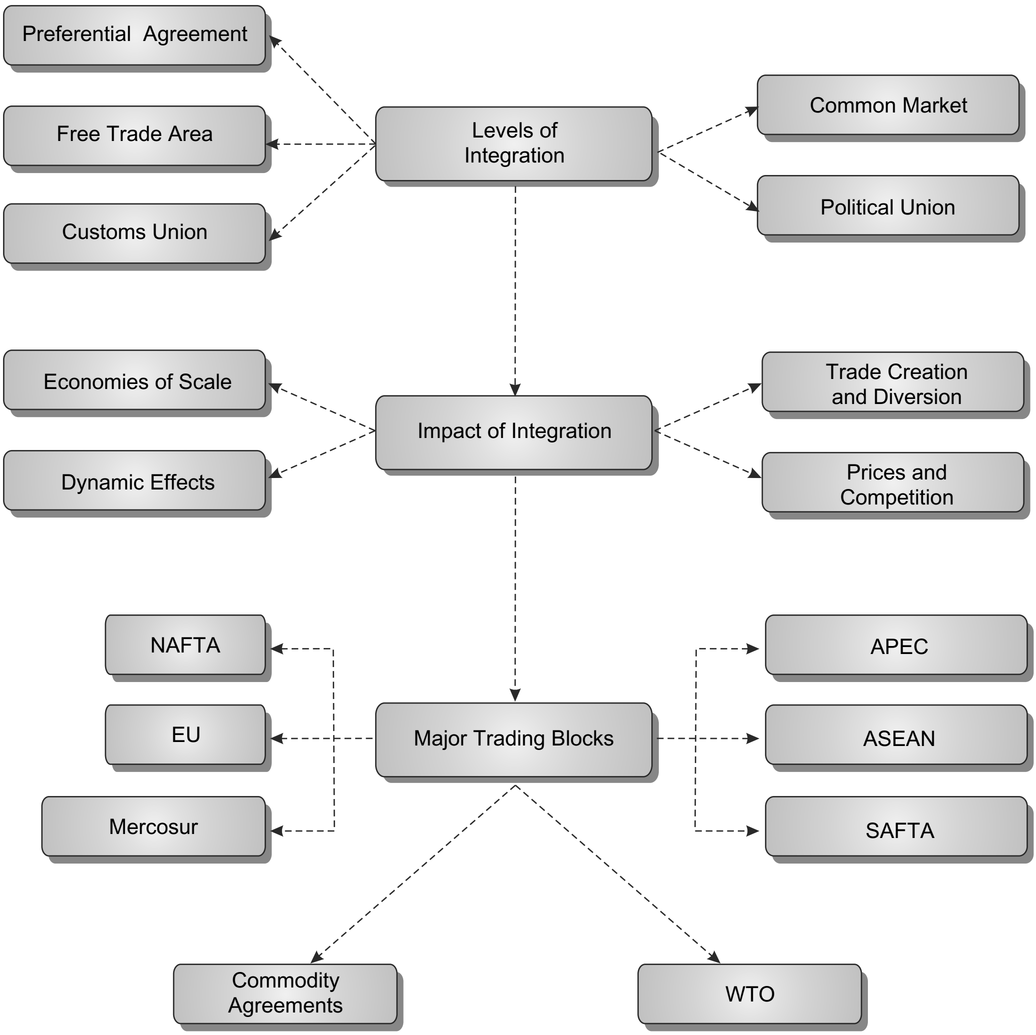
CHAPTER


Preferential Agreement
Free Trade Area
Customs Union
Levels of Integration
Common Market
Political Union
Economies of Scale
Dynamic Effects
Impact of Integration
Trade Creation and Diversion
Prices and Competition
NAFTA
EU
Mercosur
Major Trading Blocks
APEC
ASEAN
SAFTA
Commodity Agreements
WTO

14

Integration Between Countries

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Identify the levels of integration
- **LO 2:** Examine the growth of trading blocks
- **LO 3:** Infer the impact of integration
- **LO 4:** Recognise the major regional trading groups
- **LO 5:** Discuss commodity agreements
- **LO 6:** List India's trade agreements

Opening Case

NAFTA—The Mexican Story

Located in the mid America—surrounded by the US, the Gulf of Mexico, the Caribbean Sea, Belize, Gautemala, and the North Pacific Ocean—Mexico has an area of 19,64,375 sq km and a population of more than 100 million. The country is the largest nation in Latin America, followed by Brazil and Argentina.

Like Brazil, Mexico is a newly industrialised country with abundant resources and vast economic potential. It has a large manufacturing base, fertile and productive agricultural land, and an enormous potential export market to its immediate north in the US. Despite this, Mexico like Brazil, suffered from high population growth, widespread poverty (especially in the South), excessive income inequalities, severe unemployment (especially in the cities), and a massive foreign debt-burden.

But things changed in 1994 when Mexico signed the North American Free Trade Agreement (NAFTA). Twenty years into the huge trading block, Mexico has gained immensely. FDI poured into the economy, factories sprang up, exports surged, and thousands of jobs have been created. Delphi alone, for example, created jobs for 70,000 Mexicans. Being in league with big partners—US and Canada—Mexico has gained enormously. Buoyed by its success from NAFTA, Mexico signed trade agreements with 30 other countries. Millions of Mexicans are a proof to the benefits of forming trading blocks.

Looking back, it is really heartening to know the success story of NAFTA, touted as a rival to NATO. NAFTA is now a deeper and better trading block. America's trade with Mexico increased by 506% between 1993 and 2012, compared with 279% with non-NAFTA countries. In 2011, America traded as much with Canada and Mexico as it did with BRICS countries, Japan and South Korea combined. Some 40% of the content of imports from Mexico into the US, and 25% of the content of imports from Canada, originated in the US itself. Helped by rising energy production in all three countries, Factory North America (a la Factory Asia) is being created.

The beneficiary is Mexico, once a poor country, which is now more stable and prosperous. Import competition has improved Mexican manufacturing productivity and FDI has surged.

But of late, the glitter is fading away. If the early momentum is to be recovered, three things are to be done soon. *First*, the business of shipping goods across borders needs straightening up. Crossing from Mexico to the US, waiting times are far too long; much of the infrastructure is antiquated; railway and haulage crews still change over at the border. *Second*, NAFTA needs to do more to avert the negative effects of regional trade blocks. Such deals risk diverting trade from countries outside the club to those inside it. NAFTA should show how regional deals can act as bridges to widen liberalisation. The United States, Canada and Mexico have each pursued free trade agreements (FTAs) with the European Union (EU) separately, for example; instead, they should act in concert. NAFTA itself should also map out a way to invite in new members from Central America, the Caribbean and Latin America, to spread free trade across all the Americas.

Third, the block should embrace the freer movement of people; NAFTA had virtually nothing to say about labour mobility at its launch, beyond creating a visa category for professionals. The United States is not about to embrace European-style open borders, but more generous dispensations for frequent travellers from Mexico would be a beginning.

THE previous chapter focussed on collaborative agreements between firms. We propose to discuss similar arrangements between nations in this chapter. Integration between countries is the order of the day. Firms, in the initial stages of internationalisation, must be aware of the regional groups that encompass countries targeted for manufacturing locations or market opportunities. As firms proceed towards greater multinationalism, they need to change their organisational designs and operating strategies to take advantage of regional trading blocks.

The Great Depression plunged the world into a period of isolation, trade protectionism, and economic chaos. In the mid to late-1940s, countries realised that greater cooperation was needed to help them emerge from the wreckage of World War II. The spirit of cooperation was designed to promote economic growth and stability.

In the 1950s and 1960s regional integration gained significant momentum. Integration, also called regional trading block, involves the organising of individual countries into groups that eventually abolish trade restrictions with member countries and also may engage in other activities that promote their citizens' welfare. When we say integration, it means economic integration between nations, bordering sometimes on political integration too. WTO prefers to call the regional trading blocks as regional trading agreements (RTAs). Over time, there has been a proliferation of RTAs as Fig. 14.1 shows.

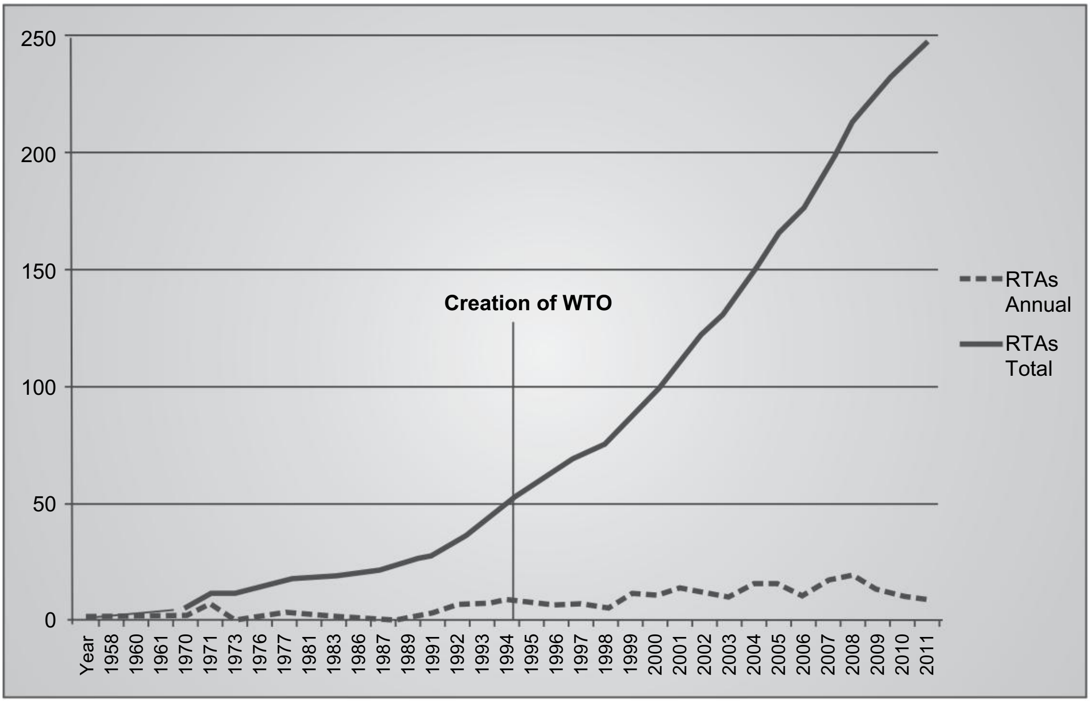


Fig. 14.1 Proliferation of (In-Force) Regional Trade Agreements (RTAs) Since 1958

(*Source:* Riad A Ajami and Jason Goddard, *International Business,* Jaico, 2014, p.183)

LEVELS OF INTEGRATION

There are six levels of economic integration as depicted in Fig. 14.2. Each level is described in brief.

LO 1
Identify the levels of integration

Preferential Trading Agreement

A preferential trading agreement is the loosest form of economic integration. Under this, a group of countries have a formal agreement to allow each other's goods and services to be traded on preferential terms. This requires that the tariffs are reduced between the countries or that special quotas allow preferential access for their products. A good example of a preferential trading agreement is the Lome' Agreement among the African, Caribbean, and Pacific (ACP) group of countries and the European Union. Like many preferential trading agreements, this arrangement mainly covers agricultural products, which are the main exports of the ACP countries. The EU also has a number of individual preferential trading agreements with other countries in the Middle East, Latin America, and elsewhere.

It is said that preferential trading agreement is merely a trading arrangement between countries rather than integration. Often, these are agreements between developed and developing countries and are designed primarily to support the latter countries' economic development. However, they may involve a degree of integration in that they increase flow of trade between member countries.

Free Trade Area

A free trade area is usually a permanent arrangement between neighbouring countries. It involves the complete removal of tariffs on goods traded among the members of the free trade area. The arrangement

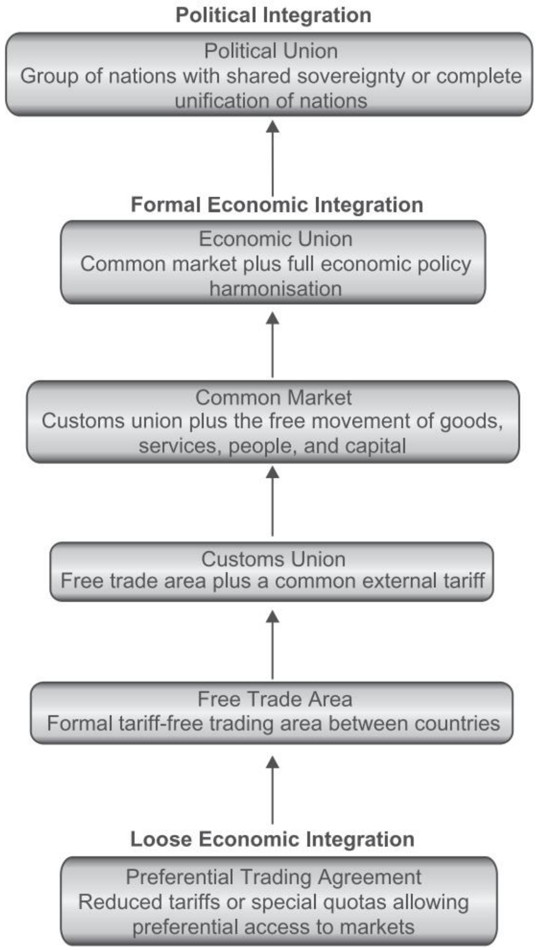


Fig. 14.2 Levels of Integration between Countries

(*Source:* Andrew Harrison, et al, *International Business,* Oxford University Press, 2000, p. 150)

does not, in general, apply to agriculture, fishing, or services, but the practice varies from one agreement to another. Member countries are free to levy their own external tariff on goods from outside the free trade area. Each member thus retains autonomy over trade with external countries and there is little need for formal institutions and policies other than to maintain the internal tariff-free area.

There are several free trade agreements in practice. The North American Free Trade Agreement (NAFTA) is the best known example. Others include the European Free Trade Association (EFTA), and the Asean Free Trade Area (AFTA).

Free trade agreements (FTAs) carry two weaknesses with them. *First*, these relate to *trade deflection*. Trade deflection is a process in which non-member nations divert their exports to member nations with the lowest external trade barriers. In order to check this deflection, *rules of origin* need to be specified. Rules of origin clarify what actually constitutes member goods and services within the FTA. *Second*, weakness of free trade area relates to trade diversion which will be explained in the next section.

Customs Union

Like members of a free trade area, members of a customs union remove barriers to trade in goods and services among themselves. In addition, the customs union establishes a common trade policy with respect to non-members. Typically, this takes the form of a common external tariff, whereby imports from non-members are subject to the same tariff when sold to any member country. Tariff revenues are then shared among members according to a prescribed formula. Mercosur Accord, and Ardean Community are the best examples of customs union. (More details on these are covered later in this chapter)

Common Market

Like the Customs Union, a common market has no barriers to trade among members and has a common external trade policy. In addition, the common market removes restrictions on the movement of factors of production (labour, capital and technology) across borders. Thus, restrictions on immigration, emigration, and cross-border investments are abolished. When factors of production are freely mobile, then capital, labour, and technology may be employed in their most productive uses.

Despite the obvious benefits, members of a common market must be prepared to cooperate closely in monetary, fiscal, and employment policies. Furthermore, while a common market will enhance the productivity of members in the aggregate, it is doubtful whether individual member countries will benefit.

Economic Union

This represents full integration of the economies of two or more member countries. In addition to eliminating internal trade barriers, adopting common external trade policies, and abolishing restrictions on the mobility of the factors of production among members, an economic union requires its members to coordinate their economic policies (monetary policies, fiscal policy, taxation, and social welfare programmes) so as to blend their economies into a single entity. Obviously, the formation of one economic union requires nations to surrender a large measure of their national sovereignty. Needless to say formation of an economic union is extremely difficult since member countries strongly desire to retain the power of nation-state, and attempts to undermine the authority of the state will encounter opposition.

The Belgium-Luxembourg Economic Union, founded in 1922, is the best existing example of this form of economic integration. The economic union of these two European neighbours has been facilitated by the tight bonds between their two currencies. The two nations coordinate their monetary policies and maintain a fixed exchange rate of one Luxembourg franc to one Belgium franc, and the Belgium franc is commonly used to conduct business in Luxembourg. However, a much larger economic union is yet to emerge.

Political Union

While some degree of political integration often accompanies economic integration, political union implies more formal political links between countries. A limited form of political union may exist where two or more countries share common decision-making bodies and have common policies. In its fullest sense, it involves the unification of previously separate nations. The world's best example of a political union occurred when thirteen separate colonies operating under the Article of Confederation grew into a new country—the USA. India, as a country, emerged after unification of numerous kingdoms. The unification of East and West Germany in 1990 is another example of total political union. Indeed, the formation of the Soviet Union itself brought political union among its various republics, though integration was less universally popular.

GROWTH OF TRADING BLOCKS

LO 2
Examine the growth of trading blocks

There has been a spurt in the growth of trading blocks. As many as 250 RTA's have been notified by WTO by July 2007 (see also Fig. 14.1). The failure of Doha Round has made member countries to go for bilateral trade agreements in a big way. Many economists, since David Ricardo, have been leery of the bilateral agreements as allegedly inefficient and suboptimal solutions leading to a 'spaghetti bowl' of treaties difficult to monitor and enact, a form of protectionism in disguise that distracts from the real task of either unilateral tariff lowering or a massive multilateral trade agreement that will effect it.

Ricardo's apprehensions notwithstanding, countries are enthusiastic about bilateral trade agreements, impatient as they are with the slow pace of multilateral trade negotiations.

Most common category of agreement is the FTA's which account for 70 percent of all the trading blocks. The one country that is at the forefront of signing agreements is Chile. The country has signed 54 of them till now. It may be noted that all the members of WTO are bound to notify to it the trading blocks in which they participate.

IMPACT OF INTEGRATION

LO 3
Infer the impact of integration

There are potential gains for member countries from economic integration. (see Fig. 14.3)

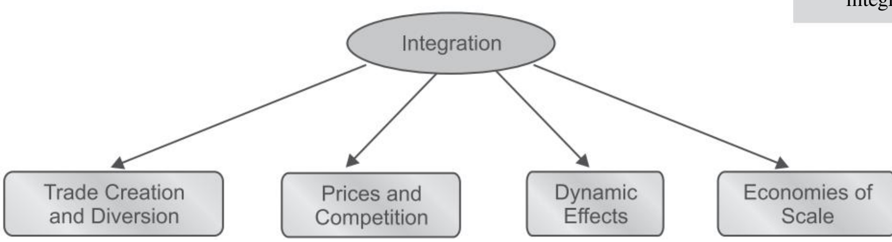


Fig. 14.3 Impact of Integration

Trade Creation and Trade Diversion

Chapter 3 illustrated that when trade barriers between countries are removed, industries in respective countries will concentrate on the most efficient use of resources and produce those goods that they are most efficient in producing. The result is that all participants will gain from trade. In addition, when tariffs and other barriers are removed between the members of a trading area, new opportunities for trade are created. This is because exports can now be sold or imports bought at more reasonable rates inside the trading block. The efficient exporter can sell surplus goods abroad, and the importer, instead of producing the goods inefficiently at home, can reallocate resources to more efficient production.

Trade diversion occurs when trade is diverted from countries outside the trading area to countries inside. This results from the removal of tariffs and other barriers in the trading area, making it cheaper or easier to export to or import from these countries. External countries will find it especially difficult to retain their export markets if the common external tariff is higher than the previous importing country's tariff. In such a case, trade diversion may not be beneficial as trade may be diverted from a more efficient producer outside the trading area to a less efficient one inside. Generally, there will be gainers and losers from trade diversion—the net gain or loss will depend on the particular circumstances.

The entry of Spain into the European Union provides an interesting example of trade creation and diversion. In 1986, Spain formally entered the European Union (EU) as a member. Prior to membership, Spain—like all non-members such as the US, Canada, and Japan—traded with the EU and suffered from the common external tariff imposed by the EU. Imports of agricultural products from Spain or US had the same tariff applied to their products, for example, 20 per cent. During this period, the US was a low-cost producer of wheat compared to Spain. US exports to UN members may have cost $3.00 per bushel, plus a 20 per cent tariff of $.60, for a total of $3.60 per bushel. If Spain at the same time produced wheat at $3.20 per bushel, plus a 20 per cent tariff of $0.64 for a total cost to EU customers of $3.84 per bushel, Spain's wheat was more expensive and therefore less competitive.

But when Spain joined the EU as a member, its products were no longer subject to the common external tariffs; Spain had become a member of the "Club" and therefore enjoyed its benefits. Spain was the low-cost producer of wheat at $3.20 per bushel, compared to the price of $3.60 per bushel from the US. Trade flows changed as a result. The increased export of wheat and other products by Spain to the EU as a result of its membership is termed *trade creation*. The elimination of tariff literally created more trade between Spain and EU. At the same time, because the US is still outside the EU, its products suffer the higher price as a result of the tariff application. US exports to the EU fell. When the source of trading competitiveness is shifted in this manner from one country to another, it is termed trade diversion.

Prices and Competition

The removal of trade barriers has both consumption and production effects. The production effect of removal of trade barriers has been explained above. The consumption effects are noticed on prices and consumer choice. When trade barriers come down, consumers can buy goods more cheaply. This applies not just to tariffs, where price is directly affected, but also to non-tariff barriers like customs formalities which raise the cost of selling goods across the borders. Similar arguments apply to consumer choice. Trade creation increases the availability of goods enabling the consumers to pick and choose.

The more relevant issue relates to competition. By removing barriers between national markets, trading blocks create competition. Generally speaking, the longer the trading area and the higher the level of integration, the more competition will be created. Competition benefits consumers immensely in the form of lower prices, wider choice, and better value for money. In addition, competition stimulates innovation, not only in the products themselves but also in the channels of distribution, methods of payment, customer area, and so on.

Economies of Scale

Many industries, such as steel and automobiles, require large-scale production in order to obtain economies of scale in manufacturing. Obviously, industries of this type and others may not be economically viable in smaller, trade-protected countries. However, the formation of a trading block enlarges the market so that large-scale production is justified. The lower per unit cost resulting from scale economies may then be obtained. These lower production costs resulting from greater production for an enlarged market are called internal economies of scale.

In a common market, external economies of scale may also be present. Because a common market allows factors of production to flow freely across borders, the firm may now have access to cheaper capital, more skilled labour, or superior technology. These factors will improve the quality of the firm's product or service, or will lower costs, or both.

Dynamic Effects of Integration

The term dynamic effects describes the continuous pressure for change that is a feature of an integrated competitive environment. Market forces act as a spur to improvements in efficiency, increase in investment, and continual innovation. A new product or process may create a competitive advantage for a time, but before long, a competitor will introduce something better. The search for success is ongoing. The need to innovate promotes investment in new technology, new methods of production and distribution, and product design. This investment has a multiplier effect on the level of economic activity generally and stimulates further increases in production, income, and demand. Competition also increases the necessity to be efficient. Not only do competitive firms try to minimise their costs of production, they also seek to maximise the effective use of resources.

In general, the dynamic effect of integration is that it brings about a more efficient allocation of resources throughout the trading block, promoting the growth of some businesses and the decline of others, the development of new technology and products, and the elimination of old. This process is creating a large-scale restructuring of industries and firms in the EU, with the relocation of industry and many cross-border mergers and alliances. Obviously, it can be painful process, but it is one, which generally improves the competitiveness of European companies.

MAJOR REGIONAL TRADING GROUPS

LO 4
Recognise the major regional trading groups

In recent years, a large number of trading blocks have emerged. These exist in all parts of the world. They range from huge regional trading blocks like APEC or the EU to loose agreements between groups of small countries. Some major trading blocks are discussed here. The African Common Market has emerged as another trading block in the recent past (see Fig. 14.4 and Table 14.1). All thsee fit into one or the other type of the levels of integration discussed earlier. Figure is only an illustrative one.

The European Union

The European Economic Community (now called the European Union or EU) was formally established

Fig. 14.4 Important Trading Groups

by the Treaty of Rome in 1957. But the efforts in this direction go back to 1951 when the European Coal and Steel Community Agreement was signed in Paris (see Fig. 14.5 for the evolution of the EU). As of now, EU has 27 members and some more are expected to join (see Table 14.2).

Table 14.1 Major Regional Trade Associations

Acronym	*Full Name/Members*
AFTA	ASEAN Free Trade Area
	Brunei, Cambodia. Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam
ANCOM	Andean Community
	Bolivia, Colombia, Ecuador, Peru Associate Members: Argentina, Brazil, Chile, Paraguay, Uruguay
APEC	Asia-Pacific Economic Cooperation
	Australia, Brunei, Canada, Chile, China, Hong Kong, Indonesia, Japan, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, Philippines, Russia, Singapore, South Korea, Taiwan, Thailand, United States, Vietnam, Darussalam.
CACM	Central American Common Market
	Costa Rica, EI Salvador, Guatemala, Honduras, Nicaragua
CARICOM	Caribbean Community and Common Market
	Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Grerada, Guyana, Haiti, Jamaica, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago
CEMAC	Monetary and Economic Community of Central Africa
	Cameroon, Central African Republic, Chad, Republic of the Congo, Equatorial Guinea, Gabon
CER	Australia-New Zealand Closer Economic Trade Relations Agreement
	Australia, New Zealand
ECOWAS	Economic Community of West African States
	Benin, Burkina Faso, Cape Verde, Gambia, Ghana, Guinea, Guinea-Bissau, Ivory Coast, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, Togo
EU	European Union
	Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Spain, Sweden, Slovenia, Slovakia, United Kingdom, Romania, Bulgaria
EFTA	European Free Trade Association
	Iceland, Liechtenstein, Norway, Switzerland
GCC	Gulf Cooperation Council
	Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates
MERCOSUR	Southern Cone Customs Union
	Argentina, Brazil, Paraguay, Uruguay, Venezuela, Associate Members: Bolivia, Chile, Columbia, Ecuador, Peru
NAFTA	North American Free Trade Agreement
	Canada, Mexico, United States
SADC	Southern African Development Community
	Angola, Botswana, Democratic Republic of the Congo, Lesotho Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tarzania, Zambia, Zimbabwe

ACS	Antigua and Barbuda, Bahamas, Barbados, Belzi, Colombia, Costa Rica, Cuba, Dominica, Elsalvador, Geneda, Guatemela, St.Kittis and Nevis, St.Lucia, St.Vincent Suriname, Trinidad and Venezula
Andean Community	Bolivia, Colombia, Escudos, Peru and Republica Bolivariwa de Venezuela
Group of Three	Colombia, Mexico, and Republica Bolivariawa de Venezuela
Latin American	Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru,
Integration Association	Uruguay and Venezula
ASEAN	Brunei, Cambodia, Indonesia, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam
APTA	Bangladesh, India, Korea, Philippines, Srilanka and Thailand
SAFTA	Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Srilanka

Table 14.2 The European Union, 2004 Data

Country	*Total Population (millions)*	*Total GDP (billions)*	*Per Capita Income (in U.S. dollars)*	*Date of Entry*	*Votes in Council*	*Votes in Parliament*
Belgium	10.4	350	31,030	1957	12	24
France	60.0	2,003	30,090	1957	29	78
Germany	82.6	2,714	30,120	1957	29	99
Italy	57.6	1,672	26,120	1957	29	78
Luxembourg	0.4	25	56,230	1957	4	6
The Netherlands	16.3	577	31,700	1957	13	27
Denmark	5.4	243	40,650	1973	7	14
Ireland	4.0	184	34,280	1973	7	13
United Kingdom	59.4	2,141	33,940	1973	29	78
Greece	11.1	203	16,610	1981	12	24
Portugal	10.4	168	14,350	1986	12	24
Spain	41.3	991	21,210	1986	27	54
Austria	8.1	290	32,300	1995	10	18
Finland	5.2	187	32,790	1995	7	14
Sweden	9.0	346	35,770	1995	10	19
Cyprus	0.8	14	17,580	2004	4	6
Czech Republic	10.2	107	9,150	2004	12	24
Estonia	1.3	9	7,010	2004	4	6
Hungary	10.1	100	8,270	2004	12	24
Latvia	2.3	14	5,460	2004	4	9
Lithuania	3.4	22	5,740	2004	7	13
Malta	0.4	5	12,250	2004	3	5
Poland	38.2	242	6,090	2004	27	54
Slovakia	5.4	41	6,480	2004	7	14
Slovenia	2.0	32	14.810	2004	4	7
Total	455.3	12,680			321	732

(*Source:* World Bank, *World Development Report,* 2006, and World Bank website)

The objectives of the EU are

- Elimination of customs duties among member states.
- Elimination of obstacles to the free flow of import and/or export of goods and services among member nations.

- Establishment of common customs duties and united industrial/commercial policies regarding countries outside the community.
- Free movement of capital and people within the block.
- Acceptance of common agricultural policies, transport policies, technical standards, health and safety regulations, and educational degrees.
- Common measures for consumer protection.
- Common laws to maintain competition throughout the community and to fight monopolies or illegal cartels.
- Regional funds to encourage the economic development of certain countries/regions.
- Greater monetary and fiscal coordination among member states and certain common monetary/fiscal policies.

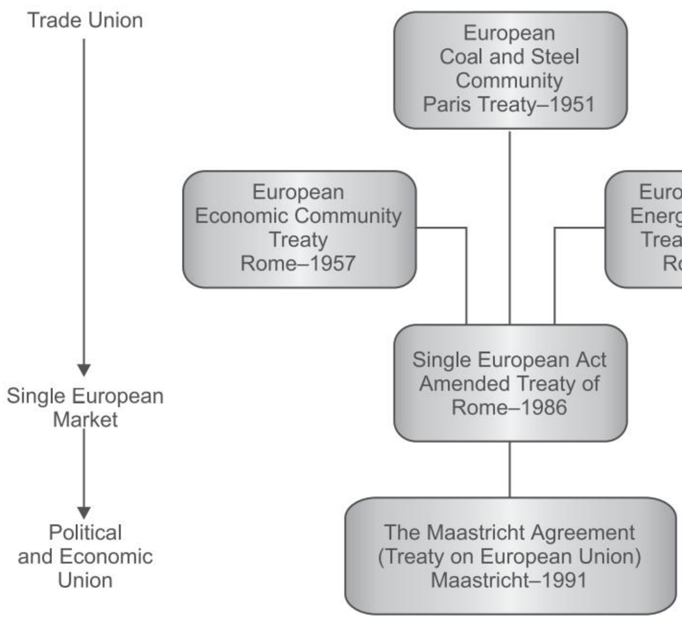


Fig. 14.5 Development of the European Union

(*Source:* Michael R Czinkota, et al, *Global Business,* The Dryden Press, p. 144)

The EU has 450 million consumers and at 10 trillion euros, will account for a fourth of the world's GNP. Besides, the 27-nation EU has a huge territory of more than 3.9 million square kilometers (see also Table 14.3).

Since the signing of the EU's founding treaty, the EU has been engaged in deeper integration as well as enlargement. After initially creating a customs union, the EU has now achieved something approaching a common or single market among all its members and beyond, and has recently introduced a fledgling monetary union between eleven of its members. The EU has also been establishing formal links with countries and trading blocks beyond its borders.

The EU is not aiming at mere economic integration. From the very beginning, economic integration was seen as a means to achieving political union.

Though attaining political integration remains the ultimate goal of the EU, the economic benefits from this huge trading block are substantial. First, there will be gains from eliminating the transaction costs associated with border patrols, customs procedures, and the like. Secondly, economic growth will be spurred by the economies of scale that will be achieved when production facilities become more concentrated. Thirdly, there will be gains from more intense competition among EU firms. Firms that were monopolistic in one country will now be subject to competition from firms in other EU countries.

There will be substantial benefits for firms operating in Europe. These firms will gain because their operations in one country can now be freely expanded into others. And their products may be sold freely across borders. In addition, the free movement of capital allows these firms to sell securities, raise capital, and recruit labour throughout Europe. Substantial economies of scale in production and marketing will also result. Perhaps the most interesting development for companies operating in the EU is the dynamic potential of the single market and economic and monetary union. A large competitive market of this kind should act as a spur to efficiency and innovation prompting the reorganisation of companies, industries, and markets. There has already been a wave of merger activity and alliance forming in the EU since the 1980s, reflecting not only global trends but also restructuring of the European industry.

Firms from non-member countries too gain from the EU. Well-established US based MNCs such as H J Heinz will be able to take advantage of the new economies of scale. For example, 3M plants earlier turned out different versions of its products for various markets. Now, the 3M plant in Wales makes videotapes and videocassettes for all of Europe. Many MNCs are developing pan-European strategies to exploit the emerging situation; that is, they are standardising their products and processes to the greatest extent possible without compromising local input and implementation.

The increased membership is expected to strengthen the EU's role in world affairs, foreign security, trade policies, and other fields of global governance. The addition of ten more members will boost economic growth and create jobs in both the old and new member states. It is also hoped that the quality of life will improve as the new members adopt EU policies on environmental protection and the campaign against crime, drugs, and illegal immigration. The EU, too, will be enriched through increased cultural diversity, interchange of ideas, and improved understanding of other people.

India's stakes with the EU are high. The country enjoys a multidimensional relationship with the EU, its largest trading partner, accounting for a quarter of its overseas trade. The EU is also the foremost investor in India, and is a major destination for service providers, a vital technology vendor, and a major contributor of development aid. Table 14.3 shows EU's trade with major trading partners.

Table 14.3 EU Trade with Major Partners (2010)

Major Export Partners				Major Import Partners			
Rank		*(Mn Euro)*	*% of Total*	*Rank*		*(Mn Euro)*	*% of Total*
1	United States	242.0951	17.10	1	China	282.0111	18.80
2	China	113.1177	8.40	2	US	169.4674	11.30
3	Switzerland	105.4334	7.80	3	Russia	158.3849	10.50
4	Russia	86.5088	6.40	4	Switzerland	84.1262	5.60
5	Turkey	61.1897	4.50	5	Norway	79.1794	5.30
6	Japan	43.7301	3.20	6	Japan	64.8981	4.30
7	Norway	41.8602	3.10	7	Turkey	42.0880	2.80
8	India	34.7988	2.60	8	S. Korea	38.6516	2.60
9	Brazil	31.2829	2.30	9	India	33.1473	2.20
10	S. Korea	27.9848	2.10	10	Brazil	32.3204	2.20

However, there are apprehensions expressed about the mighty EU. One of the main concerns of the US and Asian countries is that the EU will at some point impose new barriers on exports into the EU from non-members. There are already indications where the EU has adopted protectionist policies towards external trade. One instance relates to agriculture where the EU limits many food imports from the US. In autos, the EU reached an agreement with the Japanese to limit the Japanese market share of the EU auto market. Between 1993 and 1998, those countries that had quotas on Japanese car imports lifted them gradually until the end of 1998, when they were abolished. Meanwhile, Japanese producers committed themselves to voluntarily restraining sales so that by the end of the century they hold no more than 17 per cent of the European market. After that, all restrictions are to be abolished. The US firms describe the EU as *Fortress Europe*. They have reasons to entertain the doubt. Besides banning import of foodgrains, for example, the EU has called on members to limit the number of American television programmes broadcast in Europe. Many US firms are also concerned about the relatively strict domestic-content rules recently passed by the EU. These rules require certain products sold in Europe to be manufactured with European inputs.

These examples of protectionism do not constitute a norm and the EU countries generally have adopted a relatively free trade policy with regard to non-members.

Two forces will push the EU ahead. The first comes from business leaders who are adapting to globalisation by treating Europe as one giant area, a single market. The second force is the single European currency, the euro, together with the European Central Bank.

Some statistics are worth mentioning in this context.

- EU directives have superseded 15 sets of national rules, they have harmonised 100,000 national standards, labeling laws, testing procedures, and consumer protection measures covering everything from toys to food, to stockbroking to teaching.
- As many as 60 millions customs and tax formalities at frontiers were scrapped.
- Thanks to single-market measures, Europe's GDP is now 1 to 1.5 per cent higher than it would otherwise have been.
- Europe has 3,00,000 to 9,00,000 more jobs, and average inflation is 1 to 1.5 points below what it would have been without EU single-market measures.

The developing countries are benefiting from the EU. With regard to the less developed countries, the EU covers trade as well as aid. The EU and its member states contribute between 45 and 50 per cent of world public development aid. Much of this aid goes to Sub-Saharan Africa, South America, and Southern Asia. It helps provide food, medicine, and other humanitarian aid and also promotes agricultural and rural development projects. Much of the EU's development aid is channeled through the European Development Fund, which is made up of direct contributions from individual member states and is additional to the EU budget. In the early years, EU development assistance was mainly used to help former colonies of EU member states. But now, increasing assistance is given to developing countries in general with less regard for political or strategic ties. Priority is given to countries that are engaged in economic and political reform, however, EU firms benefit from contracts relating to project assistance.

The Euro

As stated earlier, one of the major achievements of the EU has been the introduction of a single currency for all the member countries. The single currency did come into effect from 1998, but except in three countries—Britain, Denmark, and Sweden. During the last ten years, the euro has had significant achievements. For example, with the euro zone, exchange rate risk has been abolished thus facilitating cross-border trade and investment. Similarly, the GDP of poorer countries has risen by 3.5 per cent per annum on an average and inflation has been stabilised. As of now, both EU and Euro are under severe stress. Their sustainability is under doubt. Chapter 19 provides more details on the crisis.

EU is a strategic trading partner for India, with nearly one quarter of India's exports going to the region. EU is also a source of supplies for critical imports including important raw materials and investment goods. The recent data released by the Ministry of Commerce show that the percentage share of EU in India's exports decreased marginally from 22.46 per cent in 2001–02 to 21.73 per cent in 2002–03. Though EU is a major trading partner for India, India's share in the total imports of EU is negligible, and stands at 1.3 per cent. Table 14.4 shows the top 10 items that EU imports from India. Further, the business and trade links between the two have also been at an all-time high, with business summits being held every two years. The fourth and most recent summit between India and the EU was held in New Delhi, on November 29, 2003. The two sides reviewed developments since the last India -EU Summit in Copenhagen, in October 2002, and expressed satisfaction with its positive outcome, which further reinforced the India-EU relationship. India and the EU reiterated their commitment to work towards all aspects of the Doha Work Programme in a balanced manner, including improved market access, and further strengthening of the multilateral trading regime under the WTO.

Table 14.4 European Union, Imports from India (2010)

	Value (Millions of Euro)	*Share of Total of (%)*	*Share of Total EU Imports*
Total	**33,147**	**100.0%**	**2.2%**
Miscellaneous manufactured articles	7,848	23.7%	3.9%
Manufactured goods classified chiefly by material	7,353	22.2%	4.7%
Machinery and transport equipment	6,134	18.5%	1.4%
Mineral fuels, lubricants and related materials	4,703	14.2%	1.2%
Chemicals and related prod, n.e.s.	4,025	12.1%	2.9%
Food and live animals	1,694	5.1%	2.3%
Crude materials, inedible, except fuels	784	2.4%	1.2%
Animals and vegetable oils, fats and waxes	200	0.6%	3.0%
Commodities and transactions n.c.e.	186	0.6%	0.7%
Beverages and tobacco	179	0.5%	2.6%

European Free Trade Association (EFTA)

The success of EU has made other countries in Europe to form another trading block, EFTA. EFTA comprises Iceland, Liechtenstein, Norway and Switzerland as members. Formed in 1960, EFTA focuses on trade in industrial and not consumer goods.

With a combined population of slightly less than 12 million, EFTA has a GDP of around $410 billion. Despite its relatively small size, members remain committed to free trade principles and raising the standard of living of their people.

The EFTA and EU have together formed European Economic Area (EEA) to cooperate on matters such as the free movement of goods, persons, services, environment and capital among member nations.

North American Free Trade Agreement (NAFTA)

NAFTA came into being on January 1, 1994 comprising United States, Canada, and Mexico. NAFTA is an American counterpart to the EU, but the latter aims at economic and political integration whereas in the American integration the objective is purely economic. NAFTA is more important because it encompasses the whole of North America and is the largest regional economic grouping in the world (see Table 14.5). The formation of NAFTA has also been quite controversial, especially in the USA (see Exhibit 14.1). As of now, NAFTA represents the world's largest free trade area which links 450 mn people producing $17 trillion worth of goods and services.

Table 14.5 Key Data on NAFTA Members

	Population Millions (July 1998 est.)	*GDP $ US bn (1997 est.)*	*GDP Per Cap ($ US 1997 est.)*
Canada	30.7	658	21,700
Mexico	98.6	695	7,700
USA	270.3	8083	30,200

(*Source*: Andrew Harrison, et al, *op.cit*, p. 163)

Exhibit 14.1

THE NORTH AMERICAN FREE TRADE AGREEMENT

As well as being the world's largest trading area, NAFTA is unusual in that it combines two of the world's major trading nations with a large developing nation. Clearly, geographically, there is a strong logic to this trading area. Indeed, the USA is by far Mexico's main export market and Mexico is one of the USA's main trading partners. Canada's trade with Mexico is much smaller. However, many Americans fear that Mexico's low-wage economy will attract investment from the USA, with a resulting loss of employment when US companies relocate. Business migration to Mexico's border region is certainly an issue of concern—the so-called *maquiladora* industries or assembly plants, which are attracted by tax benefits, low costs, and lax regulations. Despite these fears and a US trade deficit with Mexico, trade between the USA, Canada, and Mexico has increased substantially since NAFTA's formation in 1994. US investment in Mexico is still small compared to US domestic investment.

The main objective of NAFTA is the elimination of tariffs on most products within ten years and, on certain agricultural and other sensitive products, within fifteen years. The agreement also extends to a wider range of non-tariff barriers than the US-Canada agreement, which preceded it. These include most services, public procurement, foreign investment, intellectual property rights, and environmental measures. In this respect, NAFTA goes well beyond the scope of a simple free trade area, but it is not a customs union. Members are free to set their own external tariffs and rules of origin have been put in place requiring a minimum 50 per cent local content for cross-border trade in most products. This provision, which is common in free trade areas, restricts the ability of foreign companies to trade freely once they are inside NAFTA, unless their products are largely manufactured and sourced locally.

(*Source*: *Andrew Harrison*, et al, *op.cit*, p. 162)

Controversies notwithstanding, NAFTA has rationale, in terms of both geographic location and trading importance. Although Canadian-Mexican trade was not considerable when the agreement was signed, but it was significant between US and the other two member countries. The US is the largest

Specifically, NAFTA covers the following areas:

- Trade rules: safeguards, subsidies, antidumping measures, and standards relating to safety and health.
- Provisions to ensure trade in services (consulting, engineering, software, etc.) that exist for trade in goods.
- Market access: tariff and non-tariff barriers, rules of origin, governmental procurement.
- Establishing investment rules that will protect the interests of investors.
- Intellectual property: all the three countries pledge to provide adequate and effective protection and enforcement of intellectual property rights, while ensuring that enforcement measures do not themselves become barriers to legitimate trade.
- Dispute settlement: provides a disputes settlement process that will be followed instead of countries taking unilateral action against any offending party.

trading partner of both Canada and Mexico, and Canada and Mexico are the first and the third most important trading partners with the US.

NAFTA is expected to provide the dynamic effects of economic integration discussed earlier in this chapter. For example, Canadian and US consumers are expected to benefit from low cost agricultural products and also can count on the benefit from the large and growing Mexican market, which has a huge appetite for US products.

NAFTA is a good example of trade diversion too. Many US firms have established manufacturing facilities in Asia to take advantage of cheap labour, and then ship products from there to the US. It is anticipated that NAFTA members will be able to use each other rather than Asian countries as locations for trade investment. This movement has already begun in the automobile industry. US automakers such as Ford have established manufacturing facilities in Mexico to serve the US market.

NAFTA wields considerable impact on trade as Fig. 14.5. As the Figure shows, Mexico's share of the total trade has increased significantly. Mexico was the second top importer from the US with $163.3 bn in 2010 and the country's exports to the former in 2010 stood at $229.7 bn. In fact, Mexico replaced Japan as a significant market for the US exports, while it remains the third most important supplier to the US after Canada and Japan.

The creation of NAFTA is so significant, as the opening case indicates, that it compares with the introduction of the euro in Europe, China's metamorphosis into capitalism, and Russia's turbulent embrace of a market economy. When it was formed, NAFTA was seen as a bold attempt to demonstrate to the world the power and ability of free trade to convert a poor country into a developing one. If there was a litmus test for globalisation, it was NAFTA.

The agreement is already two decades old. The member countries have reasons to feel proud of the bloc's achievements. American manufactures, desperate for relief from Asian competition, flocked to Mexico to take advantage of wages that were a tenth of those in the US. Foreign investment almost flooded into Mexico, rising at $12 billion per annum during the last decade, three times what India receives. Exports grew, as Table 14.6 shows. Mexico's per capita income rose by 24 per cent, to roughly $4000— which is ten times higher than the per capita income in China. The economy of the country, at $594 billion, is ranked the ninth largest in the world.

Apprehensions are being voiced about the impact of NAFTA. One fear expressed is the loss of jobs to both US and Canada in favour of Mexico. This fear is without a base as jobs went to India and China and not to Mexico. This loss stems from the increasing location of manufacturing facilities in Mexico to take advantage of low-wage labour there. From the point of Mexico, the integration may lead to massive restructuring of the economy and consequent unemployment. This is likely to result from the

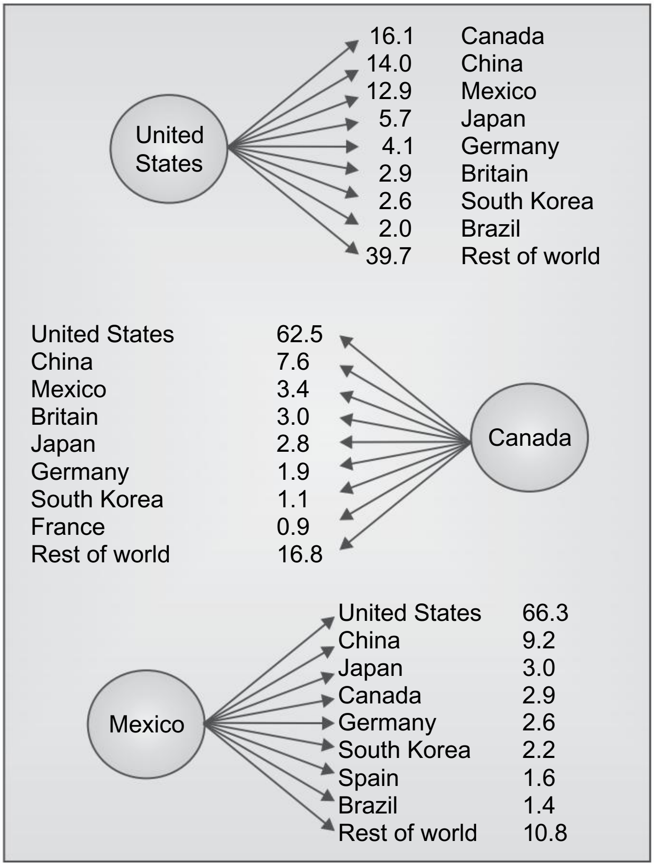


Fig 14.5 Three-way merchandise trade by main trading partners (2012, % of total)

(*Source:* Adopted from *The Economist*, Jan 4, 2014)

exposure of the Mexican firms to mighty American and Canadian competitors. Environmentalists have voiced concerns about NAFTA. They point to the sludge in the Rio Grande River and the smog in the air over Mexico City and warn that Mexico could degrade clean air and toxic-waste standards across the continent.

Then there is opposition in Mexico to NAFTA from those who fear a loss of national sovereignty. Critics in Mexico argue that their country will be dominated by the US firms that will not really contribute to Mexico's economic growth, but instead will use Mexico as a low cost assembly site, while keeping their high-paying, high-skilled jobs north of the border. The way US firms located in Mexico treat labour, particularly union organisers, has come in for sharp criticism. In early 1994, for example, Honeywell Inc was accused of firing employees who were trying to organise a union at a Mexican manufacturing plant where workers' average pay was $1.00 per hour.

Mexicans have a feeling that the US is no more interested in their country; that the country has not become another Korea or Taiwan—a promise that was held out when the country joined NAFTA; and the sacrifices made exceeded the benefits they are receiving. Mexicans hoped that their country would be America's biggest workshop. This honour, however, has gone to China, where workers often earn a fraction of what Mexicans do (see also Table 14.6).

Table 14.6 Promises and Realities of NAFTA

NAFTA and Mexico	
The promise...	*The Reality...*
EXPORTS: Mexican made goods would compete successfully in the US.	Exports have tripled, but only a handful of Mexican companies have enjoyed big gains.
INVESTMENT: Foreign capital would flow across Mexico to capitalise on the country's low wages.	FDI averages $12 billion yearly, but goes primarily to border states.
JOBS: The pact would create solid manufacturing jobs and lift Mexicans' incomes.	500,000 jobs have been created, but the peso maquiladora's crash has held down wages
STABILITY: NAFTA would force Mexico to maintain financial discipline and stick with reforms.	Mexico has not relapsed into protectionism: Sovereign debt is investment grade.
US RELATIONS: Mexico and the US would forge an unbeatable partnership in a global economy.	Business links stay strong, but governmental relations have soured.

Policy makers in Mexico believed that trade pacts would get them more benefits and signed trade agreements with 44 other countries, more than any other nation. No doubt consumers got cheaper and better goods. But local manufacturers of toys to shoes, as well as farmers of rice and corn, are struggling to survive the competition from cheap imports. This perception in Mexico is spreading to other Latin countries which, after 15 years of gradually opening their own economies to trade and investment, are exhibiting fatigue with the free market formula preached by the US and the IMF. This is an ironic twist. It was NAFTA which triggered the free-trade movement, spurring the Uruguay Round of global trade talks in the mid 1990s, and setting the stage for China's entry into the WTO.

Part of the blame for the recent declining sheen of NAFTA lies with the big brother among the trading partners – United States. Fears of terrorism in the US after Sept 11th 2001, which led to a security clamp down on its borders, is hampering trade. US is spending vast sums on border security (since 2001, it is $186 bn) neglecting infrastructure across its borders.

The setbacks are only temporary. Two factors are going to brighten up the fortunes of NAFTA. First is the demography. Two-fifth of Mexicans are under 20. Between 2000 and 2030, Mexico's labour force is likely to grow up by 58%, the United States' by 18%, while China's shrinks by 3%. Second is the shale-gas revolution and the development of Canada's oil sands and stepping up of private investment in Mexican energy.

Mercosur

MERCOSUR, the South American trading block, known as *Mercosur* in Spanish and *Mercosul* in Portuguese, includes Brazil, Argentina, Paraguay, and Uruguay. Two more countries—Chile and Bolivia—are in the process of joining the trading block. Mercosur came into effect on January 1, 1995.

The Mercosur effort has three main objectives:

1. Establishment of a free trade zone.
2. A common external tariff (a customs union).
3. Free movement of capital, labour, and services.

Mercosur seems to be making good progress. Trade among the members of Mercosur grew from $4 billion in 1990 to $16.9 billion in 1996. The combined GDP of the four member states grew at an annual average rate of 3.5 per cent between 1990 and 1996, a performance that is significantly better than the four attained during the 1980s.

There are criticisms against Mercosur however. It is pointed out that the trade diversion effects of Mercosur outweigh its trade creation effects. The fastest growing items in intra-Mercosur trade are cars, buses, agricultural equipment, and other capital-intensive goods that are produced relatively inefficiently in the member countries. In other words, Mercosur countries, insulated from outside competition by tariffs that run as high as 70 per cent of value on motor vehicles, are investing in factories that build products that are too expensive to sell to anyone but themselves. Consequently, these member countries might not be able to compete globally once the group's external trade barriers are broken. In the meantime, countries with more efficient manufacturing enterprises lose because Mercosur external trade barriers keep them out of the market.

Asia Pacific Economic Cooperation (APEC)

APEC was formed in 1989 in response to the growing interdependence among the Asia-Pacific economies. Membership of this trading block comprises 18 countries that account for about half of the total world's output, approximately half of the world's merchandise trade, and have a combined GNP of $15 trillion.

The APEC has the following specific objectives:
- To sustain the growth and development of the region;
- To encourage the flow of goods, services, capital, and technology;
- To develop and strengthen an open multilateral trading system;
- To reduce barriers to trade in goods and services among participants.

APEC is a much looser economic grouping but is unique for its members, the huge differences in their economies and stage of development, and for the juxtaposition of almost every system along the political spectrum. Its 18 members were joined by Peru, Russia, and Vietnam in November 1998. In the 1991, Seoul Declaration, APEC members agreed to work towards its objectives. They later firmed up their commitment towards their objectives by agreeing to free trade among their industrialised members by 2010 and among their developing ones by 2020. In practice, the actions of APEC's members have not yet matched their ambitions and some of its members have done little more than reaffirm their existing commitments under WTO. Potentially, however, this group could have far reaching implications for trade and investment around the Pacific Rim.

Andean Community

Formed in 1969, the Andean Community (originally the Andean Pact) includes five South American Countries located in the Andes mountain range (hence the name Andean Community)—Bolivia, Colombia, Ecuador, Peru and Venezuela. The group possesses huge potential with 105 million consumers and a combined GDP of $ 500 billion. Chile joined earlier but dropped out in 1976. During the first 20 years, the Andean Community agreement was not very successful and the trade among member countries totaled just 5 percent their total trade. The main reason was the geography of the region. The Andean mountain range makes land transportation of goods among some member countries costly. Besides, most members adopted protectionist, import substitution policies which went against free trade. Further, inherent distrust among members made lower tariffs and more open trade hard to achieve.

Then came the Mercosur Accord in 1991 which posed a big threat to the members of the Andean Community. Members of the Community agreed to reinvigorate their agreement. A year later the members established a customs union that provided for phased elimination of tariffs among themselves on most goods, a common external tariff and harmonised regulations on capital movements, immigration and agriculture. This new approach had a modest success. In 2004, about 9.5 percent of members' exports were bought by other Andean Community members.

But the ambitious objective of the members to establish a common market by 1995 remains a pipe dream. Political violence in Colombia continues to threaten stability of its government, and the nation's economy is experiencing its worst problems in decades. And as many as 80 percent of Venezuelans have fallen below the poverty line.

Yet, trade in the region is likely to become free overtime. For one thing, the Andean Community, as stated earlier, has huge potential. In 2005, the Andean Community negotiated a cooperative agreement with Mercosur. As part of this agreement Argentina, Brazil, Paraguay and Uruguay joined the Andean Community as associate members, while the members of the Andean Community became associate members of Mercosur.

Association of South-East Asian Nations (ASEAN)

ASEAN is the most prominent regional grouping in Asia. Established with the support of the USA in 1967, ASEAN includes most of the South-East Asian countries. The original five members, Indonesia, Malaysia, Philippines, Singapore, and Thailand, have been joined by Brunei, Vietnam, Myanmar, Cambodia and Laos.

The significance of ASEAN lies in the fact that it eneompasses the whole of South-East-Asia with headcount of 600 million, 8.8% of the world population. The sea area of ASEAN is about three times larger than its land counterpart. In 2010, its combined GDP was $1.8 trillion. If ASEAN were a single entity it would rank as the ninth largest economy in the world. It also includes several of the so-called Asian 'tiger economies'. Its member countries lie close to the sea lanes between Europe and China and Japan, and ASEAN is often seen as a political counterweight to China's dominance in the region. Despite their political, economic, and cultural diversity, these countries are close neighbours. They recognise development, whilst generally preferring to respect each other's independence in internal politics. The group's members have agreed to reduce tariffs on most goods to below five per cent by 2003, with ten-year phasing in periods for the new members. Future of ASEAN appears bleak as the financial crisis that swept through South-East Asia in 1997 hit several member countries particularly hard, most notably Indonesia, Malaysia, and Thailand. Until these countries can get back on their economic feet, it is unlikely that much progress will be made.

Indian Subcontinent

Indian subcontinent came a sort of late in the formation of a trading block. Initiation in the direction took birth in 1985 when seven South Asian countries formed not mainly as a trading group: SAARC (South Asian Association for Regional Cooperation). The seven countries are India, Pakistan, Sri Lanka, Nepal, Bangladesh, Bhutan, Maldives and Bangladesh. In 1995 these countries established the first economic block, vis; SAARC Preferential Trading Agreement (SAPTA). Afghanistan joined in 1997.

SAPTA identified 226 items for tariff concession ranging from 10% to 100%. India agreed to cut tariff on 106 items, Bangladesh 12 items, Maldives 17 items, Nepal 14 items, Pakistan 35 items, Sri Lanka 31 items, and Bhutan 11 items. Out of 106 items offered by India for tariff cut, 60 items would be for the least developed countries in the SAARC

SAPTA was replaced by SAFTA (South Asia Free Trade Area) in 2006. As per the new agreement, the developing countries (India, Pakistan, and Sri Lanka) have been given seven years and the least developed countries 10 years for full implementation.

With the signing of the agreement, Pakistan would have to automatically give the most favoured nation (MFN) treatment to India, which has been a major stumbling block in promoting free trade in South Asian region.

SAFTA is established on the lines as WTO. In fact, SAFTA depends heavily on WTO systems for disputes settlement, safeguard measures, BOP exceptions and special and differential treatment to LDCs. There is also a provision for withdrawal of membership. Any dissatisfied country can pull out of SAFTA by giving six months notice in writing.

There are challenges nevertheless. They are:

- The momentum in improving Indo-Pak relations will have to be maintained.
- The economic insecurity-related concerns of the smaller nations will have to be addressed.
- There is an urgent need to develop economic infrastructure. India and Pakistan have only one road to cross borders at Wagah. Trade between countries cannot be handled on a single road.
- There are certain fears in specific sectors in each country that need to be allayed.

SAFTA carries high potential as a trading block. Members of SAFTA (South Asia) are the least integrated. Neighbours supply just 0.5 per cent of India's imports, and consume less than 4 per cent of her exports. India and Pakistan are together home for a fifth of world population, but their bilateral trade is less than $3 bn per year.

India to Blame? India is blamed for the low trade flow among the SAFTA countries. "India, the regional superpower, is largely to blame. Though she is a democracy and has the biggest economy and armed forces in the region, she has rarely been a force for good. Instead, India threatened the neighbours by turns, with negligence and high-handedness", observes *The Economist,* dated Feb. 18, 2012.

The reputed weekly further argues that the lack of integration has kept South Asia poor. By one estimate, without barriers trade between India and Pakistan would grow nearly ten fold. Today, the main border-crossing near Pakistan's eastern city of Lahore is almost deserted. If educated Sri Lankans were allowed to work in India, they would get jobs instead of having to take up menial work in the Gulf, thus easing a growing shortage of skilled workers in India. A regional energy market could boost prosperity, and Indian engagement in the problem of water-sharing could reduce tension on the issue.

The weekly further adds that India should boost regional trade by unclogging roads, and building better ports and freight parks at her borders. Non-tariff barriers—including the one that insists Pakistani cement crosses the border only by train, no lorry, should go. India could take lessons from other big emerging powers, such as South Africa and Brazil, on how to build relationships in the region.

From purely trade point of view, observations by *The Economist* are highly sensible.

Middle East and African Initiatives

Middle East and African countries too have their own trading blocks. But the visibility of the blocks and their progress are not significant. The reasons are obvious: small size of the countries and the relatively low level of development. The largest of the coalitions are the Gulf Cooperation Council (GCC) and the Economic Community of West African Countries (ECOWAS).

GCC Several Middle Eastern countries, specifically, Bahrain, Kuwait, Oman, Saudi Arabia and the United Arab Emirates formed the GCC in 1980. The purpose behind forming the GCC is cooperation with the EU and the EFTA, the powerful trading blocks. However, over time, GCC has become more of a political entity than an economic block, interested in promoting trade. Nevertheless, one good thing about the GCC is that it permits citizens of member countries to travel freely within the block without visas. GCC also permits citizens of one country to own land, property and business in any other member country without the need for local partners.

ECOWAS This was formed in 1975 but the foundation for real economic integration was laid in 1992. One of the most important goals of ECOWAS is the formation of a customs union and eventually common market and monetary union. Formed by 13 sub-Saharan countries (Mali, Niger, Nigeria, Benin, Togo, Ghana, Ivory Coast, Liberia, Sierra, Guinea, Gambia, Senegal and Burkina Faso) ECOWAS encompasses a large portion of the economic activity in that region.

But the progress towards economic integration hardly deserves any write-up. The value of the trade occurring among the member nations is just 11 per cent of the trade members undertake with third parties. Political instability, poor economic policies, poor infrastructure and poor governance are the main causes for lacklustre performance in achieving economic integration. However, ECOWAS has made progress in free movement of people, construction of roads across borders and development of telecommunication links.

A New Trading Block Beginning of 2012 witnessed the emergence of a new trading block. 20 years after the breakup of the Soviet Union, Russia has moved decisively to reintegrate the former Soviet states to a closely knit economic alliance.

More specifically, on Jan 1, 2012, a Common Economic Space (CES) comprising Russia, Kazakhstan and Belarus came into being. First time in the post Soviet history, three ex-Soviet states have created a supernational economic entity to which they agreed to delegate a part of their sovereignty.

CES represents the second stage in the integration process. In the first stage was created a customs union under which the three states removed customs controls on their borders.

CES (second stage) seeks to take the integration process further. It provides for free movement of goods, services, capital and labour among the three states.

Parallel to the WTO is the creation of Eurasian Economic Commission (EEC) which monitors the compliance of the rules of the CES and the CES court for settling business disputes.

By 2015, the CES will be upgraded to the Eurasian Union, a full-fledged economic block, modelled on the European Union, with a common currency, harmonised legislation, and closely coordinated economic and monetary policies.

Yet another grouping is in the news now and in the days to come, will emerge as a strong economic block. Formed by Brazil, Russia, India, China and South Africa (BRICS), these countries have been witnessing impressive GDP growth rates. Brazil has seen much FDI in both commodities and real estate. Russia has seen strong FDI in energy sector. India has been hub for BPO and other IT services. It has snatched millions of jobs from the US. China is racing to close the gap with the US and it (former) owes its fast growth from manufacturing. Together, Brazil, Russia, India and China account for 15% of world trade (See Fig. 14.6). All of BRICS nations have begun strategic alliances with each other in a further attempt at boosting growth.

Recently all the five countries have together decided to create two financial institutions: the New Development Bank (NDB) to promote infrastructure and sustainable development projects with $50 bn in capital to start with, and $100 bn Contingent Reserve Arrangement (CRA), to tide over members in financial difficulties. Once these institutions get operationalised, the BRICS countries will have proved that they are beyond the mere acronyms ascribed to them.

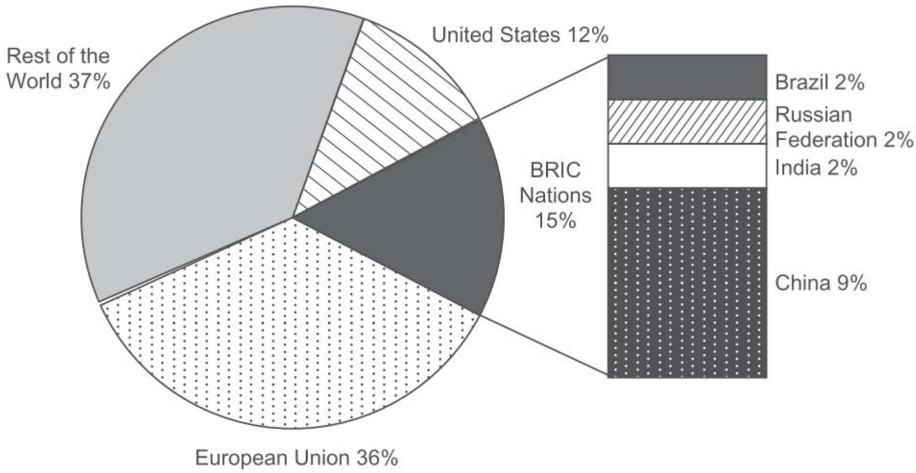


Fig 14.6 World Trade, 2010

(*Source:* Riad A Ajami and Jason Goddard, *Opcit*, 2014, p.23)

COMMODITY AGREEMENTS

LO 5
Discuss commodity agreements

Till now we have discussed the integration of countries. It is also useful to understand how countries use commodity agreements to stabilise the price and supply of selected commodities.

The most widely known commodity agreement is the Organisation of Petroleum Exporting Countries (OPEC). OPEC became a significant force in the world economy in the 1970s. In 1973, the Arab members of OPEC were angered by US support for Israel in the war in the Middle East. In response, the Arab members declared an embargo on the shipment of oil to the US and quadrupled the price of oil—from approximately \$3 to \$12 per barrel. The price peaked to \$140 in 2008. OPEC tactics included both price fixing and production quotas.

OPEC was formed by 12 countries—six gulf countries and six non-oil rich countries.

OPEC is a producer cartel (a group of commodity producing countries that have significant control over supply and that band together to control output and price) and the oil rich countries are performing that role to their advantage.

OPEC members enjoyed the strong position offered by the cartel for more than four decades.

But not always. Commencing from June 2014, oil prices are declining, questioning the clout of the cartel. The official charter of OPEC states that the group's goal is the "stabilisation of prices in international oil markets." This has been far from achieved. The price per barrel has fallen from \$ 115 in June 2014 to \$ 70 as of now, a fall by 40%. Reasons are mainly three. *First,* fall in the demand for oil thanks to the sluggish world economy. *Second,* discovery of shale gas by the US. With nearly 20,000 new wells, America is now producing close to 9 mn barrels per day. This is just 1 mn short of Saudi Arabia's output. And US is not the only depositary of shale gas. There are nearly 10 other countries who carry the potential with them. *Third,* oil importing countries have started conserving oil. (Also see exhibit 14.2)

Whatever may be the reason for fall in oil price, India is a gainer as her import bill on oil comes down drastically. People are getting oil at much reduced price. (Also read Chapter 3)

International commodity agreements involve both buyers and sellers in an agreement to manage the

Exhibit 14.2

THE POLITICS OF OIL

Iraq's latest charge that Kuwait has been stealing its crude oil (3 lakh barrels a day)—which the latter has denied—is reminiscent of the situation a decade ago, which had led to the Gulf war. Intervention by the US and its allies had ended in the defeat of Mr Saddam Hussein's plans to colonise his smaller neighbour. The threat of another such expedition by Iraq is indeed unsettling, though it is to be hoped that Mr Hussein will refrain from any adventurousness. He had defended his 1991 invasion with the claim that Kuwait was Iraq's 13th province, which had been taken away by the British during the First World War of 1914–18. Mr Saddam Hussein knew that had his annexation of Kuwait succeeded, it would have given his country control over 20 per cent of OPEC production and make it the dominant power in the Gulf.

As for the charge of oil theft, the possibility of its being true does arise from the fact that the oil fields of Iraq and Kuwait border. If the charge is to be taken seriously, it will have to be substantiated by facts about (i) any decline in Iraq's oil production, which could have resulted from pilfering by Kuwait; (ii) a matching increase in Kuwait's production, which Iraq can attribute to theft; and (iii) proof of Kuwait's access to and deployment of technology, which could bring about such a "theft" from adjacent oil wells.

Earlier reports about Iraq's annual oil production having dropped to 58 million tonnes, which is a third of its total output, because of damage to its oil fields during its war with Iran suggest that annual production had been as high as 174 million tonnes. Putting this figure down in barrels—seven barrels making a tonne—the annual production capacity should be 1,218 million barrels if Iraq had restored it fully after the war with Iran. The corresponding daily production would be around 3.3 million barrels. Iraq might by now well have reached this level of production. There have been reports about its plans to raise it to 6 million or 7 million barrels a day within the next six or seven years.

Iraq's charge of oil theft by neighbouring Kuwait has not so far been supported by any credible evidence; though it could allege that the production increases in Kuwait could not have been achieved legitimately. Kuwait has agreed under the latest accord with the Organisation of Petroleum Exporting Countries (OPEC) to step up its output from 1.98 million barrels to 2.037 million barrels a day. In a recent statement, the Kuwait Oil Minister, Sheikh Saud Nasser al-Sabbah, said the kingdom had an excess production amounting to 2.5 million barrels a day. Kuwait, like any other member of the OPEC, regulates its oil production in response to world demand, stepping it up if needed.

The next question is: what are the possibilities held out by technology for stealing oil from adjacent oil fields. When some wells in a cluster run short of reserves, the producing agency resorts to deviational drilling involving the sinking of rigs and their being diagonally directed between one group of wells and another for the desired syphoning of. Such drilling is carried out with flexible pipes that can reach out to adjacent sources of oil. The big advances made in drilling technology now make it possible to drill through solid rock. Deviational drilling is resorted to if built-up residential areas or industrial townships, spread over a region, rule out sinking of new wells. If there is any truth in Mr Saddam Hussein's allegations about oil theft by Kuwait, it could have been made possible by pressing the hi-tech available for such a transfer from adjacent wells in another country sunk to a depth of a few thousand metres would be very expensive. The Oil and Natural Gas Corporation (ONGC) and Oil India are familiar with this technology. It is an operation that could cost not only several million dollars but also calls for hundred per cent accuracy in drilling, which is easier said than done. Such diagonal drilling is very rarely resorted to since the cost of extraction would not be economical compared to the value of the oil pumped out.

The geology of the oil reserves could also forestall the need for such a costly operation. The history of oil drilling so far has been that where there is a rich hydrocarbon presence, the drillers strike oil in clusters of pools. If there are groups of oil wells adjacent to each other like on the borders of Iraq and Kuwait, subterranean movements might themselves bring about the flow of oil between them at the cost of one country to the benefit of the other, without either of them having to resort to any theft.

The geological history of such movements spread over thousands, if not millions of years, has revealed that they spread across continents. Everette Lee DeGolyer, the Kansas-born US geologist, had brought to the attention of the US government way back in 1944 to the proven presence of huge oil reserves in Iran, Iraq. Kuwait, Bahrain, and Qatar amounting to 25 billion barrels. He had believed that they may be much larger, in the region of 300 billion barrels. "The centre of gravity of world oil production," he had said, "is shifting from the Gulf-Caribbean area to the Middle East—to the Persian Gulf area." It turned out to be a prophecy since until as late as the 1940s, the entire Arabian Peninsula was producing only 5 per cent of world oil as against 63 per cent by the US. The hopes of the ONGC striking it rich in the Godavari and Kaveri offshore basins in fact hinged upon hopes mentioned by the former Union Petroleum Minister, K D Malaviya, that oil had in fact run away from the land to the sea in these basins.

Iraq, which had long been a monarchy, was signatory to the "Red Line Agreement" signed in 1928 between Calouste Gulbenkien of the Turkish Petroleum Company and Walter Teagle of Standard Oil of New Jersey. The agreement provided for the partners binding themselves not to engage in oil operations within the vast territory excluding Kuwait and Iran except in cooperation with other members of the Turkish Petroleum Company. It is not known whether the exclusion of these two countries was deliberately initiated by Iraq—a possibility that suggests itself because of Iraq being always at loggerheads with them. Along with king Faisal of Iraq, the other signatories to the agreement were Calouste Gulbenkien and Walter Teagle.

The recurring turbulence that the Middle East had been going through had been mainly because of the attention its oil wealth had begun to invite during the last century. It was Everette DeGolyer who predicted in the early 1950s that the Middle East would be replacing the US as the world's major, crucial oil producer. While US production had gone up from 8.7 million barrels a day in 1948 to 42 million barrels in 1972, its share of world production dropped during this period from 65 to 2 per cent. This decline has actually served US interests by making it possible to preserve its own oil reserves at the cost of depleting the non-renewable reserves of the Middle East.

The US in fact calls its unexploited petroleum deposits a strategic reserve on which it could fall back if supply from the Middle East suffers from any prolonged disruption. This makes its selfishness more 'strategic' than its oil reserves.

output and price of a certain commodity. Often, the free market is allowed to determine the price of the commodity over a certain range. However, if demand and supply pressures cause the commodity's price to move outside that range, an elected or appointed manager will enter the market to buy or sell the commodity to bring the price back into the range. The market controls the *buffer stock* of the commodity. If prices float downward, the manager purchases the commodity and adds to the buffer stock. Under upward pressure, the manager sells the commodity from the buffer stock. International commodity agreements are currently in effect in oil, sugar, tin, rubber, cocoa, and coffee.

World Trade Organisation

Till now this chapter focussed on regional trading blocks and international commodity agreements.

Members of all the trading blocks and agreements are also part of the World Trade Organisation, more popularly known by its acronym WTO. The next chapter is devoted to a detailed discussion on WTO.

INDIA AND TRADE AGREEMENTS

India has been promoting free trade and this was the main reason for it to be one of the founding members of WTO. For the same purpose, India has signed bilateral trade agreements with several countries as shown in Table 14.7.

LO 6
List India's trade agreements

Table 14.7 India's Trade Agreements

Agreement	*Year*
India – Nepal	1996
India – Afghanistan	2003
India – Thailand	2004
India – Mercosur	2004
India – BIMSTEC	2004
India – Gulf Cooperation Council (GCC)	2004
India – Singapore	2005
India – SAFTA	2006
India – Bhutan	2006
India – Chile	2006
India – South Korea	2009
India – Asian	2009

Bilateral agreements are either proposed or under negotiation between India and Pakistan, India and South Korea, and India and Japan.

The bilateral and multilateral agreements benefit India in several ways. Firms in cooperating countries can expand volumes and gain the advantage of economies of scale. India can access resources from partnering countries and set up operations in them.

SUMMARY

- Integration among countries may assume any of the six levels. Each successive level represents a better fusion than the earlier one. (LO1)
- Trading blocks have come to stay, periodically neighbouring countries forming new blocks. (LO2)
- Trading groups have mostly positive benefits. This is the reason why they are being formed. Dynamic effect, trade creation and trade diversion, and competition and prices are the major effects of integration. (LO3)
- NAFTA, AFTA, APEC, ECOWAS, EU, MERCSUR are a few major blocks. (LO4)
- OPEC is the major commodity block. It is also called a cartel whose clout is waning thanks to fall in demand for oil. (LO5)
- Being a member of SAFTA, India has trade agreements with countries around the world. (LO6)

Review Questions

1. Why do countries form themselves into regional trading blocks? (LO3)
2. Bring out the impact of integration between countries. (LO3)
3. What is a preferential trading agreement? How is it beneficial to trading partners? (LO3)
4. Write short notes on (LO1)
   (a) Free trade area (b) Customs union.
5. Write notes on (LO1)
   (a) Common market (b) Economic union.
6. Bring out the implications of European Union on world trade. (LO4)
7. Explain the role of NAFTA in promoting trade among its member countries. (LO4)
8. What are commodity agreements? What is their role in promoting world trade? (LO5)
9. Write notes on (LO4)
   (a) APEC (b) ASEAN
10. How do various forms of economic integration differ? (LO1)

Discussion Questions

1. What are the economic and political arguments for regional economic integration? Given these arguments, why don't we see more integration in the world economy? (LO3)
2. "NAFTA is likely to produce net benefits for the US economy." Discuss. (LO4)
3. Should international businesses promote or fight the creation of regional trading blocks? (LO3)
4. Do regional trading blocks help or hurt world trade? (LO3)

Reinforcing Exercises

- Trade diversion refers to a situation where trade between members of a trading block increases at the expense of non-members. For example, elimination of the tariff created more trade between Spain and the EU. At the same time, because the US was still outside the EU, its products suffered the higher prices as a result of tariff application. US exports to the EU fell.

  Give similar example for trade creation.
- Organisation of Petroleum Exporting Countries (OPEC) is one example of a commodity agreement. Formed by six Middle Eastern countries and six other oil producing countries, OPEC seeks to bargain as a single entity in world markets. Also called cartels, such commodity agreements are detrimental to buyers. Being a single largest supplier of oil, OPEC has been hiking the oil price per barrels from time to time – in the early 1970s, in 2003 and in 2008. In 2008, the price peaked to $140 per barrel. Crude prices are now falling. Hold of OPEC on the world is also waning. Any other similar cartels?

CLOSING CASE 1

The New World Order

The fall of communism in the late 1980s and early 1990s prompted much new thinking about the post-cold war world. Enter Samuel P. Huntington. In his *Clash of Civilizations and the Remaking of World Order*, Huntington sets out the seven (or eight, including Africa) civilisations that are set to dominate world culture and politics in the 1990s and beyond.

Western Civilisation includes the Catholic and Protestant cultures of Western Europe, North America, Australia, and New Zealand and promotes the ideas of individualism, liberalism, human rights, equality, the rule of law, democracy, free markets, and the separation of church and state. So pervasive are these ideas that a "West versus the Rest" mentality influences economic progress worldwide and has resulted in returns to grassroots cultures: "Asianisation," "Hinduisation," and "re-islamisation". The anthropologist Harry Triandis concludes that: "the values that are most important in the West are least important worldwide."

Latin American civilisation, despite its geographic ties to the Western hemisphere, evolved from its European immigrant roots differently to North America, becoming more authoritarian, adopting a different religion (Catholicism), and incorporating native American ways into its regional culture.

Slavic Orthodox civilisation includes Russia, Greece and other Eastern European countries with Orthodox traditions. While geographically close to Western Europe, religious, ethnic divisions, and ultimately political differences caused major divergences.

African civilisation, especially south of the Sahara, has retained its many cultural identities despite the long presences of colonial powers, though today there are appearances of the establishment of an African identity.

Islamic civilisation has a religion-based identity whose philosophies and lifestyles have caused frictions with Christianity (from the crusades onward, and currently in Africa), Orthodox Serbs in the Balkans, Judaism in Israel, Hindus in India, Buddhists in Burma, and Catholics in the Philippines. Given this history, Huntington correctly forecasted continued conflicts in the later 1990s.

Japanese civilisation, despite owing much to its Chinese origins, has managed to preserve its Asian cultural identity while becoming a world economic power to rival the West.

Hindu civilisation has religion as its centerpiece; this religion defines many aspects of Indian and Sri Lanka societies.

The Chinese-Confucian civilisation has influenced mainland China and had significant impacts on mainstream Asian culture.

These eight civilisations are differentiated by history, language, culture, tradition, and religion. They are, as Huntington notes, "the product of centuries. They will not soon disappear."

Questions

1. Which factors – religious or economic – decide clustering of countries?
2. Do the eight cultural clusters promote free trade across countries?

CLOSING CASE 2

Use of Trading Blocks

You are an international business consultant in India. Your speciality is exporting to and investing, licensing, or franchising in emerging markets.

One of your clients is a hotel company that wants to build, operate, a 100 per cent owned hotel in Guatemala. Your client is willing to put up about half of the original capital but wants to be assured that its share of the profits can be repatriated to India as dividends.

To what trading blocks discussed in this chapter—might you look for assistance in raising the rest of the needed capital? To what organisations might you look for information concerning the Guatemala company's ability to repatriate profits as dividends?

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Suggested Readings

The Economist, July 19, 2014.

CHAPTER

- United Nations Organisation (UNO)
- World Bank
- International Monetary Fund (IMF)
- International Labour Organisation (ILO)
- United Nations Conference On Trade And Development (UNCTAD)
- World Intellectual Property Organization And Development (WIPOD)
- United Nations Industrial Development Organization (UNIDO)
- Asian Development Bank (ADB)
- World Trade Organization (WTO)
- Treaties and Conventions

15

Institutional Support to International Business

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Identify the institutions that promote world trade
- **LO 2:** Describe the role played by each institution in promoting business across the globe
- **LO 3:** Review treaties and conventions that are active in international trade

Opening Case

Social Issues and World Bank

Jim Kim, the president of the World Bank, wants the World Bank to promote gay rights. He has declared the "fight to eliminate all institutionalised discrimination" to be an "urgent task". He recently put on hold a $90 mn loan to Uganda's health sector after its government introduced one of Africa's most draconian anti-gay laws. He has ordered an overhaul of the Bank's lending policies to make sure that no loan assists discrimination.

Bigotry is abhorrent and laws that entrench it should be condemned. Uganda's new law, which allows a maximum sentence of life imprisonment for anyone convicted of homosexuality and requires citizens to report anyone suspected of being gay, is particularly awful. Nonetheless, Mr Kim's initiative is misguided. The World Bank is a technocratic development organisation, not a place for political advocacy. Setting up gay rights as a test of its lending decisions is likely to make the Bank less effective at what Mr Kim himself has emphasised is its core job, tackling extreme poverty.

The Bank's technocratic approach is a big part of its DNA. Its founding documents prohibit "political activity", notwithstanding how unpleasant a regime might be. Only "economic considerations" should be relevant to lending decisions. That does not, by itself, preclude it from opposing nasty laws. You can draw a link from fighting bigotry to alleviating poverty. Unfair treatment of groups of people, whether on the basis of gender, race or sexuality, leads to their social exclusion, which, in turn, is likely to harm economic growth and make it harder to alleviate poverty. By this logic the Bank has, rightly, long been pushing for the education of girls. The fight against other forms of discrimination can be justified on the same economic grounds.

A rainbow of reasons

But even if it can be justified in principle, Mr Kim's focus on gay rights is likely to be counterproductive in practice, for three reasons. *First*, it seems capricious. Uganda is hardly the only country with anti-gay laws on the books. Nor is it the only one to have recently toughened its anti-gay stance. Almost 80 of the Bank's member countries, including most in Africa, have legislations that discriminate against gays. In many places, the laws are ignored, but in several other places, notably Ethiopia and Nigeria, stiffer anti-gay statutes have been introduced. Uganda's behaviour is odious. But it is not alone.

Second, the stress on gay rights itself seems arbitrary. Of the many forms of bigotry the Bank could battle, it is not clear that anti-gay laws are the most harmful to the poor. The Bank lends to many countries that discriminate against women under Islamic law. It also lends to countries with laws that discriminate against minorities. The economic impact of these forms of bigotry is far bigger. But if Mr Kim tries to tackle all institutionalised discrimination by withholding lending, he will soon have no customers left.

Third, his approach is likely to backfire. In the short term, it weakens the campaign to lessen poverty. Uganda's loan, designed to support maternal-care clinics, was the equivalent of 20% of its health budget. And it still has a high child-mortality rate. Politically, the pressure from Mr Kim, though winning plaudits in Washington, is having perverse results, where it matters most. Uganda's government declares itself to be standing up against the arrogant imposition of "Western values". The more the World Bank adds such conditions to its lending, the more African countries will be inclined to seek money elsewhere, at least from the no-question asking Chinese Government.

The uncomfortable truth is that an economic institution like the World Bank has to pick its battles. There is a limit to the number of conditions that outsiders can attach to their aid. Its aim is to encourage economic development. Most of the evidences validate that the Bank is most effective when client countries see it as an economic partner, rather than a boss imposing a Western agenda.

Ironically, at one level, Mr Kim seems to realise that. He is sponsoring a big management reform designed to make the Bank better and finding the most promising solutions from around the world to help countries develop faster. Launching a battle for gay rights may solve consciences, but will make it harder to achieve that goal.

IN Chapter 1, we had stated that one of the triggers for international business is the support it gets form certain world bodies. We propose to describe more prominent world bodies that facilitate and encourage global business. Together called, institutions, we propose to review the World Blank, the International Monetary Fund (IMF), International Labour Organisation (ILO), the United Nations (UN), UNTAD, WTO and others.

Towards the end we propose to cover certain treaties and conventions that facilitate international business in a significant way.

UNITED NATIONS (UN)

LO 1
Identify the institutions that promote world trade

The United Nations was formed after World War II, to provide leadership in fostering peace and stability around the world. Currently, the UN has 193 members. Most countries, both communist and democratic, are members. Switzerland, which is prohibited from joining international organisations by its Constitution, is not a member. The UN provides food and medical supplies, educational facilities and training and financial resources to poorer member nations. The UN receives its funding in the form of contributions from members based primarily on gross national product (GNP).

The UN essentially is a political organisation but deals with economic issues also. One of the key economic issues that it is actively concerned about is the environment. In 1992, more than a hundred heads of state met in Rio de Janeiro, Brazil, for the first International Earth Summit convened to address urgent problems of environmental protection and socioeconomic development. The assembled leaders signed the 'Convention on Climate Change' and the 'Convention on Biological Diversity', endorsed the 'Rio Declaration' and the 'Forest Principles', and adopted a 300-page plan for achieving sustainable development in the twenty-first century.

A number of organisations affiliated with the UN undertake activities affecting the international business environment. The following list provides an idea of the types of work many of the agencies perform:

- Food and Agricultural Organisation (FAO)
- International Labour Organisation (ILO)
- World Bank
- International Monetary Fund (IMF)
- United Nations Education, Scientific and Cultural Organisation (UNESCO)
- World Health Organisation (WHO)
- World International Property Organisation (WIPO)

Of particular interest is the role of the UN in shaping international trade law, which, in turn, has its impact on the economic environment. The United Nations Commission on International Trade Law (UNCITRAL) is one of the numerous Commissions established by the UN. The objective of this agency is to promote international trade through the harmonisation of trade laws between nations. It has members from many nations. One of the achievements of UNCITRAL has been the enforcement of the Convention on Contracts for the International Sale of Goods. The UN Convention on the Carriage of Goods by Sea of 1978 was initiated by this agency and addresses international bills of lading used in the shipment of goods. In 1976 UNCITRAL adopted arbitration rules which have been widely used.

WORLD BANK

LO 1
Identify the institutions that promote world trade

Creation of the World Bank and the IMF has a 70-year-old history worth recollecting here. The economic conditions aftermath of World War I resulted in many countries facing problems such as inflation, unemployment and currency fluctuations. Many nations turned towards protectionism as a way to deal with these problems. Although protectionist measures were largely unsuccessful, the onset of World War II diverted the world's attention from these economic issues. While the war was still on several meetings involving the world leaders were held, laying the groundwork to prevent future economic and military catastrophes. An international conference was convened in 1944 at Mount Washington Hotel at Bretton Woods near the East coast of the US. Nearly 730 delegates from 44 countries participated in the extravaganza. The reason for selecting the venue was that Bretton Woods was attractive because of its salubrious climate at a time when air conditioning was not a common facility. In particular, the hotel was selected because it was open to Jews. The delegates met over three weeks to ensure that a repeat of the financial calamities that had scarred the world in previous decades would be avoided in the future. The conference resulted in the creation of the famous "twins" – the International Monetary Fund and the World Bank.

It is a matter of pride that India played its role in making of the history. Six delegates (two British officials and four Indians) participated in the conference. At the end of the conference, India got a quota of $400 mn (China got $550 mn) and Keynes played a decisive role in this hefty quota.

The World Bank, together with the IMF, was intended to strengthen the structure and encourage the development and efficiency of international financial markets. The World Bank consists of five main agencies: the International Bank for Reconstruction and Development (IBRD, popularly known as the World Bank); the International Development Association (IDA); the International Finance Corporation (IFC); and the Multilateral Investment Guarantee Agency (MIGA); and the International Centre for Settlement of Investment Disputes (ICSID).

The IDA was established in 1960 to provide long-term funds at concessional rates to the poorest member countries of the Bank. In fiscal 2012, IDA provided $14.7 bn in financing various projects in low-income countries – most of them in Africa and South Asia. The five largest recipients of IDA credits are India, Vietnam, Bangladesh, Pakistan and Ethiopia.

IDA does not have a separate organisational structure and the staffs of the Bank conduct its activities. The President of the Bank is also the President of IDA.

IFC was set up in 1956 with the objective of promoting the development of private enterprises in member countries. Organisationally, the status of IFC is ditto of IDA.

The MIGA was set up in 1998 to promote overseas direct investment flows into developing countries by providing guarantees against non-commercial risks that investors face in most countries. Risks covered by MIGA include expropriation of assets by local governments, nationalisation without adequate compensation, losses arising out of wars and civil disturbances.

The ICSID was set up in 1966 to settle investment disputes that arise between governments and foreign private investors. Till now, over 375 disputes have been reconciled, 38 of them in 2011 itself.

Membership

The World Bank has the following number of members in each of its institutions:

- The International Bank for Reconstruction and Development (IBRD) – 187
- The International Development Association (IDA) – 169
- The International Finance Corporation (IFC) – 182
- The Multi lateral Investment Guarantee Agency – 175
- The International Centre for Settlement of Investment Disputes – 144

Activities of the Bank

The Bank focuses on the following:

- Economic Policy
- Education
- Energy
- Environment
- Financial Sector

- Gender
- Governance
- Health, Nutrition and Population
- Industry
- Agriculture
- Information and Communication Technologies
- Information Computing and Telecommunications
- International Economics and Trade
- Labour and Social Protections
- Law and Justice
- Macro Economic and Economic Growth
- Mining
- Poverty Reduction
- Private Sector
- Public Sector Governance
- Rural Development
- Social Development
- Social Protection
- Trade
- Transport
- Urban Development
- Water Resources
- Water Supply and Sanitation

Bank's Loans and Grants

The main objective of the Bank is to support social and economic progress in developing countries by promoting better productivity and utilisation of resources so that their citizens can lead better life. The Bank seeks to achieve its objective by making financial assistance available to developing countries, especially for specific, economically-sound infrastructural projects, particularly in the areas of power and transport. The Bank's activities listed above are carried out in fulfilment of its objectives.

Role in International Business

The World Bank promotes international business in two specific ways: setting up of the Multilateral Investment Guarantee Agency (MIGA) and Creation of the International Centre for Settlement of Investment Disputes (ICSID).

MIGA, established in 1988, provides non-commercial guarantees (insurance) for FDI in developing countries. The MIGA's guarantees offer protection to investors against non-commercial risks such as expropriation, currency inconvertibility, breach of contracts and civil disturbance. MIGA also provides advisory service to help countries attract and retain FDI. Should there be investment related disputes, MIGA tries to mediate to settle the disputes amicably.

ICSID set up in 1966, seeks to resolve disputes, if any, between foreign investors and host countries. ICSID seeks to foster trust between countries and foreign investors. Many international agreements relating to investment refer to the ICSID's arbitration clauses. The world body also conducts research and disseminates information relating to arbitration and investment laws through its own publications. The Bank has the onerous task of achieving Millennium Development Goals.

Criticism

The Bank has been criticised by developing countries, academies and several NGOs. The Bank, together with the IMF, has been criticised on the ground that the duo have forced economic reforms on developing countries, assuring that the poor countries would become rich through reforms. But the reforms have not made poor countries any better.

Further, it has also been criticised because it let itself to be dominated by a small number of economically powerful countries. The Bank has, no doubt, 187 member countries, but the small number of powerful countries rules the roost. They choose the leadership and senior management and obviously, their interests predominate within the Bank. The president of the Bank is always an American citizen, nominated by the president of the US. The Bank is so much US and Western oriented that Seven South American nations have established the Bank of the South in order to minimise US influence in their region.

In arriving at its decision, the Bank uses a weighted voting system that reflects the contributions and economic power of its members. The US holds the largest block of votes (16 per cent), followed by Japan (8 per cent), Germany (4 per cent), the UK (4 per cent), France (4 per cent), and six countries with 3 per cent each: India, Canada, China, Italy, Russia and Saudi Arabia. The voting weights keep changing from time to time as economic power shifts and new members join the Bank. Obviously, the voting pattern is skewed in favour of the U.S.

Some analysts have come to the conclusion that the Bank has increased poverty and been detrimental to the environment, public health and cultural diversity. It has also been alleged that the Bank has been pursuing neo-liberal agenda, imposing policies on developing countires which have been damaging, destructive and anti-development. (Also see Exhibit 15.1). Of late the Bank appears to be drifting away from its main objectives, as the opening case indicates.

Exhibit 15.1

WORLD BANK'S IRRELEVANCE

Western economists have begun questioning World Bank's role in providing finance to a country, whose economy is booming, foreign exchange reserves are growing and which has access to global capital markets. Prof. Allan Meltzer of Carnegie Mellon University, who did a seminal study of the World Bank's operations in 2000, is of the view that India (like China) has a huge capital influx, and is accumulating foreign exchange reserves. So, it does not really need World Bank's assistance. China and India had the highest portfolio of 74 and 67 active Bank-aided projects, respectively during 2006–2007.

Meltzer has made light of the Bank's current thrust on anti-poverty progress, and says that countries like China and India, that have moved the greatest number of people out of poverty in the recent past, did so through macro-economic reforms that unleashed capitalist energies, and not through the Bank's projects. In regions like sub-Saharan Africa where the Bank has been active, progress is less visible. Some critics maintain that except India and China, poverty has increased or stayed stable in places where the Bank has operated.

Another proponent of this theory is Kenneth Rogoff of Harvard University, who feels that trade flows and market forces have done a lot more to alleviate poverty in India and China than any amount of aid.

Rogoff is harsher in his assessment of the Bank's engagement with China, than with India. 'China has more than a trillion dollars in reserves, a lot of which are US treasuries. The World Bank's lending resources are only a fraction of that. The idea of the Bank going in and giving loans to a country with a space programme, building nuclear submarines, it is just an absurdity', he said.

Western economists are increasingly beginning to feel that the Bank should provide only technical assistance on technology transfer and climate-control-driven issues like clean coal and emissions to 'liquid' countries, which need not be packaged with a loan.

Some have even begun advocating that, with the financial markets of today bearing no similarity to 1944, when the Bank was set up, the whole concept of lending, with a big balance-sheet tied up in long-term loans, needs to be totally overtaken by securities. In that case the loans are the starting point for packaging together securities that can be sold and traded in the market place.

Bank earns a prosperous margin from lending operations to countries such as India and China, where a huge chunk of the world's poor live. The operating profits from the large-scale lending are used to employ roughly 10,000 civil servants and finance unprofitable programmes elsewhere in the world. Such a financing structure is not in India's interests as nation-building in the poorest countries is a global public good, whose expenses can be borne by the 25 biggest countries of the world.

A recent independent evaluation group report of the International Financial Corporation (IFC), the Bank's financial arm, has an observation: IFC promotes growth in the developing countries by financing private sector investments and providing technical support and advice to governments and businesses. In partnership with private investors, it provides loans and equity finance of business ventures in developing countries. The report found that almost 40 percent of the IFC projects had low development ratings.

The study examined the performance of 627 IFC projects, under implementation between 1996 and 2006. Although the report does not provide a break-down of results by project, it suggests that the projects' profitability for IFC and development impacts 'have tended to go together'. The report says very little about 10 percent of the projects that were very profitable for the IFC, but unsuccessful at generating development results. As of July 2006 IFC's portfolio of $1.26 billion made India its third largest country of operation.

NGOs Do Better

Apart from financing of projects, the Bank supplies knowledge inputs for its projects. But, as has often been found, it is not the bank experts but humble NGOs who have discovered the real chinks in flagship schemes like the Sarva Shiksha Abhiyan (SSA). Between 2003 and 2006, the cost of SSA was $3.5 billon in which the three development partners, IDA, UK's department for International Development and European Commission, contributed $1 billion. The Centre contributed $1.58 billion, whereas, the states chipped in with another $ 875 million. Apart from contributing $450 million, IDA provided technical support for strengthening the feedback system about the scheme, learning assessment, teacher accountability and contracting and pubic expenditure tracking. Yet, it was not IDA but the Mumbai-based NGO, Pratham, which discovered that children enrolled under the SSA were learning nothing.

The 2006 annual status of education report of Pratham found that poor families in urban slums and villages were pulling their children out of primary government schools and enrolling them in private schools. The shift to private schools was prompted by the fact that the teachers were more accountable there. Pratham found that while enrollment in primary education was high, only 95 percent of the 7–10 year olds and 91 percent of the 11–14 year-olds in school, could read a simple passage or text or do elementary arithmetic. The study wondered whether India could expect a 'demographic dividend' from a poorly educated workforce.

(*Source:* Rakesh Joshi, "Do We Need the World Bank", *Business India*, Sept. 23, 2007)

INTERNATIONAL MONETARY FUND

LO 2
Describe the role played by each institution in promoting business across the globe

The IMF was established to regulate the exchange rates and enforce the rules of an international monetary system. At the time of its formation, the IMF had 29 member countries and today the figure has gone up to 184. Among the main purposes of the IMF are:

- Promoting international monetary cooperation
- Facilitating expansion and balanced growth of international trade
- Promoting exchange stability, maintaining orderly exchange arrangements and avoiding competitive exchange devaluation
- Making the resources of the fund temporarily available to members
- Shortening the duration and lessening the degree of disequilibrium in the balance of payments of member nations
- To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation
- To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions that hamper the growth of world trade

The IMF lends money to developing countries to assist them in overcoming the fundamental problems hindering development such as high interest rates and inflated oil prices.

The main plank of IMF is to ensure stability in the monetary system—the system of exchange rates and international payments that enable countries to buy goods and services from each other. This is essential to sustain economic growth and rising living standards.

To maintain stability and to prevent crises in the international monetary system, the IMF reviews national, regional and global economic and financial developments. It provides advice to its 184 member countries, encouraging them to adopt policies that foster economic stability, reduce their vulnerability to economic and financial crises and raise living standards. It also serves as a forum where the member countries can discuss the national, regional and global consequences of their policies.

As stated above, IMF lends money to member countries on a short-term basis to tide over their balance of payments crisis. IMF's lending falls into three different categories:

- ***Stand-By Arrangements*** are designed to deal mainly with short-term balance of payments problems. The IMF's largest loans fall into this category. In 1997, it introduced the Supplemental Reserve Facility, under which it can quickly provide large loans with very short maturities to countries going through a capital account crisis.
- The IMF introduced the **Extended Fund Facility** to help countries address balance of payments difficulties related partly to structural problems that may take a longer time to correct than macroeconomic imbalances. A program supported by an extended arrangement usually includes measures to improve the way markets and supply side of the economy function, such as tax and financial sector reforms, privatisation of public enterprises and steps to make labour markets more flexible.
- Under its **Poverty Reduction and Growth Facility**, the IMF provides concessional loans — loans with an annual interest rate of 0.5 percent and a maturity of 10 years—to its poorest member countries. The majority of the IMF's loans now fall into this category. In 2005, it approved the establishment of the **Exogenous Shocks Facility**, under which it can give quick access to funds on a concessional basis to low income countries that are not receiving funds under the Poverty

Reduction and Growth Facility and that are suffering a balance of payments problem because of a shock beyond their control.

The IMF also provides **Emergency Assistance** to countries coping with balance of payments problems caused by natural disasters or military conflicts. The interest rates are subsidised for low-income countries.

The **Trade Integration Mechanism** allows the IMF to provide loans under one of its facilities to a developing country whose balance of payments suffer because of multilateral trade liberalisation, either because its export earnings decline when it loses preferential access to certain markets or because prices for food imports go up when agricultural subsidies are eliminated.

UN Millennium Development Goals

In 2000, 189 members of the UN agreed on a set of development targets known as the UN Millennium Development Goals, which range from halving extreme poverty to halting the spread of HIV/AIDS and providing universal primary education, all by the target date of 2015. They have been agreed upon by all countries and leading development institutions. The financial assistance and advice the IMF offers to its poorest members are geared to help them achieve these goals. The goals are:

1. Eradicate extreme poverty and hunger
2. Achieve universal primary education
3. Promote gender equality and empower women
4. Reduce child mortality
5. Improve maternal health
6. Combat HIV/AIDS, malaria and other diseases
7. Ensue environmental sustainability
8. Develop a global partnership for development

As the world commences the last year of the solemn pledge, the World Bank and the IMF have jointly authored the *Global Monitoring Report* to not only gauge the level of achievement in MDGs but also set out an even more ambitious target for the next 15 years.

Coming to the achievement of MDGs, the picture is a mixed one. Barring six sub-targets, out of a total of 21, none will be met by 2015 deadline. Nevertheless, the ones achieved, especially halving the population living in extreme poverty (i.e., income less than $ 1.25 per day) has cheered up the World Bank and the IMF to define the next round of targets to be achieved by 2030.

The new targets will be called *Sustainable Development Goals* (SDGs). Broadly, these SDGs fall under two groups. First, reducing the proportion of the global population living under extreme poverty to 3-1. Second, promoting shared prosperity by improving living standards of the bottom 40% of the population in every country, including the developed economies.

In order to achieve these goals, three things are necessary. First, greater investment on human capital which includes policies to provide early childhood education, vocational training and improve access to equal opportunities. Second, providing safety nets to the vulnerable people who otherwise face significant barriers in raising incomes. Third, making economic growth environmentally sustainable.

IMF and International Business

Needless it is to raise a doubt about the role of IMF in promoting business across the countries. It looks as though IMF was created to promote cross-border business. Its focus on international monetary co-operation; its emphasis on facilitating expansion and balanced growth of international trade; and its target on maintaining exchange stability speak volumes about the role of IMF in promoting global business.

Criticisms

As with the World Bank, IMF too has been criticised by several people and organisations. One criticism relates to the conditionality. Countries seeking foreign aid are typically asked to meet a large number of conditions. For instance, a country may be told that it must quickly pass piece of legislation or reform social security, bankruptcy or other financial systems if it is to receive aid. The large number of conditions often distracted governments from more vital tasks.

Another criticism relates to the myopic 'one-size-fits-all' approach followed by the IMF. Its conditionality and structural adjustments were made applicable to all economies whether developing or underdeveloped. Consequently, conditional ties (economic performance targets set up as a pre-condition for IMF loans) retarded social stability and hence impeded the stated goals of the IMF, and structural adjustments lead to an increase in poverty in the recipients countries.

Argentina is one country which stands as an example of a nation worst hit by IMF dictates. Hailed as a model economy in its compliance of policy proposals by the Bretton Woods institutions, Argentina experienced a catastrophic economic crisis in 2001, which was caused by IMF induced policies. The crisis added to widespread hatred for IMF in Argentina and other South American countries. Critics may sound harsh when they say it is not International Monetary Fund, but International Monstrous Fund (See Exhibit 15.2).

Exhibit 15.2

INTERNATIONAL MONSTROUS FUND?

The International Monetary Fund was charged with preventing another global depression. It would do this by putting international pressure on countries that were not doing their fair share to maintain global aggregate demand, by allowing their own economies to go into a slump. When necessary it would also provide liquidity in the form of loans in those countries facing an economic downturn and unable to stimulate aggregate demand with their own resources.

In its original conception, then, the IMF was based on a recognition that markets often did not work well—that they could result in massive unemployment and might fail to make needed funds available to countries to help them restore their economies. The IMF was founded on the belief that there was a need for *collective action at the global level* for economic stability, just as the United Nations had been founded on the belief that there was a need for collective action at the global level for political stability. The IMF is a *public* institution, established with money provided by taxpayers around the world. This is important to remember because it does not report directly to either the citizens who finance it or those whose lives it affects. Rather, it reports to the ministries of finance and the central banks of the governments of the world. They assert their control through a complicated voting arrangement based largely on the economic power of the countries at the end of World War II. There have been some minor adjustments since, but the major developed countries run the show, with only one country, the United States, having effective veto. (In this sense, it is similar to the UN, where a historical anachronism determines who holds the veto—the victorious powers of World War II—but at least there the veto power is shared among five countries.)

Over the years since its inception, the IMF has changed markedly. Founded on the belief that markets often worked badly, it now champions market supremacy with ideological fervour. Founded on the belief that there is a need for international pressure on countries to have more expansionary economic policies —such as increasing expenditures, reducing taxes, or lowering interest rates to stimulate the economy—today the IMF typically provides funds only if countries engage in policies like cutting deficits, raising taxes, or raising interest rates that lead to a contraction of the economy. Keynes would be rolling over in his grave were he to see what has happened to his child.

The most dramatic change in these institutions occurred in the 1980s, the era when Ronald Reagan and Margaret Thatcher preached free market ideology in the United States and the United Kingdom. The IMF and the World Bank became the new missionary institutions, through which these ideas were pushed on the reluctant poor countries that often badly needed their loans and grants. The ministries of finance in poor countries were willing to become converts, if necessary, to obtain the funds, through the vast majority of government officials, and, more to the point, people in these countries often remained sceptical.

The result for many people has been poverty and for many countries social and political chaos. The IMF has made mistakes in all the areas it has been involved in: development, crisis management, and in countries making the transition from communism to capitalism. Structural adjustment programs did not bring sustained growth even to those, like Bolivia, that adhered to its structures; in many countries, excessive austerity stifled growth; successful economic programs require extreme care in sequencing—the order in which reforms occur—and pacing. If, for instance, markets are opened up for competition too rapidly, before strong financial institutions are established, then jobs will be destroyed faster than new jobs are created. In many countries, mistakes in sequencing and pacing led to rising unemployment and increased poverty. After the 1997 Asian crisis, IMF policies exacerbated the crises in Indonesia and Thailand. Free market reforms in Latin America have had one or two successes—Chile is repeatedly cited—but much of the rest of the continent has still to make up for the lost decade of growth following the so-called successful IMF bailouts of the early 1980s, and many today have persistently high rates of unemployment—in Argentina, for instance, at double-digit levels since 1995—even as inflation has been brought down. The collapse in Argentina in 2001 is one of the most recent of a series of failures over the past few years. Given the high unemployment rate for almost seven years, the wonder is not that the citizens eventually rioted, but that they suffered quietly so much for so long. Even those counties that have experienced some limited growth have seen the benefits accrue to the well-off, especially the *very* well-off-the top 10 percent—while poverty has remained high, and in some cases the income of those at the bottom has even fallen.

Underlying the problems of the IMF and the other international economic institutions is the problem of governance: who decides what they do. The institutions are dominated not just by the wealthiest industrial countries but by commercial and financial interests in those countries, and the policies of the institutions naturally reflect this. The choice heads for these institutions symbolises the institutions' problem, and too often has contributed to their dysfunction. While almost all of the activities of the IMF and the World Bank today are in the developing world (certainly, all of their lending), they are led by representatives from the industrialised nations. (By custom or tacit agreement the head of the IMF is always an European, that of the World Bank an American.) They are chosen behind closed door, and it has never even been viewed as a prerequisite that the head should have any experience in the developing world. The institutions are not representative of the nations they serve.

(*Source:* Joseph Stiglitz, *Globalisation and Its Discontents*, Penguin Books, 2002, pp. 12-13 and 18-19.)

A serious of criticism leveled against IMF is its insistence on privatisation of state-run undertakings as a pre-condition for sanctioning aid. Many developing countries were forced to divest their undertakings in favour of MNCs at heavily discounted prices.

Over the years, as many as 100 member countries have experienced banking collapses and reduced GDP, far more than at any time in post-Depression history. All these countries are members of IMF. It has been criticised for its delay in responding to crises, worst, even creating crisis situations instead of preventing them.

IMF has been using its bully pulpit to ward off risks created by large-country policies. Small countries are subject to market discipline, as any Latvian will tell. But when large economies, whose currencies are used internationally, need more resources, they can just print more money. Not only do they feel less market discipline, but they are subject to less IMF discipline, since they are not compelled to borrow from the Fund. (see also Exhibit 15.3)

The IMF has bungled in all the areas where it has laid its hands: development, crisis management, and helping transition economies. Structural adjustment programme did not bring sustained growth even to those, like Bolivia, that adhered to its conditionalities; in many countries, excessive austerity stifled growth; successful economic programmes require extreme care in sequencing (the order in which reforms occur) and in pacing. For example, if markets are opened up for competition rapidly, before strong financial institutions are established, then jobs will be destroyed faster than created. In

Exhibit 15.3

THE GROWING IRRELEVANCE OF IMF

The International Monetary Fund is widely regarded as one of the most powerful financial institutions in the world. Indeed, leftists regard the IMF as a key factor in the imperialist conspiracy to subjugate the world.

So, it is surprising to learn that the IMF has suddenly become irrelevant, since major countries (Argentina, Russia, Brazil) are pre-paying old loans and hardly any country needs fresh loans. Like a typical unemployed person, the IMF itself is projected to suffer financial losses for the next two years totalling SDR 348 million. It is digging into its reserves to stay afloat, thus committing what it would criticise as a sin in commercial banks using financial reserves to bridge its revenue deficit instead of conserving them for loan losses.

Why has the IMF, which once seemed all-important, declined in relevance? There is a cyclical reason and a structural reason. The world economy is booming for the fourth year in a row. Even sub-Saharan Africa, which grew at barely 2.4% annually in the 1980s and 1990s, has averaged 5.5% growth for four years running, and will top 6% this year. The global boom has been financed, in large measure, by the enormous trade deficit of the US, of $800 billion. This is injecting more liquidity into the global economy than the IMF ever did or could.

However, this cyclical upturn will not last forever. At some point, the global economy will turn downward, balance of payments crises will recur and the IMF will be needed again.

Yet, structural changes in the world economy suggest that even in cyclical downturns, the IMF will be much less important than in the past. Devesh Kapur and Richard Webb produced a paper, 'Beyond the IMF'; for the G-24 meeting in March, 2006. They hold that all the four key functions of the IMF, crisis resolution, exchange rate management, financial policy co-ordination and country surveillance are now being done increasingly by institutions and actors, other than the IMF.

The debt crisis of the 1980s, the transition in the 1990s of countries from communism to market systems and the Asian financial crisis, all required IMF loans for crisis resolution. But, even in those troubled times, alternative institutions and arrangements were coming up.

The IMF was originally created as a governmental solution (all members of the IMF are governments) to a major market failure (weak or missing capital markets). But, today world capital markets have become deep and willing to invest in instruments and countries earlier perceived as too risky. Private equity and hedge funds are the latest institutions driving global money to every nook and corner of the world. Pension funds are increasingly investing in emerging markets. And now, central banks (like China's) are thinking of parking part of their foreign exchange reserves in instruments with higher yields (and risks) than gilts. These flows, put together, run into trillions of dollars, dwarfing the $20 billion that the IMF could provide.

This flood of money has sent stock markets and real estate booming across developing countries. In a cyclical downturn, some of this money will doubtlessly flow out. But, precisely to avoid that from becoming a crisis and to avoid 1990s-style reliance on the IMF, developing countries across the world have built up massive foreign exchange reserves. Self reliance has replaced reliance on the IMF.

Besides, fear of (or dislike for) IMF loans has engineered a structural fiscal change in Latin American counties like Mexico and Brazil. These now run conservative fiscal policies instead of populist ones. Fiscal responsibility and budget management legislation has been introduced, not just in India, but in the European Union and in developing countries across the globe. This will further reduce future crises and the need for IMF rescue.

Another huge structural change has been the skyrocketing of labour remittances from migrants to poor countries. Such remittances were estimated at $ 99 million in 2006, more than double the level in 2001 and ten times the lending volume of either the World Bank or IMF in their peak years. Remittances are stable flows, providing security in difficult times.

Kapur and Web show that the rapid growth of financial markets has created an army of experts who do the economic surveillance that the IMF believed was its USP. Credit/rating agencies, commercial and investment banks and brokers, regional agencies, NGOs like Oxfam, local think tanks and host of other institutions constantly scrutinise and analyse developments of all significant IMF clients. The Internet facilitates the exchange of such surveillance reports instantly across the globe. IMF country analyses, arising from Article IV consultation add little, if any value to the dozens of independent analyses of other agencies.

The IMF has traditionally performed a major role in financial policy co-ordination. But a variety of other coordinating mechanisms have come up over the years. Some are governmental groups (G-8, G-20 Cairns group, European Union or global institutions for harmonising procedures and practices (WTO, UN agencies). Others are private sector groups: International Federation of Accountants, International Organisation of Securities Commissions, and International Associations of Insurances Supervisors. The Bank of International Settlements has set up the Basel I and II standards for banking which are being adopted by developing countries too.

Many old critics will refuse to believe that the IMF has ceased to be a major imperialist tool. In fact, the rapid globalisation of capital markets, and rise of dense, skilled networks of institutions have transformed international financial structures. The IMF still has a residual role as a lender of last resort in crises, especially to poor countries. But it's a pale shadow of what it used to be.

(*Source*: Swaminatham S. Anklesaria Aiyar, "The Gowing Irrelevance of IMF", *The Economic Times*, March 28, 2007)

many countries, mistakes in sequencing and pacing led to rising unemployment and increased poverty. After the 1997 Asian crisis, IMF policies exacerbated the crisis in Indonesia and Thailand. Even those countries that have experienced some limited growth have witnessed a few becoming richer at the cost of majority whose conditions worsened.

Much of the criticism should go to the way the IMF and the World Bank are governed. As stated earlier, these two institutions are remote-controlled by the USA and the European countries. Obviously, these international organisations provide the smoke-screen for the real intentions of the rich countries who want to dominate the development agenda in order to capture the resources of the developing world for their own long-term needs. The World Bank and the IMF propose policies which impact people, but the same people have no voice in their administration. Indian legislatures do not discuss some of those policy changes and this is often justified on the plea that there are certain international obligations which need to be respected. Therefore, many policy changes do not go through legislatures where people's voice has no chance of being heard. Consequently, India's democratic institutions have been undermined as the process of marketisation makes in-roads into the national economy.

The IMF is expected to finance and advice member countries (particularly the poor ones) on achieving Millenium Development Goals. The target set is 2015, but several countries have failed to realise even one goal. One-and-a-half billion people live in areas affected by fragality-conflict and violence. An estimated 1.4 bn people still live in extreme poverty. As per the World Development Report 2011, several countries have not even touched half of the universal enrolment to primary education—one of Development Goals. For example, Burkina Faso has achieved only 38 percent, Burundi 45 percent, Central African Republic 35 percent, and Chad 31 percent.

The IMF's capital base has been steadily shrinking relative to the world economy: its clout is half what it was in 2000. Moreover, the emerging markets—India, China and Brazil—have only 8% of the voting rights, even though they account for 19% of the global output. This makes BRICS bank highly relevant to finance infrastructure. Blame for the declining clout of the IMF may be thrown at America. The country promised to pump in additional capital to the IMF in 2010 but failed to do so.

INTERNATIONAL LABOUR ORGANISATION (ILO)

LO 2
Describe the role played by each institution in promoting business across the globe

The ILO came into being in 1919 and is the most important agency concerned with establishing labour standards. The initiative to create the ILO came for industrially developed nations which desired to establish internationally agreed norms and standards of behaviour for the conduct of employee relations.

The constitution of ILO mandates it to:

- Encourage the improvement of the conditions of workers
- Discourage particular countries from failing to adopt humane conditions of labour
- Promote the principle that labour is not to be regarded a mere 'commodity or article of commerce'
- Support the view that the price of labour be determined by human need and that workers are entitled to a reasonable standard of living.

The ILO is a specialised agency of the UN and is headquartered in Geneva. Its secretariat is known as the International Labour Office. ILO is a tripartite agency in that it brings together representatives of governments, employers and workers to jointly frame policies and programmes.

Each ILO member nation sends two government representatives-one representing employers and the other the trade unions, to the ILO conference which meets annually at Geneva. Debates and proposals placed before the conference are either accepted or rejected. Examples of proposals accepted are that:

- there be freedom of association in all member countries
- workers have the right to strike

- specific health and safety measures be obligatory in certain industries
- recognised trade unions have the right to conduct activities on employers' premises
- employees be protected against dismissal for trade union membership

The above together constitute what is popularly known as the International Labour Code.

ILO and International Business

What is ILO's contribution to international business? The answer cannot be assertive for the reason that ILO was not created to promote trade or business anywhere. It is fundamentally concerned with safety, health, working conditions and welfare of workers across the world. ILO promotes global business in an indirect way. It seeks to maintain human resource' health. Healthy labour is productive and motivated. The contribution of such motivated labour to domestic and international business is considerable.

UNCTAD

UNCTAD is an acronym for the United Nations Conference on Trade and Development, set up in Geneva in 1964. UNCTAD was established to address the problems of the developing countries related to trade and development and integrate those countries into the world economy. Generally, UNCTAD focuses on analytical research on trade, investment, technology, entrepreneurship and development strategies for nations. It voices concerns of developing nations through UN conferences.

Specifically, the functions of UNCTAD include:

- Assisting developing countries in trade negotiations
- Conducting investment policy reviews of different countries
- Advisory service on technology to developing countries
- Trade analysis and disseminating information
- Assessing the impact of trade and development on environment
- Macro economic and development policy reviews for the countries
- Assisting developing countries in modernising customs clearance procedures
- Bringing least developed countries into the mainstream of WTO
- Training in different aspects of international trade for the developing nations
- Assisting the poor countries in formulating strategies for development and poverty reduction

The UNCTAD meets once in four years. In a recent conference the focus was directed on how developing nations' musical traditions could alert youth worldwide to press development issues, including AIDS, poverty and national debt. The conference also proposed a new initiative designed to develop the business management skills of individuals in developing nations so that they could benefit from the rich cultural assets they possessed.

UNCTAD has been actively interacting with WTO, governmental institutions, NGOs, research institutes and universities across the world. The UNCTAD continues to be an important resource base for developing countries and provides a forum to network and form issue-based coalitions with like-minded countries. The UNCTAD has been playing a critical role in educative, signalling and watch-dog function relating to developing countries' interests in the functioning of WTO.

UNCTAD and WTO have joined forces to ensure a better functioning of the multilateral trading system. In 2003, the two bodies signed an MOU, providing for cooperation and consultations on their technical assistance and for the conduct of joint studies on selected issues. UNCTAD and WTO interact frequently to promote free trade across nations.

WIPO

WIPO stands for the World Intellectual Property Organisation. As a specialised agency of UN, WIPO was set up in 1970. As the name itself signifies, WIPO's main function is to protect and effectively use intellectual property rights. The WIPO treats intellectual properties as important instruments for the economic, social and cultural development of all countries and hence the need for their protection and effective use. But WIPO has a critical limitation: it has no enforcement mechanism. There is little any country or EU can do, if any nation chooses to disrespect the intellectual property rights. Under TRIPS, the rich countries can choose to impose economic sanctions to legally enforce intellectual property rights.

There is a conflict between developed and developing countries over patent laws. The former wants harmonisation of national patent laws, which implies that there should be 'one size fits all' international patent system. But the developing countries contend that the international patent system should have adequate flexibilities so as to enable them to adopt patent law suited to their development needs. Resolving the conflict between the developed and the developing countries is a challenge for the WIPO. Towards this end, the WIPO has prepared a draft Substantive Patent-Law Treaty (SPLT). But this is only a draft waiting final conclusion.

UNIDO

Yet another wing of the UN is the United Nations Industrial Development Organisation (UNIDO). Set up in 1966, UNIDO seeks to promote industrial growth and development in developing countries and in economies in transition. It mobilises skills, knowledge, information and technology to achieve all-round growth in the poor countries. UNIDO has 173 member countries.

UNIDO is now recognised as a highly relevant specialised and efficient provider of critical services in support of the interlinked challenges of poverty reduction, integration of developing countries in global trade, fostering sustainable environment and improving access to energy.

UNIDO focuses on three areas:

- Poverty reduction through productive activities
- Trade capacity enhancement
- Energy and environment

Services of UNIDO are based on two core functions: *as a global forum*, the agency generates and disseminates industry-related knowledge; and as a *technical co-operation agency,* it provides technical support to implement projects.

Apart from promoting growth of developing countries, UNIDO has been highly active in eliminating ozone depleting substance (ODS). Since 1992, UNIDO has significantly contributed to the elimination of the world consumption of ODS. Through its assistance, 85 counties are well equipped to reach their Montreal Protocol targets.

UNIDO and International Business

Like the role of ILO in promoting international business, the contribution of UNIDO to world trade is indirect, but significant. UNIDO seeks to integrate developing countries and makes them join the main stream of the world economy, thus enhancing cross-border business.

UNIDO's role in maintaining database is commendable. Its statistics branch maintains database on industries across the globe. UNIDO in collaboration with OECD compiles, stores and disseminates global data. UNIDO collects national data directly from all countries and areas that are not members of OECD while the latter collects and provide data relating to its members. Data collected from both are compiled, published and made available to all interested parties. Such databases are highly useful for nations, academics and policy makers.

ASIAN DEVELOPMENT BANK

As the name itself suggests, Asian Development Bank (ADB) seeks to promote growth and remove poverty in Asia and Pacific regions which happen to be the home for two-thirds of the world's poor. ADB has 67 member countries, comprising 48 from Asia and Pacific region and 19 from the other parts of the globe. US and Japan happen to be the two major shareholders each holding 12.8 percent of capital. ADB is headquartered in Manila. Its main partners are governments, private sector, NGOs, development agencies, community-based organisations and foundations. The approved lending of the ADB exceeds $17.5 bn as of 2010. Major share of this has gone to Bangladesh ($3 bn), followed by India ($2.4bn) and China ($1.95 bn).

LO 2
Describe the role played by each institution in promoting business across the globe

The main functions of ADB include:

- The external loans and equity investments to its developing member countries for their economic and social development
- To provide technical assistance for planning and execution of development projects and programmes and for advisory services
- To promote and facilitate investment of public and private capital and development
- To respond to request for assistance in coordinating development policies and plans of its member (developing) countries

ADB pursues three agendas: inclusive growth, sustainable development and regional integration. The means it uses to pursue the agendas include loans, technical assistance, advice, grants and knowledge.

Though focus of ADB is on public sector and governments, it also provides direct assistance to private enterprises of developing countries through equity investment guarantees and loans. In addition, its triple-A credit rating helps mobilise funds for development.

ADB and International Business

The role of ADB in promoting international business is obvious from its functions. Through its emphasis on developing the poor countries, ADB contributes to world trade considerably.

AFRICAN DEVELOPMENT BANK (AFDB)

Set up in 1963, AFDB seeks to accelerate the development process and improving socio-economic conditions in the newly independent countries of Africa. It commits itself to maintenance of African character and orientation. Currently, AFDB has 53 members from Africa and 25 member from non-African countries, including the US, Canada, France, China and the UK. Since inception, AFDB has funded more than 3600 loans and advances.

WORLD TRADE ORGANISATION

World Trade Organisation (WTO) is a premier world organisation that promotes cross-border business. With the establishment of WTO, the expression Bretton Woods twins needs to be replaced by 'triple sisters'. The role and status of WTO is more than that of IMF or the Bank. Since its activities are varied and its role is critical, we propose to devote more space for WTO. Next chapter covers WTO in greater detail.

LO 2
Describe the role played by each institution in promoting business across the globe

TREATIES AND CONVENTIONS

LO 3
Review treaties and conventions that are active in international trade

Along with international agencies, there are treaties which also shape the international business environment. A treaty is a formal agreement between two or more nations in reference to peace, alliance, economies and so on. Treaties can cover almost any subject of mutual concern to nations-from ending war and conflict to the elimination of nuclear weapons, and to the promoting of trade and investment across national borders. Treaties may be bilateral (between two nations) or multilateral (among several nations).

A convention is a treaty on matters of common concern usually negotiated on a regional or global basis and open to adoption by nations.

Some prominent treaties and conventions are shown in Fig. 15.1.

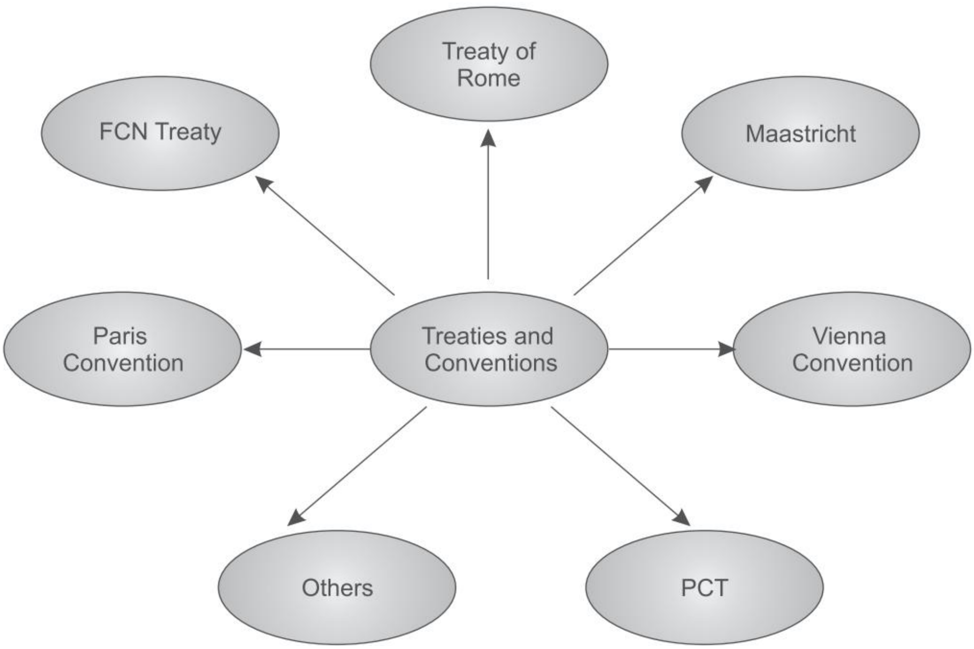


Fig. 15.1 Treaties and Conventions

Treaties of Friendship, Commerce and Navigation (FCN Treaties)

These are bilateral agreements that provide a broad range of protection to foreign nationals doing business in the host country. Although each is different, all treaties typically state that each county will allow the establishment of foreign branches or subsidiary corporations; the free flow of capital and technology; the equitable and non-discriminatory treatment of foreign firms, individuals and products; the privilege of acquiring and owning real estate; and most-favoured nation trading status for goods.

The Treaty of Rome

The Treaty of Rome is a historic agreement in the sense that it gave birth to the European Community-EU. Six member counties (Belgium, West Germany, France, Italy, Luxembourg and the Netherlands) signed the Treaty of Rome on March 25, 1957. The community was committed to achieving the free movement of people, goods, services and capital eradicating barriers, and creating a common market.

Maastricht Treaty

If the Treaty of Rome created the EU, Maastricht Treaty carried the Union beyond what was initially thought to be possible. Members of the EU met in 1991 for a summit meeting in Maastricht, Netherlands, to plan for more advanced stages of integration among the member nations. The result was a historic treaty that was signed by the EU members in 1993. The treaty called for creation of common currency and political union. Today, a common currency (Euro) has been created, but political integration—common foreign and defense policies and common citizenship—is yet to kick-start.

The Vienna Convention on the Law of Treaties

This was adopted in 1969, but came into force in 1980. The convention covers issues such as the interpretation, amendment, termination and rights and duties of countries party to a treaty which is in force. This convention has a bearing on international business because treaties affect trade between parties from countries that are signatories to various conventions.

Paris Convention

The first intellectual property treaty was the International Convention for the Protection of Industrial Property, better known as the Paris Convention. This Convention, originally prepared in 1883 and since revised many times, guarantees that foreign trademark and patent applications from signatory countries receive the same treatment and priority as domestic applicants. In other words, no signatory country can give intellectual property protection to its own citizens unless it provides the same protection to the citizens of other countries. This principle of 'national treatment'—an animating principle of all intellectual property treaties—eliminated the potential discrimination against foreigners in obtaining patents.

The Patent Cooperation Treaty (1970) (PCT)

This treaty supplemented the Paris Convention by establishing a centralised patent application process. The PCT application is filed on a standard form with the World Intellectual Property Organisation (WIPO). The WIPO processes the common application and forwards it to the countries designated by the applicant. The PCT gives a patent applicant in a signatory country a *priority claim* once it files an international application in the standard PCT format. After the filing, the applicant will have upto 30 months to begin the processing of application in the countries in which it wishes to obtain protection. This allows the applicant business to lock in one application date while giving it time to raise capital on the basis of patent filing. Failing to raise capital, the applicant can walk away without having spent needless sums in worldwide patent processing.

Other Treaties and Conventions are—

1. **Bahran-US Treaty** concerning encouragement and reciprocal protection of investments.
2. **Chemical Weapons Convention** prohibiting the development, stock piling and use of chemical weapons as well as deals for their destruction.
3. **The Basel Convention** regulating movement of wastes that display hazardous characteristics.
4. **The Warsaw Convention** regulating the carriage of passengers, baggage and cargo across borders.

5. **The Hague Convention** providing a method to collect evidence through (i) letter of request, (ii) diplomatic consular officer, or (iii) a specially appointed commissioner.
6. **GAATS** because of its vast significance, is considered in detail in the chapter on WTO.

Summary

- UN, World Bank, IMF, ILO, UNCTAD, WIPO, and Asian Development Bank are the premier institutions that promote global business. (LO1)
- Each institution has been facilitating the growth of international business in its own way. World Bank's role is felt in establishing MIGA and ICSID. By emphasising an international monetary cooperation, IMF has been of a significant promoter of world business. So also other institutions. (LO2)
- Treaties and conventions also shape the way international business is conducted. (LO3)

Review Questions

1. Detail the functions and roles of any three world bodies engaged in promoting international business. (LO2)
2. Bring out the differences in roles and functioning of World Bank and IMF. (LO2)
3. State and explain the different treaties and conventions that are promoting international business. (LO3)

Discussion Question

1. Do you think that the existence of multiple institutions leads to duplicity, overlapping and confusion? Yes or no, discuss. (LO1 and LO2)

Reinforcing Exercises

Joseph Stiglitz, in his book "Globalisation and It's Discontents" observes that the world bodies meant to promote world trade are too many and their objectives often overlap and clash. The ILO, for example, worries that IMF pays too little attention to workers rights and the Asian Model of development proposed by the Asian Development Bank is different from the American model pushed by the Washington – based institutions. What is your take on this?

CLOSING CASE

Currency Trouble in Malawi

When the former World Bank economist Bingu wa Mutharika became President of the East African nation of Malawi in 2004, it seemed to be the beginning of a new age for one of the world's poorest countries. In landlocked Malawi, most of the population subsists on less than a dollar a day. Mutharika was their champion. He introduced a subsidy programme for fertilizer to help the poor farmers and gave them seeds. Agricultural output expanded, and the economy boomed, growing by 7 percent per year between 2005 and 2010. International donors loved him, and aid money started to pour in from the United Kingdom and the United States. By 2011, foreign aid was accounting for more than half of Malawi's annual budget.

In 2009, to no one's surprise, Mutharika was re-elected as the President. Then, things started to fall apart. Mutharika became increasingly dictatorial. He pushed aside the country's central bankers and ministers to take full control of economic policy. He called himself "Economist in Chief". Critics at home were harassed and jailed. Independent newspapers were threatened. When a cable from British ambassador describing Mutharika as "autocratic and intolerant of criticism" was leaked, he expelled the British ambassador. Britain responded by freezing aid worth $550 million over four years. When police in mid-2011 killed 20 anti-government protestors, other aid donors withdrew their support, including most significantly the United States. Mutharika told the donors they could go to hell. To compound matters, tobacco sales, which usually accounted for 60 percent of foreign currency revenues, plunged on diminishing international demand and the decreasing quality of the local products, which had been hurt by a persistive drought.

By late 2011, Malawi was experiencing a full-blown foreign currency crisis. The International Monetary Fund (IMF) urged Mutharika to devalue the kwacha, Malawi's currency, to spur tobacco and tea exports. The kwacha was pegged to the U.S. dollar at 170 kwacha to the dollar. The IMF wanted Malawi to adopt an exchange rate of 280 kwacha to the dollar, which was closer to the black market exchange rate. Mutharika refused, arguing that this would cause price inflation and hurt Malawi's poor. He also refused to meet with an IMF delegation, saying that the delegates were "too junior." The IMF put a $79 million loan programme it had with Malawi on hold, further exacerbating the foreign currency crisis. Malawai was in a tailspin.

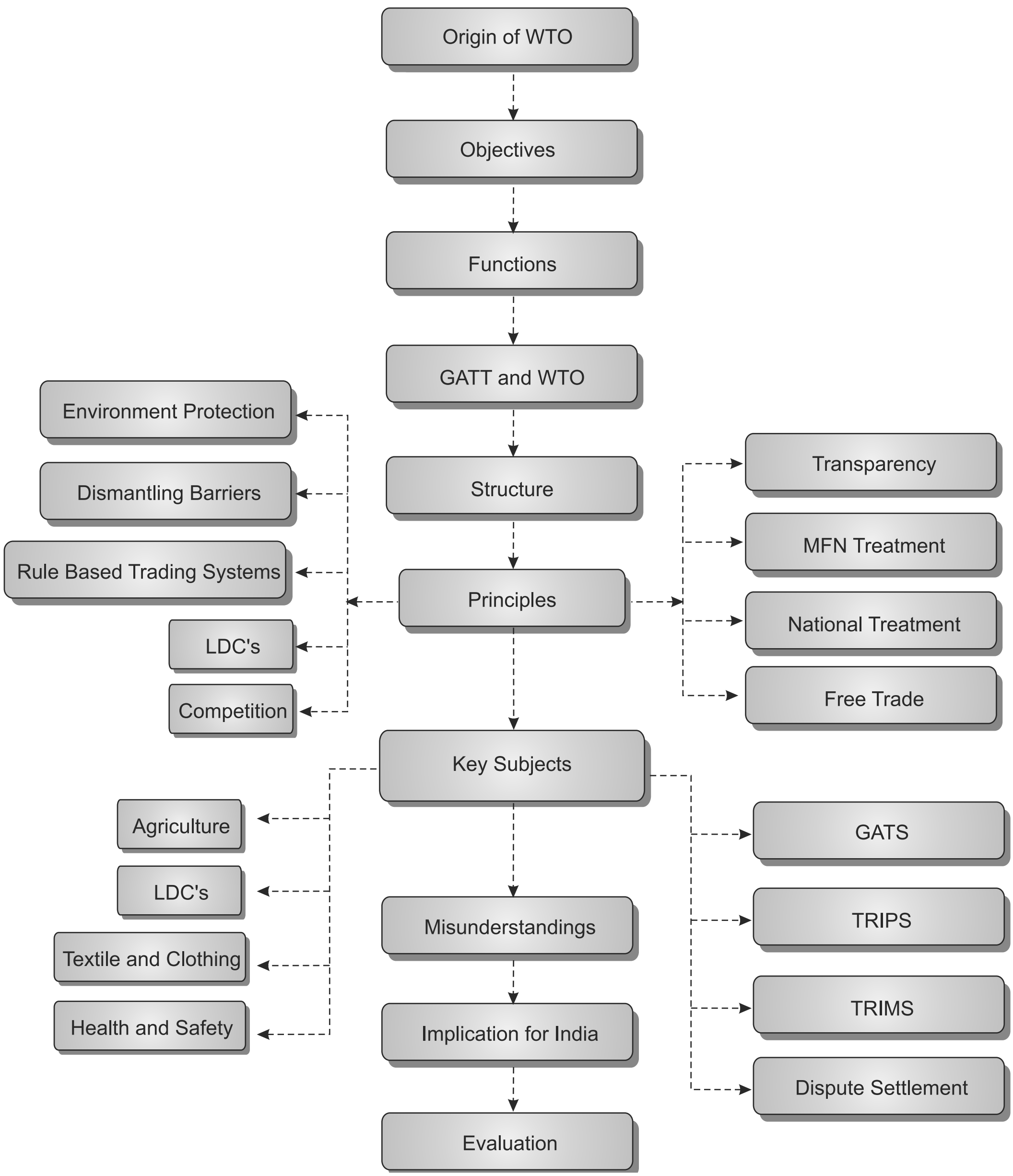
In early April 2012, Mutharika had a massive heart attack. He was rushed to the hospital in the capital Liongwe, but ironically, the medicines that he needed were out of stock – the hospital lacked the foreign currency to buy them! Mutharika died. Despite considerable opposition from Mutharika supporters who wanted his brother to succeed him, Joyce Banda, the vice president, was sworn in as president. Although no one has stated this publicly, it seems clear that intense diplomatic pressure from the United Kingdom and United States persuaded Mutharika's supporters to relent. Once in power, Banda announced that Malawi would devalue the kwacha by 40 percent. For its part, the IMF unblocked its loan programme, while foreign donors, including the UK and the United States, stated that they would resume their programme.

Questions

1. What were the causes of Malawi's currency troubles?
2. Why did Mutharika resist IMF calls for currency devaluation? If he had lived and remained in power, what do you think would have happened to the economy of Malawi assuming that he did not change his position?
3. Now that Malawi's currency has been devalued, what do you think the economic consequences will be? Is this good for the economy?

(Source: Charles W L Hill and Arun Kumar Jain, *International Business*, McGraw-Hill, 2014, pp 397-398)

CHAPTER


Origin of WTO
Objectives
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16

World Trade Organisation

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Outline the origin of WTO and describe its structure, objectives, and functions
- **LO 2:** Explain the principles of WTO
- **LO 3:** Describe the agreements of WTO
- **LO 4:** Point out certain apprehensions about WTO and give clarifications
- **LO 5:** Identify implications for India as a member of WTO
- **LO 6:** Review the performance of WTO

Opening Vignettes

It is Bad News

Global trade, of which WTO has been a champion, is slowing down, particularly after the 2008 crisis. There has been a significant increase in new measures impeding world trade, to 2500 a year since 2008, compared with barely half that number in 2000. Many of these are non-tariff barriers, including onerous environmental and safety standards.

In 2008, the US imported 46 mn tires from China, three times as it did in 2004. China's share of the American market leaped from 5% to 17% during the same period. So far so good. But the bad news is that the US employment in the industry fell by more than 5000 and domestic production slumped from 218 mn tires to 160 mn pieces.

This led to protests from the United Steel Workers Union which represents 15000 workers at 13 plants in the US. The Union petitioned the International Trade Commission (a wing of the US Department of Commerce). The Commission felt that the cheap tire imports from China did cause "market disruption". Following this, the US administration imposed a 35% tariff for one year on tire imports from China, followed by a 30% tariff in the second year and 25% in the final year.

China went on an appeal to WTO against the tariff imposed by the US. China felt that it was a clear case of protectionism. The disputes resolution panel of WTO went with the US administration.

Atleast on three critical areas WTO has not been clear and effective. They are: antidumping actions, protection to agriculture and protecting intellectual properties.

The newly elected leader of WTO made a telling comment on the world body. He said, "WTO is a sick patient. The head has to put on gloves, the masks and start operating immediately because the patient is almost terminal."

INDIAN manufacturers from Punjab, Tamil Nadu, Karnataka and Maharashtra have been able to strike deals with Wal-Mart thanks to free-trade environment ushered in by the World Trade Organisation. This chapter is devoted to a detailed discussion on the functions, achievements, and other issues relating to the world trade body.

The World Trade Organisation (WTO) was established on 1st January 1995. Governments had concluded the Uruguay Round negotiations on 15th December, 1993 and ministers had given their political backing to the results by signing the Final Act at a meeting in Marrakesh, Morocco in April 1994. The 'Marrakesh Declaration' of 15th April 1994, affirmed that the results of the Uruguay Round would "strengthen the world economy and lead to more trade, investment, employment, and income growth throughout the world". The WTO is the embodiment of the Uruguay Round results and the successor to the General Agreement of Tariffs and Trade (GATT).

The WTO has larger membership than GATT, the present number of members stands at 159. India is one of the founder members of WTO.

ORIGIN OF WTO

LO 1
Outline the origin of WTO and describe its structure, objectives, and functions

The need for a world trade body was felt much earlier. The International Trade Organisation (ITO) was proposed to be set up along with the World Bank and the IMF on the recommendations of the Bretton Woods Conference in 1944. The ITO was not setup but in its place GATT was established by the US, UK, and some other countries in 1947. GATT was biased in favour of the developed countries and was appropriately called the "rich men's club". The developing countries insisted on setting up of ITO but opposition to the proposal came from the US. To solve the issue, the UN appointed a committee in 1963; the committee recommended, as a via media, the UNCTAD (United Nations Conference on Trade and Development). UNCTAD came into being in 1964. It could manage to secure some concessions for the developing countries.

In the meantime, GATT itself was made progressively liberal in a series of negotiations, as shown in Exhibit 16.1. In its Uruguay Round of negotiations, WTO was proposed and the proposal became a reality on 1st January, 1995.

GATT AND WTO

The WTO is not a simple extension of GATT. On the contrary, it completely replaces its predecessor and has a very different character. The major differences between the two bodies are the following:

- The GATT was a set of rules, a multilateral agreement, with no institutional foundation, only a small associated secretariat which had its origins in the attempt to establish an International Trade Organisation in the 1940s. The WTO is a permanent institution with its own secretariat.
- The GATT was applied on a 'provisional basis' even if, after more than 40 years, governments chose to treat it as a permanent commitment. The WTO commitments are full and permanent.

Exhibit 16.1

NEGOTIATION ROUNDS

Date	*Name (Round)*	*Outcome*	*No. of Countries*
1947	Geneva round	45,000 tariff concessions representing half of world trade	23
1949	Annecy round	Modest tariff reductions	13
1950–51	Torquay round	25 per cent tariff reductions in relation to 1948 level	38
1955–56	Geneva round	Modest tariff reductions	26
1961–62	Dillon round	Modest tariff reductions	26
1963–67	Kennedy round	Average tariff reduction of 35 percent of industrial products, only modest reduction for agricultural products, anti-dumping code	62
1973–79	Tokyo round	Average tariff reduction of 34 per cent for industrial products. Non-tariff trade barrier code	102
1986–94	Uruguay round	Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, creation of WTO, etc.	123
2001 (Present)	Doha	Tariffs on goods, non-agricultural market access, special and differential treatment, trade facilitation, etc. Negotiations deadlocked for long but concluded	159

- The GATT rules applied to trade in merchandise goods. In addition to goods, the WTO covers trade in services and trade-related aspects of intellectual property rights.
- While GATT was a multilateral instrument, by the 1980s, many new agreements had been added of a plurilateral, and therefore selective nature. The agreements, which constitute the WTO, are almost all multilateral and thus, involve commitments for the entire membership.
- The WTO dispute settlement system is faster, more automatic, and thus much less susceptible to blockages, than the old GATT system. The implementation of WTO dispute findings will also be more easily assured.

'GATT 1947' continued to exist until the end of 1995, thereby allowing time for all GATT members to accede to the WTO and permitting an overlap of activity in areas like dispute settlement. Moreover, GATT lives on as 'GATT 1994', the amended and updated version of GATT 1947, which is an integral part of the WTO Agreement and which continues to provide the key disciplines affecting international trade in goods.

THE WTO STRUCTURE

The structure of the WTO is dominated by its highest authority—the Ministerial Conference. This body is composed of representatives of all WTO members. It meets every two years and is empowered to make decisions on all matters under any of the multilateral trade agreements

The Ministerial Conferences have been taking place regularly, though the outcomes have not been on the expected lines. The Ministerial Conference held in 2002-popularly called the Doha Round—focussed on issues such as eliminating agricultural tariffs and subsidies, reducing tariffs on manufactured goods exported to developing countries, and freeing trade in services. Although, the Doha negotiations were supposed to be completed by 2007, the talks deadlocked.

The day-to-day work of the WTO is entrusted to a number of subsidiary bodies; principally, the General Council, also composed of all WTO members, which is required to report to the Ministerial Conference.

The General Council also convenes in two particular forms—as the Dispute Settlement Body and the Trade Policy Review Body. The former overseas the dispute settlement procedures and the latter conducts regular reviews of trade policies of individual WTO members.

The General Council delegates responsibility to three other bodies—namely,

- the Councils for Trade in Goods,
- Trade in Services, and
- Trade-Related Aspects of Intellectual Property Rights.

The Council for Goods overseas the implementation and functioning of all the agreements covering trade in goods, though many such agreements have their own specific overseeing bodies. The latter two Councils have responsibility for their respective WTO agreements and may establish their own subsidiary bodies as deemed necessary.

Three other bodies are established by the Ministerial Conference who report to the General Council. The **Committee on Trade and Development** is concerned with issues relating to the developing countries and especially, to the 'least-developed' among them. The **Committee on Balance of Payments** is responsible for consultations among WTO members and countries that resort to trade restrictive measures in order to cope with their balance of payments difficulties. Finally, issues relating to WTO's financing and budget are dealt with by a **Committee on Budget, Finance, and Administration.**

Each of the plurilateral agreements of the WTO—those on civil aircraft, government procurement, dairy products and bovine meat—establish their own management bodies, which are required to report to the General Council (see also Fig. 16.1).

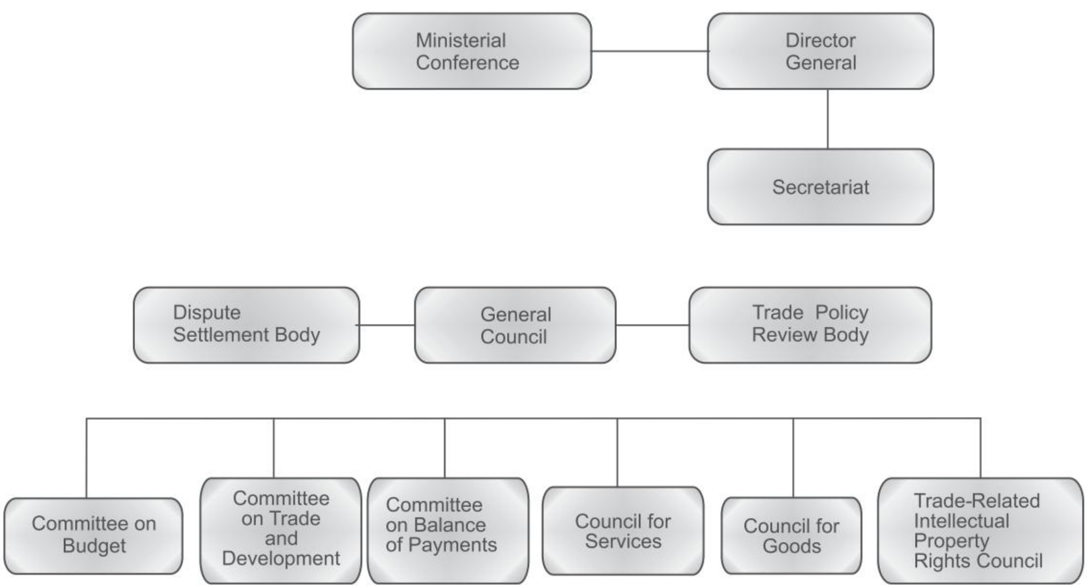

Fig. 16.1 Structure of the World Trade Organisation

OBJECTIVES OF WTO

The WTO reiterates the objectives of GATT, which are as follows:

- Promote trade flows by encouraging nations to adopt nondiscriminatory and predictable trade policies.
- Raising standard of living and incomes, promoting full employment, expanding production and trade, and optimum utilisation of world's resources.
- Introduce sustainable development—a concept which envisages that development and environment can go together.
- Taking positive steps to ensure that developing countries, especially the least developed ones, secure a better share of growth in world trade.
- Establish procedures for resolving trade disputes among members.

FUNCTIONS OF WTO

WTO is based in Geneva, Switzerland. Its functions are:

- Administering and implementing the multilateral and plurilateral trade agreements, which together make up the WTO.
- Acting as a forum for multilateral trade negotiations.
- Seeking to resolve trade disputes.
- Overseeing national trade policies.
- Cooperating with other international institutions involved in global economic policy-making.
- Maintaining trade related database. Members are required to notify in detail various trade measures and statistics.
- Acting as a watchdog of international trade, constantly examining the trade regimes of individual members.
- Acting as a management consultant for world trade. Experts on the panel of WTO scan the world economic environment, and make observations on contemporary issues.
- Technical assistance and training for developing countries.

As the functions make it clear, WTO does not aim at economic or political integration, but seeks to promote free trade among member countries.

The WTO Agreement contains some 29 individual legal texts—covering everything from agriculture to textiles and clothing, and from services to government procurement, rules of origin, and intellectual property. Added to these are more than 25 additional ministerial declarations, decisions, and understandings, which spell out further obligations and commitments for WTO members.

PRINCIPLES OF WTO

The WTO is based on nine principles (see Fig. 16.2). These principles are explained below.

LO 2
Explain the principles of WTO

Transparency

WTO aims at achieving transparency in world trade relations by obligating members to publish their respective laws, regulations, judicial decisions and administrative rulings pertaining to the classification or valuation of products for customs, rates of duty, taxes or other charges affecting sale, distribution,

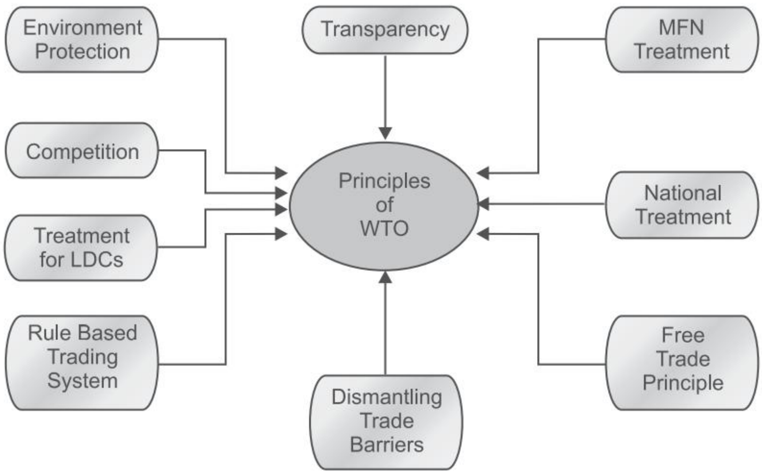

Fig. 16.2 Principles of WTO

transportation, insurance and warehousing with the objectives of enabling governments and traders to become familiar with them. This helps exporters plan their trade and safeguard them against hassles. Besides, WTO conducts periodic review of trade policies of member countries to promote transparency in their trade policies.

MFN Treatment

Trade needs to be conducted without discrimination. Any member country shall not discriminate between its trading partners—all members countries are granted "most favoured—nation" or MFN status. MFN means that every time a member country lowers a trade barrier or opens up a market, it needs to extend the benefits to all trading partners.

The basic principle that guided the erstwhile GATT and directs the present incumbent WTO is to promote trade without discrimination.

National Treatment: Non-discrimination within a Country

This principle implies that imported and locally-produced goods should be treated equally. Article III of the GATT 1994 states that "the products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded no less favourable treatment than that accorded to like products of national origin in respect of all laws, regulations, and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use". This requirement continues in the WTO also.

Free Trade Principle: Optimal Utilisation of Resources

Lowering trade barriers is the best way of promoting trade. Trade ensures optimum utilisation of resources. All countries including the poorest, have assets—human, industrial, natural, financial—which they can employ to produce goods and services for their domestic market or to compete overseas. 'Comparative advantage' implies that countries prosper by taking advantage of their assets in order to concentrate on what they can produce best. Bigger markets, domestic as well as overseas, will help these countries produce more and reap economies of scales. Liberal trade policies that allow unrestricted flow of goods and services will result in expanded markets.

On the other hand, protection and perpetual government subsidies lead to bloated, inefficient companies supplying consumers with outdated and unattractive products. Ultimately, factories close and jobs are lost despite protection and subsidies. If other governments pursue such policies overseas, markets contract and world economic activity is reduced. Hence the need for free and open trade is emphasised upon.

Dismantling Trade Barriers

Physical restrictions on the import and export of goods are prohibited under GATT. However, member countries can protect domestic industry through tariff. The WTO is not a 'free trade' institution. It permits tariffs and other forms of protection but only in limited circumstances.

Rule-based Trading System

The WTO stands for rule based trading system. Towards this end, the WTO sets and enforces rules necessary for conducting world trade fairly. Through its automatic and speedier disputes settlement mechanism, the WTO adjudicates on disputes between members. This helps in the open trade between countries.

Treatment for LDCs

The WTO recognises the need for positive policies efforts to help developing countries reap the benefits of trade liberalisation. The WTO contains special and differential treatment provisions for developing and least developed countries that run across the whole range of agreements covered by WTO. Infact, there is a separate committee on trade and development that overseas the implementation of these provisions by developed countries.

There are specific provisions under all the WTO agreements that stipulate trade concessions for developing and least developed countries. These concessions include waiver or deferral of obligations, transfer of technology and the like.

Competition Principle

The WTO system is designed to promote open and fair competition. Removal or reduction of tariffs and subsidies will expose locally produced goods and services to imported ones. There is 'level playing field' between foreign and local goods and services and this promotes competition between them. The Singapore Ministerial Conference (1996) set up a Working Group on Trade and Competition Policy. The Working Group has the mandate to study issues raised by members relating to trade and competition in order to identify areas that may merit further consideration in the WTO framework.

The WTO also seeks to protect consumer interest by promoting competition among trading members.

Environment Protection

The last principle of WTO relates to the protection of environment. The preamble to the WTO agreement refers to the objective of sustainable development and to the need to preserve the environment. Agreements on Technical Barriers to Trade and Sanitary contain provisions to protect human, animal and plant life, health and the environment. Similarly, both TRIPs Agreement and the GATS contain provisions relating to the environment.

KEY SUBJECTS IN WTO

LO 3
Describe the agreements of WTO

The major provisions of the Final Act relate to agriculture, sanitary measures, helping least developed countries, clothing, TRIPS, GATS, and anti-dumping measures. A brief description of each of these is given below.

Agriculture

The agreement relating to agriculture is made up of several elements, which seek to reform trade in agriculture and provide the basis for market-oriented policies, thereby improving economic cooperation for importing and exporting countries alike. It establishes new rules and commitments in market access, domestic support, and export competition, and includes provisions that encourage the use of less trade-distorting domestic support policies to maintain the rural economy. It also allows actions to be taken to ease adjustment burdens and provides some flexibility in the implementation of the commitment. Specific concerns for developing countries are addressed including those of net-food importing developing countries and less developed economies.

Health and Safety Measures

The agreement on the Application of Sanitary and Phytosanitary Measures concerns the application of food safety and animal and plant health regulation. It recognises government's rights to take sanitary and phytosanitary measures but stipulates that they must be based on science, should be applied only to the extent necessary to protect human, animal or plant life or health and should not arbitrarily or unjustifiably discriminate among members where identical or similar conditions prevail.

Helping Least Developed and Food Importing Countries

It is recognised that during the reform programme, least developed and net food-importing developing countries may experience negative effects with regard to giving food supplies on reasonable terms and conditions. Such countries need assistance. Therefore, a special ministering decision calls for appropriate mechanisms related to the availability of food and the provision of basic foodstuffs in full grant from, and aid for agriculture development. It also refers to the possibility of assistance from the International Monetary Fund (IMF) and the World Bank with respect to the short-term financing of commercial food imports. The Committee on Agriculture holds responsibility to monitor the follow up to the decision.

Textiles and Clothing

The objective of this agreement is to secure the integration of the textiles and the clothing sector where much of the trade is currently subject to bilateral quota negotiations under the Multi-Fibre Agreement (MFA)—into the main stream of WTO. The integration, however, shall take place in stages. All MFA restrictions in force on 31st December 1994 would be carried over into the Final Act and maintained until such time as the restrictions are removed or the products integrated into WTO.

Trips

The WTO agreements of Trade-Related Aspects of Intellectual Property Rights (TRIPs) recognises that widely varying standards in the protection and enforcement of intellectual property rights and the lack of multilateral disciplines dealing with international trade in counterfeit goods have been a growing source of tension in international economic relations. With this end in view, the agreement addresses the applicability of basic GATT principles and those of relevant international intellectual property agreements; the provision of adequate intellectual property rights; the provision of effective enforcement measures for those rights; multilateral dispute settlement and transitional implementation arrangements.

The TRIPs agreement contains three parts; Part 1 sets out the provisions and principle; Part 2 addresses different kinds of intellectual property rights, and Part 3 concerns enforcement.

Trims

International businesses are aware of the many restrictions on their investments in foreign countries. Trade Related Investment Measures (TRIMs) are those restrictions a nation places on foreign investment that adversely affect trade in goods and services. WTO measures on TRIMs have been incorporated in the agreement as a part of the Uruguay Round agreements.

This agreement does not set broad rules for investors in a WTO country. It simply prohibits laws or regulations that condition a firm's right to import foreign goods based on the volume of goods exported. For example, Argentina may not say to a US based MNC: 'You may only import foreign raw materials on condition that you export an equal volume of finished goods from our country'.

The requirements would violate the prohibition of quantitative restrictions of GATT. Also prohibited are laws that condition the receipt of foreign exchange on the company's foreign exchange revenues.

GATS

The General Agreement on Trade in Services (GATS) is the first set of multilateral, legally-enforceable rules covering international trade in services. It was negotiated in the Uruguay Round. GATS operates at four modes:

Mode 1 Cross-border trade. Defined as delivery of a service from the territory of one country into another.

Mode 2 Consumption abroad. Covers supply of a service of one country to the service consumer of another country. This mode of supply involves the consumer of services travelling abroad to avail the service.

Mode 3 Commercial presence. Covers services provided by a service supplier of one country in the territory of any other country by setting up a professional establishment.

Mode 4 Temporary movement of natural persons. A mode of service supply or trade where services are supplied by nationals of one country in the territory of another, requiring the physical presence of the service provider in the host country. This mode includes both independent service providers as well as employees of the service providers of another member.

A Council for trade in services overseas the operations of the agreement.

Disputes Settlement

The Disputes Settlement Understanding (DSU) is the legal text that spells out the rules and procedures for settling disputes between member countries. It contains 27 articles. It is a legally binding agreement among all the member countries, and is the ultimate means of enforcing the trade rules. (See also Exhibit 16.2 for an illustration)

The WTO also involves itself in settling disputes relating to dumping and granting of subsidies. But there is a technical problem. Since dumping is resorted to by a firm but not by a country, the WTO cannot punish the country in which the offending firm is located. Rather, it can only respond to the steps taken by the country that retaliates against the firm. The WTO allows a nation to retaliate against dumping if it can show that dumping is actually occurring, can calculate the damage to its own firms, and can show that the damage is substantial. The normal way a country retaliates is by charging an antidumping duty—an additional tariff placed on an imported product that a nation believes is being dumped on its market. But such measures must cease within five years of initiation unless a country can show that conditions necessitated their continued existence.

India leads in the adaption of antidumping measures, followed by the US, the EU, Argentina, South Africa, Australia, Canada, Brazil, China and Turkey (see Table 16.1)

Countries also retaliate when the competitiveness of their business is threatened by a subsidy that another country pays to its own producers. Like antidumping measures, nations can retaliate against

Exhibit 16.2

INDIA WINS WTO CASE AGAINST EC

India has won a case against the European Union at the World Trade Organisation (WTO) involving special tariff concessions on textiles being given to Pakistan.

The EU was given this special treatment on the ground that Pakistan is a beneficiary of a scheme for countries involved in combating drug production and trafficking.

The WTO has ruled that the European Commission has violated its obligations to the international body by granting tariff preferences to 12 countries, including Pakistan, under this special Drug Arrangements program.

The program comes under the EC's Generalised System of Preferences (GSP) scheme, which provides lower tariffs on imports, largely from developing countries to the EU.

The decision will come as a big relief to textile exporters in India who are competing against Pakistan in the European market. The EC's decision to include Pakistan in the drug arrangement scheme since January 2002 had upset Indian exporters who were faced with a significant tariff reduction being provided to textile goods produced in the neighbouring country.

The WTO's decision provides relief to Indian exporters to the EC who are otherwise disadvantaged due to duty concessions to Pakistan under the Drug Arrangements.

The dispute, in the first place, arose primarily because the EC included Pakistan as beneficiary under its Special Tariff Arrangement for combating Drug Production and Trafficking within the GSP scheme for the years 2002–04. Such a scheme was in operation even earlier but the beneficiaries were restricted to Andean and Central American countries. While the scheme, in India's view, was not compatible with WTO rules, even then it had not taken up the issue at the world body as it was not significantly affected. The inclusion of Pakistan, as a beneficiary country since January 2002, changed the situation since Indian exports were directly affected. There are a number of export sectors such as clothing where the two countries are close competitors in the EC market.

products receiving an unfair subsidy by charging a countervailing duty—an additional tariff imposed on an imported product that a country believes is receiving an unfair subsidy. Unlike dumping, the WTO regulates the actions of both the government that pays the subsidy (since payment of subsidy is an action by a country) as well as the government that reacts to the subsidy.

Table 16.1 Users of Anti-dumping Measures (1995–2007)

India	474
US	375
EU	363
Argentina	220
South Africa	203
Australia	189
Canada	141
Brazil	138
China	138
Turkey	109

(*Source*: *Economic Survey,* 2007–08)

Other Issues

The WTO reached at an Information Technology Agreement (ITA) in the mid-December 1996 meeting at Singapore. It seeks to eliminate tariffs to zero level by the year 2000 on the rapidly growing $600 million world market in computer-related products.

Other issues on which the deliberations are being carried out at WTO are:

- Multilateral Agreement on Investment (MAI); the MAI aims to give MNCs the right to establish any business in any country without being discriminated against by virtue of being foreign MNCs. It would also give member states the right to settle any dispute arising out of non-compliance with the MAI at the WTO.
- Core labour standards; these provide that standardised international labour wages and working conditions must prevail. (These have since been dropped, and shall be addressed only by the ILO.)
- Trade and environment.
- Government procurement policies that should aim at weeding out corruption at governmental level.

These issues were originally discussed at the Uruguay Round. But these were given up in face of strong opposition from the underdeveloped countries, including India, and have since been revived.

COMMON MISUNDERSTANDINGS ABOUT WTO

LO 4
Point out certain apprehensions about WTO and give clarifications

Table 16.2 brings out the apprehensions held against WTO and how each has been cleared.

Table 16.2 Doubts and Clarifications

Doubts	*Clarifications*
1. The WTO dictates policies	*Not true*. The WTO does not tell the governments how to conduct their trade policies. Rather, it is a member-driven organisation. Decisions made at the WTO are based on consensus of members.
2. The WTO is for free trade at any cost	*Not true.* It is really a question of what countries are willing to bargain with each other. The role of the world body is to provide a forum for negotiating and implementing the tenets of liberalisation.
3. Commercial interests precede focus on environment	*Not true*. Concern for environment is visible in many agreements reached at the WTO. Agreements also provide for efficient allocation of scarce resources. Sustainable development, protection of environment and efficient utilisation of resources are the primary objectives of the WTO.

4. Commercial interests overtake the develop mental needs	*Not true*. The WTO believes that free trade promotes and not impedes economic development. Commerce and economic development supplement each other.
5. Interests of health and safety are compromised in favour of commercial interest	*Not true*. Certain agreements (such as GATT Art. 20), allow governments to take actions to protect human, animal or plant life and health. Some other agreements deal in greater detail with product standards, and with health and safety for food and other products made from animals and plants.
6. Jobs are destroyed and poverty worsened	*Not true*. Trade helps promote economic activities which in turn generate job opportunities which inturn reduce poverty. As a result of eight rounds of negotiations since 1948 (the year of origin of the world trade body), the average import tariff in the world came down from 40 per cent to 6 per cent. The annual value of goods and services traded across the globe is now 14 times more than what it was in 1948. These figures demonstrate the growth of trade and along with it jobs would have multiplied.
7. Small countries are becoming helpless	*Not true*. Infact, small countries would become weaker without the WTO. The WTO has boosted their bargaining power. The fact that 75 per cent of the member countries are either poor or small nations shows how the WTO has been pro-small and pro-poor countries.
8. The WTO is the tool of power centres	*Not true*. The WTO system offers governments a means to reduce the influence of powerful lobbies. The 'round' type of negotiations and the decision are the consequence of different interests being balanced.
9. Weaker countries are forced to join	*Not true*. As told earlier, weaker countries would remain weaker by staying outside of the WTO. The principles of non-discrimination and transparency guarantee benefits to all member countries—small or large, poor or rich.
10. The WTO is undemocratic	*Not True*. Decisions at the WTO are arrived on consensual basis. Consensus rule means every country has a voice, and every country needs to be pursuaded to join consensus.

(*Source*: Adapted from *World Trade Organisation* by P.K. Vasudeva, pp 70–76)

IMPLICATIONS FOR INDIA

LO 5
Identify implications for India as a member of WTO

India was one of the 76 governments that became a member of the WTO on its first day. Divergent views have been expressed in support and against India becoming a member of the WTO.

Arguments for Joining WTO

1. India is one of the few developing countries which has succeded in implementing liberation programmes Over three-quarters of WTO members are developing countries in the process of economic reform from non-market systems. These countries have chosen to join WTO after careful deliberations in their respective countries. Obviously, they have perceived economic gains for themselves by becoming members. India should not be an exception.

   The criticism that the WTO exists only for industrialised countries is not all that valid. During the seven-year course of the Uruguay Round—between 1986 and 1993, over 60 developing countries implemented trade liberalisation programmes. Some did so as part of their accession negotiations to GATT while others acted on an autonomous basis. At the same time, developing countries and transition economies took a much more active and influential role in the Uruguay Round negotiation than in any previous round.

   With the end of the Uruguay Round, developing countries showed themselves prepared to take on most of the obligations that are required of developed countries. They were, however, given transition periods to adjust to the more unfamiliar and difficult WTO provisions—particularly the poorest, 'least-developed' countries. In addition, a ministerial decision on measures in favour of least-developed countries, gives extra flexibility to those countries in implementing WTO agreements; calls for an acceleration in the implementation of market access concessions, affecting goods of export interest to those countries; and seeks increased technical assistance for them. Thus the value to development of pursuing open market policies, based on WTO principles, is widely recognised and is appreciated. So is the need for some flexibility with respect to the speed at which these policies are pursued.

2. The real importance of the WTO to India lies in the role that a dynamic export industry can play in the country's development. Both in terms of job creation, skill development, and technological evolution, an opening up to the outside world is essential. The semi-autarkic earlier system resulted in a major leap forward in the development of indigenous industry and agriculture. But it lacked an internal dynamic impetus. There were no incentives to improve technology and productivity. In short, it was a closed system that left no room for evolution. It is only by forcing industries to sell outside the country and compete for export markets that they will have an incentive to evolve.

   There is another reason why India needs to search for external markets—the crucial dependence on imports for survival. The country has for long believed that it is a self-sufficient, independent economy. But, infact, from petroleum and fertilizers to capital goods, raw material and life saving drugs, the Indian economy is vitally dependent on imports. As long as it is dependent on imports, it needs to export to pay for these imports.

   As long as India needs to export and import, it makes far more sense to be part of the multilateral trading system than stay out of it. That is why even a country like China, despite its fiercely-guarded sovereignty and its status as the world's last major socialist power, has sought and succeeded in joining the WTO.

3. By being a member of the WTO, India can benefit from the International Trade Centre jointly operated by the WTO and the United Nations, the latter acting through UNCTAD (the UN Conference on Trade and Development). The International Trade Centre was earlier set up by GATT in 1964 at the request of the developing countries to help them promote their exports.

   The Centre responds to requests from developing countries for assistance in formulating and implementing export promotion programmes as well as import operations and techniques. It provides information and advice on export markets and marketing techniques, and assists in establishing export promotion and marketing services and training personnel required for these services. The Centre's help is freely available to the least-developed countries.

4. Estimates have been made by the World Bank, OECD, and the GATT Secretariat, which shows that the income effects of the implementation of the Uruguay Round package will add between 213 to 274 billion US dollars annually to world income. The GATT Secretariat's estimate of the overall trade impact is that the level of merchandise trade in goods will be higher by 745 billion US dollars in the year 2005, than it would otherwise have been. The GATT Secretariat further projects that the largest increases will be in the areas of clothing (60%), agriculture, forestry, and fishery products (20%) and processed food and beverages (19%). Since India's existing and potential export competitiveness lies in these product, groups, it is logical to believe that India will obtain large gains in these sectors. Assuming that India's market share in world exports improves from 0.5% to 1% and that we are able to take advantage of the opportunities that are created, the trade gains may conservatively be placed at 2.7 billion US dollars extra exports per year. A more generous estimate will range from 3.5 to 7 billion US dollars worth of extra exports.

5. Another advantage of WTO membership stems from the fact that India (any member country for that matter) is saved from entering multiple bilateral trade negotiations with other countries. In the

absence of WTO, India, for example, would be required to enter as many bilateral agreements as the country desires to have trade links. With the WTO membership, India has the advantage of having trade links with all other member countries without the need for bilateral agreements. The role of WTO is like that of a telephone exchange in this context.

6. WTO provides for a multilateral set of rules, which are beneficial to a country like India. Such rules provide greater protection against bilateral pressures or against the trade restrictions that cannot be justified under a multilaterally agreed framework. Further, the system of multilateral rules imparts greater predictability and stability to the international trading system. If the system of rules is not followed, the ensuring chaos and uncertainty will result in a trading system dominated by might rather than right.
7. There are several areas in the Uruguay Round package that relate to market access. The more important ones are tariffs, textiles, and agriculture. India's position in all these sectors is advantageous to her and the provisions are favourable to the country.
8. GATS is another area, when operationalised, benefits India immensely as Exhibit 16.3 shows:

Exhibit 16.3

LABOUR PAINS

India's economic and social landscape would undergo an unprecedented transformation if opportunities to tap the global job market were not blocked by visa restrictions and mandatory work permits. Consider a situation where your daughter gets a call from Melbourne for a job interview and she takes off the same evening to prove her mettle. Such a scenario is impossible right now in the case of Australia. If the destination is Thailand, your daughter could still take off, availing herself of the visa-on-arrival facility, but that's where the dream run would go into pause mode. The interview may turn out to be a cakewalk, but the real barriers made their presence felt at this stage: employment visa, work permit and numerous other roadblocks prevent Indians from making the best of the global job opportunities. Insensitive employers and unscrupulous agents exploit job seekers and—in most cases—sour the middle class dream of an overseas job that could put a family firmly on the path to progress.

Being the second most populous country in the world, with the largest pool of English-speaking youth educated in various streams including engineering, medicine, law, management and accountancy, India stands to benefit most if the World Trade Organisation (WTO) manages to liberalise market access for services. Countries like India will stand to gain the most if visa restrictions are dismantled to open up the global job market. New Delhi can congratulate itself on joining the WTO when your son can spot a job in London on the Internet, board the next morning's flight to meet prospective employers, and— more importantly—start his innings the same day without having to wade through red tape for a job visa or work permit. This may sound like a distant dream, but that should be India's single-minded aim at the WTO as the impact of such a breakthrough will work wonders for the country.

Apart from professionals, highly-educated, skilled and trained categories of job seekers, liberalisation of visa norms and work permits would benefit the least educated the most. Labourers and semi-skilled artisans are the most exploited and deprived in terms of job opportunities abroad. The recent unrest involving Indian construction labourers in the UAE highlighted the situation.

Opening up of overseas employment will enable rural youth to shift away from the farm sector where income is subject to the vagaries of nature. Once an unskilled or semi-skilled job in labour-scarce countries in West Asia or South-east Asia widens horizons, rural families would be in a better position to spend on education, brightening the prospects for the next generation. The ripple effect could lift lakhs out of poverty, boost progress on health and education and catalyse economic growth in a big way.

Unfortunately, WTO talks have taken a backseat due to differences over the Doha Development Agenda. Even the minor progress made at the Hong Kong ministerial meeting of 2005 has not resulted in any liberalisation in the way goods and services are being traded. Rich nations have been particularly shy in opening up services, especially Mode 4 (movement of natural persons) which deals with visa restrictions.

(*Source: The Economic Times*, Nov. 22, 2007)

Arguments Against Membership

Argument against India's membership in WTO are equally strong. The major ones are stated below:

1. The claim that world trade would increase substantially and that India's exports will expand considerably is not acceptable to many. The estimates relating to world trade may prove to be suspect. Flow of goods and services across the globe depends not much on trade restrictions but on factors like infrastructure, political environment, technology, assured supply of exportable goods, and quality consciousness of producing countries. It may be observed that India is short, to some extent, in all these requisites. Removal of trade barriers will not guarantee expansion in world trade.
2. India and other developing countries have blindly walked into the trap laid by the developed countries. WTO, along with IMF, and World Bank, represents the interests of developed countries. Rhetoric and platitudes notwithstanding, WTO will not ensure open trade for goods produced by developing countries. It ensures necessary climate for domination and hegemonisation by the consortium of the capitalist countries. In fact, the Uruguay Round negotiations were motivated by the needs of the United States and Western Europe to discover new markets for their industries, especially in sectors like services and finance.
3. It is claimed that there are several areas in the Uruguay Round package that relate to market access and India would, therefore, gain substantially in the long run because of the market access. Figures demonstrating the gains from market access are no doubt praiseworthy. But the gains, if any, in tariff concessions or removal of quotas could easily be lost because of the new rules and disciplines and potential for trade harassment.
4. The worst fears expressed about the WTO agreement relate to the steep hike in prices of drugs and agriculture inputs. Table 16.3 shows how select drug prices will be costlier across the globe. Exhibit 16.4 is a snapshot of WTO for India.
5. There are other areas where India and other developing countries are at the receiving end: (i)WTO is heavily biased in favour of developed countries. Though the number of the developed member countries in WTO is smaller, they make key decisions in their own favour. (ii) Reciprocity is the basic principle of trade liberalisation under WTO regime. Reciprocity implies "You give and you take". This principle benefits mainly developed nations as they have enough to give and they also get back more than adequately. Developing countries cannot afford to give and are therefore denied of taking. (iii) Developing countries should not remain developing for ever. But this is precisely what WTO is doing. It is always extracting concessions from developing countries depriving them of time, energy and opportunities for their development. (iv) A country with a clout can retaliate if something goes against its interests. Through retaliation the country gets back its

Table 16.3 International Comparison of Select Drugs Prices

Drug	*India*	*Pakistan*	*Times Costlier*	*USA*	*Times Costlier*	*UK*	*Times Costlier*
Anti-Bacterials							
Oflaxacin	73.03	151.26	2.07	192.39	2.63	178.77	2.45
Norfloxacin	33.61	161.94	4.82	613.77	18.26	290.88	8.65
Tobramycin	16.43	150.08	9.13	387.50	23.58	86.66	5.27
Anti-inflammatory							
Diclofenac	5.67	72.00	12.70	234.70	41.40	110.29	19.45
Anti-Ulcerants							
Rantidine	30.03	336.00	11.57	729.93	25.14	553.88	19.08
Cardiovascular							
Alenolol	7.86	111.78	14.22	223.85	28.45	118.78	15.11
Diltiazem	19.29	96.00	4.98	161.84	8.34	90.90	4.71
Anti-Viral/Fungal							
Ketaconazole	43.00	286.40	6.66	660.36	15.36	287.85	6.69
Anti-Histamine							
Aztemizole	6.00	156.00	26.00	427.74	71.29	115.14	19.19
Anti-Anxiolytics							
Buspirone	4.05	115.73	28.58	147.62	36.48	193.92	47.88
Anti-Cancer							
Mitoxantrone	446.25	NA	–	14876.65	33.34	9116.06	20.43
Vincristine	28.00	416.98	14.48	1047.26	36.36	624.79	21.69
Anti-Depressant							
Pluoxentine	29.00	798.40	27.53	507.60	17.50	647.21	22.32

Notes:
1. Prices for 1991 and in rupees
2. Costlier over the Indian prices
3. Prices are for the same dosage and pack

(*Source:* USA Prices Annual Pharmacists Reference.
UK Prices—UK Monthly Index for Medical Specialities (MIMS), December 1991.
Pakistan Prices—Quarterly Index for Medical Pharmaceuticals (QIMP))

Exhibit 16.4

BALANCE SHEET FOR INDIA

Advantages

- Benefits from reduction of tariffs on the products of export of interest to India.
- Improved prospects for agricultural exports as a result of likely increase in the world prices of agricultural products due to reduction in domestic subsidies and barriers to trade.
- Increase in the export of textiles and clothing due to the phasing out of the MFA by 2005.
- Advantages from greater security and predictability of the international trading system due to the revamped dispute settlement procedures, and the agreements on safeguard, subsidies, and anti-dumping measures.
- Compulsion imposed on us to be competitive in the world market.

Disadvantages

- Tariff reductions on goods of export of interest to India are very small. On the other hand, there will be erosion of the preference enjoyed by India, and India will most probably be graduated out of the Generalised System of Preferences (GSP).
- Meagre prospects of increase in agricultural exports due to the very limited extent of agricultural liberalisation.
- India will be under the tremendous pressure to liberalise her services industries.
- There will be only marginal liberalisation of the movements of labour services in which India is competitive.
- India will lose policy options in several areas because of
  - the extensive bindings undertaken by the country.
  - prohibition of certain type of subsidies and making certain other types actionable.
  - giving up the option of granting process patents only in some sectors.
  - limitations put on India's ability to apply restrictions on balance of payments ground.
- Increased outflow of foreign exchange due to commitments undertaken in the field of TRIMs and services.
- Technological dependence on foreign firms will increase as the R&D required to take advantage of the Uruguay Round may not be undertaken on an adequate scale due to paucity of resources.
- Concentration in market structure where by only a few large firm or transnational corporations may benefit and smaller and tiny firms may disappear.
- Increasing intrusion in India's sovereign domestic space in TRIPs, TRIMs, Services, and Agriculture.
- The Uruguay Round has paved the way for similar other instructions in future through linkages between trade and environment, trade and labour standards, and a new regime for the treatment of foreign capital.
- Trend towards neo-protectionism in developed countries against India's exports.
- Possibility of cross-retaliation against India's goods and services.

due share of benefits. Developing countries cannot retaliate as they are weak economically and politically. Exhibit 16.4 draws a balance sheet for India.

REVIEW OF PERFORMANCE

LO 6
Review the performance of WTO

During the last 20 years of its existence, the WTO has proved to be totally different from its predecessor GATT. GATT was toothless but WTO has been armed with adequate power by the way disputes between trading countries have been settled. It is to the credit of the WTO that even the mighty US was brought to book in no more than one case. GATT negotiating rounds took place once in a decade or so, but at Singapore, just two years after the conclusion of the Uruguay Round, the WTO virtually concluded an information technology agreement, and launched studies on investment, competition policy, transparency in government procurement, and trade facilitation. The old leisurely pace of GATT is gone, instead, there is enormous pressure to compress into the next few years what used to take decades to complete.

The agenda of the WTO is expanding and the US is trying to push everything possible under the ambit of the WTO. This would facilitate smooth flow of trade across the globe. The other achievements are:

- Greater market orientation has become the general rule.
- Tariff-based protection has become the rule, rather than the exception.
- The use of restrictive measures for BOP reasons has declined markedly.
- Services trade has been brought into the multilateral system and many countries are, as in goods, opening their markets for trade and investment either unilaterally or through regional or multilateral negotiations.
- Many developing countries have undergone radical trade, exchange, and domestic reforms which have improved the efficiency of resource use, opened new investment opportunities, and, thus, promoted economic growth.
- Bilateralism has been, to a great extent, placed under control by the extension of WTO provisions to services, TRIPs and TRIMs, and by the unified dispute settlement mechanism, in which the possibility of unilaterally blocking the adoption of panel decisions no longer exists.
- The Trade Policy Review Mechanism has created a process of continuous monitoring of trade policy developments that, by promoting greater transparency, has assisted in the process of liberalisation and reform.

The new initiative–Aid for Trade–is bound to help the member countries considerably. Aid for Trade programme involves two commitments from WTO: first, provider of trade-related technical assistance, budgeted at $30 million a year; second, act as a forum to mobilise, monitor and evaluate Aid for Trade programmes which implies working closely with all the aid providers. Basically, Aid for Trade programme is about mobilising more developmental assistance to help expand the trade capacity of developing countries and to connect them to global markets.

Most significant achievement of WTO is its policing and enforcing roles. Between 1995 and 2008, more than 370 trade disputes among member countries were brought to the WTO. Of these, three-fourths had been resolved by informal consultations among the parties in conflict. Others too have been resolved through formal procedures. In general, disputing countries have accepted WTO recommendations and this shows that the member countries repose faith in the world trade body.

There is the other side of the WTO too. From day one WTO has been opposed by NGOs and civil societies across the globe. These bodies oppose free trade in general. They argue that the WTO is an undemocratic institution that usurps the national sovereignty of member countries.

There are other problems as well. For example, the multilateral trade rules are increasingly becoming a codification of the policies, perceptions, laws, and regulations of the industrialised countries. The policies and rules appropriate or advantageous to the industrialised world are getting established as common rules to be obeyed by the developing world as well. As a result, a "one-size fits all" approach is increasingly getting embedded in the WTO rules and disciplines.

Trade reform processes are incomplete in many countries, tariff peaks remain, and negotiations in telecommunications and financial services are proceeding slowly.

Major gainers from WTO are the rich countries. The WTO has opened doors and created opportunities for the industrialised countries to benefit immensely at the cost of less-developed countries. Reform process is fast in the areas that benefit rich countries. Where the benefits of free trade accrue primarily to the developing countries, progress has been slow and halting.

In the past 60 years, world trade has grown from $10 billion to 12 trillion dollars. Exports which accounted for only five per cent of the $200 billion world economy in 1950, now represent 60 per cent of a $60 trillion economy. However, the wealth created by this phenomenal growth in trade was distributed in a lopsided way because of the way trade rules operated. According to the WTO, the total trade of all nations in 2004 was almost $19 trillion, but just $133 billion, or less than one per cent, was accounted for by the 50 least developed countries. While the removal of trade barriers helped developed nations step up their manufactured exports quickly, poor countries, which relied on textiles, leather goods, fisheries, and farming, were held back by tariff walls and subsidies. (Also see Exhibit 16.5).

Exhibit 16.5

FLYING COWS FIRST CLASS

The WTO adopted three framework agreements dealing with trade in goods, services, and intellectual property rights but excluded two of the most sensitive issues, agriculture and textiles, from the general agreement on trade. Setting them aside turned out to be merely postponing the battle. The sensitivity of the textile trade labour unions of the rich countries was shown in 2005. According to an agreement, the Multi-Fiber Arrangement (MFA) that had protected the textile industry of developed countries was abolished in January 2005. Freed from constraints, low-cost producer China flooded the market, triggering protests from the American textile lobby. The American Manufacturing Trade Action Coalition claimed that 19 factories have closed and some 26,000 jobs have been eliminated since the end of the Multi-Fiber arrangement. Fearful of unleashing a protectionist backlash, American and European officials turned to a safeguard clause in the WTO provisions to reimpose production restrictions on the Chinese. The critics of globalisation got a reprieve, but only for four years.

Farm trade, although it makes up barely 10 per cent of world trade, touches sensitive nerves in the developing world. It involves food and the livelihoods of the vast majority of people in the least developed countries (LDCs), which incidentally make up more than 20 per cent of the WTOs membership. The Korean farmers who have battled police outside WTO meetings from Cancun to Hong Kong remind one of farmers' fears for their livelihood in the face of competition from big multinationals. Farmers in South Korea, Brazil, India, Kenya, and other African countries have resisted opening up their economies further to developed countries unless unfair subsidies, antidumping regulations, and other nontariff barriers by rich countries are removed. One calculation shows that the 300 billion dollars that rich countries lavish on farm subsidies would be enough to fly every cow in the industrial countries of the OECD (Organization for Economic Co-operation and Development) around the world first class every year, with plenty of money to spare.

Aside from flying cows first class, the subsidy policy of developed nations amounts to the world trade equivalent of sending a beefy sumo wrestler to battle a scrawny and malnourished competitor. Travelling in Senegal, in the fall of 2005, I saw huge chicken farms abandoned and hundreds of unemployed youth milling about in the stress. The chicken farms that had once provided employment had been shut down after heavily subsidised European poultry products were dumped in Senegal, making it impossible for local suppliers to sell their more expensive poultry. The most scandalous example of rich country protectionism has been the story of cotton. Not surprisingly, it is frequently invoked by critics as evidence of the rigged trading rules that typify globalisation. Farmers from such countries as Benin, Burkina Faso, Cameroon, Chad, and Mali, who rely on cotton farming, have no practice of selling their produce in world markets, where massive American and European Union cotton subsidies ($230 for every acre of American cotton farmland) have lowered prices to a level below their own production costs. According to one estimate, in the three years between 1999 and 2001, eight African cotton-growing countries lost $330 million in export earnings—a huge amount for some of the poorest nations in the world. Compare this with the $3.9 billion subsidy that America's twenty-five thousand cotton farmers received in 2001-02. The European Union meanwhile pays Greek farmers a billion dollars a year to grow cotton. If such subsidies were dismantled, the price of world cotton would perhaps rise by 15 per cent or more, allowing thousands of African farmers to make a living.

(*Source:* Nayan Chand, *Bound Together*, Penguin/Viking, 2007, pp. 280-281)

Major weaknesses of the WTO include its inability to attend to three challenges, as stated in the beginning of this chapter. The challenges include: antidumping measures, protection to agriculture and protecting intellectual properties.

Anti dumping actions became frequent in 1990s. But WTO was not able to tackle the issue because of vague definition of what is dumping and what is not. Second challenge relates to the high tariffs imposed on agricultural products by developed countries. The implication is that consumers in these countries are paying significantly higher prices than on those that are imported from other countries. Consumers have less money to buy imported goods. WTO members believe that strict enforcement of intellectual property rights would add to the world trade, particularly in such sectors as drugs, computer software, and music recordings. But, WTO has not been able to check the piracy.

The present economic crisis forces countries to go back to protectionist measures. Infact, protectionism has already surfaced in many developed countries. In the US there is an official push to buy American goods. Visa rules for computer professionals have been cited to keep investors away form specific sectors such as ports. The big challenge for WTO is to ensure that channels of trade remain open in the face of the economic adversity.

There is one more contentious issue between the developed and developing countries. The rich countries are seeking a shift from 'development' orientation to 'market access' orientation. Yielding to the shift towards market access orientation implies that the markets of developing countries would be thrown open to the agri-products, industrial goods and services of developed countries, while the latter would continue to subsidise their produce.

The WTO's rigid stand undid the world trade body. Its approach – nothing is agreed until everything is agreed – proved too much for the developing countries to swallow and compromise.

Meanwhile, an observation made by *The Economist* dated Oct. 12, 2013 goes to question the very relevance of the WTO. The reputed weekly points out that the WTO has become a victim of its own success. Thanks to the earlier rounds of tariff reductions, further liberalisations would offer lesser economic benefits. Even if Doha round negotiations succeed, output of the participants would rise only by 0.5%.

Doha Negotiations

A major weakness of the WTO relates to its failure to complete negotiations scheduled at Doha, the capital city of Qatar. The WTO had placed three issues for negotiations at Seattle, in 1999. The issues were: anti-dumping duties, trade in agricultural products and enforcement of intellectual property laws. Seattle negotiations were a fiasco. The issues were again brought for negotiation in 2001 meeting held at Doha. Agreements on the three issues were to be reached by 2007, but dragged on for more than a decade. Unlike the Seattle meetings, at Doha, the member countries agreed to launch a new round of talks and agreed upon a new agenda.

The agenda for Doha negotiations includes cutting tariff on industrial goods and services, phasing out subsidies to agricultural producers, reducing barriers to cross-border investments, limiting the use of anti-dumping laws, and enforcement of intellectual property laws.

It is one thing to have a lofty agenda and another to reach consensus. Serious differences between developed and developing countries cropped up. At the core of the differences relates to a agriculture. While the developed countries are heavily subsidising their farmers, they expect the developing countries to cut their subsidies. If yielded to pressure, farmers in developing countries will be hit hard, in the sense that their produce will become highly expensive compared to the produce from the US and EU. Developing countries are resisting the pressure while developed countries are mounting the same. India took the lead in championing the cause of developing countries.

The negotiations concluded. In Dec 2013, all 159 members of WTO, meeting in Bali had struck a trade "facilitation agreement" (TFA) – a pledge to cut red tape at customs posts around the world. It was the first big win of the Doha round in 13 years of efforts to bring down trade barriers.

But on July 31st, just before ratification, India withdrew its support, spelling the collapse of the FTA. According to the FTA, subsidies to farmers in a developing country cannot exceed 10% of the total value of its total output that too arrived at 1980-81 price level. But, under the new food security law, India is introducing a \$4 bn a year scheme to provide subsidised food for 800 million people; and the minimum support prices the government offers to farmers, which for rice have more than doubled since 2001-02, will continue rising. If these measures breach the 10% limit, India would be open to a WTO challenge. The government insists that it will not sacrifice food security for a trade deal.

SUMMARY

- Being an outgrowth of GATT, set up in 1995, headquartered at Geneva and having a membership of 159 countries, WTO has travelled a long way, covering humps and pitches on the way. (LO1)
- WTO has a formal structure, unlike its predecessor. Ministerial Conference is the highest authority in the structure. (LO1)
- Promoting free trade across the globe is the main objective of the WTO. Through heightened free trade, standard of living of people will be enhanced. (LO1)
- WTO has its own well defined functions. Of course, promoting free trade is the main objective. For this it undertakes several related activities (LO1)
- Several principles guide the functioning of WTO. Transparency, MFN Clause, national treatment, and free trade are a few of them (LO2)
- Key agreements at the WTO include agriculture, textiles and clothing, trips, trims, and the like. (LO3)
- People entertain their own doubts about WTO which are sought to be cleared. (LO4)
- Being a founding member of WTO, India has gained and lost also. (LO5)
- WTO's balance sheet includes assets and liabilities, the letter being heavier than the former. It may be difficult to tally the balance sheet. (LO6)

Review Questions

1. Bring out the objectives and the functions of WTO. (LO1)
2. Describe the various WTO agreements. (LO3)
3. How far has India benefited by becoming a member of WTO? (LO5)
4. Bring out the principles of WTO. (LO2)
5. Review the performance of WTO. (LO6)

Discussion Questions

1. Do you think that WTO has been pro-rich? Yes or No—discuss. (LO4)
2. Do you think that the euphoria associated with WTO initially has died down? (LO6)

Reinforcing Exercises

- *The Economist* dated Oct 12 – 18, 2013 almost wrote obituary to the world trade body. The reputed weekly pointed out that WTO has become a victim of its own success. Thanks to the earlier rounds of tariff reductions, further liberalisation would offer lesser economic gains. Even if Doha round talks succeed, output of the participants would rise only by 0.5 percent.
  The newly elected leader of WTO made a telling observation on the world trade body. Said he, "WTO is a sick patient. The head has to put on the gloves and masks and start operating immediately because the patient is almost terminal".
  What are his other challenges?

CLOSING CASE 1

Unfair Protection or Valid Defense?

"Mexico Widens Anti-dumping Measure … Steel at the Core of US-Japan Trade Tensions … Competitors in Other Countries Are Destroying an American Success Story … It Must Be Stopped", scream headlines around the world.

International trade theories argue that nations should open their doors to trade. Conventional free trade wisdom says that by trading with others, a country can offer its citizens a greater volume and selection of goods at cheaper prices than it could in the absence of it. Nevertheless, truly free trade still does not exist because national governments intervene. Despite the efforts of the World Trade Organisation (WTO) and smaller groups of nations, governments seem to be crying foul in the trade game now more than ever before.

We see efforts at protectionism in the rising trend in governments charging foreign producers for "dumping" their goods on world markets. Worldwide, the number of antidumping cases that were initiated stood at about 150 in 1995, 225 in 1996, 230 in 1997, and 300 in 1998.

There is no shortage of similar examples. The United States charges Brazil, Japan, and Russia with dumping their products in the US market as a way out of tough economic times. The US steel industry wants the government to slap a 200 per cent tariff on certain types of steel. But car makers in the United States are not complaining, and General Motors even spoke out against the antidumping charge—as it is enjoying the benefits of low-cost steel for use in its auto production. Canadian steel makers followed the lead of the United States and are pushing for antidumping actions against four nations.

Emerging markets, too, are jumping into the fray. Mexico recently expanded coverage of its Automatic Import Advice System. The system requires importers (from a select list of countries) to notify Mexican officials of the amount and price of a shipment ten days prior to its expected arrival in Mexico. The ten-day notice gives domestic producers advance warning of incoming low-priced products so they can complain of dumping before the products clear customs and enter the marketplace. India is also getting onboard by setting up a new government agency to handle antidumping cases. Even Argentina, China, Indonesia, South Africa, South Korea, and Thailand are using this recently-popularised tool of protectionism.

Why is dumping on the rise in the first place? The WTO has made major inroads on the use of tariffs, slashing them across almost every product category in recent years. But the WTO does not have the authority to punish companies, but only governments. Thus, the WTO cannot pass judgments against individual companies that are dumping products in other markets. It can only pass rulings against the government of the country that imposes an antidumping duty. But the WTO allows countries to retaliate against nations whose producers are suspected of dumping when it can be shown that: (1) the alleged offenders are significantly hurting domestic producers, and (2) the export price is lower than the cost of production or lower than the home-market price.

Supporters of antidumping tariffs claim that they prevent dumpers from undercutting the prices charged by producers in a target market and driving them out of business. Another claim in support of antidumping is that it is an excellent way of retaining some protection against potential dangers of totally free trade. Detractors of antidumping tariffs charge that once such tariffs are imposed they are rarely removed. They also claim that it costs companies and governments a great deal of time and money to file and argue their cases. It is also argued that the fear of being charged with dumping causes international competitors to keep their prices higher in a target market than would other wise be the case. This would allow domestic companies to charge higher prices and not lose marketshare—forcing consumers to pay more for their goods.

Questions

1. "You can't tell consumers that the low price they are paying for a particular fax machine or automobile is somehow unfair. They're not concerned with the profits of companies. To them, it's just a great bargain and they want it to continue." Do you agree with this statement? Do you think that people from different cultures would respond differently to this statement? Explain your answers.
2. As we've seen, the WTO cannot currently get involved in punishing individual companies for dumping—its actions can only be directed toward governments of countries. Do you think this is a wise policy? Why or why not? Why do you think the WTO was not given the authority to charge individual companies with dumping? Explain.
3. Identify a recent antidumping case that was brought before the WTO. Locate as many articles in the press as you can that discuss the case. Identify the nations, product(s), and potential punitive measures involved. Supposing you were part of the WTO's Dispute Settlement Body, would you vote in favour of the measures taken by the retailing nation? Why or why not?
4. Update the contents of this case. Offer your comments on the future of WTO.

CLOSING CASE 2

GATT's Legacies

- It was so asymmetric that the poorest countries were actually worse off; sub-Saharan Africa, the poorest region with an average income of just over $500 per capita per year, lost some $1.2 billion a year.
- Seventy per cent of the gains went to the developed countries—some $350 billion annually. Although the developing world has 85 per cent of the world's population and almost half of total global income, it received only 30 per cent of the benefits—and these benefits went mostly to middle-income countries like Brazil.
- The Uruguay Round made an unlevel playing field less level. Developed countries impose far higher—on average four times higher—tariffs against developing countries than against developed ones. A poor country like Angola pays as much in tariffs to the United States as does rich Belgium; Guatemala pays as much as New Zealand. And this discrimination exists even after the developed countries have granted so-called preferences to developing countries. Rich countries have cost poor countries three times more in trade restrictions than they give in total development aid.
- The focus was on liberalisation of capital flows (which developed countries wanted) and investment rather than on liberalisation of labour flows (which would have benefited the developing countries), even though the latter would have led to a far greater increase in global output.
- By the same token, liberalisation of unskilled labour services would have led to a far greater increase in global efficiency than liberalisation of skilled labour services (like financial services), the comparative advantage of the advanced industrial countries. Yet negotiators focused on liberalising skill-intensive services.
- The strengthening of intellectual property rights largely benefited the developed countries, and only later did the costs to developing countries become apparent, as lifesaving generic medicines were taken off the market and developed-world companies began to patent traditional and indigenous knowledge.[5]

Question

Do you think that the ghost of GATT is still haunting WTO? If yes, how? If no, prove.

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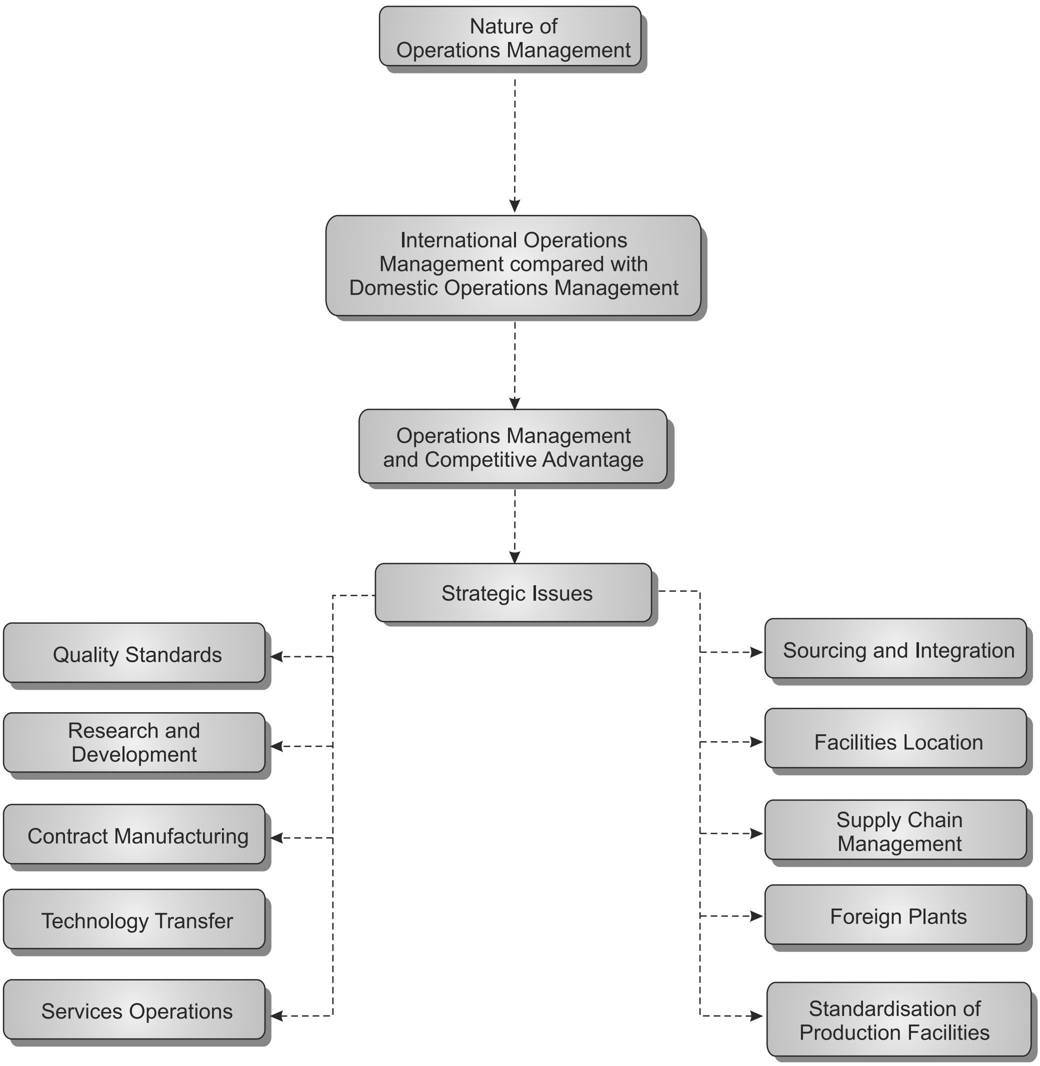
PART 4

CHAPTER


Nature of Operations Management
International Operations Management compared with Domestic Operations Management
Operations Management and Competitive Advantage
Strategic Issues
Quality Standards
Research and Development
Contract Manufacturing
Technology Transfer
Services Operations
Sourcing and Integration
Facilities Location
Supply Chain Management
Foreign Plants
Standardisation of Production Facilities

17

International Operations Management

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Describe the nature of international operations management
- **LO 2:** Compare and contrast international operations management with domestic operations management
- **LO 3:** Categorise how operations management can be a source of competitive advantage for an international business
- **LO 4:** Recognise why international operations management needs to be integrated with corporate strategy
- **LO 5:** Assess the various strategic issues involved in international operations management

Opening Case

The GE Production Process and Six Sigma

General Electric is a multibillion-dollar, multinational corporation whose products range from 65 cent light bulbs to billion-dollar power plants. In fact, based on revenues, assets, profits, and market value, the firm was listed by *Fortune* magazine as number one in the world in 2000. One reason for the company's annual revenue of more than $130 billion is its ability to manage a diverse multiproduct-line operation. Much of its success can be attributed to the production-related concepts that it has employed over the last two decades.

During the 1980s, *work-out*, *process mapping*, and *best practices* were the concepts applied. *Work-out* is a training programme designed to empower employees to implement their problem-solving ideas. In this process, a group of 40 to 100 people, picked by management from all ranks and functional areas, attend a three-day meeting. The first day's session consists of a manager leading the group in drawing out an agenda related to areas where productivity can be increased. Then the manager leaves and for the next 1½ days the group breaks up into teams to tackle the agenda. On the last afternoon, the manager returns and all the team members make their proposals for improved productivity. The manager can respond in either of three ways: agree, disagree, or ask for more information—in which case the individual must empower a team to respond by an agreed-upon date. These work-out sessions have proved extremely successful. In one case, a group of workers convinced the management to allow their factory to bid against an external vendor for the right to build new protective shields for grinding machines. As a result, the GE group completed the job in $16,000 as opposed to $96,000 quoted by the vendor.

The second method, *process mapping,* involves the creation of a flowchart to show all the steps, no matter how small, that go into making or doing something. The map is analysed for ways of eliminating steps and of saving time and money. In one case a work group was able to reorganise production, cut manufacturing time in half, and reduce inventory by $4 million.

The third method, *best practices*, consists of finding companies that do things better than GE does and then emulating them. In this process, GE personnel try to answer the question: What is the secret of this other company's success? Quite often it includes such things as getting products to market faster than anyone else, or treating their suppliers like partners, or having superior inventory management. As a result of best practices, GE is now leaving executives in their jobs for longer periods of time rather than rotating them quickly through new jobs; the best practices process revealed that frequent changes create problems in new product introduction. The company is also learning how to use the continuous improvement process more effectively so that it can bring a new product into the market ahead of the competition and then work on introducing new technologies. In the past, the firm would try to perfect all technologies first and then introduce the final version of the product.

These three concepts—work-out, process mapping, and best practice—were the main concepts of GE's production strategy in the 1980s. In the 1990s the dominant production concept was Six Sigma. The name originates from a statistical method for deriving near-perfect quality, equal to 3.4 defects per million operations. The Six Sigma process allows GE to measure how many "defects" there are in a given process and then systematically work to eliminate them to approximate "zero defects".

Six Sigma recognises three elements: the customer, the process, and the employee. The first element, the customer, is the key to defining quality. GE uses the term "Delighting Customers" to generate a mentality whereby customer's expectation on performance, reliability, competitive prices, on-time delivery, service, clear and correct transaction processing, and other customer needs become a key factor in all processes. The second element, the process, promotes "Outside-In Thinking Quality". GE must understand the transaction life cycle from the customer's point of view and identify significant value and improvement from their perspective. Under the banner "Leadership Commitment People", the third element of Six Sigma, the employee, requires that all employees use their talents and energies to satisfy customers. All the employees are trained in Six Sigma, including statistical tools, strategy, and techniques of Six Sigma quality. At the core of Six Sigma is a workforce mentality on customer quality expectations, defect reduction, process capability, variation (the customer reacts to the variance not the average results), stability of operations and designing processes to meet customers' expectations.

GE's advantage over failing conglomerates is its ability to transfer knowledge across the whole company. This can be attributed to former CEO Jack Welsh who oversaw GE's transformation from a mainly manufacturing company to a service-oriented knowledge-based company. He defined the company's culture by creating a workforce that could identify opportunities and implement changes.

ORGANISATIONAL structure for an MNC having been decided, and its strategy formulated (read Chapters 11 and 12), the next logical step is to plan and implement the firm's operations strategy. This chapter is devoted to a detailed description of the nature and related issues faced by an MNC with regard to its operations function.

NATURE OF OPERATIONS MANAGEMENT

LO 1
Describe the nature of international operations management

Two terms need to be clearly understood in this context: *production management* and *operations management*. To many people, the term *production* conjures up images of factories, machines, assembly lines, inventories, and workers. Mustering these and other facilities and putting them to proper use to produce tangible goods is *production management*, alternatively called *manufacturing management*. Basically, production involves transformation of various inputs (materials, men, machine, time, and other resources) into finished goods. In recent years, the scope of production management has broadened considerably. Production concepts and techniques are applied to a wide range of activities and situations *outside* manufacturing, that is in *services* such as health care, food service, recreation, banking, hotel management, retail sales, education, transportation, and even government. This broadened scope has given the field the name *operations management*.[2] Operations management may, therefore, be understood as those activities of a firm that are related to the design, planning and control of resources for transforming them not only into more useful and tangible goods but also into intangible services. *International operations management* refers to the transformation-related activities of an international firm.

INTERNATIONAL OPERATIONS MANAGEMENT COMPARED WITH DOMESTIC OPERATIONS MANAGEMENT

LO 2
Compare and contrast international operations management with domestic operations management

International markets are predominated by MNCs who have perfected the principles, procedures, and practices of operations management. Most of the international businesses originate from developed countries, which have a long history of industrial growth and this has kept the MNCs in good stead. MNCs have deep pockets, spend vast sums on R&D, carve core competencies for themselves, come out with innovative products, add new features to existing products, maintain quality, and fix low prices for their products.

International businesses are in a position to take advantage of location economies. An MNC can locate its subsidiary in any part of the world where cost of production is the lowest. If American and Canadian firms invest in Mexico or European companies go to China, the motive behind such move is to take advantage of the low cost labour in those countries. China has proved to be low wage country. Its wage rates are a third of Mexico's and Hungary's and five percent of those in the US or Japan.

Multinational enterprises have yet another advantage—the ability to enjoy the benefits of the experience curve. By producing a product in high volumes, an MNC can reduce the cost of value addition in every unit of output. Coke, for example, is able to sell standardised soft drink in more than 160 countries across the globe. The American leader in soft drink obviously has the benefit of the experience curve. However, two criteria are to be met to take advantage of the experience curve: (1) the product must fit customers' needs, and (2) the demand must be sufficiently large to support the volume. Chrysler is an example to be cited in this context. By the 1970s the experience curve had given Chrysler the lowest production costs of all the US auto manufacturers. Unfortunately, its cars no longer met customers' needs, so Chrysler could not sell enough of them to operate its large plants, driving their costs upto the highest level among the US products at the time.

Global businesses seek to create new values through operations. For example, they can consolidate manufacturing for several European countries to take advantage of economies of scale and reduce shipping costs and tariffs. They can substitute lower cost foreign suppliers and reduce transportation costs. More important, MNCs can take advantage of having an international network of operations. For instance, they can sell the same products in several countries—thus increasing their sales and customer base as well as reducing the per unit cost of production. Subsidiaries can together provide products and services to the international subsidiaries of a global customer. Further, they can shift production among plants in different countries in response to exchange rate fluctuations, thus insulating themselves from extreme movements to which domestic businesses are vulnerable. MNCs can use operations management and technology innovations to devise new applications to enhance their global operations.

While domestic businesses are denied the above stated competitive advantages, they are also confronted with severe competition. Often, the competitors for domestic businesses are not foreign firms but small units from within the country. Small-scale enterprises enjoy privileges and incentives from the government. They need not pay taxes, labour laws do not apply to them, are given loans on soft terms, and are even helped in marketing their products. Not satisfied with these, owners of small units resort to unethical means such as not billing sales, stealing electricity, and the like. Small units price their products so low that it becomes highly difficult for large firms to reduce their prices. Take wristwatches, for example. Every second unit in Bangalore is a horological centre assembling watches. Each watch is priced around Rs 50 posing a big threat to HMT and Titan. Similarly, UPSs (Uninterrupted Power Supply) and dry batteries are assembled and priced low by small-scale units.

If small-scale units received encouragement from governments, the large units were hounded and their growth stifled in the name of socialism. Thanks to the liberalisation of economies, the orientation towards socialism has been red signalled and businesses are allowed to do what they think is the best.

OPERATIONS MANAGEMENT AND COMPETITIVE ADVANTAGE

LO 3
Categorise how operations management can be a source of competitive advantage for an international business

Operations management is significant for a firm as the function offers strength to compete successfully in the international market. It is the operations management that has made GE (see opening case) a highly successful firm.

Fisher and Paykel Industries Ltd, has grown from being a small New Zealand-based business in a non-strategic location to a multinational manufacturer and distributor of white goods. The firm has flourished for many reasons. Among them is the ability to focus on meeting customer needs through the development of innovative, indigenous technology instead of licensing technology from offshore. The company is also able to overcome the limitations of economies of scale by introducing flexible and automated manufacturing processes, which enable it to service diverse customer demands promptly and efficiently. In addition, Fisher and Paykel is able to gain a competitive edge by developing an 'active organisation' where all employees contribute to the company's success through the triangle of scientific development, teamwork, and quality focus. The basis for planning and implementing these activities is *operations management*.

Operations management function of an organisation offers to it five benefits as follows:

1. **Cost:** Skill and capability to manufacture at low cost.
2. **Quality:** Capacity to produce to meet specification and expectation and with least slip-up.
3. **Speed:** Capability to produce in response to client requirements. Minimise lead times between receiving and executing an order.

4. **Dependability:** Ability to produce as per the commitments made to clients and consumers.
5. **Flexibility:** Ability to change in response to changing environment as reflected below:
   - Changes in the volumes of production.
   - Changes in time taken to produce.
   - Changes in the product mix.
   - Innovating and introducing new products.

Now these benefits enable an organisation achieve overall objectives as shown in Fig. 17.1.

Operations Benefits	*Corporate Objectives*
• Cost	Low price
• Quality	High quality and wide acceptance in the market.
• Speed	Quick delivery
• Dependability	Reliable servicing of orders and ensuring good feedback.
Flexibility	Frequent-new products

Fig. 17.1 Benefits matching corporate objectives

The other areas of gaining competitive advantage are Total Quality Management (TQM), Business Process Re-engineering (BPRE), shorter new-product lead time, greater flexibility, Business Process Outsourcing (BPO), six sigma and reduced cost of production.

It is no exaggeration to state that production makes a significant contribution to society's well being. The standard of living of people depends on production of goods and services. More the production, higher the standard of living of the people. Alexander Solzhenistyn in his novel *August 14* beautifully sums up the significance of operations management. One of the characteristics in the work is Suyataslav Takintovich Obodovsky, a former anarchist, who maintains the following position; "As for industry, anyone who has created something with his own hands knows that production is neither capitalist nor socialist but one thing only, it is what creates national wealth, the common national basis without which no country can exist".

Having reached the conclusion, Obodovsky went on to say, "Before, I was most concerned with how to distribute everything that other people had created without my help. The best brains and hands in the country should concentrate on doing that, we can safely leave distribution to the second raters. When enough has been built and made, then even if distribution is less than perfect, no one will be left completely without his share".

INTERNATIONAL OPERATIONS MANAGEMENT AND CORPORATE STRATEGY

LO 4
Recognise why international operations management needs to be integrated with corporate strategy

Operations management of an international business needs to be integrated with the firm's corporate strategy. The central role of operations management is to create the potential for achieving superior value for the firm. If operations management takes Rs 100 worth of inputs and brings out product worth Rs 150, it has created considerable value for the firm. However, if it requires Rs 140 worth of inputs to obtain the same output, value creation does take place, but is very little. Therefore, the way in which the firm structures and manages its operations management function both influences and is influenced by strategy.

Infact, the corporate strategy of the firm should set the tone and tenor for planning and implementation of activities relating to operations management. For example, if a firm is pursuing a differentiation strategy, the operations management function must be able to create goods or services that are distinct from those of competitors. This effort may require a greater investment in high quality resources and equipment with cost being a secondary consideration. For a firm following a cost leadership strategy, the operations management function must be able to reduce the costs of creating goods or services to the absolute minimum so that the firm can lower its prices while still earning a reasonable level of profit. Here, major consideration shall be cost and price, quality being relegated to the background.

Therefore, the firm's corporate strategy decides strategies relating to its operations management. Specifically, corporate strategies decide where to source, where to locate operations, logistics management, and other related activities.

STRATEGIC ISSUES INVOLVED IN INTERNATIONAL OPERATIONS MANAGEMENT

LO 5
Assess the various strategic issues involved in international operations management

In operations management, an MNC needs to make decisions on several strategic issues, more important of them being: (see Fig. 17.2)

- International sourcing and vertical integration
- Standardisation of production facilities

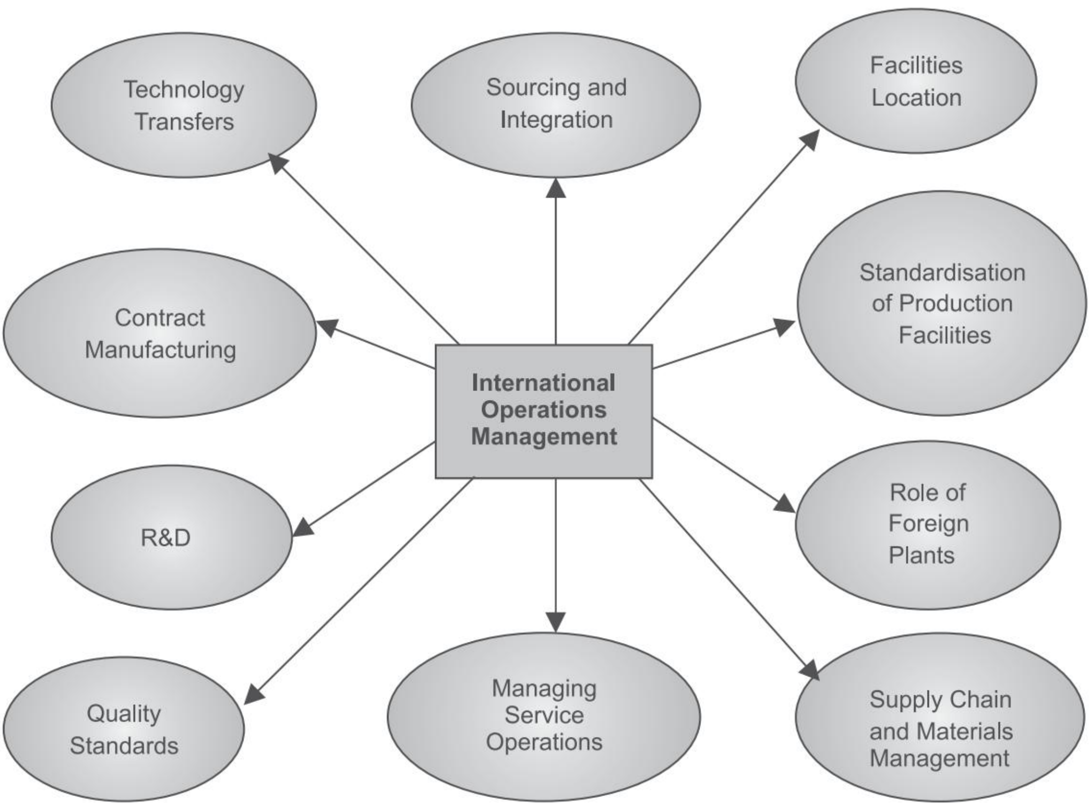


Fig. 17.2 Strategic Issues

- International facilities location
- Contract manufacturing
- Strategic role of foreign plants
- Supply chain management
- Managing service operations
- International quality standards
- Internationalisation of R&D
- Managing technology transfers

Sourcing and Vertical Integration

Sourcing, also called procuring, refers to a series of steps and processes a firm uses to acquire the different components it needs to produce its own goods and services.

The famous *make or buy* decision becomes relevant in this context. An international firm can make, in-house, all its needed parts or may decide to outsource them from suppliers who can provide them more efficiently, regardless of where they are geographically located. Make or buy decisions are important factors in operations strategies. In the automobile industry, for example, the typical car contains more than 10,000 components, so automobile firms frequently face make or buy decisions. Ford of Europe, for example, produces only about 45 per cent of the value of the Fiesta in its own plants. The remaining 55 per cent mainly comprising components, come from independent suppliers. (Also see Exhibit 17.1)

Exhibit 17.1

MAKE OR BUY DECISION AT THE BOEING COMPANY

The Boeing Company is the world's largest manufacturer of commercial jet aircraft with a 55 to 60 per cent share of the global market. Despite its large market share, in recent years Boeing has found the going tough competitively. The company's problem are two-fold. First, Boeing faces very aggressive competition from Europe's Airbus industry. The dogfight between Boeing and Airbus for market share has enabled major airlines to play the two companies off against each other in an attempt to bargain down the price for commercial jet aircraft. Secondly, several of the world's major airlines have gone through some very rough years during the 1990s and many lack the financial resources required to purchase new aircraft. Instead, they are holding onto their used aircraft for much longer than has typically been the case. Thus, while the typical service life of Boeing 737 was once reckoned to be about 15 years, many airlines are now making the aircraft last as long as 25 years. This translates into lower orders for new aircraft. Confronted with this new reality, Boeing has concluded that the only way it can persuade cash-starved airlines to replace their used airlines with new aircraft is if it prices very aggressively.

Thus, Boeing has had to face up to the fact that its ability to raise prices for commercial jet aircraft, which was once quite strong, has now been severely limited. Falling prices might even be the norm. If prices are under pressure, the only way Boeing can continue to make a profit is if it also drives down its cost structure. With this in mind, in the early part of the 1990s, Boeing undertook a companywide review of its make or buy decisions. The objective was to identify activities that could be outsourced to subcontractors, both in the United States and abroad to drive down production costs.

When making these decisions, Boeing applied a number of criteria. First, Boeing looked at the basic economics of the outsourcing decision. The issue here was whether an activity could be performed more cost-effectively by an outside manufacturer or by Boeing. Secondly, Boeing considered the strategic risk associated with outsourcing an activity. Boeing decided that it would not outsource any activity that it deemed to be part of its long-term competitive advantage. For example, the company decided not to outsource the production of wings because it believed that doing so might give away valuable technology to potential competitors. Thirdly, Boeing looked at the operational risk associated with outsourcing an activity. The basic objective was to make sure Boeing did not become too dependent on a single outside supplier for critical components. Boeing's philosophy is to hedge operational risk by purchasing from two or more suppliers. Finally, Boeing considered whether it made sense to outsource certain activities to a supplier in a given country to help secure orders for commercial jet aircraft from that country. This practice known as offsetting is common in many industries. For example, Boeing decided to outsource the production of certain components to China. This decision was influenced by the fact that current forecasts suggest that the Chinese will purchase over $100 billion worth of commercial jets over the next 20 years. Boeing's hope is that pushing some subcontracting work China's way will help it gain a larger share of this market than its global competitor, Airbus.

One of the first decisions to come out of this process was the decision to outsource the production of insulation blankets for 737 and 757 aircraft to suppliers in Mexico. Insulation blankets are wrapped around the inside of the fuselage of an aircraft to keep the interior warm at high altitudes, Boeing has traditionally made these blankets in-house, but it found that it can save $50 million per year by outsourcing production to a Mexican supplier. In total, Boeing reckons that outsourcing cut its cost structure by $500 million per year between 1994 and 1997. By the time the outsourcing is complete the amount of an aircraft that Boeing builds will have been reduced from 52 per cent to 48 per cent.

(*Source*: Charles W L Hill, *International Business*, p. 517)

Make or buy decisions pose many problems for purely domestic business but even more problems for multinational business. These decisions in the international arena are complicated by volatility of countries' political economies, exchange rate movements, changes in relative factor costs, and the like.

Though, deciding on make or buy in practice is highly difficult, theoretically, the issue involves consideration of the pros and cons of the few choices to manufacture in-house or outsourcing the needed components.

The Arguments To Make and To Buy If the international business decides to make all the components in-house, it is having vertical integration. Vertical integration means owning or controlling all the supply sources or the channels through which the firm's products or services are distributed. The former is called backward integration, while the latter is called forward integration.

The justification for integration and the reasons for outsourcing are shown in Fig. 17.3.

Trade-offs are always involved in make or buy decisions. The benefits of manufacturing components in-house seem to be very strong when highly specialised assets are involved, when vertical integration is necessary for protecting proprietary technology, or when firm is simply more efficient than external suppliers at performing a particular activity.

When these conditions are not present, the risks of strategic inflexibility and organisational problems suggest that it may be better to contract out manufacturing components to independent suppliers. Since issues of strategic flexibility and organisational control loom even larger for international businesses than purely domestic ones, an MNC should be particularly wary of vertical integration into component manufacturing.

The make or buy issue does not end with making a choice of either. Assuming that the firm decides to manufacture its components in-house, it has the option of making the parts by itself, or in partnership

	Reasons for Integration (Make)		*Reasons for Outsourcing (Buy)*
1.	Where quality consideration is uppermost, better the firm itself performs the conversion function better	1.	Available capacity to manufacture in-house is inadequate to meet demand
2.	Where demand for an item is high and steady in-house conversion is ideal	2.	The firm does not have expertise to produce a given product
3.	Risks associated with outsourcing force a firm adopt in-house making. Risks include loss of control over quality, possibility of default in execution and the like	3.	Strategic flexibility – switching, orders between suppliers as circumstances warrant
4.	Invest on new facilities to meet demand thus create more jobs	4.	Time and energy can be focused on core competencies and critical areas
		5.	Minimise inventory, materials handling and other non-value added costs
		6.	Possibility of obtaining orders from the countries where suppliers are located

Fig. 17.3 Integration vs Outsourcing

with others. If partnership is the choice, yet another decision is required as to the degree of control the firm wants to exercise. Similarly, when the firm decides to buy rather than to make, there arises the need to choose between long-term and short-term supplier relationships (see Fig. 17.4).

Outsourcing When an international business decides to buy a service or process, it is resorting to what is known as an outsourcing strategy. Outsourcing is the act of moving some of the firm's internal activities and decision responsibility to external service providers. If a B-school, for example, assigns house-keeping of the school to an external contractor, it is outsourcing the work of house-keeping. Complete responsibility for house-keeping—equipment for scrubbing, mowing, washing, dusting—is taken over by the service provider.

The reasons why a company decides to outsource can vary. Outsourcing allows a firm to focus on

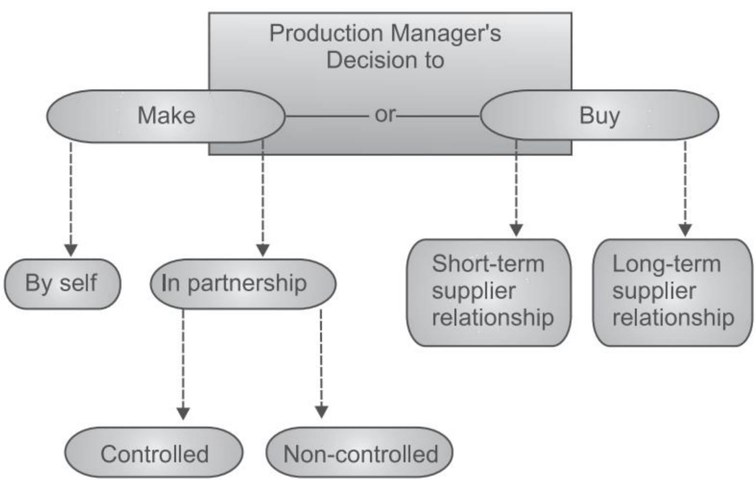


Fig. 17.4 Basic Make or Buy Options

(*Source*: Darrell Mahoney, *International Business*, p. 650) activities that represent its core competencies. Thus, a firm can create a competitive advantage while reducing cost. Outsourcing has its flip side too. There is fear of losing jobs, sensitive information may be lost, there can also be lack of psychological acceptance, questionable quality and ethics of the venders.

An entire function, or some elements of an activity, may be outsourced, with the rest kept in-house. For example, some of the elements of information technology may be strategic, some may be critical, and some may be performed less expensively by a third party. Identifying a function as a potential outsourcing target, and then breaking that function into its components allows decision makers to determine which activities are strategic or critical and should remain in-house and which can be outsourced.

Outsourcing has become extremely popular in the business of computer manufacturing. Components makers (Eg. Intel in microprocessers, Seagate in hard disk drives) supply to big and small manufacturers worldwide. Computer companies buy components from these manufacturers, assemble them in their own factories, and sell complete systems to buyers. A related concept in the computer industry is known as "stealth manufacturing" which calls for outsourcing the actual assembly of the computers themselves, as well as the job of shipping them to distributors and other intermediaries.

Outsourcing is highly visible in the information technology (IT) sector. It has been estimated that worldwide outsourcing of the IT-related activities (activities relating to creation, storing and dissemination of information) was about $50 billion in the mid-1990s, and the figure is growing. The market for IT outsourcing is expected to exceed $200 billion in the year 2015.

Human resource function is another area involved in outsourcing. Potential activities that can be outsourced include payroll, benefits administration, and contract staffing. More than 72 per cent of the Indian companies are outsourcing their HR functions.

Outsourcing has found a new area of application—defence. The US government is increasingly relying on private firms to fight the war in Iraq. It is estimated that civilian contractors are handling 20–30 per cent of essential military support services in Iraq. These civilian contractors are called Private Military Companies (PMCs). The popular PMCs across the world are Dyncorp, Vinnell, Military Professional Resources, and Aecom Govt. Services. The services provided by these PMCs include training, oil field repairs, maintainence of war logistics, food, shelter, medicine, intelligence, security for heads of governments, and the like. Out-sourcing of military services is proving to be less expensive and the only out way for a country like the US where the number of military personnel is too small compared to its international obligations and requirements. In fact, America employs more contract workers in Afghanistan than regular troops.

Outsourcing has transformed international business. Over the past few decades, companies have contracted out everything from mopping the floors to spotting the flaws in their internet security. TPI, a company that specialises in the sector, estimates that $100 bn-worth of new contracts are signed every year. Oxford economics reckons that in Britain, one of the world's most matured economies, 10% of workers toil away in outsourced jobs and companies spend $200 bn every year on outsourcing.

Outsourcing has travelled a long way. Ford's transformation is only one example. When Ford's River Rogue Plant was completed in 1928, it boasted everything it needed to turn raw materials into finished cars: 100,000 workers, 16 m square feet of factory floor, 100 miles of railway track and its own docks and furnaces. Today it is still Ford's largest plant, but only a shadow of its former glory. Most of the parts are made by sub-contractors and merely fitted together by the plant's 6,000 workers. The local steel mill is run by a Russian company, Severstal.

Outsourcing is a sprawling, unseen, unglamorous industry that is hard to define and harder still to measure. Outsourced facilities management firms clean offices, guard premises, feed students, manage heating and lighting, move prisoners from cell to workshop and so on, for customers who prefer to focus on their core activities.

Employing millions, outsourcing firms have combined revenues that some put as high as $1 trillion a year. The market is most established in Europe and North America, though it is on the rise in Asia too. Now the structure of the business is changing, as firms that used to specialise in one sort of outsourced service increasingly aim to be all things to all men, and trip over each other in the process.

Facilities Location

An MNC needs to give priority towards decision relating to location. Location decisions are closely tied to the organisation's corporate strategies. For example, if the strategy is low cost production, then preference needs to be towards a low wage country or near the source of raw materials. Secondly, location decision has strategic relevance in as much as it involves investment on fixed assets in a particular country which might prove difficult to shift should the chosen location prove unsuitable subsequently. Thirdly, a poor choice of location might result in excessive transportation costs, shortage of skilled labour, and shortage of raw materials. All these negatives would rub off the competitive advantage of the organisation. For services, a poor location could result in lack of customers and high operating costs. For both manufacturing and services, location decisions have a significant impact on competitive advantage.

An organisation has at least four location options. *First*, the organisation seeks to expand the existing capacity. Generally, this option does not involve elaborate exercise as additional machinery and equipment are added to the existing ones. But where the present location does not permit expansion, a new location needs to be chosen as did by Maruti Suzuki which decided to locate a new facility in Gujarat. *Second*, the company adds new locations while retaining existing ones, as is done in many retail operations. *Third*, the organisation dismantles the present structure and move on to a new location. This option is a costly one and needs to consider the cost of shifting and compare it with the benefits expected from the new location. *Finally*, companies have the option of doing nothing. If a detailed analysis of potential locations fails to uncover benefits that make one of the previous three alternatives attract, a firm may decide to maintain the status quo, atleast for the time being.

A major decision facing an international firm is where to locate its manufacturing activities. For a company contemplating international production, several sets of factors must be considered: (see Fig. 17.5)

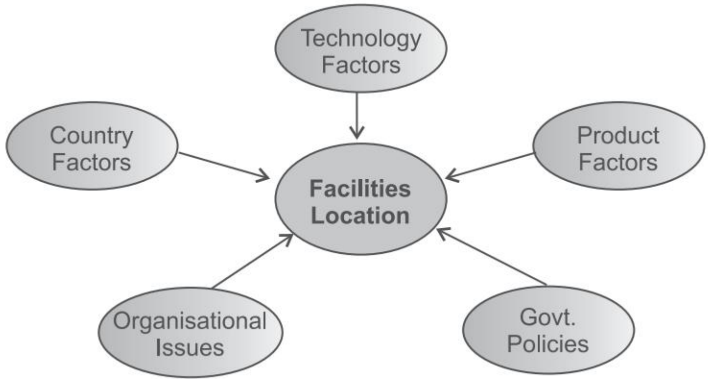


Fig. 17.5 Considerations in Facilities Location

(*Source*: Darrell Mahoney, *International Business,* p. 650)

- Country factors
- Technology factors
- Product factors
- Government policies
- Organisational issues

Country Factors Several features of countries can influence their attraction as sites for locating international facilities. *Resource availability* is one such factor. The availability and cost of resources is a primary factor which determines whether a country is suitable for location or not. As advocated by classical trade theorists (discussed in Chapter 3) countries that enjoy large low cost endowments of a factor of production will attract firms needing that factor of production. The trend now being witnessed is the physical proximity between the customer and suppliers to reduce supplier lead times. This has been facilitated by the just-in-time manufacturing techniques. Because of this trend, US firms are re-considering decisions to locate offshore.

Three causes determined the location of TCS facility in Milford, Ohio, US. One reason is the proximity of Midwestern clients: ten Fortune 500 companies are based in Cincinnati alone. Second is the cost. Milford is one of the cheapest among American main cities and has plenty of land on its fringes. Third is the presence of decent universities nearby. TCS set up shop in Milford not only to be closer to clients, but to begin in earnest to hire American graduates. Most of TCS new coders in Ohio are fresh from the nearby universities of Kentucky, Cincinnati, Purdue, Ohio State and others. The facility has 450 employees, nearly all American, and the number is expected to rise to 1000.

Infrastructure comprising construction materials and equipment, electricity, water, transportation, telephone, medical care, education, housing, entertainment, and other services will also determine the attractiveness of a country as a site for location.

Culture of the land, particularly living circumstances for foreign workers and their dependents, religious holidays and traditions, will have an impact on facility location. Finally, *country-of-origin*, that is brand preferences of local customers should also be considered. Often, an international business needs to counter negative sentiments such as 'not made in this country' or *'Swadeshi'*.

Technological Factors The type of technology a firm uses in its production process can be decisive in location decisions. Technological constraints may render it feasible to perform certain manufacturing activities in only one location and serve the world market from there. Fixed costs of setting up a manufacturing plant are so high that a firm must serve the world market from a single location or from very few locations. For example, it can cost more than $1 billion to set up a plant to manufacture semiconductor chips. In such cases, a single plant makes sense.

Technology may also render it feasible to perform an activity from multiple locations. This is particularly true when fixed costs to set up the facility are low. Multiple locations are advantageous as they permit accommodating demands for local responsiveness. Manufacturing in multiple locations may also help the firm avoid becoming too dependent on one nation.

Product Factors Product related factors may also influence the location decision. Among the more important of these are the product's value to weight ratio and if it is serving universal needs.

Value to weight ratio refers to the share of transportation costs in the total costs. Electronic components and pharmaceuticals have high value to weight ratios; they are expensive but do not weigh much. Even if they are shipped halfway around the world, their transportation costs account for a very small percentage of total costs. Obviously, there is compulsion to manufacture these items at an optimum location and serve the world market from there. Iron ore, cement, coal, bulk chemicals, and agricultural commodities have low value to weight ratio and they tend to be produced in multiple locations to minimise transportation costs.

The second product feature that can influence location decision is whether the product serves *universal needs*—needs that are same all over the world. Such products include calculators and personal computers. Since there are few national differences in consumer tastes and preferences for such products, the need for local responsiveness is reduced. This increases the attractiveness of concentrating manufacturing at an optimal location.

Government Policies Government policies will exercise considerable impact on location decisions. Government related factors include policies on foreign ownership of production facilities, extent of indigenisation, import restrictions, currency restrictions, local product standards, stability issues, labour legislations and the like.

Related to government policies is the emergence of trading blocks. Trade agreements among the countries influence location decisions, both within and outside trading block countries. Firms typically locate, or relocate, within a block to take advantage of new market opportunities or lower total costs afforded by the trading agreement. Other firms (those outside the trading block) decide on locations within the block so as not to be disqualified from competing in the new market. Examples include the location of various Japanese auto manufacturing plants in Europe before 1992 as well as recent moves by many communications and financial services companies into Mexico in a post-NAFTA environment.

Political risk (discussed in Chapter 5) in the host and home countries deserves due consideration while choosing a location. An interesting case is the India–Iran gas pipeline project, which is still hanging because of the potential risk in India's neighbours.

Of late, environmental regulations have become major factor in location decision. Any new project needs clearance from the Ministry of Environment and Forests (MOEF) and the clearance is not coming forward easily. The proposed company needs to first undertake Environment Impact Analysis (EIA), which is aimed to take care of environmental degradation. There are State Pollution Control Boards (SPCBs) which monitor and ensure compliance. Multi-agencies often discourage MNCs from selecting a host country and choosing a location in the said country.

Organisational Issues A firm's business strategy, organisational structure, and inventory management are also determinants of facility location.

A firm's business strategy affects its location decisions in several ways. A firm that adopts a price leadership strategy must seek low cost location, while the one that focuses on product quality should locate facilities in areas that have adequate skilled labour and managerial talent. A firm may choose to concentrate production geographically to better meet organisational goals. Fisher and Paykel does this with its New Zealand production facilities to achieve better control of product design and quality. So is the case with Boeing, which has concentrated its final aircraft assembly operations in the Seattle area to take advantage of the skilled aviation machinist and engineering talent in the area. Several other firms seek to disperse their facilities to different foreign locations in order to meet their strategic goals. Intel has manufacturing plants in the US, Ireland, Puerto Rico, Israel, Malaysia, and the Philippines to take advantage of the relatively low cost resources available in each of those markets. Delphi Corporation's Indian subsidiary has plans to export half-shafts to North America, though the world's biggest and most diversified automotive components and systems vendor has operations in North America itself. The Indian plant of Delphi has adopted the same level of technology and yet has far lower staff costs than an

American plant. Even if the logistics cost and higher transaction costs are factored in, India will be still cheaper as a production centre in the international market by as much as two-digit percentage factor.

Organisational structure of a firm also influences its location decisions. For example, adoption of a global area structure decentralises authority to area managers. These managers, seeking to maintain control over their area, are likely to favour locating factories within their area to produce the goods sold there.

Location decisions are affected by inventory management policies of a firm. Inventory management is a complex area, which all operations managers must confront. They must balance the costs of maintaining inventory against the risks of running out of stock of finished goods. Good inventory management is often the hall mark of well-run organisations.

Facility location affects the level of inventory that firms must hold because of the distances and transit times involved in shipping goods. For example, the Daewoo auto major selected Chennai for locating its facility in India because the city is flush with manufacturers of auto-parts. Compaq Computer has chosen to locate its primary assembly plants in the US, Scotland, Singapore, and Brazil so as to improve service to its North American, European, Asian, and South Asian customers respectively, while minimising overall inventory levels.

Factory location becomes particularly critical when a firm adopts the JIT inventory management system as is done in Toyota. (see Exhibit 17.2 for details)

An MNC does well to proceed by steps while locating a plant. *First*, decide on the host country for possible location. *Second*, having decided on a country, select a region within it. *Third*, identify an area within the chosen region. *Fourth*, shortlist two to three locations out of the area identified earlier. Finally, conduct cost-benefit analysis of each site and zero in on one, which has the potential to offer more benefit than the cost.

Recent Trends One trend observed in recent times is the location of automobile manufacturing plants in the US. The US presents a huge market for cars, trucks, and recreational vehicles. By locating in the US, manufacturers of automobiles can shorten delivery time and reduce delivery costs. Besides, they can avoid any future tariffs that might be applied to imports.

A development that affects location decisions is the creation of the World Trade Organization (WTO). The main objective of this world body is the reduction and elimination of various tariffs. Consequently, location within the borders of a country to escape tariffs is no longer a relevant issue.

Another development is the just-in-time (JIT) manufacturing technique which encourages suppliers and customers to be located near each other to eliminate suppliers' lead time. Particularly in light manufacturing (e.g. electronics), low-cost labour is becoming less important than proximity to markets; users of electronic components want suppliers that are close to their manufacturing facilities. One outcome of this is the possibility that the future will see a trend towards smaller factories located close to markets.

It is likely that advances in information technology will enhance the ability of manufacturing firms to gather, track, and distribute information that link purchasing, marketing, and distribution with design, engineering, and manufacturing. This will reduce the need for these functions to be located close to each other, thereby permitting a strategy of locating production facilities near major markets. GM selected Thailand for its plant because of the proximity to Asian markets, such as Vietnam.

Exhibit 17.2

THE NUTS AND BOLTS OF FACTORIES IN JAPAN

"If American automobile king, Henry Ford I, were alive today, I am positive he would have done what we did with our Toyota production system." —Taiichi Ohno

TOYOTA CITY, Japan—groping to explain "how Japan does it", experts have made much of the close ties between business and government and of the loyalty of Japan's highly skilled workers to their employers. They've noted the fierce competitiveness of Japanese companies in their home market, the nation's high saving rate, even the relative scarcity of lawyers.

Doubtless these are among the pieces needed to solve the puzzle. But some management consultants who've studied how Japan makes such high-quality, competitively priced products, say there's another piece often overlooked. The Japanese, they say, have proved themselves increasingly adroit at organising and running manufacturing operations. Japanese managers may lack the MBAs or the ability to plot big picture business strategy of their American counterparts. But they know how to run factories.

"There's growing acceptance that Japanese success is based, at least in part, on the development of manufacturing techniques that often tend to outrun our own", says management consultant Rex Reid, head of A T Kearney's Toyota's office.

One of the most interesting examples of Japanese production management skills is a concern quite familiar to Americans: Toyota Motor Co, the largest-selling foreign automaker in the US.

Believe in their System

Toyota officials resist claiming that their way of building autos is better than anyone. They're somewhat embarrassed by the exuberant projections of Henry Ford's behaviour essayed by their former chief production executive, Taiichi Ohno, in his 1978 book. But Toyota men clearly remain believers in what Mr Ohno called "The Toyota Production System".

For a first-hand look at the system, take a walk through the Tsutsumi plant here in Toyota city, a town of 280,000 in central Japan that's the site of 8 of Toyota's 10 factories. Over here, Muneo Nakahara, 26 years old and an 8-year Toyota veteran, is doing his job. With the help of an overhead crane that Mr Nakahara controls from a hand-held device, he hoists auto engines onto a conveyor belt that will take them to be matched up with auto bodies.

Mr Nakahara is lifting the engines onto the conveyor from a small flat-bed truck that has brought them from the engine plant. Only two trucks carrying just 12 engines apiece park at Mr Nakahara's post at any given time, so every few minutes an empty truck back to the engine plant and a new one takes its place.

That's the first feature of the Toyota system: no inventories. Toyota's factories keep on hand only that amount of parts needed for immediate production from a few minutes worth up to a few hours' worth, depending on the part. When fresh parts are needed and only when they're needed—they're delivered from other Toyota plants or from outside suppliers directly to the production line.

Outsiders who've seen Toyota in action often call this the "Kanban system," Kanban being the Japanese word for the piece of paper enclosed in clear plastic that accompanies each bin of parts. (When a worker on the line begins drawing from a new bin, he removes the kanban and routes it back to the suppliers, for whom it serves as an order for a new bin of parts.) But Toyota officials say the pieces of paper are just tools. They call this inventory control aspects of their broader system the "just-in-time" system.

The same philosophy guides the meshing of operations within each plant. An assembly line that is building subcomponents makes just that number of subcomponents immediately needed at the next stage of production. When it's made enough, it's changed over to build some other kind of subcomponent for a while. Likewise, the final assembly line first builds one kind of car, then another, in small lots only as much as called for in actual orders from Toyota's sales unit. Toyota engineers "average" and "level" production among the lines to coordinate output without building inventories. They compare auto assembly to rowing a boat: everybody has to be pulling on the oars at the same rate. "They concentrate very heavily on avoiding end-item and intermediate-item storage," says a Ford official in Detroit who's seen the system at work. "They throw out the whole concept of mass production".

The benefits are substantial. Toyota doesn't need space for inventory, people to handle and control inventory, or borrowed money to finance inventory. "It cuts costs in a lot of ways", says an official of Nissan Motor Co, Japan's second-largest automaker, which has adopted an inventory control system similar to its rivals in some plants.

Then there are the side benefits. Because Toyota is constantly changing over its machines to make new things, its workers have become fast at repair and changeover. In his book, Mr Ohno cites a mold on a press that took two to three hours to change in the 1940s. Today "it takes only three minutes to change the mold", Mr Ohno says.

Aside from its emphasis on holding down inventories, Toyota's system stresses quality controls. Throughout the Tsutsumi plant are boards with electrical lights to indicate conditions on each assembly line. A red light means a line has been stopped because of a problem. Every worker has a button or cord with which he can stop the line, and he's told to use it whenever he thinks something's wrong with the operation of the line or when he spots defects in the product.

"We lose production temporarily this way", concedes Fujio Cho, manager of the production control department at Toyota's headquarters, "but in our experience stopping lines helps us detect problems early and avoid bad practices".

Another feature that becomes clear is the company's penchant for training workers to do more than one job. The man who runs one machine switches off every few moments to run another. The man who feeds rear windows to a robot also "tags" car shells with instructions telling workers farther down the line what to install in them. This versatility allows Toyota to realign its workforce more efficiently when business is bad.

Indeed, "recession" thinking underlies a big part of Toyota's system. Much of the system originated in the late 1940s and early 1950s, when Toyota was producing exclusively for a domestic market that wasn't very strong. The company has been operating on the conventional assumption that it's most efficient to produce in large lots, "but that kind of thinking has pushed us close to bankruptcy, because, the large lots we were producing couldn't be sold," says Mr Cho. Toyota couldn't lay off workers due to Japan's "life-time" employment system. Toyota executives hit upon the simple yet radical idea that still pervades its operations: over-production is a waste.

Special Relationship

It is, of course, open to question whether Toyota's (system) is the best way to make cars, and Toyota officials themselves doubt whether other automakers could adopt it readily. They note, among the other problems, that it takes a special kind of relationship with suppliers to make the system work.

Out of Toyota's 250 suppliers, 50 are headquartered in Toyota city, and almost all have plants here. They have to be close to make all those deliveries every day. It still shocks Toyota officials to be told that American automakers buy parts from suppliers all over the United States and even from suppliers in Europe and Japan. Toyota's most distant supplier is a five-hour drive away.

Then, too suppliers must have close working relations with Toyota to adjust to Toyota's peculiar needs. It isn't surprising that many of Toyota's suppliers do all or most of their business with Toyota, and that Toyota owns large blocks of the stock of some of its most important suppliers.

Many suppliers, even those Toyota doesn't own, have adopted Toyota's production system for their own operations. It improves coordination with Toyota and helps them avoid getting stuck with the inventory buildup that Toyota refuses to get stuck with.

The point isn't whether Toyota's system is best. The point is that it's very good and that Toyota is in many ways typical of Japanese manufacturers in its continual striving to improve production techniques. When experts talk about the competitiveness of Japanese products in international markets, that's something that shouldn't be forgotten.

(*Source*: William J Stevenson, *Production and Operations Management*, McGraw-Hill,1999, pp. 658–660)

Standardisation of Production Facilities

International businesses often use the same production methods, degree of capital invested, plant layout, and control systems in all their operations across the globe. Stated differently, there is absence of variety in a product, service or process. Standardised products are being manufactured in large quantities, for instance mobile phones, calculators and computers.

Standardisation offers advantages to international business but carries certain defects too. The advantages include:

- Inter-changeability of components across plants and the ability to shift production between countries easily and quickly.
- Less need for production planning and control.
- Simplicity in comparison of the performances of production units in various countries.
- Less worldwide stockholdings and more efficient inventory management across plants.
- Easy transfer of technology among plants.
- Reduced training costs and time.
- More routine purchasing, handling, and inspection procedures.
- Orders filled easily from inventory.
- Opportunities for long production runs and automation.
- Easy establishments of new plants as the employees have already acquired expertise in erecting equipment and machinery.

The disadvantages from standardisation include:

- Designs may be frozen with too many imperfections remaining.
- High costs of design changes increase resistance to improvements.
- International businesses need to customise products to meet local needs, rendering standardisation less acceptable.

Standardisation is becoming impracticable, as the experience of Ford India shows. In the 100 years of Ford's manufacturing history, petrol and diesel engines were never made on the same production line. This was changed in 2008 when a new plant was set up at Chennai. A flexible plant that would help switch to either power train depending on the demand was set up. In Feb. 2011, Ford India's ratio of petrol cars manufactured to diesel was 70:30. But by Nov. 2011, this ratio was reversed.

Next, Ford india brought flexibility to assembly line. Traditionally, at Ford's US facility, each assembly line produced a single product, but the need to keep costs low called for a departure in the Chennai plant. It began testing and deploying sensors and robots that could do part of the job of identifying models, and then welding or assembling them accordingly on the same assembly line. The Chennai plant is now capable of handling six models of cars at any given time.

Contract Manufacturing

Contract manufacturing refers to an arrangement wherein an international business places orders with local manufacturers for the production of goods which it then sells locally or exports to other foreign markets. When Coca-Cola staged a comeback to India in the early 1990s, it chose local bottling plants to bottle its cola. Local manufacturing can be dovetailed to the needs of local distribution arrangements and several cost savings benefits may be availed of. Other advantages of contract manufacturing include:

1. Avoidance of FDI
2. Easy exploitation of foreign markets with less investments
3. Home-grown image can be attached to the goods

There are problems, however, associated with contract manufacturing. There are difficulties in monitoring and maintaining quality standards, protecting proprietory intellectual property, betraying own weaknesses—unable to set up own facilities in foreign markets, and clash of management styles, as it happened between Coca-Cola and the bottling plants of Chauhan.

Strategic Role of Foreign Plants

The strategic issue relevant in this context is whether to treat an overseas plant as a low cost production centre or a centre of excellence that can handle design, development, and assembly operations.

Initially, overseas locations are selected for locating international facilities to take advantage of low cost labour. The strategic role typically is to produce labour intensive products at as low cost as possible. It was precisely for this reason that many US firms in the computer and telecommunications equipment business established factories in Malaysia, Thailand, and Singapore. These countries offered an attractive combination of low labour costs, adequate infrastructure, and favourable tax and trade regulations. Initially, the components manufactured by these factories were designed elsewhere and the final products would be assembled somewhere. As years went by, however, the strategic role of some of these factories has expanded; they have become important centres for the design and final assembly of products for the global market place. Hewlett-Packard's operations in Singapore typify this trend. Originally established as a low-cost location for the production of circuit boards, the facility has become the centre for the design and final assembly of portable ink-jet printers for the world market.

Striking examples in this context are India and Brazil. India has emerged as the R&D destination for several MNCs. The R&D operating cost of MNCs has declined steadily over the last two years. According to a study by Zinnov, a consultancy firm, MNCs saved $14 bn in 2009 by off-shoring R&D to India.

Brazil is intent on positioning itself as the country of the future, based on its innovation investments. The flex-fuel engines developed in Brazil allow vehicles to run on an ethnol-gasoline mixture. As a result, it attracts millions of dollars of R&D investments from global oil and gas giants such as Shell and Exxon Mobil.

The main reason for the growing status of a foreign factory is the abundance of advanced factors of production in the nation in which the facility is located. Many nations that were considered economically backwards a generation ago have been experiencing rapid economic development during the 1980s and 1990s. Africa is typical of such an economic transformation. Once labelled as "The hopeless continent", Africa is emerging as a land of hopes and opportunities. From Ghana in the West, Mozambique in the South, Africa's economies are consistently growing faster than those of almost any other region of the world. Atleast a dozen countries have expanded by more than 6.1% a year for six or more years.

Ethiopia grew by 7.5% (2011) and once a byword for famine, it is now the world's tenth-largest producer of livestock. Their communications and transportation facilities and the education level of the people 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.

For the manager of an international business, the important point to remember is that knowledge does not reside just in a firm's domestic operations; it may be found in its foreign subsidiaries so that foreign factories can improve their capabilities overtime, and this can be of immense strategic advantage to the firm. Rather than viewing foreign factories simply as sweatshops where unskilled labour churns out low cost goods, managers need to view them as potential centres of excellence and to encourage and foster attempts by their local managers to upgrade the capabilities of their factories and thereby enhance their strategic standing within the corporation.

Supply Chain Management

A supply chain is the sequence of organisations – their facilities, functions, and activities – that are involved in producing and delivering a product or service. The sequence begins with the basic suppliers of raw materials and extends all the way to the final customer. Facilities include warehouses, factories, processing and distribution centres, retail outlets, transport agencies, and offices. Supply chain even includes flow of information and cash back and forth. Figure 17.6(a) illustrates a typical supply chain for a manufacturing company and Fig. 17.6(b) illustrates a typical supply chain for a service provider. In both cases, some storage of shipments from suppliers is involved, though this can be minimal for service operations.

Supply chain management (SCM) refers to the strategic co-ordination of activities within a firm and throughout its supply chain for the purpose of integrating supply and demand management. Supply chain managers are people at various levels in the firm who are responsible for managing supply and demand both within and across organisations. They are involved in planning and co-ordinating activities that include sourcing and procurement of materials and services, transportation services and logistics.

Typical activities included in the SCM are: forecasting, purchasing, inventory management, information management, quality assurance, scheduling, production, distribution, delivery, customer service, and cash handling.

Supply chain management offers competitive advantage to manufacturers but the firms need to configure their supply chain operations effectively. Dell Computers, for example, skips the distribution and retail steps typical of a manufacturer's supply chain. Dell takes order for its computers from customers over the Internet and manufactures according to the orders. The computers are never sent to distribution centers and are never displayed in a retail store. Customers are able to get latest models at competitive prices in only five to six days due to this approach. Cadbury's experience is worth recollecting. The confectionery maker had a rehaul of its supply chain. Consequently, the company's write-offs (of stale and unsalable products) dropped by as much as 70%, translating into considerable cost savings. The rehaul also helped Cadbury replenish stock at a faster rate and the waiting time for distributors to secure supplies also came down heavily. For all those, Cadbury was awarded the FMCG Manufacturing Supply Chain Excellence Trophy at the Express Logistics and Supply Chain Conclave held in 2010. Essar Steel switched onto a consolidated supply chain function three years before. All the plants were earlier working at optimum capacity internally, but now with a complete production overview and demand and production running in sync, production is optimised across

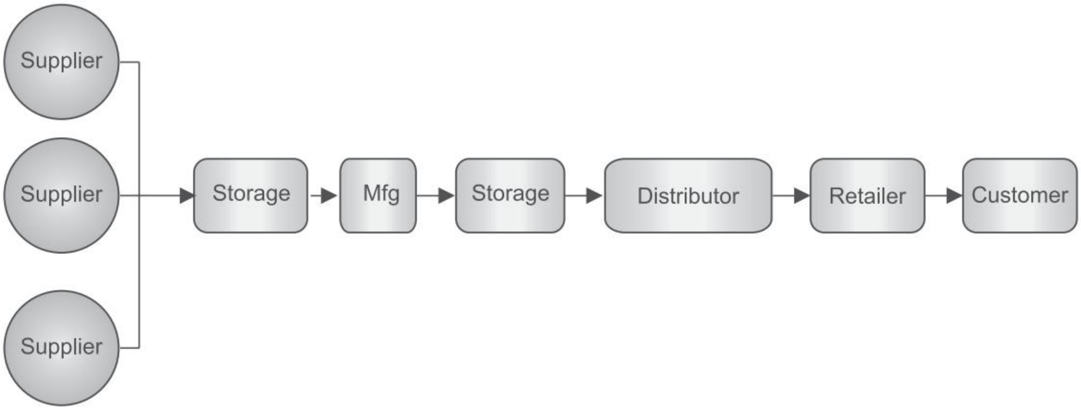


Fig. 17.6(a) Supply Chain for a Manufacturer

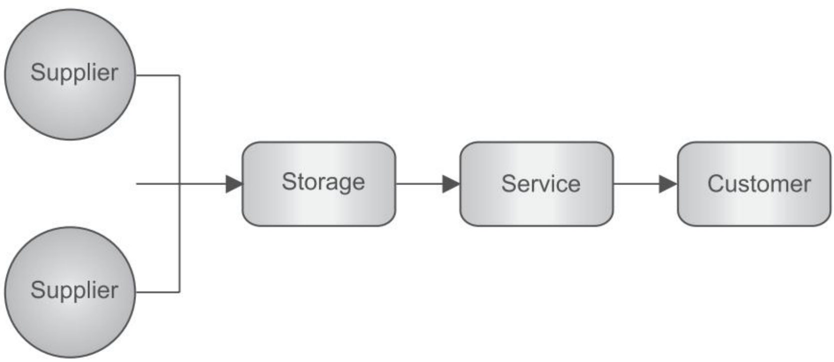


Fig. 17.6(b) Supply Chain for a Service Provider

(*Source*: William J. Stevenson, p. 694)

multiple locations. Pepsi managed supply chain extending up to farmers who supply tomatoes to the soft drink major. The company established direct link with the farmers. It also provides farmers seeds developed in its own labs, as also pesticides and other relevant information. Farmers are guaranteed certain prices for potatoes, season, non-season, glut or scarcity. Dabur manages 800 SKUs (Stock Keeping Units) produced at 22 locations and service 15 lakh outlets. The company brought in multiple software solutions to seamlessly integrate production planning and logistics. Each Maruti car needs over 7,000 components and these are supplied by 250 local vendors and 20 global suppliers. All the local vendors were relocated so that they would be within 100 km radius of its factories, effectively shortening the pipeline. Given the magnitude of managing so many vendors, Maruti insists on a full supply system from Tier-1 vendors instead of each component being supplied independently. The configuration of the supply chain of Airbus, in the manufacture of A380, is typical. (Exhibit 17.3 gives details of the supply chain.)

Another typical example of supply chain configuration is that of Li & Fung, as told in the closing case at the end of this chapter.

Logistics is a term used along with the SCM. Logistics is also called materials management. Materials management is in-bound logistics or the movement and management of materials and products from

Exhibit 17.3

A 380–MEGA PLANE

Airbus is placing heavy bet on new technology. The company, for the first time, has created a complete digital mock-up of the aircraft, incorporating the work of some 11,000 engineers and giving managers a powerful tool to track the plane's development. Engineering specifications from the digital mock-up are downloaded directly to production equipment, saving time and reducing errors.

The company is building major components of the A380 in four countries—wings are manufactured in Britain, tails in Spain, and fuselages in France and Germany. The parts are loaded on to bulbous freighter planes and brought to Toulouse for assembly. But the A380 parts are too big to fit in any freighter plane. So Airbus has developed a plan that requires building an ocean-going ferry and specially designed river barges. From the barges, the components will be loaded on to huge trucks. They will travel on a highway that Airbus had to widen to accommodate the oversize loads. The trucks will travel only at night when the road is closed for other traffic. The trip will take three days, so they had to build big roadside parking lots where trucks will sit during the day.

purchasing through production. Next section carries more details on materials management. The main difference between SCM and logistics is that logistics focuses more on the transportation and storage of materials and finished goods, whereas SCM extends beyond that to include the management of supplier and customer relations.

Key activity in logistics management is the decision relating to the efficient movement of goods from plants to customers. Major trade-offs involved are cost of transporting the product, speed of delivery and flexibility. There are six widely recognised modes of transportation: high ways (trucks), water (ships), air (aircraft), rail (trains), pipelines and hand delivery. Each mode has pluses and minuses as shown in Fig. 17.7.

Every firm is an actor at least in one supply chain, and many are part of multiple supply chains. Often the number and type of organisations involved in a supply chain are determined by whether the supply chain is manufacturing or service oriented as Fig. 17.6 shows.

Yet another term that goes with the supply chain is the *value chain*. Value chain refers to the value that is added to the goods and services progressed through the chain. Supply or value chains are typically comprised of separate organisations, rather than a single firm. Besides, the supply or value chain comprises two components for each organisation: a supply component and a demand component. The former starts at the beginning of the chain and ends with the internal operations of the firm. The latter start at the point where the firm's output is delivered to its immediate customer and ends with the final customer in the chain. In other words, demand chain refers to the sale and distribution in the value chain. All organisations must deal with both the components.

Materials Management

Managers of international business need to address two issues relating to materials management:

- Flow of materials, parts, and supplies from suppliers to the firm;
- Flow of materials, parts, and supplies within and between units of the firm itself.

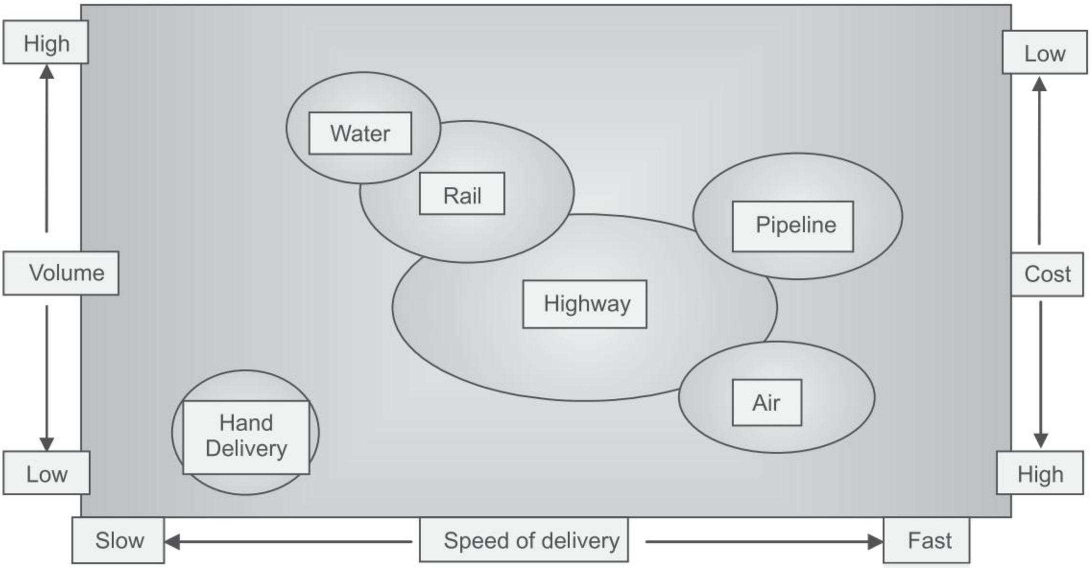


Fig. 17.7 Logistic-System Design Matrix: Framework Describing Logistics Process

(*Source:* Richard B. Chase, et al., *Operations and Supply Management*, TMH, 2011, p. 451)

Three factors differentiate domestic and international materials management functions. First is simply the *distance* involved in shipment. Because of the long haul of materials, manufacturing components in some facilities and final assembly in some others make sense. Second point of difference is the sheer number of *transport modes* that are likely to be involved in shipping materials from one end to another. Shipments within the same country often use only a single mode of transport, such as truck, or rail. But shipments that cross national boundaries, and especially those travelling great distances, almost certainly involve multiple modes of transport. Third, the *regulatory context* for international materials management is much more complex than for domestic materials management. Most countries regulate many aspects of their internal transport systems such as price, safety, and packaging. Shipments that cross through several countries are subject to the regulations of each of these countries.

For an international business, having factories in several foreign locations, managing materials is a massive task. Managing the costs associated with purchasing, currency exchange, inbound and outbound transportation, production, inventory, communication, expediting, tariffs and duties, and overall administration indeed is formidable. Figure 17.8 shows the linkages that might exist for a firm that sources, manufactures, and sells internationally. Each linkage represents a flow of materials, capital, information, decisions, and people.

Seemingly innocuous issues connected with materials management often become more complex in the international context. Take packaging for example. Packaging protects the goods in transit, enables easy handling of goods, and facilitates delivery of finished goods at their final destination. However, international shipping complicates packaging decisions because of the use of multiple modes of transport as well as the variation in conditions that will be encountered.

The weight of the packaging is also a significant consideration, especially for finished goods en route to their customers. Weight often determines the amount of import duty, so firms frequently repackage

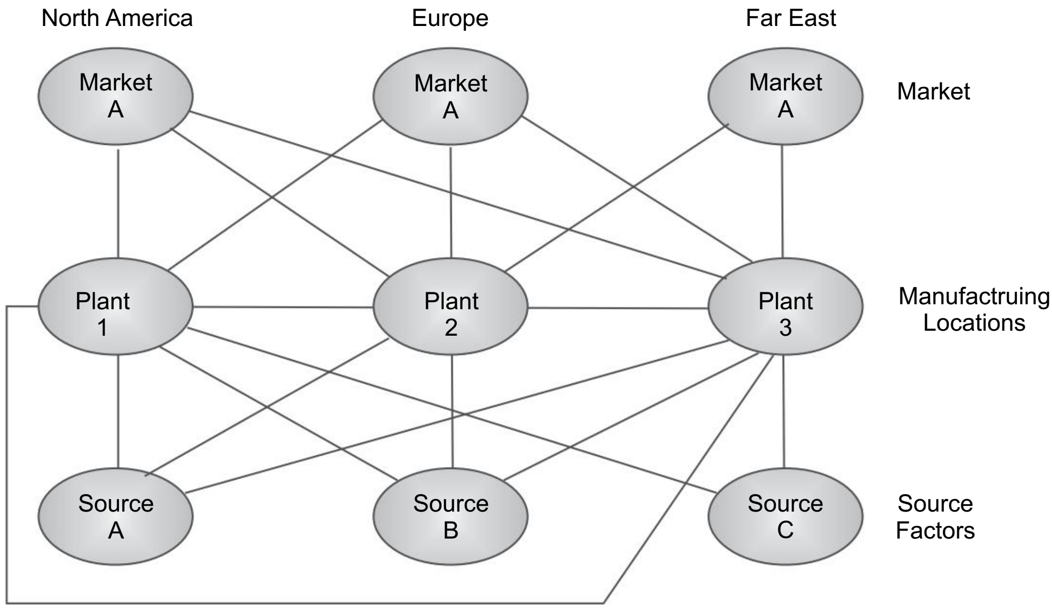


Fig. 17.8 Potential Materials Management Linkages

(*Source*: Charles W L Hill, *op.cit*, p. 522)

goods after shipment. Sometimes, customers even go so far as to specify precise total weights they will accept, including packaging, and may require that packaging meets certain specifications.

Managing Service Operations

The service sector, also called the tertiary sector, is becoming increasingly important in the developed countries, and the trend is visible in developing countries too. The service sector accounts for approximately 60 per cent of Australian GDP. In India, the share of tertiary sector in GDP in 44 per cent and agricultural sector accounts for 25 per cent and the rest is contributed by the industrial sector. It is therefore, not surprising that the services are becoming an integral part of international trade and of the global economy.

An *international services business* is a firm that transforms resources into an intangible output that creates utility for its customers. Examples of international services are British Airways' transportation of passengers from London to India, Ernst and Young's assistance with the accounting and auditing functions of a global enterprise, and Daiichi Kargyo Bank's handling of international corporate business accounts.

Managing international service operations involves a number of basic issues. Deciding how many customers the firm will be able to serve at a time is typically called *capacity planning*. Capacity planning is crucial in service providing as purchasing of any service involves close customer participation. As with manufacturing of tangible goods, *location planning* is important for international service operations. By the very nature, any service provider must be close to customers, except in information providing where data can be transmitted through electronic communication over long distances. International service *facilities design and layout* must also be carefully managed so that the proper look and 'feel' are established. Further, international service providers must manage their *operations scheduling* to best meet the customer's needs. For example, any airline transporting passengers schedules its departure and arrival timings to suit the convenience of passengers. Finally, the international service provider should learn to live with the *intervention of government*. Many governments seek to protect local firms and to ensure that domestic standard and credentials are upheld. Governments seek to restrict the entry of banks, insurance, telecommunications and power companies into local markets. Where allowed, they are subject to local restrictions imposed by the government of the land.

International Quality Standards

Quality refers to the ability of a product or service to consistently meet customer requirements or expectations. Quality dimensions of a product are different from those of a unit of service. For a product quality means:

- Performance
- Aesthetics
- Special features
- Conformance
- Reliability
- Durability
- Perceived quality
- Serviceability

Quality dimensions of a unit of service include:

- Convenience
- Reliability
- Responsiveness
- Timely
- Assurance
- Courtesy
- Tangibles (appearance of facilities that provide service)

Organisations that maintain consistent quality are offered awards of international repute. Balridge Award, European Quality Award, and Deming Prize are prominent international awards. In India, we have the Award for Business Excellence instituted by CII and Exim Bank.

Total Quality Management (TQM) When one talks about quality, TQM must be referred to. TQM refers to a quest for quality in an organisation. Three dimensions are unique to TQM. First is the never ending push to improve, popularly known as continuous improvement; second is the involvement of everybody in the organisation; and the third is the goal of customer satisfaction.

Being a Japanese concept, TQM has takers all around the world. Successful TQM programmes are built through the dedication and combined efforts of everyone in the organisation. Top management must be committed and involved. Else, TQM becomes a fad and tends to fade away.

TQM seeks to break down communication barriers among employees and also between the organisation and its external stakeholders in order to increase cross-functional integration and provide new avenues for co-operation to improve quality. A TQM organisation strives to develop co-operative relationships with its suppliers and distributors so that continuous improvement of quality becomes their goals too. Ford, Motorola, and GM have taken steps to develop long-term relationships with their suppliers and distributors.

Six Sigma Six Sigma refers to the philosophy and methods that help eliminate defects in products and processes. Statistically, six sigma means having not more than 3.4 defects per million opportunities in any process, product or service. It is based on the application of certain tools and techniques to selected projects to achieve excellent results. Being a part of TQM, six sigma programmes have become a key to improve quality, save time, and cut costs. It can be applied in design, production, service, inventory management, and delivery.

Motorola pioneered the concept of six sigma programme during the 1980s. Since then, many other companies have developed their own six sigma programmes, including GE, TI, and Allied Signal.

When anyone talks about quality, he or she should refer to the excellence in quality reached by, not a corporate entity, but by Mumbai *Dabbawallahs*. What *dabbawallahs* have achieved is more than six sigma approaches. *Dabbawallahs* collect, transport, and distribute home-cooked food in tiffin boxes from homes to workplaces and bring back the empty containers in the afternoon. In 1998, *Forbes* Global Magazine ranked excellence achieved by *Dabbawallahs* at an accuracy ranging at 99.999999. It noted, "Mumbai's 'tiffinwallahs' have achieved a level of serve to which Western businesses can only aspire".

Quality Certification Many international businesses recognise the benefits of quality certification. The International Organisation for Standardisation (ISO) has the task of promoting worldwide standards for the improvement of quality, productivity, and operating efficiency through a series of standards and guidelines. Widely used by organisations of all types, the standards offer significant benefits to ensure quality.

The major international standards are ISO 9000 and ISO 14000 (both developed by the ISO). ISO 9000 pertains to quality management and ISO 14000 is primarily concerned with environmental management. Both ISO 9000 and ISO 14000 relate to a company's processes rather than its products and services and both underline continuous improvement.

The ISO 9000 standards are critical for MNCs to enter dealings with their counterparts elsewhere, particularly European firms. The MNCs go through a process that involves documenting quality procedures and on-site assessment, which may spread over 12 to 18 months. With certification comes registration in an ISO directory that companies sourcing suppliers can refer to for a list of ISO certified companies. Certified firms are generally given preference over non-registered ones. More than 40,000 companies are registered all over the world, three-fourths of them are located in Europe.

ISO 9000 standards were revised in 2000 and are now organised into three major categories: ISO 9000:2000, ISO 9001:2000, and ISO 9004:2000. The standards are based on eight quality management principles that are defined in the ISO 9000:2000 document. Those principles include (1) customer focus, (2) leadership, (3) involvement of people, (4) process approach, (5) system approach to management, (6) continuous improvement, (7) data-based decision making, and (8) mutually beneficial supplier relationships. The ISO 9001:2000 document contains detailed requirements for meeting the standards. ISO 9004:2000 describes standard tools that are used for improving quality in the firm.

The standards for ISO 14000 certification provide for three major areas:

Management Systems—systems development and integration of environmental responsibilities into business planning.

Operations – consumption of natural resources and energy.

Environmental Systems—measuring, assuring, and managing emissions, effluents, and other waste streams.

Internationalisation of R&D

Research and development (R&D) refers to organised efforts that are directed towards increasing scientific knowledge and product (or process) innovation. Most of the advances in semiconductors, communications, medicine, and space technology can be attributed to R&D efforts at colleges and universities, research foundations, government agencies, and private enterprises.

R&D efforts comprise basic research, applied research, or development.

Basic Research has the objective of enriching knowledge, without any short-term expectation of commercial applications.

Applied Research has the objective of achieving commercial applications.

Development converts the results of applied research into useful commercial applications.

The benefits of successful R&D can be tremendous. Some research leads to patents, with the potential of licensing and royalties. However many discoveries are not patentable, or firms do not wish to divulge details about their ideas through patents. Even then, the first firm to bring a new product or service to the market generally stands to gain, particularly before competition catches up.

The costs of R&D can be very high. Kodak, for example, spends more than $1million a day on R&D. Companies in the automotive, computers, communications, and pharmaceuticals spend even more.

International businesses have several options before them so far as R&D efforts are concerned. MNCs need not invest money any more on R&D. Because their suppliers are doing it for customers—the case of outsourcing R&D, suppliers continuously work to improve the products they make for their customers. Companies that manufacture auto seats for car makers, for example, now build stronger, more durable units so that the seats better withstand wear and tear.

Often, MNCs are pressured by host countries to locate R&D facilities alongside their subsidiaries. This arrangement benefits an MNC in several ways: (i) easy technology transfer from MNC to subsidiary, (ii) customising products and processes to suit local needs (for example, P&G's R&D centre in Kobe, Japan, developed a dish soap formula specially for the Japanese market), (iii) utilisation of local skills and offer of jobs to locals, and (iv) incentives, concessions, and other facilities may be offered by local governments. To take advantage of these benefits, Motorola has set up 14 R&D facilities located in seven countries.

MNCs on their own, prefer to locate R&D facilities in foreign countries. For example, to expose themselves to R&D work being done in Japan, many US firms have set up satellite research centers in Japan. Kodak has its $65 million R&D centre in Japan to concentrate on electronic imaging technology. Similarly TI, IBM, P&G, Pfizer, Dupont, and Monsanto too have their R&D centres in Japan.

The fourth option for an international business is to set up R&D facility in a foreign country through strategic alliance with a local partner. Dupont, for example, has set up recently an R&D facility in India in association with Reliance Industries. The joint R&D will help develop advanced polyester process and product technologies.

Finally, international businesses are establishing a global network of R&D centers. Within this arrangement, fundamental research is undertaken at basic research centers around the globe. These centers are located in regions or cities where basic scientific knowledge is generated and where there is a pool of skilled research talent (e.g., Silicon Valley in the US and Kobe in Japan). These centers focus on basic research.

The ideas generated are then picked up by R&D units attached to global product divisions. The ideas are converted into useful products, customisation to suit local needs being taken care of.

HP is an example to be cited here. The company has four basic research centers located in Palo Alto, California; Bristol, England; Haifa, Israel; and Tokyo, Japan. These laboratories generate new ideas. They are the company's innovation engines. The Palo Alto centre, for example, pioneered HP's thermal ink-jet technology. The ideas are put to commercial use 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 inkjet technology.

Managing Technology Transfers

The final strategic issue in operations management relates to the management of technology transfers. Technology transfer is the transfer of systematic knowledge of the manufacturer of a product, for the application of a process, or for the rendering of a service and does not extend to the mere sale or lease of goods.

Technology transfer from an international business to its foreign plants is a complex, time-consuming, and costly process that is composed of many stages. The process ranges from research and development to product planning and design. It includes training of personnel, quality control, management practices, marketing skills, and service supports. Successful transfer of technology demands cooperation and communication between the transferring and the transferee firms and their respective countries. (Technology transfers were covered in Chapter 9 in greater detail).

Summary

- International operations management refers to the transformation related activities of an MNC. (LO1)
- Capability of an MNC to relocate a plant to take advantage of low cost production and capacity to reap benefits of experience curve make international operations management different from domestic operations management (LO2)
- By emphasising on TQM, BPRE, Jit, BPO and other techniques, operations management lends competitive advantage to an MNC (LO3)
- Corporate objectives of cost, quality dependability and flexibility are vastly met by operations management function of an organisation. (LO4)
- Prominent strategic operations management issues include sourcing vs integration, standardisation vs customisation, facilities location, role of foreign plants, and the like. (LO5)

Review Questions

1. What do you understand by the term operations management? Bring out the similarities and dissimilarities between domestic operations management and international operations management. (LO1 and LO2)
2. How can operations management be integrated with corporate strategy? (LO4)
3. State and explain the strategic issues involved in operations management. (LO5)
4. Why is effective international operations management important for an MNC? (LO3)
5. What factors must a firm consider while addressing the make or buy decision? (LO5)

Discussion Questions

1. What is the relationship between international operations management and logistics management? (LO1)
2. Why are services important? Why is manufacturing important? (LO3)
3. Discuss how an efficient materials management function can help an international business compete more effectively in the global market place. (LO5)
4. Discuss how international businesses decide on location of their facilities. (LO5)
5. What are the advantages and disadvantages of being vertically integrated? (LO5)

Reinforcing Exercises

- India is ranked as the third largest economy in the world next only to the US and China. But a worrying factor for policy makers in India is the declining sheen of industrial sector in the total economy. Contribution of manufacturing to total employment is declining but that of service sector is rising. Not withstanding this trend, industrial sector can not be sidelined. Look at the following:
  - Nearly 50 mn workers are employed in manufacturing sector
  - Industry contributes to 27 percent of GDP
  - Industrial growth stood at 8.2 percent (2010-11) which was higher than the growth rate of the economy
  - More than 80% of exports is accounted for by the manufacturing sector

  Yet noise is made about by Infosys, TCS, Flipkart, WIPRO and HCL pushing behind Tatas, Reliance, Birlas, Bajaj, and Mahindra.

  What are your observations on the above?
- The table given below gives examples of firms and their operations strategies. You need to enlarge the table, collecting names of Indian firms.

Factor	*Operations Strategy*	*Examples of Companies or Services*
Price	Low cost	Wal-Mart
		Southwest Airlines
Quality	Design and high quality	Sony TV
		Lexus
		Disney land
	Consistent quality	Coca-Cola, Pepsi
		Xerox, Motorola
Time	Rapid delivery	McDonald's restaurants
		Express Mail
		Fed-Ex
	On-time delivery	Dominos Pizza
		Fed-Ex
Flexibility	Variety	Burger King
		Toyota
Service	Superior Customer Service	Disneyland
		HP
		IBM
Location	Convenience	Supermarkets, ATMs, Mall stores, Banks, Restaurants

(Source: Adopted from *Operations Management* by William Stevenson, 9th Edn, p.43)

CLOSING CASE 1

LI & Fung on a Roll

Li & Fung has emerged as one of Hong Kong's most famous and successful trading companies, dealing in various types of "high volume time sensitive" consumer goods. Founded about 100 years back, it employs 27000 people worldwide. The company was ranked 8th in Asia and 3rd in Hong Kong in the Asian Management Excellence Survey recently conducted by *Assets* Magazine. The Harvard educated Fung Brothers, Victor and William have been the architects of the company's success and are today leading business personalities in Hong Kong.

Li & Fung was founded in Guangzhou in 1906 by Fung Pak Liu and Li Toming. The company began by exporting porcelain and silk from China. Later, it moved into bamboo, jade, ivory, handicrafts, and fireworks. As the Canton port was shallow, Li & Fung moved to Hong Kong, a better equipped port, in 1937. During World War II, trading operations were suspended. Shortly after the War, the company was bought out by the Fung family.

In the late 1940s, Hong Kong rapidly emerged as a manufacturing base for labour-intensive consumer products. Li & Fung began to export garments, toys, electronic goods, and plastic flowers and quickly emerged as one of Hong Kong's biggest exporters. In 1968, the firm opened an office in Taiwan, its first outside mainland China. In the 1960s and 1970s, Li & Fung diversified into shipping services and property.

Li & Fung's next phase of evolution began with the return, in the early 1970s, of Victor and William, third generation family members from the US.

The two brothers began efforts to modernise and rebuild the company as a professionally managed enterprise. They not only extended Li & Fung's geographical reach but also made coordinated efforts to transform Li & Fung from a sourcing agent to "a manager and deliverer of manufacturing programmes". Li & Fung's shares were listed on the Hong Kong Stock Exchange after a public issue, which was oversubscribed by 113 times. The brothers hoped that this would professionalise the management and free it from family control.

In 1989, Li & Fung became a privately held company after a management buy-out. It was restructured subsequently into two separate businesses, export trading and retail. In 1992, the export trading business was listed on the Hong Kong Stock Exchange.

The 1995 acquisition of Inchcape Buying Services helped Li & Fung not only to double its turnover but also to expand its customer base in Europe. In the late 1990s, Li & Fung expanded its sourcing options by tapping new regions such as the Indian sub-continent, the Carribean, and the Mediterranean basins.

Over the years, Li & Fung executives have been continually looking for new suppliers in different countries. After collecting market information, they identify the most promising vendors and then visit their factories to verify the information furnished by them. After a tie-up has been finalised, Li & Fung educates the supplier on procedures for making bids, placing and accepting orders, ensuring quality control and releasing payment. In many cases, Li & Fung staff work closely with the supplier to improve the manufacturing and quality assurance processes. Monitoring of supplies reduces progressively with the passage of time.

Currently, Li & Fung has a network of 240 offices in 40 countries. The company has access to some 15,000 suppliers and works with as many as 2500 of them at any given time. Li & Fung's product range now includes fashion, accessories, festive products, furnishings, garments, giftware, handicrafts, home products, sporting goods, toys, and travel goods.

Li & Fung should be named first when there is a discussion on supply chain management. It is highly educational to understand the operation of supply chain management in Li & Fung. The company has 500 or so customers and they are a diverse group and include clothing retailers and consumer electronics companies. Li & Fung takes orders from customers and then sifts through its network of 7500 independent suppliers located in 40 countries to find the right manufacturing enterprise to produce the product at low cost and high quality. Attaining this objective requires Li & Fung to break up the value chain and disperse different activities to producers located in different countries depending on an assessment of factors such as labour costs, trade barriers, transportation costs, and the like. Li & Fung then coordinates the whole process, managing the logistics and arranging for the shipment of the finished product to the customer.

Typical of its customers is The Limited, Inc., a large U.S based chain of retail clothing stores. The Limited outsources much of its manufacturing and logistics functions to Li & Fung. The process starts when The Limited comes to Li & Fung with designer sketches of clothes for the next fashion season. Li & Fung takes the basic product concepts and researches the market to find the right kind of yarn, dye, buttons, and so on, then assembles these into prototypes that The Limited can inspect. Once The Limited has settled on a prototype, it will give Li & Fung an order and asks for delivery within five weeks. The short time between an order and requested delivery is necessitated by the rapid rate of product obsolescence in the fashion clothing industry.

With order in hand, Li & Fung distributes the various aspects of the overall manufacturing process to different producers depending on their capabilities and costs. For example, Li & Fung might decide to purchase yarn from a Korean company but have it woven and dyed in Taiwan. So, Li & Fung will arrange for the yarn to be picked up from Korea and shipped to Taiwan. The Japanese might have the best zippers and buttons, but they manufacture them mostly in China. So Li & Fung will go to YKK, a big Japanese zipper manufacturer, and order the right zippers from the company's Chinese plants. Then Li & Fung might decide that due to constraints imposed by export quotas and the labour cost, the best place to make the final garments is in Thailand. So, everything will be shipped to Thailand. In addition, because The Limited, like many retail customers, needs quick delivery, Li & Fung might divide the order across five factories in Thailand. Five weeks after the order has been received, the garments will arrive on the shelves of The Limited, all looking like they came from one factory, with colours perfectly matched. The result is a product that may have a label that says "Made in Thailand," but is a global product.

Unlike many trading companies, which are divided on the basis of geographic regions, Li & Fung is divided into divisions that are focused on a single customer or a group of customers.

Li & Fung's divisions are small, entrepreneurial, and empowered to take all the relevant merchandising divisions that go into coordinating a production programme for a customer. When Li & Fung acquires a large customer, it often creates a separate division to serve the customer. For a smaller customer, an existing division is assigned the responsibility, but usually with a dedicated team.

The divisional system aims to achieve quick compliance with the customer's design, quality, shipping, and invoicing needs.

Li & Fung has made each product group executive responsible for one country, to make him or her sensitive to local needs.

While allowing divisions to operate with a great deal of autonomy, Li & Fung has tightly centralised some functions. A standardised and fully computerised information system allows headquarters to keep track of orders and their execution. Financial controls are stringent, especially in the case of working capital. The Hong Kong headquarters centrally manages cash flows. All letters of credit come to Hong Kong for approval.

Li & Fung's day-to-day activities are handled by product group managers. Together with the top management, they constitute the Policy Committee of 30 people. The committee typically meets every five to six weeks and discusses various important issues such as ethical practices of suppliers and country of origin regulations. The committee not only formulates policies but also prescribes operating procedures to implement them.

Questions

1. In what way has operations management lent competitive advantage to Li & Fung?
2. How effective is Li & Fung's value chain configuration? Ineffective? Discuss.

(*Source:* Charles Hill, *Global Business Today*, TMH, 2011, p. 485 and Parviz *Asheghian and Bahman Ebrahini*, *International Business,* Harper Collins, 1993, p. 294)

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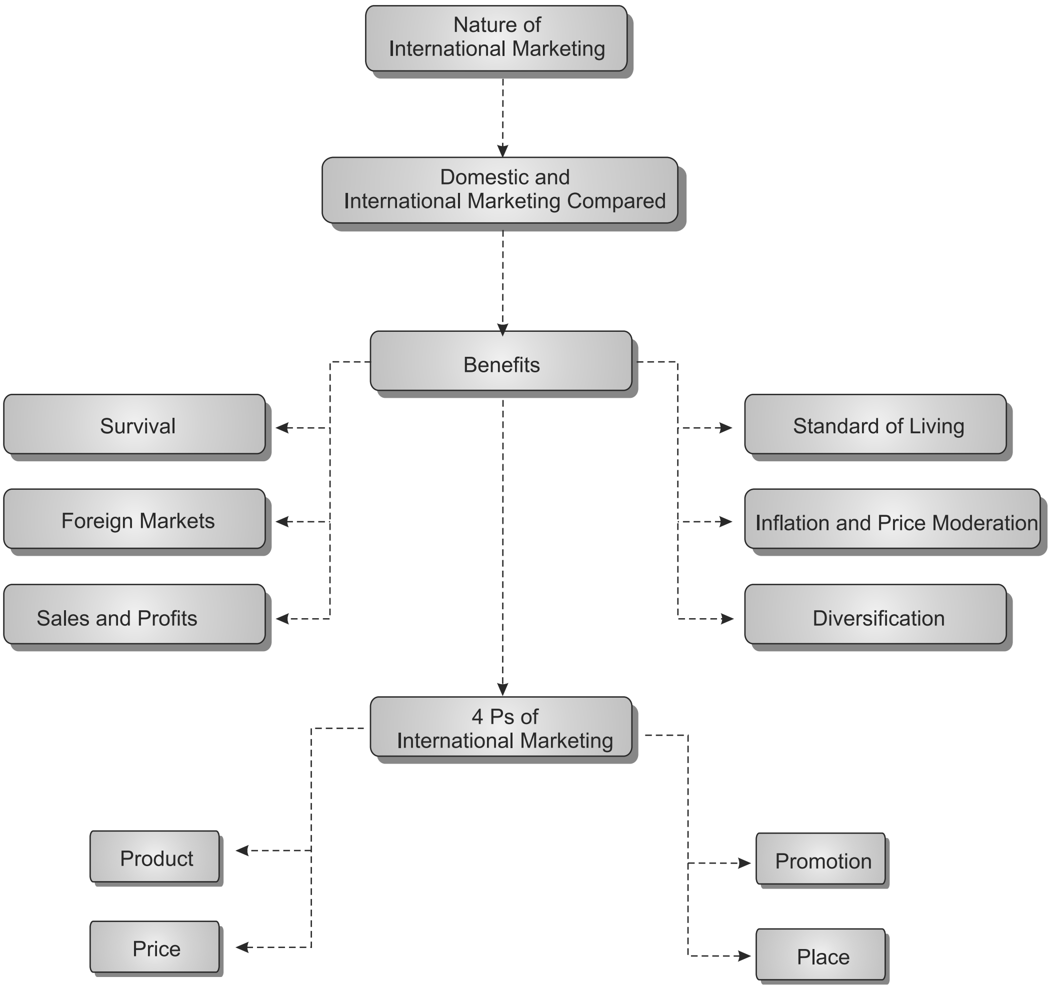
Suggested Readings

Asheghian and Bahman Ebrahini, *International Business*, Harper Collins, 1993.

CHAPTER


Nature of International Marketing
Domestic and International Marketing Compared
Benefits
Survival
Foreign Markets
Sales and Profits
Standard of Living
Inflation and Price Moderation
Diversification
4 Ps of International Marketing
Product
Price
Promotion
Place

18

International Marketing

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Distinguish between domestic and international marketing
- **LO 2:** Recognise the benefits of international marketing
- **LO 3:** List the major activities in international marketing
- **LO 4:** Assess international markets
- **LO 5:** Analyse international product strategies
- **LO 6:** Identify brand decisions
- **LO 7:** Estimate pricing issues and decisions
- **LO 8:** Relate to promotional issues and policies
- **LO 9:** Evaluate distribution issues and decisions

Opening Case

Wal-Mart Courts Global Shoppers

Wal-Mart, the world's largest retailer, has built its success on a strategy of everyday low prices and highly efficient operations, logistics, and information systems that keep the inventory to a minimum and ensure against both over-stocking and no-stocking. The company employs some 1.8 million people, operates 3,900 stores in the U.S and 2,700 across the globe, and generated sales of $345 bn in 2007. Of these sales, some $77 bn were generated in 15 countries outside of the U.S.

In the meanwhile, it is the aggressive marketing strategies followed by Wal-Mart that have made the retail giant as what it is today.

When you are the biggest retailer in your home market, international expansion is the key to continued growth, as Wal-Mart's executives were quick to understand. The company's initial internationalisation efforts in the early 1990s focused on Mexico and Canada. At the end of the decade Wal-Mart turned its sights on a much more lucrative but complex target, Europe. Wal-Mart first entered the United Kingdom by buying the Asda retailing chain, which operates more than 230 stores. The purchase meshed well with Wal-Mart's business strategy because the firms were alike in stressing aggressive growth and low prices. Soon after the acquisition Wal-Mart announced it would build six new Asda outlets, super-size six more, and establish a dozen new facilities to cut distribution costs. Wal-Mart's goal was to expand the breadth of its British operations, allowing it to replicate the efficient, low-cost logistics system that forms the basis of its competitive advantage in the United States.

The new management team also enhanced Asda's competitiveness by cutting prices further, high-lighting selection, and promoting friendly service. Wal-Mart touched off price wars in food products and other categories, sending competitors scrambling to meet or beat its price tags. Because other British retailers are accustomed to higher profit margins, the Wal-Mart formula of low-markup pricing has put pressure on rival chains such as Tesco, Safeway, and Sainsbury and given smaller stores even bigger headaches. So far the strategy seems to be paying off: In 2001 Asda earned about $745 million on sales of $13.5 billion, and raised its share of the British market to 10.5 percent, up from the 8.4 percent share it possessed prior to the Wal-Mart takeover.

Wal-Mart adopted an acquisition strategy to attack the German market as well. It first acquired the 21-store Wertkauf chain and then bought Spar Handels AG and its 74 stores. Wal-Mart hung an American flag outside each store to herald the change in management and symbolise its superior service and selection. Wal-Mart's next step was to initiate a massive renovation project to enlarge and modernise each outlet, with wider aisles, brighter lights, and more accessible shelving loaded with merchandise—all of which were intended to boost sales.

But Wal-Mart ran into some rough spots in its attempts to crack the German market. The company's "Always low prices" policy upset German regulators who feared that price-cutting might force small retailers out of business. The German Cartel Office forced the company to raise its prices on loss leaders like flour, cooking oil, and butter, which it had been selling below cost. Wal-Mart never really came to understand the psyche of the typical German shopper, and it woefully underestimated the ferocity of its primary German competitors, Aldi and Lidi. Moreover, the company did not carry on its aggressive expansion plans, instead choosing to be cautious and grow slowly. This approach, though, kept it from reaching critical mass and achieving the economies of scale that would allow it to become profitable.

There were other problems too. The first CEO, Ron Tiarks, was a U.S. citizen who had previously supervised 200 U.S. stores from the company's headquarters in Bentonville. He brought a number of U.S. managers to work in Germany. Tiarks did not speak German and made no attempt to learn the language. Instead, he decided that English would be the official language in Germany at the senior level. This hubris was not enough for him and so, he reportedly displayed a high degree of ignorance concerning complexities of retailing in Germany, particularly with regard to the different legal and institutional framework in the nation. Nor did he understand how German shopping culture differed from that in the U.S.

Tiarks was replaced by an English man, Allan Leighton. He also spoke no German, and decided to run the German unit from his office in the U.K. Obviously, this too did not work. After six months, a German, Voker Barth, replaced Leighton. Barth and his German successor, Kay Hafner, who took over in 2001, struggled to make the unit profitable, but they were hamstrung by the requirement that they impose the Wal-Mart way of doing things on German stores.

Finally, in mid-2006, Wal-Mart announced that it would cease operations in Germany (the company had also closed its operations in South Korea).

Wal-Mart had a brief honeymoon with Bharti Enterprises, India. Both entered a joint venture agreement in 2007, opened its first retail store at Amritsar in 2009. The marriage was short-lived and broke in 2013. Incidentally, government has now legalised entry of FDI into retail business in India.

Wal-Mart is a strong believer in ethnocentrism. This attitude has made its life difficult in India, South Korea and Germany.

INTERNATIONAL marketing refers to the process of identifying the goods and services that customers outside the home country want and then providing them at the right price and place. Viewed from this perspective, international marketing is almost the same as domestic marketing. But there are differences between the two and it is useful to understand the distinction before we proceed to discuss international marketing mix.

DOMESTIC AND INTERNATIONAL MARKETING COMPARED

LO 1
Distinguish between domestic and international marketing

Environmental factors—controllable and uncontrollable—make international marketing difficult as compared to domestic marketing. Domestic marketing is constrained by both controllable as well as uncontrollable factors, the former comprising price, product and promotion and the latter including economic, legal, political, and competitive forces. The domestic marketing manager must understand each of these controllable and uncontrollable forces objectively and come out with appropriate marketing strategies.

International marketing is much more complex because the marketer faces several uncontrollable forces originating from different countries. A firm's marketing mix needs to be modified to conform to different environments. The varying environments may rule out uniform marketing strategies across countries. McDonald's, although renowned for its American symbols and standardisation, has been flexible overseas. Recognising the importance of foreign markets and local customs, the company customises its menu by region. Infact, it has even excluded beef from its menu in India.

Name any marketing function, the task becomes more complex in international marketing. Take pricing for example. In domestic marketing, price fixation is a complex task. Pricing is more complicated in foreign markets because of additional problems associated with tariffs, dumping laws, inflation, and currency conversion.

Problems arise in international advertising too. Most firms face the problem of language translation while advertising in overseas markets. There are also problems in selecting media in foreign markets. Often, the media used in the domestic market may not be readily available in foreign markets. In domestic marketing, language translation may not pose a problem, except in countries like India, which is known for multilinguism.

Difficulties arise in selecting an agency to prepare and place the firm's advertisements. Along with the growth in multinational corporations, more multinational advertising agencies have also come up. The issue is whether to use a local agency or a multinational agency. A domestic marketing manager is free from these hassles.

BENEFITS OF INTERNATIONAL MARKETING

LO 2
Recognise the benefits of international marketing

Contrary to perceptions that international marketing is adversarial, trade across countries is beneficial to all participating countries. It is desirable to understand the benefits so as to dispose wrong notions prevailing about international marketing. The following points help appreciate the importance of global marketing. (see Fig. 18.1)

Survival

Many countries need to trade across the globe for their survival. Hong Kong, for example, has historically

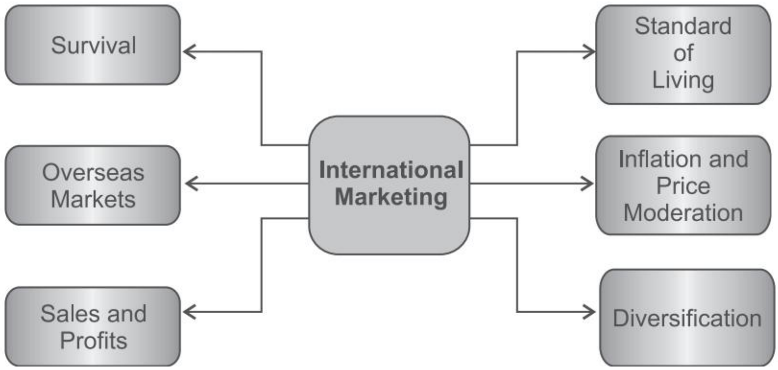


Fig. 18.1 Benefits of International Marketing

underscored this point well, for without food and water from China, the British colony would not have survived long. The countries of Europe have had a similar experience, since most European nations are relatively small in size. Without foreign markets, European firms would not have sufficient economies of scale to allow them to be competitive with the US firms. Nestlé, for example, is forced to depend on foreign markets as its home country, Switzerland, is relatively small in size.

Growth of Overseas Markets

Developing countries are growing into potential markets for international business, particularly Latin America and Asia/Pacific are experiencing considerable economic growth. MNCs cannot afford to ignore the growing markets.

Throughout history, firms have achieved worldwide dominance mainly through forays into overseas markets, notwithstanding their home country markets being small in size. Successful global firms from the Netherlands, a smaller country in Western Europe, have become giants worldwide. Among them are Philips (electronics), Royal Ahold (retail), Royal Dutch/Shell (petrol), and Uniliver (consumer products). Similarly, Japanese firms dominate many industries; among them are Mitsui and Mitsubishi (electronics, banking, import-export), Dentsu (advertising), Sony and Panasonic (electronics), and Ito Yokado (retail).

Sales and Profits

Foreign markets constitute a large share of the total business of many firms that have wisely cultivated markets abroad. As stated in the first chapter in this book, foreign sales constitute a major share of total revenues of many firms. Coca-Cola's foreign sales, for example, account for 80 per cent of its total revenue. No international business can ignore overseas markets.

Diversification

Demand for most products in domestic market is affected by cyclical factors (e.g. recession) and seasonal factors (e.g. climate). These factors are likely to cause a drop in sales often forcing firms to lay off personnel. Foray into overseas markets may help a firm avoid such a possibility. Foreign markets iron out fluctuations by providing outlets for excess production capacity. Cold weather, for instance, may depress soft drink consumption. Yet, not all countries enter the winter season at the same time, and some countries are relatively warm the year-round.

A similar situation pertains to the business cycle. Europe's business cycle often lags behind that of the US. That domestic and foreign sales operate in differing economic cycles works in favour of Ford because overseas operations help even out the business cycles of the North American market.

Inflation and Price Moderation

The benefits of exports are pretty obvious. Even imports can be beneficial to a country. Without imports, there is no force to influence domestic firms to moderate their prices. Absence of imported products compels consumers to buy domestic products at higher prices, resulting in inflation and excessive profits for local firms. This development usually acts as a prelude to workers' demand for higher wages, further exacerbating the problem of inflation.

Standard of Living

Trade affords participating nations and their citizens higher standards of living than is otherwise possible. Without trade, product shortages force people to pay more for less, denying them the purchasing power to buy more. In addition, life in most countries would be much more difficult were it not for many strategic materials that must be imported. Trade also makes it easier for industries to specialise and gain access to raw materials, while at the same time fostering competition and efficiency. A diffusion of innovations across national boundaries is a useful by-product of international trade. Absence of such trade would impede the flow of innovative ideas.

MAJOR ACTIVITIES IN INTERNATIONAL MARKETING

LO 3
List the major activities in international marketing

The major activities in global marketing are: (i) market assessment; (ii) product decisions; (iii) promotion strategies; (iv) pricing decisions; and (v) place or distribution strategies. The latter four areas—product, promotion, price, and place—are often referred to as the four P's of marketing, and they constitute the heart of international marketing efforts. The mix of these four P's is called the marketing mix (see Fig. 18.2).

Generally, an MNC's marketing activities are organised as a separate and self-contained function within the firm. Yet that function both effects, and is affected by, virtually every other organisational activity as shown in Fig. 18.3. If marketing managers of an MNC, for example, intend to promote a particular product on the basis of its high quality, the production and operations managers must be prepared to ensure that quality is indeed high. Further, if the firm's financial controller plans to cut operating budgets across the board, its marketing managers must be prepared to deal with fewer resources in carrying out their tasks. Therefore, international marketing management encompasses an MNC's efforts to ensure that its global marketing activities comply with the firm's corporate strategy, business strategy, and other functional strategies.

INTERNATIONAL MARKET ASSESSMENT

LO 4
Assess international markets

International marketing starts with the identification of markets where goods and services can be profitably sold. Identification of overseas markets should follow the following steps:

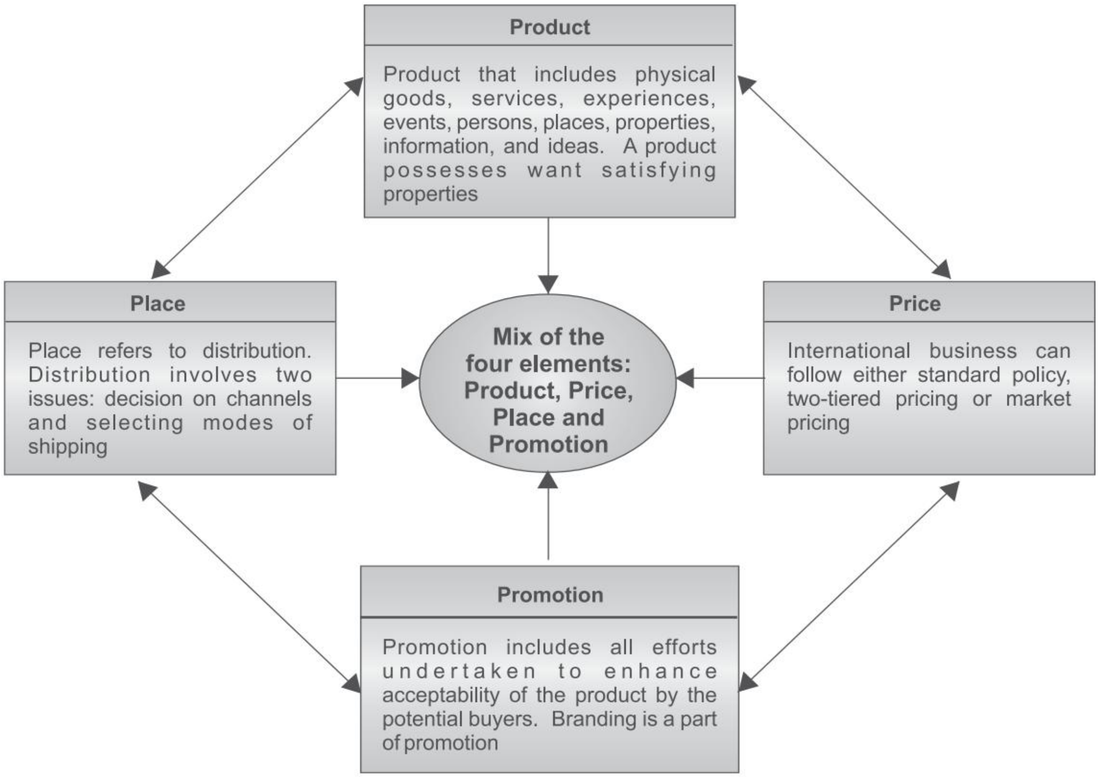


Fig. 18.2 The International Marketing Mix

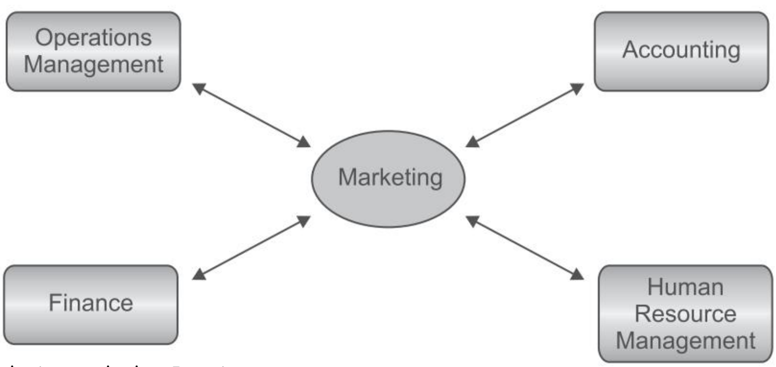


Fig. 18.3 Marketing and other Functions

- Assess alternative foreign markets;
- Evaluate the respective costs, benefits, and risks of entering each market;
- Select those that hold the most potential for entry or expansion.

Assessing Alternative Foreign Markets In assessing alternative foreign markets, an MNC must consider a variety of factors such as market potential, levels of competition, legal and political environments, and socio-cultural influences.

Of particular significance is the assessment of competitive forces. The following check-list may be useful to assess competitive forces:

1. The number, size, and financial strength of the competitors.
2. Their market shares.
3. Their apparent marketing strategies.
4. The apparent effectiveness of their promotional programmes.
5. The quality levels of their product lines.
6. The source of their products—imported or locally produced.
7. Their pricing policies.
8. The levels of their after-sales services.
9. Their distribution channels.
10. Their coverage of the market.

Evaluation of Costs, Benefits and Risks The next step in foreign market assessment is a careful evaluation of the costs, benefits, and risks associated with doing business in an international market.

Speaking about *costs,* it may be stated that there are two types of costs: direct and opportunity. Direct costs are those that the firm incurs in entering a new foreign market and includes costs associated with setting up a business operation, transferring managers to manage the factory, and shipping equipment and parts. Opportunity costs are associated with foregoing one option in preference to a second option. As a firm has limited resources, entering one market may preclude or delay its entry into another.

Entering a new market presumably offers a firm many potential *benefits.* The most obvious benefits include increased sales and profits from the market. Others include lower acquisition and manufacturing costs, foreclosing of markets to competitors (which limits the ability of competitors to gain strategic advantage), competitive advantage, access to new technology, and the opportunity to achieve synergy with other operations.

There are *risks* associated with every business, and international business is no exception. An MNC entering a new market incurs the risks of opportunity costs, additional operating complexity, and direct financial losses due to inadequate assessment of market potential or exchange rate fluctuation. In extreme cases, it also faces the risk of war or terrorism, or loss through government seizure of property.

Selecting Markets for Entry or Expansion For any given firm, different circumstances will dictate the markets it enters and/or the market within which it expands. Infact, some choices are very simple. Virtually, all international businesses have operations in N America, Europe, and the Asia-Pacific region. However, complex questions surround the decision to enter the markets of South America, Africa, Eastern Europe, and other regions. In most cases, firms are sophisticated enough to have a general view of any given market's potential. To exploit a firm's strength and opportunities effectively, detailed analysis and careful, well-conceived strategic assessments are necessary, often combined with multiple site visits, so that managers can witness first-hand the environment in which they may be competing.

Developed or Developing Country Whether to enter a developed country or a developing country is a relevant issue in this context. For an MNC seeking to enter a developed country, careful consideration of local conditions is highly important. Developing countries have unique problems that international managers in developed countries do not face. Gillette's experience in China illustrates how easy it is to misread an emerging market. In the early 1990s, Gillette set up a $43 million joint venture with the state owned Shanghai Razor and Blades Factory (SRBF). At the time of commencing operations, SRBF had a 70 per cent share of the market, consisting mostly of the cheap blades of the double-edged carbon variety. Gillette felt that it would not be too difficult to persuade atleast a fraction of these customers to opt for more sophisticated blades. Gillette also assumed that SRBF's distribution network would enable efficient and fast coverage of consumers throughout China. Both assumptions were proved wrong. Gillette has learnt with experience that Chinese men do not shave as frequently as their western counterparts and that too prefer cheaper blades. SRBF's distribution network has also proved to be ineffective. Under Chinese laws, state owned distributors typically collect their quotas from consumer goods manufacturers. Consequently, they lack customer orientation. Gillette learnt that an unwarranted focus on the upper end of the market, losing sight of ground realities, can lead to serious marketing problems.

Entering a developed country can be more problematic as Acer has learnt to its dismay. Acer is the Taiwanese computer manufacturer, established in 1976. Founder chairman Stan Shih has led the company's globalisation efforts since then to make Acer the third largest PC manufacturer in the world. In 1998, Acer generated 24.1 per cent of its sales in the Asia Pacific, 24.3 per cent in Europe, 4.2 per cent in Latin America, and 41.6 per cent in North America with only 9.5 per cent of its sales coming from the home market. Total worldwide sales amounted to \$6.717 billion in 1998. Acer currently operates 176 subsidiaries, employing about 32,000 employees in 42 countries offering a wide product range, including PC's, servers, notebook computers, networking solutions, ISP services, and various types of peripherals. Acer has appointed more than 10,000 resellers in 100 countries.

After establishing a strong presence in South-east Asia and Latin America, Acer decided to target the US market with its popular Aspire Home PC, only to find itself outmanoeuvered by stronger rivals such as Dell with superior marketing capabilities. As the Aspire line began to pile up losses, Acer announced that it would concentrate on its power PCs backed by a \$10 million marketing campaign to target small and medium businesses. Acer also indicated that it would seriously consider launching low-cost computer appliances called XCs priced \$200 or lower once they were established in Asia. Notwithstanding these moves, Acer's market share slipped from 5.4 per cent (late 1995) to 3.2 per cent (late 1998) and it began to make losses in the US market. Finally, after losing \$45 million in the US, in 1999 Acer withdrew from the US computer market. Acer's experience illustrates that to be successful in the US market where competition is cuthroat, vast financial resources and strong marketing capabilities are needed.

INTERNATIONAL PRODUCT STRATEGIES

LO 5
Analyse international product strategies

The first 'P' in international marketing mix is the product itself. A product is anything that can be offered to a market to satisfy a want or need. Products that are marketed include physical goods, services, experience, events, persons, places, properties, organisations, information, and ideas. Marketing activities begin with the product. Not only the product sets for all other activities, it determines success of marketing, nay, the entire business itself. Product should be ideally designed, produced satisfying strict quality specifications, priced reasonably, packaged attractively, positioned intelligently and branded catchily. Red Bull is one product which meets all the above requirements (See Exhibit 18.1).

Standardisation/Adaptation Some products can be sold anywhere in the world with little or no modification. Other products need to be modified or adapted and sold according to needs of markets. Table 18.1 shows a range of possibilities. Goods and services located on the left side of the continuum

Table 18.1 Selected Examples of Product Modification in the International Arena

Little, if any modification required	*Moderate amount of modification required*	*Extensive modification required*
Heavy equipment	Automobiles	High-style consumer goods
Electronic watches	Clothing	Cosmetics
Notebook computers	Appliances	Prepackaged foods
Chemical processes	Pharmaceuticals	Advertising
Writing implements	Aircraft	Packaging
Cameras	Athletic running shoes	Health services
Tennis rackets	Television sets	Cultural products
Cigarettes	Beer	

Exhibit 18.1

AN NWD PRODUCT!

Red Bull, an energy drink, is a need fulfilling, want satisfying and demand meeting (NWD) product. No wonder, the 'tonic drink' is a rage all over the world. The energy drink is present in over 160 countries and in 2010 a total of 4204 billion cans were sold worldwide.

Sales figures are zooming across countries, as for example, Turkey 86% plus, Japan 80% plus, Brazil 32% plus, Germany 13% plus, and the US 11% plus. The company has 7758 employees and over 5000 students are gaining first work experience from it every year.

A peep into how it all started is a rewarding experience.

In 1982, Dietrich Mateschitz became aware of products called "tonic drinks", which enjoyed widespread popularity throughout the Far East. The idea to market these functional drinks outside Asia came to him while sitting in a bar at the Mandarin Hotel in Hong Kong. In 1984, Mateschitz founded Red Bull. Having developed and produced the product, he started selling Red Bull Energy Drink on the Austrian Market in 1987.

The Red Bull (both the company and the drink are called by the same name) is headquartered in Austria, but it had eyes on foreign markets right from inception. While consumption was doubling year on year in Austria, Red Bull arrived in the foreign markets—Singapore (1989), Hungary (1992), Germany (1994) and UK (1995). Red Bull is targeting the core markets of Western Europe and the USA, as well as the growth markets of Brazil, Japan, China and India. As of now, Red Bull is the leading energy drink across the globe, commanding a whopping 70% of the world market share.

Need Fulfillment: Red Bull is positioned as energy giver, status enhancer and revitaliser of body and mind. Particularly targeted at youth, the drink contains caffeine, glucuronolactone, and B vitamins. It is available only in rather expensive 250 ml cans, 350 ml bottles, with 4 packs and only two flavours. Youth who drink Red Bull get the feeling that they are in an exclusive and elite clubs. Their social and belongingness needs are fulfilled.

Red Bull is addressing region-specific issues too. Childhood obesity and type 2 – onset diabetes have become a major issue across Western developed countries. By introducing 'sugar free', Red Bull is meeting the needs of health conscious and diabetic patients.

Want Satisfaction: An athlete desires to have a drink between events–a drink that revives the spirits. This want of athletics and others in similar situations is satisfied by Red Bull. The energy drink helps revive quickly, increase physical endurance, improve concentration, enhance vigilance and stimulate metabolism.

Demand Meet: Red Bull is priced relatively high. In fact, it is the most expensive soft drink. Yet, the drink appeals to the high rich, particularly in the age group of 15 to 30.

Behind the huge success of Red Bull is the brilliant marketing strategy. Well brought out product is no doubt crucial, but equally important is how it is marketed. Nano is one example of a brilliant product seems not to have made it big because of not so effective marketing efforts initiated after the mini car was launched. For one thing, Red Bull does not believe in encashing on by-products which the rivals like Coke and Pepsi are doing. Red Bull is the only product and it receives focused attention from everybody in the company. Red Bull is known for innovative advertising. By shunning conventional methods, the company has switched to online advertising and Generation Y Cartoons. In addition, the company is sponsoring extreme sports events and atheletic meets.

require little modification; those on the right need to be modified to fit the market. Table 18.2 gives reasons for standardisation and adaptation.

Table 18.2 Factors Favouring Standardisation versus Adaptation

Standardisation	*Adaptation*
* High cost of adaptation	* Differences in technical standards
* Industrial products	* Consumer and personal use products
* Convergence and similar tastes in divergent markets	* Variations in consumer needs
* Predominant use in urban environments	* Variations in conditions of use
* Marketing to predominantly similar countries	* Variations in abilities to buy
* Centralised management and operations	* Independent national subsidiaries
* Country-of-origin effect	* Cultural impact
* Economies of scale	* Government influence
* Economies in R&D	
* Economies in marketing	

(*Source*: Adapted from *International Marketing* by Vern Terpstra and Ravi Sarathy, p. 253)

Factors Encouraging Standardisation The advantages of standardisation are obvious. It can result in lower costs and economies of scale in all activities.

High Cost of Adaptation Adaptation to suit local needs may add to cost which is sure to weaken the competitive advantage of a firm. In the case of washing machines and driers, for example, Whirlpool found that the colder Scandinavian countries required more powerful heating elements to dry clothes as opposed to Italy (and other tropical countries too) where it was a practice to hang clothes out to dry. Adding a different drying module affected the competitive strength of the company.

Standardisation helps save on cost as a firm can reap the benefits of economies of scale which is bound to accrue because of huge volumes.

Industrial Products Industrial products tend to be more standardised than consumer goods. Even when industrial goods are modified, the changes are likely to be minor—an adaptation of the electric voltage or the use of metric measures. The same is true in services also. For example, international engineering and construction firms find that their product strategies are similar worldwide. People interested in having a dam or power plant constructed use the same basic concepts and have similar needs throughout the world. Customisation hardly takes place in such cases.

Convergence and Similar Tastes Another reason far standardisation is the convergence and similar tastes in diverse markets. As countries attain economic development, their consumption patterns are likely to converge. Europe is a good example of this trend. The European region has emerged as a single large market with more or less similar consumption patterns and more or less equal per capita incomes. This allows firms to sell a standardised product throughout Europe.

Predominant use in Urban Environments It has been observed that products targeted at urban markets in developing countries tend to be similar to those marketed in developed countries. Products targeted at semi-urban markets require more changes, and those targeted for national markets in developing countries need even more adaptation to accommodate the requirements of the poorer, more culturally diverse population. This observation suggests that urban environments are similar across countries and products such as compact cars, designed to be used primarily in large cities, could be standardised across groups of countries that share similar levels of incomes.

Marketing for Predominantly Similar Markets As discussed in Chapter 6, countries tend to cluster based on similarities in cultures. Using this phenomenon, firms can market standardised products within each cluster of similar countries.

Centralised Management and Operations Some firms make forays into foreign markets through exports. They do so through standardised products as adaptation proves to be expensive.

Country-of-Origin Effects The tag ‘Made in Japan’, ‘Made in France’, or ‘Made in the US’, adds value to a product. In such cases, firms tend to gain from selling standardised product which is sold in their home markets.

Economies of Scale Standardisation demands high production volumes, which results in economies of scale. Economies of scale help bring down the cost and price of products. But this advantage is lost if a firm were to customise its products.

Economies in R&D If a firm offers an identical product around the world, it gets an advantage out of its R&D efforts. Less research needs to be directed towards the individual requirements of national markets, allowing efforts to be focused on developing the next generation of products. Standardised products thus yield an advantage in product development costs and may shorten the time taken to develop new ones.

Economies in Marketing High production volumes, made possible through standardisation, result in economies of scale in manufacturing. In addition, benefits of economies of marketing also accrue to the firm. True, salesforce training and advertising tend to vary from country to country. But such efforts tend to be more alike than when the product is differentiated to suit each country. Service requirements and parts inventories also are easier with standardised products.

Factors Encouraging Adaptaion A number of factors force an MNC to resort to product adaptation. Modifying products to meet local needs tends to raise sales revenue. There are specific reasons for product adaptation.

Differences in Technical Standards Each country has its own technical specifications and a given product should meet these standards if it were to be marketed there. In Europe, for example, there are restrictions on the sale of beef from cows treated with growth hormones. A product containing beef tallow is banned from sale in the Indian market. In Saudi Arabia, the label of any product containing animal fat or meat must clearly state the kind of animal used and the fact that no swine products were used. Saudi Arabia also requires electrical connecting cords on consumer appliances to be two metres long. GE suffered the embarrassment (and the loss of profit) for having its goods turned back at a Saudi port when an inspector noticed that its connecting cords were only two yards long, a mere 17 cm discrepancy.

Consumer and Personal Use Products A firm marketing consumer or personal use products has no choice but to adapt its offering to suit local needs. In fast food franchises like McDonald's, portions of the menu are the same thoughout the world, but some items are designed specifically to suit local tastes. For example, coffee in South American units tends to be of a much stronger blend than that sold in North America. And in certain parts of Europe and Asia, the food is more spicy in keeping with local tastes. Similarly, clothing and entertainment need to be adapted to the differing needs of local populations.

Variation in Consumer Needs and Differing use Conditions Although a given product fulfils a similar need in different countries, the conditions under which the product is used may vary. Climate, for example, has an influence on products sensitive to temperature or humidity, making it necessary to modify these products for tropical or Arctic markets. Oil drilling is an example to be remembered in this context. There are differences between oil drilling process in the Sahara and that of offshore drilling in Alaska. Another factor is the difference in the skill level of users, especially between users in developed countries and those in less developed nations. With regard to cars, trucks, and tyres, differing road and traffic conditions may require product modification.

The way in which products are used also necessitates adaptation. A typical American family owns multiple cars—a mini van for weekend family trips and a small car for daily commuting to the workplace. An European family, on the other hand, owns a single car but uses it for multiple purposes. Further, buyers of small cars are demanding luxury features traditionally more common to bigger cars. In response, manufacturers intending to sell cars in Europe are trying to develop products for what they perceive to be distinct segments. Ford envisions three segments: *traditionalists,* who look for wood and leather in their cars; *environmentalists* who seek the cheapest options; and *adventurers,* who like cars and pick them to match their egoes.

The sloping nose in a tractor is highly popular in West but is not acceptable to the Indian tiller. A slopping nose offers better visibility to Western farmers but for the Indian farmer, anything that is nose down is akin to rubbing one's nose in the dirt.

Variations in Ability to Buy Income levels differ from country to country. This affects not only the demand for consumer durables but also for inexpensive consumer goods. Product features may have to be adapted to make the products affordable to lower income people. Bicycles in US will have several frills or extras as the two-wheelers are used for exercise and recreation. But in many less developed countries only basic models of bicycles are available as they are used primarily for transportation.

Fragmented Independent National Subsidiaries Some firms have foreign operations that predate World War II. Because of the economic rational prevailing at that time, these subsidiaries were largely self-contained units. Many of them developed products for their markets without regard to international product uniformity within the company. These subsidiaries have become accustomed to their independence and may desire to be allowed to develop their own products, even when it is desirable to standardise them. Some MNCs may deliberately follow a policy of decentralisation as a strategy. In such cases, product adaptation is likely to be a norm. Hindustan Unilever is an example to be cited in this context. HUL is operating as a stand alone company within its parent company, Uniliver. Many of the products which HUL offers are tailor-made for Indian markets.

Cultural Differences Culture necessitates adaptation of products. Culture influences purchasing decisions made on the basis of style or aesthetics. Cosmetics and other beauty aids are good examples. Cosmetics that sell well in the US may not be acceptable to Indian women. So also shampoos and deodorants, which may have strong appeal in Europe, but fail to attract customers in the US.

Colour and language are other culturally driven forces that necessitate product modification. Black colour signifies mourning in some countries whereas white does the same in others. These colours are not obviously used in consumer goods. Language can be an important point of modification because a product may need to carry instructions regarding contents or procedures for use. In countries where two or more languages are spoken, such as India, Canada, and Switzerland, this information is provided in all appropriate languages. Language is also important in conveying the right image for the product. Quite often, it is difficult to replicate the message because the slogan has no meaning in another language.

Often, shape and pictures need to be adjusted as they have quite different meanings in other cultures. For example, in China the elephant is liked because it symbolises the "fresh start of a new year" whereas in Western countries an elephant is akin to "white elephant"—something useless. Even names need to be changed to suit local needs. In Sweden, Helen Curtis changed the name of "Every Night" shampoo to "Every Day" because Swedes wash their hair in the morning.

Influence of Governments The government of a land may prohibit the import of a product or its local manufacturing. Conversely, the product may be required to be locally manufactured and not imported. The taxation policy of a government may also influence product modification, a notable example being the European tax on car and engine size that has been a predominant influence on car designs there.

Local market regulations may also influence product adaptations. Islam, for example, prohibits the consumption of alcohol. European and American MNCs sell nonalcoholic beer in the Middle East. The drink is called a malt beverage (avoid use of beer) and cannot be advertised, so marketers rely on in-store promotions and contests.

Trade-off between Standardisation and Adaptation Standardisation is as unavoidable as adaptation. Cost savings from standardisation outweigh the disadvantages of not adopting to meet customers' precise requirements. At the same time, the benefits from customer satisfaction, because of adaptation, are well understood by firms. Where the combined costs are at a minimum (Fig. 18.4), there emerges the optimal level of standardisation. Finding this point in practice is often a delicate balancing act.

BRAND DECISIONS

LO 6
Identify brand decisions

An important issue related to international strategy is the use of brands. Firms often like to standardise the brand name of the product. A firm that succeeds in this attempt can reduce its packaging, design, and advertising costs, as explained in the opening case. A good brand name can evoke feelings of trust, confidence, security, strength and many other desirable characteristics. Table 18.3 contains world's 10 most trusted brands. Table 18.4 contains India's 10 trusted brands.

Nature of Brand

Brand is understood as a name, term, design, symbol, or any other feature that identifies a company's goods or services as distinct from those of other firms. A global brand refers to the worldwide use of a name, term, sign, symbol, design, or a combination thereof indented to identify goods or services of one seller and to differentiate them from those of their competitors.

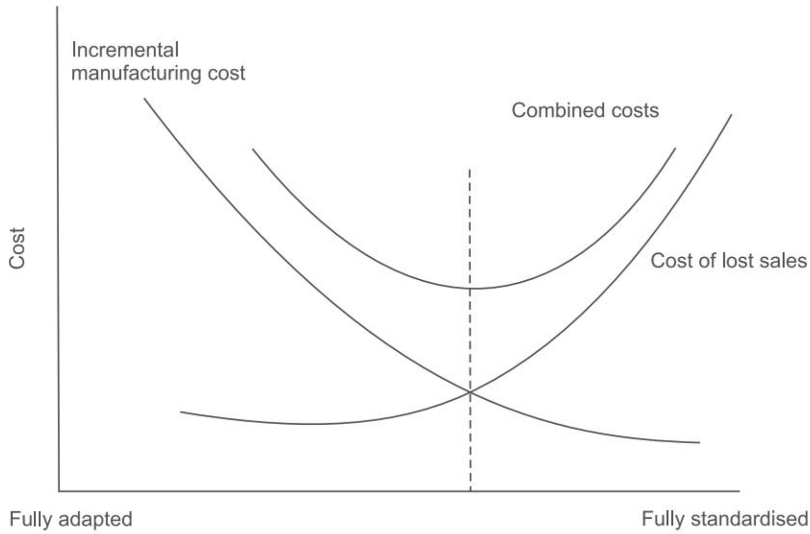


Fig. 18.4 The Trade-Off between Standardisation and Adaptation

(*Source*: Johny K. Johansson, *Global Marketing*, Irwin McGraw-Hill, 2000, p. 367)

Table 18.3 Top Global Brands

Rank 2000/2008	*Brands*	*2009 Brand Value ($ mn)*	*2008 Brand Value ($ mn)*	*Country of Ownership*
1/1	Coca-Cola	68,734	66,667	U.S
2/3	IBM	60,211	59,031	U.S
3/2	Microsoft	56,647	59,007	U.S
4/4	GE	47,777	53,086	U.S
5/5	Nokia	34,864	35,942	Finland
6/8	McDonald's	32,275	31,049	U.S
7/10	Google	31,980	25,590	U.S
8/6	Toyota	31,330	34,050	Japan
9/7	Intel	30,636	31,261	U.S
10/9	Disney	28,447	29,251	U.S

Table 18.4 Top of the Heap (2014) ($ mn)

Rank	*Brand*	*Business*	*Value*
1	HDFC	Banking	9,425
2	Airtel	Telecom	8,217
3	State Bank of India	Banking	6,828
4	ICICI Bank	Banking	3,536
5	Bajaj Auto	Automobiles	3,034
6	Asian Paints	Paints	2,812
7	Hero Motor Corp	Automobiles	2,164
8	Idea	Telecom	1,882
9	Kotak Mahindra	Banking	1,721
10	R-Com	Telecom	1,636

Brand Equity

Brand equity can be viewed as the set of assets (or liabilities) linked to the brand that add (or subtract) value. The value of these assets is dependent upon the consequences or results of the market place's relationship with the brand. Brand equity is determined by the consumer and is the culmination of the consumer's assessment of the product, the firm, and all other variables that impact on the product.

Issues Relating to Brand Name One issue relating to brand name is whether or not to use *uniform* brands internationally. Firms such as Nestlé, associate many of its products under the same family of brands such as *Nestea* and *Nescafe* to broaden the goodwill the company name has developed. But there are problems in using uniform brands across the globe. Language becomes a barrier, as names may carry a different association in another language. Rolls Royce avoided the name Silver Mist in German markets, where 'mist' means 'manure'. Pronunciation too presents a problem in that language and alphabets may lack some of the sounds of a brand from another country, or the pronunciation may have a different meaning.

Another issue relating to brand name is its *expansion* to the overseas markets. It may be stated that much international expansion occurs through acquisition of companies in foreign countries that already have branded products. When Coke acquired Parle in India, the brand was well-known in the country. But the problem with the brand name acquisition is the likely fall in goodwill even though there is local goodwill where the brand is used. Colgate Palmolive, for example, acquired half ownership in Hawley and Hazel, a Hong Kong firm with a leading market share for toothpaste in several Asian countries. The brand name 'Darkie' and the logo showing a black minstrel—like figure in a silk top hat, was offensive to many customers. Subsequently the company changed the brand name to 'Darlie' and put a man of an ambiguous race under the top hat.

Firms should consider the *image* they wish to create for their products—local or foreign. Countries with higher levels of economic development tend to have a higher quality image for their products than do less developed countries. But image can change. For example, a variety of Korean brands were sold under private brands, or under contract, with well-known company brand names for many years. Some of these companies are now emphasising their own trade names and the quality of Korean products, such as Samsung. Country Road perceives its brand as international but does not deny its Australian roots. Many of the images on Country Road clothing are Australian.

In addition, there are always legal or cultural factors that force a firm to alter the brand names under which it sells its products. For example, Grupo Modelo SA markets Corona beer in Spain as Coronita because a Spanish vineyard owns the Corona brand name. Coca-Cola calls its low-calorie soft drink, Diet Coke in weight-conscious Australia and North America but Coca-Cola in other markets.

Where the brand is used to promote a product within the political boundaries of a country it becomes a *national* brand. Some MNCs use both global as well as national brands. 'Nestle', for example, is a global brand. At the same time the firm has 7,000 local brands (all acquired) in its brand kitty. In markets where local brands are not popular, Nestle uses its global brand name. The company is described as preferring brands to be *local*, people to be regional, and technology to be global. It does, however, own some of the world's largest global brands, e.g. Nescafe.

Finally, there is the issue of *country-of-origin* effect. A country-of-origin effect refers to the perception – positive or negative – on a product that comes from a country where it was manufactured or assembled. A company competing in global markets today manufactures products worldwide, when the customer becomes aware of the country of origin, there is the possibility that the place of manufacture will affect the brand image. 'Made in India' image, for a long time, had a negative impact on Indian made goods and services. But over a period of time, this negative perception has been broken and several brands like Tata Motors, Mahindra, Reddy Labs, TCS, WIPRO, Infosys and the like are accepted all over.

PRICING ISSUES AND DECISIONS

LO 7
Estimate pricing issues and decisions

One of the most important and complex decisions a firm has to make relates to pricing its products or services. If consumers or organisational buyers perceive a price to be too high, they may purchase competing brands or substitute products, leading to a loss of sales and profits for the firm. If the price is too low, sales might increase, but profitability will suffer. Thus, pricing decisions must be given careful consideration when an MNC is introducing a new product or planning a short or long-term price change.

Compared to a domestic firm, pricing strategy is much more complex in an international firm. To begin with, a firm's costs of doing business vary widely by country. Differences in transportation charges and tariffs cause the landed price of goods to vary by country. Differences in distribution practices also affect the final price the end user pays. For example, intense competition between some distributors of processed foods in Australia minimises the margin between retail prices and manufacturer's prices. In contrast, Japan's inefficient multilayered distribution system, which relies on a chain of distributors, often inflates the prices Japanese consumers pay for goods. Exchange rate fluctuations can also create pricing problems. If an exporter's home currency rises in value, the exporter must choose between maintaining its prices in the home country (which makes its goods more expensive in the importing country) and maintaining its prices in the host country (which cuts its profit margins by lowering the amount of home-country currency it receives for each unit sold). Varying degrees of governmental intervention and greater diversity of markets add to the complexity of international pricing.

Pricing is complicated by another problem—rigidity in price structures found in many foreign markets. Many foreign intermediates are not aggressive in their pricing policies. They often prefer to maintain high unit margins with low sales volume, rather than develop large sales volume by means of lower prices and smaller margins per unit. Many times this rigidity is encouraged by legislation that prevents retailers from cutting prices substantially at their own discretion.

Pricing Policies Any MNC, in the early stages of its internationalisation, finds its price as a fairly static element; it takes whatever sales and profits that inure and look to a benefit in contribution towards corporate overheads. As the firm climbs up the global experience curve, pricing strategy becomes much more proactive and the target is to optimise the returns in any particular country-market.

International firms generally adopt one of the three pricing policies:

- Standard price policy
- Two tiered pricing
- Market pricing

Standard Price Policy An MNC is said to follow standard price policy when it charges the same price for its products and services, regardless of where they are sold. The firms that adopt this policy are of two types: (i) A firm whose products or services are highly visible and allow price comparisons to be readily made. Boeing, for example, sells commercial aircraft for approximately the same price to airlines worldwide, regardless of whether the customer is Qantas, Japan Airlines, Lufthansa, or some other airline. (ii) A firm which sells commodity goods in competitive markets. For example, producers of crude oil, such as Ampol, Kuwait Oil, and Pemex, sell their produce at prices determined by supply and demand in the world crude oil market.

Amazon.com, the retail bookstore, follows global pricing of the books it sells, except in cases where cheaper reprints are available for developing countries.

Standardisation of price is followed by firms that follow the geocentric approach to international marketing. An international business that follows an ethnocentric philosophy will use a two-tiered pricing policy, where it sets one price for all its domestic sales and a second price for all its international sales.

Two-tiered Pricing This type of pricing is often used by domestic firms that are just beginning to internationalise. Obviously, this policy can be a short-term strategy. The strong ethnocentric bias of two-tiered pricing suggests that it is not a suitable long-term pricing strategy. A firm that views foreign customers as marginal to its business rather than as integral to it—will never develop the international skills, expertise, and outlook necessary to compete successfully in the global arena.

Market Pricing An MNC that follows a polycentric approach to international marketing will use a market pricing policy. This is the most complex of three pricing policies and the one mostly used by international businesses. A firm utilising market pricing customises its prices on a market-by-market basis to maximise its profits in each market.

Market pricing policy is desirable in the car industry. Companies such as Ford and GM are realising that their Indian customers are unwilling to pay ₹ 8-9 lakhs for the same models that cost Rs 70 lakh plus in the US and Western Europe. This is putting pressure on them to look for ways to cut costs, indigenise, and offer cheap models (see also Fig. 18.5).

Pricing in international business is tanged with two issues: discriminatory pricing and dumping.

Price Discrimination Also called going-rate pricing, price discrimination involves charging different prices for consumers in different countries for the same product. Price discrimination involves charging whatever the market will bear. In a competitive market, prices may have to be lower than that of in a market where the firm has a monopoly. Price discrimination can help maximise profits. It also makes economic sense to charge different prices in different countries.

Dumping Dumping is understood differently by various economists. One approach classifies international shipments as dumped if the products are sold below their cost of production. The other approach characterises dumping as selling goods in a foreign market below the price of the same good in the home market. Even rate cutting on cargo shipping has been called dumping.

As per WTO definitions, dumping occurs when imports cause injury to domestic industry as a result of a specific unfair trade practice by an MNC.

Types of Dumpings Different types of dumping are being practised by firms—sporadic, predatory, persistent, and reverse.

Sporadic Dumping This type of dumping occurs when a manufacturer with unsold inventories desires to get rid of distressed and excess merchandise. Goods are sold at any price that can be realised. The excess supply is dumped abroad in a market where the product is normally not sold.

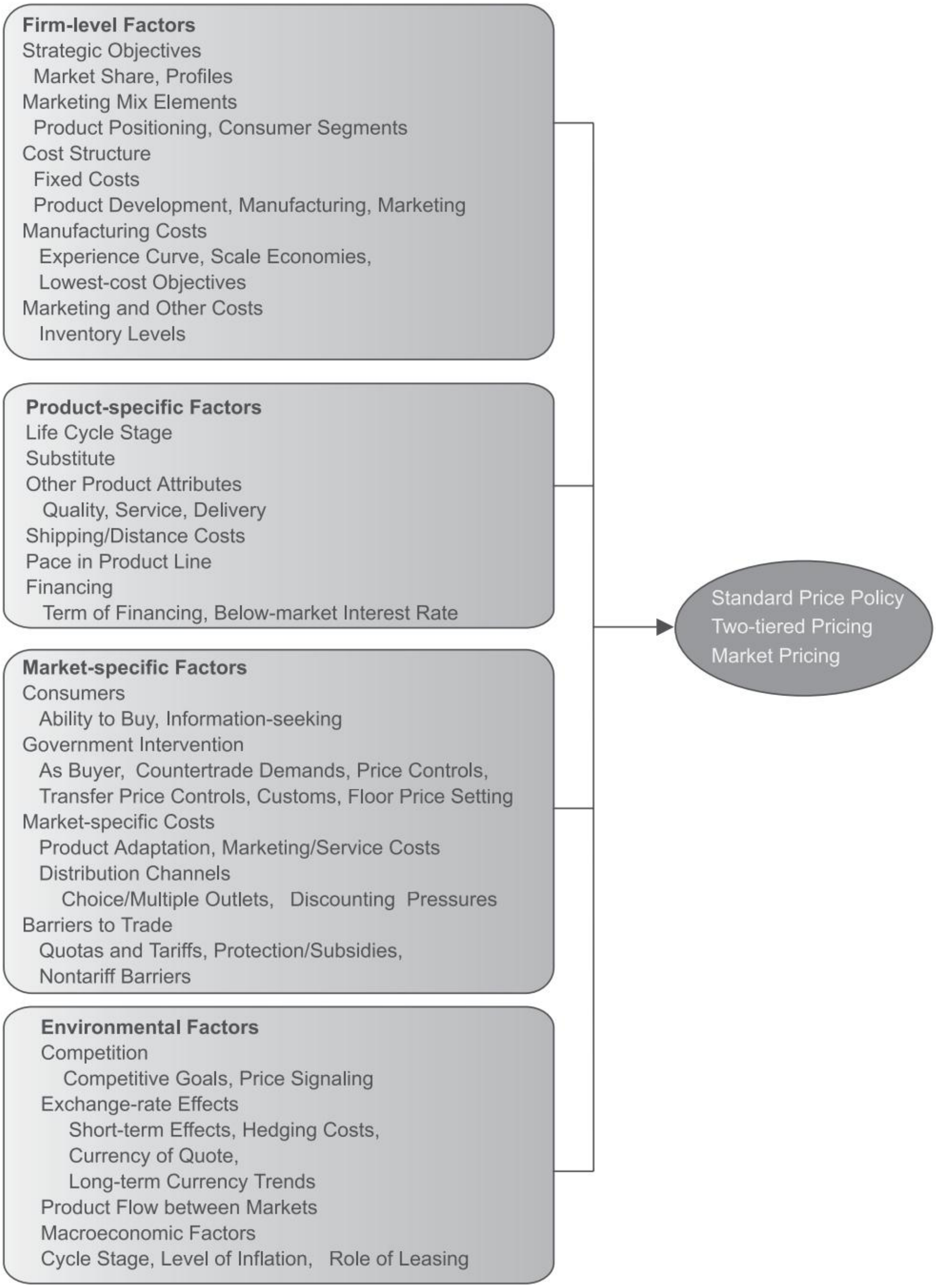


Fig. 18.5 Framework for International Pricing Strategy

(*Source*: Adapted from Vern Terpstra snd Ravi Sarathy, op. cit, p. 523)

Predatory Dumping This involves selling at a loss to gain access to a market and perhaps to drive out competition. Once the competition is destroyed or the market is established, the firm uses its monopoly position to increase price.

Persistent Dumping This involves selling at a lower price in one market than in others. Japan is able to keep prices high at home, especially for consumer electronics, because it has no foreign competition there. But it is more than willing to lower prices in the US market in order to gain or maintain market share. Japanese consumers, as a result, must sacrifice by paying higher prices for Japanese products that are priced much lower in other markets.

Reverse Dumping The three kinds of dumping discussed above have one characteristic in common: each involves charging lower prices abroad than at home. It is also possible to have the opposite tactic—*reverse dumping.* In order for this to happen, the overseas demand must be less elastic, and the market will tolerate a higher price. Any dumping will thus be done in the manufacturer's home market by selling locally at a lower price.

Dumping Related Issues In the 1960s and 1970s, dumping was hardly an issue because world markets were strong. As the 1980s began, dumping became a major issue for a large number of industries. Excess production capacity relative to home-country demand caused many companies to price their goods on a marginal cost basis figuring that any contribution above variable cost would add to profits.

Dumping is illegal since it is destructive to trade, and competitors can take an offender to court to settle a dumping case. The usual penalty imposed on a firm resorting to dumping is countervailing duty—an assessment levied on the foreign producer that pushes the price to the level of domestic price and also imposition of a fine.

Virtually all developed nations have statutes that permit the importing country to impose antidumping duties on dumped products to offset the unfair low price and to prevent injury to a domestic producer. The US, the EU, Canada, and Australia—all have antidumping laws. China enacted its antidumping law in 1997. In the EU, the antidumping laws are imposed only on trade between a member country and non member country. The Japanese have similar laws, although they are not widely enforced. Developing countries, such as Mexico, Brazil, Argentina, and Korea are currently enacting an antidumping code. Japan has been the most important single target for both US and EU antidumping laws. Fifteen per cent of all EU and US actions against market economies in the 1980s were brought against Japan.

The objective behind any such legislation is to protect domestic firms from unfair foreign competition. WTO, for example, contains the following features: (i) Stricter definitions of injury; (ii) higher minimum dumping levels needed to trigger imposition of duties; (iii) more rigorous petition requirements; and (iv) dumping duty exemptions for new shippers. (see also Exhibit 18.2 for more details).

The Government of India has initiated the following measures to protect domestic industry from cheap imports:

- Use of tariff mechanism, for examples, rise in import duty on edible oils.
- Anti-dumping probe, for example, on Chinese toys, sports shoes, and dry cells.
- Laying down BIS (Bank of International Settlements) standards for imported goods.

Exhibit 18.2

DUMPING ACROSS THE GLOBE

Contrary to the popular belief, the number of anti-dumping cases initiated worldwide during 2000 came down to 251 from a record 339 cases in 1999, a drop of 26 per cent. Rowe & Maw, the London-based international law firm, in its *Global Trade Protection* released recently, pointed out that steel and chemicals remained the two most-affected sectors, accounting for almost two-thirds of global anti-dumping investigations. According to the report, of the 251 cases initiated by 21 countries during 2000 involving 120 products, China remained the most targeted country, with the European Commission and its member-states coming second. The US was said to be the most active user of this legislation with 46 new cases, followed by Argentina and India. Almost 77 per cent of Indian anti-dumping investigations involved chemical products, accounting for almost 40 per cent of all cases started against this sector. On the other hand, 80 per cent of US anti-dumping cases involved steel products, accounting for nearly all such investigations worldwide.

China has lost exports worth $15 billion because of the antidumping cases filed against it. By April 2002, 32 countries and regions had initiated 494 cases of anti-dumping and protective measures targeting over 4000 Chinese exporters. The number of anti-dumping cases against China is the result of lower tariffs and quotas after China's accession to the WTO and the rising protectionsim.

(*Source: Business India,* June 11 to 24, 2001, and *The Economic Times,* June 6, 2002)

- Printing of retail price mandatory for all imported goods.
- Compulsory licensing for all imports though permission to import will not be denied.

PROMOTIONAL ISSUES AND POLICIES

LO 8
Relate to promotion issues and policies

The third 'P' in the international marketing mix is promotion. Promotion embraces all efforts by an international business to enhance the desirability of its products among potential buyers. While many promotional activities are specifically targeted at buyers, successful firms recognise that they must also communicate with their distributors and the general public to ensure that the public is favourably disposed towards the firm and its products. As promotion involves communication with the audiences in the host country, it is the most culture-bound of the four Ps. Therefore, a firm must take special care to ensure that the message given to host-country public is, infact the message the firm intended to send. In this way, international marketing managers must effectively blend and utilise the four elements of promotion mix—advertising, personal selling, sales promotion and public relations—to entice potential customers to buy the firm's products.

Advertising The first element of promotion mix is advertising. Advertising is any paid form of non-personal presentation and promotion of goods or services by an identified sponsor.

Constraints on Advertising Advertising, in international marketing, needs to function under several constraints both internal as well as external (see Fig. 18.6).

Language Differences Language is one of the major barriers to effective communication through

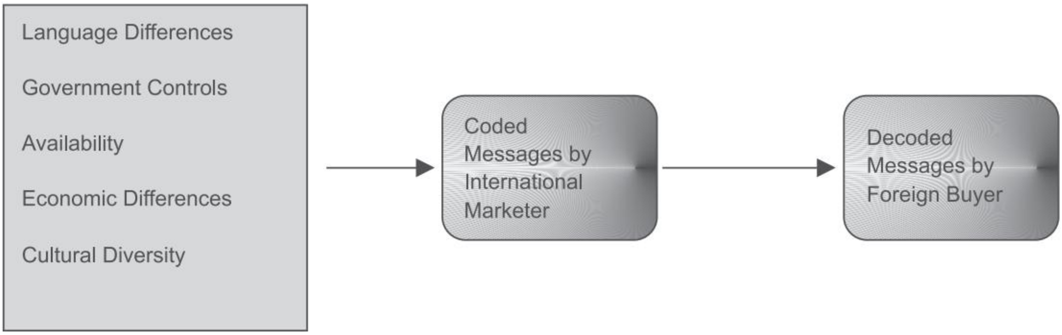


Fig. 18.6 Constraints on International Advertising

advertising. The problem is compounded by the presence of different languages in different countries, different dialects within one country, and the subtler problems of linguistic nuance and vernacular.

It is said that construction of the biblical tower of Babel stopped when the workers could no longer communicate with each other. The manager of international advertising may face a similar constraint while facing the diversity of languages in the world market. Careless handling of language will create serious problem as happened to Chrysler. Chrysler Corporation was nearly sent out of Spain when it translated its US theme, "Dart is Power" to Spanish, and the phrase implied that buyers sought but lacked sexual vigour.

Accurate translation into the local language is only half of the story. What is needed is that persuasive messages must speak the "language of the heart", and for this intimate local knowledge is required. Local help can be of two kinds: local personnel in countries where the firm has subsidiaries, and the advertising agency located in the market. In either case, the firm gets the benefit of employees in whose language the firm wants to advertise. In other markets, the firm may have to rely on its distributors for advertising.

Government Controls The international marketer often faces problems from local government controls. Government regulations can affect the media, the message, the budget, and the agency ownership. Following are specific constraints:

1. Tobacco, alcohol, and drugs are special targets. For example, cigarette advertising is partially or totally banned in most Western European countries, and even in India and Argentina.
2. Due to government regulation some media are not available or are limited for commercial use.
3. Advertising messages have a variety of restrictions. Forty countries regulate the languages that can be used. Many countries have limits on comparative advertising, and about 25 countries require preclearance of certain commercials.
4. The ad budget can draw government attention. India attacked the ad budgets of foreign tyre companies, and Britain made a similar attack on the ad budgets of Unilever and Procter & Gamble, which were considered too large. Developing countries are concerned about the ad budgets of drugs firms.
5. Some countries restrict ownership of ad agencies. Seventeen countries allowed only minority foreign ownership, and Indonesia, Nigeria, and Pakistan allowed none at all.

Agency Availability The international marketer also faces the problem of agency availability. Some countries have only one agency, for example, Bermuda, Ireland, Mozambique, and Syria. A majority of countries have only two agencies, such as, Bolivia, Bulgaria, Ghana, Ivory Coast, Jordan, Morocco, Nambia, Nigeria, and Zambia. The quality of agency service roughly corresponds to the economic growth and size of its economy. Thus, India, though not a developed country, has a number of ad agencies because of her large market.

Economic Differences Differences in income levels will influence the media in communicating a message. Hightech advertising may not be effective in countries where income levels are low. Linked to income levels is the rate of literacy of the people. Electronic media may not be the right choice in countries where a large number of people cannot read or write.

Cultural Diversity Cultural diversity poses the greatest problem in advertising. Communication is more difficult because cultural factors largely determine the way objects are understood. Knowledge about cultural diversity is, therefore, a must in advertising.

There are subcultures within a culture and the advertiser needs to take care of them. In Hong Kong, for example, there are ten different patterns of breakfast-eating. The youth of a country constitute a different consuming culture from the older people, and urban dwellers differ significantly from rural residents. Besides these differences, there is the problem of changing traditions. In all cultures, people of all ages, urban or rural, cling to their heritage to a certain extent but are willing to change some areas of behaviour. A few years ago, it was unthinkable to try to market coffee in Japan, but it has now become highly fashionable among youth to drink the beverage. Drinking coffee is equated with the western and sophisticated style (Read also Exhibit 18.3).

Advertising Programme A firm needs to consider three factors while designing its advertising programme:

1. The message it wants to convey.
2. The media available to convey the message.
3. The extent to which the firm wants to globalise its advertising efforts.

Message The message an advertiser seeks to convey to the potential buyers refers to the facts or impressions relating to the product. A vehicle manufacturer wants to convey a message of value (low price), reliability (quality), and/or style (image and prestige).

The choice of message is an important reflection of how the firm sees its own products and how it wants them to be preceived by others. Coca-Cola, for example, believes its products help consumers enjoy life, and its advertising messages consistently stress them worldwide. Products that are used for different purposes in different areas will need to be marketed differently. For example, in Australia, motorcycles are seen primarily as recreational products, but in many other countries such as Malaysia and Indonesia, they are seen mainly as means of transportation. Therefore, Honda and Kawasaki's ads in Australia stress the fun and excitement of riding. In poorer countries, they stress the reliability and functionalism of motorcycles as a mode of inexpensive transport.

The country of origin of a product is an important part of the advertising message. For example, among fashion-conscious teenagers and young adults around the world, US goods are often viewed as being very trendy. Levi Strauss, Nike, and the National Basket Ball Association highlight the US origins of their products. Japanese products, on the other hand, are often preceived to be of high quality. So international marketers stress the Japanese origin of products like Toyota cars and Sony electronic goods.

Exhibit 18.3

EATING HABITS ACROSS COUNTRIES

India

- India boasts of some of the best cuisines in the world. At the same time, food habits vary so widely from one region to the other as is beyond the imagination of the westerners accustomed to more or less standard food choices.
- An average Indian (mid to high-income group) takes three to four meals a day—a breakfast followed by a heavy lunch typically between noon and one, a moderately heavy snack early evening followed by a late dinner. It is difficult to give a comprehensive description of Indian food and what the foreigner might expect because of the wide diversity referred to above. However, a very generalised description might be as follows:
  In the eastern region rice forms the staple diet. Fish and sweets are very common. In the north and west, chapati (Indian version of the tortilla) and vegetables are widely eaten while in the south, a lot of curry, pickles accompanied by rice and/or chapati are eaten, but the food tends to be extremely hot even by Indian standards.
- Some helpful tips for the foreigner: since Indian food is very spicy (and occasionally hot), it needs to be 'mellowed' down to suit the foreign palate, if eating out. Try to avoid street side stalls and unbottled water (if it is not a posh eating place). Also avoid cut fruits and food that is not thoroughly cooked.
- Drink: Tea is India's favourite drink and many of the varieties are enjoyed throughout the world. It will often come ready-brewed with milk and sugar unless 'tray tea' is specified. Coffee is increasingly popular. Nimbu Pani (lemon drink), Lassi (iced buttermilk) and tender coconut water are also popular.

Indonesia

- Almost every type of international cuisine is available in Jakarta, the most popular being Chinese, French, Italian, Japanese and Korean. Indonesia's spices make its local cuisine unique. Specialities include: rijstafel (an Indonesian-Dutch concoction consisting of a variety of meats, fish, vegetables and curries), sate (chunks of beef, fish, pork, chicken or lamb cooked on hot coals and dipped in peanut sauce), sate ajam (broiled, skewered marinated chicken), ajam ungkap (Central Java; deep-fried, marinated chicken), sate lileh (Bali; broiled, skewered fish sticks), ikan acar kuning (Jakarta; lightly marinated fried fish served in a sauce of pickled spices and palm sugar), soto (a soup dish with dumpling, chicken and vegetables), gado-gado (Java; a salad of raw and cooked vegetables with peanut and coconut milk sauce), babi guling (Bali; roast suckling pig) and opor ajam (boiled chicken in coconut milk and light spices).
- Indonesians like their food highly spiced and the visitor should always bear this in mind. In particular, look out for the tiny, fiery hot, red and green peppers often included in salads and vegetable dishes. A feature of Jakarta are the many warungs (street stalls). Each specialises in its own dish or drink, but the traveler is best advised not to try them without the advice of an Indonesian resident.
- There are restaurants in the hotels that, along with many others, serve European, Chinese and Indian food. Two "safe" and reasonably-priced places to sample Indonesian cuisine are the food courts located at the top of Sogo Department store next to the Grand Hyatt Hotel on Jalan Jend. Sudirman and in the Senayan Mall, South Jakarta.
- There are top notch-bakeries and a couple of grocery store chains like Hero, Kem Chicks, Golden Truly, which offer a wide variety of products, many imported from the US and Australia, for a price about double of that you find at home.

- If a guest, Indonesian or foreigner, arrives unexpectedly at your home while you are eating, it is courteous to invite that person to join you at the table.

Switzerland

- Swiss cuisine is varied. The great specialty is fondue, the delicious concoction of Gruyere and Emmental cheese, melted and mixed with white wine, flour, Kirsch and a little garlic. Other cheese specialities are Emmental and Tête de Moine. Regional specialities include viande sechée. Papet vaudoir is a delicious dish made from leeks and potatoes. Geneva's great speciality is pieds de porc. Port sausages or salami come in a variety of local recipes including landjÀger, beinwurst, engadinerwurst, leberwurst, kalbsleberwurst, and knackerli. Try rösti and fondue Bourguignonne. Cakes and pastries are also varied.
- Drink: A great variety of Swiss wines are available throughout the country. There are also spirits made from fruit, the most popular being Kirsch, Marc, Pflümli and Williams. Swiss beer of a lager type is also available. Bottled mineral water is an accepted beverage, local brands including Henniez and Passuger.

Venezuela

- Cumin and Saffron are used in many dishes but the distinctive and delicate flavor of most of the popular dishes comes from the use of local roots and vegetables. Some local specialities are tequenos, arepas (the native bread), and tostadas, which are used for sandwiches.
- Drink: There is no good local wine, although foreign wines are bottled locally. There are several good local beers, mineral waters, gin and excellent rum. Coffee is very good and a merengada (fruit pulp, ice, milk and sugar) is recommended. Batido is similar but with water and no milk. Poussee-café is an after-dinner liqueur. A lisa is a glass of draught beer and a tercio a bottled beer.

Saudi Arabia

- Local food is often strongly flavored and spicy. The staple diet is pita bread that accompanies every dish. Rice, lentils, chickpeas (hummus) and cracked wheat are also common. The most common meats are lamb and chicken. Beef is rare and pork is proscribed under Islamic law. The main meat meal of the day is lunch, either kultra or kebabs served with soup and vegetables. Arabic cakes, cream desserts and rice pudding also feature in the diet. Mezzeh, the equivalent of hôrs d'oeuvres, may include up to 40 dishes.
- Foreign cooking is on offer is larger towns and the whole range of international cuisine, including fast food, is available in the oil-producing Eastern Province and in Jeddah.
- Drink: There are no bars or night clubs. Alcohol is forbidden by law, and there are severe penalties for infringement; it is important to note that this applies to all nations regardless of religion. Arabic coffee and fruit drinks are popular alternatives. Alcohol free beers and cocktails are served in hotel bars.
- If you are invited to the home of a Saudi for a party or reception, a meal is normally served at the end of the evening, and guests will not linger long after finishing. If you invite a Saudi to dine with you, expect to be refused at least once. Customs and manners differ, so be observant and adapt your behavior to that of your host.

The Philippines

- Unlike a lot of Asian cooking, Filipino cuisine is distinguished by its moderate use of spices. Chinese, Malay, Spanish, Japanese and American influences have all left their mark in a subtle blending of cultures and flavors.
- Naturally, seafood is featured, freshly harvested and often simply grilled, boiled, fried or steamed and served with kalamansi (the local lemon), bagoong (a fish paste) or vinegar with labuyo (the fiery native pepper). Restaurants specialising in seafood abound, offering crabs, lobsters, prawns,

oysters, tuna, freshwater fish, bangus (the bony but prized milkfish) and the sweet maliputo. The lechon (roasted whole pig) is prepared for fiestas and family celebrations. Rice is a staple substance of the Filipino cuisine. For the less adventurous, there are also European-style restaurants and American fast food.

- Alcoholic drinks include locally brewed beer and the delicious Philippine rum. The local San Miguel beer is considered one of the best in the world.

Korea

- Korea has its own cuisine, quite different from Chinese or Japanese. Rice is the staple food and a typical Korean meal consists of rice, soup, rice water and 8–20 side dishes of vegetables, fish, poultry, eggs, bean curd and sea plants. Most Korean soups and side dishes are heavily laced with red pepper. There is waiter as well as counter service. Most major hotels will offer a selection of restaurants, serving Korean, Japanese and Chinese cuisine or more Western-style food.
- Drink: Local drinks are mostly made from fermented rice or wheat and include jungjong (expensive variant of rice wine), soju (like vodka and made from potatoes of grain) or yakju/takju (cloudy and light tan-colored) known together as makkoli.

Germany

- The main meal of the day in Germany tends to be lunch. Breakfast served in homes and hotels usually consists of a boiled egg, bread rolls with jam, honey, cold cuts and cheese, while supper usually consists of soups or sandwiches.

Australia

- Australia's reputation as a world gourmet destination is growing, as understanding spreads of Australia's abundance of fresh, pure, and prime quality fruits, vegetables, meats, seafood, dairy products, specialty cheeses and fine wines. Australia's cultural diversity provides abroad choice of cuisines, and modern Australian chefs are reaching new heights of creativity. The coastal cities are renowned for fresh seafood, and the traditional Australian barbecue is a way of life.
- Australia is winning international wine awards; and its wine industry export earnings are growing exponentially. Of course, the Aussies' traditional dedication to their beer is legendary.

(*Source*: http://www.ibrc.bshool.ukans.edu / Cultural_Perspectives/australia/dw_australia.htm)

Medium The medium is the communication channel used by the advertiser to convey a message. To advertise overseas, the advertiser needs to consider the availability, legal restrictions, standards of living, literacy rates, and cultural homogeneity of the national market before selecting a medium. In bilingual or multilingual countries such as India, Belgium, Hong Kong, Singapore, and Canada international firms must adjust their mix of media outlets to reach each of the cultural groups in the country.

A country's economic development may also affect the media that firms use. In many less developed countries, television viewership and literacy rates are low. This eliminates the use of TV and print media but makes radio advertising more relevant.

Legal restrictions may prompt the use of certain media. Most national governments limit the number of TV stations as well as the broadcast time sold to advertisers. Countries often ban the advertisement of certain products which may be harmful to their societies. For example, South Korea, Malaysia, Hong Kong, China, India, and Singapore ban cigarette advertising on television. (see also Exhibit 18.4)

South Korea has extended this ban to magazines read primarily by women and by persons below 20 years; Hong Kong to radio; China to radio, newspapers, and magazines; and Singapore to all other media.

Exhibit 18.4

A BAN IS NOT A BAN

Tobacco firms in Canada are prohibited from using traditional advertising outlets. Yet there is a loophole: they are permitted to sponsor sports and cultural events. As a result, they use sponsorships almost exclusively to promote their products. By capitalising on the exemption, they are able to keep their brand names and logos in magazines, newspapers, store windows, and on billboards. The advertisements about the sponsored events can be targeted to reach specific demographic segments. The advertisements promoting tennis and golf tournaments often resemble cigarette packages since they use similar graphic designs, typefaces, and colour schemes.

China is a tobacco company's paradise. There are some 300 million smokers who consume 1.8 trillion cigarettes annually. Even though Beijing bans cigarette advertising on TV and radio and in newspapers, magazines, and cinema, it excludes sponsorship of events and broadcasts from the ban. Philip Morris Cos, accounting for a quarter of all advertising spending in China, sponsors music programs on national TV and radio, and China's national soccer leagues have become known as the Marlboro League.

Britain's BAT has probably the best known foreign brand in China (i.e. 555). Like its competitors, the company is a sponsor. For example, it is the sponsor of the annual Hong Kong-to-Beijing Motor Rally. In addition, it uses the BAT Education Foundation to give money to schools.

Cigarettes are a harmful product. If they were a brand new product recently created, one has to wonder whether they would ever be allowed to reach the market. One also has to question whether it is ethical for cigarette makers to continue marketing their products. In addition, a question must be raised as to why governments have not chosen to close all advertising loopholes.

(*Source*: Sak Onkvisit & John JK Shaw, op. cit, p. 570)

In order to deal with issues related to messages and media, international businesses use multinational advertising agencies which have branch offices or affiliates in various cross-border markets. The top international agencies include: Dentsue, McCann Erickson, BBDO, O&M, Thomson and others. Table 18.5 shows the most sought after (top 20) Indian advertising agencies.

Table 18.5 Indian Top Ad Agencies (2014)

Rank	*Agency*	*Rank*	*Agency*
1	Ogilvy & Mather	11	BBDO India
2	JWT	12	L&K Saatchi & Saatchi (formerly Law & Kenneth and Saatchi & Saatchi)
3	Lowe Lintas	13	FCB Ulka (formerly draftFBC Ulka)
4	McCann Erickson	14	Grey
5	Taproot India	15	Publicis
6	DDB Mudra	16	Creativeland Asia
7	Leo Burnett	17	Dentsu
8	Contract	18	Percept/H
9	RK Swamy BBDO	19	Havas Worldwide (formerly Euro RSCG)
10	Rediffusion Y&R	20	Interface Communications

(*Source: The Economic Times,* dated 10, Sept 2014)

International firms also use local domestic agencies or in-house agencies. A local domestic agency may provide a company with best cultural interpretations in situations where local modification is sought. The local agency has the best feel of the market, particularly when the MNC has little experience in the market. East Europe has been a problem for the multinational agency that is not completely attuned to the market. In Hungary, a US baby care company's advertisement of bath soap showing a woman holding her baby hardly seemed a risk. But where westerners saw a young mother, Hungarians saw an unwed mother. The model was wearing a ring on her left hand; Hungarians wear wedding bands on the right hand. It was obvious to viewers that this woman wearing a ring on her left hand was telling everybody in Hungary that she was not married. Mistakes of this type and others shown in Exhibit 18.5 can be avoided if local ad agencies are employed.

The ideal choice is the multinational agency with local branches because it has the sophistication of a major agency with local representation. In addition, the multinational agency with local branches

Exhibit 18.5

SOME ADVERTISING MISSES AND NEAR-MISSES

When translating an advertisement into another language, several mistakes are possible: Some words may be euphemisms in another language, a literal translation does not convey the intended meaning, phonetic problems may result in brand names sounding like a different word, or symbols become inappropriate or project an unintended message. Here are a few examples that have shown up on advertisements.

Euphemism

Parker Pen Company translated a counter display card for its brand of ink which had been very successful in the United States. The card said, "Avoid Embarrassment—Use Quink." The Spanish translation, "Evite embarazos—Use Qunik," unfortunately means, idiomatically, "Avoid Pregnancy—Use Quink."

Incorrect translation of phrases
Stepping stone translated into **stumbling block.**
Car wash translated into **car enema**.
High rated translated into **over rated**.
One leather translated into **naked**.
Phonetic problems with brand names
Bardok sounds like the word for brothel in Russian.
Misair sounds like the word for misery in French.

Symbols

An owl was used in an advertisement for India, where the owl is bad luck.
An elephant used in an ad for India was an African elephant, not Indian.
A turbaned model in Indian ad wore a turban style of Pakistan.

Unintended Message

Pictured were soiled clothes on the left, soap in the middle, clean clothes on the right. This is fine unless you read from right to left. Then the ad seems to say: take clean clothes, use our soap, and they will be soiled.

(*Source:* Philip R Cateora and John H Graham, *International Marketing*, p. 513) is better able to provide a coordinated worldwide advertising campaign. This has become especially important for firms doing business in Europe.

Global versus Local Advertising An international business should also decide whether advertising for its products or service can be the same everywhere, or whether it must be tailored to each local market. Certain products like Coke's soft drinks and McDonald's hamburgers have almost universal appeal. These firms use the same message everywhere, of course translating into local languages where necessary.

Often firms adopt a global campaign but make subtle adaptations to meet the needs of local markets. For example, Unilever has applied a strategy of 'think global, but act local' for its advertising campaign for Dove soap. Its TV commercials are identical in each market, but the actors are not. On the same stage and set, US, Italian, German, French, and Australian models are filmed in succession, each stating in her own language, 'Dove has one-quarter cleansing cream'. Nestlé used one theme in promoting Kit Kat chocolate bars to its European customers—'Have a break, have a Kit Kat'—but changed the backgrounds to better appeal to customers across national markets.

Some firms opt for a regionalisation strategy. For example, IBM began advertising its PCs in European markets by creating a Pan-European advertising campaign. Instead of customising its ads by country, IBM featured the same text and visual images in all its European ads, altering only the language used for its broadcast and print ads. However, maintaining uniformity of the product's image is of paramount importance. Similarly, Levi Strauss used the same TV ad to sell its 501 jeans in six European markets.

However, many firms find it useful to use both standard and localised approaches to advertising. Unilever follows this strategy with telling effect. The firm developed its national ad campaign for its products in China. But recognising that regional differences persist within the country, Unilever developed 50 specialised commercials for its Lux soap for separate markets in China.

Benefits of Advertising In 2008, Nielson—a consulting firm, conducted a global study covering 25000 consumers spread over 50 countries across the globe. The objective of the survey was to provide a better understanding of consumer perceptions of the benefits of advertising. Findings of the survey are presented in Table 18.6.

80% of the world's consumers believe that advertising helps create jobs and 72% say advertising contributes to economic growth. About 68% of the respondents believe it helps to reduce prices by stimulating competition. A clear majority of consumers across all markets also understand the importance of advertising and sponsorship as a critical source of funding for sports, arts and the media.

Future of Advertising

'Revolution' is probably the right word to describe the change that has taken place in advertising. Conventional advertising that flourished for decades is almost a *passe*, except in low income countries where people have no access to modern electronic devices.

Advertising has gone digital. In 2013, online advertising made up about a quarter of the \$ 500 bn global advertising business, and it is growing fast. Some of the 21st century most powerful companies, including Google, emerged as the champions of internet advertising.

Atleast two developments are behind the revolution in advertising. First is the rise of mobile devices, such as smart phones and tablets, which began when Apple introduced the iPhone in 2007. Now more than 1.7 bn people use smart phones. Second is the rise of social network such as Facebook, Twitter

Table 18.6 Benefits of Advertising

		Global	*India*
Advertising stimulates competition, which leads to better products and lower prices	Agree	68%	81%
	Disagree	27%	17%
By providing information, advertising allows us to make better consumer choices	Agree	67%	86%
	Disagree	27%	12%
Advertising contributes to the growth of the economy	Agree	72%	77%
	Disagree	20%	18%
By helping companies succeed, advertising creates jobs in those companies and in the advertising industry	Agree	80%	85%
	Disagree	14%	10%
Advertising funds low cost and free content on the Internet, TV, newspapers and other media	Agree	67%	79%
	Disagree	23%	15%
Advertising and sponsorship are important to fund sporting events, art exhibitions and cultural events	Agree	81%	88%
	Disagree	13%	10%
Advertising provides useful information on important issues in society, such as safety and health	Agree	63%	80%
	Disagree	30%	17%
Advertising often gets one's attention and is entertaining	Agree	66%	87%
	Disagree	29%	10%

(*Source*: *The Economic Times*, August 5, 2009)

and Pinterest. These carry huge data about the users which make target advertising possible. Digital advertising has transformed itself from mass to person-specific advertising.

All this means that sellers must learn the ins and outs of digital marketing. They must hire skilled netizens and carry out experiments to find what works. Buyers are increasingly welcoming fresh content rather than just repetitive ads.

Personal Selling Personal selling is the second element in the promotion mix of an international business. Personal selling is making sales on the basis of personal contacts. Personal selling, more commonly known as salesmanship, is used at every distribution level. The cost of personal selling can be very high. One extreme case is the German software maker SAP, the world's leader in applications packages for client-server networks. In the US, SAP America has removed the $140,000 annual limit on sales commission, making it possible for a salesperson to earn as much as $2 million a year—more than what the company's top German executives make.

In spite of the high cost, personal selling should be emphasised when certain conditions are met. Industrial buying, for example, deserves personal attention because of high unit value. Personal selling is also effective when the market is concentrated or a salesperson must develop a measure of confidence in a customer. The effectiveness of personal selling is also a function of product type. In general, personal selling works well with high-unit value and infrequently purchased goods. Such products usually require a demonstration, are custom-made or fitted to an individual's need or involve trade-ins. In addition, increased global competition coupled with the dynamic and complex nature of international business increases the need for closer ties with both customers and suppliers.

The tasks of designing, building, training, motivating, and compensating an international salesforce generate unique problems for an MNC. Difficulties notwithstanding, personal selling is employed by almost all international businesses because of several advantages:

- Firms that hire local sales representatives can be reasonably confident that those individuals understand the local culture, norms, and customs. For example, a native of India selling products in India will be better informed about local conditions than will someone sent from New Zealand to sell products in India.
- Personal selling promotes close, personal contacts with customers. Customers see real people and come to associate that personal contact with the firm.
- Personal selling makes it easier for the firm to obtain valuable market information. Knowledgeable local sales representatives are an excellent source of information, which can be used to develop new products and/or improve existing ones for the local market.
- When compared to advertising, personal selling commands a much larger share of aggregate sales revenue and accounts for several times more in terms of the number of prospects contacted. This relationship exists in all countries. Infact, the abundant supply of labour in LDCs makes it easy and inexpensive to employ sales personnel.

One controversial subject with regard to personal selling relates to the nationality of the salesperson to be used in a market abroad. Some marketers favour expatriate salespersons, or those from the home country for use in a foreign market. Others take the opposite point of view by contending that the best policy is to use local nationals or those salespersons who were born in the host country.

Expatriate salespeople are favourably viewed because they are already familiar with their company's product, history, technology, and policies. The only preparation they would need is the knowledge about the foreign market. Yet this may be an obstacle for the expatriate salesperson. Whereas some may enjoy the challenge and adjustment, other expatriates find it difficult to cope with the new environment. The failure to understand a foreign culture and its customs will impede the effectiveness of an expatriate salesperson. British managers, for instance, have difficulty in running retail stores in the highly competitive US market, which is characterised by longer shopping hours and sizing differences.

Sales Promotion Sales promotion consists of a diverse collection of incentive tools, mostly short-term, designed to stimulate quicker purchase of a product or service. Whereas advertising offers a reason to buy, sales promotion offers an incentive to buy. Sales promotion includes samples, coupons, price-offs, premiums, prizes, patronise rewards, warranties, demonstrations, point-of-purchase displays, sweepstakes, games, money refund offers, and trading stamps. Firms offer sales promotion to enhance their sales.

Being temporary in nature, sales promotion mainly supplements advertising, personal selling, and publicity. Further, sales promotion may be used to gain middlemen's support as well. Moreover, the use of sales promotion is not limited to consumer products only. It can be used with industrial selling also. Pfizer, for example, attracts drug wholesalers by sponsoring trips and other events. Gifts are given to doctors and doctor's wives are taken on shopping tours.

Sales promotion is effective when a product is first introduced to a market. It also works well with existing products that are highly competitive and standardised, particularly when they are of low unit value and have a high turnover. Under such conditions, sales promotion is needed to gain the extra competitive advantage.

The effectiveness of sales promotion can be tempered by psychological barriers, and this is true with consumers as well as middlemen. Foreign retailers may be reluctant to accept a manufacturer's coupon's because of the fear that they might not be reimbursed. Similarly, consumers may review rebates, mail-in coupons, and money-back guarantees with suspicion, perceiving that something might be wrong with the product.

As is the case with advertising, sales promotion activities are constrained by local laws that may not permit premiums or free gifts to be given. Laws in some countries control the amount of discount given at retail, others require permits for all sales promotions, and at least in one country, no competitor is permitted to spend more on a sales promotion than any other company selling the product. Belgium prohibits sweepstakes and, in Greece couping is illegal. Effective sales promotions can enhance the advertising and personal selling efforts and, in some cases, may be effective substitutes when environmental constraints prevent full utilisation of advertising.

Unique Forms of International Promotion Certain forms of promotion have an international dimension. They are discussed in a separate section here because such measures do not form the traditional promotion mix. The special measures are: government role, international trade fairs, barter, bribery, and other related forms.

Government Role The Government of India has been encouraging exports from the country in a big way. Export promotion measures cover several areas such as production, quality control, packaging, export credit and finance, and export incentives and assistance. Not only India, every country resorts to promotion of her exports in a big way.

Trade Fairs Several thousand international trade fairs take place annually in over 70 nations. In some countries, companies spend huge sums on trade fairs. In the UK, for example, manufacturing firms spend about one-fourth of their promotion budget on trade fairs, whereas American firms spend 18 per cent.

International trade fairs are either general, covering many product categories, or specialised, displaying the products of a single industry. The annual Hanover Fair in Germany is the largest of the general fairs, with over 5000 exhibiters in 20 major categories, and 500,000 visitors. Because so many buyers and sellers from different nations gather at a big fair, contacts can be made quickly which otherwise might take several years.

Barter and Countertrade A system of transaction where an exporter accepts, in part or full payment of his exports, products of an importer is called barter, countertrade, or counterpurchase. Essentially, countertrade is a non-monetary transaction.

Countertrade coustitutes a huge market and estimates of size range upto 10 per cent of world trade. More than 100 countries practise countertrade, and over 90 governments have mandated countertrade. The famous barter deals of modern business are the following:

- NEC, which assembles TVs in Egypt has a 50 per cent share of the market there. To keep the business, NEC agreed to transport Japanese tourists to Egypt on Egypt Air (3000 yearly). Half of the airfare and all local spending by the tourists is used to buy parts from NEC.
- Coca-Cola operated a tomato paste factory in Turkey, sold Polish beer in the United States, and marketed Yugoslav wine in Japan—all to sell Coke in eastern and southern Europe.
- Singer supplied its name and technical expertise to a sewing machine plant in Poland. As payment for its name and services, Singer receives part of the plant's output for sale in Singer's other markets.
- Gillette's British subsidiary was selling 20 per cent of its exports to eastern Europe. Barter deals were an important factor in its success there. The company has taken anything from rabbit skins to butter, from carpets to pajamas in exchange for razor blades. However, it relied on a specialised London barter house to handle the mechanics of the trade. (More examples of countertrade are cited in the next chapter.)

Barter trade is a crude and awkward form of business. Yet it is practised by nations because it promotes sales and purchases. Particularly for developing countries, countertrade is advantageous in as much as it helps them procure goods even though they do not possess precious foreign exchange reserves to buy goods and services from international businesses.

Bribery Bribery, though not a lawful and ethical practice, has been an effective and extensive form of promotion in international marketing. The issue on bribery relates not to its effectiveness as a promotional tool but its legality and morality. Considering bribery as illegal and immoral, many countries have passed legislations banning illegal payments. In 1997, 29 members of the OECD passed "The Convention on Combating Bribery of Foreign Public Officials in International Business Transactions". It called on all member countries to enact legislation in 1998 to declare bribery a crime. As of Feburary 1999, only 12 of the member countries had ratified the Convention. Others are expected to fall in line.

Miscellaneous Measures International marketers keep on devising new ways of promoting their products. For example, company-sponsored *seminars* are considered to be effective in international marketing. A company seminar usually includes lectures as well as demonstrations and/or films of new products, applications, or developments in the industry. Another marketing tool is the *videodisk.* IBM Europe is using videodisk linked to touch-screen TVs to market its personal computers. The sales/training message is interactive, allowing the viewers to call various programs. One of the fastest growing areas is the *Internet*. It offers intriguing opportunities—and challenges.

Public Relations (PR) Public relations is the fourth element in the promotion mix of an international business. PR involves a variety of programmes designed to promote a company's image or its individual products. The consequence of effective public relations is a general belief that the firm is a good 'corporate citizen', that it is reputable, and that it can be trusted. Ineffective public relations can often lead to a public perception that the firm cannot be trusted or that it cares little for community welfare.

The old name for PR was *publicity,* which was seen as the task of securing editorial space—as opposed to paid space—in print and broadcast media to promote or 'hype' a product, service, idea, place, person, or organisation. But PR goes beyond publicity and plays an important role in assisting in the launch of a new product, assisting in repositioning a mature product, influencing special target groups, defending products that have encountered public problems, building the corporate image in a way that reflects favourably on its products, and helps win political allies.

As the power of mass advertising is weakening, smart international businesses are turning to PR in a big way (see Exhibit 18.6 for more details).

MNCs realise that money spent on PR is money well spent because they gain political allies and it makes it easier to communicate the firms' needs to the general public. They also realise that as foreigners, they become often political targets; thereby they attempt to reduce their exposure to political attacks. Welcome Glaxo, the British pharmaceutical MNC, is a case in point. In 1996, the company provided all of the hardware and software necessary to establish an Organ Donor Registry for Australia. This allows donor organs, such as hearts, livers, and eyes, to be speedily identified and the critical time factor for delivery of body parts to hospitals for transplant recipients minimised. This act of corporate philanthropy shows community concern and gains goodwill of both politicians and the community.

Conflicts arise when an MNC enters a new country by acquiring a local company or by setting up its own operations. When American companies such as Ford, GM, IBM, Xerox, Honeywell, and GE began investing in Europe in 1950s and 1960s, Europeans became alarmed by the American challenge. So was the case when Japanese firms like Nissan, Mitsubishi, and Honda established their presence in the US. The American expressed their apprehensions against Japanese invasion. Even though the economic justifications of these and other FDI entries are usually sound, and the host countries benefit

Exhibit 18.6

CREATIVE USE OF PR

Intel and the Pentium Chip When users of the Intel's Pentium computer chip began to notice a problem with it in 1994, the company refused to replace the chip unless the computer users could prove they needed their computers for complex mathematical operations (the only operations affected by the flaw). Following the uproar of consumer dissatisfaction, Intel's MPR people came to the rescue by using a "one-two punch", following up intense one-on-one marketing to corporate and retail Pentium users with the introduction of a worldwide network of Pentium-replacement service centres (offering free replacements on request). Intel tried to reach customers one-on-one, whether they were large customers or individual users. The company did this by mobilising huge number of people inside the company, putting them on phone lines to talk to anybody concerned, and by flying marketing teams all over the country to visit corporate accounts and replace Pentium chips. To reach individual customers, Intel even placed its own employees inside retail stores in the weeks before Christmas of 1994. As a result of the intense MPR campaign, Intel was able to rescue its reputation, which had been seriously jeopardised just a few weeks earlier.

Microsoft and Windows 95 Microsoft's campaign launching Windows 95 was an MPR success story. No paid ads for Windows 95 had appeared by August 24, 1995, the launch day. Yet everyone knew about it! The Wall Street Journal estimated that 3,000 headlines, 6,852 stories, and over 3 million words were dedicated to Windows 95 from July 1 to August 24. Microsoft teams around the world executed attention-grabbing publicity. Microsoft hung a 600-foot Windows 95 banner from Toronto's CN Tower. The Empire State Building in New York was bathed in the red, yellow, and green colors of the Windows 95 logo. Microsoft paid The London Times to distribute free its entire daily run of 1.5 million copies to the public. By the end of first week, US sales alone were $108 million, not bad for a $90 product. The lesson is clear: Good advance PR can be more effective than millions of dollars spent on advertising.

(*Source*: Philip Kotler, *Marketing Management*, p. 607)

immensely, the companies' PR departments have to work hard to establish the 'good local citizen' image among the general public.

Push vs Pull Strategies With regard to sales promotion, international marketer needs to decide on push strategy or pull strategy. A push strategy emphasises personal selling rather than mass media advertising in the promotional mix. Although effective as a promotional tool, personal selling requires intensive use of salesforce and is naturally expensive. A pull strategy depends more on mass media advertising to communicate the marketing message to potential buyers.

Though it is said that the choice lies between push and pull strategies, in reality firms employ both. Factors that determine the relative attractiveness of push and pull strategies include product type relative to consumer sophistication, channel length and media availability.

DISTRIBUTION ISSUES AND DECISIONS

LO 9
Evaluate distribution issues and decisions

The fourth P of the international marketing mix is *place*—more commonly referred to as distribution. Distribution involves moving products and services from the firm to its customers. Distribution, though it looks routine, is important because the goods or services must be available where people want to buy them. In the absence of such an arrangement, all the earlier efforts such as designing, developing, pricing, and promoting a product or service will be a waste.

As far as distribution is concerned, an international business should address two issues:

1. Selecting channels of distribution.
2. Selecting the modes of transportation for shipping goods from their point of origin to their destination.

Channels of Distribution Firms make use of two principal channels of distribution when marketing abroad: (1) indirect selling, and (2) direct selling.

Indirect selling *Indirect selling,* also known as local or domestic channel, is employed when a manufacturer markets its products through another firm from the same country that acts as intermediary. As such, the sales intermediary is just another local or domestic channel because the manufacturer has no dealings with a foreign firm. By exporting through the local intermediary, the manufacturer avoids setting up of an international department. The intermediary, acting as the manufacturer's external export organisation, assumes the responsibility for moving the product overseas.

With an indirect channel, a manufacturer does not have to correspond with the foreign parties in foreign countries. Instead, the manufacturer deals with one or more domestic middlemen, who in turn move and/or sell the product to foreign middlemen or final users. Although there are many kinds of local sales intermediaries, all can be grouped under two broad categories: (1) domestic agents, and (2) domestic merchants. The basic difference between the two is ownership (title) rather than just the physical possession of the merchandise. Domestic agents never take title to the goods, regardless of whether the agents take possession of the goods or not. Domestic merchants on, the other hand, own the merchandise, regardless of whether the merchants take possession or not. An agent represents the manufacturer, whereas a merchant represents the manufacturer's products. The merchant has no power to contract on behalf of the manufacturer, but the agent can bind manufacturer in authorised matters to contracts made on the manufacturer's behalf.

Direct Selling *Direct selling* is employed when a manufacturer develops an overseas channel. Here, the firm deals directly with a foreign party without going through an intermediary in the home country. The firm must set up the overseas channel to take care of the business activities between the countries. Being responsible for shipping the product to foreign markets itself, the firm exports through its own internal export department or organisation.

Direct selling involves selection of distributors in foreign markets. A distributor is a foreign firm that has exclusive rights to carry out distribution for a manufacturer in a foreign market. The distributor purchases merchandise from the manufacturer at a discount and then resells or distributes the merchandise to retailers and sometimes to final users. The length of association between the manufacturer and its foreign distributor is established by a contract that is renewable provided the continued arrangement is satisfactory to both.

Research findings indicate that the continued arrangement is far from satisfactory. In many cases, MNCs bought or fired their distributors or created their own direct-sale subsidiaries. Three reasons have been advanced to explain why relationship between a manufacturer and a distributor is shortlived: (i) the distributor does not know-how to grow the market, (ii) the distributor does not invest in business growth, and (iii) the distributor is not ambitious enough.

In the light of the experience, eight guidelines have been advocated to make multinational-distributor partnership tick. They are—

1. Select distributors. Don't let them select you.
2. Look for distributors' capabilities of developing markets, rather than those with a few obvious customer contacts.
3. Treat the local distributors as long-term partners, not temporary market-entry vehicles.
4. Support marketing entry by committing money, managers, and proven marketing ideas.
5. From the start, maintain control over marketing strategy.
6. Make sure distributors provide you with detailed market and financial performance data.
7. Build links among national distributors at the earliest opportunity.
8. Understand host country culture (read also Exhibit 18.7).

Exhibit 18.7

AMWAY GOES ASTRAY IN CHINA BUT GUNGHO IN INDIA

Amway is a US-based direct sales company that sells a wide variety of household and personal products using a grassroots marketing approach. The company signs up individual consumers as "distributors" who then earn a commission on sales of Amway products. The distributors are taught to engage in door-to-door selling and are encouraged to sell to friends, relatives, and acquaintances. In 1997, the company racked up $7 billion in sales using this approach, more than half outside the US.

Amway entered China in 1995, closely behind rival direct marketers Avon and Mary Kay. From the outset, Amway was determined to be one of the first direct marketers to establish significant presence in China. The company had signed up 80,000 distributors in 37 cities across mainland China. It had opened a major factory in Guangzhou and had plans to invest $30 million in a second factory in Shanghai. Sales had reached $178 million in 1997, an 80 per cent increase from the previous year. Then suddenly, on April 22, 1998, the Chinese government announced a ban on direct-selling!

According to the Chinese government, direct-selling practices such as those employed by Amway spawned "Weird cults, triads, superstitious groups, and hooliganism". The core problem was that the success of Amway and its American kin had encouraged thousands of local imitators, including a number of fraudulent enterprises and fly-by-night operators that sold everything from fake gold to potency pills. The government also objected to the motivational meetings used by Amway and others to reward top sellers and recruit new ones. The official Chinese media compared such gatherings—at which people sang and chanted company slogans—to "religious cults". The People's Daily, the mouthpiece of China's governing Communist Party, complained that the meetings encouraged "excessive hugging" and references to "God"!

After intense lobbying, the Chinese government agreed to a partial reversal of the ban. Under the new regulations, issued in July 1998, the ban on direct selling stays in place, but Amway, Avon, and Mary Kay will be allowed to sell their products through retail outlets. In addition, they can use their sales representatives for service and delivery but not for direct selling.

Amway restarted its business in China the day after the change in regulations was announced. However, the three-month shutdown had cost the company millions of dollors in lost sales. More significantly, the ban on direct-selling made it impossible for Amway to follow its normal business practices in China. Given this, the company might not grow as fast as planned.

Different Experience in India

It is an encouraging experience for Amway in India. Established in 1995, and commercialised in 1998, Amway India Enterprises has already become the country's largest direct selling company and is the fastest growing firm not only in Asia but worldwide. About 150,000 entrepreneurs are actively involved as distributors and the company has services in 351 towns and cities in the country. The company registered a turnover of Rs 700 crore during 2001–2002.

Amway has tied up with contract manufactures for making its products in India: Sarvottam Care and Yodeva Plastics in Hyderabad and Naisa Industries in Daman.

(*Sources*: Charles W L Hill, International Business, *The Economic Times*, April 29, 2002 and Hamara Apna Business by Amway)

Physical Distribution Physical distribution is a necessary as well as a costly activity. It is said that the average time required to move a product from "firm to shelf" is four to five months. Although it takes only about seventeen minutes to produce a product, the rest of the time is spent on logistical activities—storage, handling, transition, packing, and so on.

In the developed economies, the distribution sector typically accounts for one-third of the GDP. Furthermore, international logistics costs can account for 25 to 35 per cent of the sales value of a product, a significant difference from the 8 to 10 per cent in the domestic shipment.

Examples are endless that could demonstrate the significance in moving goods physically across countries. Port congestions coupled with the lack of efficient materials handling equipment can cause long delays. Even inland movements can become difficult as some road networks cannot accommodate long containers and rail gauges vary across countries. China, for example, deliberately uses different rail gauges for security reasons (i.e. to prevent quick troop movement in the case of foreign invasion). Not only must a company make arrangement for transportation, but it must also pay attention to how the product is packed for shipping.

Modes of Transportation To move a product both between countries and within a country, three fundamentals means of transportation are available: air, water (ocean and inland), and land (rail and truck). Ocean and air shipments are appropriate for moving goods across the countries, especially when the distance is considerable and the boundaries are separated. Inland water, rail, and highways are more suitable for inland and domestic transportation. When national markets are connected by land (e.g., North America), it is possible to use rail and highway to move merchandise from locations such as from the US to Canada. In Europe, train is an important mode because of the contiguity of land areas and the availability of modern and efficient rail network.

The appropriate transportation mode depends on (1) market location, (2) speed, and (3) cost. (Also read Chapter 17 for supply chain management).

Market Location A firm must consider *market location.* Contiguous markets can be served by rail or truck as is the case when goods are shipped from US to Canada or Mexico. To move goods between continents, ocean or air transport is needed.

Speed *Speed* is another consideration. Where speed is most important, air transport is the preferable means of distribution. Air transport is also necessary when the need is urgent or when delivery must be quickly completed as promised. For perishable items, a direct flight is preferable because a shorter period in transit reduces both spoilage and theft.

Cost *Cost* also needs consideration as well. Cost is related to speed—speedier the means, costlier does it become. But there is a trade-off between the two in terms of other benefits. Packing costs for air freight are less than for ocean freight because for air freight the merchandise does not have to be in transit for a long period of time, and the hazards are fewer. For similar reasons, the air mode reduces the inventory in float (i.e. in the movement process). Thus, there is less investment cost because the overall inventory is minimised and inventory is turned over faster.

A firm must understand that there is no one ideal mode of transportation. Each mode has its own hazards. Hazards related to the ocean/water mode include wave impact, navigation exposures, water damage, and the various vessel motions (rolling, pitching, heaving, surging, swamping, and yawing). Hazards related to the air mode include ground handling and changes in atmosphere pressure and temperature. Hazards related to the rail and highway modes include acceleration/deceleration (braking), coupling impact, swaying on curves, and shock on vibration.

SUMMARY

- International or national marketing activities essentially remain the same. Core of marketing is to identity what people want, produce and supply goods and services accordingly. International marketing, unlike domestic marketing, is complex because of several variables that constrain it. (LO1)
- MNCs derive several benefits from their marketing functions. Growing overseas markets, sales and profit, diversification and the like are the major ones. (LO2)
- Four Ps of marketing constitute the crux of international marketing. (LO3)
- MNCs need to assess international markets. The parameters include: assessing alternative markets, conducting cost – benefit analysis and select the ideal one. (LO4)
- MNCs need to analyse product strategy which includes decision on standardisation vs. adaptation. (LO5)
- Branding decision involves decision on uniform name or product – specific, local name or foreign name, and country-of-origin effect. (LO6)
- MNCs need to decide one of the three pricing strategies: standard pricing, two-tired pricing and market pricing. (LO7)
- Advertising, personal selling, sales promotion and PR are the major means of sales promotion. (LO8)
- MNCs need to decide on channels of distribution and modes of transport as part of international marketing. (LO9)

REVIEW QUESTIONS

1. What is international marketing? How does international marketing compare and contrast with domestic marketing? (LO1)
2. Define international marketing. Bring out its benefits. (LO1 and LO2)
3. How are product decisions made in international business? (LO5)
4. Explain the various promotion strategies adopted by an international business. (LO8)
5. Explain the different pricing strategies of an international business. (LO7)
6. Bring out the distribution strategies of an international business. (LO9)
7. What is international marketing mix? (LO5)

8. Why are brand names an important marketing tool for international business? (LO6)
9. What is distribution channel? What options does an international firm have in developing its channels? (LO9)
10. Explain the fundamental issues that need to be addressed in international advertising. (LO8)

Discussion Questions

1. "Price discrimination is indistinguishable from dumping." Discuss the accuracy of this statement. (LO7)
2. Go to the soft drink section of a supermarket. How many different types of soft drink packages are there (in terms of size, form, and so on)? Should any of them be modified for the overseas market? (LO5)
3. Is Hyundai a good name to use for an international brand? How do you justify your answer? (LO6)
4. Cite the factors that may force a company to modify its package for overseas markets. Discuss both mandatory and optional modification. (LO5)
5. Are the four Ps of international marketing of equal importance to all the firms? What factors might cause some to be more or less important than others? (LO3)
6. Identify several products that you think could be marketed in a variety of foreign markets with little customisation. Identify other products that would clearly require customisation. (LO5)
7. Why do international firms use market pricing? (LO7)

Reinforcing Exercises

- International marketing is a hard work. But if handled well, its benefits are several. It can enrich you, your family, your company, your country. And ultimately, when international marketing is done well, by large or small companies, the needs and wants of customers are well understood, and peace and prosperity are promoted along the way.

  Consider one example out of hundreds. Large proportion of Brazil's population comprises blacks who have been discriminated against because of the skin colour. But Unilever saw it differently. It has introduced a range of skin care products and cosmetics aimed at black Brazilians.

  Unilever makes money no doubt. But behind this, the health-care-products major is serving the neglected sections of societies. And Unilever is no exception.

  Come out with more examples of this type.

- Food preferences vary not only across countries but within them as well. For example, many Vietnamese still have to eat whatever they can lay their hands on. Pet birds and dogs are kept indoors to save them from the cooking pot. In 1998, the government tried to reduce the consumption of snakes and cats by banning their sale because the exploding rat population was damaging crops. Instead, peasants simply took to eating rats as well. The dwindling number of rats, in turn, has increased the numbers of another tasty treat: snails.
  Where do you position the first of four Ps – product – in the above?

CLOSING CASE

Delving Deep into User's MIND

Whirlpool is an American brand alright, but has succeeded in empowering the Indian housewife with just the tools she would have designed for herself. A washing machine that doesn't expect her to get 'ready for the show' (Videocon's old jingle), nor adapt her plumbing, power supply, dress sense, values, attitudes and lifestyle to suit American standards.

That, in short, is the reason that Whirlpool White Magic, in just three years since its launch in 1999, has become the choice of the discerning Indian housewife. Also worth noting is how quickly the brand's sound mnemonic, 'Whirlpool, Whirl-pool', has established itself.

Whiteboard Beginning

As a company, the US-based white goods major Whirlpool had entered India in 1989, in a joint venture with the TVS group. Videocon, which had pioneered washing machines in India, was the market leader with its range of low-priced 'washers' (spinning tubs) and semi-automatic machines, which required manual supervision and some labour. The brand's TV commercial, created by Pune-based SJ Advertising, had evoked considerable interest with its jingle ('It washes, it rinses, it even dries your clothes, in just a few minutes...and you're ready for the show'). IFB-Bosch's front-loading, fully-automatic machines, which could be programmed and left to do their job, were the labour-free option. But they were considered expensive and unsuited to Indian conditions. So Videocon faced competition from me-too machines such as BPL–Sanyo's. TVS Whirlpool was something of an also-ran.

The market's sophistication started rising in the 1990s and there was a growing opportunity in the price-performance gap between expensive automatics and laborious semi-automatics. In 1995, Whirlpool gained a majority control of TVS Whirlpool, which was then renamed Whirlpool Washing Machines Ltd (WMML). Meanwhile, the parent bought Kelvinator of India, and merged the refrigerator business in 1996 with WMML to create Whirlpool of India (WOI), to market both fridges and washing machines. Whirlpool's 'Flexigerator' fridge hit the market in 1997. Two years later, WOI launched its star White Magic range of washing machines.

Whitemagic was late to the market, but WOI converted this to a 'knowledge advantage' by using the 1990s to study the Indian market intensely, through qualitative and quantitative market research (MR) tools, with the help of IMRB and MBL India. The research team delved deep into the psyche of the Indian housewife, her habits, her attitude towards life, her schedule, her every day concerns and most importantly, her innate 'laundry wisdom'.

If Ashok Bhasin, vice-president marketing, WOI, was so keen on understanding the psychodynamics of Indian clothes washing, it was because of his belief that people's attitudes and perceptions of categories and brands are formed against the backdrop of their bigger attitudes in life, which could be shaped by broader trends. It was intuitive, to begin with, that the housewife wanted to gain direct control over crucial household operations. It was found that clothes washing was the daily activity for the Indian housewife, whether it was done personally, by a maid, or by a machine.

The key finding, however, was the pride in self-done washing. To the CEO of the Indian household, there was no displacing the hand wash as the best on quality. And quality was to be judged in terms of 'whiteness'. Other issues concerned water consumption, quantity of detergent used, and fabric care—also something optimized best by herself. A thorough wash, done with gentle agility, was what the magic was all about.

That was the break-through insight used by Whirlpool for the design of all its washing machines, which adopted a '1-2, 1-2 Hand Wash Agitator System' to mimic the preferred handwash technique. With a consumer so particular about washing, one could expect her to be value-conscious on other aspects too. Sure enough, WOI found the housewife willing to pay a premium for a product designed the way she wanted it. Even for a fully automatic, she wanted a top-loader; this way, she doesn't fear clothes getting trapped in if the power fails, and retains the ability to lift the shutter to take clothes out (or add to the wash) even while the machine is in the midst of its job.

The target consumer, defined psychographically as the Turning Modernist (TM), was decided upon only after the initial MR exercise was concluded. This was also the stage at which the unique selling proposition (USP)—'whitest white'—was thrashed out.

WOI first launched a fully automatic machine, with the hand-wash agitator. Then came the deluxe model with a 'hot wash' function. The product took off well, but WOI felt that a large chunk of the TM segment was also budget-bound. And was quite okay with having to supervise the machine. This consumer's identity as a 'home-maker' was important to her, an insight that Whirlpool was using for the brand overall, in every product category.

So WOI launched a semi-automatic washing machine, with 'Agisoak' as a catchword to justify a 10–15 per cent premium over other brand's semi-automatics available in India.

The advertising, WOI was clear, had to flow from the same stream of reasoning. It had to be responsive, caring, modern, stylish, and warm, and had to portray the victory of the Homemaker. FCB-Ulka, which had bagged Whirlpool's account in March 1997 from contract (in a global alignment shift), worked with WOI to coin the sub-brand Whitemagic, to break into consumer mindspace with the whiteness proposition.

The launch commercial on TV, in August 1999, scored a big success with its 'Whirlpool, Whirlpool' jingle... and a mother's fantasy of her daughter's clothes wowing others. A product demonstration sequence took the '1-2, 1-2' message home, reassuring the consumer that the wash would be just as good as that of her own hand. The net benefit, of course, was an unharried home life.

Second Wave

Sadly, the Indian market for washing machines has been in recession for the past two years, with overall volumes declining. This makes it a fight for market share, with the odds stacked against premium players.

Even though Whirlpool has sought to nudge the market's value perception upwards, Videocon remains the largest selling brand in volume terms with its competitively priced machines. Washers have been displaced by semi-automatics, which are now the market's mainstay (in the Rs 7,000–12,000 price range). In fact, these account for three-fourths of the 1.2 million units the Indian market sold in 2000. With a share of 17 per cent, Whirlpool is No. 2 in this voluminous segment.

Whirlpool's bigger success has been in the fully automatic segment (Rs 12,000–36,000 range). This is smaller with sales of 177,600 units in 2000, but is predicted to become the dominant one as Indian GDP per head reaches for the $1,000 mark. With a 26 per cent share, Whirlpool has attained leadership of this segment.

That places WOI at the appropriate juncture to plot the value curve to be ascended over the new decade.

According to IMRB data, Whirlpool finds itself in the consideration set of about 54 per cent of all prospective washing machine buyers, and has an ad recall of close to 85 per cent. This indicates the medium-term potential of Whitemagic, a Rs 200 crore subbrand already. In 2000, WOI recorded a profit after tax of Rs 20.5 crore on a turnover of Rs 1,042.8 crore, one-fifth of which was on account of washing machines.

The innovations continue. Recently, Whirlpool has launched a semi-automatic machine with 'hot wash'. The brand's 'magic' isn't showing signs of wearing off either. The current 'mummy's magic' campaign on TV is trying to sell Whitemagic as a competent machine even for heavy duty washing such as ketchup stains on a white tablecloth.

The Homemaker, of course, remains the focus of attention. And she remains as vivacious, unruffled, and in control as ever. The attitude: you can sling the muckiest of stuff on to white cloth, but sparkling white is what it will remain for its her hand that'll work the magic, with a little help from some friends... such as Whirlpool.

Questions

1. What product strategy did WOI adopt? And why? Global standardisation? Local customisation?
2. What pricing strategy did WOI follow? What, according to you, could have been the appropriate strategy?
3. What lessons can other white goods manufacturers learn from WOI?

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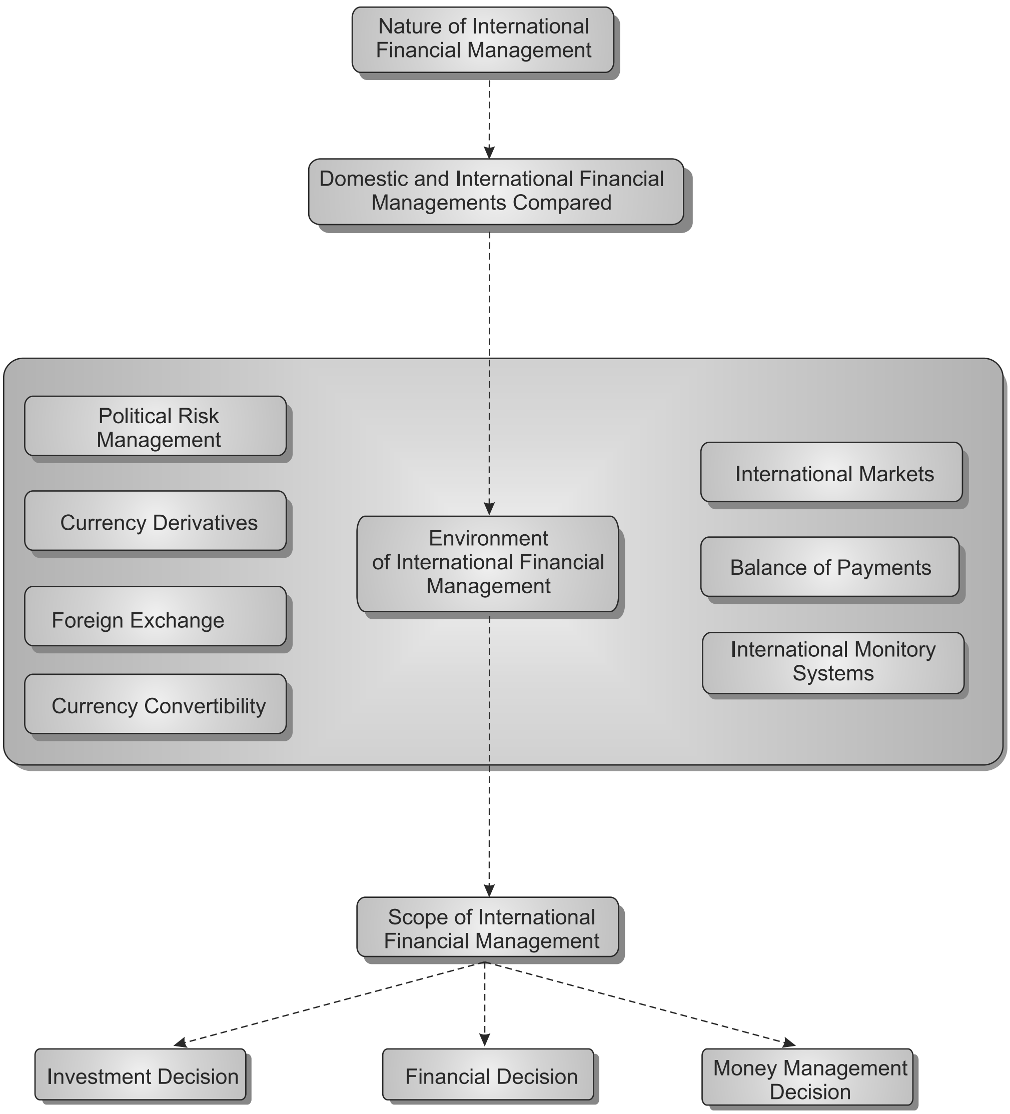
Chapter


Nature of International Financial Management
Domestic and International Financial Managements Compared
Political Risk Management
Currency Derivatives
Foreign Exchange
Currency Convertibility
Environment of International Financial Management
International Markets
Balance of Payments
International Monitory Systems
Scope of International Financial Management
Investment Decision
Financial Decision
Money Management Decision

19

International Financial Management

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Outline the nature of international financial management
- **LO 2:** Distinguish between domestic and international financial management
- **LO 3:** Assess the environment of international financial management
- **LO 4:** Predict the scope of international financial management

Opening Case

European Sovereign Debt Crisis

The crisis has origins from the significant increase in savings available for investment during 2000-2007. During this period, the global pool of fixed income securities increased from nearly \$36 trillion in 2000 to \$70 trillion by 2007. The major factor contributing to the phenomenal growth was due to savings from high-growth developing nations entering the global capital markets. Investors shifted the focus to other than US Treasury Bonds in search of higher returns from European markets. The governments which received favourable response went on raising more sovereign debt and expanded their spending resulting in fiscal deficit shooting up by 2010, in the case of Greece (143% of GDP), Iceland (123% of GDP), Italy (119% of GDP), Ireland (95% of GDP) and Portugal (93% of GDP). The public debt as percentage of GDP went up steeply in countries shown in Fig. 19.1.

The factors which contributed to the phenomenon are the globalisation of finance, easy credit conditions during 2002-08 encouraging high risk lending and borrowing practices, trade

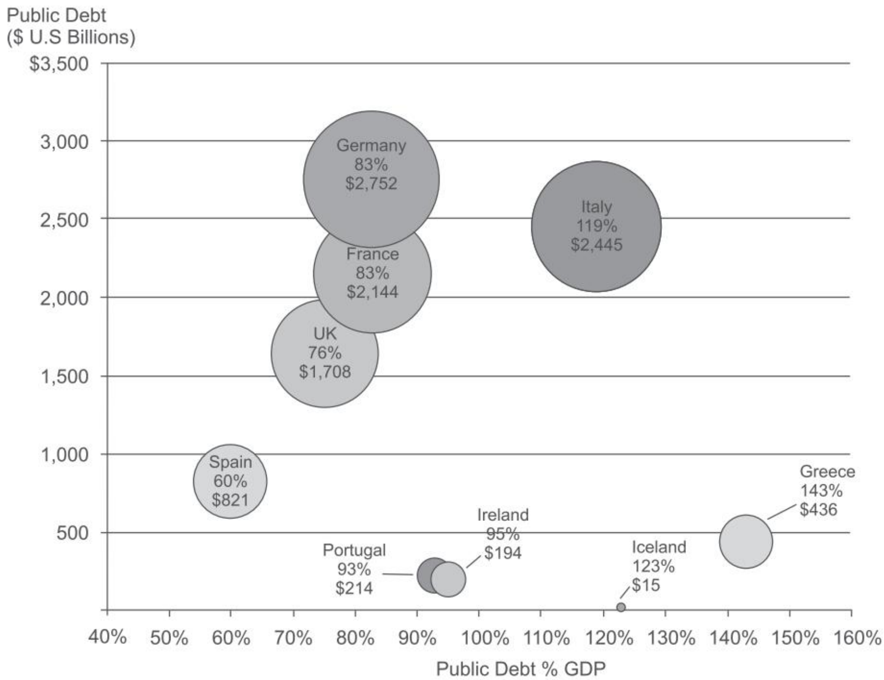


Fig. 19.1 Public debt and deficit in GDP - 2010

(*Source:* Data OIA World Factbook)

imbalances, real estate bubbles, fiscal policy choices, approaches used by countries to bail out troubled banking institutions and government bond holders. These issues got accentuated further due to slowdown in economic growth conditions from 2008 onwards.

It all began with Greece. The economy of Greece recorded robust growth since 2000 and the government took advantage of this scenario and started running a large deficit by spending on defence due to its enmity with Turkey. As the global growth slowed down since 2007, Greece was impacted severely as its main–shipping and tourism–suffered from these business cycles. Its debt piled up rapidly since then (See Fig. 19.2).

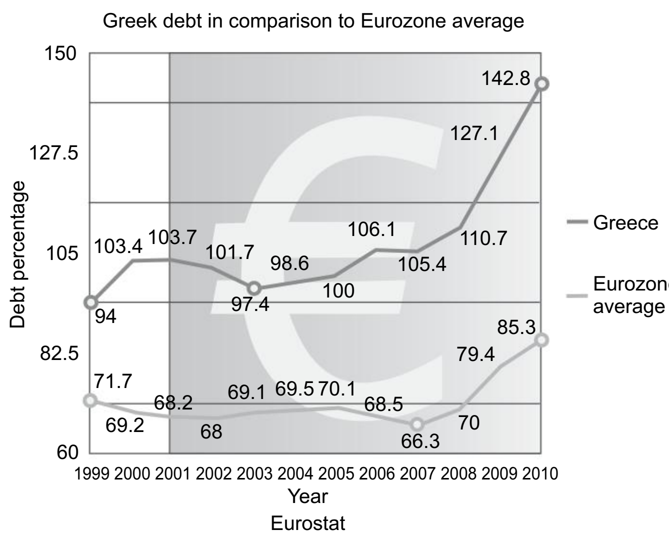


Fig. 19.2 Greek debt in comparison to Eurozone average

The debt percentage went up from 97.4% in 2003 to 142.8% by 2010, pushing the country into sovereign debt crisis.

In April 2010, the Greek government approached IMF/EU for a bailout package. The first package amounting to € 45 billion was announced. The problem got further aggravated by the poor rating by Standard & Poor's (BB+). In May, 2010, IMF has agreed for a € 110 billion loan with harsh austerity measures. This was followed by € 85 billion for Ireland in November 2010 and € 78 billion package for Portugal in May 2011. In June 2011, Standard & Poor further downgraded the Greece's sovereign debt rating to ccc, the lowest in the world. This step creaked ripples in the financial markets, with major stock exchanges incurring losses. Further commitments by the EU members failed at EU summit in early December resulting in the global stock exchanges incurring further losses. The debt crisis is spilling over to currency markets as most of the currencies started depreciating in their values against dollar, particularly Indian Rupee, in the recent weeks.

What happens in Europe has its ripple effects on the Indian economy. Indian economy is no more insulated from other economies in the world. It is an integral part of international financial system.

NATURE OF INTERNATIONAL FINANCIAL MANAGEMENT

LO 1
Outline the nature of international financial management

International financial management refers to the financial function of an overseas business. Specifically, the finance function of an international business deals with—

- Investment decisions—decisions about what activities to finance.
- Financing decision—decisions about how to finance those activities.
- Money management decisions—decisions about how to manage the firm's financial resources most efficiently.

The discussion in this chapter centres around the three broad decisions of international financial management. Before describing the three vital decisions, it is useful to draw comparisons between domestic financial management and international financial management. Similarly, a brief explanation about the environment of international financial management is also in order.

DOMESTIC FINANCIAL MANAGEMENT AND INTERNATIONAL FINANCIAL MANAGEMENT COMPARED

LO 2
Distinguish between domestic and international financial management

There are similarities between domestic financial management and the financial management of an international business. Objectives of financial management, that is, profit maximisation and wealth maximisation are the same whether the firm serves only the domestic market or does its business in overseas markets. The major decisions a finance manager needs to make remain the same notwithstanding whether the business is domestic or international. The key decisions of financial management are: investment, financing, and asset management. The investment decision refers to the determination of the total amount of assets needed to be held by a firm. Determination of sources of funds to acquire the assets refers to the financing decisions. The third important decision of the firm is the asset management decision. Once assets have been acquired and appropriate financing provided, these assets must be managed efficiently. The financial manager of a domestic business or international business is required to make all the three decisions judiciously.

There are dissimilarities, however, between domestic financial management and international financial management. The motivation to invest funds in a foreign operation, for example is to provide a return in excess of what is normally expected. There may be gaps in foreign markets where excess return can be earned. Domestically, competitive pressures may be such that only a normal rate of return can be earned.

International financial management requires an understanding of certain unique risks that are not normally a threat to domestic operations. These unique risks are related to foreign exchange risks and political risks. Foreign exchange risks can raise the cost of capital and lower the optimal debt ratios for international business. International portfolio investors require a foreign exchange risk premium when valuing the equity and debt of MNCs, especially if those firms have heavily invested in countries with volatile currencies. Contemporary financial analysis incorporates a political risk premium when foreign activities are being evaluated. Banks and investors require a higher rate of return on loans to, and bonds issued by foreign sovereign entities or corporations when they are residents in relatively unstable countries or even in emergent market countries.

Factors Constraining MNCs' Efforts to Maximise Returns

An MNC's efforts to maximise returns are often thwarted by three categories of constraints: environmental, regulatory, and ethical.

Environmental Constraints Each country enforces its own environmental constraints. Building codes, disposal of waste materials, and pollution controls are examples of constraints. Compliance on these adds to a subsidiary's costs.

Regulatory Constraints Each country also enforces its own regulatory constraints pertaining to taxes, currency convertibility rules, profit repatriations, and other regulations that can affect cash inflows of a subsidiary located there. Because these regulations influence cash flows, they need to be recognised while assessing financial policies.

Ethical Constraints Ethical practices vary from country to country. Bribery is an accepted practice in some countries but it is prohibited in some others. An MNC faces, thus, a dilemma. If it does not offer bribes, it tends to lose out on business to competitors. If it does offer bribes, its reputation receives a beating.

It should be understood that the domestic business is also not free from these constraints. However, an MNC is more exposed, its compliance is more under scrutiny, and any deviance hits headlines in newspapers across the globe.

International financial management needs an understanding of cultural, historical, and institutional differences existing in each country and which guide the way businesses operate. The pattern of ownership of business in some countries has prevented the development of a market for corporate control. For example, in Germany and France, many businesses are not corporatised. They are privately held. In Japan, ownership of many groups of *keiretrus* is internal to the group itself. Each member owns shares of other members. A bank is typically closely involved, both in cross ownership and as a prime lender. Obviously, a hostile takeover or merger is unlikely in the ownership environments typified by Germany, France, or Japan.

MNCs also face risks that can be classified as extensions of domestic finance theory. For example, the normal domestic approach to the cost of capital, sourcing debt, and equity, capital budgeting, working capital management, taxation, and credit analysis needs to be modified to accommodate foreign complexities such as foreign exchange risks and political risks.

Moreover, a number of financial instruments that are used in domestic financial management have been modified for use in international financial management. Examples are foreign currency futures and options, interest rates and currency swaps, and letters of credit.

Tables 19.1 and 19.2 bring the differences between domestic and international financial management into sharp focus.

Table 19.1 International Financial Management Compared with Domestic Financial Management

Global Financial Management	*Domestic Financial Management*
• Main object is to earn excess return on investment	• Normal returns are expected
• Attempts to maximise returns are often thwarted by several constraints	• Enjoys relative freedom
• Historical, cultural, and institutional environment obtaining in each host country impacts the way financial decisions are made and implemented. Decisions need to vary between one country to another	• Impact is country-specific
• Financial management requires an understanding of unique risks.	• Domestic financial management is free from such risks

Table 19.2 Contextual Questions

Traditional questions for the local finance function	*New questions for the global finance function*
• How should we finance ourselves?	• How should we finance our subsidiaries?
• How should we return cash to shareholders?	• How should we get money out of our subsidiaries?
• How should we analyse investment opportunities?	• How should we analyse the same investment opportunities in different countries?
• How should we communicate information to shareholders and lenders?	• How should we communicate financial information inside the firm?
• How should our ownership structure influence operations?	• How should we decide what to own and with whom?

(*Source*: Mihir A. Desai, The Finance Function in a Global Firm, *Harvard Business Review,* July-Aug, 2008, p. 111)

ENVIRONMENT OF INTERNATIONAL FINANCIAL MANAGEMENT

LO 3
Assess the environment of international financial management

International financial management is subject to several external forces. We focus on the more important of them, namely foreign exchange markets, currency convertibility, international monetary system, balance of payments, derivatives, political risk, and international financial markets (see Fig. 19.3). Though each of these needs an independent chapter for detailed discussion, we focus only on their basics.

Political Risk Management

International businesses are exposed to political risks. A political risk is the risk that adversely affects the fortunes of an MNC because of a governmental action. Types of political risks, ways of assessing them and methods of managing the risks were covered in Chapter 5.

Fig. 19.3 Environment of International Financial Management

Foreign Currency Derivatives

International financial management is influenced by the presence of derivatives. A derivative is so named because its value is derived from underlying assets like stock or currency. Derivatives are highly popular in international business as they serve two distinct objectives: speculation and hedging. The international manager buys these derivatives in order to take positions in the expectation of profit (speculation) or uses these instruments to reduce the risk associated with every day management of cash flow (hedging).

Derivatives are a powerful tool in the hands of careful and competent financial managers. But they can be destructive if handled recklessly and carelessly. The 1990s (and the current financial crisis) were replete with cases in which financial managers lost control of their derivatives, resulting in heavy losses for their companies and often their bankruptcy. In the right hands and with proper controls, financial derivatives can provide the management with opportunities to enhance and protect their corporate financial performance.

In India financial derivatives are available in the forms of currency forwards and options. Specifically, the following derivative products are legally permitted to be traded in Indian markets:

- Equity derivatives—permitted to be traded in SEBI recognised stock exchanges.
- Commodity trading—commodity futures are permitted but not option contracts.
- Foreign exchange derivatives—forward contracts, as approved by the RBI, are permitted to be transacted by banks and approved forex dealers.
- Exchange traded interest rate derivatives.

Foreign Exchange Market

The foreign exchange market is the place where money denominated in one currency is bought and sold with money denominated in another currency. For instance, if US firm imports goods from a British company, US dollar needs to be converted into sterling. This conversion from one currency into another is typical of the transactions that take place in the foreign exchange market.

The foreign exchange market spans the globe, with prices moving and currencies trading somewhere every hour of every business day. Major world trading starts each morning in Sydney and Tokyo, moves West to Hong Kong and Singapore, passes on to Bahrain, shifts to the main European markets of Frankfurt, Zurich, and London, jumps the Atlantic to the New York, goes west to Chicago, and ends up in the San Francisco and Los Angeles. The market is deepest, or most liquid, early in the European afternoon, when markets of both Europe and the US East Coast are open. This period is regarded as the best time to ensure the smooth execution of a very large order.

At the end of the day in California, when traders in Tokyo and Hong Kong are just getting up for the next day, the market is thinnest. During these hours, when the US West Coast is awake and Europe sleeps, aggressive speculators or central banks try to move prices by trading large blocks, at times to influence European attitudes about particular currencies the following morning. Many large international banks operate foreign exchange trading rooms in each major geographic trading centre in order to serve important commercial accounts on a 24 hours-a-day basis.

In some countries, a portion of foreign exchange trading is conducted on an official trading floor by open bidding. Closing prices are published as the official price for the day and certain commercial and investment transactions are based on this official price. Business firms in countries with exchange controls often must surrender foreign exchange earned from exports to the central bank at the daily fixing price.

Banks engaged in the foreign exchange trading are connected by highly sophisticated telecommunications networks. Professional dealers and brokers obtain exchange rate quotes on desk-top computer screens and communicate with each other by telephone, computer, fax, and telex. The foreign exchange departments of many non-bank businesses also use computer networks to keep in touch with the market and to seek out the best quotations. Reuters, Telerate, and Bloomberg are the leading suppliers of foreign exchange rate information and trading systems. A recent development has been the introduction of automated "matching" systems into computerised quotation systems. Many dealers are of the opinion that computer-executed transactions will replace other more conventional trading systems in the near future.

Functions of Foreign Exchange Market A well developed foreign exchange market is of vital importance to international business as it discharges three important functions: facilitates conversion of currencies, provides credit for international transactions, and minimises exposure to the risks of exchange rate fluctuations.

As stated in the beginning of this chapter, the foreign exchange market facilities conversion of one currency into another currency. If a Japanese exporter, for example, sells Toyota automobiles to a Brazilian importer, the exporter could bill the Brazilian importer in Japanese Yen, Brazilian Real, or a third country currency—say US dollar. The currency should be agreed upon beforehand. If the transaction is in yen, the Brazilian importer must buy yen with real. If the transaction is in real, the Japanese exporter must sell the real received for yen. If US dollars are used, the Brazilian importer must exchange real for dollars and the Japanese exporter must then exchange dollars for yen. The foreign exchange market provides the mechanism for carrying out these currency conversions.

Yet another function of a foreign exchange market is the provision of credit. International business involves movement of goods across the globe. As the movement of goods between countries takes time, inventory needs to be financed. In the case of the Toyota sale, somebody must finance the automobiles while they are being shipped to Brazil. It may take anywhere from a few weeks to six months for the transaction to be completed, depending on how the cars are shipped.

The Japanese exporter may agree to provide this credit by carrying the accounts receivable of the Brazilian importer with or without interest. Alternatively, the Brazilian importer may pay cash on shipment from Japan and finance the automobiles with its local bank. The foreign exchange market offers a third source of credit. Specialised instruments such as bankers' acceptances and letters of credit are available to finance international trade.

The greatest service of the foreign exchange market to international business is the facility of minimising foreign exchange risk. Coming to the example of Toyota automobiles, neither the Brazilian nor the Japanese exporter may wish to carry the risks of exchange rate fluctuations. Each may prefer to earn a normal business profit on the automobile transaction without exposure to an unexpected change in anticipated profit because exchange rates suddenly change. The foreign exchange market provides "hedging" facilities for transferring foreign exchange risks to someone else.

Market Participants The foreign exchange market consists of two tiers: the inter-bank or wholesale market, and the client or retail market. The retail market comprises travellers and tourists who exchange one currency for another in the form of currency notes or travellers cheques. The total turnover and average transaction size are very small. The spread between buying and selling prices is large. The participants in the wholesale market are commercial banks, investment banks, corporations and central banks. In addition, there are currency brokers who act as middlemen between banks, trading on their own account. The average transaction size is huge. For instance, the Bank of International Settlements (BIS) survey reports an average transaction size of four million US dollars in the US market, with many deals being much larger.

Currency Convertibility

The discussion of the foreign exchange market was based on the assumption that the currencies of various countries are freely convertible into other currencies. This assumption is not valid. Many countries restrict the ability of residents and non-residents to convert the local currency into foreign currency, making international businesses more difficult. Many international businesses use "countertrade" practices to circumvent problems that arise when a currency is not freely convertible.

> A country's currency is said to be freely convertible when the country's government allows both residents and non-residents to purchase unlimited amounts of foreign currencies with the local currency. A currency is non-convertible when neither residents nor non-residents are allowed to convert local currency into a foreign currency.

Generally countries follow a non-convertible policy. They place restrictions on their residents' ability to convert the domestic currency into a foreign currency. 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 business's ability to take foreign currency out of the country). The first country to industrialise, the UK, lifted restrictions as recently as 1979. The success story of the 20th century, South Korea, still maintains extensive controls. Most developed countries have removed controls only in the last two decades and the vast majority of developing countries continue to impose restrictions.

Serious problems arise when non-convertibility is in force. This was the practice of the former Soviet Union, and it continued to be the practice in Russia till recently. When strictly applied, non-convertibility means that although a US 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 global business.

Countries follow non-convertibility to preserve their foreign exchange reserves. A country needs foreign exchange reserves to service its international debt commitments and to pay for imports. This is one of the reasons why India has imposed restrictions on capital account convertibility. Governments typically impose convertibility restrictions on their currencies when they fear that free convertibility will lead to run on their foreign exchange reserves. This occurs when residents and non-residents rush to convert their holding 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 home currency is falling rapidly because of hyper-inflation, or when a country's economic prospects are shaky in other respects. Under such circumstances, both residents and non-residents tend to believe that their money is more likely to hold its value if it is converted into a foreign currency and invested abroad.

India's Experience The Government of India has been following a dual policy, so far as convertibility is concerned. The government allows convertibility on current account. This means that consumers can buy goods and services from abroad without hassles. Current account convertibility, it is believed, will help achieve efficient utilisation of resources, innovations, and quality improvements in domestic industry.

But the government has followed a non-convertibility policy in the capital account. Obviously, the purpose is to prevent run on foreign exchange reserves. But, this policy cannot continue for long, particularly when the economy is getting integrated into the global economy. Moreover, having allowed current account convertibility, the country cannot hold on to non-convertibility in its capital accounts.

The Tarapore Committee on capital account convertibility (report submitted on June 3, 1997) has laid down a three-year, three-phase schedule for allowing convertibility. It has laid down three pre-conditions: (1) fiscal consolidation implying that the centre's fiscal deficit should come down to 3.5 per cent of GDP; (2) a mandated inflation target; and (3) strengthening of the financial system to involve (a) a near complete clampdown on activities of weak banks, (b) major cut in the CRR, and (c) complete deregulation of interests rates.

As on today, there are few restrictions on an inward flow of foreign exchange for investment purposes, there remain controls on outward flows in the capital account.

Countertrade Firms can deal with non-convertibility problems 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 non-convertible. For example, consider the deal that GE struck with the Romanian government in 1984, when the country's currency was non-convertible. When GE 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 in international markets. In a similar case, the Venezuela government negotiated a contract with Caterpillar in 1986 under which Venezuela would trade 3,50,000 tons of iron once for Caterpillar's heavy construction equipment. Caterpillar, subsequently traded the iron ore to Romania in exchange for Romanian products, which it then sold on the international markets for dollars. Countertrade often assumes funny dimensions. Venezuela, for example, invests $3.5 bn a year in Cuba by sending an estimated 1,15,000 barrels of oil a day. Cuba pays in kind, in the form of 40,000 doctors, intelligence and security experts and other workers stationed in Venezuela.

Countertrade is practised in India but in essential commodities like wheat and rice. The countries involved in countrertrade are Latin America, Africa, and Middle East. STC, MMTC, Exim Bank, and ECGC are the agencies through which countertrade is routed, which implies that the Government of India itself encourages countertrade but of the following three types:

- Countertrade against major purchases by the Central Government and its companies;
- Countertrade through evidence account; and
- Countertrade through escrew account.

There is enough scope for countertrade with countries/groups when India has run deficits, for example, EU, Australia, and OPEC. Since EU wants to sell airbuses and telecom equipment to India, in turn, the EU must buy software, apparel, and leather components from India. Similarly, the OPEC nations should come to India for their turnkey projects like hospitals, airports, and petro-chemical complexes. Similarly, contacts can be developed with high-risks but high-populated areas like Siberia and CIS members for countertrade to buy their oils and minerals for India's consumer goods.

What is the future of countertrade? At one stage countertrade was a significant component of world trade. In 1985, between 20 to 30 per cent of world trade involved some form of countertrade agreements. Since then however, more currencies have become fully convertible and the percentage of world trade that involves some form of countertrade has fallen to 10 from 20 per cent. But countertrade will continue to stay. The next chapter offers more details on countertrade.

International Monetary System

Every country needs to have its own monetary system and an authority to maintain order in the system. Monetary system facilitates trade and investment. India has its own monetary policy that is administered by the Reserve Bank of India. Primarily, RBI aims at controlling inflation and money supply and maintaining an interest rate regime that is helpful to economic growth.

Extending the argument to the global level, there is need for an international monetary system to promote trade and investment across countries. Such a system has been in existence since 1944. It was in that year that representatives of 44 countries met at Bretton Woods (New Hampshire, USA) to give a concrete shape to the international monetary system and to decide on the institutional framework to maintain such a system. An agreement was signed by all the representatives present (the agreement came to be known as Bretton Woods Agreement) committing themselves to set up two major institutions—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 supervised 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. The US government had committed to exchange gold for dollar on demand.

The fixed exchange rate regime imposed considerable monetary discipline on each member country. But most countries found it difficult to maintain a fixed exchange rate, as the post-war conditions demanded that each country adopted its own policies that would promote employment and economic growth, even if it meant balance of payments deficits and currency devaluations.

The fixed exchange rate system collapsed in 1971 when the US government declared that its currency was no more convertible into gold and that its currency would float against other currencies. The collapse was attributed to the US policy of increasing government spending on welfare programmes.

It is the floating exchange rate system that is in existence since the collapse of the fixed exchange rate regime. Under the floating system, the exchange rates are allowed to seek their own levels in the foreign exchange markets without government interventions. However, to smoothen out exchange fluctuations, many central banks have been intervening quite frequently. Therefore, the present international monetary system is known as 'Managed Float System'.

The floating exchange rate system has considerable impact on international business. It increases the uncertainty of cash flows for an international business; greater are the number of countries with which it has business dealings, higher is the uncertainty. In other words, the foreign exchange risk assumed by an international business is proportional to the spread of its business across countries. Obviously, an international business needs an efficient currency management and risk minimisation mechanisms.

The International Monetary Fund (IMF) At the time of its formation, the IMF had just 89 members and now the figure has shot up to 183. Included among the main purposes of the IMF are promoting international monetary cooperation and contributing to exchange stability.

The IMF has been of great help to member countries. Through its short-term adjustment loan facility, the IMF has helped many countries in their efforts to solve currency crisis and solve problems relating to balance of payments.Over a period of time, IMF has developed several loan instruments to address the specific requirements of member countries. These are Extended Credit Facility (ECF), the Standby Credit Facility (SCF) and the Rapid Credit Facility (RCF) for low-income countries and are in the nature of concessional loan facilities. Non-concessional loans are provided through Stand-By Arrangements (SBA), the Flexible Credit Line (FCL), the Precautionary and Liquidity Line (PLL) and the Extended Fund Facility (EFF). Emerging Loans are also considered under the newly introduced instrument called Rapid Financing Instrument (RFI) for meeting urgent balance of payments needs.When Russia, for example, was facing severe economic challenges in the wake of the Asian financial crisis, the IMF stepped in to bail out the country. In 1999, it notified the Russian government that it would approve a 17-month standby credit for Russia to the tune of $4.5 billion to support the government's 1999–2000 economic programme. By mid-November 2011, the IMF has committed loans to the extent of $282 billion. The biggest borrowers were Greece, Portugal and Ireland while biggest precautionary loan borrowers were Mexico, Poland and Colombia.

Special Drawing Rights In order to help increase international reserves, the IMF created the *Special Drawing Right* (SDR), an international money, in 1969. SDR is an IMF asset which is created by contributions from five of its richest members. The five members and their contributions in terms of percentage are:

US: 39 (dollar)
Germany: 21 (euro)
Japan: 18 (yen)
France: 11 (euro)
UK: 11 (pound)

The contribution of any member country is a reflection on its role in international trade.

As stated earlier, SDR is an international reserve asset created to supplement members' existing reserve assets such as gold and foreign exchange. The significance of the SDR is that it is the unit of account for the IMF. Each nation is assigned a quota based on the size of the economy when it enters the IMF. Payment of this quota by each nation provides the IMF with the funds it needs to extend short-term loans to members.

The IMF has been criticised severely in recent past. For one thing, the IMF's *conditionality* for granting loans has been highly controversial. Conditionality refers to a series of structural adjustments and stabilisation policies sought to be placed on the economies of receiving countries. The terms of conditionality are frequently draconian and impose greatest hardship on the poorest households in debtor countries.

Over the years since its inception, the IMF has changed markedly. Founded on the belief that markets often acted adversely, it now champions market supremacy with ideological fervour. Founded on the belief that there is need for international pressure on countries to have expansionary economic policies—such as increasing expenditures, reducing taxes, or lowering interest rates to stimulate the economy-now IMF typically provides funds only if countries engage in policies like cutting deficits, raising taxes, or raising interest rates that lead to a contraction of the economy.

The IMF has also realised that the conditionalities earlier imposed to sanction assistance, do not work any more. The Fund realised that the dozens of conditions made it difficult for the recipient countries to focus on priorities. Worse, the conditionality has undermined the democratic processes in the developing countries. There is a thinking that the conditionalities, as criteria for lending, to be replaced by selectively-giving aid to the countries with a proven track record, allowing them to choose for themselves their own development strategies. The evidence is that aid given selectively can have significant impact both in promoting growth and reducing poverty.

Recently, attention has been focussed on debt forgiveness as without that many of the developing countries would not simply grow. High proportions of their incomes from exports go to repaying loans to the developed countries. Hence the need for debt forgiveness.

The World Bank The official name of the World Bank is the International Bank for Reconstruction and Development. The immediate purpose of the World Bank was to finance European reconstruction following the Second World War. Later, there was a shift towards financing projects in developing countries.

The World Bank offers funds to countries unable to obtain loans from commercial sources for projects considered too risky. The projects financed by the Bank include transportation networks, power facilities, agriculture, and educational programmes. The activities of the Bank were expanded to include technical support, research, public provision of information and statistics, co-financing of enterprises, and co-operative ventures with other non-profit organisations.

The Bank has a bigger agenda before it—achieving UN targets for 2015. The UN targets include universalising primary education, gender equality in schooling, and achieving significant reductions in maternal and child mortality.

In arriving at its decisions, the Bank uses a weighted voting system that reflects the contributions and economic power of its members. The US holds the largest block of votes (16 per cent), followed by Japan (8 per cent), Germany (4 per cent), the UK (4 per cent), France (4 per cent), and six countries with 3 per cent each: India, Canada, China, Italy, Russia and Saudi Arabia. The voting weights keep changing from time to time as economic power shifts and new members join the Bank. In order to finance its lending operations, the Bank borrows money in its own name from capital markets across the globe. Interests earned on existing loans add to the lendable funds. (Chapter 15 carries more details on IMF and World Bank).

The World Bank is made up of two unique development institutions, viz. International Bank for

Reconstruction and Development (IBRD) and International Development Association (IDA). The IBRD aims to reduce poverty in middle-income and credit worthy poor countries, while IDA focuses on the world's poorest countries. These two institutions are complemented by International Finance Corporation (IFC), Multilateral Investment Guarantee Agency (MIGA) and the International Centre for the Settlement of Investment Disputes (ICSID). The World Bank is headquartered at Washington D.C. and operates with more than 100 offices worldwide. Currently the Bank has 187 members.

The Bank's portfolio consists of 75 to 80 per cent of loans in the form of investment loans, credits and grants. By the end of 2010, under IBRD the loans outstanding amounted to $120 billion, development credit outstanding under IDA amounted to $113 billion.

Asian Development Bank Asian Development Bank headquartered at Manila is a major source of development financing for the Asia and Pacific Region. The approved lending of the Bank exceeds $ 17.5billion.

At the time of establishment of the ADB in 1966 there were 31 member countries and since then it has grown to 67 members of which 48 are from Asia and Pacific Region and 19 from outside this Region.

The financing by ADB is in the form of investment in infrastructure, health care services, financial and public administrative system, helping nations to prepare for climatic changes and to manage their natural resources. The needs of these activities were met by the Bank through loans, grants, technical assistance and equity investments. Out of $17.5 billion loans and other funding's by ADB as of 2010, Bangladesh tops the list of loan recipients with nearly $3.0 billion, followed by India with $2.4 billion and China with $1.95 billion

Balance of Payments

Balance of Payments (BOP) is a statistical statement that systematically summarises, for a specified period of time, the monetary transactions of an economy with the rest of the world. BOP data help measure financial transactions between residents of the country and residents of all other countries. Transactions include exports and imports of goods and services, income flows, capital flows, and gifts and similar one-sided transfer payments.

BOP is an accounting statement prepared on double entry book-keeping system. All currency *inflows* are recorded as *credits,* and *outflows* are recorded as *debits.* Credits indicate a sign of surplus, and debits have a minus sign.

There are three major BOP categories:

- Current account
- Capital account
- Official reserves account

Current Account Current account records all flows of goods, services, and transfers. Current account itself can be broken into two parts: balance on trade (BOT) and balance on invisibles (BOI). BOT deals only with exports and imports of merchandise (or visibles). The BOI shows net receipts on invisibles such as dividends or interest on foreign investments, royalties on patents or trade marks held abroad, travel, insurance, banking, transportations, and unilateral transfers.

Capital Account Capital account records all public and private investment and lending activities. The capital account is segmented by direct foreign investment, portfolio investment, and other capital investment. Direct foreign investment represents the investment in fixed assets in foreign countries. Examples of direct foreign investment include a firm's acquisition of a foreign company, its creation of a new manufacturing facility or its expansion of an existing plant in a foreign country.

Portfolio investment represents transactions involving long-term financial assets (such as stocks and bonds) between countries that do not affect the transfer of control.

In addition to direct foreign investment and portfolio investment, other capital investment is another component of capital account, which represents transactions involving short-term financial assets (such as money market securities) between countries. In general, direct foreign investment measures the expansion by firms in foreign operations, while the portfolio investment and other capital investment measure the net flow of funds due to financial asset transactions between individual or institutional investors.

Official Reserves Account This account measures changes in holdings of gold and foreign currencies (reserve assets) by official monetary institutions. The change in official reserves measures a nation's surplus or deficit on its current and capital account transactions by netting reserve liabilities from reserve assets. For example, a surplus will lead to an increase in official holdings of foreign currency and/or gold; a deficit will normally cause a reduction in these assets.

Importance of BOP to International Business Home country and host country BOP data are important to international managers, investors, consumers, and government officials because such data influence and are influenced by other key macroeconomic variables such as gross domestic product, employment, price levels, exchange rates, and interest rates. Monetary and fiscal policies must take the BOP into account at the national level.

Business managers and investors need BOP data to anticipate changes in host country economic policies that might be driven by BOP events. BOP data may be important for any of the following reasons:

- The BOP helps forecast a country's market potential, especially in the short run. A country experiencing a serious BOP deficit is not likely to import as much as it would if it were running a surplus.
- The BOP is an important indicator of pressure on a country's foreign exchange rate, and thus on the potential of a firm trading with or investing in that country to experience foreign exchange gains or losses. Changes in the BOP may presage the impositions (or removal) of foreign exchange controls.
- Changes in a country's BOP may also signal the imposition (or removal) of controls over payment of dividends and interest, license fees, royalty fees, or other cash disbursements to foreign firms or investors.
- BOP data can also signal increased riskiness of lending to particular countries.

Figure 19.4 indicates a generic BOP statement applicable to any country for any period.

India's BOP India has been facing BOP deficits from time to time either due to domestic compulsions or because of external pressures (see Table 19.3 and Fig. 19.5). Ever expanding imports, decline in receipts from invisibles, fall in concessional assistance from international monetary institutions, oil shock, mounting burden of external debt servicing, low image of the country in the mind of a foreign investor, and so on, have contributed to the debit balance on BOP statement.

Additionally, a country with BOP deficit can try devaluing its currency, fixing tariffs and quotas, and enforcing currency exchange controls. India has been trying all these measures, of course with mixed results.

	Debits	Credits
1. Current account		
a. Goods or merchandise–imports and exports		
b. Services		
Net goods and services balance		
c. Unilateral transfer		
To abroad		
From abroad		
Net current account balance		
2. Capital account		
a. Direct investment		
To abroad		
From abroad		
b. Portfolio investment		
To abroad		
From abroad		
c. Short-term capital		
To abroad		
From abroad		
Net capital account balance		
3. Official reserves account		
a. Gold export or import (net)		
b. Increase or decrease in foreign exchange (net)		
c. Increase or decrease in liabilities to foreign central banks (net)		
Net official reserves		
4. Net statistical discrepancy		
BOP = Current Account Balance + Capital Account Balance + Reserve Balance		

Fig. 19.4 Balance of Payments Accounts

International Financial Markets

International financial markets constitute the last component in the environment of international financial management.

Due to the growth in international business over the last 30 years, various financial markets have been developed. The global financial markets benefit both borrowers and investors. Borrowers are benefited as the funds are made available in abundance and at low cost. Financial markets benefit investors because they provide a wider range of investment opportunities, thereby allowing the investors to build portfolios of international investments that diversify their risks.

International financial markets have grown over time. Some statistics are worth quoting in this context. Table 19.4 and Figure 19.6 show the growth in international bank lending from 2001 to 2010. As can be seen, international bank lending increased rapidly over this period touching the peak of $24.5 trillion in 2007, when the world markets were at their zenith. Thereafter, lending declined to $22 trillion in 2010 due to crises in the financial markets of Europe and America. Table 19.5 and Figure 19.7 present data on debt securities while Table 19.6 and Figure 19.8 show details on Net Bonds issued world over. The peak levels achieved up to 2007 showed signs of declining trends owing to global financial crisis. Net issue of Bonds and notes peaked to $2.8 trillion in 2001, subsequently declined to $1.5 trillion in 2010.

Table 19.3 India's Foreign Trade (In billions of US dollars)

Year	*Exports*	*Imports*	*Trade Balance*
2000-01	44560	50536	-5976
2001-02	43827	51413	-7586
2002-03	52719	61412	-8693
2003-04	63843	78149	-14306
2004-05	83536	111517	-27981
2005-06	103091	149166	-46075
2006-07	126414	185735	-59321
2007-08	163132	251654	-88522
2008-09	185295	303696	-118401
2009-10	178751	288373	-109622
2010-11	251105	369769	-118664

(*Source:* Economic Survey of India 2010-11 & Annual Report of RBI 2011)

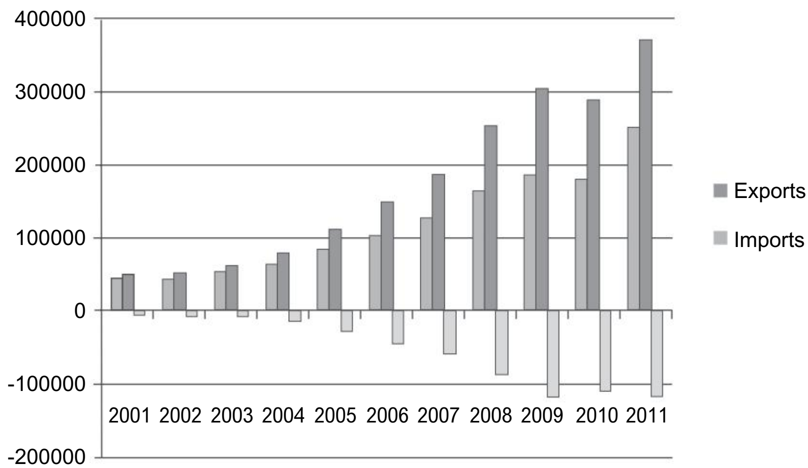


Fig. 19.5 India's Foreign Trade

Table 19.4 External Assets of BIS Reporting Banks (In billions of US dollars)

Year	*Total External Assets*	*Loans & Deposits*	*Securities & Other Assets*
2001	11628	8871	2756
2002	13375	10059	3316
2003	15929	11802	4127
2004	19180	13829	5351
2005	21110	15184	5926
2006	26127	18942	7185
2007	33459	24528	8931
2008	30927	22480	8447
2009	30074	21656	8418
2010	30117	22004	8113

(*Source:* BIS.org)

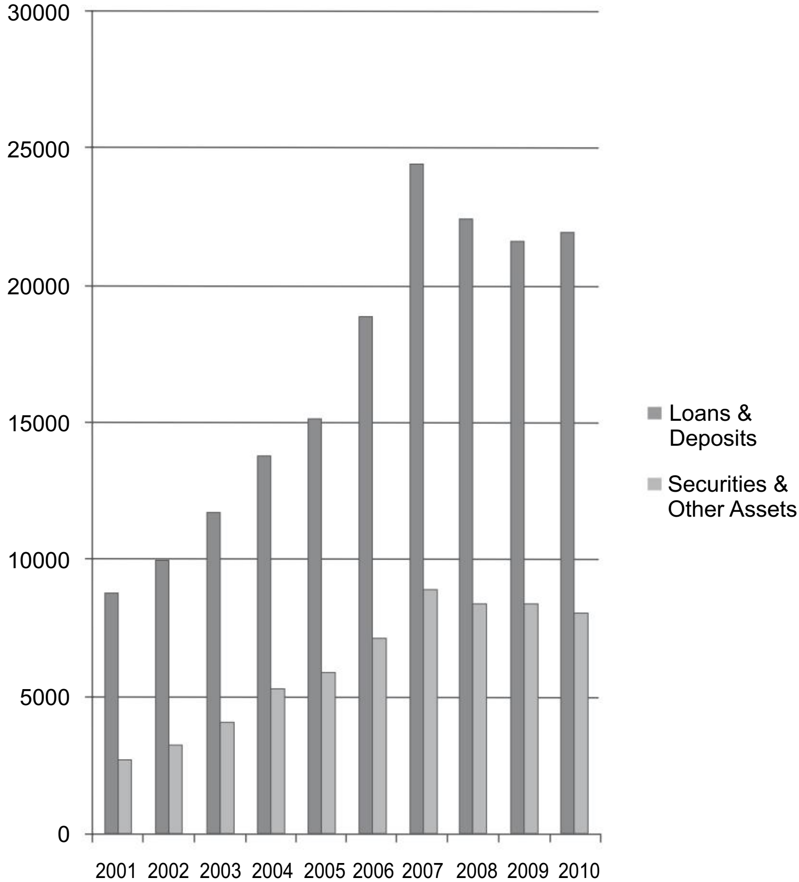


Fig. 19.6 External Assets of BIS Reporting Banks

(*Source:* BIS.org)

Table 19.5 International Debt Securities (In billions of US dollars)

Year	*Amount Outstanding*	*Net Issues*
2001	7503	1348
2002	9193	1011
2003	11672	1470
2004	13946	1607
2005	14635	1869
2006	18419	2776
2007	22708	2977
2008	23864	2436
2009	26993	2329
2010	27689	1514

(*Source:* BIS.org)

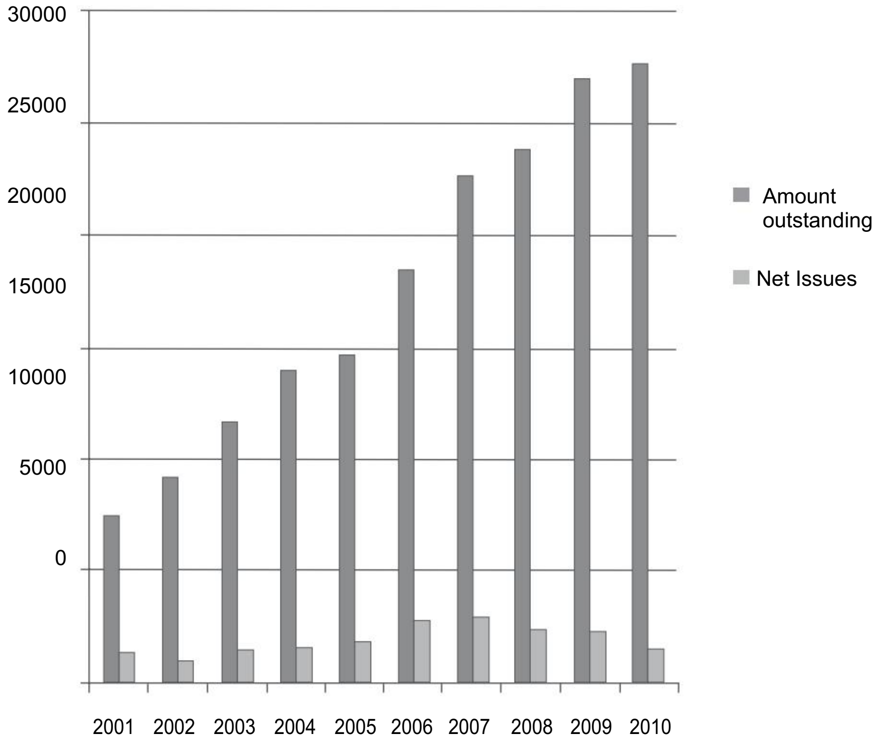


Fig. 19.7 International Debt Securities

Table 19.6 International Bonds & Notes (In billions of US dollars)

Year	*Amount Outstanding*	*Net Issues*
2001	7113	1427
2002	8755	1010
2003	11103	1395
2004	13282	1545
2005	13984	1821
2006	17557	2609
2007	21571	2778
2008	22732	2355
2009	26061	2567
2010	26773	1501

(*Source:* BIS.org)

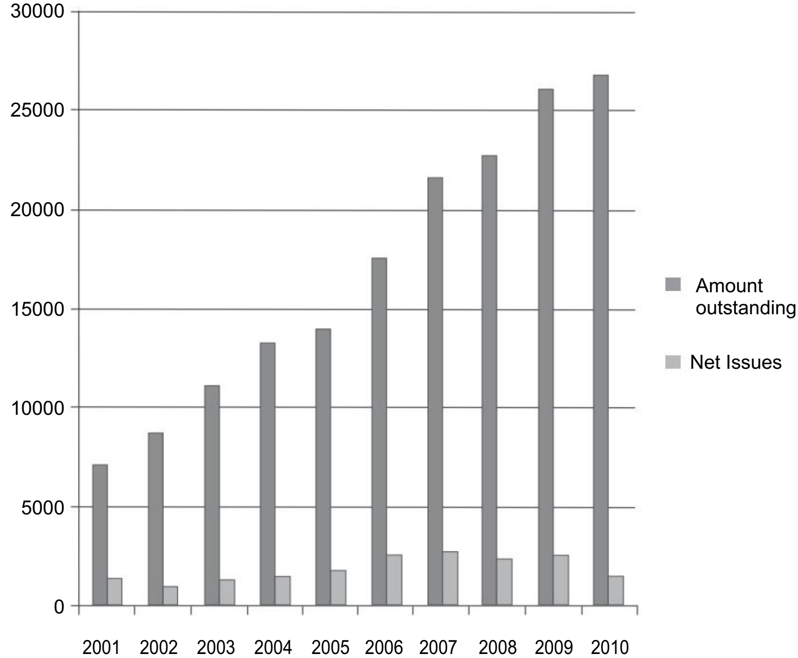


Fig 19.8 International Bonds & Notes

(*Source:* BIS.org)

Reasons for the Phenomenal Growth in Global Financial Markets There seem to be two answers: advances in information technology and deregulation by governments.

Information Technology The financial services industry is highly information-intensive. It draws on large volumes of information about markets, risks, exchange rates, interest rates, creditworthiness, and the like. This information is used by the industry to make decisions about what to invest where, how much to charge borrowers, how much of interest to pay to depositors, and the value and riskiness of a range of financial assets including corporate bonds, stocks, government services, and currencies.

The growth in information technology is so phenomenal, that instantaneous communication between any two points on the globe is now possible. At the same time, rapid advances in data processing capabilities have enabled market makers to absorb and process large volumes of information from around the world.

The developments in information technology have really facilitated the emergence of an integrated international capital market. It is now technologically possible for global financial services companies to engage in 24 hours-a-day trading, be it in stocks, bonds, foreign exchange, or any other financial instrument. And the global capital market never sleeps. San Francisco closes one hour before Tokyo opens, but during this period trading continues in New Zealand.

This integration of financial markets, as facilitated by rapid advances in telecommunications, has its flip side. “Shocks” that occur in one financial centre now spread around the globe very quickly. The collapse of US stock prices on the notorious Black Monday of October 19, 1987, immediately triggered similar collapses in all the world’s large stock markets, wiping billions of dollars off the value of corporate stocks worldwide. But, it is believed by the market makers all over that the benefits of integrated global markets far outweigh any potential costs.

Deregulation The financial sector was highly regulated in almost all the countries. There were restrictions on the entry of foreign financial service firms, and limits were imposed on foreign investors to purchase equities in domestic firms.

These regulations started crumbling since the late 1970s. Collapse of controlled economies, and pressure from financial service firms to operate in a free market are the main reasons for the trend towards deregulation.

In addition to the deregulation of the financial services industry, many countries, beginning in the 1970s, started to dismantle capital controls, loosening both restrictions on inward investment by foreigners and outwards investment by their own citizens and companies. By the 1980s, this trend spread from developed countries to the developing nations as countries across Latin America, Asia, and Eastern Europe started to dismantle decades old restrictions on capital flows.

Major International Financial Markets Following are the main financial markets operating across the globe: (see Fig. 19.9)

- International banks
- Eurocurrency market
- Eurobond market
- International stock markets

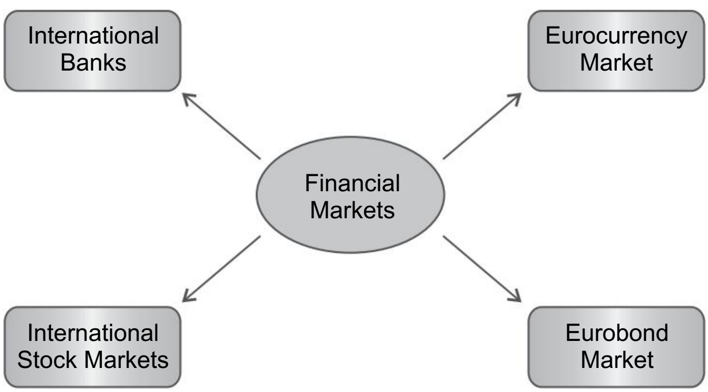


Fig. 19.9 Major Financial Markets

International Banks International banking has grown notably in both complexity and risk over the past two decades. Until recently, international banking was confined largely to providing foreign exchange and to finance specific export and import transactions through letters of credit and acceptances, but not any more.

International banking has grown steadily throughout the post-World War II period. Expansion of international trade in the 1950s and the effective emergence of the MNCs in the 1960s sharply increased the demand for international financial services. Banks located in the traditional financial centres responded by extending loans and developing new, highly innovative financial technologies (such as eurocurrency markets) that laid the foundation for totally new approaches to the provision of international banking services.

The banks play a critical role in financing international business by acting as both commercial banks and investment banks. As commercial banks, they finance exports and imports, accept deposits, provide working capital loans, and offer sophisticated cash management services to their clients. As investment banks, they underwrite or syndicate local, foreign, or multinational loans, and as brokers (act as agents), facilitate, or even finance mergers and joint ventures between foreign and domestic firms.

Major international banks have their headquarters located in the world's financial centres—Japan, the US, the UK, Germany, and France. These banks are involved in international commerce on a global scale. In terms of total assets of the world's largest ten banks, Japan is home to nine, a reflection in part, of Japan's global financial power and in part, to the key role Japanese banks play in financing the business needs of the country's business persons.

International banking takes many forms. Most international banking is undertaken through reciprocal correspondent relationships between banks located in different countries. A corresponding relationship is an agent relationship where one bank acts as a correspondent, or agent, for another bank in the first bank's home country. For example, a New Zealand bank could be the correspondent bank for a French bank in New Zealand, while the French bank could be the New Zealand bank's correspondent in France. Services performed by the correspondent banks include paying or collecting foreign funds, providing credit information, and honouring documents relating to international trade. To facilitate these transactions, each bank maintains accounts at the other that are denominated in the local currency.

As the large banks have internationalised their operations, they have increasingly provided their own overseas operations so as to improve their ability to compete internationally, rather than utilising the service of correspondent banks. A bank that has its own foreign operations is better able to access new source of deposits and profitable lending opportunities. Equally important, as its domestic clients internationalise their operations, it can better meet those clients' international banking needs, thereby retaining the international business of its domestic clients and reducing the risks of losing the accounts to some other international bank (Table 19.7 contains top banks in the world).

Even if viewed as diversion, it is desirable that we mention about the status of Indian banks. Appropriately called the "rotten banks" by *The Economist*, the public sector banks (PSBs) in India are examples of how not to run a commercial bank.

State-run banks have become notorious for their high share of bad loans or non-performing assets (NPAs), which are loans where the interest or the principal has been over-due for over 90 days. PSBs' gross NPA (GNPA), as a share of total advances, has shot up from 1.84% in March 2011 to 5.07% in December 2013. Private banks, on the other hand, witnessed their GNPA fall from 2.29% to 2.06% during the same period. What is even more alarming are PSBs' stressed assets, where interest or principal payment has not be made up to 90 days, which are over 12% of their total advances and about three times higher than that of private banks. Moreover, about 7% of PSBs' total loans were restructured in December 2013, compared to just over 2% for private banks. (See Fig 19.10)

Not only on the extent of bad loans, PSBs are also accused of being corrupt, inefficient, and bureaucratic. It is these negatives that have made the life of private sector banks comfortable.

Eurocurrency Market Another component of international financial markets is the Eurocurrency market. Originally called the Eurodollar market, the Eurocurrency market first made its appearance in the early 1950s when the communist-controlled governments of Central and Eastern Europe needed dollars to finance their international trade but feared that the US government would confiscate or block

Table 19.7 Top Banks in the World 2011 (*Source:* Standard and Poor)

Rank	*Bank*	*Country*	*Assets ($b)*
1	BNP Paribas	France	2,792.1
2	HSBC Holdings	UK	2,690.9
3	Deutsche Bank	Germany	2,681.3
4	Mitsubishi UFJ Financial Group	Japan	2,479.5
5	Barclays PLC	UK	2,395.3
6	Royal Bank of Scotland Group	UK	2,319.9
7	Industrial & Commercial Bank of China	China	2,304.4
8	Bank of America	US	2,264.4
9	JPMorgan Chase	US	2,246.8
10	Credit Agricole SA	France	2,236.8
11	Citigroup	US	1,956.6
12	Mizuho Financial Group	Japan	1,942.6
13	China Construction Bank	China	1,818.4
14	ING Group	Netherlands	1,798.6
15	Banco Santander	Spain	1,785.8
16	Bank of China	China	1,776.47
17	Agricultural Bank of China	China	1,773.11
18	Sumitomo Mitsui Financial Group	Japan	1,652.82
19	Societe Generale	France	1,590,72
20	Lloyds Banking Group	UK	1,570.59
21	Groupe BPCE	France	1,532.53
22	UBS	Switzerland	1,469.46
23	UniCredit S.p.A.	Italy	1,331.88
24	Wells Fargo	US	1,259.73
25	Credit Suisse Group	Switzerland	1,160.72
26	Commerzbank	Germany	991.085
27	Rabobank Group	Netherlands	963.910
28	Intesa Sanpaolo	Italy	934.576
29	Nordea Bank	Sweden	859.851
30	Norinchukin Bank	Japan	839.80
31	Morgan Stanley	USA	830.747
32	BBVA (Banco Bilbao Vizcaya Argentaria)	Spain	824.389
33	China Development Bank	China	775.20
34	Royal Bank of Canada	Canada	765.396
35	Dexia	Belgium	750.521
36	National Australia Bank	Australia	708.360
37	TD Bank Group	Canada	696.503
38	Natixis	France	656.665

(*Source:* BIS.org)

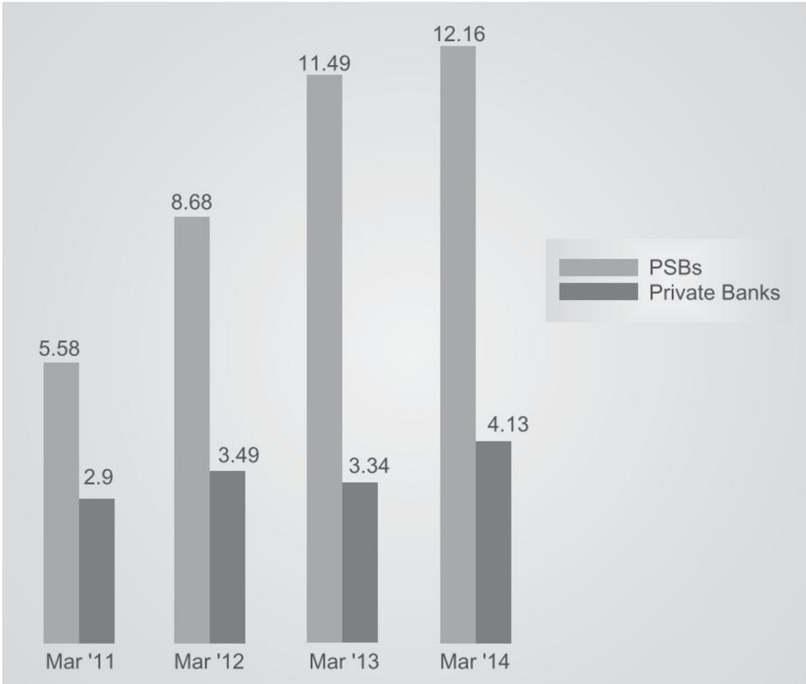


Fig. 19.10 Restructured laws as percent of total advances

their holdings of dollars in the US banks for political reasons. These governments solved their problem by using European banks that were willing to hold their dollar accounts for them. In this way, the Eurodollar was born—US dollars deposited in the European bank accounts. As other currencies became stronger in the post-war era—particularly the yen and the Deutsche mark—the Eurocurrency market broadened to include Europounds, Euroyen, Euromarks, and other currencies. Today, a Eurocurrency is defined as a currency on deposit outside of its country of issue. Obviously, the term Eurocurrency is a misnomer because a Eurocurrency can be created anywhere in the world; the persistent Euro-prefix reflects only the European origin of the market.

Eurocurrency markets serve two valuable purposes: (1) Eurocurrency deposits are an efficient and convenient market device for holding surplus cash; and (2) Eurocurrency market is a major source of short-term bank loans to finance corporate working capital needs, including the financing of imports and exports. The unique feature of the Eurocurrency market is the relatively low cost of borrowings. The Eurocurrency market loans are low cost because of three reasons. Firstly, the loans are free from costly government banking regulations, such as revenue requirements, that are designed to control the domestic money supply but which push up lending costs. Secondly, these loans involve large transactions, so the average cost of making the loan is less. Thirdly, since the most creditworthy borrowers avail the loans, the risk premium that lenders charge is also less.

Eurobond Market MNCs, like domestic firms, can obtain long-term debt by issuing bonds in their local markets. MNCs can also access long-term funds in foreign markets by issuing bonds in the international bond markets. International bonds are typically classified as either foreign bonds or Eurobonds. A foreign bond is issued by a borrower foreign to the country where the bond is placed. Thus, when

Dow Chemical issues bonds in Japanese yen and sells them in Japan, it is issuing foreign bonds. Many foreign bonds have nicknames; they are called Yankee bonds in the US, Samurai bonds in Japan, and bulldogs in the UK.

Eurobonds are sold in countries other than the country represented by the currency denominating them. They have been very popular during the last decade as a means of attracting long-term funds. US based MNCs such as McDonald's and Walt Disney commonly use the Eurobond market. Non-US firms such as Guinness, Nestle, Volkswagen, and Volvo also use this market as a source of funds.

As with the Eurocurrency market, the Eurobond market is highly competitive and borrowers are often able to obtain funds on very favourable terms. Large transaction sizes, creditworthy borrowers, and freedom from restricting regulations imposed on domestic capital markets contribute to lower rates of interest charged on such loans.

Global Equity Markets The growing integration of global operations and improvements in telecommunications technology have made the trading of stock on equity markets more global (In India, Australia, and New Zealand, the term *share* is used instead of *stock* to describe ownership entitlements—equity in companies. However, the term *stock* is widely used in international financial markets). MNCs are no longer restricted to raising new equity solely from domestic stock markets. They are raising funds through equity from overseas markets too.

Internationalisation of equity fund raising has led to two developments. First is the internationalisation of corporate ownership. Today, it is still generally possible to talk about US firms, British companies, and Japanese corporations, primarily because the majority of the stockholders of these MNCs are of the respective nationality. However, this is changing. Increasingly, US citizens are buying stock in companies incorporated abroad, and foreigners are buying stock in firms registered in the US.

Secondly, companies with historic roots in one nation are broadening their stock ownership by listing their stock in the equity markets of other nations. The idea is to tap into the liquidity of foreign markets, thereby increasing the funds available for investment and lowering the firm's cost of capital. Another idea behind raising funds from overseas stock exchanges is to facilitate future acquisitions of foreign companies. Other reasons for listing a company's stock on a foreign equity market are that the company's stock and stock options can be used to compensate local management and employees, it satisfies the desire for local ownership and it increases the company's visibility with local employees, customers, bankers, and suppliers.

Figure 19.11 contains characteristics of major stock exchanges across the globe. Numerous stock exchanges are also available. Some foreign markets are much smaller because firms in those countries have relied more on debt financing than equity financing in the past. However, these firms have been recently issuing stocks more frequently, which has resulted in the growth of non-US stock exchanges.

MNCs have begun to simultaneously float new stock issues in various countries. Investment banks underwrite stocks through one or more syndicates across countries. The global distribution of stocks can reach a much larger market, so greater quantities of stocks can be issued at a given price.

Currency Crises

In a discussion on international financial management, reference to currency crises is in order. We refer to five crises—Mexico's crisis, Asian crisis, debt crisis, the sub-prime crisis, and Euro crisis, in that order.

Stock Exchange	Number of companies listed	Market Capitalization (in billion of $)	Average Daily Volume (millions of shares)	Restrictions on Foreign Ownership
Australia	1,219	560	350	Only on strategic industries, such as uranium.
Belgium	263	136	NA	None.
Canada (Montreal)	577	484	17	Some financial institutions are subject to a maximum limit.
Canada (Toronto)	1,323	758	88	See above
Denmark	249	94	NA	None.
Finland	126	74	NA	None.
France	886	970	NA	Non-European investors are subject to a maximum limit.
Germany	3,003	824	NA	None.
Hong Kong	674	278	887	None.
Italy	213	490	NA	None.
Japan	2,387	1,917	454	Investors may be subjected to maximum limit.
Mexico	309	NA	33	Various restrictions apply.
Netherlands	350	91	NA	None.
New Zealand	387	15	7	Non-residents are subject to maximum limits.
Norway	217	66	NA	Non-residents are subject to maximum limits.
Singapore	326	NA	NA	Some restrictions apply.
South Korea	762	57	88	Non-residents can invest only through mutual funds.
Switzerland	3,890	56	NA	Registered shares are restricted to residents.
Taiwan	NA	92	NA	Restrictions apply to non-residents.
United Kingdom	2,991	2,063	NA	None.
United States	3,047	8,450	540	None.

Fig. 19.11 Characteristics of Stock Exchanges

(*Source*: Jeff Madura, *International Financial Management*, South Western, 2000, p. 78)

Mexico's Crisis The crisis in Mexico occurred in 1995 and the root cause was the use of foreign capital inflows to generate quick growth with the help of imports. The depletion of foreign exchange reserves ensured that once the inflow slowed down, the current account deficit in the BOP reached crisis proportions. The devaluation that was meant to ease this crisis only added on inflation, leading to a collapse of the stock market. The resultant losses to foreign investors caused a capital flight that deepened the crisis.

To bail Mexico out of the crisis, the IMF, the US Government, and the Bank for International Settlements stepped in. Together the three institutions pledged close to $50 billion to help Mexico stabilise the peso and redeem $47 billion of public and private sector debt that was set to mature in 1995. Without the aid package, Mexico would probably have defaulted on its debt obligations, and the peso would have lost its credibility. But the IMF insisted on tight monetary policies and further cuts in public spending, both of which pushed the economy into a deep recession. However, the recession was relatively shortlived, and by 1997, the country was once more on a growth path, had pared down its debt, and had paid back 20 million debt ahead of schedule.

The Asian Crisis The crisis began in Thailand in July 1997 when the value of the Thai baht plummeted. The crisis slowly spilled over and engulfed Indonesia, Republic of Korea, Malaysia, and

Philippines by the end of 1997. Many banks and financial institutions in the region were closed, the real estate sector collapsed, interest rates soared, currencies depreciated rapidly, and many regional stock markets fell to unprecedented lows. Thus the "Asian Tigers" found themselves without teeth suddenly.

The seeds of the crisis were sown during the previous decade when these countries were experiencing an unprecedented economic growth. Exports had been the engine of economic growth in these countries. From 1990 to 1996, the value of exports from Malaysia had grown by 18 per cent annually, Thai exports had grown by 16 per cent per year, Singapore's by 15 per cent, Hong Kong's by 14 per cent, and those of South Korea and Indonesia by 12 per cent each annually. 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.

But the cyclical downturn in the demand for electronics, along with a rising dollar and a falling yen, had an adverse effect on exports, which lead to skepticisms about the health of the economy of the Asian countries. This threatened the large inflow of foreign capital, which was now badly needed to sustain the mounting current account deficits. This in turn led to market concern about the prevailing exchange rates and the eventual collapse of the Thai baht. Once the crisis unfolded, investors realised that there were no implicit government guarantees for investment, and asset price bubbles burst. Falling asset prices resulted in the bankruptcy of financial intermediaries, leading to a full-fledged financial crisis.

The crisis did not confine itself to Thailand alone. It spread far and wide, S Korea, Malaysia, Indonesia, and Philippines were badly hit. The crisis hit Russia too. There was downward pressure on the Russian rouble and the Central Bank of Russia had to use the direct intervention of using dollars to purchase roubles in the foreign exchange market. Japan was also affected by the Asian crisis because its exports to the 'Asian Tigers' were hit and many of its corporations have subsidiaries in these countries whose business performance was hit by the local economic conditions.

The Asian crisis also affected Latin American countries. Countries such as Chile, Mexico, and Venezuela were adversely affected because they exported their products to Asia, and the weak Asian economies resulted in a lower demand for the Latin America exports.

European countries too were adversely affected by the Asian crisis. Like firms in Latin America, many European firms experienced a reduced demand for their exports to Asia during the crisis. In addition, they lost some exporting business to Asian exporters as a result of the weakened Asian currencies that reduced the Asian prices from an importer's perspective. European banks were especially affected by the Asian crisis, since they provided huge loans to numerous Asian companies which had defaulted.

The effects of the Asian crisis were even felt in the US. Stock values of US firms such as 3 M, Motorola, HP, and Nike, which had business dealings with the Asian countries were hit. Many US engineering and construction businesses in Asia lost their business as the local countries stopped infrastructural developments.

The Indian economy had not been saved. Having embraced globalisation, the Indian economy cannot be insulated against any crisis occurring in any part of the globe. The macroeconomic fundamentals had been affected by the Asian crisis. Duff and Phelps downgraded India's economic outlook. The NCAER's report revealed a fall in the index of business confidence by over 18 per cent. The rupee fell to a massive low of Rs 43.71 between August 8, to August 19, 1998. Towards the close of 1997, the Sensex went into a tailspin, falling to a low of 3247. RBI, expectedly, intervened with a series of corrective measures and the crisis was averted from becoming a catastrophe.

The Asian region has now come out of the crisis. The swiftness of the recovery owes to the macroeconomic policy responses like stringent fiscal and monetary measures and structural reforms. Of course, the role played by the IMF is not to be underplayed.

However, the Asian crisis demonstrates how economies are integrated and how an economic crisis in one part of the globe can effect the entire world. The crisis also shows how even US and European economies are susceptible to conditions in emerging markets. Finally, the integration of developing economies into the global system no doubt helps them, but as the Mexico's experience of 1995 and the recent experience of 'Tigers' show, it also needs stricter discipline in economic management as it leaves them less room for policy errors.

Debt Crisis By the early 1980s, certain Latin American countries had accumulated huge debts payable to the IMF, the World Bank, and major commercial banks. In 1982, Mexico, Brazil, and Argentina, declared, in despair, that they would be unable to pay interest on their loans. Many African countries, too, had the same problem.

Coupled with this was the runaway inflation which almost wrecked these economies. In 1988, the inflation rate in Brazil was 933 per cent. Although Brazil spent heavily on social welfare programmes, much of the money was squandered on a bloated and corrupt bureaucracy.

Bank for International Settlements In order to prevent a melt down of the entire financial system, international agencies stepped in with a number of solutions to resolve the crisis. Repayment schedules were redrawn to postpone repayment. One international agency that played a key role in the debt crisis, by providing temporary loans, is the Bank for International Settlements (BIS)—an international banking institution that serves national central banks around the world and helps stabilise the international monetary system. Traditionally, only the richest countries were members of the BIS. But in 1996–97, the bank added to its membership emerging markets from Asia, central and eastern Europe, Latin America, and the Middle East. Today, the BIS has 60 nations as its members.

Brady Plan The Brady plan (named after the US Treasury Secretary, Nicholas Brady) was unveiled in 1989. The plan called for large-scale reduction of the debt of poorer nations, the exchange of old loans for new low interest loans, and the making of debt instruments (based on these loans) that would be tradable on world financial markets. The last feature allowed a debtor country to receive a loan from the institution and then use to buy special securities (called Brady Bonds) on financial markets. Funds for these new loans came from private commercial banks and were backed by the IMF and the World Bank.

Sub-Prime Crisis Financial crises are not new. They have been occurring across the globe with sickening regularity. There were the Dutch Tulip Mania, the Wall Street Crash of 1929, the Japanese Property bubble of 1980s, Latin America's Crisis of 1980s, the Asian Crisis of 1997 and dot.com bubble of 2000-01. Most of these crises originated in the developing economies.

But the sub-prime crisis is unique in at least three ways. First, the crisis took place in the US—the protagonist of free economy and home for scores of noble laureates in economics—demonstrating the fact that the US is not infallible. Second, the ripple effects of the crisis have spread across the globe. Third, the US economy itself has been hit very severely. Bear Stearns has been sold to J.P. Morgan and Lehman Brothers went bankrupt. Millions of Americans lost their jobs and the loss to the US economy has been pegged at $ 500 billion. The US growth rate has come down. Credit crunch across the US and Europe has hit consumer spending, housing loan defaults continue to rise, financial institutions continue to make massive write-offs and government has been infusing sovereign wealth funds in the name of bail-out and stimulus packages.

It all started in the US between 2000 and 2006. Mortgage loans on residential properties were lent, disregarding the criteria of 'prime' mortgages, to those whose creditworthiness was low. The low repayable capacity debtors are called the 'sub-prime' borrowers. Most of these loans carried low margin money and with low initial teaser payments. Because of the high risk of default, sub-prime borrowers were charged higher interest rates than prime borrowers. Most shocking development was that these mortgage loans were securitised by the Wall Streets firms. International investors such as hedge funds, pension funds and banks have been investing in such securities. These derivatives proved to be toxic assets that have contaminated the Western countries' banking system.

The crisis started now. The sub-prime borrowers defaulted in repaying the stipulated initial monthly instalments followed by high delinquency rates. Side by side, interest rates increased and house prices flattened and then turned negative in a number of regions. Many borrowers were left with no option but to default as repayment and refinancing options were not feasible with little or no housing equity.

The crisis in sub-prime lending sent shock waves through other parts of the financial system. Many of the structural credit and mortgage market products could not be traded at all. Many investors facing margin calls from worried counterparts were unable to sell holdings to raise capital because there were no buyers that forced them to seek cash via the money market instead. Investors with hedge funds in structured products also reportedly faced withdrawals and margin calls. Several banks were also reported to have been hit by losses from risky property loans.

It is not that the housing loans only triggered the crisis. Persistence of large global imbalances, which in turn, were the outcome of long periods of excessively loose monetary policies in the major advanced economies during the early part of the first decade of the 21st century have also contributed to the crisis.

Impact on India The effect of the sub-prime crisis on Indian banks/financial sector has been negligible because of limited exposure to complex derivatives and other prudential policies pursued by the Reserve Bank. The relatively lower presence of foreign banks in the Indian banking sector also minimised the direct impact on the domestic economy. The larger presence of foreign banks can increase the vulnerability of the domestic economy to foreign shocks.

It does not mean that the Indian economy has been completely insulated. India is a part of global economy and the US is the major player in the world economy. Whatever happens to the US economy has its impact on India. Gobalisation does not mean only internationalisation of business. It also means cross-border movement of H1 N1 and financial crisis.

Orders from the US for goods and services suddenly stopped throwing domestic production, investment and employment out of gear. For nearly three years 2007-2009, there were talks, discussions and articles on economic downturn and how Indian companies could cope with it. Thanks to the proactive role played by the RBI, the damage to the economy has been minimal. Indian businesses have left the crisis behind and are looking ahead for registering a double digit growth rate in the years to come. The current fears of recession in major economies and the Euro crisis have resulted in Rupee depreciating sharply against dollar.

Euro Crisis The opening case to this chapter speaks enough about the Euro crisis. What remains to be said now is that the existence of both EU and Euro is at stake. How these two can be saved is the question which only time can answer. One or two lessons can be drawn from this ongoing crisis. No country should live beyond its means. Second, austerity, belt-tightening and frugal life are virtues. Third, living always on past laurels is unwise. Times change and one should learn to live with them. Finally, citizens should know how to stand on their feet and not depend on government subsidies all the time.

SCOPE OF INTERNATIONAL FINANCIAL MANAGEMENT

LO 4
Predict the scope of international financial management

As stated in the beginning of this chapter, finance function of an international business comprises three broad activities, namely, investment decisions, financing decisions, and money management decisions. The following sections discuss these three major activities in detail.

Investment Decisions

A decision to invest in activities in a given country must consider many economic, political, and cultural factors. All of these factors were considered at several places till now in this book. Keeping these and other forces in mind, the financial manager in an international business should try to quantify the various benefits, costs, and risks that are likely to flow from an investment in a given location. This is done by using capital budgeting technique.

Capital Budgeting Capital budgeting framework enables an international financial manager to make decisions on long-term investments such as major acquisitions, the building of new plants, and the refurbishing of existing equipment. Capital budgeting is a process of matching advantages from possible uses of funds against the cost of alternative ways to obtain the needed resources. In domestic business, capital budgeting has become highly developed with sophisticated analytical approaches available for investment decisions. In the international field, the use of capital budgeting techniques has also developed despite a variety of complications and uncertainties that must be handled when national boundaries are crossed.

Capital budgeting for a foreign project uses the same theoretical framework as is applicable to domestic business; that is, the firm must first estimate the cash flows associated with the project over time. In most cases, the cash flows will be negative at first, as the firm will be investing heavily on production facilities. After some initial period, however, the cash flows will become positive as investment costs decline and revenues grow. Once the cash flows have been estimated, they must be discounted to determine their net present value using an appropriate discount rate. The most commonly used discount rate is either the firm's cost of capital or some other required rate of return. If the net present value of the discounted cash flows is greater than zero, the firm should go ahead with the project.

Although, capital budgeting might sound quite simple, in practice the process is very complex.

Factors Complicating the Process for an International Business

- Parent cash flows must be distinguished from project cash flows. Each of these two types of flows contributes to a different view of value.
- Parent cash flows often depend on the form of financing. Thus, cash flows cannot be clearly separated from financing decisions, as is done in domestic capital budgeting.
- Additional cash flows generated by a new investment in one foreign affiliate may be in part or in whole taken away from another affiliate, with the net result that the project is favourable from a single affiliate's point of view but contributes nothing to worldwide cash flows.
- Remittance of funds to the parent must be explicity recognised because of differing tax systems, legal and political constraints on the movement of funds, local business norms, and differences in the way financial markets and institutions function.

- Cash flows from affiliates to the parent can be generated by an array of non-financial payments, including payment of license fees and payments for imports from the parent.
- Differing rates of national inflation must be anticipated because of their potential to cause changes in competitive position, and thus changes in cash flows over a period of time.
- The possibility of unanticipated foreign exchange rate changes must be kept in mind because of possible direct effect on the value to the parent of local cash flows, as well as indirect effects on the competitive position of the foreign affiliate.
- Use of segmented national capital markets may create an opportunity for financial gains or may lead to additional financial costs.
- Use of host-government subsidised loans complicates both capital structure and the ability to determine an appropriate weighted-average cost of capital for discounting purpose.
- Political risk must be evaluated because political events can drastically reduce the value or availability of expected cash flows.
- Terminal value is more difficult to estimate because potential purchasers from the host, parent, or third countries, or from the private or public sector, may have widely divergent perspectives on the value of acquiring the project.

Thus, capital budgeting is of considerable importance for an international business as it dictates the types of operations and the locations of operations run by the MNC. It also affect the expected foreign currency cash flows generated by the MNC's foreign subsidiaries.

Cross-Border Mergers and Acquisitions Another decision relating to international investment refers to cross-border mergers and acquisitions and their valuation. The 1980s and 1990s were characterised by a spate of mergers and acquisitions (M&As) with both domestic and foreign partners. Particularly, the latter half of the 1990s saw a number of mega mergers between international businesses such as Daimler Chrysler and Exxon-Mobil, which virtually changed the entire competitive environment of their respective global markets.

Reasons for Mergers and Acquisitions The main motive behind a merger or an acquisition is creation of shareholder value. The United Nations Conference on Trade and Development (UNCTAD) has summarised the triggers for mergers and acquisitions, which are shown in Fig. 19.12. Table 19.8 shows the biggest bidders in 2014.

The other drivers of M&A activity are both macro (the global competitive environment) and micro (the variety of industry and firm-level forces and actions driving individual firms) in scope. The primary forces of change in the *global competitive environment*—technological change, regulatory change, and capital market change—create new business opportunities for MNCs, which they pursue aggressively.

The global competitive environment offers a level playing field, the ground upon which the individual players compete. International businesses undertake M&As for a variety of reasons, such as:

- Gaining access to property and strategic proprietary assets
- Gaining market power and dominance
- Achieving synergies in local/global operations and across different industries
- Becoming larger, and then reaping the benefits of volumes
- Diversifying and spreading risks wider
- Exploiting financial opportunities

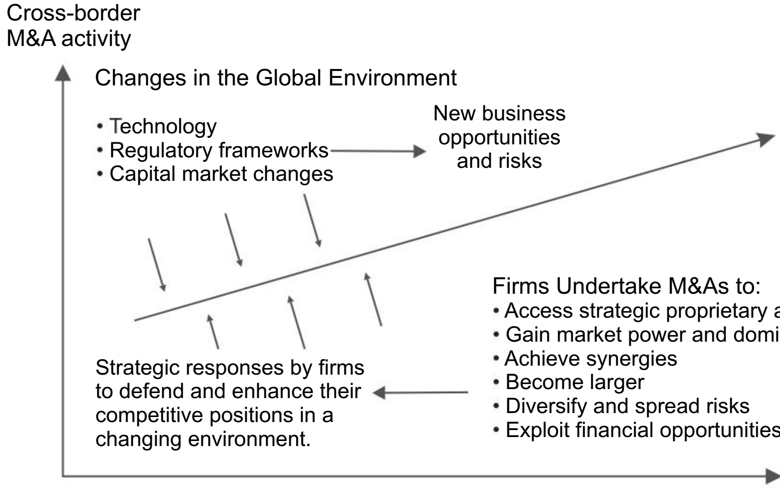


Fig. 19.12 Driving Forces Behind Cross-Border M&As

(*Source*: UNCTAD, World Development Report 2000: *Cross-border Mergers and Acquisitions and Development*)

Several other reasons come out when one digs into the justifications why deals take place. At times, companies accumulate huge cash in their subsidiaries and they do not know what to do with it, as has happened to the American firms now. And they cannot repatriate the money without paying heavy taxes. Pfizer, for example, has huge cash pile of $69 bn. Buying companies in subsdiaries is ideal way of draining up the cash. Each deal has its own motives. Facebook feared the popularity of WhatsAPP and bought it for $19 bn.

Table 19.8 Eat or be eaten (Biggest takeover bids of the year to April 30th 2014)

Target	*Bidder*	*Industry*	*Value, $ bn*
AstraZeneca (Britain)	Pfizer (US)	Health care	98.7
Time Warner cable (US)	Comcast (US)	Cable	69.8
Allergan (US)	Valeant (Canada)	Health care	47.5
Lafarge (France)	Holcim (Switzerland)	Cement	40.6
Forest Laboratories (US)	Actavis (US)	Health care	25.3
SFR (France)	Altice (Luxembourg)	Telecoms	23.6
WhatsApp (US)	Facebook (US)	Social media	19.4
Alstom (France)	GE (US)	Machinery	17.1
Beam (US)	Suntory (Japan)	Drinks	16.0
GlaxoSmithKline (Britain)	Novartis (Swtizerland)	Health care	16.0

(*Source: The Economist,* May 3rd-9th, 2014)

Mergers and Acquisitions—Advantages and Disadvantages Compared to greenfield investment, merger or acquisition is advantageous to an international business. In the first place, this method is faster. Setting up a new project and developing it is a time-consuming, painful, and expensive affair.

By acquiring an existing firm, an MNC can gain access to market from day one. Second, by acquiring a firm, an MNC can gain competitive advantages in technology, logistics and distribution advantages, brand equity, and possible elimination of local competitors.

The disadvantage of acquisition is the cost of buying an ongoing firm. In general, the larger and more experienced a firm becomes, the less frequently it uses acquisitions to expand overseas. Smaller and relatively less experienced companies often turn to acquisitions. Another pitfall of acquisition is the problem of managing the post-acquisition phase. The aftermath of acquisition is generally characterised by downsizing to gain economies of scale and scope of overhead functions. This is resisted by employees. Additional difficulties also arise from host governments intervening in pricing, financing, job security, and general nationalism and patriotism.

The most ticklish issue relating to an acquisition is the pricing of the firm to be acquired. A variety of valuation techniques are widely used in international business today. Some of them are age-old techniques like discounted cash flow. Some others are industry-specific measures, for example, cost per tonne of brewing capacity in a brewery.

Financing Decisions

Financing decisions refer to designing a capital sourcing strategy by an international business. Figure 19.13 is a visual presentation of alternative paths towards raising adequate funds at low cost.

Normally, the choice of paths and implementation is aided by an early appointment of an investment bank as official advisor to the international business. Investment bankers are the persons in touch with potential foreign investors and knowledgeable about what these investors are currently requiring. They can also help navigate the various institutional requirements and barriers that must be surmounted. Their services include advising whether, when, and where a crosslisting should be initiated. They usually prepare the required stock prospectus if an equity issue is desired, help price the issue, and maintain an after market to prevent the share price from falling below its initial price.

As seen from Fig. 19.13, most firms raise their initial capital in their own domestic markets. The temptation with many firms is to jump to the bottom line—Euro equity issues in global markets. This is the time when the advise of an investment banker is required. Wisdom lies in sourcing abroad with an international bond issue. It could be placed on a less prestigious foreign market. This could be followed by an international bond issue in the target market or in the Eurobond market. The next step might be to crosslist and issue equity in one of the less prestigious markets to attract international investor attention. The next step could be to crosslist shares on a highly liquid prestigious foreign stock exchange such as London, NYSE, or NASDAQ. The ultimate step would be to place a direct equity issue in a prestigious target market or Euro equity issue in global equity markets.

Another issue in financing decisions relates to configuring the capital structure of an international business. By capital structure we mean the mix of debt and equity used to finance a business. It is well known that Japanese firms rely more on debt financing than do most US firms.

Tax regimes determine the relative attractiveness of debt and equity in a country. For example, if dividends are taxed highly, a preference for bond financing may be expected.

Local capital composition norms often determine the capital structure of an international business. There are valid reasons for conforming to local norms. One advantage claimed is that management can more easily evaluate its return on equity relative to local competitors in the same industry. Another point often made is that conforming to higher host-country debt norms can improve the image of foreign affiliates that have been operating with too little debt and thus appear insensitive to local

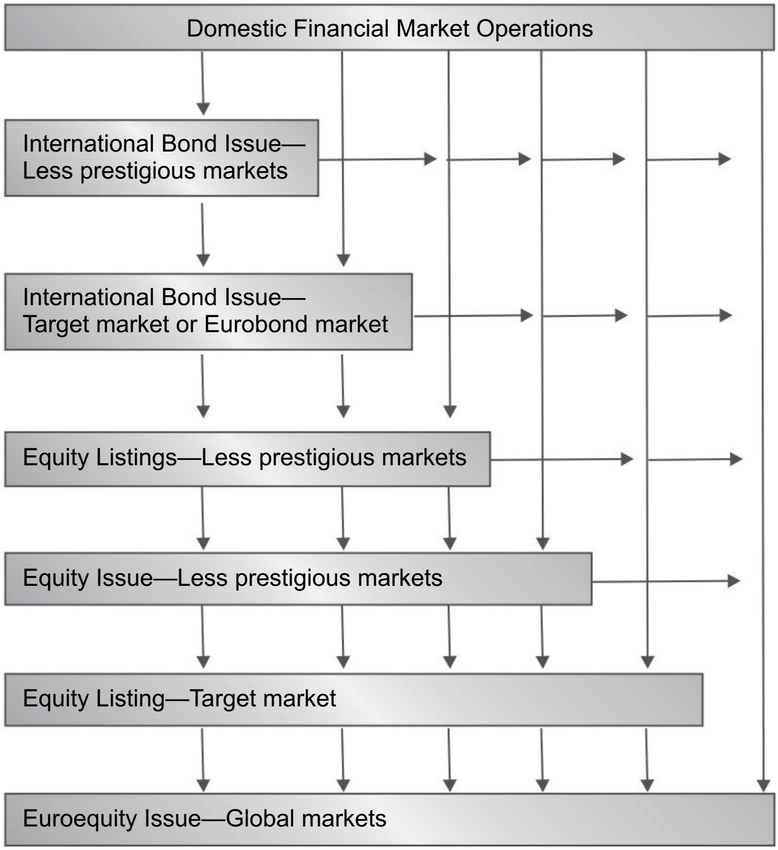


Fig. 19.13 Alternative Paths to Internationalise the Cost and Availability of Capital

(*Source*: David Eiteman, et al, *Multinational Business Finance*, p. 338)

monetary policy. The best approach is that an international business should adopt a capital structure for each foreign affiliate that minimises its cost of capital, irrespective of whether that structure is consistent with local practice.

Money Management Decisions

Management decisions refer to the strategies of managing an MNC's working capital efficiently. The management of working capital in the MNC is similar to its domestic counterpart. Both are concerned with selecting the combination of current assets that will maximise the value of the firm. The essential differences between domestic and international working capital management include the impact of currency fluctuations, potential exchange controls, and multiple tax jurisdictions on the decisions, in addition to the wider range of short-term financing and investment options available. We cover international cash management, management of accounts receivable, and inventory management in this section. Towards the end we refer to the management of taxation. Two other topics relating to management decisions, namely, financing foreign trade and international accounting will be covered respectively in the next two chapters.

International Cash Management One major task of an international financial manager relates to the management of cash. This task is more complicated for MNCs than for purely domestic businesses. The financial manager of an MNC must consider the firm's cash position for each of its foreign subsidiaries and in each currency in which the subsidiaries do business, as well as for the firm as a whole. For example, Cathay Pacific uses over 30 currencies in its operations. Similarly, Pacific Dunlop—one of Australia's most diversified manufacturing companies—conducts business primarily in 10 currencies, and deals with a number of other currencies in small amounts.

While managing cash, the international financial manager needs to address three issues:

- Minimising cash balances,
- Minimising currency conversion costs, and
- Minimising foreign exchange risks.

Minimising Cash Balances A firm needs to hold cash to facilitate daily transactions and to cover the firm against unexpected demands for cash. It is unwise to hold cash idle and it is equally risky to run out of cash. This principle holds good whether the firm is an MNC or does business within the boundaries of a particular country.

An international business generally makes use of *centralised treasury* to minimise its companywide cash holdings. Also called, *cross-border pooling,* the centralised treasury coordinates an MNC's worldwide cash flows and pools its cash reserves. These centralised treasuries are generally located in important money market centres such as Tokyo, New York, and London. These centres have well-developed financial services sectors, excellent worldwide communication links, truly convertible currencies, and laws that facilitate international currency flows. Hong Kong, New Zealand, Australia also act as depositories for MNCs with regional headquarters in those countries.

The centralised treasury operates, more or less, on a set pattern. Each subsidiary of an MNC sends to the centralised cash depository a daily cash report and an analysis of expected cash balances and needs over the short run, which may range from a week to a month depending on the parent company's operating requirements. These reports are then assembled by the central treasury's staff, who use them to plan short-term investment and borrowing strategies for the MNC. The treasury may receive excess cash held by each subsidiary and pool these funds, funneling them to subsidiaries when and if emergencies arise. The unexpected need for additional cash by one subsidiary will often be offset by equally unexpected excess of cash generated by a second. Therefore, the central cash depository is able to reduce the precautionary cash balances held by the firm as a whole, and thereby reduce the amount of cash held idle. Further, the expertise of the depository staff can be used to seek out the best short-term investment opportunities available for the firm's excess cash holdings and to monitor expected changes in the values of foreign currencies.

Minimising Currency Conversion Costs Minimising currency conversion costs, also, called transaction costs, is a tough task for the international financial manager. Firms' foreign subsidiaries continually buy and sell parts and finished goods between each other. These transactions generate invoices and need to transfer funds between the companies' bank accounts. Cumulative bank charges for transferring these funds and converting the currencies can be quite high. For large transactions involving two major European currencies, currency conversion fees and expenses may average 0.3 per cent of the total value of the transaction. For smaller-sized transactions or for transactions involving minor currencies with narrow markets, like many of the currencies in Asia, such fees and expenses can easily be three or four times together.

Consequently, most MNCs use netting operations where it is possible to minimise the amount of funds that must be converted in the foreign exchange market to settle transactions between subsidiaries. Bilateral netting occurs between two business units, and multilateral netting involves three or more business units.

When a German subsidiary of an MNC, for example, sells goods worth $1million to its Italian affiliate that in turn sells goods worth $2 million to the German unit, the combined flows total $3 million. On a net basis, the German unit needs remit only $1million to the Italian unit. This is bilateral netting. Bilateral netting, though useful, works only when subsidiaries sell back and forth to each other. However, bilateral netting helps reduce conversion costs.

Bilateral netting would be of little use where there is a more complex structure of internal sales, such as the situation shown in Fig. 19.14 where no company both buys from, and sells to, any one affiliate. Where transactions take place among three or more units, multinational netting would become essential.

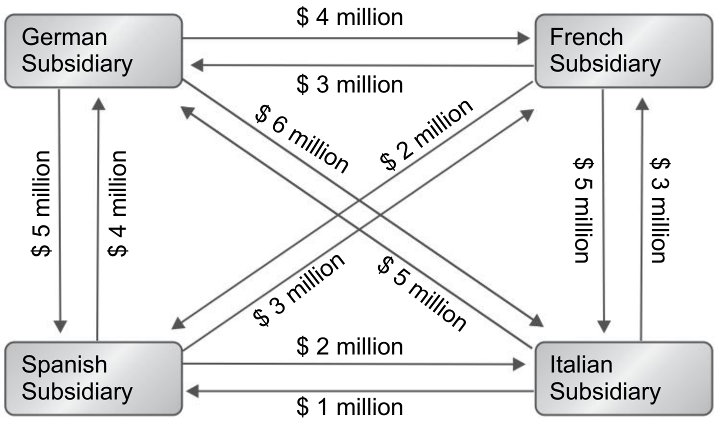


Fig. 19.14 Cash Flows before Multilateral Netting

Multilateral netting operates in a definite pattern. Consider a firm that wants to establish multilateral netting among four European subsidiaries based in Germany, France, Spain, and Italy. All these subsidiaries trade with each other, so at the end of each month, a large volume of cash transactions must be settled. Figure 19.15 shows how the payment schedule might look at the end of a given month. Figure 19.15 is a payment matrix that summarises the obligations among the subsidiaries.

Going by the data shown in Fig. 19.14, the parent company needs to spend $4,30,000 on transaction costs, which is equivalent to one per cent on $43 million—the total funds to be transferred among the subsidiaries. However, this amount can be reduced by multilateral netting. Using the payment matrix (Fig. 19.15), the firm can determine the payments that need to be made among its subsidiaries to settle these obligations. Figure 19.16 shows the results. By multilateral netting, the transactions depicted in Fig. 19.15 are reduced to just three; the German subsidiary pays $3 million to the Italian subsidiary, and the French affiliate pays $1 million to the Italian and $1 million to Spanish subsidiaries. The total inter-subsidiary transfers of funds are brought down to $5 million from $43 million. The conversion costs have been reduced from $4,30,000 to $50,000, a saving of $3,80,000 achieved through multilateral netting.

Managing Foreign Exchange Risks Managing foreign exchange risk is a challenging task for an international business. Changes in the values of currencies, both devaluations and revaluations, and frequent

Receiving Subsidiary	Paying Subsidiary					
	Germany	France	Spain	Italy	Total Receipts	Net Receipts
Germany	–	3	4	5	12	($3)
France	4	–	2	3	9	(2)
Spain	5	3	–	1	9	1
Italy	6	5	2	–	13	4
Total	15	11	8	9	–	–

Net Receipts = Total payments – Total receipts

Fig. 19.15 Calculations of Net Receipts

(*Source*: Figure 19.14 and 19.16 have been taken from *International Business* by Charles W L Hill, pp. 629–630)

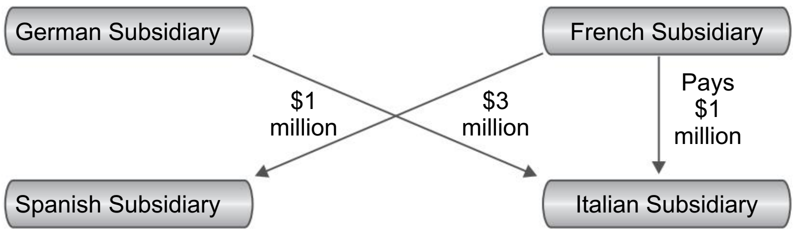


Fig. 19.16 Cash Flows after Multilateral Netting

fluctuations in currency conversion rates add to the risk in handling foreign currencies.

Foreign exchange risk is not associated only with MNCs. Any company with a receivable or payable to be collected or paid in a foreign currency is exposed to foreign exchange risk. But the exposure of the multinational business is far more complex. First, the enterprise must specify and analyse through an exchange audit all aspects of its operations that have foreign exchange implications. Secondly, it must identify and measure the types of exposure it has to change in currency values. Thirdly, it must have a strategy for exposure management. Fourthly, it must develop procedure for forecasting the amount, timing, pattern, and probability of changes in foreign exchange rates. Finally, it must develop a system to implement its exposure strategy.

The Exchange Audit The importance of having a comprehensive understanding of the implications of foreign currency changes on a company's operations cannot be overstressed. The audit should include an analysis of:

1. The types of transactions that are affected.
2. How each unit in the system, both at home and abroad, is affected.
3. How elements of corporate strategy are affected.
4. How each function of management is affected, that is, marketing, production, personnel, and so on.

The implications of currency changes can be extensive. A remuneration policy for the company personnel of different nationalities and located in different countries can be equitable at one exchange rate and inequitable when currency values change. Or even more fundamentally, the best strategy for serving a foreign market can change from mere exporting to foreign affiliates, or vice versa, as a result of major changes in exchange rates.

Foreign Exchange Exposure When we speak of foreign exchange exposure, we keep in mind the risk that future fluctuations in a country's exchange rate will hurt the firm. Foreign exchange exposure is normally broken into three categories: transaction exposure, translation exposure, and economic exposure (see Fig. 19.17).

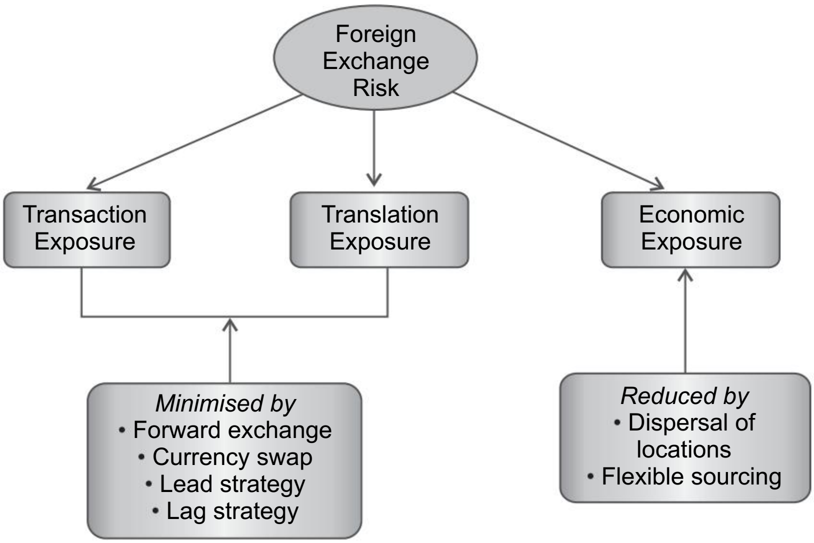


Fig. 19.17 Foreign Exchange Risks and Strategies to Reduce Them

Transaction Exposure Transaction exposure is typically understood as 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 borrowing and lending of funds in foreign currencies. Transaction exposure is the uncertain value to the firm of its open position in cross-currency commitments. Transaction exposure can result in real, as contrasted to book-keeping gains and losses.

Translation Exposure Translation is the process of restating foreign financial statements in the currency of the parent company. For example Pepsi Company will translate the balance sheet and income statements of its subsidiaries into dollars. The translated financial statements enable the management and the shareholders to see how each unit is functioning.

Translation exposure is the foreign exchange risk that the international businesses faces when translating foreign currency financial statements into the currencies of parent companies. Also called the *accounting exposure,* the translation exposure is basically concerned with the present measurement of past events. The resulting accounting gains or losses are said to be notional—they are 'paper' gains and losses—yet are important. For example, consider a US firm having a subsidiary in India. If the value of the Indian rupee depreciates significantly against the dollar, the dollar value of Indian subsidiary's equity gets subsequently reduced. In return, this would reduce the total dollar value of the firm's equity reported in its consolidated balance sheet. Cumulatively, this would raise the apparent leverage of the firm (its debt ratio), which could increase the firm's cost of borrowing and restrict its accesses to the capital market. Thus, translation exposure can have a very negative impact on a firm. However, the degree of impact of translation exposure depends upon how the company's reported results are evaluated by the investment community, shareholders, financial institutions, and so on.

Economic Exposure This refers to 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. In technical terms, economic exposure reflects the extent to which the net present value of expected after-tax flows will be affected as exchange rates change. Economic exposure is distinct from transaction exposure, which is concerned with the effect of exchange rate changes on individual transaction, most of which are short-term affairs that will be executed within a few weeks or months. From the standpoint of the long run health of a firm, economic exposure is far more important than either translations or transaction exposure.

In short, transaction exposure refers to the immediate or near term effects on cash flows. Economic exposure refers to the same types of effects on cash flows over the long run. Translation exposure is the accounting reflection of a change in position that has not yet been realised.

Tactics and Strategies to Reduce Foreign Exchange Risk A number of strategies and tactics can help firms reduce their foreign exchange exposure. The major ones are explained here.

Reducing Transaction and Translation Exposures Various tactics can help firms minimise their translation and transaction exposure. These tactics primarily protect short-term cash flows from adverse changes in exchange rates.

Forward Exchange One popular tactic used is to enter a *forward exchange.* A forward exchange occurs when two parties agree to exchange currency and execute the deal at some specific date in future. Exchange rates governing such future transactions are referred to as forward exchange rates. For most major currencies, foreign 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.

Currency Swaps Another popular tactic available to minimise foreign exchange risk is the *currency swap.* 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.

Currency swaps between multinationals are frequently used both as a hedge and as a means of securing overseas financing. The swaps may be bilateral or multilateral. They may be simple or highly complex. As a relatively simple example, a French company may have a Brazilian subsidiary that needs more local currency for expansion. Through an investment bank or a broker, the French company locates a British firm whose Brazilian subsidiary has surplus domestic currency. The French company makes the swap by buying the Brazilian cruzados from the British company and simultaneously entering an agreement to reserve the sale at some future date. Nominal interest rates are agreed upon at the outset.

The swap is a hedge in the sense that foreign currency liability is matched by a similar foreign currency asset. Furthermore, neither loan requires the approval of any government agency, and the cost of funds can be cheaper than funds from alternative sources. Besides, the swap may be one of the few sources open to non- resident companies for securing the use of foreign exchange over a period of time at a fixed rate.

Lead and Lag Strategies In addition to buying forward and using swaps, firms can minimise their foreign exchange exposure through leading and lagging payables and receivables—that is, collecting and paying early or late depending as expected exchange rate movements. A *lead strategy* involves 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 foreign currency is expected to appreciate. A *lag strategy* involves delaying collection of foreign currency receivables if that currency is expected to appreciate and delaying payables if the currency is expected to depreciate. Leading and lagging involve accelerating payments from weak-currency to strong-currency countries and delaying inflows from strong-currency to weak-currency countries.

Reducing Economic Exposure This 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 that the firm's long-term financial wellbeing is not severely affected by adverse changes in exchange rates. The post-1985 trend by Japanese auto-makers to establish productive capacity in N America and W Europe can partly be seen as a strategy for reducing economic exposure. Before 1985, most Japanese automobile companies concentrated their productive assets in Japan. However, the rise in the value of the yen on the foreign exchange market has transferred Japan from a low cost to a high cost manufacturing location over the last 10 years. In response, Japanese auto firms have moved many of their productive assets overseas to ensure their car prices will not be unduly affected by further rises in the value of the yen. In general, reducing economic exposure necessitates that the firm ensures its assets are not too concentrated in countries where likely rises in currency values will lead to damaging increases in the foreign prices of the goods and services they provide. (See Exhibit 19.1 for an example of a firm which pursued strategies for minimising economic exposure).

Management of Receivables International business grants credit to customers because it expects the investment in receivables to be profitable, either by expanding sales volume or by retaining sales that otherwise would be lost to competitors. Some firms also earn a profit on the financial charges they levy on credit sales.

The need to scrutinise *credit terms* is singularly important in countries experiencing rapid rates of inflation. The incentive for customers to defer payment, liquidating their debts with less valuable money in the future, is great. Furthermore, credit standards abroad are often more relaxed than in the home market, especially in countries lacking alternative sources of credit for small customers. To remain competitive, MNCs may feel compelled to loosen their own credit standards. Finally, the remuneration system in many companies tends to reward higher sales more than it penalises an increased investment in accounts receivable. Local managers frequently have an incentive to expand sales even if the MNC overall does not benefit.

The effort to manage overseas receivables better will not get far if finance and marketing managers coordinate their efforts perfectly. In many companies, finance and marketing work at cross purposes. Marketing thinks about selling, and finance plans about speeding up cash flows. One way to ease the tensions between finance and marketing is to educate the salesforce on how credit and collection affect firm's profits. Another way is to tie bonuses for salespeople to *collected* sales or to adjust sales bonuses for the interest cost of credit sales. Forcing managers to bear the opportunity cost of working capital ensures that their credit, inventory, and other working capital decisions will be more economical.

Inventory Management Inventories are necessary to carry on business, whether the business is domestic or international. They form a link between the production and sale of a product. A

Exhibit 19.1

HOW BLACK & DECKER HEDGES AGAINST ECONOMIC EXPOSURE

Black & Decker is one of the few multinationals 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 per cent 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 per cent 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, as the dollar depreciated during the latter half of the 1980s, the amount of imports into the United States from overseas subsidiaries was reduced, and the amount of exports from US subsidiaries to other locations was increased.

According to the company, the ability to move production in response to changes in foreign exchange movements is a source of competitive advantage. Black & Decker enjoys a much better long term competitive position than one of its most significant competitors in the power tool business, Japan's Makita Electric Works, Ltd, because 90 per cent of Makita's operations are located in Japan, and it exports heavily to the United States. Although Makita may benefit when the yen is depreciating, its margins are vulnerable during periods of yen strength. Black & Decker, in contrast, is not so vulnerable to appreciations in the value of the dollar.

(*Source*: Charles W L Hill, *op.cit*, p. 633)

manufacturing company must maintain a certain amount of inventory, known as work-in-process, during production. Although other types of inventory-in-transit, raw materials, and finished goods inventories are not necessary in the strictest sense, they enable the firm to be flexible. **Inventory-in-transit**, that is, inventory between various stages of production or storage—permits efficient production scheduling and utilisation of resources. Without this type of inventory, each stage of production would have to wait for the preceding stage to complete a unit. The possibility of resultant delays and idle time gives the firm an incentive to maintain an in-transit inventory.

Raw materials inventory gives the firm flexibility in its purchasing. Without it, the firm must exist on a hand-to-mouth basis, buying raw materials strictly in keeping with its production schedules.

Finished-goods inventory allows the firm flexibility in its production scheduling and in its marketing. Production does not need to be geared directly to sales. Large inventories allow efficient servicing of customer demands. If a certain product is temporarily out of stock, present as well as future sales may be lost. Thus, there is an incentive to maintain stocks of all types of inventory.

The traditionally extolled advantages of increased inventories are many. The firm can effect economies of production and purchasing and can fill orders more quickly. In short, the firm is said to be more flexible. The obvious disadvantages are the total cost of holding the inventory, including storage and handling costs, and the required return on capital tied up in inventory. An additional disadvantage is the danger of obsolescence. Because of the benefits, however, firms tend to hold relatively large inventories. It is the responsibility of the finance manager to dampen the temptation for large inventories.

This is done by forcing consideration of the cost of funds necessary to carry inventories as well as holding costs.

In recent years, additional support for the financial manager's questioning of the maintenance of large inventories has come from an understanding of a Japanese inspired inventory control technique called *just-in-time,* or Jit for short. Jit breaks with the conventional wisdom of maintaining large inventories as buffers against uncertainties. The basic objective of Jit is to produce (or receive) a required item at the exact time needed, or "just-in-time." Inventories of all types would thus be reduced to a bare minimum (in some case, zero). Reduction in inventory carrying costs is the main benefit from Jit technique. Other benefits include improvements in productivity, quality and flexibility.

Theoretically, inventory management problems of international business are the same as those faced by domestic businesses. However, certain problems are unique to MNCs. For instance, international businesses typically find it more difficult to control their overseas inventory and reap fast turnover rates. There are a variety of reasons: long and variable transit times if ocean transportation is used, lengthy customs proceedings, dock strikes, import controls, higher duties, supply disruption, and anticipated changes in currency values.

Inventory control practices vary across countries. Japanese firms, for instance, use smaller lot sizes while placing orders than their Western counterparts. The idea is to minimise carrying costs. Western companies can reduce inventories by reducing the amount of safety stock carried. Important factors in safety stock are lead time and lead time variability, reduction of which will result in lower safety stocks. Firms can realise this reduction by working with suppliers, choosing suppliers located close to the buyer, and shifting to smaller lot sizes.

Many US firms have eschewed domestic manufacturing for offshore production to take advantage of both low wage labour and tax holidays, low interest loans, and other government largesse. But a number of firms have found that low manufacturing cost is not everything. Aside from the strategic advantages associated with US production, such as maintaining close contacts with domestic buyers, onshore manufacturing allows for a more efficient use of capital. In particular, because of the delyas in international shipment of goods and potential supply disruptions, firms producing abroad typically hold larger work-in-progress and finished goods inventories. The result is higher inventory carrying costs.

International Taxation As is well known, taxes have a significant impact on areas as diverse as making foreign investment decisions, managing exchange risk, planning capital structures, determining financing costs, and managing inter-affiliate fund flows. Consequently, the international financial executive needs to be knowledgeable about the broad outlines of the international tax system and its impact on various corporate decisions.

International tax management involves using the flexibility of the MNC in structuring foreign operations and remittance policies in order to maximise global buffer-tax cash flows. Tax management is difficult because the final tax burden on an MNC's income (see Table 19.9) is the result of a complex interplay between the heterogeneous tax systems of home and host governments, each with its own fiscal objectives.

Many countries follow the worldwide principle that they have the right to tax income earned outside their boundaries by entities based in their country. Thus, the US government can tax the earnings of the German subsidiary of a firm headquartered in the US. Double taxation occurs when the income of a foreign subsidiary is taxed by the host-country and home-country governments. However, the burden of double taxation is mitigated to some extent by tax credits, tax treaties, and the deferred principle.

Table 19.9 OECD Corporate Income Tax Rates (2011)

Country	*Combined corporate income tax rate*
Australia	30
Austria	25
Belgium	34
Canada	27.6
Chile	20
Czech Republic	19
Denmark	25
Estonia	21
Finland	26
France	34.4
Germany	30.2
Greece	20
Hungary	19
Iceland	20
Ireland	12.5
Israel	24
Italy	27.5
Japan	39.5
Korea	24.2
Luxembourg	28.8
Mexico	30
Netherlands	25
New Zealand	28
Norway	28
Poland	19
Portugal	26.5
Slovak Republic	19
Slovenia	20
Spain	30
Sweden	26.3
Switzerland	21.2
Turkey	20
United Kingdom	26
United States	39.2

(*Source: Organisation of Economic Cooperation and Development*)

A *tax credit* allows an international business to reduce the taxes paid to the home country by the amount of taxes already paid to the host country. A *tax treaty* between two countries is an agreement specifying what items of income will be taxed by the authorities of the country where the income is earned. For instance, a tax treaty between the US and Germany may specify that a US firm need not pay tax in Germany on any earnings from its German subsidiary that are remitted to the US in the form of dividends.

A *deferred principle* specifies that parent companies are not taxed on foreign source income until they actually receive a dividend.

Managing Tax Issues For the international business with activities in many countries, the various tax treaties have important implications for how the firm should structure its internal payments system among the foreign subsidiaries and the parent company. A typical firm uses several strategies to manage the tax issues. Tax havens, offshore financial centres, transfer prices, fronting loans, and the income remittal form are some of them. (See Fig. 19.18)

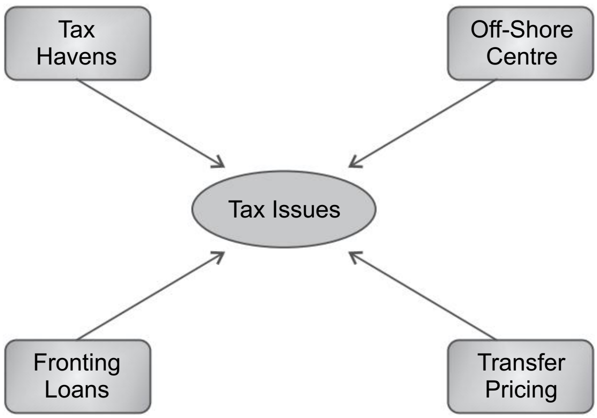


Fig. 19.18 Strategies to Manage Tax

Tax Havens Some firms use tax havens to minimise their tax burden. Tax havens are countries that impose little or no corporate income taxes. Cayman Islands, the Bahamas, Bermuda, and Vanuatu are tax havens. International businesses avoid or defer income taxes by establishing a wholly owned, non-operating subsidiary in the tax haven. The tax haven subsidiary owns the common stock of the operating foreign subsidiaries. This allows all transfers of funds from foreign operating subsidiaries to the parent company to be funneled through the tax haven subsidiary. The tax is levied on foreign source income by a firm's home government, which might normally be paid when a dividend is declared by a foreign subsidiary, can be deferred under the deferred principle until the tax haven subsidiary pays the dividend to the parent. This dividend payment can be postponed indefinitely if foreign operations continue to grow and require new internal financing from the tax haven affiliate. One example that can be cited in this context is registration of Tailwinds—a holding company of Jet Airways—in Cayman Islands.

In the meanwhile, OECD has some control over tax havens. The body identifies countries as tax havens depending on their transparency and safeguards against money laundering. Countries that agree to transparency and safeguards are dropped from the list and those who do not agree are blacklisted. OECD's blacklisted countries in 2000, 2002 and 2004 are given in Fig 19.19.

Off-shore Financial Centre International business may also use the advantages presented by an off-shore financial centre which offers ample opportunities for more effective international tax planning. For example, Malaysia recently established the International Off-shore Financial Centre at Labuan on the small island of Labuan, located off the north-east coast of Sabah in East Malaysia. Labuan operates

March 2004	April 2002
Andorra, Liberia, Liechtenstein, Marshall Islands, Monaco	Andorra, Liberia, Liechtenstein, Marshall Islands, Monaco, Nauru, Vanuatu
June 2000	Antigua, Aruba, Bahamas, Bahrain, Barbados, Belize, British Virgin Islands, Cook Islands, Dominica, Gibraltar, Granada, Isle of Man, Jersey, Liberia, Liechtenstein, Maldives, Marshall Islands, Monaco, Montserrat, Nauru, Netherlands Antilles, Panama, St. Kitts and Nevis, St. Lucia, St. Vincent, Seychelles, US Virgin Islands, Vanuatu, Samoa

Fig. 19.19 OECD Blacklist

as a free port where no sales tax, excise, import or export duties are imposed, and was established by the Malaysian government to promote off-shore business activity. To attract MNCs to Labuan, the Malaysian government is providing 365 million Malaysian Ringgit to develop Lubuan's infrastructure, including an airport and an international bank. The plan is working to some extent as more than 40 banks, including some Australian banks, have established representative offices in Labuan. It has also attracted securities firms including Japan's Nikko Securities. In addition, many international companies have established their presence in Labuan.

Transfer Pricing Over one-third of world trade occurs between related parties, i.e., head office and subsidiaries and among the subsidiaries themselves. The price of an international transaction between related parties is called transfer price. The price of a transaction between unrelated parties is known as arm's length price which is the normal one (see Fig.19.20). Transfer price invites scrutiny from enforcement authorities as it has tax implications.

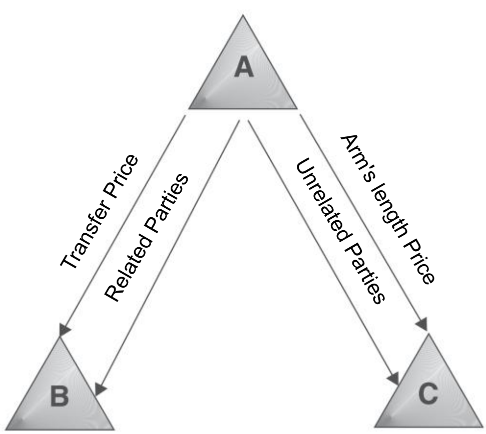


Fig. 19.20 Nature of transfer price

Why is transfer pricing followed? MNCs seek to maximise their profits in low-tax regime by using differential rates of transfer pricing at the cost of high-tax countries. Second, where countries either restrict or tax remittances heavily—such as profit repatriations, fees or royalties, MNCs resort to transfer pricing to avoid tax nets.

Third, transfer pricing may be beneficial when the host country restricts the amount of foreign exchange that can be used for importing specific goods. In this event, a lower transfer price allows a greater quantity of the goods to be imported under a quota restriction. This may be more important consideration than income-tax savings, if the imported item is a necessary component needed by an assembly or manufacturing affiliate to continue or expand production.

Finally, transfer prices tend to have an impact on how affiliates of an MNC are perceived locally. A low mark up price helps an affiliate to show better performance in its books. If the parent company expects the affiliate to borrow short-term funds in the event of a cash shortage, the affiliate will be able to do so easily as its performance creates trust and confidence in the minds of investors.

Transfer pricing has both legal as well as ethical implications. It is immoral to deny a country tax revenue it should get from MNCs that are either headquartered or subsidiaries are being located there. Avoiding tax payment is blatantly illegal.

Across the world, countries are viewing transfer pricing from the legal perspective. Several countries have adopted measures to regulate transfer pricing (see Fig. 19.21).

REINING IN TRANSFER PRICING

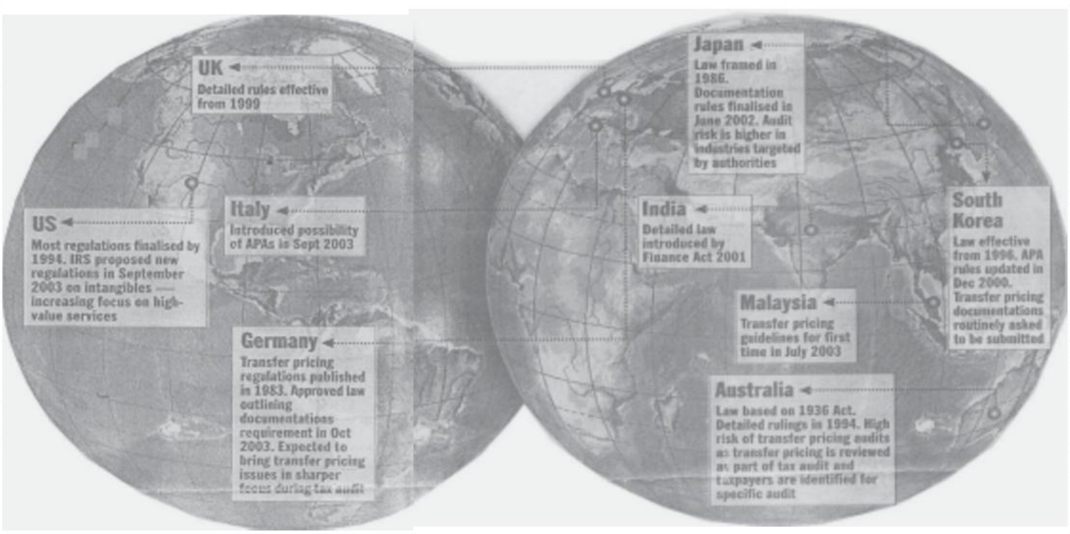


Fig. 19.21

When detected, transfer pricing may result in double taxation. In a global survey by Earnst and Young, carried out in 19 countries, 42 per cent of the respondents reported that adjustments arising out of transfer price investigations by governments resulted in double taxation.

Yet another problem associated with transfer pricing is related to management incentives and performance evaluation. Transfer pricing is inconsistent with a policy of treating each subsidiary in a firm as a profit centre. When transfer prices are manipulated by the firm, the subsidiary's performance may depend as much on transfer prices as it does on management effort. A subsidiary directed to charge a high transfer price for a good supplied will appear to be doing better than it actually is, while the subsidiary purchasing the goodwill appear to be doing worse. Unless this is recognised while evaluating performance, serious distortions in management incentives system can occur.

The subject of transfer pricing has been recognised as one of the most important and challenging issues that has arisen from the internationalisation of business (See Table 19.10). The Organisation for Economic Cooperation and Development (OECD) has identified five issues for consideration by a Group of Experts. These covered administrative capabilities with transfer pricing issues, assistance to developing countries, treatment of finished goods versus primary goods, exchange of information, and mechanism for correlative adjustments.

Table 19.10 Important Future Tax Issues

Overall Importance	*Percent*
Transfer Pricing	61
Double Tax Relief	18
Tax Reform	13
Value Added Tax (VAT)	8
International Tax Legislation	7
Customs Duties	5
Controlled Foreign Corporation Rules	4
Foreign Tax Credits	4
Taxation of Expatriates	2

Note: Multiple choices allowed.

(*Source*: Survey by Ernst & Young, 1999)

In India transfer pricing is outlawed. The relevant provisions relating to legality of transfer pricing are available in the Indian Income Tax Act, 1961. Sectors 92A to 92F of the Act deal with the income from transfer pricing. As per the provisions, income arising out of international transactions shall be computed having regard to the "armslength price" principle. Income earned in excess of this principle shall be subject to taxation.

The Act requires every entity who enters an international transaction should maintain all information and documents as specified in the Income Tax rules and furnish the same to the appropriate authorities as and when required. Failure to comply invites penalty.

Invoking the provisions of the Act, the Income Tax Department had served notices to 500 MNCs to disclose their compliance with the transfer price rules.

The Income Tax Department botched up while handling Vodafone and Royal Dutch Shell companies. Recently, the Department served notices on the two MNCs demanding payment of hafty tax (nearly ₹20,000 cr) to the government on incomes earned in the form of undervaluation of shares issued by the Indian subsidiaries to their ponent companies. Obviously, incomes earned on share transfers cannot be construed as regular taxable income. The two MNCs appealed against the notices in the Bombay High Court which expectedly struck down the claims made by the Tax Department.

For China, issues relating to transfer pricing are highly important, given the huge foreign investments in that country. While there is still a lack of smooth-functioning organisations to effectively deal with the transfer pricing, the country has made an early beginning as it recognised the impact of transfer pricing way back in the 1990s.

In 1991, the Chinese government introduced the Income Law for Enterprises with Foreign Investment and Foreign Enterprises. It detailed the regulations which now form the primary legal framework dealing with taxing of foreign firms and transfer pricing. The regulations empower the authorities to perform tax auditing and to take legal action against transfer pricing.

Other countries which have rules regulating transfer pricing are—

UK	—	since 1999
US	—	since 1994
Italy	—	since 2003
Germany	—	since 1983
Japan	—	since 1986
S. Korea	—	since 1996
Malaysia	—	since 2003
Australia	—	since 1994

Fronting Loan A fronting loan, also called *back-to-back* loan or *link financing,* is a loan between a parent and its subsidiary channeled through a financial intermediary, usually a large international bank. In a typical arrangement, the parent company deposits funds with a bank in country A that in turn lends the money to a subsidiary in country B (see Fig. 19.22). By contrasting fronting loan with a direct intercompany loan, the figure reveals that, in effect a back-to-back loan is an intercompany loan channeled through a bank. From the bank's point of view, the loan is risk free because the parent's deposit fully collaterises it. The bank simply acts as an intermediary or a front (hence the name 'fronting loan'); compensation is provided by the margin between the interest received from the borrowing unit and the rate paid on the parent's deposit.

Firms use fronting loans for two reasons. First, back-to-back loans can circumvent host country restrictions on the remittance of funds from a foreign subsidiary to the parent company. A host government might restrict a foreign subsidiary from repaying a loan to its parent in order to preserve the country's foreign exchange reserve, but it is less likely to restrict a subsidiary's ability to repay a loan to a large international bank. To stop payment to an international bank would hurt the country's credit image, whereas halting payment to the parent company would probably have a minimal impact on its image. Consequently, international businesses sometimes use fronting loans when they want to lend funds to a subsidiary based in a country with a fairly high probability of political turmoil that might lead to restrictions on capital flows (i.e. where the level of political risk is very high).

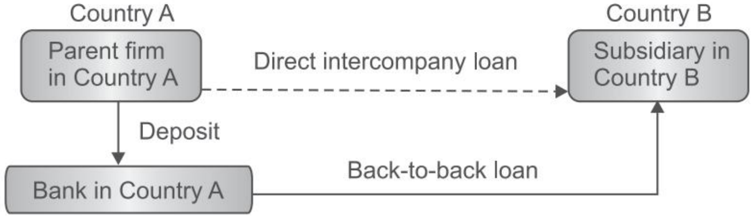


Fig. 19.22 Structure of a Fronting Loan

(*Source*: Alan C Shapiro, *International Financial Management*, p. 366)

The more relevant benefit of fronting loan strategy is its tax saving propensity. For example, a tax haven (Bermuda) subsidiary that is 100 per cent owned by the parent company, deposits $1 million in a London-based international bank at 8 per cent interest. The bank lends the $1 million to a foreign operating subsidiary at 9 per cent interest. The country where the foreign operating subsidiary is based taxes corporate income at 50 per cent (see Fig 19.23).

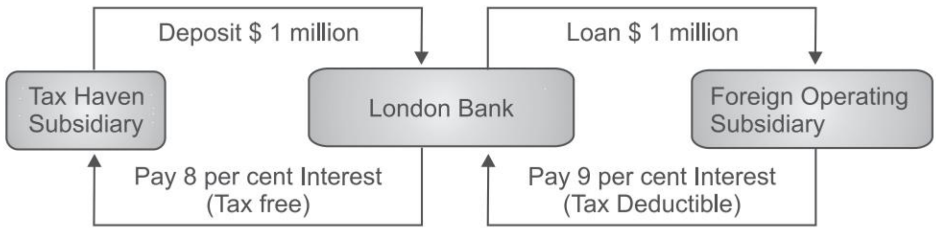


Fig. 19.23 Tax-saving Propensity of Fronting Loan

(*Source*: Charles W L Hill, *International Business*, p. 627)

Under this arrangement, interest payments net of income tax will be as follows:

1. The foreign operating subsidiary pays $90,000 interest to the London bank. Deducting these interest payments from its taxable income results in a net after-tax cost of $45,000 to the foreign operating subsidiary.

2. The London bank receives $90,000, of which it retains $10,000 for its services and pays $80,000 interest on the deposit to the Bermuda subsidiary.

3. The Bermuda subsidiary receives $80,000 interest on its deposit tax free.

The net result is that $80,000 in cash has been moved from the foreign operating subsidiary to the tax haven subsidiary. Because the foreign operating subsidiary's after tax cost of borrowing is only $45,000, the parent company has moved an additional $35,000 out of the country by using this arrangement. If the tax haven subsidiary had made a direct loan to the foreign operating subsidiary, the host government may have disallowed the interest charge as a tax-deductible expense by ruling that it was a dividend to the parent disguised as an interest payment.

Summary

- International financial management refers to the financial management of an international business. It involves decisions relating to investment, finance and money management. (LO1)
- Several factors make international financial management different from management of finance domestically. Risks in international situations are more, influencing factors are complex, and tasks are huge. Domestic finance management is relatively free. (LO2)
- International financial management is subject to several environmental factors such as forex markets, currency convertibility, bop, political risk and the like. (LO3)
- As stated in LO1 above, international financial management involves decision relating to financing, investment and money management. (LO4)

Review Questions

1. What is international financial management? How does it compare and contrast with domestic financial management? (LO1 and LO2)
2. Define international financial management. Bring out its scope. (LO1)
3. Explain the environment of international financial management. (LO3)
4. How do international businesses seek to minimise foreign exchange risks? (LO4)
5. What are financing decisions of international businesses? (LO4)
6. How do MNCs manage their current assets? (LO4)

Discussion Questions

1. Today's high interest rates put a premium on careful management of cash and marketable securities.
   (a) What techniques are available to an MNC with operating subsidiaries in many countries to economise on these short-term assets?
   (b) What are the advantages and disadvantages of centralising the cash management function?
   (c) What can the firm do to enhance the advantages and reduce the disadvantages described in part (b)? (LO4)
2. Suppose a subsidiary is fully equity financed and hence has no interest expenses. Does it still make sense to charge local managers for the working capital tied up in their operations? Explain. (LO4)
3. Under what circumstances is leading and lagging likely to be of most value? (LO4)
4. What are the principal advantages of investing in foreign affiliates in the form of debt instead of equity? (LO4)

Reinforcing Exercises

- Tax laws obtaining in different countries pose problems of their own for an MNC. Google stands out as an example. In 2013, the internet search firm came under severe attacks from politicians in England. It was revealed that the company had adopted strategies to avoiding paying tax on the bulk of its earnings outside the US, majority of which was generated in Europe. Estimates suggest that in 2011 Google avoided about $2bn in worldwide corporate income tax by shifting $9.8 bn in revenues into a small company in tax haven-Bermuda. Google was charged of gross immoral act.

  What is your take on Google's "immoral act"?
- As of March 31, 2013, Microsoft held cash reserves amounting to $66 bn in its foreign subsidiaries. This cash hoard represents 89 percent of all the company's cash holdings. Is it right on the part of Microsoft to hoard such huge cash in subsidiaries just to avoid paying tax to the US? Is this practice in the interest of the company's shareholders? Do you have any Indian parallel to Microsoft?

CLOSING CASE

Tax Strategy at Google

In early 2013, the Internet search firm Google found itself under sharp attack from politicians in Europe when it was revealed that the company had adopted strategies to avoiding paying corporate income tax on the bulk of its earnings outside the United States, the majority of which was generated in Europe. Estimates suggest that in 2011, Google avoided about $2 billion in worldwide corporate income tax by shifting $9.8 billion in revenues into a shell company in Bermuda where there is no income tax. Google's tax rate on profits earned overseas was just 3.2 percent, even though most of its foreign sales were made in European countries with corporate income tax rates ranging from 26 percent to 34 percent.

Politicians in Britain, where Google has a major presence, called the strategy "deeply immoral". Google generated revenues of £2.5 billion in the UK in 2011, but ended up paying just £6 million as corporate income tax. For its part, Google insists that it has done nothing wrong, and is playing by the rules that the politicians themselves have written. In a British radio interview on the matter, Google's chairman, stated: "You're describing the way taxes work globally. And the fact of the matter is these are the ways taxes are done globally. The same is true for British firms operating in the U.S., for example," Chairman went on to defend Google's operations in the UK, stating, "We empower literally billions of pounds of start-ups through our advertising network (in the UK). And we're a key part of the electronic commerce expansion of Britain, which is driving a lot of economic growth for the country. So from our perspective you have to look at it in totality."

So how does Google minimise its overseas tax liability? The company starts with a tactic known as the "Double Irish". *First*, the U.S. parent creates an Irish subsidiary and gives that subsidiary the rights to all of Google's products in Europe. Thus, all European income that should have been taxed in the United States is taxed in Ireland. This, in itself, is advantageous since Ireland's corporate income tax rate is just 12.5 percent, compared to 35 percent in the United States. *Second*, the new Irish subsidiary then changes its headquarters to Bermuda, a true tax haven of no corporate income tax. *Third*, Google forms another Irish subsidiary. The first Irish subsidiary (now headquartered in Bermuda) then licences company products to the second Irish company in exchange for royalties. The second Irish subsidiary books sales in Europe and pays Irish corporate income tax of 12.5 percent on any profits earned on those sales, as opposed to higher rates in places like the UK and France. Now the tax rate in Ireland can be reduced below the 12.5 percent level, since the royalties paid to the Bermuda-based company are treated as an expense and can be deducted against earnings in Ireland.

If this were not enough, Google has added another twist to the strategy, known as the "Dutch Sandwich". This involves creating a third subsidiary in the Netherlands. Instead of licensing the parent's products directly to the second Irish subsidiary, the Bermuda-based subsidiary grants them to the Dutch subsidiary, which in turn licenses them to the second Irish subsidiary. The Irish subsidiary pays royalties to the Dutch subsidiary, which in turn passes them to the Bermuda subsidiary. The key to all this is that Ireland does not tax money as it moves between other members of the European Union, and authorities in the Netherlands only take a tiny fee on money going from a Netherlands company to one in Bermuda. By using this stratagem, Google has effectively reduced its corporate income tax on money earned in Europe to almost zero. All this, it should be noted, is perfectly legal and Google simply takes advantage of corporate tax rules as they are written in the different countries. Whether it is immoral, as some British politicians have claimed, is another question, of course.

(Source: Charles W.L. Hill and Arun Kumar Jain, *International Business*, McGraw-Hill, 2014, pp 713-714)

Questions

1. Do you agree with the UK's politicians charge against Google? If yes, how? If not why?
2. What are your views on Google's chairman's British radio interview?
3. Comment on Google's tax planning strategies: Double Irish and Dutch Sandwich.

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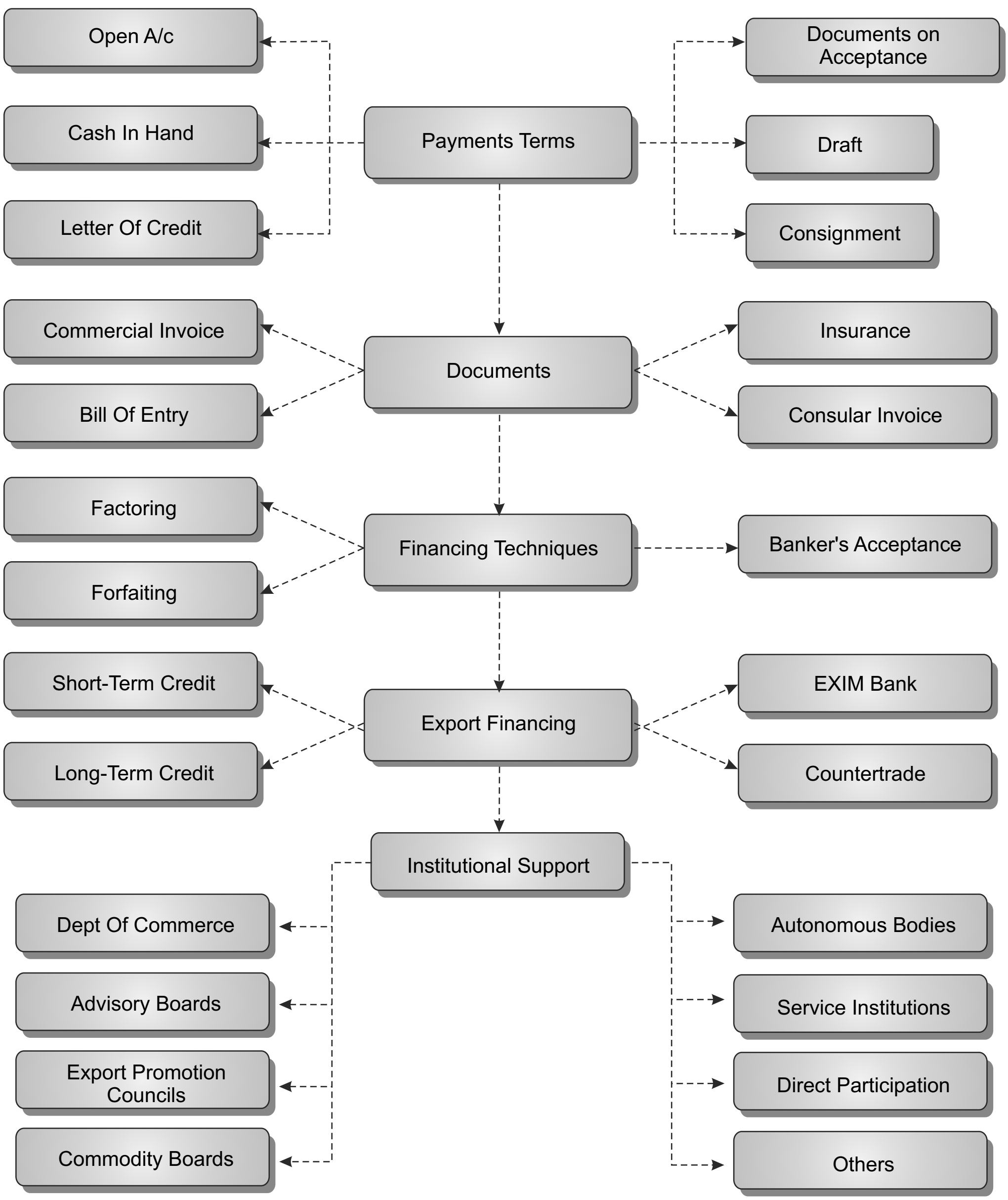
CHAPTER


Open A/c
Cash In Hand
Letter Of Credit
Payments Terms
Documents on Acceptance
Draft
Consignment
Commercial Invoice
Bill Of Entry
Documents
Insurance
Consular Invoice
Factoring
Forfaiting
Financing Techniques
Banker's Acceptance
Short-Term Credit
Long-Term Credit
Export Financing
EXIM Bank
Countertrade
Institutional Support
Dept Of Commerce
Advisory Boards
Export Promotion Councils
Commodity Boards
Autonomous Bodies
Service Institutions
Direct Participation
Others

20

Financing Foreign Trade

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Identify payment terms in foreign trade
- **LO 2:** Recognise the documents in international trade
- **LO 3:** List the financing techniques in foreign trade
- **LO 4:** Examine export financing and institutional support
- **LO 5:** Assess countertrade
- **LO 6:** Interpret institutional support for foreign trade

MOST international businesses are heavily involved in foreign trade in addition to their other overseas activities. The financing of trade related working capital requires large amounts of money, as well as financial services such as letters of credit and acceptances. It is, therefore, essential that the international financial executive has knowledge of the institutions and documentary procedures that have evolved over centuries to facilitate the international movement of goods.

This chapter is devoted to a detailed explanation of the various payment terms associated with international trade, along with the necessary documentation associated with each procedure. It also examines the different methods and sources of export financing that are available from the government. The size of countertrade and institutional support to foreign trade are also covered.

PAYMENT TERMS IN FOREIGN TRADE

LO 1
Identify payment terms in foreign trade

Every shipment abroad requires some kind of financing while in transit. The exporter also needs funds to buy or manufacture its goods. Similarly, the importer has to carry these goods in inventory until they are sold.

A financially strong exporter can finance the entire trade cycle out of its own funds by extending credit until the importer has converted these goods into cash. Alternatively, the importer can finance the entire cycle by paying cash in advance. Usually, however, some in-between approach is chosen, involving a combination of financing by the exporter, the importer, and one or more financial intermediaries.

The five principal means of payment in international trade, ranked in order of increasing risk to the exporter, are: (see Fig. 20.1)

- Cash in advance
- Letters of credit
- Draft
- Consignment
- Open account
- Documents on acceptance

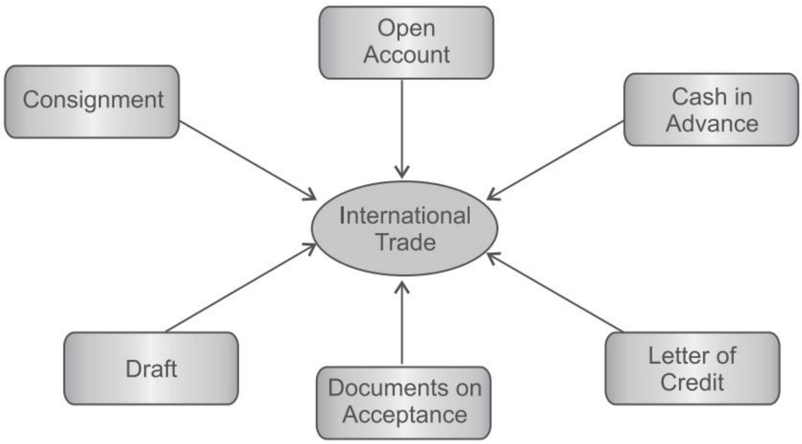


Fig. 20.1 Means of Payment

As a general rule, the greater the protection afforded to the exporter, the less convenient are the payment terms for the importer. Some of these methods, however, are designed to protect both parties against commercial and/or political risks. It is upto the exporter, when choosing among these payment methods, to weigh the benefits in risk reduction against the cost of lost sales.

The five basic means of payment are described in the following paragraphs.

Cash in Advance

Cash in advance affords the exporter the greatest protection because payment is received either before shipment or upon arrival of the goods. This method also allows the exporter to avoid tying up its own funds. Although less common than in the past, cash payment, upon presentation of documents, is still widespread.

Cash terms are insisted upon where there is political instability in the importing country or where the buyer's creditworthiness is doubtful. Political crises or exchange control in the purchaser's country may cause payment delays or even prevent fund transfers, leading to a demand for cash in advance. In addition, where goods are made to order, prepayment is usually demanded, both to finance production and to reduce marketing risks.

Letter of Credit

Importers will often balk at paying cash in advance, and will demand credit terms instead. When credit is extended, the letter of credit (L/C) offers the exporter the greatest degree of safety.

Letter of credit is a letter addressed to the seller, written and signed by a bank acting on behalf of the buyer. In the letter, the bank promises that it will honour drafts drawn on itself if the seller confirms to the specific conditions set forth in the letter of credit. In exchange for the bank's agreement to honour the draft for payment that results from the transaction, the importer promises to pay the bank the amount of transaction and an agreed fee. The letter of credit obviously becomes a financial contract between the issuing bank and a designated beneficiary that is separate from the commercial transaction.

The letter of credit offers several advantages to the exporter.

1. The letter of credit eliminates credit risk if the bank that opens it is of undoubted standing. Obviously, the exporter needs to check only on the reputation of the bank.
2. A letter of credit also reduces the danger that payment will be delayed or withheld due to exchange control or other political risks. Countries generally permit local banks to honour their letters of credit. Failure to honour them could severely damage the country's credit standing and credibility.
3. A letter of credit reduces uncertainty. The exporter knows all the requirements for payment because they are stipulated on the letter of credit.
4. The letter of credit can also guard against preshipment risks. The exporter who manufactures, under a contract, a specialised piece of equipment runs the risk of contract cancellation before shipment. Opening a letter of credit will provide protection during the manufacturing phase.
5. Letter of credit facilitates financing because it ensures the exporter a ready buyer for its product. It also becomes easy to create a banker's acceptance—a draft accepted by a bank.

A letter of credit offers advantages to the importer too. Major benefits to the importer are:

1. The letter of credit ensures that the exporter delivers goods and produces certain documents which are carefully examined by the bank. If the exporter fails to deliver the goods, it will be much simpler for the importer to withdraw deposit from the bank.
2. Because a letter of credit is as good as cash, the importer can usually command better credit terms and/or prices.
3. Letter of credit financing may be cheaper than the alternatives. There is no tie-up of cash if the letter of credit substitutes for cash in advance.

The letter of credit operations are quite simple. To illustrate how it operates, consider the case of USA Importers Inc, of Loss Angeles. The company is buying spare auto parts worth $38,000 from Japan Exporter Inc, of Tokyo, Japan. USA Importers applies for, and receives, letter of credit for $38,000 from its bank, Wells Fargo. The actual process is shown in Fig. 20.2.

Types of Letters of Credit Letters of credit can be classified as revocable versus irrevocable, and confirmed versus unconfirmed documents.

Revocable Vs Irrevocable An irrevocable L/C obligates the issuing bank to honour drafts drawn in compliance with the credit and can neither be cancelled nor modified without the consent of all concerned parties. A revocable L/C can be cancelled or amended at any time before payment. It is intended to serve as a means of arranging payment, but not as a guarantee of payment.

Confirmed Vs Unconfirmed An L/C issued by one bank can be confirmed by another, in which case the confirming bank undertakes to honour the draft drawn in compliance with the credit. An unconfirmed L/C is the obligation of only the issuing bank. An exporter is likely to insist on a foreign bank's L/C confirmed by a domestic bank when the exporter has doubts about the foreign bank's ability to pay. Such doubts can arise when the exporter is unsure of the financial standing of the foreign bank, or if political or economic conditions in the foreign country are unstable.

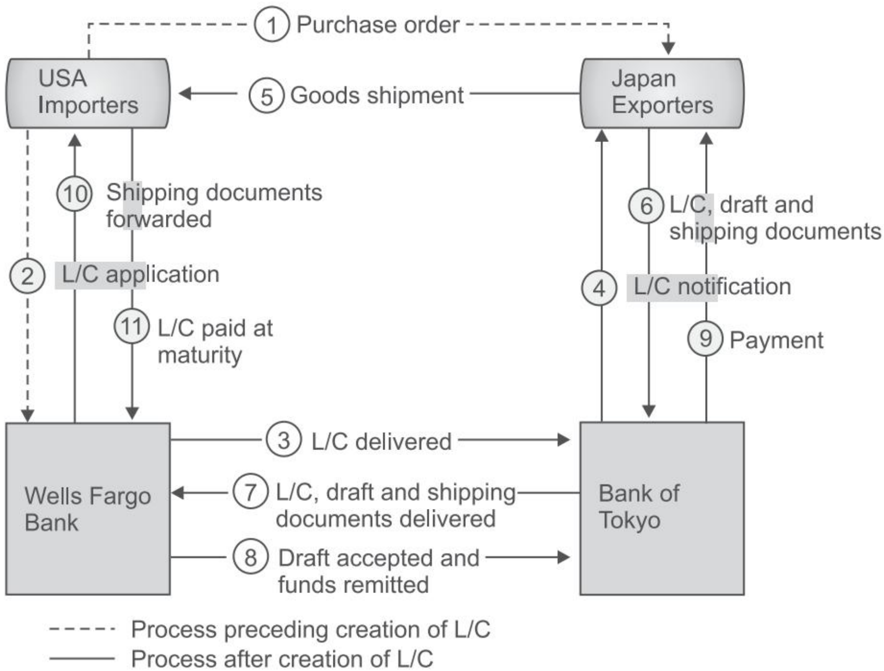


Fig. 20.2 Example of Letter of Credit Financing of US Imports

(*Source*: Alan C Shapiro, *Multinational Financial Management*, p. 307)

The Draft

The draft, also called the bill of exchange, is written by an exporter on the importer directing the latter to pay a certain sum on a specified date for having goods shipped to the importer. The exporter submits the bill to its banker who collects the stated amount from the importer's bank and remits the proceeds to the seller or to the bearer.

The draft has three parties. The exporter—is the party who draws the bill and hence called the drawer, the importer on whom the bill is drawn and hence called the drawee, and the party who is entitled to receive payment is called the payee. Normally, the drawer and the payee are the same persons in which case there are only two parties to a draft.

The draft serves three important functions and hence is widely used in foreign trade:

1. It provides written evidence of obligations in a comprehensive form.
2. It enables both parties to potentially reduce their costs of financing.
3. It is a negotiable and unconditional instrument.

To serve the three purposes, the draft needs to fulfill the following conditions:

- It must be in writing
- Signed by the drawer (exporter)
- An unconditional order to pay
- A certain sum of money
- Payable on demand or on a specified future date
- Payable to order or bearer

Consignment

Under the consignment the exporter sends goods, on consignment, to the importer who arranges for their sale and makes payment to the exporter, after deducting a specified commission. Goods on consignment are duly shipped to the importer, but they are not sold. The exporter (consignor) retains title to the goods until the importer (consignee) has sold them to a third party. This agreement is normally made only with a related company because of the high risks involved. There is little evidence of the buyer's obligation to pay, and should the buyer default, it becomes difficult to collect.

An exporter from India, shipping goods on consignment, is required to declare the full value of the goods exported. Foreign Exchange Management Act requires that an exporter, shall not, without the permission of the Reserve Bank of India, allow the sale of goods on consignment at a value less than the amount declared by it at the time of export.

Open Account

Open account selling is shipping goods first and billing the importer later. The credit terms are arranged between the buyer and the seller but the seller has little evidence of the importer's obligation to pay a certain sum at a certain date. Sales on open account, therefore, are made only to a foreign affiliate or to a customer with which the exporter has a long history of favourable business dealings. However, open account sales have greatly expanded due to the major increase in international trade, the improvement in credit information about importers and the greater familiarity with exporting in general. The benefits include greater flexibility (no specific payment dates are set) and involve lower costs, including fewer bank charges than with other modes of payment. As

Mode of payment	Usual time of payment	Goods available to buyers	Exporter's risks	Importer's risks
Cash in advance	Before or on presentation of documents	After payment	None	Almost none
Letter of Credit	When shipment is made	After payment	Very little or none, depending on credit terms	Assured shipment made, but relies on exporter to ship goods described in documents
Draft	On maturity of draft	Before payment	Relies on buyer to pay	Same as above unless importer can inspect goods before payment
Consignment	As agreed	Before payment	Allows importer to sell goods before paying exporter	None
Open account	As agreed	Before payment	Relies completely on buyer to pay account as agreed	None

Fig. 20.3 Features of Modes of Payment–Comparison

(*Source*: Adapted from *International Financial Management*, by Jeff Madura, p. 524) with shipping on consignment, the possibility of currency controls is an important factor because of the low priority in allocating foreign exchange normally accorded to this type of transaction. (Fig. 20.3 summarises features of different modes of payment).

Documents of Acceptance

In this, negotiable documents are sent through a bank to the buyer, the buyer signs the documents, accepting liability to pay as per the terms specified, and takes delivery of the goods. The exporter runs the risk of the importer not honouring his commitment even though he has taken possession of the goods. Obviously, such deals are made only when the importer is known for trust and integrity. To be on the safer side, the exporter does well to take an insurance through the ECGC.

DOCUMENTS IN INTERNATIONAL TRADE

LO 2
Recognise the documents in international trade

Letter of credit, bill of lading, commercial invoice, insurance certificate, and consular invoice are the documents generally used in financing international trade. These documents are developed and modified over decades to protect both importer and exporter from the risk of non-completion and foreign exchange risk, as well as to provide a means of financing.

Letter of Credit (L/C)

As stated earlier, L/C is a bank's promise to pay issued by a bank at the request of an importer (the applicant/buyer) in which the bank promises to pay an exporter (the beneficiary of the letter) upon presentation of documents specified in the L/C. An L/C reduces the risk of non-completion, because the bank agrees to pay against documents rather than actual merchandise. L/C can also be a source of settling international transactions, as explained earlier. Bank will also be in a position to finance parties involved in import and export based on goods-in-transit. Banks come forward to finance goods-in-transit only after the risks associated with non-completion and foreign exchange fluctuations are removed.

Bill of Lading (B/L)

The most important document used in financing of foreign trade is the bill of lading (B/L). A B/L is a shipping document issued to the exporter or its bank by a common carrier that ships the goods. It serves three important functions:

1. It is a receipt acknowledging that the goods have been received by the carrier.
2. It is a contract binding the carrier to deliver the goods to the importer.
3. The negotiable B/L, its most common form, is a document that establishes control over the goods.

A bill of lading can be either a straight or order B/L. A straight B/L consigns the goods to a specific party, normally the importer, and is not negotiable. A straight B/L is used where no financing is involved. As the straight bill is not negotiable, this is not popularly used in export financing.

What is mostly used is the order B/L. Under an order B/L, the goods are consigned to the order of a named party, usually the importer. The exporter retains title to the goods until it endorses the B/L on the reverse side. The exporter's representative may endorse to a specific party or endorse it in blank by simply signing his or her name. The carrier delivers the goods in the port of destination to the bearer of the endorsed order B/L, who must surrender it.

As an order B/L represents goods in transit that are readily marketable and fully insured, this document is generally considered to be good collateral by banks. It is required under letter of credit financing and for discounting of drafts.

Commercial Invoice

A commercial invoice contains an authoritative description of the merchandise shipped, including full details on quality, grades, price per unit, and total value. It also contains the names and addresses of the exporter and the importer, the number of packages, any distinguishing external marks, the payment terms, other expenses such as transportation and insurance charge, any fees collectible from the importer, the name of the vessel, the ports of departure and destination and any required export or import permit numbers.

Insurance Certificate

All cargoes going abroad are insured. Most of the insurance contracts used today are under an *open, or floating* policy. This policy automatically covers all shipments made by the exporter, thereby eliminating the need for arranging individual insurance for each shipment. To evidence insurance for a shipment under an open policy, the exporter makes out an *insurance certificate* on forms supplied by the insurance company. This certificate contains information on the goods shipped. All entries must conform exactly with the information on the B/L, on the commercial invoice and where required, on the consular invoice.

Consular Invoice

Exports to many countries require a special consular invoice. This invoice, which varies in its details and information requirements from nation to nation, is presented to the local consul in exchange for a visa. The form needs to be filled carefully, for even trivial inaccuracies can lead to substantial fines and delays in customs clearance. The consular invoice does not convey any title to the goods being shipped and is not negotiable.

Figure 20.4 is a flow chart of exports from and imports into India.

As the figure shows, the process starts with a foreign supplier/buyer who places an order. Once the order has been received, the exporter prepares documents and marks copies to the importer's bank, importer and to territorial waters. In the meantime, goods are dispatched to the carrier. After the arrival of goods, agent in India attends to customs clearance and finally takes possession of goods.

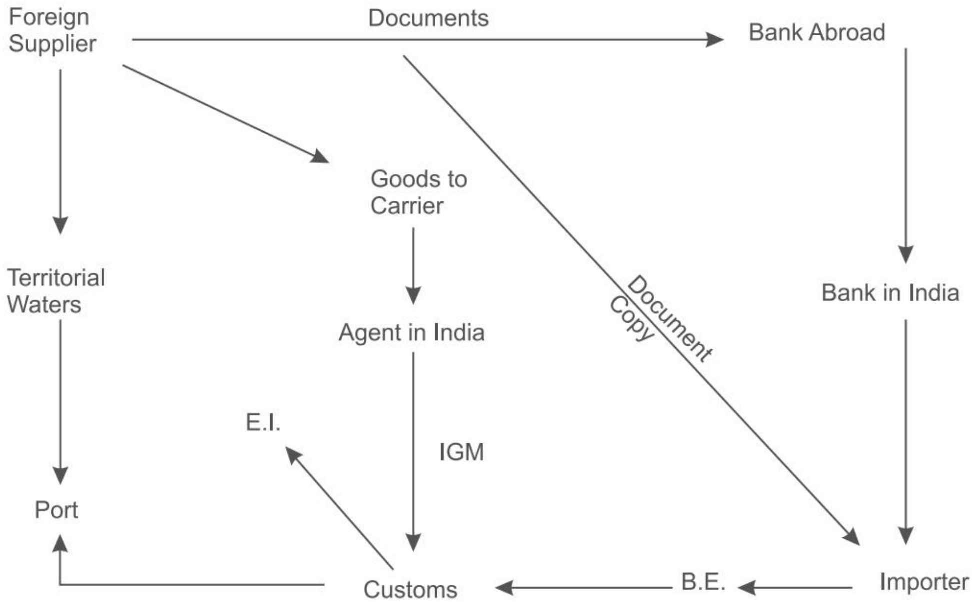
FINANCING TECHNIQUES IN FOREIGN TRADE

LO 3
List the financing techniques in foreign trade

Besides direct bank financing, there are several other techniques available for trade financing: bankers' acceptances, factoring, and forfaiting.

Bankers' Acceptance

Bankers' acceptances have played a significant role in financing foreign trade for centuries. As stated earlier, a banker's acceptance is a time draft drawn on a bank. By "accepting" the draft, the bank makes an unconditional promise to pay the holder of the draft a stated amount on a specified day. Thus,



E.I. = Entry Inwards
IGM = Import General Manifest
B.E. = Bill of Entry

Fig. 20.4 Export/Import Flow Chart (By Ship)

the bank effectively substitutes its own credit for that of a borrower, and in the process, it creates a negotiable instrument that may be freely traded.

Factoring

Many firms resort to factoring in which the factoring company buys the exporter's foreign accounts receivable at a discount. The factor assumes all the credit and political risks involved in collecting from the importer. For the exporter, factoring is advantageous in as much as it helps the firm realise cash immediately. Factoring is usually provided by the factoring subsidiaries of commercial banks, finance companies, and other specialised finance houses.

Forfaiting

This is a type of medium-term trade financing used to finance the sale of capital goods. Forfaiting involves the sale of promissory notes signed by the importer in favour of the exporter. The **forfait**, usually a bank, buys the notes at a discount from the exporter. In this way, the exporter receives payment for the export. The forfait does not have recourse against the exporter in the event of default by the importer. The promissory notes are typically structured to extend in a series over a period—three to seven years—with a note in the series maturing every six months. Since forfaiting transactions are typically used to finance capital goods, they are usually for amounts of $50,000 or more. Forfaiting began in Switzerland and Germany, but it has now spread throughout Western Europe and the US. Forfait transactions are typically denominated in Swiss francs, euros, and US dollars.

EXPORT FINANCING AND INSTITUTIONAL SUPPORT

LO 4
Examine export financing and institutional support

The export credit, in India, may be studied with reference to its two stages, namely, (i) Pre-shipment credit, and (ii) Post-shipment credit. While pre-shipment credit is required for production, processing and packaging, post-shipment credit is required to finance overseas buyers.

On the basis of the period of loans, export credit can be classified as short-term, medium, and long-term credit.

Short-term Credit

Short-term export credit, in the form of pre-shipment and post-shipment finance, is provided by the commercial banks, which are authorised dealers in foreign exchange. These credits have been covered by a special refinance scheme of the RBI and are provided at concessional rates of interest. In this connection, a mention may be made of two schemes, namely, the scheme for pre-shipment credit in foreign currency (PCFC) and the scheme for post-shipment credit. In the first case, exporters can get credit both in rupees (at an interest rate of 13 per cent) and in foreign exchange (at an average of 7.5 per cent). Post-shipment credit is available in rupees at a rate not exceeding 13 per cent for 90 days or less; beyond 90 days and upto six months 15 per cent interest is charged. (Since Feb. 7, 1996, this credit is not available in dollars).

In this connection it is useful to state the prevalence of Duty Drawback Credit Scheme 1976. This scheme benefits exporters who avail of interest free finance from banks upto 90 days against shipping bills provisionally certified by the Customs Authorities towards refund of duty. The lending banks are eligible to avail of interest-free refinance from the RBI pending the final settlement of duty drawback claims of exporters.

Long-term Credit

The medium and long-term export credit is provided mainly by the Exim bank and the commercial banks refinanced by the IDBI.

An important aspect of export credit is the risk of transacting with overseas buyers. These risks arise out of insolvency of foreign buyers, fluctuations in exchange rates, or any government action that may block or delay payment to exporters. Such risks can be insured with the Export Credit and Guarantee Corporation (ECGC). The Corporation offers two types of services: one, export credit insurance, comprising policies issued to exporters to protect themselves against possible losses likely to arise from their granting credit terms to foreign buyers, and two, direct guarantees to banks which give protection in respect of exports.

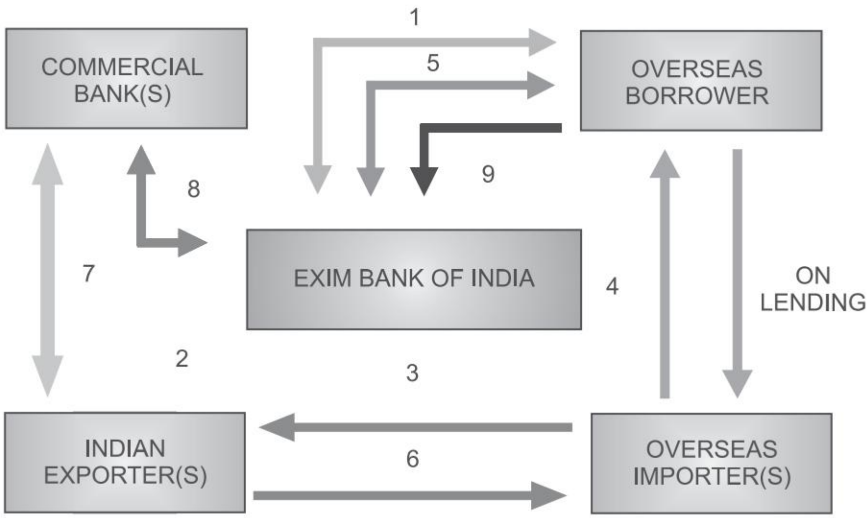
Exim Bank

The Government of India has set up the Export-Import Bank (Exim Bank) with wide functions to finance, promote, and develop foreign trade. It came into being on Jan 1, 1982. It is fully government owned body with powers to borrow not only from RBI but also from abroad.

Exim Bank is the lead bank in the sphere of export financing. It is the principal financial institution engaged in promoting foreign trade. The Bank provides financial assistance to promote Indian exports through direct financial assistance, overseas investment finance, term finance for export production and export development, pre-shipment credit, buyers' credit, lines of credit, relending facility, export bills rediscounting, refinance to commercial banks, finance for computer software exports, finance for export marketing, and bulk import finance to commercial banks. The Bank also extends non-funded facility to exporters in the form of guarantees. The diversified lending programmes of the Exim Bank now cover various stages of exports, that is, from the development of export markets to expansion of production capacity for exports, production for exports, and post-shipment financing. The Bank's focus is on export of manufactured goods, project exports, export of technology services, and export of software.

Meanwhile, the Bank has signed an MOU with the European Bank for Restructuring and Development (EBRD), which will facilitate assistance in the form of structural information about the projects and opportunities in eastern Europe.

In terms of the range of financial support for exporters, the financing programmes of the Exim Bank are rated as the most comprehensive among the export credit agencies all over the world. (Read Exhibit 20.1 for more details on Exim Bank and Fig. 20.5 for decision tree relating to line of credit.)



1. Exim Bank signs agreement with **borrower** and announces when effective.
2. Exporter checks procedures and service fee with **EXIM Bank** and negotiates contract with **importer**.
3. Importer consults **borrower** and signs contract with **exporter**.
4. Borrower approves contract.
5. Exim Bank approves contract and advises **borrower** and also **exporter** and **commercial bank**.
6. Exporter ships goods.
7. Commercial bank negotiates shipping documents and pays **exporter**.
8. Exim bank reimburses **commercial bank** on receipt of claim by debit to **borrower**.
9. Borrower repays **Exim Bank** on due date.

Fig. 20.5 Line of Credit – Decision Tree

COUNTERTRADE

LO 5
Assess countertrade

Countertrade is a unique way of settling overseas transactions. At times, countries experience difficulty in generating enough foreign exchange to pay for imports. They, therefore, need to devise creative ways to get the products they want. This

Exhibit 20.1

BANK'S MAJOR PROGRAMMES

Overseas Entities

- Buyer's credit
- Lines of credit

Commercial Lending

- Refinance of Term Loans to Export-oriented Units
- Export Bills Rediscounting
- Refinance of Export (Supplier's) Credit
- Refinance of Foreign Currency Pre-shipment Credit

Indian Entities

- Pre-shipment Credit
- Export-oriented Units
- Import Finance
- Bulk Import Finance
- Export (Supplier's) Credit
- Export Marketing Finance
- Working Capital Finance
- Finance for Deemed Exports
- Production Equipment Finance
- Export Vendor Development Finance
- Equity Finance and Equity Participation for Indian Ventures Overseas
- Foreign Currency Pre-shipment Credit
- Finance for Research and Development
- Technology Upgradation Fund Scheme
- Asian Country Investment Partners Facility
- Forfaiting
- Underwriting
- Guarantee Facility
- Africa Enterprise Fund
- Software Training Institute
- Minor Ports Development
- Africa Project Development Facility
- African Management Services Company
- Executive Services Overseas Programme
- Product and Process Certification Programme
- Project Preparatory Services Overseas
- Business Advisory and Technical Assistance Services Overseas
- Finance for Consultancy and Technology Services
- Financing Rupee Expenditure for Project Export Contracts
- Mekong Project Development Facility

shortage of foreign exchange, though associated with developing countries, is common in industrialised countries too. For example, Canada and Australia found that they had to enter a special agreement with McDonnell Douglas to pay for military aircraft they wanted to purchase. Thus, both MNCs and governments often are forced to resort to creative ways of settling payment, many of which involve trading of goods for goods as part of the transaction.

Countertrade occurs when a firm accepts something other than money as payment for its goods or services. Thus, countertrade is essentially a barter trade.

Countertrade tends to decrease the efficiency of world trade because it substitutes barter as exchange of goods by the price system. For example, a US exporter of machinery to Indonesia may have to take payment in an equivalent value of palm oil or rattan. The exporting firm will have to sell these products for which it has no expertise itself or to sell them through a broker or other firm. Some party to the trade—exporter, importer or consumer—must bear these additional costs. There are other problems too. The goods that can be exchanged are usually undesirable. Those that could be readily converted into cash have already been done so. Thus, a firm shipping computers to Brazil is prepared to take coffee beans in return, but Brazil has only shoes to offer. In addition, the trading details are difficult to work out, as for instance deciding on the worth of a pile of shoddy Eastern European goods.

Despite the obvious inefficiencies, countertrade is common across nations and about 20 per cent of the world trade is accounted for by the exchange of goods for goods. Infact, the governments of developing nations sometimes insist on a certain amount of countertrade. 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 per cent of their payment in Thai agriculture products. Between 1994 and mid-1998 foreign firms purchased 21 billion baht ($517 million) in Thai goods under countertrade.

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 categorised as five distinct types of trading arrangements: barter, counterpurchase, offset, switch trading, and compensation or buyback. (See Fig. 20.6)

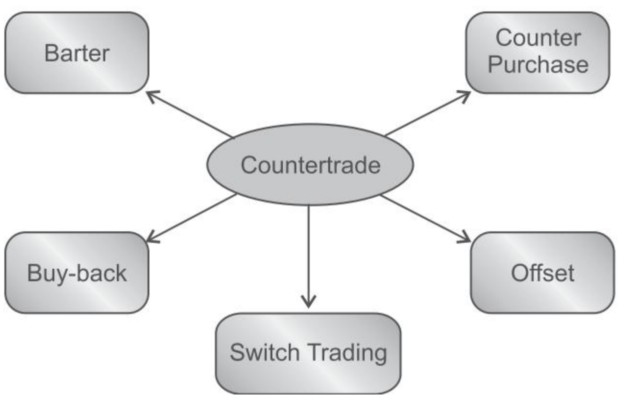


Fig. 20.6 Types of Countertrade

Barter Barter is the direct exchange of goods and/or services between two parties without a cash transaction. In 1993, Eminence S A, one of France's major cloth makers, launched a five-year deal to barter $25 million worth of US produced underwear and sportswear to customers in eastern Europe in exchange for a variety of goods and services, including global transportation and advertising space in Eastern European magazines. Though examples of the type do exist, barter is not very common. There are two-fold problems associated with barter. First, if goods are not exchanged simultaneously, one party ends up financing the other for a period. Secondly, firms engaged in barter run the risk of having to accept the 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 This 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 US firm sells some products to China. China pays the US firm in dollars, but in exchange, the US 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 US firm, it knows it will receive some of these dollars back because of the counterpurchase agreement. In one counterpurchase deal, Rolls Royce sold jet parts to Finland. As part of agreement, Rolls-Royce agreed to use some of the proceeds from the sale to purchase Finish-manufactured TV sets that it would sell in UK.

Offset An example for an offset deal is that Pepsi Co. sells its cola syrup to Russia for roubles and agrees to buy Russian vodka at a certain rate for sale in the US. Going by this example, offset resembles counterpurchase agreement. But there is difference. The difference is that Pepsi can fulfill the obligation with any firm in Russia. From an exporter's perspective, offset is more attractive than a straight counterpurchase deal because it gives the exporter greater flexibility to choose the goods that it wished to purchase.

Switch Trading Switch trading refers to the use of a specialised third-party trading house in a countertrade agreement. When a firm enters a counterpurchase or offset deal 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 US firm concludes a counterpurchase agreement with Poland for which it receives some number of counterpurchase credits for purchasing Polish goods. The US firm cannot and does not want any Polish goods, however 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 at a profit.

In an example of switch trading, Poland and Greece had a counterpurchase agreement that called for Poland to buy the same US 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 2,50,000 counterpurchase dollars from Poland for $2,25,000 and sold them to a European sultana (grape) merchant for $2,35,000 who used to purchase sultanas from Greece.

Buyback A buyback also called *compensation* 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 deal. A US chemical company built a plant for an Indian company and accepted partial payment in cash and the reminder in chemicals manufactured at the plant. In another buyback deal, Internationale Vine of Latvia agreed to buy equipment for producing apple concentrate from PKL of Switzerland, and made available part of the output of concentrates as buyback.

Countertrade is of particular importance to countries that lack convertible currency and, as stated earlier, is often used as means of reducing the drain on scarce foreign currency holdings. For example, the former Soviet Union was a major countertrade user. Often goods were traded between the Soviet Union and the former members of COMSCON under countertrade deals. The former communist countries also engaged in countertrade with capitalist countries. The practice continues even today. For example, Russia is supplying Hungary with military equipment and non-military goods such as transport vehicles and agricultural machinery in order to eliminate debt. In addition to repay its debt to Finland, Russia is providing an air defence system.

What is interesting is that there is an expansive growth in countertrade with the third world countries. The basis for the new wave of countertrade is the cutting off of bank credit to developing nations. Third world countertrade involves more commodities and fewer hard-to-sell manufactured goods. Big players such as GE, and Caterpillar have set up countertrading subsidiaries in order to make it easier for the Third World countries to buy their products. Arms manufacturers selling to developing countries are often forced to accept local products in return. For example, Iraqi oil for French Exocet missiles or Peruvian anchovies for Spanish Piranha patrol boats.

A relatively new form of countertrade involves *swaps.* Swaps are generally carried out in relation to developing countries where the government and private sector face large debt burdens. Given that these debtors are unable to pay their debt in the immediate future, lenders have grown amenable to exchange the debt for something else, as for example, *debt-for-equity swaps* in the private sector, and *debt-for-nature swaps* in the public sector.

Table 20.1 brings out the pluses and the minuses of countertrade to sharp focus.

Table 20.1 Pluses and Minuses of Countertrade

Pluses	*Minuses*
• Countertrade results in benefits to the firms and the country such as enhanced economic development, increased employment, technology transfer, market expansion, increased profitability, less costly sourcing of supply, reduced inventories, and development of marketing expertise.	• Forced on certain countries, their resistance notwithstanding. • Trade between countries is not reflected truly as countertrade transactions are not accounted and not shown in official statistics. • Efficiency of world trade tends to decrease as transactions are not monetised.
• Conservation of cash and hard currency	• Countertrade carries bags of the evils associated with the traditional barter system.
• Improvement in trade imbalances.	
• Centrally planned economies use as a substitute for FDI.	
• Countertrade between developing countries helps avoid repayment of external debt.	
• Countertrade between developed countries is helpful to bypass cartels and commodity arrangements.	

INSTITUTIONAL SUPPORT FOR FOREIGN TRADE

LO 6
Interpret institutional support for foreign trade

In Chapter 15, we had explained, in detail, the institutional support in general to international business. Here, we propose to present a brief profile of institutions that support India's foreign trade exclusively. The country has comprehensive institutional framework that promotes and facilitates its exports and imports. The major institutions are Department of Commerce, advisory bodies, commodity organisations, service organisations, government trading organisations and others.

Department of Commerce

Department of Commerce is the apex body set up by the government for formulating and directing trade policies and programmes. The body also looks after India's trade relations with other countries, state trading, and regulation of export oriented industries.

The Department of Commerce operates through various divisions: economic, trade policy, foreign trade territorial, export product, export industries and export services.

Economic Division takes care of such important activities as export planning, strategising, evaluation and review of policies. It also coordinates the activities of all other divisions and agencies set up to promote exports. *Trade Policy Division* interacts and keeps updating the developments in world bodies such as WTO, UN, UNCTAD and other regional trading blocks. *Foreign Trade Territorial Division* shoulders the responsibility for the development of trade across the globe and also handles state trading, countertrade, and trade fairs and exhibitions. *Export Product Division* is industry-specific. It handles rubber, tobacco, cardamom, textiles, woolens, handlooms, silk, readymade garments, jute, and coir. *Export Services Division* looks after export credit, export houses, free trade zones, quality check, logistics and import of capital goods.

Advisory Bodies

Board of Trade and Export Promotion Board come under the category of advisory bodies. Set up in 1989, the *Board of Trade* ensures constant interaction with trade and industry in order to advice the government on policy measures, identify bottlenecks and offer industry-specific measures to boost exports. *Export Promotion Board* coordinates with concerned ministries involved in exports. The Board is of great help in as much as it gives a big push to exports and resolves inter-ministerial differences, should they arise. *Commodity Organisations* include export promotion councils, commodity boards and autonomous bodies.

Export Promotion Councils

Set up as non-profit organisations; export promotion councils develop and promote export of specific products. There are 21 councils and all are given financial assistance by the government. A few export promotion councils include; Engineering Export Promotion Council, Projects Export Promotion Council, Apparel Export Promotion Council, Cotton Textile Export Promotion Council, Cashew Export Promotion Council, Pharmaceutical Export Promotion Council, and the like.

These Councils seek to project India's image abroad as a supplier of quality goods and services. They also issue registration-cum-membership certificates to their members which are essential to obtain export incentives.

Commodity Boards

Commodity boards discharge functions similar to those of export promotion councils. Specifically, functions of the boards relate to production, marketing and development of commodities. There are nine such boards and they are: Spice Board, Tobacco Board, Cardamom Board, Tea Board, Coffee Board, Coir Board, Central Silk Board, Handlooms and Handicrafts Board, and Rubber Board.

Autonomous Bodies

These include the Agriculture and Processed Food Products Export Development Authority, and Marine Products Export Development Authority. The former looks after the promotion of exports of agri products and the latter promotes all kinds of fisheries and related products.

Service Institutions

Service organisations include Export Inspection Council, Indian Council of Arbitration, Indian Trade Promotion Organisation, ECGC, Exim Bank and Indian Institute of Packaging. These organisations attend to such functions as marketing research, finance, human resource, publicity, trade fairs and exhibitions, inspection and quality control, data base and the like.

Direct Participation

Besides setting up various agencies, government involves directly in exports through such bodies as State Trading Corporation (STC), Trade Point, and Minerals and Metals Trading Corporation (MMTC).

STC was set up in 1956 to enlarge the scope of India's exports and to arrange for essential imports. MMTC was created in 1963 for expanding export of mineral ores form the country. The Mica Trading Corporation was set up in 1973 as a subsidiary of MMTC to handle mica trade exclusively.

Trade Points are being sponsored by UNCTAD and India has been among the first few countries to establish a Trade Point. A Trade Point offers a large number of traders all over the world the information and the state of the technology required to find markets and carry out on-the-spot transactions.

Others

There are three offices of the government which deal exclusively with exports. There is the Directorate General of Foreign Trade (DGFT). DGFT has wider responsibility of implementing foreign trade policy (Exim Policy) announced by the government once in five years. The Directorate also looks after issue of licences and monitoring the export obligations of firms.

Director General of Commercial Intelligence and Statistics (DGCIS) is another wing of the government. DGCIS, set up in 1962, looks after the duties of collecting, compiliating and dissemination of trade related information. DGCIS also publishes journals which are highly useful for policy makers and academics. Its two main publications include *Indian Trade Journal* and *Foreign Trade Statistics of India*.

Finally, there is the Directorate General of Anti-Dumping and Allied Duties (DGAD). The DGAD, established in 1998, is incharge of investigating into alleged dumpings and recommending the imposition of anti-dumping countervailing duties.

Appendix

INTERNATIONAL COMMERCIAL TERMS (INCOTERMS)

Ex Works (ExW): The term ExW is commonly used between the manufacturer (seller) and export-trader (buyer), and the export-trader resells on other trade terms to the foreign buyers. Some manufacturers may use the term Ex-Factory, which means the same as Ex Works.

Free Carrier: The delivery of goods on truck, rail car or container at the specified point (depot) of departure, which is usually the seller's premises, or a named rail road station or a named cargo terminal or into the custody of the carrier, at seller's expense. In the air shipment, technically speaking, goods placed in the custody of an air carrier are considered as delivery on board the plane. In practise, many importers and exporters.

Free Alongside ship (FAS): Goods are placed in the dock shed or at the side of the ship, on the dock or lighter, within reach of its loading equipment so that they can be loaded aboard the ship, at seller's expense. Buyer is responsible for the loading fee, main carriage/freight, cargo insurance, and other costs and risks.

Free on Board (FOB): The delivery of goods on board the vessel at the named port of origin (loading, at seller's expense). Buyer is responsible for the main carriage/freight, cargo insurance and other costs and risks.

Cost and Freight (CFR): The delivery of goods to the named port of destination (discharge) at the seller's expense. Buyer is responsible for the cargo insurance and other costs and risks. The term was formerly written as C & F. Many imports and exports worldwide still use the term C & F.

Cost, Insurance and Freight (CIF): The cargo insurance and delivery of goods to the named port of destination (discharge) at the seller's expense. Buyer is responsible for the import customs clearance and other costs and risks.

Carriage Paid To (CPT): The delivery of goods to the named place of destination (discharge) at seller's expense. Buyer assumes the cargo insurance, import customs clearance, payment of custom duties and taxes and other costs and risks.

Carriage and Insurance Paid To (CIP): The delivery of goods and the cargo insurance to the named place of destination (discharge) at seller's expense. Buyer assumes the import customs clearance, payment of customs duties and taxes and other costs and risks.

Delivered At Frontier (DAT): The delivery of goods to the specified point at the frontier at seller's expense. Buyer is responsible for the import customs clearance, payment of customs duties and taxes, cargo insurance, and other costs and risks.

Delivered Ex ship (DES): The delivery of goods on board the vessel at the named port of destination (discharge), at seller's expense. Buyer assumes the unloading fee, import customs clearance, payment of customs duties and taxes, cargo insurance, and other costs and risks.

Delivered Ex Quay (DEQ): The delivery of goods to the quay (the port) at destination at seller's expense. Seller is responsible for the import customs clearance and payment of customs duties and taxes at the buyer's end. Buyer assumes the cargo insurance and other costs and risks.

Delivered Duty Unpaid (DDU): The delivery of goods and the cargo insurance to the final point at destination, which is often the project site or buyer's premises, at seller's expense. Buyer assumes the import customs clearance and payment of customs duties and taxes. The seller may opt not to insure the goods at his/her own risks.

Delivered Duty Paid (DDP): The seller is responsible for most of the expenses, which include the cargo insurance, import customs clearance, and payment of customs duties and taxes at the buyer's end, and the delivery of goods to the final point at destination, which is often the project site or buyer's premises. The seller may opt not to insure the goods at his/her own risks.

Free In (FI): The word free as used in the charter shipping term means not including. FI is a pricing term indicating that the charterer of a vessel (i.e. , the shipper) is responsible for the costs of loading goods on to the vessel and unloading goods from the vessel.

Free Out (FO): FO is a pricing term indicating that the charterer of a vessel (i.e., the shipper) is responsible for the cost of unloading goods from the vessel.

Free In and Free Out (FIO): FIO is a pricing term indicating that the charterer of a vessel (i.e., the shipper) is responsible for the costs of loading goods on to the vessel and unloading goods from the vessel

Source: Export 911.Com

Summary

- In international trade payment terms are crucial. A few of them are: cash in advance, l/c, draft, consignment, and open account. (LO1)
- L/c, B/L, commercial invoice, insurance certificate and consular invoice are the major documents used in world trade. (LO2)
- Financing techniques in overseas trade include forfaiting and factoring. (LO3)
- Short and long term credits and Exim bank are the major ways of export financing. (LO4)
- Countertrade, also called barter trade, has staged a comeback. It is one of the ways of settling international transactions. (LO5)
- Too many agencies have been set up to facilitate foreign trade. Department of Commerce, Advisory Boards, Export Promotion Councils, and Commodity Boards are prominent among them. (LO6)

Review Questions

1. Write notes on (LO2)
   (a) Cash in advance as is used in international trade
   (b) Letter of Credit

2. Briefly explain (LO1)
   (a) Draft
   (b) Consignment
   (c) Open account

3. Describe briefly (LO2)
 (a) Bill of Lading
 (b) Commercial Invoice
4. Write notes on (LO2)
 (a) Insurance Credit
 (b) Consular Invoice
5. Explain the various financing techniques employed in foreign trade. (LO3)
6. Bring out the export financing facilities available to Indian exporters. (LO4)
7. What is countertrade? What are its different types? (LO5)

Discussion Questions

1. What are some benefits and costs of countertrade for the parties involved ? (LO5)
2. The principal problem in analysing different forms of export financing is the distribution of risks between the exporter and the importer. Analyse the following export financing instruments in this respect: (LO5)
 (a) Letter of Credit
 (b) Cash in advance
 (c) Draft
 (d) Consignment
 (e) Open Account

Reinforcing Exercises

Pepsi Co. dominates the cola market in Russia and all the former Soviet republics in part because of its exclusive countertrade agreement with Russia, which locked Coca-Cola out of the Russian cola market for more than 12 years. After the Soviet Union was dismembered, the Russian economy crashed, and most of the Russian payment system broke down into barter operations. Truck loads of aspirin were swapped by one company, then traded for poultry, which in turn was bartered for timber, in turn to be exchanged for X-ray equipment – all to settle debts. Many of these transactions involved regional electricity companies that were owed by virtually every one. Barter system of transactions settlement, condemned by economists of yore, seems to be staging a come back. Will you agree?

CLOSING CASE

American Machine Tools, INC

American Machine Tools is a mid-western manufacturer of tool-and-die-making equipment. The company has had an inquiry from a representative of the Estonian government about the terms of sale for a $5,000,000 order of machinery. The sales manager spoke with the Estonian representative, but he is doubtful that the Estonian government will be able to obtain enough hard currency to make the purchase. While the US economy has been growing, American Machine Tools has not had a very good year. An additional $5,000,000 in sales would definitely help. If something cannot be arranged, the firm will likely be forced to lay off some of its skilled workforce.

Is there a way that you can think of that American Machine Tools might be able to make the machinery sale to Estonia?

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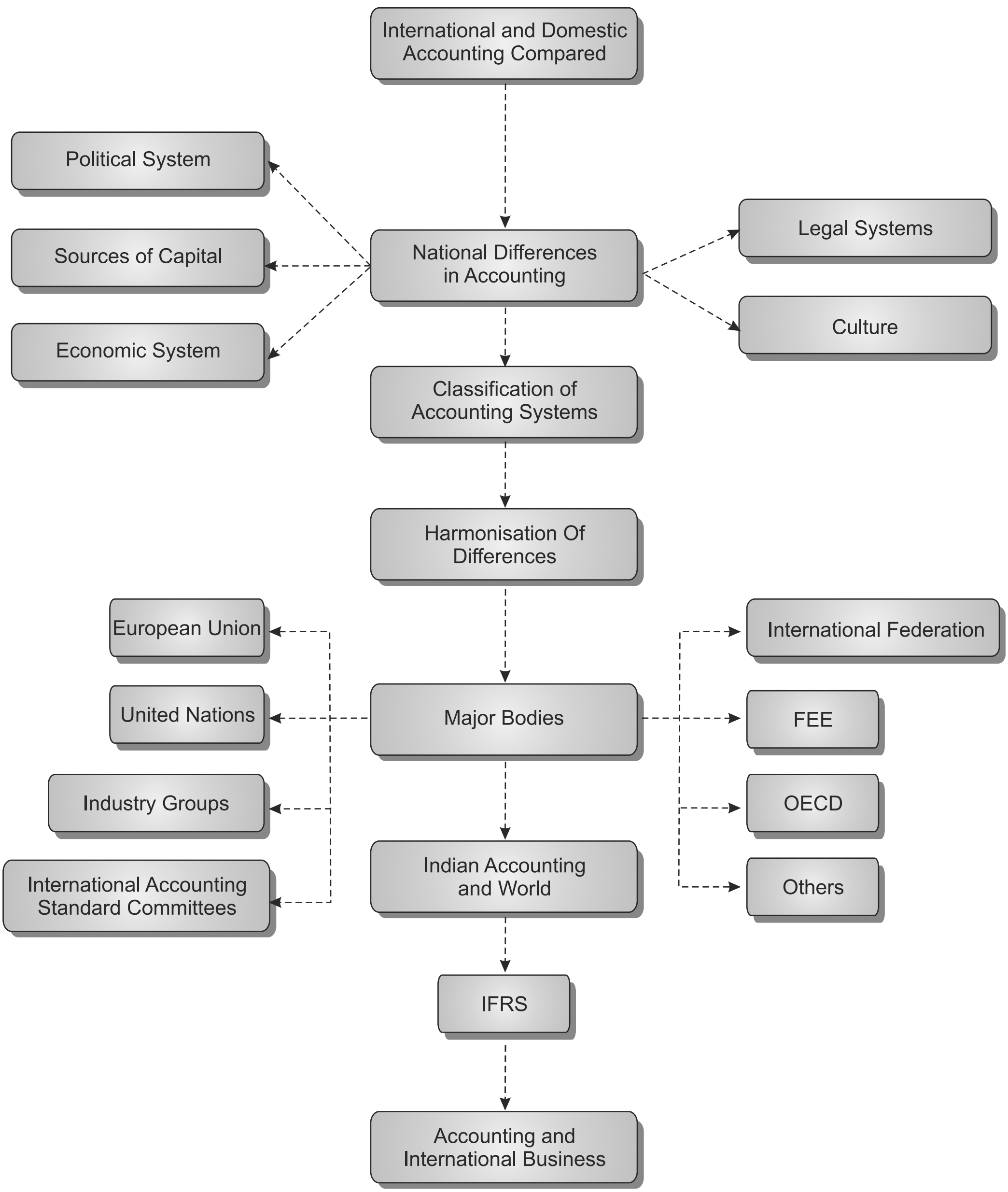
CHAPTER


International and Domestic Accounting Compared
Political System
Sources of Capital
Economic System
National Differences in Accounting
Legal Systems
Culture
Classification of Accounting Systems
Harmonisation Of Differences
European Union
United Nations
Industry Groups
International Accounting Standard Committees
Major Bodies
International Federation
FEE
OECD
Others
Indian Accounting and World
IFRS
Accounting and International Business

21

International Accounting

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Distinguish between international and domestic accounting
- **LO 2:** Recognise national differences in accounting
- **LO 3:** Illustrate the classification of accounting systems
- **LO 4:** Discover the harmonisation of differences
- **LO 5:** List professionals and regulatory bodies
- **LO 6:** Place Indian accounting in the world accounting system.
- **LO 7:** Outline International Financial Reporting Standards (IFRS)
- **LO 8:** Interpret accounting for international business

Opening Case

Differing Accounting Issues

Table 21.1 shows the differences obtaining in two accounting systems—one American and the other German.

It was against this accounting background that the two giant car makers—Daimler-Benz (German) and Chrysler (US) merged in 1998, creating the fifth largest auto company in the world with annual revenues of around $130 billion. While the merger was based on justifiable reasons, it raised several issues relating to preparation of statements and disclosure of information. The new company, Daimler Chrysler, had to determine which currency and accounting standards (German or American) it would use to report its results to investors all over the world.

Being a true global company, Daimler Chrysler chose what is the best—adopt practices which are truly global.

In November 1998, the company's stock

Table 21.1 Accounting Issues

German	*American*
1. German companies are more conservative in their reporting. Tax law is highly codified and this has considerable influence on the accounting system.	1. Companies favour a liberal approach to accounting disclosures.
2. The accounting system in Germany gives preference to the information needs of the creditors and tax administrators. There exists a very conservative approach to valuation with strict adherence to historical cost accounting, which means that the assets are valued at their original costs.	2. Firms differ considerably in all these areas from their counterparts in Germany.
3. Firms rely more on banks and others for funds than on equity capital markets. To protect the interests of creditors, the law requires companies to create a legal reserve.	3. Firms differ from their counterparts in Germany.
4. Managers report financial information annually. Footnote disclosures are common giving an impression that financial statements are not transparent.	4. Financial information is reported quarterly and statements tend to be transparent as US accounting standards are oriented to the stock market.
5. Accounting focuses on asset valuation on the balance sheet.	5. US accounting standards focus on earnings.
6. Accounting standards are included in the law.	6. Standards are set by an independent body.

began trading on stock markets worldwide under the symbol DCX. It was the first company in the world to introduce the "global share" —a share registered in 21 stock exchanges around the world. In the notes to the 1998 consolidated financial statements, management states that the Daimler Chrysler financial statements are prepared according to US GAAP, with a few exceptions. Besides, the statements are presented in euros, instead of the Deutsche mark or dollar—the first company to do so. Previous year's earnings in Deutsche marks and dollars had to be restated in terms of euros for comparative purposes.

The company that audited the 1998 accounts, KPMG Deutsche Treuhand-Gesellschaft, stated that it audited the statements in accordance with German and US generally accepted accounting standards and that it did so in accordance with the US GAAP. Some of the items in the financial statements were prepared according to the GAAP established by the European Community and by the International Accounting Standards Committee, but the Securities Exchange Commission permitted Daimler Chrysler to do that.

The income statement of the company resembles what one finds in the US but the balance sheet is prepared differently. Although the financial statements are presented in euros, there is a column provided for the US dollar equivalent of the income statement and balance sheet. US companies tend to present their balancesheet in terms of decreasing liquidity. That means the most liquid assets, such as cash, receivables, and inventory are presented first followed by least liquid assets, such as intangible assets and property, plant and equipment. Daimler Chrysler, however, presents its balancesheet in order of least liquid to most liquid assets. Just the opposite of a US company.

It was not easy to bring together the accounting systems of two different companies from two different countries. Daimler Chrysler management first had to determine which accounting standard it would use and which currency would be its reporting currency. Then it had to deal with different hardware, software, and reporting formats. But it has succeeded in doing so successfully.

Daimler Chrysler is no exception. Any international business confronts the issue of the accounting standards to be followed and the currency in which statements should be prepared. This chapter is devoted to a detailed discussion on the differences prevailing in accounting standards, efforts to harmonise these differences, and other related issues.

ACCOUNTING has been understood as the 'language of business'. This language finds expression in profit and loss statements, balance sheets, budgets, investment analysis, and tax analysis. Accounting information is the means by which firms communicate their financial position to investors, creditors, governments, and other stakeholders. The accounting system provides operational information to line managers and financial data to top executives to help them make marketing, financial, and strategic decisions.

International accounting extends general-purpose, nationally-oriented accounting in its broadest sense to: (1) international comparative analysis, (2) accounting measurement and reporting issues unique to multinational business transactions and the business form of the international enterprise, and (3) harmonisation of worldwide accounting and financial reporting via political, organisational, professional, and standard-setting activities. This chapter centres around these areas.

INTERNATIONAL ACCOUNTING AND DOMESTIC ACCOUNTING

LO 1
Distinguish between international and domestic accounting

International businesses are confronted with a number of accounting problems that do not accost domestic businesses. The accounting system of a purely domestic firm must meet the professional and regulatory standards of its home country. However, an MNC and its subsidiaries must meet, often, contradictory accounting and auditing standards of all the countries in which it operates, which leads to a lack of comparability between businesses in the group. To effectively manage and control their operations, local managers need accounting information prepared according to local accounting concepts and denomination in the local currency. However, for financial controllers to assess the foreign subsidiary's performance and value, the subsidiary's accounting records must be translated into the parent's home currency using accounting concepts and procedures detailed by the parent. Investors around the world seeking the highest possible returns on their capital need to be able to interpret the firm's track record, even though it may be using a currency and an accounting system different from their own. The firm will also have to pay taxes to the countries in which it does business based on the accounting statements it develops in these countries. In addition, when a parent corporation attempts to integrate the accounting records of its subsidiaries to create consolidated financial statements, additional complexities arise because of changes in the value of the host and home currencies over time.

NATIONAL DIFFERENCES IN ACCOUNTING

LO 2
Recognise national differences in accounting

As stated before, one of the problems confronted by an international business relates to the lack of consistency in accounting standards of different countries. Contrasting financial results are often shown by the firms because of differences in accounting standards. For example, in 1994, under German rules, Daimler reported a profit of over $100 million, but under the Generally Accepted Accounting Principles (GAAP), the company reported a loss of $1 billion.

Another example is the US-based SmithKline Beechm (SKB), which got merged with the British company Beecham Group in 1989. After the merger, SKB had quotations on both the London and New York stock exchanges, so it had to prepare financial reports in accordance with both US and British standards. SKB's post merger earnings, properly prepared in accordance with British accounting standards, were $130 million—quite a bit more than the $187 million reported in SKB's statement prepared in accordance with US accounting standards. The difference resulted primarily from treating the merger as a pooling of assets for British purposes and as a purchase of assets for US purposes. Even more confusing, the differences resulted in a shareholders' equity of $3.5 billion in the US, but a negative $300 million in the UK! Not surprisingly, after these figures were released, SKB's stock was trading 17 per cent lower on the London Stock Exchange than on the New York Stock Exchange (also see Exhibit 21.1).

Exhibit 21.1

INFOSYS, ICICI PROFITS DOWN UNDER US GAAP NORMS

July 15: The application of US generally accepted accounting principles (GAAP) has had a mixed impact on the bottomlines of Indian companies. While HCL Infosystems and Hughes Software's balance sheets look much healthier, Infosys Technologies and ICICI's profits have taken a beating.

Infosys Technologies' net profit under US GAAP comes to $61.34 million (Rs 273 crore), which is nearly 10 per cent (Rs 29 crore) lower than its $67.77 million (Rs 301 crore) net profit under the Indian GAAP for the year ended March, 2000.

In ICICI's case, its $167.40 million (Rs 745 crore) net profit as per US GAAP is 25 per cent (Rs 256 crore) lower than its net profit of $225 million (Rs 1001 crore) during the year ended March, 1999.

However, the picture is completely different in the case of HCL Infosystems and Hughes Software who are already following the stringent accounting policies which have boosted their bottomlines when profit is calculated as per US GAAP norms.

HCL's net profit of Rs 34.92 crore as per Indian GAAP vaults to Rs 57.14 crore when calculated under the US GAAP for the year ended June, 1999 as a result of adjustments on account of accrued income on lease, depreciation and extended warranty income. Similarly, Hughes Software's profit of Rs 17.81 crore as per Indian GAAP is much lower when compared to its profit of Rs 23.53 crore under US GAAP for the year ended March, 1999.

Infosys' profits were down under US GAAP on account of deferred tax liability of $0.08 million, provision for retirement benefits to employees ($0.74 million) and employee stock-based compensation ($0.51 million). Similarly, ICICI's profits slipped under US GAAP norms because of provision on account of allowance for credit losses, amortisation of fees, deferred tax adjustments, preference dividend payment and inter-company elimination.

These are the findings of a study done by the Centre for Accounting Research and Education, a research body promoted by the All India Chartered Accountants Society.

The Zee group has posted a net loss of Rs 69 crore for the financial year ended March 31, 2001 under the US GAAP. Under the Indian practices, the group posted a net profit of Rs 183 crore for the period. These results were compiled affer the group concluded an exercise to make its accounts compatible with US GAAP. For the year ended March 31, 2001, it registered a loss of Rs 17.1 crore under the US GAAP against the reported net profit of Rs 160 crore under Indian practice.

Accounting treatment under US accounting practices is stringent as compared to Indian accounting standards. Material differences exist between the financial statements prepared according to Indian and the US GAAP. Material differences arise due to provision of short-term investments, which are marked to market and adjusted against retained earnings.

"Major differences occur on account of consolidation of accounts of subsidiaries, which is currently not followed under the Indian GAAP. As a result, the impact of subsidiaries which are making losses is not reflected in the accounts under the Indian GAAP." Centre for Accounting Research and Education's Vice-chairman Vinod Rustagi told the *Financial Express*.

"There is a need to provide for deferred taxes, amortisation of deferred stock compensation, consolidation of accounts and provision for diminution in the value of current investments so as to present a true and fair picture of the company," he said.

Experts feel that with more and more corporates looking for a listing on US bourses, sooner or later, they will have to follow the US accounting policies to reflect the actual financial picture. This would result in a scaling down of the profits as shown under the Indian GAAP.

A company has to accept all the principles under the US GAAP before being eligible for listing at any of the US stock exchanges. Non-US companies with registered securities in the US may issue financial statements under US GAAP or another comprehensive basis of accounting principles provided reconciliation to the US GAAP is provided in the note to accounts.

Differences in accounting standards exist because of different political, legal, economic, and cultural system prevailing across the countries. Accounting standards and practices are also influenced by the sources of capital used to fund business. Figure 21.1 shows the influencing factors on a country's accounting practices.

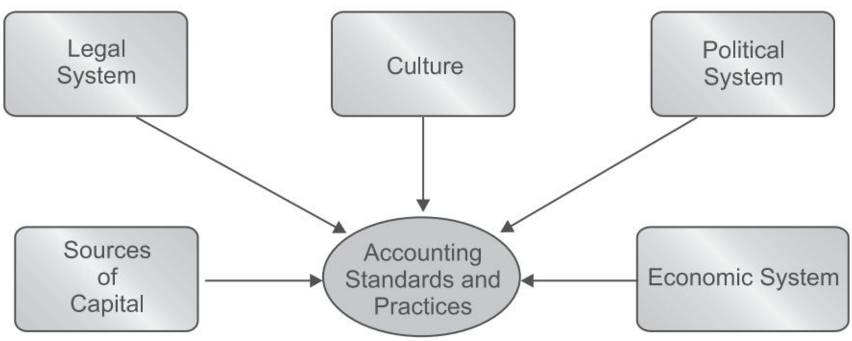


Fig. 21.1 Influences on a Country's Accounting System

Legal System

As stated in Chapter 5, there are civil law and common law countries. In common law countries such as Australia, New Zealand, the UK, and the US accounting procedures normally derive from decisions of independent standards setting boards, such as the Australian Accounting Standards Board (AASB) or the US Financial Accounting Standards Board (FASB). Each board works in consultation with professional accounting groups. In Australia, for example, the two major accounting bodies, the Australian Society of Certified Practising Accountants (ASCPA) and the Institute of Chartered Accountants in Australia

(ICAA) jointly fund the Australian Accounting Research Foundation (AARF), which recommends standards to the AASB.

The common law countries accountants typically follow the GAAP, which provide a 'true and fair view' of a firm's performance based on the standards agreed to by these professional boards. Operating within the boundaries of these standards, accountants have leeway to exercise their professional discretion in reporting a 'true and fair' depiction of a firm's performance.

Countries following civil law, on the other hand, are likely to codify their national accounting procedures and standards. In these countries accounting practices are determined by the law, not by the collective wisdom of professional accounting groups. For example, France's code law system and long tradition of strong central government control over the economy is reflected in its imposition on French firms of a national uniform chart of accounts—the *Plan Comptable Général*. This accounting system, which dates back to 1673, creates accounting records designed to serve as proof in legal procedures. To facilitate this legal role, all corporate accounting records must be officially registered with the government. Similarly, German accounting practices adhere to requirements laid down by law or court decisions.

How accounting practices are enforced also depends on the legal system. Most developed countries rely on both private and public enforcement of business behaviour, although the public/private mixture varies by country. As French and German accounting procedures are laid down by law, the government plays a major role in monitoring accounting practices in those countries. Therefore, French and German firms are more concerned about satisfying government standards than providing information to shareholders, creditors and investors. In contrast, in the US greater reliance is placed on private litigation to enforce the accuracy and honesty of a firm's accounting practices. In the US any attempt to mislead private investors or creditors is likely to lead to a lawsuit. Such private litigation is far less in Australia than in the US.

The extent of the legal system is a significant constraint on the development of accounting standards by the accounting profession and it may well be the countries where accounting regulations are contained in detailed legislation, passed by governments, present the biggest problems to the international accounting bodies striving for increased harmonisation of national accounting frameworks. This is because such government-controlled regimes tend to be less flexible and find private sector influences less acceptable.

Culture

A major source of influence on accounting standards and procedures is culture. Of special interest to international investors are the differences in measurement and disclosure practices among countries. Measurement refers to such issues as how to value assets, including inventory and fixed assets. Disclosure refers to the presentation of data and discussion of results in documents that are prepared for external users of financial information, such as annual reports.

Figure 21.2 depicts the possible locations of the accounting practices of various groupings of countries in a matrix of the cultural values—secrecy/transparency and optimism/conservatism. With respect to accounting, secrecy and transparency refer to the degree to which companies disclose information to the public. Countries such as Germany, Switzerland, and Japan tend to have less disclosure (revealing cultural value of secrecy) than do the US and the UK—Anglo Saxon countries—which are more transparent or open with respect to disclosure. This is illustrated by the more extensive footnotes in reports of the Anglo-Saxon countries than is the case elsewhere.

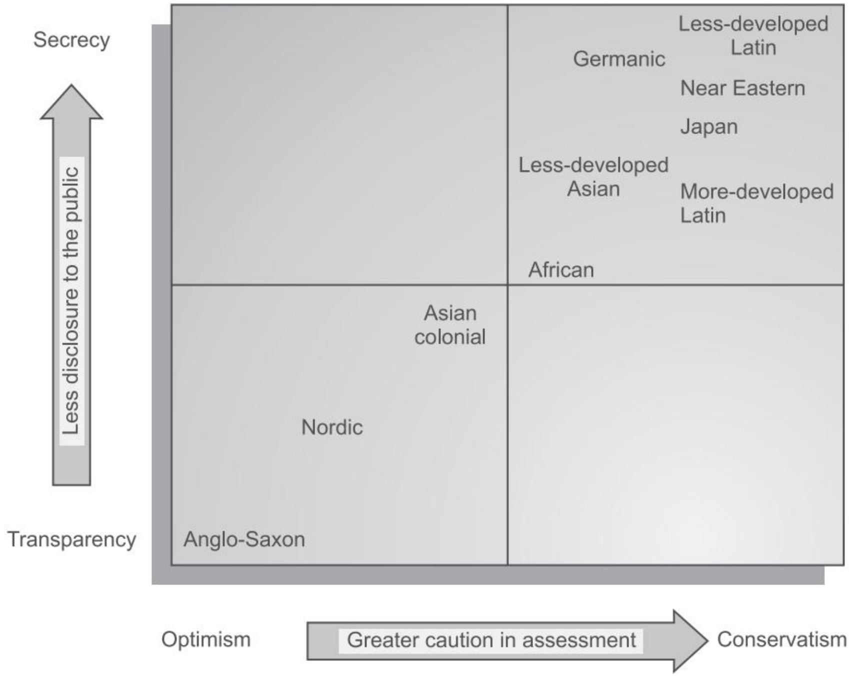


Fig. 21.2 Cultural Differences in Measurement and Disclosure for Accounting Systems

(*Source*: John D Daniels and Lee H Radebaugh, *International Business*, p. 791)

Optimism and conservatism refer to the degree of caution companies exhibit in valuing assets and calculating income. More conservative companies tend to underestimate assets and income, whereas optimistic countries tend to be more liberal in their assessment of income.

German companies tend to be very conservative in recording profits, which keeps them from paying taxes and declaring dividends. In contrast, US and British companies want to show optimistic earnings in order to attract investors.

Cultural typologies developed by Hofstede have their own bearing on accounting systems and practices. According to Hofstede, a culture characterised by *uncertainty avoidance* has an impact on accounting systems. Uncertainty avoidance refers to the extent to which cultures socialise their members to accept ambiguous situations and tolerate uncertainty. Members of high uncertainty avoidance cultures place a premium on job security, career patterns, retirement benefits, and the like. They also have strong need for rules and regulations; the manager is expected to issue clear instructions, and subordinates initiatives are highly controlled. Lower uncertainty avoidance cultures are characterised by a greater readiness to take risks and less emotional resistance to change. According to Hofstede, countries such a Britain, the US, and Sweden are characterised by low uncertainty avoidance, while countries such as Japan, Mexico, and Greece have high uncertainty avoidances. It is said that countries with low uncertainty avoidance cultures tend to have strong independent auditing professions that audit a firm's accounts to make sure they comply with generally accepted accounting regulations.

Another cultural dimension that has a bearing on accounting systems and practices is the language. Some countries in the Asian region have sought to preserve their identity by limiting the use of foreign languages for financial reporting purposes. Countries such as China, Indonesia, Korea, and Japan stipulate the use of their own language for reporting of financial data. Financial information does not always translate precisely from one language to another. Obviously, international businesses face additional costs for both translation and interpretation of foreign language financial reports.

Other cultural dimensions too have their impact on accounting standards and practices. For example, financial reporting must take account of the assumptions and attitudes of the people in a culture. If they feel that they can influence the future they will require relevant, reliable data to help in the process of shaping that future: alternatively they may consider ‘Fate’ to be the primary consideration and therefore detailed financial statements aimed at, for example, providing information for assessing future cash flows would be viewed as inappropriate.

Some societies tend to concentrate on the short-term and obviously there is great emphasis put on periodic profit measurement while other societies tend to think more long-term and therefore put more emphasis on the balance sheet and trends of profit over many accounting periods.

The personal beliefs, aspirations, and motivations of people will influence their demand for financial information and shape the accounting practices adopted in their formulation. In some countries, for instance, Japan, the motivation is towards activities that benefit the country rather than one person, while in some western countries personal gain is considered to be more important.

Accounting will place emphasis on the profit or loss to the party that is considered to be more important. Obviously, income-smoothing practices, which are considered unacceptable in some societies are considered the norm in others where such a practice aids stability within the economy as a whole. These cultural and behavioural factors are also of special interest to the design of management accounting systems, which may in turn have a knock-on effect on external financial reporting.

The cultural norms relating to interpersonal relations can effect the level of influence considered by society to be acceptable from an independent accounting profession or, in contrast, the amount of government regulation that is considered to be acceptable. For example, the level of government control in France and Germany would be unacceptable to many in the UK, where great efforts are being made to keep a majority of the regulatory framework outside direct government control.

Social structure too can have its impact on accounting standards and practices. In societies, for example, the US, where all are supposed to be equal, widespread equity ownership is an accepted norm. This is something that is very important in those countries where privatisation of government enterprises is an acceptable business practice. Accounting and widespread financial reporting in such situations is very important.

Social structure has implications for status assigned to the accounting profession. This is particularly true in many reforming Eastern European countries where the centrally planned economies put little emphasis on accounting skills and accountants were therefore treated as unskilled clerks. With the developments in these countries, their society’s attitude to accountants must change if they are to make use of the opportunities that are available to them. It is essential that accountants are seen to be important members of the business community and that they are trained to provide financial information that is relevant to the resource-allocation and decision-making processes.

Political System

The political environment existing in a country will have a greater impact on accounting and auditing practices. The way a country is governed can have considerable influence on the development of financial reporting. The glaring example is the developments that took place in the centrally planned economies of the communist states that existed in Eastern Europe compared with the developments that have occurred in Western Europe.

In a centrally planned economy, all accounting was reduced to the level of basis statistics designed to show whether or not the production plan has been achieved, while in Western Europe, in general, accounting developed in a more constructive manner. The differences have, perhaps, become even more apparent as the Eastern European countries have given up their communist philosophy and moved towards a form of government that is more in line with a free market economy.

The relevance of the political system can also be seen in countries that are effectively run by dictators. In such countries, accounting development is likely to be controlled with little or no influence being exerted from outside the country. This does not help the harmonisation process of international accounting. Similarities in the accounting systems of countries are often due to the country's close political ties. Most members of the British Commonwealth, such as Australia, India, New Zealand, and Hong Kong, for example, have historically adopted the British accounting system, while the former colonies France and the Netherlands have adopted those of their colonial rulers. Similarly, the accounting procedures of the Philippines follow those of the US, which controlled the country from 1898 to 1946.

Economic System

Developed countries tend to have large and complex organisations, whose accounting problems are far more difficult than those of small organisations. If a country has organisations that are relatively small, owned by only a small number of people and serving only in local markets, then the extent of the accounting regulations and the level of international influence is likely to be minimum. The users interested in the financial statements would be few in number, and they would probably have access to more detailed, up-to-date, internal financial information—there is therefore little need for the development of extensive external reporting regulations nor extensive control requirements in the form of independent audits in such economic conditions.

At the other extreme are very large enterprises, owned by a large number of people or institutions, and with extensive links overseas. It is the complexity and international nature of such businesses that require the development of extensive accounting regulations and result in the need for independent audit verification of the financial statements.

It is also interesting to note that the existence of these multinational organisations in an economy makes it imperative that accounting is studied on an international scale—they think in international terms, and therefore an assessment of their accounting needs should also be considered in those terms—and they are also quoted as one of the reasons for the closer harmonisation of national financial reporting requirements.

A good example of a financial reporting requirement that is dependent on the form of organisation, particularly the multinational form, is segmental reporting. Breaking down figures for income, profit, net assets, and overall funding is particularly important where an organisation operates in areas of differing levels of profitability and risk. This is most likely to be where they operate in different countries. The segmented information is therefore an essential piece of financial reporting in such circumstances; but where such diverse organisations do not exist in significant numbers such developments would be considered unnecessary.

The complexity and type of organisation will also affect the need to develop regulated accounting practices for research and development expenditure, pension costs, long-term contracts, depreciation (unnecessary for example in an environment that is mainly agrarian), mergers, leases, and intangible fixed assets.

Besides the form of organisation, one must also consider the sources of finance that are used by all forms of organisations to fund their activities. Some countries may have similar forms of organisations, for example, large corporations in Japan, Germany, UK, and US. But the accounting regulations required differ because of the form of their primary source of finance.

In Germany and Japan, for example, the banks are a much more significant source of long-term finance than in, say, the UK. Such financial institutions can have more direct access to detailed accounting information than the shareholders who provide the equity finance that is predominant in the UK and therefore there is less of a need to develop financial reporting and auditing regulations to protect and inform such financiers.

The position is however constantly changing as established stock exchanges around the world deregulate, making it easier for overseas enterprises to use them, and further new stock exchanges are introduced. The need for reporting in detail to shareholders at home and abroad who see financial reports as their main source of financial information is growing and the need for accounting standards similar to those published by the International Accounting Standards Committee (IASC) will also grow.

There is also a need to consider the sophistication of the users of financial statements. There is little point in producing accounts that cannot be read or understood by the main target-user. This consideration may also effect the need to have financial statements made available to a wide variety of users.

For example, the need to give every employee a set of accounts would be considered a waste of scarce resources in many developing countries—even the employees in many developed countries do not understand published statements.

The level of sophistication of investors is particularly relevant when a large majority of them are from the general public who have little or no accounting knowledge.

Economic ties of the countries do have an impact on accounting systems and practices. Member countries of the European Union are attempting to harmonise accounting standards among them. Accounting systems of Great Britain, Germany, and France are different now, but are likely to converge on some norm eventually. In a centrally planned economy such as that of China, North Korea, or the former Soviet Union, the accounting system is driven by the need to provide output-oriented information to state planners. Such accounting systems focus on documenting how state funds are used and whether state-mandated production targets are being met. On the other hand, in market-oriented economies, managers and investors require profit and cost-oriented information.

Capital Provider

Australian firms have historically raised capital by selling shares and debentures to the public. Therefore, Australian accounting standards emphasise the provision of accurate and useful information to investors to make appropriate investment decisions. In Germany, the dominant role of a few banks in providing capital results in accounting practices that focus on the needs of creditors. The dominant feature here is to undervalue assets and overvalue liabilities. This conservative approach is favoured by the lending banks. The stock market source is much less in Germany than in Australia, and German accounting practices provide less information to public investors than do those in Australia.

The US and the UK have well developed stock and bond markets from which firms can raise capital by selling stocks and bonds to individual investors. The accounting system in these countries tends to be oriented towards providing information to individual investors.

In some other countries, the national governments have historically been an important provider of capital, and this has influenced the accounting practices. This is the case in France, Sweden, and India, where the national governmentes have stepped into make loans or to invest in firms whose activities are deemed in the national interest. In these countries, financial accounting practices tend to be oriented towards the needs of government planners.

CLASSIFICATION OF ACCOUNTING SYSTEMS

LO 3
Illustrate the classification of accounting systems

Although accounting standards and practices vary significantly worldwide, systems used in various countries can be grouped according to common characteristics. Figure 21.3 illustrates one approach to classifying accounting systems. The figure does not include all countries but is illustrative of developed countries.

In the figure, accounting systems are initially divided into macro-uniform and micro-based systems. The former are shaped more by governmental influence than are the latter. Except for Sweden's system, macro-uniform systems are influenced by tax law or just a strong legal system. These systems also tend to be more conservative and secretive about disclosure. Micro-based systems, except for that of the Netherlands, include features that support pragmatic business practices and have evolved from the British system. The US system is closer to the macro-uniform systems than is the British.

HARMONISATION OF DIFFERENCES

LO 4
Discover the harmonisation of differences

Despite the many differences in accounting standards and practices, a number of forces are leading to harmonisation:

- A movement to provide information compatible with the needs of investors.
- The global integration of capital markets, which means that investors have easier and faster access to investment opportunities around the world and therefore need financial information that is more comparable.
- The need of MNCs to raise capital outside their home-country capital markets while generating as few different financial statements as possible.
- Regional political and economic harmonisation, such as the efforts of the EU, which affects accounting as well as trade and investment issues.
- Pressure from MNCs for more uniform standards to allow greater ease and reduced costs in reporting in each country and in reporting to be used by investors in the company's home-country.

Differences in accounting systems are confusing and costly to international business. Incomparabilities in these systems make it more difficult for firms to monitor their foreign operations and for investors to comprehend the relative performance of firms based in different countries. To help solve such problems, many accounting professionals and national regulatory bodies are attempting to harmonise different national accounting practices. Before describing such efforts, it is useful to understand the arguments in favour of harmonisation. It may be stated that the forces listed above are themselves the arguments for harmonisation of accounting systems. In addition, there are other forces too.

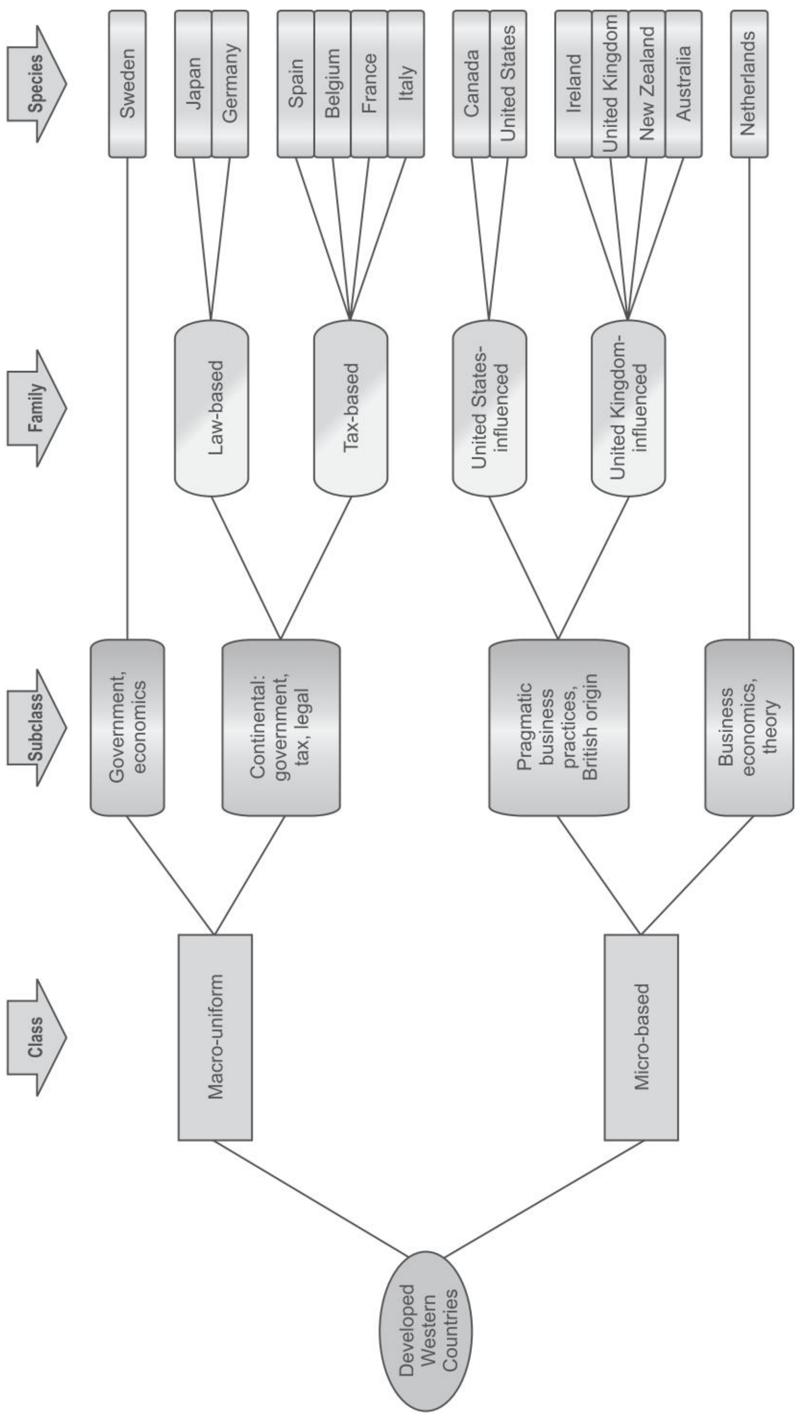


Fig. 21.3 Hypothetical Classification of Accounting Systems of Western Countries

(*Source*: John D Daniels and Lee H Radelaugh, *International Business*, p. 792)

Arguments Supporting Harmonisation (See Fig. 21.4)

Investors Harmonisation of accounting and external financial reporting may assist in the optimum global distribution of private-sector finance. Investors should be able to achieve a more efficient portfolio of companies on an international scale as well as on a national scale. This can be very beneficial to the investor. For example, a French (or UK) investor who dealt in the share markets in Brazil, Sri Lanka, Finland, and Zimbabwe would have achieved higher returns in 1994 than if they had invested only in their home market. Global capital markets are here and if they are to operate properly, financial information disclosed to the market-place must be global.

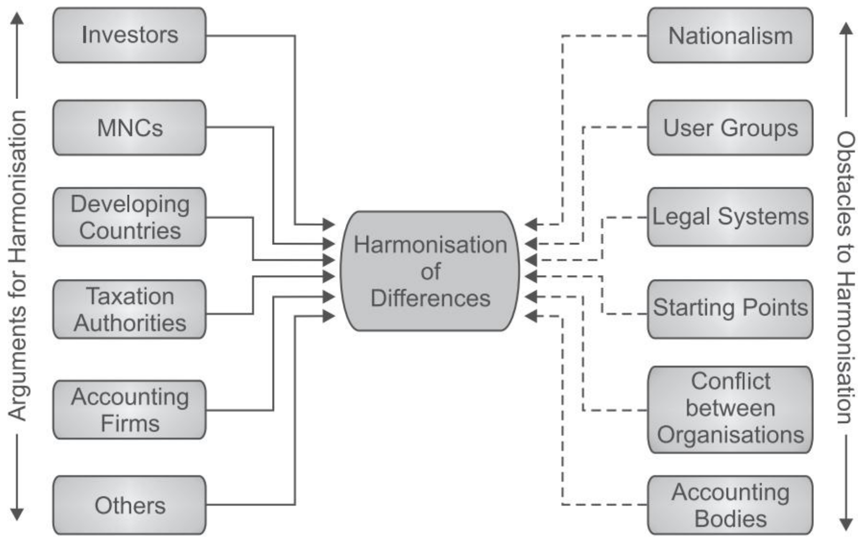


Fig. 21.4 Arguments for and against Harmonisation

However, as we have already seen, the standards of accounting disclosure requirements and auditing vary from country to country, making cross-border analysis very difficult. It is possible that these differences will present a barrier to investors because they will 'feel uncomfortable' with the information available to them if such information is disclosed in a manner which is very different from that which exists in their home country.

Harmonisation of accounting and auditing practices will help reduce the size of the barrier. Investors must be able to deal with the different accounting practices and disclosures, and have trust in the figures presented by accepting the standard of auditing, if they are to diversify their portfolios internationally in an optimal manner—the harmonisation programme will be a considerable aid in this task.

MNCs It is not only investors who stand to benefit from harmonisation of accounting standards and practices. MNCs which seek to diversify globally through the acquisition of foreign firms gain considerably from standardisation of disclosure practices. MNCs have several additional benefits that could arise from the harmonisation of accounting and auditing standards including the following:

- The consolidation of foreign subsidiaries will be greatly simplified if the accounting and auditing standards applied by both the parent and the foreign entity in meeting local reporting requirements were similar. The more adjustments that have to be made to eliminate accounting policy inconsistencies and the more controls that have to be imposed to bring the auditing standards up to an acceptable level, the more the time and money that will be wasted by the MNC.

- If the reporting and disclosure requirements of the stock exchanges around the world can be harmonised, it will be easier for the MNC to develop accounting systems to meet these requirements. This harmonisation would also aid the MNC in its efforts in sourcing foreign investor funds by making it easier to produce audited accounts that meet the information needs of these investors. Poor or inappropriate financial reporting can mean that the MNC has to provide higher returns through interest and dividend payments than may be necessary because of the perceived level of risk by the investor resulting from such reporting, or could result in lower than expected share prices on foreign stock markets.
- Harmonisation of external financial reporting will enable the MNC to introduce consistent internal management accounting to support the external reporting requirements and provide suitable information for internal performance appraisal. It is essential for planning, control, and motivatonal purposes that the management accounting system is suitable for the local environment in which the management of the foreign entity operates but it is also important that the measures are reasonably consistent within the group. The harmonisation process should help with this balancing act.
- Common accounting practices will make it easier for the MNC to communicate financial information within the group. This applies to both the management accounting information discussed above and the external financial accounting information that will be used by those outside the company and the group to assess their financial performance and stability.
- If accounting practices are similar throughout the group it will be easier to move accounting staff between group companies. This is very important where suitably qualified staff are not available in the foreign country and accountants are sent from the head office.
- If accounting practices and controls are similar, then the audit requirements may also be similar. It is possible that this may result in reduced audit fees, thereby reducing the bought-in cost of the audit.

Developing Countries Developing countries too are gainers. If international accounting practices are harmonised and the MNCs report following such practices, the governments of developing countries will be able to exercise more financial control over the MNCs. If all accounting practices were similar then MNCs would not be able to 'hide' behind accounting practices that are 'foreign' to the developing countries—the differences in accounting would be minimised and the 'foreign' accounting would not be so different from their own that the developing country would not be in a position to appreciate the significance of the figures reported by the MNC.

Taxation Authorities The job of taxation authorities is made easier. With tax very often being levied on the total global income of individuals and business enterprises, it would obviously be of considerable assistance to the national tax authorities around the world if the net income was computed on similar accounting principles and practices. However, governments and their related tax authorities tend to consider matters on a national, rather than an international scale when it comes to establishing the tax regulations; they will therefore tend to cause some of the differences that the harmonisation process is trying to reduce. This is particularly important in countries where the commercial accounting systems that produce the reports, that are so important to the capital markets, are directly linked to the tax regulations.

International Accounting Firms These firms, very often partnerships, will be affected by the level of harmonisation of accounting practices, auditing standards, and tax regulations. If accounting practices are similar then movement of staff across national boundaries becomes easier and it is less expensive to provide training. The same can be said of auditing, but it is the ability to rely on the standard of local auditing of the overseas branches and subsidiaries of multinational client companies that is the most important factor.

In addition, many large accounting firms undertake a considerable amount of tax work, providing the link between the tax authorities and their clients. The harmonisation of accounting would help in this work. These professional accounting firms have the advantage of being effectively represented on committees of several of the bodies, which are involved in the harmonisation process, in particular the International Accounting Standards Committee.

Other Interested Parties There are several other groups who would be interested in the harmonisation of accounting and auditing, mainly because of the benefit of increased understandability and usefulness that would arise. These bodies include:

- trade unions, particularly those with members in MNCs who are affected by financial performance in more than one country or whose controlling body is based in another country;
- international credit agencies, including the international banks dealing with developing countries with large national debts;
- accounting academics, particularly those trying to teach or research into comparative accounting practices and the technical differences between national accounting systems;
- regional economic groups, who may find their task of promoting trade within a specific geographical region aided by similar accounting practices operating within the region. This is a particular problem for those dealing with the African continent because of the diversity of accounting that has resulted from the differing colonial links of the African nations.

Overall there are several interested groups who would appear to benefit from the reduction in the diversity of accounting in the world. However, such diversity has always existed in the past, still exists today, and is likely to continue to exist.

Obstacles and Deterrents to Harmonisation

If there are supporters of harmonisation of accounting and auditing practices, there are impediments to such a process. In other words, there are obstacles and deterrents to harmonisation. These obstacles and deterrents are very important to an understanding of international accounting because they give an insight into what a complex subject this is and an appreciation of the problems facing accountants working in the international arena.

Nationalism Jingoism is the maior deterrent to harmonisation. Nobody wants to accept somebody else's accounting principles and practices. There is a general unwillingness built into the culture of many to adopt the principles and practices of those of another country. This may be a very important cultural trait because it provides a line of defense against adopting methods of accounting and financial reporting not suitable to the local environment.

In addition, local standard-setting bodies who establish standards and guidelines for national accounting purposes are not likely to want to see their work become subordinate to those developed elsewhere. This would include International Standards that are perceived to reflect another country's standards too closely.

User Groups An investor is considered to be the main user of accounts in the US and the UK. This is not the case in Germany where the tax authorities take a more prominent position and in countries like France where the use of a 'plan' can provide information to the government. Until there is agreement on the need of the user groups and the rankings of these various groups, it is unlikely that significant progress in global harmonisation can be made.

It may be the case that with the globalisation of the capital markets, the international investor becomes the most highly ranked of all the user groups, but even this position would be questionable in the countries that have little or no need for a stock exchange to raise corporate finance. In some countries the influence of the stock exchange is strong, in others it is growing, but in some it is non-existent and is likely to continue to be that way; the importance of external reporting to investors will therefore differ.

The different user groups require different denomination. Investors need information that is relevant to investment decisions, the tax authorities require statements produced in line with the tax regulations, governments need statements produced with national standardised planning in mind, and employees and their representatives require some form of social/employee type reporting. It is unlikely that all these differing financial reporting requirements can be met from a limited accounting model. The different purposes that users consider accounting information can be put to will continue to result in different models being developed in an effort to meet those information needs.

Legal Systems Legal system is a powerful stumbling block. The historic position of accounting in legislation has created barriers that are going to be very difficult to breakdown. In some cases, typically those with a codified law system, harmonisation in financial reporting would require changes in the legislation, something many governments would not be prepared to do, or the production of two separate sets of financial statements by reporting entities, one to meet local legal requirements and another to comply with the harmonised international standards. In some countries, typically, Scandinavian countries, such dual reporting does already take place but it is unlikely that businesses in many developed countries would take kindly to such duplication and in the developing countries the benefits from the use of scarce resources in such a manner would probably not outweigh the relatively heavy cost.

Different Starting Points The varying levels of influence of a country's legal system over its accounting regulations is just one of the factors that mean that countries are going down the harmonisation route from different starting points, and are therefore not necessarily going in the same direction or at the same speed.

The harmonisation process must take account of the historical development of accounting in a country if it is to result in the accounting practices of that country moving towards those of other countries. The overall end point for all countries may be at the same junction on the harmonisation road but the ways and means of reaching that point may be very different. Countries who already have a history of using accounting standards produced by independent private-sector bodies may find the route that employs the use of International Accounting Standards (IAS) a suitable one on which to travel, while another which is used to a government enforced commercial code and accounting plan will find such a pathway most unsuitable. They will need an alternative route to be mapped out if they are eventually to have accounting and financial reporting practices that are in harmony with the countries following the IAS route.

It is very important that those attempting the harmonisation of global accounting appreciate that countries are in a very different position at the moment as they will not all want to be treated in a common manner in the future. The developments will be tailored with not only the finishing point in mind—the various starting points must also be considered. This is most important when comparing developed and developing countries where even the use of similar systems, for example, accounting 'plans' in France and in Burkina Faso, will obviously not necessarily give the countries the same starting point nor the same feasible rate of harmonisation progress.

Conflicts between Organisations The various public and private-sector organisations involved in the harmonisation process have differing goals and ambitions. Each of them has its own idea on whom the harmonisation process should concentrate and for whose benefit it is being undertaken, which means that they will have different expectations as to suitable accounting practice and necessary financial disclosures.

The United Nations, for example, wants to extend the disclosure requirements of MNCs, very often keeping in mind the national interests of the developing countries in which the MNCs operate, the Organisation for Economic Cooperation and Development will however see the disclosures from the point of view of the developed country where the MNC is based. It is therefore possible that the two organisations will see the same situation in a very different way.

These types of conflict will not necessarily prevent harmonisation nor deter them from their endeavours but they will present obstacles that must be overcome. Efforts are being made through consultation to reduce the conflicts.

Professional Accounting Bodies There is little point in developing harmonised accounting practices if there is no effectual accountancy body, either private-sector or government-controlled, to put the programme into operation and enforce its provisions. With some countries, particularly the developing countries, which lack such a body, it will clearly be difficult to proceed with the harmonisation process at anything other than a slow pace.

In contrast, the strength of the accounting body may also work against the harmonisation process because it is these bodies that are most likely to advance the nationalism deterrent discussed earlier. A strong profession will consider itself to be sufficiently competent to deal with the accounting problems of its home country and go about the business of solving such problems with little regard for developments in other countries or the international organisations.

Overall, the main problem would appear to be that all countries have different social, political, economic, and cultural environments and it is difficult to judge how far the harmonisation process can and should proceed in each of the various environmental mixtures. For harmonisation to succeed to any degree on a global scale, there needs to be agreement on the required level of enterprise financial disclosure for the information to be relevant to users, the required level of macro reporting to aid national planning, and the standards of accounting and auditing required to give the accounts the right level of reliability for the environments in which they exist.

PROFESSIONALS AND REGULATORY BODIES

As stated earlier, several professionals and regulatory bodies are active in bringing about harmonisation of accounting standards. Efforts of some such bodies are explained here.

LO 5
List professionals and regulatory bodies

European Union

The most ambitious effort towards harmonisation is taking place in the European Union. The European Commission is empowered to set directives, which are orders to member countries to bring their laws inline with EU requirements within a certain transition period. The initial accounting directives addressed the type and format of financial statements, the measurement base on which the financial statements should be prepared, the importance of consolidated financial statements, and the requirement that auditors must ensure that the financial statements reflect a true and fair view of the operations of the company being audited.

The EU's influence is spreading beyond its jurisdiction. The EFTA and Eastern European countries are attempting to adopt EU accounting directives in preparation for becoming members. In addition, Eastern European countries and those of the former Soviet Union are moving from centrally planned to market economies, and they need an accounting system that will facilitate the transition. The EU directives provide some guidelines in this area.

Even though the EU has improved the comparability of financial statements, the directives do not cover several important issues. Further, some directives allow options, and member countries interpret the directives differently. Thus, EU firms listing outside their home countries must still provide two sets of financial statements—the home country statements and a reconciliation. In order to speed up the harmonisation process, the EU has decided to put its weight behind the IASC. The reason for choosing the IASC is that the EU can influence standards since it is represented on the IASC, and it also avoids funding and developing a competing standards setting body.

United Nations

The United Nations has been interested in the field of international accounting since the early 1970s when a 'Group of Eminent Persons' looking into the activities of MNCs found that the financial reporting of such organisations was inconsistent and very often contained gaps in what they considered to be important areas of reporting. As a result a 'Group of Experts' were convened and during the late 1970s, this group published details of what they considered to be minimum financial (and non-financial) disclosure by transnational corporations.

These developments finally led to the establishment in 1982 of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) by the UN Economic and Social Council. The ISAR is part of the Transnational Corporations and Management Division (previously part of the United Nations Center on Transnational Corporations) and has three main objectives:

- to serve as the international body for the discussion of accounting and reporting issues;
- to make a positive contribution to national and regional standard-setting;
- to take into account the interests of developing countries in the field of information disclosure.

The ISAR attempts to aid the developing countries by making recommendations on the availability and comparability of information disclosed by international businesses. The ISAR has proportional representations from the various regions around the world (there are 32 countries represented) but it is often associated with improvements in accounting and financial reporting for the developing countries. It is, for example, the only intergovernmental group that includes developing countries and the reforming countries, as well as the developed countries, as full participating members.

The discussions of the ISAR are reported in annual publications and cover the accounting developments around the world, as well as reports on accounting issues of importance to global accounting. These reports are very useful sources of data on world accounting and cover many issues relating to developing countries, particularly of the reforming Eastern European countries. For example, the 1992 report covered the problems of privatisation in Hungary, Poland, and the former Czechoslovakia.

The ISAR is currently involved in developing discussions on international environment reporting and the role and responsibilities of accountants and auditors.

It is difficult to measure the effect that the UN has had on the financial disclosures made by transnational corporations but it is likely that the ISAR will prove a very useful source of technical accounting data for some of the developing countries and for the reforming Eastern European countries. This is particularly true in the former USSR nations where the UN is involved in programmes relating to accounting education and the modernisation of the chart of accounts for use in the new independent states.

Organisation for Economic Cooperation and Development (OECD)

The OECD was established by 24 of the world's 'developed' countries with the objective of promoting world trade and global economic growth. As with the UN, this organisation has become involved in international accounting mainly by addressing itself to the financial reporting requirements of multinational enterprises (MNEs), but the OECD tends to consider matters from the viewpoint of the economically developed countries rather than the developing country bias of the UN. For example, they argue that foreign controlled companies should be treated on an equal basis with national companies.

The council of the OECD has established a Committee on International Investment and Multinational Enterprises. This Committee, as well as publishing guidelines on disclosure of information by MNE, has established a Working Group on Accounting Standards. This Working Group undertakes research studies to promote international harmonisation of accounting standards and practices.

In recent years the Working Group has published a 'Clarification of the OECD Guidelines', undertaken a survey of the implementation of these guidelines, and published reports as part of an 'Accounting Standards Harmonisation' series. This series has covered a diversity of subjects including, 'Consolidation Practices in OECD Countries' (Accounting Standards Harmonisation No. 2) and 'Relationship between Taxation and Financial Reporting—Income Tax Accounting' (Accounting Standards Harmonisation No. 3). The Working Group has also considered Accounting for Leases, Segmental Reporting (which was a main part of the original guidelines published in 1976), Contents and Presentation of Management Reports, Accounting for Intangibles, and Accounting and Reporting for New Financial Instruments.

Most recently the OECD has established a 'Centre for European Economies in Transition', which together with the Working Group and FEE, has organised workshops, seminars, and meetings to identify the objectives and constituents of accounting systems in these countries, providing a direct link between representatives of these countries and a body that has a good appreciation of the level of diversity of accounting systems that currently exist in the developed countries.

It will be very difficult to measure the level of direct influence that the OECD will have, but they may at least be able to get across the message that all is not perfect in the developed countries and that no single accounting model exists for the reforming countries to benchmark. The international accounting situation is far more complex than that.

International Accounting Standards Committee

The most important effort in the direction of harmonisation was the creation of the International Accounting Standards Committee (IASC) in 1973. The IASC founding memebers were drawn from the professional accounting societies of the leading trading nations, including Germany, Japan, the UK, the US, the Netherlands, Canada, Australia, Mexico, and Ireland. Today, IASC membership includes more than 100 professional societies from over 70 countries. The body has issued a series of standards designed to harmonise the national treatment of accounting issues within the member countries. One of its most important goals is the promotion of comparability of financial statements among countries by establishing standards for inventory valuation, depreciation, deferred income taxes, and other matters.

However, the IASC itself has no authority to support its efforts and this has been considered to be one of its most critical shortcomings. The IASC relies on the efforts of its member organisations to support these objectives by undertaking certain obligations. These obligations used to include the need to ensure that published financial statements comply with these (IASC) standards or that there is disclosure of the extent to which they do not and the need for auditors to make reference in their audit report to any failure for the disclosure of non-compliance. These obligations have been 'watered down' to a more realistic level of expectation and now include the following:

- to support the work of IASC by publishing the International Accounting Standards in their respective countries;
- to attempt to ensure that published financial statements are in line with IASs and disclose the fact of such compliance;
- to endeavour to persuade national standard setters, including governments, security market governing bodies and the business community in general, that published financial statements should comply with IASs;
- to endeavour to get auditors to consider compliance with IASs in their audit work.

The influence of the IASC is therefore totally dependent on the efforts of its members in meeting these obligations. Such a task may be almost impossible in some countries where the regulatory framework is not under direct control or influence of the representative professional accounting body—Japan and Germany are examples of such countries. Even in countries where the profession has influence, the commitment to IASs is not always obvious.

A significant achievement of the IASC however has been the production of the International Accounting Standards (IASs). The publication and international acceptance of these standards is essential to the harmonisation efforts of the IASC and it is not surprising therefore to find that a considerable amount of the IASC's work is related to the development of acceptable IASs.

To date, the IASC has produced 31 International Accounting Standards covering a wide variety of topics, although only 29 standards are 'active'—IAS 3 'Consolidated Financial Statements' has been superseded by the IAS 27 with the same title and IAS 28 'Accounting for Investments in Associates'; IAS 6 'Accounting Responses to Changing Prices' has been superseded by IAS 15 'Information Reflecting the Effects of Changing Prices.' IASC has been replaced by International Accounting Standards Board (IASB).

The International Federation of Accountants

One more body concerned with international harmonisation in accounting is the International Federation of Accountants (IFAc). Formed in 1977, IFAc comprises over 80 accounting bodies from 59 countries. It fully supports the work of the IASC and recognises the IASC as the sole body to have responsibility and authority to issue rules on international accounting standards. IFAc has parallel responsibilities to the IASC in as much as it has the objective of developing international guidelines for auditing, ethics, education and management (intra firm) accounting.

Fédération des Experts Comptables Européens (FEE)

The Federation was established in October 1986 and commenced operations from January 1, 1987. From that date, FEE took over the responsibility for the activities previously undertaken separately by the Union Européene des Experts Comptables, Economiques at Financiers and the Group d'Etudes des Experts Comptables de la CEE. These two organisations had served the accountancy profession in Europe but this role is now the sole responsibility of FEE. The Federation brings together 34 professional bodies from 22 countries, including all the members of the European Community. These bodies have a joint membership of well over 3,00,000 individuals.

The stated objectives of FEE are:

- to work generally towards the enhancement and harmonisation of the practice of accountancy in Europe in both the public and private sectors;
- to promote cooperation among the professional accountancy bodies in Europe in relation to issues of common interest in both the public and private sectors;
- to represent the European accountancy profession at the international level;
- to be the sole consultative organisation of the European accountancy profession in relation to the EC authorities;
- to arrange the holding of periodic congresses and seminars.

Other Organisations

The Confederation of Asian and Pacific Accountants (CAPA) This has members from 31 professional accountancy bodies, from 22 different countries. The Confederation provides a useful forum for the discussion of accounting problems met by accountants in Asia and the Pacific. It has established a regional accountancy development centre and has developed teaching material for use by accounting technicians in the area.

The Intra American Accounting Association (IAA) This has a membership of 28 accountancy bodies from 23 different countries. Most of this Association's activities take place in Central and South America where it is actively involved in the translation and publication of International Accounting Standards. There are also North American representatives and the main administrative body is located in Florida. The IAA is also involved in the publication of technical textbooks and the organisation of conferences and management courses.

The European Accounting Association This is an association of institutional and individual members from around the world. As well as members from all over Europe, including many from the reforming East European countries, there are members from the USA, South Africa, Egypt, Australia, Middle East, Japan, and several African countries. The Association therefore provides a truly international organisation for the discussion of financial accounting, management accounting, and auditing problems. The Association organises annual conferences and publishes an editorial. The *European Accounting Review*, which ensures that research efforts of members is published to an international, rather than national, audience.

There are many other national accounting associations, all making a positive contribution to the development of accounting and financial reporting, including the development of international accounting. All these organisations are vital to the continuation of the globalisation of accounting such that one day perhaps we will all realise that accounting is an international subject, having international problems, requiring international solutions.

Industry Groups

Industry groups too have been busy in their efforts at the harmonisation process of accounting standards and practices. For instance, the International Air Travel Association (IATA) has attempted to draft industry-specific accounting standards. The airline industry constitutes one of the most obvious cross-border industries. It deals in a multitude of currencies, is extremely capital-intensive, and relies on many capital markets for funds. The industry is also experiencing a number of mergers and strategic alliances among carriers. To date, IATA has released four airline accounting guidelines covering issues such as fleet-acquisition costs, depreciation, frequent-flyer programmes, and foreign currency borrowings.

INDIAN ACCOUNTING AND THE WORLD

LO 6
Define Indian accounting and the world

Indian accounting practice is influenced chiefly by the views of the Institute of Chartered Accountants of India (ICAI), the statutory body charged with regulating the profession, but also by others including the Government of India's Department of Company Affairs (DCA), the Securities and Exchange Board of India (SEBI), the Reserve Bank of India, and the Income Tax Department.

Accounting standard-setting in India is, by and large, based on an 'associationist' system in which accounting regulation is accomplished through professional organisations. The accounting profession has issued a number of statements, standards, and guidance notes describing desirable accounting practices. They shape accounting practice, though they have no legal force.

In 1977, the ICAI established the Accounting Standards Board (ASB) to harmonise the accounting practices in use in India. The ASB is constituted as a committee of the ICAI's council, which issues the final standards. As of May 1997, 15 standards have been issued and compliance with all but two—inventory valuation and cash flow reporting—is mandatory for accounting periods commencing on or after 1 April, 1995.

Some recent actions of the government and the SEBI could have far-reaching implications for standard-setting and GAAP. In 1995, Parliament authorised the government to issue 'accounting standards' for tax reporting purposes. The government stated that a separate set of tax accounting standards was necessary since the ICAI's standards allowed 'flexibility'. Companies might consider adopting the tax standards for shareholder reporting as well. In May 1995, the SEBI directed listed companies to publish cash flow statements not required by the Companies Act (CA) 1956.

Besides, listed companies have been directed to send their shareholders full annual reports in place of the abridged reports supplied so far.

Some time ago, the DCA considered a proposal to set up an autonomous body to formulate accounting standards. The involvement of some of the country's leading accounting firms in the audit of banks and companies affected by the securities scandal in 1992 seemed to emphasise the need for such a body.

The proposal appears to have been abandoned for the time being because of opposition from the ICAI.

Given the current standards of financial reporting, it is only a matter of time before drastic accounting reforms are initiated.

The ICAI is a member of the International Accounting Standards Committee (IASC) and has agreed that it will give due consideration to International Accounting Standards (IASs) and try to integrate them, as far as possible, with domestic standards in light of local conditions and practices. As a result, Indian standards have been significantly influenced by IASs.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

LO 7
Outline International Financial Reporting Standards (IFRS)

With the introduction of IFRS, differences in accounting standards is no more an issue and the need for harmonisation is no more a relevant topic.

IFRS represent a set of accounting standards developed by the International Accounting Standards Board (IASB), an independent body based in London. IASB has succeeded the International Accounting Standards Committee (IASC).

Specifically, IFRS involve the following:

- Basis of revenue recognition to change from realised sales to transfer of ownership.
- Companies, listed and unlisted, will have to consolidate accounts eventually. Not just of their subsidiaries, but also of their associate companies and vendors.
- 'Fair Value' accounting—every transaction or entry should reflect its current market value. These include accounting for intangible assets, ESOPs and derivatives, among others.
- Instead of being amortised, goodwill will be tested every year for loss in value.

More than 12000 companies in as many as 100 countries have adopted IFRS. By adopting IFRS, a company can present its financial statements on the same basis as its foreign competitors, making comparisons more easy.

Being one of the signatories, India has committed itself to implement IFRS from April 2011. But due to pressure from stakeholders, the implementation is put on hold. In the meanwhile, Indian companies will gain in several ways by adopting IFRS. Following are the benefits of IFRS for Indian companies:

- Improved access to international capital markets.
- Lower cost of raising funds as preparation of dual sets of financial statements will be avoided.
- Benchmarking with global peers and improve brand value.
- Elimination of multiple reports.
- Reflection of true values of acquisitions.

ACCOUNTING FOR INTERNATIONAL BUSINESS

LO 8
Interpret accounting for international business

Towards the end of this chapter, we propose to describe the specific accounting problems faced by an international business. There are two such problems.

1. Transactions in foreign currencies.
2. Translation of foreign currency financial statements.

Transactions in Foreign Currencies

A major accounting problem for an MNC arises from operating in different currencies. In addition to minimising or eliminating foreign exchange risk, an international business must concern itself with proper recording and subsequent accounting of assets, liabilities, revenues and expenses that are measured or denominated in overseas currencies. These transactions can result from the purchase and sale of goods and services as well as borrowing and lending of foreign currency.

Firms often confront the problem of accounting for transactions in foreign currency whenever they agree to pay or receive payment in a foreign currency as settlement of a purchase or sale of goods, services, or assets. It is likely that the exchange rate will change between the time a firm enters into an international transaction and the time it receives payment, or pays for the goods, services or assets in question.

Foreign Currency Translation

A second type of international accounting problem confronts an MNC when it reports the results of its foreign subsidiaries' operations to its home country shareholders and tax authorities. As its foreign subsidiaries will normally conduct their business using their local currency, the firm must convert its subsidiaries' financial reports into its home currency. This process of transforming a subsidiary's reported operations denominated in a foreign currency into the parent's home currency is called *translation*. For most MNCs, the translation process is intertwined with the need to create *consolidated financial statements* to report the combined operations of a parent and its subsidiaries in a single set of accounting statements denominated in a single currency. It may be stated that translating financial reporting from one country into another requires the use of an appropriate exchange rate to convert the first currency to the second. (Read Chapter 19 for more details on transactions and tarnslations).

Summary

- Domestic accounting confirms to principles and rules of home country accounting. For an MNC, accounting becomes complex because it has to comply with each country's accounting standards which differ from one another. There are other differences as well. (LO1)
- Legal system, culture, political system, economy, and sources of funds are some of the forces which make up a nation's accounting standards. (LO2)
- Though accounting standards of nations differ from each other, they can be broadly classified into coherent groups. (LO3)
- True, accounting standards differ. There is also need for harmonisation of differences. (LO4)
- EU, UN, OECD and IASC are some of the bodies which are active in bringing harmony in accounting rules and regulations. (LO5)
- Though India has its own standards and enforcing agencies, the country is committed to comply with world standards. This is in tune with increasing integration of Indian economy with the rest of the world. (LO6)
- Though International Financial Reporting Standards (IFRS) go a long way in dispersing with harmonisation efforts, their implementation is put on hold. (LO7)
- Two issues are relevant with accounting standards and international business: transactions in foreign currencies, and translation of foreign currency financial statements. (LO8)

Review Questions

1. Why do national differences exist in accounting standards and practices? (LO2)
2. Why are harmonisation efforts of accounting standards and practices resisted? (LO4)
3. Bring out the obstacles to harmonisation of disclosure norms. (LO4)
4. Enumerate the regulatory and professional bodies associated with harmonisation of accounting standards and practices. (LO5)

Discussion Questions

1. What impact would harmonisation of national accounting standards have on international business? (LO4)
2. What factors influence the accounting procedures adopted by a country? (LO2)
3. What is the impact of differing accounting standards on the international capital market? (LO8)

Reinforcing Exercises

- Anamolies arise while disclosing profit or loss positions because of differing accounting standards. Many large Chinese public corporations now report results according to two sets of rules: Chinese accounting standards and IASB standards. In mid – 2008, China Eastern, one of the airlines reported that its net profit fell by 29 percent from a year earlier to 41.6 mn yuan ($6.1 mn) under Chinese accounting standards. Based on IASB standards, the airline incurred a net loss of 215 mn yuan.

  One can go on recollecting instances of the above type. Where is the answer?

CLOSING CASE

Chinese Evolving Accounting System

Attracted by its rapid transformation from a socialist planned economy into a market economy, economic annual growth rate of around 12 per cent, and a population in excess of 1.2 billion, Western firms over the past 10 years have favoured China as a site for foreign direct investment. Most see China as an emerging economic superpower, with an economy that will be as large as that of Japan by 2000 and that of the US before 2010, if current growth projections hold true.

The Chinese government sees foreign direct investment as a primary engine of China's economic growth. To encourage such investment, the government has offered generous tax incentives to foreign firms that invest in China, either on their own or in a joint venture with a local enterprise. These tax incentives include a two-year exemption from corporate income tax following an investment, plus a further three years during which taxes are paid at only 50 per cent of the standard tax rate. Such incentives when coupled with the promise of China's vast internal market have made the country a prime site for investment by Western firms. However, once established in China, many Western firms find themselves struggling to comply with the complex and often obtuse nature of China's rapidly evolving accounting system.

Accounting in China has traditionally been rooted in information gathering and compliance reporting designed to measure the government's production and tax goals. The Chinese system was based on the old Soviet system, which had little to do with profit or accounting systems created to report financial positions or the results of foreign operations.

Although the system is changing rapidly, many problems associated with the old system still remain.

One problem for investors is a severe shortage of accountants, financial managers, and auditors in China, especially those experienced with market economy transactions and international accounting practices. As of 1995, there were only 25,000 accountants in China, far short of the hundreds of thousands that will be needed if China continues on its path towards becoming a market economy. Chinese enterprises, including equity and cooperative joint ventures with foreign firms, must be audited by Chinese accounting firms, which are regulated by the state. Traditionally, many experienced auditors have audited only state-owned enterprises, working through the local province or city authorities and the state audit bureau to report to the government entity overseeing the audited firm. In response to the shortage of accountants schooled in the principles of private-sector accounting, several large international auditing firms have established joint ventures with emerging Chinese accounting and auditing firms to bridge the growing need for international accounting, tax, and securities expertise.

A further problem concerns the somewhat halting evolution of China's emerging accounting standards. Current thinking is that China won't simply adopt the international accounting standards specified by the IASC, nor will it use the generally accepted accounting principles of any particular country as its model. Rather, accounting standards in China are expected to evolve in a rather piecemeal fashion, with the Chinese adopting a few standards as they are studied and deemed appropriate for Chinese circumstances.

In the meantime, current Chinese accounting principles, present difficult problems for Western firms. For example, the former Chinese accounting system didn't need to accrue unrealised losses. In an economy where shortages were the norm, if a state-owned company didn't sell its inventory right away, it could store it and use it for some other purpose later. Similarly, accounting principles assumed the state always paid its debts—eventually. Thus, Chinese enterprises don't generally provide for lower-of-cost or market inventory adjustments or the creation of allowance for bad debts, both of which are standard practices in the West.

Questions

1. What factors have shaped the accounting system currently in use in China?

2. What problems does the accounting system, currently in use in China, present to foreign investors in joint ventures with Chinese companies?

3. If the evolving Chinese system does not adhere to IASC standards, but instead to standards that the Chinese governments deem appropriate to China's "special situation", how might this affect foreign firms with operations in China?

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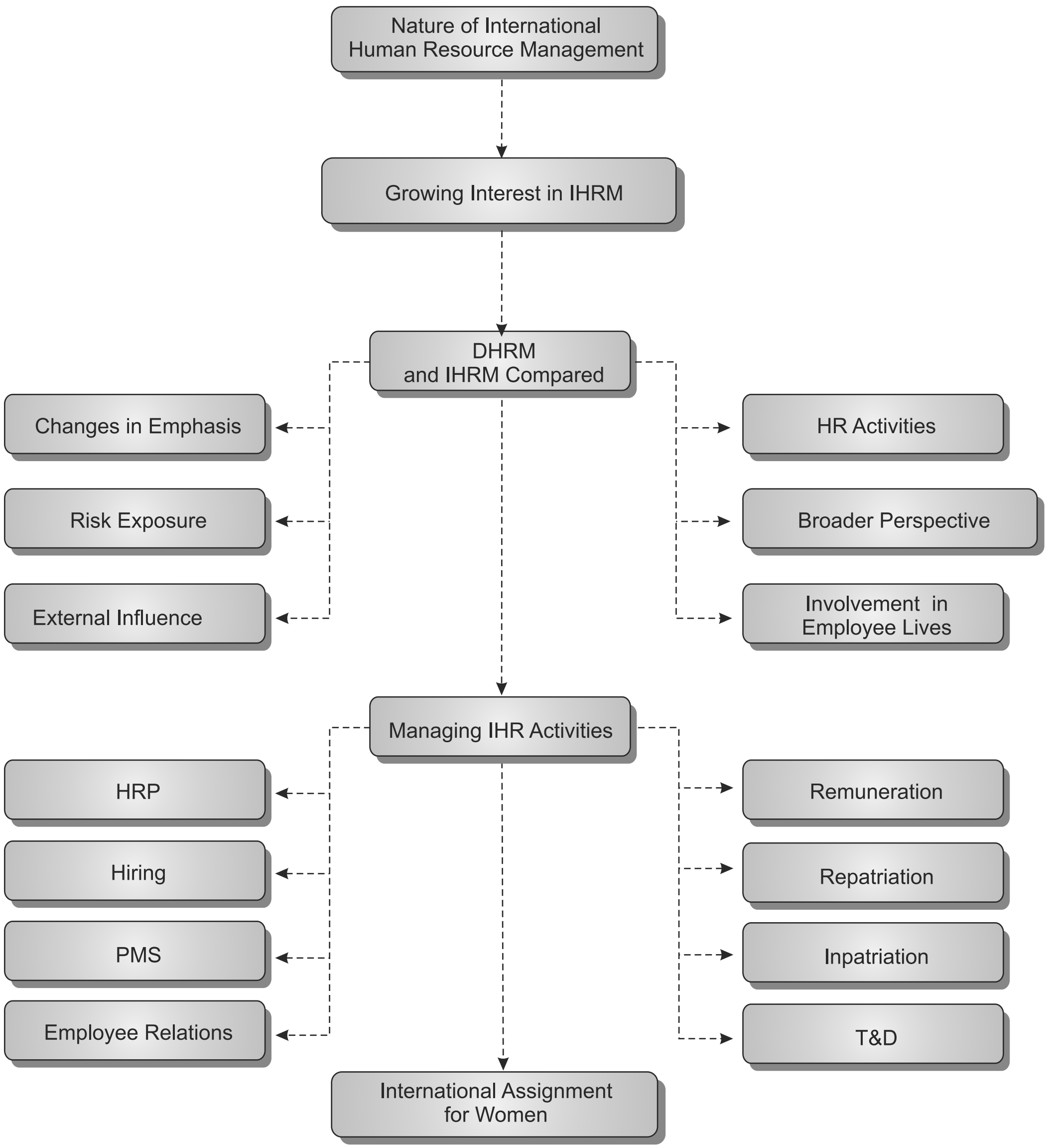
CHAPTER



Nature of International Human Resource Management
Growing Interest in IHRM
DHRM and IHRM Compared
Changes in Emphasis
Risk Exposure
External Influence
HR Activities
Broader Perspective
Involvement in Employee Lives
Managing IHR Activities
HRP
Hiring
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Employee Relations
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Inpatriation
T&D
International Assignment for Women

22

International Human Resource Management

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Describe the nature of international human resource management
- **LO 2:** Recognise the growing interest in IHRM and factors contributing to it
- **LO 3:** Distinguish between DHRM and IHRM
- **LO 4:** Assess the management of international HR activities
- **LO 5:** Illustrate the life cycle of expatriates and appraise their role in international businesses
- **LO 6:** Appreciate the role of international assignments for women and identity reasons for their low presence

Opening Case

Global HRM at Colgate Palmolive Co.

Colgate-Palmolive, the $6 billion a year personal products giant, earns nearly two-thirds of its revenues outside the United States. For years, Colgate succeeded, as many US multinationals have, by developing products at home and then "throwing them over the wall" to foreign subsidiaries. Each major foreign subsidiary was responsible for local manufacturing and marketing. Senior management positions in these subsidiaries were typically held by Americans, and practically all the company's US-based managers were US citizens.

In the early I980s, Colgate realised that if it was going to succeed in the rapidly changing international business environment, it would have to develop a more transnational orientation. Its competitors, such as Procter & Gamble, Unilever and Kao, were trying to become transnational companies, and Colgate needed to follow suit. Becoming a transnational requires developing an international cadre of executive managers who are as at home working in one culture as in another and who have the ability to rise above their ethnocentric perspectives.

As a first step towards building such a team, Colgate began recruiting college graduates in 1987 and putting them through an intensive international training programme. The typical recruit holds an MBA from a us university, speaks at least one foreign language, has lived outside the United States, and has strong computer skills and business experience. Over one-quarter of the participants are foreign nationals.

The trainees spend 24 months in a US programme. During three-month stints, they learn global business development secrets of, for example, Colgate toothpaste, compiling a guide for introducing a new product or revamping an existing one in various national markets. Participants also receive additional language instruction and take international business trips. When they have completed the programme, the participants become associate product managers in the United States or abroad. Unlike most US companies, Colgate does not send foreign-born trainees to their native countries for their initial jobs. Instead, it is more likely that a French national will remain in the United States, a US national will be sent to Germany, and a British national will go to Spain. The foreigners receive the same generous expatriate compensation packages the Americans do, even if they are assigned to their home country. This extra pay can create resentment among locally hired managers of foreign subsidiaries. Colgate is trying to resolve this problem by urging its foreign subsidiaries to send their brightest young managers to the training programme.

In addition to the management training programme, Colgate has taken a number of other steps to develop its international cadre of managers. In Europe, for example, the company is developing "Euromanagers", managers who have experience working in several European countries. This is a departure from the established practice of having managers spend most (if not all) of their working careers in their home country. Also, Colgate now tries to ensure that project teams contain managers from several different countries.

In keeping pace with the requirements of internationalisation of its business, Colgate customises its HR practices to suit the needs of each overseas market. The company has institutionalised a process that encourages, rewards, moves around, provides incentives, and closely manages the careers of the best performers worldwide notwithstanding their national origin.

Colgate has established a talent tracking programme. It has operations in more than 200 countries and has developed comprehensive database that records information about the capabilities and potential of key international employees. The database (now called HR Analytics) helps in identifying talent and performance, predict attrition, improve productivity and answers the questions like who among all Colgate employees has the potential to become its CEO.

JUST as the success of a domestic business depends on its human resource, so is the case with an international business as illustrated in the opening case. The type of people, the willingness with which they work, and the commitment they exhibit towards the organisation determine the competitive edge of an MNC in the international market. The international firm may have the best of resources at its headquarters, but the resources cannot be effectively utilised or transferred to its foreign affiliates without using human power.

NATURE OF INTERNATIONAL HUMAN RESOURCE MANAGEMENT

LO 1
Describe the nature of international human resource management

An international business must procure, motivate, retain, and effectively utilise services of people both at the corporate office and at its foreign plants. The process of procuring, allocating, and effectively utilising human resources in an international business is called international human resource management (IHRM).

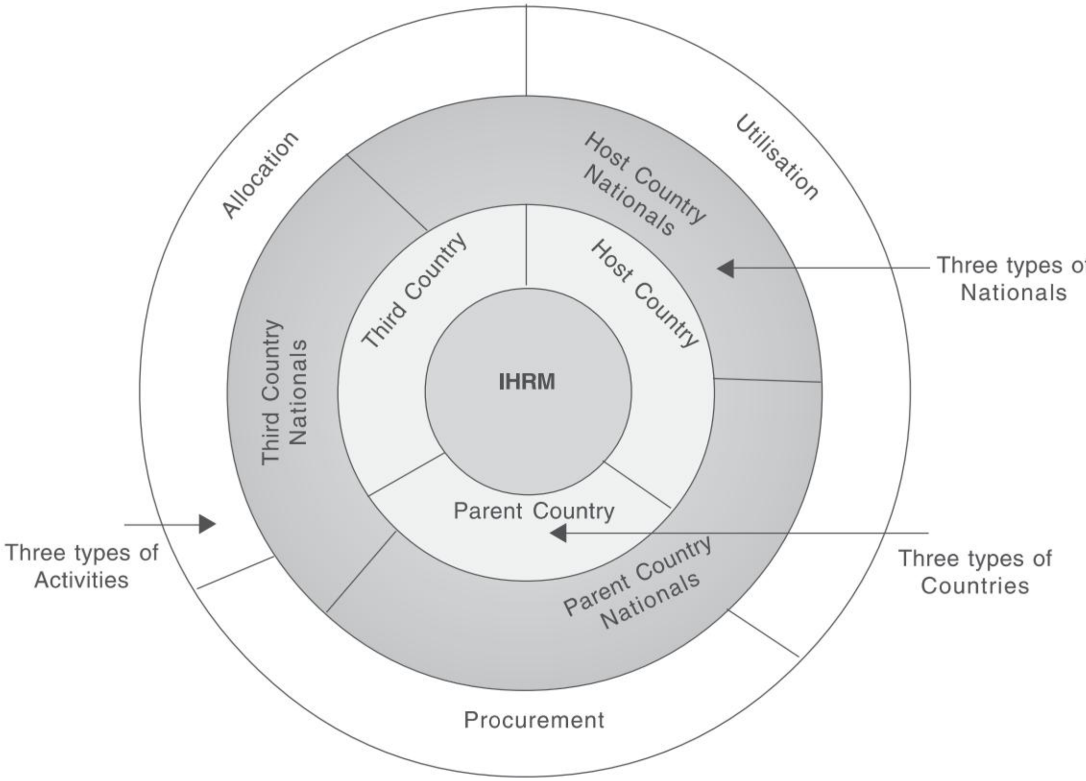


Fig. 22.1 Model of International HRM

IHRM is the interplay among the three dimensions: human resource activities, types of employees, and countries of operation (see Fig. 22.1).

1. The three broad activities of IHRM, namely, procurement, allocating, and utilising, cover all the six activities of domestic human resources management (HRM). The six functions of domestic HRM are: human resource planning, employee hiring, training and development, remuneration, performance management, and industrial relations. These six functions can be dovetailed with the three broad activities of IHRM.
2. The three national or country categories involved in IHRM activities are: the host-country where a subsidiary may be located, the home-country where the company is headquartered, and 'other' countries that may be the source of labour or finance.
3. The three types of employees of an international business include host-country nationals, parent-country nationals, and third-country nationals. Thus, for example, IBM employs Australian citizens in its Australian operations, often sends US citizens to Asia-Pacific countries on assignment, and may send some of its Singaporean employees on an assignment to its Japanese operations. Table 22.1 summarises advantages and disadvantages of hiring PCNs, HCNs and TCNs.

Keeping aside TCNs, what is the choice between HCNs and PCNs for handling subsidiaries in foreign locations? Table 22.2 summarises the factors influencing the choice. The factors fall into four categories: Parent country characteristics, industry characteristics, subsidiary characteristics and host country variables.

Table 22.1 The Advantages and Disadvantages of using PCNs, HCNs and TCNs

PCNs	*Advantages*	*Disadvantages*
	• Familiarity with the home office goals, objectives, policies and practices.	• Difficulty in adapting to the foreign language and the socio-economic, political, cultural, and legal environment.
	• Easy organisational control and coordination.	• Excessive cost of selecting, training, and maintaining expatriate managers and their families abroad.
	• Promising managers are given International exposure.	• Promotional opportunities for HCNs are limited.
	• PCNs are the best people for international assignments because of special skills and experiences.	• PCNs may impose an inappropriate HQ style. • Compensation for PCNs and HCNs may differ. • Family adjustment problems, especially concerning unemployed spouses.
HCNs	*Advantages*	*Disadvantages*
	• Familiarity with the socio-economic, political, and legal environment, and with business practices in the host country	• Difficulty in exercising effective control over the subsidiary's operations.
	• Lower cost incurred in hiring them as compared to PCNs and TCNs.	• Communication difficulties in dealing with home-office personnel.
	• Promotional opportunities for locals and consequently their motivation and commitment.	• Lack of opportunities for the home country's nationals to gain international and cross-cultural experience.
	• Responds effectively to the host country's demands for localisation of the subsidiary's operations.	• HCNs have limited career opportunity outside the subsidiary.
	• Languages and other barriers are eliminated. • Continuity of management improves, since HCNs stay longer in positions.	• Hiring HCNs may encourage a federation of nationals rather than global units.
TCNs	*Advantages*	*Disadvantages*
	• Salary and benefit requirements may be lower than for PCNs.	• Host country government may resent hiring TCNs.
	• TCNs may be better informed than PCNs about host country environment.	• TCNs may not want to return to their own countries after assignment.
	• TCNs are truly international managers. • HCNs are impeded in their efforts to upgrade their own ranks and assume responsible positions in the multinational subsidiaries.	• Host country's sensitivity with respect to nationals of specific countries.

GROWING INTEREST IN IHRM

LO 2
Recognise the growing interest in IHRM and factors contributing to it

Several reasons have contributed to the growing interest in IHRM. They are :

1. The rapid growth of globalisation has increased the number and significance of MNCs which, in turn, has increased the mobility of human resources.

Table 22.2 Factors Favouring HCNs or PCNs

(a) Parent country characteristics	Uncertainty avoidance, cultural distance between parent unit and subsidiary, size of operations, research intensity
(b) Industry characteristics	Financial institutions, need for control, need to customize, age
(c) Subsidiary characteristics	Age, acquired or green-field project, performance, ownership pattern
(d) Host Country characteristics	Educational level, political risk, cost of living

(*Source*: Anne Wil Harzing, *International Human Resource Management*, Sage, p. 256)

2. The effective management of human resources is being recognised as a major determinant of success or failure in international business.
3. Underperformance or failure in international assignments proves to be quite expensive.
4. The implementation of global strategies is being limited by the shortage of international management talent.
5. The shift from traditional hierarchical organisational structures towards the networked MNC organisations has been facilitated by the development of networks of personal relationships and horizontal communication channels. HR plays a significant role in network organisations.

DHRM AND IHRM COMPARED

LO 3
Distinguish between DHRM and IHRM

Several factors differentiate IHRM from domestic human resource management (DHRM). They are:
1. More human resource activities;
2. Need for broader perspective;
3. More involvement in employees' personal lives;
4. Changes in emphasis as the workforce mix of expatriates and locals varies;
5. Risk exposure; and
6. More external influences (see Fig. 22.2).

More Human Resource Activities

The scope of IHRM is much broader than managing domestic human resource activities. These are issues connected with international taxation, international orientation and relocation, administrative services for expatriates, host government relations, and language translation services that only IHRM involves. Expatriates are subject to *international taxation* and are often subject to home country and host country tax liabilities. Tax equalisation policies must be designed to ensure that there is no tax incentive or disincentive associated with any particular international assignment. *International relocation and orientation* involves arranging for pre-departure training; providing immigration and travel details, providing housing, shopping, medical care, recreation, and schooling information; and finalising remuneration details such as designing of salary, determination of various international allowances, and taxation treatment. An international business also needs to provide *administrative services* for expatriates in the host country in which it operates. Providing administrative service can often be a time-consuming and complex activity because policies and procedures are not always clear and may conflict with local conditions. Ethical issues can arise where a practice that is legal and accepted in the host country may be unethical and illegal in the home country, for

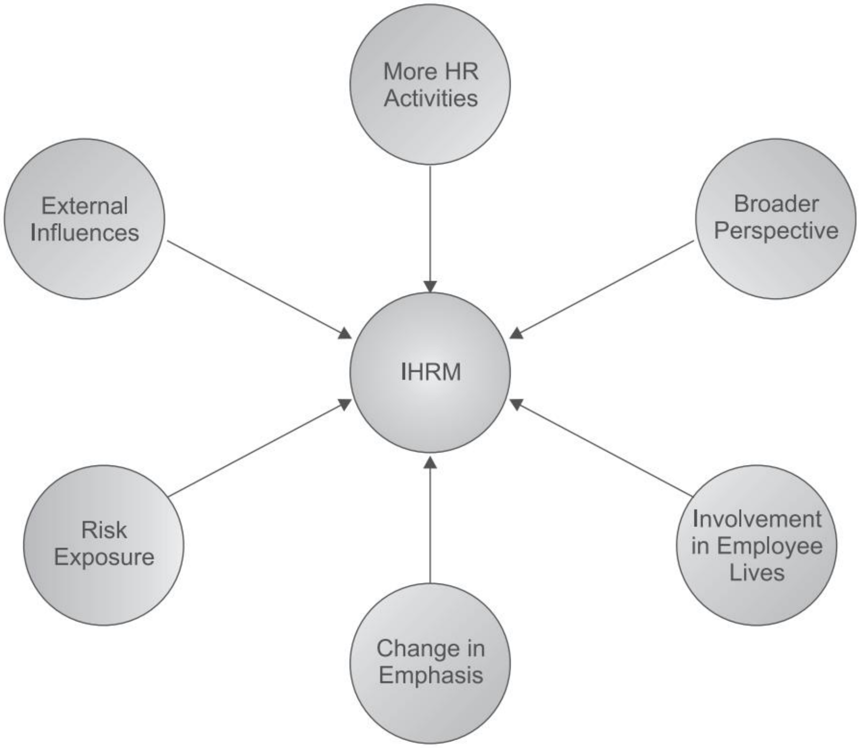


Fig. 22.2 Unique Features of IHRM

example, a situation may arise in which a host country requires an AIDS test for a work permit for an employee whose parent firm is headquartered in the US, where employment-related AIDS testing remains a controversial issue. How does the corporate human resource manager deal with the potential expatriate employee who refuses to meet this requirement for an AIDS test and the foreign affiliate which needs the services of a specialist expatriate from headquarters? These issues add to the complexity of providing administrative services to expatriates. *Host-government relations* represent an important activity for the human resource department, particularly in developing countries where work permits and other certificates are easily obtained when personal relationship exists between relevant government officials and international managers. Provision of *language translation services* for internal and external correspondence is an additional activity involved in IHRM. More specifically, additional activities of IHRM are as follows:

- Human resource planning:
  - (i) Difficulty in implementing HR procedure in host countries.
  - (ii) Difficulty in tying strategic business planning to HRP and vice versa.
  - (iii) Providing developmental opportunities for international managers.
- Employee hiring:
  - (i) Ability to mix with organisation's culture.
  - (ii) Ethnocentric, polycentric or geocentric approach to staffing.
  - (iii) Selection of expatriates.

(iv) Coping with expatriate failure.
(v) Managing repatriation process.

- Training and development:
  (i) Emphasis on cultural training.
  (ii) Language training.
  (iii) Training in manners and mannerisms.
- Compensation:
  (i) Devising an appropriate strategy to compensate expatriates.
  (ii) Minimising discrepancies in pay between parent, host and third country nationals.
  (iii) Issue relating to the reentry of expatriate into the home country.
- Performance management:
  (i) Constraints while operating in host countries need to be considered.
  (ii) Physical distance, time differences and cost of reporting system add to the complexity.
  (iii) Identification of raters to evaluate subsidiary performance.
- Industrial relations:
  (i) Who should handle industrial relations problem in a subsidiary?
  (ii) What should be the attitude of parent company towards unions in a subsidiary?
  (iii) What should be union tactics in subsidiaries?

Thus, the list goes on. Be it employee selection, training or compensation, IHRM adds to new dimensions which are not being felt or being observed in DHRM.

Need for a Broader Perspective

When compared to DHRM, IHRM requires a much broader perspective on any HR activity. This is because an MNC continues to recruit and select a mix of different types of employees including host country nationals, third country nationals and parent country nationals. International joint ventures, for example, can include as many as nine different types of employees each with their own distinct characteristics—foreign parent expatriate, host parent expatriate, foreign parent transferee, host country national, third country national, expatriate of foreign parents, third country expatriate of host country parents, third country expatriate of the joint venture, foreign headquarter executive, and host headquarter executive. The various employee groups, each with its own cultural background add to the need for broader perspective on the part of IHR manager. Take training and development for instance. The tasks involved here are to identify the type of overseas assignment for which training is required, determine the specific cross-cultural training needs and impart training and evaluate its effectiveness. Similarly, while dealing with pay issues, the IHR manager needs to coordinate pay systems in different countries with different currencies that may change in relative value to one another over time. While handling fringe benefits too, complications tend to arise. It is a common practice in most countries to provide health insurance to employees and their families. The interpretation of family varies across countries. In some countries, the family is understood to include the employee’s spouse and children. In other countries, the term family encompasses a more extended group of relatives-multiple spouses, aunts, uncles, grandparents, nephews and nieces. The IHR manager finds himself or herself in a difficult situation while including or excluding a relative in the family nest.

Whether or not a country is developed or developing, makes IHRM orientation different. The establishment of the EU, for instance, had significant implications for HRM. HRM in Europe is in a transition. There is a doubt whether a distinct European HRM culture does exist. In anticipation of the creation of the single European market, prior to 1993, organisations were beginning to review their strategies to take advantage of the markets freed from border tariffs, which were going to open before them. The 1990s witnessed an unprecedented number of mergers and acquisitions in Europe as organisations sought to develop an integrated Europe. This led HR professionals across the different countries to think: first to map what practices prevailed at the national and industry level; and second, to find common ground for European HRM policy.

The European HRM policy did emerge overtime. The distinct features of European HRM policy are: impact of culture, sense of organisational and managerial responsibility towards employees, greater involvement of groups, and wider support towards trade unions and other forms of employee representations.

This pan European HRM policy almost contrasts with the US policy towards HRM. The hallmarks of the latter are: freedom and autonomy, low interference from state, hands-off attitude towards employees, and antagonism towards trade unions.

The IHR manager operating in developing countries encounters unique problems. In most developing countries there is a paradigm shift in management policies, orientations and practices. Many of the countries are emerging as market driven economies emphasising on professionalisation of managerial practices including those relating to HR. There may be resistance from some quarters to accept new ideas and approaches and it is the responsibility of IHR manager to ensure that they are put in place.

More Involvement in Employees' Personal Lives

A greater degree of involvement in employees' personal lives is necessary for the selection, training, and effective management of both parent-country and third-country nationals. The HR department needs to ensure that the expatriate employee understands housing arrangements, health care, and all aspects of remuneration package provided for the foreign assignment. Many international businesses maintain an "International Human Resource Services" section that co-ordinates administration of the above programmes and provides services for parent country and third-country nationals such as handling their banking, investments, home rental while on assignment, coordinating home visits, and final repatriation.

Involvement of HR department in the personal lives of employees is limited in domestic HR management. The firm may, for example, provide employee insurance programmes, or when a transfer is involved, the HR department may provide some assistance in relocating the employee and family. But in the international setting, HR departments must get more involved and understand personal lives of employees to provide the service and support needed. For example, some governments require the presentation of a marriage certificate before granting visa to an accompanying spouse. Thus, marital status could become an important consideration in the selection process. In such a situation, the HR department should advise all candidates being considered for the position of the host-country's visa requirements with regard to marital status and allow each candidate to decide whether he or she wishes to remain in the selection process. Apart from providing suitable housing and schooling in the assignment location, the HR department may also need to assist children left behind at boarding schools in the home country. These issues do not figure in domestic HR management.

Changes in Emphasis

As international business matures, the emphasis placed on various human resource activities change. For example, as the need for parent-country and third-country nationals declines and more trained locals become available, resources previously allocated to areas such as expatriate taxation, relocation, and orientation are transferred to activities such as staff selection, training, and management development. The latter activity may require establishment of a programme to bring high-potential local staff to corporate headquarters for developmental assignments. The need to change emphasis in HR activities as a foreign subsidiary matures is clearly a factor that broadens the responsibilities of local HR activities.

Risk Exposure

Risk exposure is high in domestic HRM. Unfair hiring practices may result in a firm being charged with violation of the constitutional provisions and be liable for penalties. Failure to maintain cordial relations with unions may result in strikes and other forms of labour unrest. BPO firms are exposed to the risks of female employees, during night shifts, being sexually abused and killed. Males too are frequently robbed of cash and cell phones.

In IHRM, there are additional risks as for example: terrorism, kidnapping and murders.

An American engineer Paul Johnson was beheaded in Saudi Arabia in 2004. An Indian labourer, Kutty was kidnapped and killed in Afghanistan in 2005. So was Suryanarayana, a telecom engineer in 2006. Terrorism poses a great risk to international operations. The cost of kidnapping may run to $2 to $3 million, and it is estimated that there are 10,000 to 15,000 kidnapping a year worldwide. Firms are, therefore, forced to spend 1 to 2 per cent of their revenues on protection against terrorism.

The IHR department may also be required to devise emergency evacuation procedures for highly volatile locations. The invasion of Kuwait by Iraq and the ensuing Gulf war in 1991 is an example of such an eventuality.

Then there is the risk of expatriate failure. The failure of an expatriate can have disastrous results. Substantial monetary costs are involved while sending expatriates abroad, bringing them back to the home country, and finding replacements (between $300,000 and $1 million per expatriate per year). One estimate is that the US companies lose $2 billion a year as a result of expatriate failure. Besides, the poor performance of an expatriate may damage the firm's image in the host country. There are also the personal tragedies of employees who fail even though they have been viewed as competent managers within the domestic organisations. These individuals may have sold their homes, left the jobs they liked, and uprooted their families to take a foreign assignment—only to find themselves back in the home country branded as failures. Their early return may also affect their future career prospects in the firm.

DHR manager may be free from such risks.

External Influences

The IHRM activities are influenced by a greater number of external factors than are domestic HRM functions. Because of the visibility that the international businesses tend to have in host countries (particularly in developing countries), subsidiary HR managers may have to deal with ministers, political figures, and a greater variety of economic and social interest groups than would normally be encountered in purely domestic HRM. A host country government can dictate hiring procedures as is the case in Malaysia. During the 1970s, the Malaysian government introduced a requirement that foreign firms comply with an extensive set of affirmative action rules designed to provide additional employment opportunities for Malaysia.

In developed countries, labour is more expensive and better organised than in less developed countries, and governments require compliance with guidelines on issues such as labour relations, taxation, health, and safety. These factors shape the activities of the subsidiary manager considerably. The subsidiary HR manager also needs to spend time learning and interpreting the local ways of doing business and the general code of conduct regarding activities such as gift giving. It is also likely that the subsidiary HR manager will become more involved in administering benefits such as housing, education, and other facilities not readily available in the local economy.

MANAGING INTERNATIONAL HR ACTIVITIES

LO 4
Assess the management of international HR activities

Managing international HR activities is an elaborate and complex task. Figure 22.3 outlines the basic steps involved in IHR activities.

HR Planning

Human resource planning (HRP) is the process of forecasting an organisation's future demand for and supply of, the right type of people in the right numbers. HRP assumes greater relevance in international businesses where efficient use of human resources is necessary to realise strategic global objectives. But the implementation of HRP procedures may be more difficult in some host countries than in others. In cultures where people are viewed as basically subjugated to nature, there is very little need for HR planning. After all, why plan when people are unable to determine what happens? The implementation of extensive HR planning systems in such cultures would be met with bemusement at best and significant resistance at worst. Likewise, societies that are oriented towards the present would not view long-term planning as valuable. In societies oriented towards the past, planning would tend to focus on purely historical data and the use of these data in predicting future HR needs. Such an approach might be appropriate for firms that operate in relatively stable environments but would not work well for firms operating in highly volatile environments, where the past has little to do with the future.

Fig. 22.3 International HR Management Process

Six other key issues in international HR planning are as follows:
1. Identifying top management potential early.
2. Identifying critical success factors for future international managers.
3. Providing developmental opportunities.
4. Tracking and maintaining commitments to individuals in international career paths.
5. Tying strategic business planning to HR planning and vice versa.
6. Dealing with multiple business units while attempting to achieve globally and regionally focussed (e.g. European, Asian) strategies.

Employee Hiring

Human resource planning having been done, the international human resource manager must proceed with the job of hiring the right number of people of the right type. The international human resource manager must not only select people with skills, but also employees who can jell with the organisation's culture. GE, for example, is not just hiring people who have skills required to perform particular jobs; it wants to hire employees whose styles, beliefs, and value systems are consistent with those of the firm.

HR manager needs to have staffing strategies before initiating the process of employee hiring. Staffing strategies should be aligned with the life cycle of an MNC as Table 22.3 shows.

Table 22.3 Linkages of Staffing Strategies with the Life Cycle of an MNC

Stage in Unit life Cycle	*Staffing impetus*	*Hiring headcounts*	*Staffing approach*	*Role of parent MNC*
Setting up the host unit	Focussed staffing challenges, pace is slow and micro-managed as the senior management team is put together	Normally 5–20	Usually an ethnocentric or a geocentric approach as the 'management team' is put together	Closely and carefully monitored by the parent MNC; literally handpicked
Establishing the technology team to begin core operational activities	Unit staffing challenges are stepped-up; hiring focuses on obtaining individuals with high emphasis on competency; common vendor linkages with placement consultants and RPO's (Recruitment Process Outsourcing)	Hiring headcount normally 20–200	Polycentric approach is preferred as the unit sets up its own operational teams	Role of the parent unit is somewhat reduced as the responsibility of the newly structured unit takes shape
Full-blown operations of the host unit with significant role in establishing global objectives and targets	Increased staffing challenges as hiring targets are stepped up, focus shifts to numbers, competencies receive reduced focus as in-house skills development initiatives are established; newer linkages with third parties like colleges, vocational institutes and training institutions are established	Hiring headcount varies between 200–1000 depending on nature of business	Distinctly polycentric approach as achievement of unit objectives becomes significantly self-contained	Role of parent unit is minimal. Focus on global framework for hiring, leaving the rest to the unit management.

Strong operational leadership at the unit level while globally consolidating with parent	Move to volume hiring as unit's global contributions are clear; focus on referral hiring; establishing long term liaisons with educational and training institutions	Hiring headcounts are steeper between 500–10,000 depending on nature of business	Distinctly polycentric approach; could get to geocentric approach as labour costs provide the competitive advantage for the achievement of global objectives	Role of parent unit is at a strategic level, taking decisions to optimise global operating costs

International businesses are said to adopt either of the four approaches to staffing: ethnocentric, polycentric, regiocentric and geocentric.

Ethnocentric Approach In this approach, all key management positions are held by parent-country nationals. This strategy may be appropriate during the early phases of international business, because firms at that stage are concerned with transplanting a part of the business that has worked in their home country. This practice was widespread at one time. Firms such as P & G, Philips NV, and Matsushita originally followed the ethnocentric approach. In the Dutch firm Philips, for example, all important positions in most foreign subsidiaries were at one time held by Dutch nationals who referred to by their non-Dutch colleagues as the Dutch Mafia. In many Japanese and south Korean firms today, such as Toyota, Matsushita, and Samsung, key positions in international operations are still held by home-country nationals. According to the Japanese Overseas Enterprise Association, in 1996 only 29 per cent of foreign subsidiaries of Japanese companies and presidents were not Japanese. In contrast, 66 per cent of the Japanese subsidiaries of foreign companies had Japanese presidents.

There are sound business reasons why ethnocentric approach is preferred. Some of the justifications for the approach are:

- Perceived lack of qualified host country nationals;
- Understanding that a united corporate culture can be maintained; and
- Need to maintain good communication, coordination, and control links with headquarters.

Ethnocentric approach has a number of disadvantages. The major drawbacks are:

- Denial of promotional opportunities to host-country nationals, leading to reduced productivity and increased turnover.
- The adaptation of expatriate managers to host countries takes a long time during which home-country nationals make poor decisions and commit mistakes.
- For many expatriates a key international posting means new status, authority, and increased standard of living. The changes may affect expatriates' sensitivity to the needs and expectations of their host-country subordinates.

Polycentric Approach The polycentric staffing policy requires host-country nationals to be hired to manage subsidiaries, while parent-country nationals occupy key positions at corporate headquarters. Although top management positions are filled by home-country personnel, this is not always the case. For example, many US MNCs use home-country managers to get the operations started, then hand it over to the host-country managers. Hindustan Unilever Ltd, (HUL), the Indian subsidiary of Unilever, has locals as its chiefs.

Preference for home-country citizens for key positions does not fit into a pattern, unless government interventions dictate selection processes. In Brazil, for example, two-thirds of the employees in any foreign subsidiary traditionally had to be Brazilians. In addition, many countries exert real and subtle pressures to staff the upper-management ranks with nationals. In the past, these pressures by host countries have led companies such as Standard Oil to change their approach to selecting managers.

The polycentric approach to staffing has both merits as well as demerits. Hiring host country nationals eliminates language barriers, expensive training periods, and cross-cultural adjustment problems of managers and their families. It also allows to take advantage of (lower) local salary levels while still paying a premium to attract high-quality employees. Employment of locals allows a firm to take a lower profile in sensitive political situations. Finally, employing host-country nationals gives continuity to the management of foreign subsidiaries. This approach avoids the turnover of key managers that, by its very nature, results from an ethnocentric approach.

The disadvantages of the polycentric approach are equally strong. Local managers may have difficulty bridging the gap between the subsidiary and the parent company, because the experience and exposure they possess may not have prepared them to work as part of a global enterprises. Language barriers, national loyalties, and a range of cultural differences may isolate the corporate headquarters staff from the various foreign subsidiaries. The lack of transfers from home-country to host-countries and vice versa, can exacerbate this isolation and lead to a lack of integration between parent company and its 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 the experience curve and location economies may be difficult to achieve.

The federation that may result from the polycentric approach can also be a force for inertia within the firm. After decades of pursuing the staffing policy, Unilever found that staffing from a multidomestic strategic posture to a transnational posture was very difficult. Unilever's foreign subsidiaries had evolved into quasi-autonomous operations, each with its own strong national identify. These 'little kingdoms' objected strenuously to headquarters' attempts to limit their autonomy and to rationalise global manufacturing.

Finally, consideration of only home and host-country nationals may result in the exclusion of competent executives.

Regiocentric Approach The regiocentric approach uses managers from various countries within the geographic regions of a business. Although, the mangers operate relatively independently in the region, they are not normally moved to the home country.

The regiocentric approach is adaptable to fit the company and product strategies. Locals (of the region) are hired when regional expertise is needed. If product knowledge is critical, then parent county nationals, who have ready access to corporate sources of information can be brought in.

But the problem with regiocentric approach is that the managers at the region may not understand the managers at the head office. Besides, headquarters may not employ enough managers with international experience. This might result in poor decisions. The regiocentic approach is a step towards geocentric approach.

Geocentric Approach This staffing philosophy seeks the best people for key jobs throughout the organisation, regardless of nationality. Seeking the best person for the job, irrespective of nationally is most consistent with the underlying philosophy of a global corporation. Colgate Palmolive is an example of a company that follows the geocentric approach. It has been operating internationally for more than 50 years, and its products are household names in more than 170 countries. 60 per cent of the company's expatriates are from countries other than the US. All the top executives speak atleast two languages, and important meetings routinely take place all over the globe.

Coca-Cola is another name to be remembered in this context. As far as possible, the MNC tries to staff its operations with local personnel. The belief held by the company is that local people are better equipped to do business at their home locations. However, expatriates are needed in the system for two reasons. One is to fill a need for a specific set of skills that might not exist at a particular location. For example, when Coca-Cola started operations in Eastern Europe, it has to bring in an expatriate from Chicago, who was of polish descent, to fill the position of finance manager. The second reason for using an expatriate is to improve the employee's own skill base. Coca-Cola believes that because it is a global company, senior managers should have had international exposure.

Feasibility of implementing a geocentric policy is based on five assumptions, viz;

1. Highly competent employees are available not only at headquarters, but also in the subsidiaries;
2. International experience is a condition for success in top positions;
3. Managers with high potential and ambition for promotion are always ready to be transferred from one country to another;
4. Competent and mobile managers have an open disposition and high adaptability to different conditions in their various assignments; and
5. Those not blessed initially with an open disposition and high adaptability can acquire these qualities as their experience abroad accumulates.

As with other staffing philosophies, the geocentric approach has merits and demerits.

Among its advantages is the possibility of making the best use of its human resources. Second, and perhaps more important, a geocentric policy enables the firm build a cadre of international executives who feel at home working in a number of cultures. Third, firms pursuing a geocentric 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 following other staffing approaches. In addition, the multinational composition of the management team that results from geocentric staffing tends to reduce cultural myopia and to enhance local responsiveness. Thus, other things being equal, a geocentric policy seems to be the most attractive.

There are disadvantages associated with the geocentric philosophy. First, host governments impose restrictions on staffing, dictating that a high number of their citizens be employed in subsidiaries. Secondly, geocentric policy can be expensive to implement because of increased training and relocation costs. A related factor is the need to have a remuneration structure with standardised international base pay, which may be higher than national levels in many countries. Finally, large numbers of parent, host, and third-country nationals need to be sent abroad in order to build and maintain the international team required to support a geocentric staffing policy. To successfully implement the geocentric policy, therefore, requires longer lead time and more centralised control of the staffing process. This necessarily reduces the role of subsidiary management in these issues, and this loss of autonomy may be resisted by the subsidiary.

The four staffing approaches having been described, it may be stated that based on top management attitudes, an international business can pursue one of the four philosophies.

Nation's culture affects the staffing policy pursued by a firm. European firms are more likely to adopt the geocentric approach than their US or Japanese counterparts. This approach is encouraged in the EU by firms wishing to improve the mobility of workers and managers throughout Europe. Japanese firms favour the ethnocentric approach, in part because their consensus-oriented approach to decision-making is facilitated by employing locals in key roles in their foreign subsidiaries.

The typology (the four approaches discussed above) has been criticised. The critics argue that the typology is too simplistic and that it obscures the national differentiation of management practices within international businesses. The critics claim that within some MNCs, staffing policies vary significantly from subsidiary to subsidiary; while some are managed on an ethnocentric basis, others are managed in a polycentric or geocentric manner. Other critics note that the staffing policy adopted by a firm is primarily driven by its geographic scope, as opposed to its strategic orientation. Firms that have a very broad geographic scope are most likely to have a geocentric mindset. Thus, Coca-Cola, which is involved in about 200 countries is more likely to have a geocentric mind-set than a firm that is involved in only three countries.

THE EXPATRIATES

LO 5
Illustrate the life cycle of expatriates and appraise their role in international business

Of the four staffing policies we have discussed above, two of them namely, ethnocentric and geocentric approaches rely on extensive use of expatriates-employees working outside their home country with a planned return to that or a third country. As expatriates play a major role in international businesses, MNCs take great care in their selection process. Figure 22.4 contains the model of the life cycle of an expatriate assignment. It involves a process of determining the need for an expatriate assignment, identifying and then selecting likely candidates, preassignment training, departure, postarrival orientation and training, crisis and adjustment or crisis and failure, reassignment abroad and/or repatriation and adjustment.

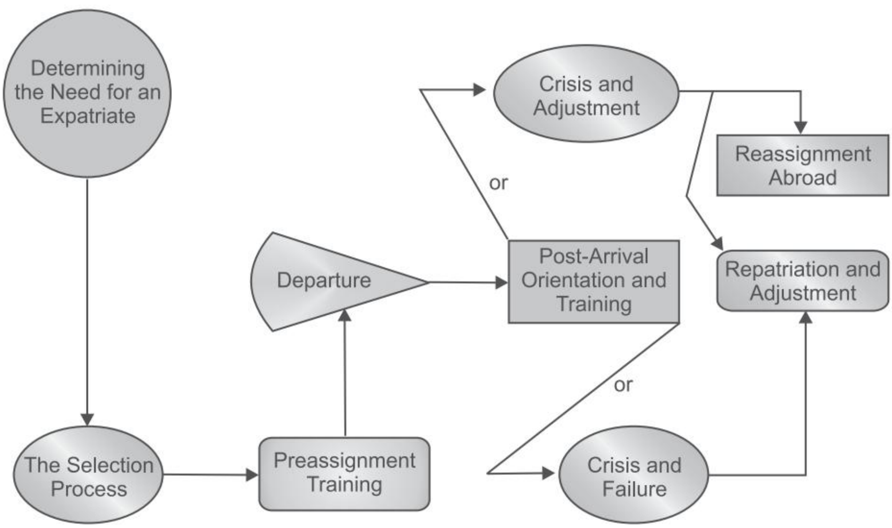


Fig. 22.4 The Expatriate Assignment Life Cycle

(*Source*: Cynthia D Fisher, et al, *Human Resource Management*, Houghton Miffin Co., 1997, p. 781)

Expat Selection

Several studies have been conducted to identify the requisites a foreign assignee should possess, if he or she were to be successful as an expat. One such study was made by Tung in 1981. After an extensive review of literature on the selection of expats, the researcher identified eighteen variables and grouped them into four categories as follows:

Technical competence One should possess technical skills to perform better in his or her job. This is particularly true in an expat who is located away from headquarters and advise or help in case of doubt is not easily available.

Relational skills This refers to the ability of the individual to deal effectively with his/her superiors, peons, subordinates and clients. This requisite becomes all the more pronounced in an expat who needs to function in an alien environment. Relational skills include multicultural sensitivity, interpersonal skills and language and communication skills.

Ability to cope with environmental variables In the domestic situation, environment comprises political-legal, cultural, technological and economic factors. Knowledge about these factors is essential for a manager to be successful. In an international context cultural environment of the host country is more significant. The expat should be knowledgeable about host country nationals, tastes, attitudes, beliefs, practices, customs and manners. Knowledge about international laws adds to the competitive strength of the expat.

International managers of today need to see the world not just as a collection of national markets, but also as a source of scarce information, knowledge and expertise—the key resources required in the development and diffusion of innovation worldwide.

The global manager should have open mindedness. This trait helps the global manager come out of a parochial mindset and ask such questions as, "What is that we could learn from the leading-edge environmental trends in Germany? Or the most sophisticated consumers in Japan? Or from our toughest competitor who happens to be coming at us out of India?"

As important as openmindedness is the ability of the global manager to legitimise diversity. Diversity doesnot mean managing gender differences. It is about total perspective. It is about legitimising diverse views in an organisation, including those based in cultural differences.

Family situation This refers to the ability of the expat's family to adjust to living in the foreign environment. This factor determines the performance or lack of it of the assignee.

Another insightful study was made by Mark Mendenhall and Gary Oddon in 1985. The two researchers have identified four major dimensions that could influence an expat's selection and adjustment. These dimensions are:

- **Self orientation** includes activities that contribute to the expat's self-confidence, self-esteem, and mental hygiene.
- **Others orientation** consists of activities and attributes that enhance the expat's ability to interact effectively with host citizens and develop lasting friendships and close relationships with them and acculturate more easily in overseas assignments.
- **Perceptual dimension** concerns the ability of expats to understand why foreign nationals behave the way they do, the ability to make correct attributions about the reasons or causes of host-nationals' behaviour.
- **Cultural toughness dimension** refers to the situation rather than to people. Cultural toughness can modify the importance of the first three dimensions. In culturally tough countries (countries that are culturally very different from the home country), the first three dimensions become even more important than in culturally similar countries. For example, American expatriates assigned to a small village in Kerala shall face tougher time in adjusting than if they had been assigned to Sydney in Australia where locals' culture is identical and they too speak English.

Lessons drawn from these and other studies boil down to the specific criteria to select expats as shown in Fig. 22.5.

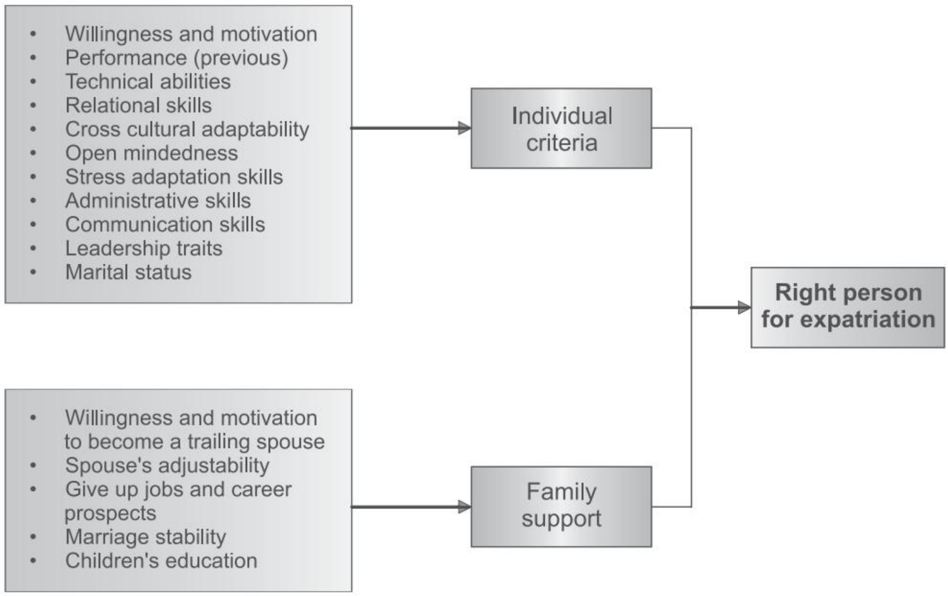


Fig. 22.5 Criteria for Expat Selection

Once chosen, the candidate (and often the entire family) needs to be provided with support and information required to enable smooth transition into the role. This support is critical to the success of the expat and in turn the success of the host unit as well. And the amount of assistance provided depends on the location of the assignment and duration of stay.

Having selected the right candidates, and before expatriating them, the MNC needs to:

- Provide culture and language orientation to make the unfamiliar become a little less strange.
- Authorise pre-assignment visits for the expatriate and spouse so that they can find appropriate accommodation, explore the host city and surrounding environs, and investigate schools and shopping. Encourage the family to involve the children in the discussion on educational options.
- Provide local contact information so that the family will be welcomed on arrival. A combination of company expatriates and new local colleagues can be very beneficial, along with the advice of a destination service provider. MNCs generally provide destination services to their employees who are locating to another country.
- Assign home-country mentors who are familiar with the challenges of expatriation to help guide the employee during the assignment. Have the two meet before the relocation happens.
- Provide EAP (Employee Assistance Programme) at the host location, should there be a crisis, so that the employee has a contact that he or she can approach.
- Provide explicit job description so that the employee knows precisely what is expected, thus minimising insecurity about vaguely described position responsibilities. Reporting relationships and peer positions within the unit is also important information that can be provided to the employee in advance.
- Inform the family, prior to their acceptance of the move, of expected hardship conditions so that they can prepare themselves beforehand (see Exhibit 22.1 for the hardship factors).

Exhibit 22.1

COMMON HARDSHIP FACTORS

- Housing—availability and quality of expatriate housing, limitations due to crime or security considerations, reliability of utilities;
- Climate and physical conditions—conditions of excessive temperature or weather, risk of major climatic problems or natural disasters;
- Pollution—severity of atmospheric, water, radiation, and noise pollution;
- Diseases and sanitation—health risks, public sanitation, need for food or water treatment;
- Medical facilities—availability and quality of healthcare facilities and medical staff;
- Educational facilities—availability of quality schools for expatriate children;
- Infrastructure—quality and reliability of telephone, mail, utilities, road conditions;
- Physical remoteness—geographic isolation, travel systems;
- Political violence and repression—risk of violence, terrorist activities, government repression;
- Political and social environment—freedom of expression, human rights, intolerance, corruption and poverty levels;
- Crime—risk to person and property , police force;
- Communication—use of major world languages, media availability and censorship;
- Cultural and recreational facilities—availability and range of sports facilities, theater and so on;
- Availability of goods and services—availability and quality of food supplies, clothing and grocery.

There is an increasing trend of this entire process being outsourced to specialist consultant groups who help in this process. Most MNCs are moving towards this approach as expatriation is on the rise.

Expat Failure

Inspite of tight screening of the potential candidates for expatriation and notwithstanding intensive training given to them, assignees fail and seek to comeback to the home country. Globally, the expat failure rates vary between 25% and 40%, and differs from country to country. Many of the US based MNCs, for instance, have 10% to 40% failure rates, with less than five per cent failure rates in Japanese and European organisations.

Universally, the critical cause for expat failures is the "soft issue"-impact of culture. Culture has its impact on several behavioural nuances of the expatriate, both off-the-job and on-the-job. While issues of punctuality, greetings, dress, gift giving, negotiating and conducting meetings belong to the first, the second includes socialising, celebrating festivals and events, and the like. Failure to understand and adjust to these by the assignee and by his or her spouse is the decisive factor contributing to premature return of the assignee.

An expat's adjustment to the local culture typically comprises three stages (see Fig. 22.6). The U-shaped curve starts with a *high,* suggesting that the expat enjoys a great deal of excitement, as he or she discovers the new culture. This stage is called the tourist stage. Business travellers, as compared with expatriates, often have the luxury of remaining at this stage. This initial phase is followed by a period of *disillusionment* (second stage) in which the expat faces depression as the difficulties with the new culture become clear. These difficulties include inability to converse in the local language,

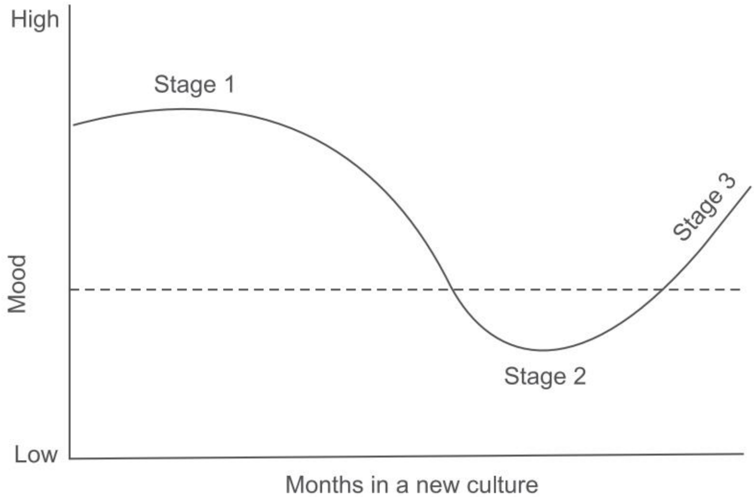


Fig. 22.6 Culture Shock Cycle

problems in obtaining certain products and food supplies of personal preference, home sickness and the like. At this stage, the curve hits a low and is characterised by what is called *culture shock.* (See Exhibit 22.2 for description of a person with culture shock).

Exhibit 22.2

SYMPTOMS OF CULTURE SHOCK

- Home sickness
- Boredom
- Withdrawal (for example, spending excessive amounts of time reading; seeing only other fellow natives; avoiding host country nationals)
- Need for excessive amounts of sleep
- Compulsive eating
- Compulsive drinking
- Irritability
- Exaggerated cleanliness
- Marital stress
- Family tension and conflict
- Chauvinistic excuses
- Stereotyping of host nationals
- Hostility towards host nationals
- Loss of ability to work effectively
- Unexplainable fits of weeping
- Physical ailments (Psychosomatic illnesses)
- Feelings of isolation
- Weight loss
- Feelings of helplesness

- Tenseness, moodiness, and irritability
- Loss of confidence
- Fear of the worst happening

(*Source*: Gary P. Ferraro, *The Cultural Dimension of International Business*, Pearson, 2007, p.153)

The expat feels strongly displaced, uncertain, out of place and even fearful when culture shock hits him or her. Established norms of behaviour are disrupted and the more routines are disrupted, the more severe is the culture shock. In addition, the more critical the routine that is disrupted, greater the mental energy that is required to adjust, and greater the frustration, anxiety and anger. Culture shock is a critical stage, and how the individual copes with the psychological adjustment in this phase has significant impact on his or her success or failure.

If culture shock is handled successfully, the expat enters the third stage, which may be called the *adapting* or *adjustment* phase. He or she begins to feel more certain, positive, confident, works more effectively and has learned to cope with the diversity challenges.

While culture shock continues to be the main reason for expat failure, ultimately, all roads lead to the 'selection rigour.' The IHR manager's role in picking up the right candidate for international assignment is equally critical in deciding success or failure.

Expat failure results in high cost. It is estimated that the cost of sending a failed manager and his or her family back home is around $250,000. In addition, the indirect costs of such failures are substantial. The tangible costs of expat failure can be easily measured in money value as cost of expatriation to host location, such as travel and relocation of personal belongings, high salaries, training for the assignment, support provided to spouse and family members and re-staffing the position are quantifiable. The intangible costs can be understood as loss of business and industry/government contacts and liaisons, company's reputation being at stake, impact on the host unit's operations and morale of employees. In addition, there is expat's own sense of failure, declining status with peers and impact on the emotional behaviour of the family of the expat.

An early return is not necessarily an accurate measure of expatriate failure, because ineffective assignees might remain overseas and cause even more harm to their organisations. There are also expatriates who satisfactorily complete their overseas assignment but, dissatisfied with their new position, or with their projected career path, leave the company within two years. This attrition rate has been estimated as high as 22 per cent during the first year after repatriation and a further 22 per cent in the second year, depriving the organisation of the assets of a trained and experienced employee and creating the additional cost to the organisation of recruiting and training a replacement.

Reasons for expat failures are many but the major ones are shown in Table 22.4.

Inpatriation

One of the visible practices of international human resource management is inpatriation-movement of managers from a subsidiary to its parent office, a trend most in practice is Hindustan Unilever.

An inpatriate is a competent and knowledgeable individual from a host country who moves to work in the parent company. Inpatriation is also called 'reverse diffusion'.

Why inpatriation? There are a few reasons for such a practice. First, over time some host countries – India and China in particular – have acquired prominent position in the globalised world. Centuries

Table 22.4 Reasons for Expatriate Failure (in descending order of importance)

US Organisations
● Inability of spouse to adjust
● Own inability to adjust
● Other family reasons
● Own personal or emotional maturity
● Inability to cope with larger international responsibilities
Japanese Organisations
● Inability to cope with larger international responsibilities
● Difficulties with new environment
● Personal or emotional problems
● Lack of technical competence
● Inability of spouse to adjust

of civilisation behind them has made these countries strong culturally with unique norms of behaviour of their citizens. It is those cultural nuances that have made these economies insulate themselves from the recent economic melt-down. Entire world is looking at these fast developing countries to learn and benchmark their best managerial practices. Employees from these host countries are best fit for inpatriation. MNCs are too aware of this potential and are eager to leverage the talent.

Second, corporate offices of MNCs are no longer exclusive repositories of knowledge. Nor do the host countries remain backward for ever. Some of the host countries are developing fast and are emerging themselves as centres of excellence. People in these countries are more knowledgeable and are better skilled. International businesses are keen on using this talent pool for worldwide operations.

Third, competent managers and HR professionals from subsidiaries are invited to corporate office to share and educate the corporate teams and leaders on cultural nuances and thier impact on behaviour and performance in host countries.

Finally, an inpatriate learns policies and practices of corporate office while on inpatriation. Any amount of e-learning or class room instruction cannot be a substitute for on-hand experience. Back in subsidiary, the inpatriate is in a better position to translate into reality what he or she has learnt on inpatriation.

Training and Development

Once selection of right persons is completed, the next step in IHRM is to train and develop new hires. In the meanwhile, it is desirable to have an understanding of the terms—training and development. Training aims at improving current work skills and behaviour, whereas development seeks to increase 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 experience. They are attempts to improve the overall productivity and quality of the firm's management resources. Historically, most international businesses have been focusing more on training than on managerial development. In addition, they tend to focus their training efforts on preparing home country nationals for foreign postings. Recently however, the shift towards greater global competition and rise of MNCs have changed the perspective. It is now common for firms to provide management development programmes in addition to training for particular posts. In many international businesses, the explicit purpose of management development programmes is strategic. Management development is seen as a tool to help the firm achieve its strategic goals.

We will examine the type of training imparted to managers for international postings. Later, we will discuss the connection between management development and strategy in the international business.

Expatriate Training An expat needs pre-departure training before leaving for a foreign assignment. Typically, the expat needs to be taught about the host country's culture, language, food habits, socialising and other nuances. Popularly called cross-cultural-training (CCT), the training for the expat comprises the above inputs and more. Table 22.5 brings out the advantages and disadvantages of CCT.

Table 22.5 Benefits and Drawbacks of CCT

Merits	*Demerits*
• Increases chances of success in global assignment	• Develops a false sense of confidence among employees
• Provides a comprehensive global perspective for managers	• May not remove cultural biases and prejudices
• Instills a sense of confidence into people	• May not be taken seriously by the recipients
• Foreign employees can be managed better	• May not make a visible difference in business volumes
• Reduces culture shock due to frequent travels abroad	• Can never fully prepare an assignee to face real problems

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 empathise with the culture, which will enhance his or her effectiveness in interacting with host country citizens. An expatriate should receive training in the host country's culture, history, politics, economy, religion, and social and business practices. If possible, it is also advisable to arrange for a familiarisation trip to the host country before the formal transfer, as this is likely 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 the training programmes. Often cultural training includes counseling on return to home base to prevent reverse culture shock.

Cultural training is essential for Indians who migrate mainly to the US in search of greener pastures. Majority of Indians who seek postings are software professionals who are from middle class, conservative, and religious families. Many of them are from South India which is known for deep religious sentiments and vegetarianism. They are reserved, and almost shy with the opposite sex even after experiencing western winds of liberalism. The food, weather, and behaviour are all new to them. The venerable cow may have to be seen as meat in a burger, women may have to be accepted as being more masculine and freer in their interaction with men. The idea of a friendly kiss or a hug and bikinis and frocks need to be got used to. The absence of family and friends leads to loneliness and frustration. Thus, an Indian has any number of reasons for failure in an alien culture. He or she should be trained to overcome all the obstacles.

It is not just Indians only need training. Every expatriate needs to be trained in language, culture, historical and local etiquette, personal imperatives, and food and dress habits. Dealing with racial discrimination in some countries and survival tips for vegetarians in countries like Japan, China, and Eastern Europe are other inputs in training.

Cultural training is receiving considerable attention now as more and more managers are required to globe-trot on business deals. In 1994, the Japanese spent $17 million in business etiquette training. Nearer at home, firms which have recognised the importance of cultural training are the Mafatlal, O P Jindal Group, Reckitt & Coleman, India, and Ranbaxy.

CCT programmes are generally conducted through four categories of methods: didactic culture general training, didactic specific culture training, experiential cultural general training and experimental specific cultural training (see Fig 22.7)

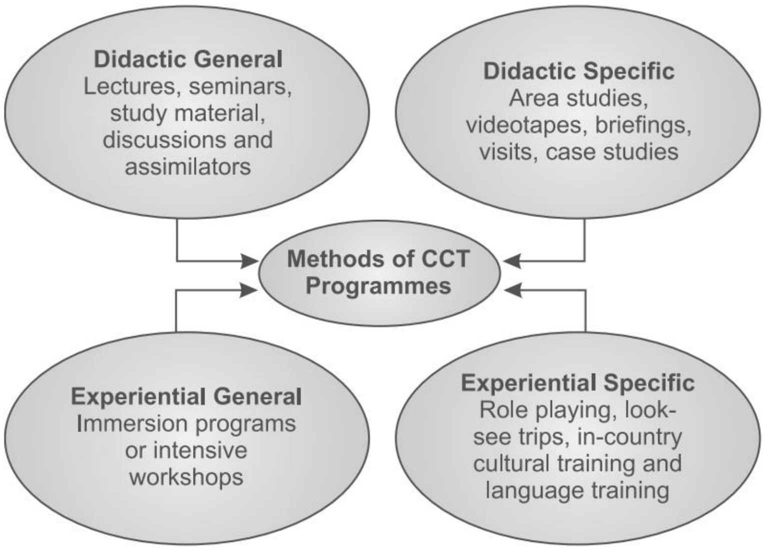


Fig. 22.7 Methods of CCT

Didactic General Training is imparted through lectures, seminars, study material, discussions, videotapes, and culture-general assimilators. Alternatively called educative training, didactic general training seeks to incur a cognitive understanding of a culture so that its norms and behaviours can be easily appreciated by the assignees.

Didactic Specific culture training, in contrast, instructs about the cultural nuances of the expatriates' host country. Methods used in this category include area studies, videotapes, orientation briefings, preliminary visits and case studies.

Experiential Training constitutes what is learnt through experience. Employees learn best from their experience in the host county or by interacting with individuals from other cultures. *Experiential general culture* training methods help assignees experience the impact of cultural differences on their behaviours. Methods in this category include immersion programmes or intensive workshops. Methods in *experiential specific training* include role play, look-see trips, coaching and language training. These methods seek to help expatriates experience and learn from interactions with individuals from the host culture.

Language Training Language training is a seemingly obvious, desirable component of a predeparture programme. One weakness of many international businesses is that they do not give sufficient attention to the importance of language training. English is the primary language of international business, and most expatriates from all countries can converse in English. Those who can speak only English are at a distinct disadvantage when doing business in non-English speaking countries like China. It may be reiterated that a willingness to communicate in the host country language will help build rapport with local employees and improve the expatriate's effectiveness. Hence the need for language training.

In addition to English, expatriate needs to know language of the host country. The ability to speak a foreign language can improve the expatriate's effectiveness and negotiating ability. It can also improve manager's access to information regarding the host country's economy, government and market.

Practical Training Practical training seeks to help the expatriate manager and family feel 'at home', in the host country. The sooner the expatriate settles down, better are the prospects that he and his family will adapt successfully. One important need is for a support network of friends for the expatriate. Where an expatriate community exists, firms often devote considerable effort to ensuring that 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 valuable in helping the family adapt to an alien culture.

Training expatriates before their departure to overseas assignment cannot be overemphasised. An extreme and tragic case highlights the importance of exposure and training for international areas. Management staff of an oil company operating in the Pacific assigned young local workers to supervisory roles over considerably older workers. Within one week all supervisors were discovered dead. Their throats were slit. The expatriate managers had been unaware that in this region status is related to age. As a result of this supervisory policy older workers were grossly insulted. This tragedy could have been avoided by training managers to re-orientate their perspective when appointing locals in a foreign culture, and providing them with careful monitoring.

Management Development and Strategy As stated earlier, international businesses use management development as a strategic tool. This is particularly true in firms pursuing a multinational strategy which is common feature among firms nowadays. Such firms need strong unifying corporate culture and informal management networks to assist in coordination and control. In addition, MNCs need to be able to detect pressures for local responsiveness. This obviously demands knowledge about host country culture.

Management development programmes help build unifying corporate culture by socialising new managers into the values and norms of the firm. In-house training programmes 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 competencies. These training courses often include songs, picnics, and sporting events that promote feelings of togetherness. These rites of integration may include "initiation rites" wherein personal culture is stripped, company uniforms are donned, and humiliation is inflicted. All these activities aim to strengthen a manager's identification with the company.

Bringing managers together in one location for extended periods and rotating them through different jobs in several countries help the firm build an informal management network. An example to be stated in this context is Ericsson, the Swedish telecommunications company. Interunit cooperation is extremely important at Ericsson, particularly for transferring know-how and core competencies from the parent to subsidiaries, from subsidiaries to parent, and among subsidiaries themselves. 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 philosophy is effective for both solidifying a common culture in the company and coordinating the firm's globally dispersed operations.

Performance Management

Performance management becomes an integral part of corporate strategy as it serves many organisational goals. Besides contributing to enhanced performance, performance management helps identify employees with high potentials, facilitates reward performance equitably and delineates employee's needs for development. These are all the activities that support the organisation's strategic orientation.

From the strategic management perspective, organisations can be grouped into any of the four categories: defenders, prospectors, analysers and reactors. The philosophy of an organisation's performance management systems (PMS) is shaped by the strategic orientation of the business unit.

Typically, **defenders** (low-cost producers) have cost control as the primary focus—predictability and a short-term focus are valued. Firms in this category seek to provide goods and services at low cost, maintain quality and provide customer service. HR activities that are relevant in this context are development and training as employees are hired at entry level, and high level vacancies are filled through promotions from within. Employees are expected to stay with the organisation for a long time. The PMS in such organisations focuses on outcome/result based as well as behavioral traits based appraisal.

Companies pursuing **prospectors** strategy look for innovation. They design and produce new products and redeploy resources from discontinued products to the development of new ones. Innovation being the key approach, those organisational conditions that foster risk taking, cooperation, creativity, and a long-term perspective are valued. Talented individuals are hired and training is mainly on-the-job. Employee turnover is high. Performance appraisal is result-based, because of the emphasis on skills identification and acquisition of human resources from external sources, as opposed to skill building within the organisation.

Companies with an **analyser** strategy operate in two types of product-market domains. One domain is stable while the other is changing. These firms are of some hybrid type in that they are both product innovators and competitors in long-run production lines. They attempt to exploit niches in the market place. The personnel policies of these firms fall between the extremes of defenders and prospectors strategies. Firms spend heavily on training but talents are also 'bought' to fill higher level positions. These companies both promote (make) and hire (buy) human resources. PMS focuses on result as well as behavioral traits.

Companies following **reactors** strategy are in highly competitive markets and are the slaves of their environments. Since these companies are essentially reactive, there are few systematic strategic implications. Focus of PMS could be result or behavioral trait based depending on the management philosophy.

One of the most challenging tasks of IHRM is managing the performance of a firm's various international facilities. While recruitment, selection, and training and development tend to focus on pre-assignment issues, performance management involves ongoing issues that continue to have an effect well past the initial international assignment.

Performance management enables an international firm to evaluate and continuously improve individuals, subsidiary unit, and corporate performance, against clearly defined, preset goals and targets. Obviously, performance management is more comprehensive in as much as it includes assessment of the performance of not only individuals but the activities of the firm and its subsidiaries too.

An international business has it own strategies and goals and it has specific expectations for each of its foreign affiliates in terms of market performance and contribution to total profits and competitiveness. A subsidiary's performance needs to be assessed it terms of its fulfillment of headquarters' expectations. However, while evaluating subsidiary's performance, the constraints within which it functions in a host-country need to be taken note of. One such constraint relates to the interpretation of data received from foreign affiliates. Consider a situation as the following:

"Sales in Peru may be booming, but the headquarters management was unaware that under Peruvian accounting rules, sales on consignment are counted as firm sales. How should the headquarters accounting system handle these sales relative to sales from other subsidiaries that do not consider sales on consignment as firm sales"?

Thus, the data obtained from subsidiaries may be neither interpretable nor reliable.

Another constraint under which a subsidiary functions relates to the volatility of the international environment. Consider the major developments that took place across the globe in the past 10 to 15 years. The fall of Communist rule, the Persian Gulf War, the formation of a single European Market, marketisation of Chinese economy, handover of Hong Kong by British to the People's Republic of China, economic reforms in India, and the current economic downturn in the economies across the globe. Each of these events has had profound implications for the global and local strategies of multinationals operating in these countries. A subsidiary needs to finetune strategies and goals set by its parent company to meet the local needs.

Besides, the assessment of a subsidiary's performance is complicated by the physical distance involved, time-zone differences, the frequency of contacts between the corporate head-office staff and subsidiary management, and the cost of the reporting system. Developments in sophisticated worldwide communications systems such as the Internet, fax machines, teleconferencing, and e-mail do not fully substitute for face-to-face contacts between subsidiary managers and corporate staff.

Finally, variable level of maturity is also a constraint in evaluating performance. Growth in foreign country is generally slower and more difficult to achieve than in the home country. There is more time needed to show any result and the effort requird is often a lot more and cannot be compared against any other benchmark, internally or externally. Sensitivity towards variations in customs and work practices in the parent, as against the host country needs to be recognised and appreciated. The focus on performance assessment of a subsidiary should be on how far strategic, corporate and functional goals have been met during the early years of establishment of the subsidiary.

Constraints notwithstanding, a subsidiary's performance needs to be assessed. Such an evaluation amounts to the assessment of the effectiveness of the subsidiary chief executive.

Expatriate Performance Management An expatriate's performance needs to be assessed to effect his or her promotions, assess training and development needs, and introduce pay rises. Though the objectives of performance assessment are appreciable, the task of evaluation is fraught with several difficulties. Unintentional bias makes it difficult to evaluate the performance of expatriate managers objectively. In most cases, two groups evaluate the performacne of expatriate managers, host-nation and home-country managers, and both are subject to biases. Biases occur because of distances, different cultural backgrounds, and lack of experience in working in a foreign setting. Environmental conditions vary across countries. Political upheavals may reduce the capacity of expatriates to perform. The condition in some countries may be very difficult so that expatriates and third-country nationals may spend considerable effort simply adopting to daily living. This would affect job performance. Managers of relatively unskilled employees may spend much of their time training workers and supervising the most basic activities within their subsidiary. Objective indicators of subsidiary performance may be low, even though the manager is doing an excellent job, given what he or she has to work with.

The nature of an expatriate's specific mission in a subsidiary tends to complicate the assessment. Expatriate managers, for example, may be sent to work in a subsidiary as troubleshooters, 'structure reproducers', 'operators', or chief executive officers. Trouble shooters are posted to fix specific problems within the subsidiary, and operators, sent as technical operations specialists may be assessed on short-term performance. Structure reproducers are expatriates sent to a subsidiary in order to reorganise its basic organisational design. These and those expatriates sent as CEO's could be judged on long term results.

Now that we have understood the difficulty of evaluating expatriate performance, we can discuss what to be assessed and who to conduct the assessment. Before describing the criteria for assessment, it is useful to understand the variables that influence expatriate performance. The factors which influence success or failure in a foreign assignment include:

- The compensation package
- The task
- Headquarter's support
- The environment in which performance takes place,
- Cultural adjustment of the individual and of his or her spouse (see Fig. 22.8)

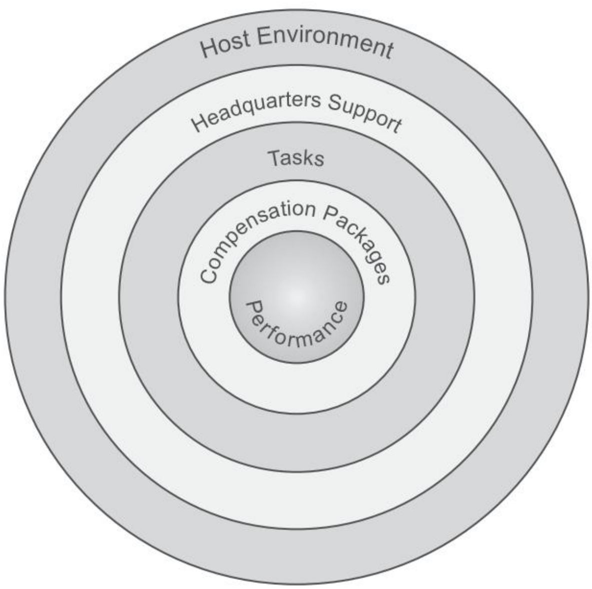


Fig. 22.8 Variables Influencing Performance of an Expatriate

Compensation Package Financial benefits, along with career prospects, motivate an individual to accept a foreign assignment. If these expectations are not met during the assignment, motivation declines and performance suffers.

Task As stated above, the mission of an expatriate may be to act as trouble shooter, operator, or executive officer. Whatever the assignment, task influences performance considerably.

Headquarters Support Home office support is crucial in expatriate performance. An assignee has accepted overseas assignment, no doubt with the objective of making extra money or improving career prospects. But there are other motives-loyalty to the organisation and commitment to make the firm successful. It is these altruistic motives which make assignees agree to work even in hostile environments. It is necessary that the home office extends support and offers moral courage particularly in times when the expatriate is passing through culture shock.

Following are the specific support facilities required from the headquarters:

- Organisational support in managing the practical problems of setting up home in a new culture is essential for enabling an expatriate to settle down.
- The provision of timely psychological counseling for expatriates encountering problems of adjustment can contribute to their mental health and performance.
- The families of employees should also be assisted in their efforts to find their feet in a new culture.

Though adds to the cost, headquarters can arrange a short visit for the expatriate back to home country so that he or she can meet up close kith and kin, refresh, get over depression, and fly again to the host country. More than arranging all required facilities and even organising a short visit to the home country, a reassurance that the head office completely supports the expatriate, will prove a source of confidence for the assignee to adjust and live in the host country.

Host Environment Environment yields considerable influence on performance, particularly of the expatriate. If the host environment is hostile, expatriates are under constant pressure and often there is threat to the life itself. We have lost two brilliant men while on duty in Afghanistan. Expecting enhanced performance from expatriates operating in such an environment is unrealistic.

The form of ownership of the subsidiary is important too. For instance, it may be relatively easier to perform in a wholly owned subsidiary than in a joint venture with a state-owned enterprise in China. Conflicting goals between the parent companies are a common problem within international joint ventures and can make the expatriate's job more difficult. Similarly, the stage of the international business will influence the success of the expatriate. An assignee overseeing the establishment of a new facility in a foreign country, especially in a developing market, will face different challenges and constraints to one who is posted into a mature operation.

Now that we have understood the difficulty of evaluating expatriate performance, we can discuss *what* to be assessed and *who* to conduct the assessment. Three types of criteria are used to assess the effectiveness of an expatriate manager—hard criteria, soft criteria, and contextual criteria. Hard criteria are objective, quantifiable, and can be directly measured such as return on investment (ROI), market share, and the like. Soft criteria tend to be relationship or trait-based, such as leadership style or interpersonal skills. Contextual criteria attempt to take into consideration factors that result from the situation in which performance occurs. Situational considerations deserve serious consideration in as much as the host country environment, as told earlier, plays a major role in expatriate performance.

To the question who should evaluate expatriate performance, the simple answer is the immediate superior. However, in the case of expatriate managers, the direct superior is often someone at the firm's headquarters several thousand kilometres away. Since the immediate superior may have little opportunity to observe the expatriate's performance information about the expatriate must be provided to those in a position to evaluate his or her activities. As with performance evaluations handled in domestic situations, many different individuals may be able to provide useful information about the performance of a particular employee.

Paying Expatriates

Yet another activity that receives considerable attention from the IHR manager is to design an attractive remuneration package to the expatriates. Any expatriate remuneration package needs to be designed to achieve the following major objectives:

1. Attract employees who are qualified and interested in international assignments;
2. Facilitate the movement of expatriates from one subsidiary to another, from home to subsidiaries, and from subsidiaries back home;
3. Provide a consistent and reasonable relationship between the pay levels of employees at headquarters, domestic affiliates, and foreign subsidiaries; and
4. Be cost effective by reducing unnecessary expenses.
5. Design pay systems that are aligned with desired outcomes and specific measurable results.
6. Be consistent with the overall stretegy, structure and business needs. The MNC needs to align all subsidiaries to a single compensation strategy linked through clearly established and transparent criteria for identifying and assessing employee competencies and performance globally.

Generally the following problems crop up while designing an international remuneration package:

- Discrepancies in pay between parent, host, and third-country nationals.
- The need to vary expatriate compensation, depending on the 'lifecycle' of the expatriate's family (e.g., young children, children in college, etc.).
- Remuneration issues related to re-entry into the parent country organisation.
- Using remuneration programmes that had not changed sufficiently over time to deal adequately with the new international business environment.

Factors Influencing International Compensation Several internal and external factors influence international compensation (see Fig. 22.9).

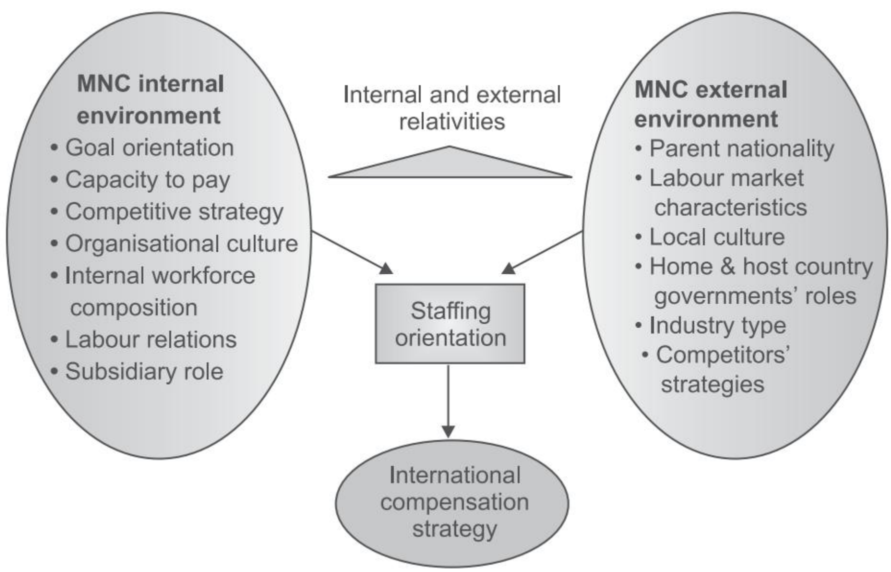


Fig. 22.9 Internal and External Variables influencing International Compensation Strategy

(*Source*: Anne-Wil Harzing, et al, *International Human Resource Management*, p. 311)

Among the internal factors is the goal orientation of the MNC. Broadly, the goal may be pursuit of economic or non-economic benefits. A non-government organisation, which seeks to realise cultural goals, will obviously have less attractive compensation package than a firm which produces and sells goods and services for profit.

An MNC's capacity to pay affects both the levels and types of international compensation. Compensation packages should be cost-effective for the international business. The competitive strategy of the MNC will most likely influence the nature of international compensation. If, for example, the MNC desires to be a market leader in employee compensation in order to attract the most competitive candidates, then the compensations might be higher.

Attitudes, values, and beliefs about the relative value of employee contributions and international compensation elements such as cash compensation, benefits, perquisites, and employee ownership plans across the MNC are inherent in the organisational culture. The latter also influences the degree to which employees are compensated on the basis of seniority, in contrast to personal connections or performance.

Workforce characteristics such as age, education level, qualifications, and experience, along tastes and preferences of employees and employee relations will result in different international remuneration approaches. Finally, the strategic role of each subsidiary will have considerable influence on international compensation strategy.

In addition to internal variables, certain factors which are external to the MNC also influence international compensation. Nationality of the parent company (in terms of culturally determined values and attitudes towards compensation policy and practices) is one such external factor. Local culture influences international compensation strategy through the dominant societal values, norms, attitudes, and attitudes towards salary differences. Other influences include labour market characteristics of supply and demand, and the education and skill levels, ages, and experience of those in the labour market. The roles of home and host country governments in labour relations will also affect the level of government regulation of the labour market and the employment relationship, including remuneration of the workforce.

Any expatriate remuneration package should seek to equalise the cost of living at home and living abroad. The remuneration package generally comprises the benefits shown in Fig. 22.10.

Components of Remuneration Package

Remuneration of expats comprise base salary, benefits, incentives, taxes, allowances, and long-term benefits (see Fig. 22.10).

Base Salary The term base salary acquires a somewhat different meaning when employees go abroad. In a domestic setting, base salary denotes the amount of cash compensation that serves as a benchmark for other components (e.g., bonuses and benefits). For expatriates, it is the primary component of a package of allowances, many of which are directly related to base salary (e.g., for-

Fig. 22.10 Components of International Compensation

eign service premium, cost-of-living allowance, housing allowance) as well as the basis for in-service benefits and pension contributions. It may be paid in home or host-country currency. The base salary is the foundation block for international remuneration whether the employee is a parent-country or third-country national.

Benefits Benefits constitute a major element of the remuneration of a regular employee. These benefits comprise a similar, or even larger, portion of expat remuneration. However, several thorny issues surround benefits for expatriates. These include:

1. Whether MNCs should maintain expatriates in home-country benefit programmes, particularly if these programmes are not tax-deductible;
2. Whether MNCs have the option of enrolling expatriates in host-country benefit programmes and/or making up any difference in coverage;
3. Whether host-country legislation regarding termination of employment affects employee benefits entitlements;
4. Whether the home or host-country is responsible for the expatriates' social security benefits;
5. Whether benefits should be subject to the requirements of the home or host country;
6. Which country should pay for the benefits;
7. Whether other benefits should be used to offset any shortfall in coverage; and
8. Whether home-country benefits programmes should be available to local citizens.

Generally, benefits provided include the following:

- Entertainment
- Festival celebrations
- Gifts
- Use of club facilities
- Provision of hospitality including food and beverage
- Conference-participation
- Employee welfare
- Conveyance, tour and travel
- Hotel, lodging and boarding
- Telephone and other telecommunication facilities
- Children's school sponsorship

Most US-based firms include expatriate managers in their home-office benefits programme at no additional cost to the expats. In some countries, expatriates cannot opt out of local social security programmes; in such circumstances, the firm normally pays for these additional costs. European parent-country nationals and third-country nationals enjoy portable social security benefits within the European Union. Laws governing private benefit practices differ from country to country; practices among firms vary too. (See Exhibit 22.3 for details).

What is unique in an expat remuneration package is the *spouse assistance*. Many MNCs offer spouse assistance to help guard against or offset income lost by an expatriate's spouse as a result of relocating abroad. Although, some firms may pay an allowance to make up for a spouse's lost income, US firms are beginning to focus on providing spouses with employment opportunities abroad, either by offering job search assistance or employment in the firm's foreign subsidiary.

Incentives In recent years some international businesses have been designing special incentive programmes for keeping expats motivated. In the process, a growing number of firms have dropped the ongoing premium for overseas assignments and replaced it with a one-time lump sum premium. For example, in the early 1990s over 60 per cent of MNCs gave ongoing premiums to their expats. Today, the figure has come down to 50 per cent and the declining trend continues.

The lump sum payment has at least three advantages. First, expats realise that they are paid this only once and that too when they accept an overseas assignment. So the payment tends to retain its motivational value. Secondly, costs to the company are losses because there is only one payment and no future financial commitment. Thirdly, because incentive is separate payment, distinguishable from regular pay, it is more readily available for saving or spending.

The specific incentive programmes vary across countries as shown in Table 22.6.

Table 22.6 Explóyer Incentive Practices Around the World

MNCs paying for moves within continents				
	Asia	*Europe*	*N America*	*Total*
Type of Premium				
Ongoing	62%	46%	29%	42%
Lump sum	21%	20%	25%	23%
None	16%	27%	42%	32%
MNCs paying for moves between continents				
	Asia	*Europe*	*N America*	*Total*
Type of Premium				
Ongoing	63%	54%	39%	49%
Lump sum	24%	18%	30%	26%
None	13%	21%	27%	22%

(*Source*: Geoffrey W Latta, "Expatriate Incentives: Beyond Tradition", *HR Focus*, March 1998)

Exhibit 22.3

DIFFERING PACKAGES

Yes, this is your big break! Newcrest Mining, an Australian company operating in Indonesia, has asked you to join its team. You have always wanted to travel, so here is your opportunity. Pending your acceptance, Newcrest has sent you all the information concerning your position and employment arrangements.

You will be Manager–Financial Services in the Jakarta office for three years with a possible extension of two years. Your appointment entails relocating your family (you, your partner and your two children) within two months. Your salary in Indonesian Rupiahs would be Rph 72,000,000 per annum for the first two years with performance reviews for future years. At an exchange rate of A$1-1700 Rupiahs, the annual salary would be equivalent to approximately A$42,000. This salary payment includes allowances for your partner and your two children with levels of tax deductions and benefits comparable to Australia. However, it does not provide any allowances for accommodation, provision of a car, or membership to sports or recreation club facilities.

When you compare this package to those of similar Australian organisations you assess that your salary is not only on the lower end of the scale for expatriates, but your benefits are relatively low. For example, comparisons with other countries show that UK companies pay a substantially higher salary to their expatriates at your level of Rph 137,060,000, against an average Australian salary of Rph 72,000,000 and a Dutch salary of Rph 70,300,000. However, some of this differential is reduced with the higher benefits many Australian and Dutch companies pay their expatriates. On the benefits side, more than 60 per cent of companies pay all energy costs, while 80 per cent of Australian firms pay club subscriptions, 60 per cent for domestic staff and at least 40 per cent of Australian firms pay for cars. The percentage of firms paying for cars increases with salary level.

Would you take your big break? This comparison demonstrates the need for careful analysis when considering opportunities for overseas assignments, because what appears to be a very large salary package is no better, and in fact may be worse, than that is being offered in the home-country where very different living conditions apply.

In addition to financial benefits, it is important to evaluate how cultural differences will impact on everyday life. While Indonesians are a friendly people, their way of life is substantially different to that in Australia. The pace of life is much slower and the bureaucracy can be frustrating. As an expatriate you will be in a large, very overcrowded city with a significant international community and an English speaking international school. While Indonesians are relatively acquainted with European manners and will most likely show no offence at your ignorance of their customs, most Indonesians are Islamic and do not drink alcohol or eat pork. Attitudes towards women are very different from Australian norms, and place greater restrictions on the independence of females. During the holy month of Ramzan, when Muslims do not eat, drink, or smoke between dawn and dusk, care should be taken not to give offence to those observing the fast. Your activities in these matters should be confined to the privacy of your hotel suite or home. 'Appearances' are very important and you should always be well-dressed in public. A quite gentle manner is appreciated and Westerners are advised to remain calm at all times. To lose your temper is to lose face.

After careful perusal of all the information and employment arrangements, what is your decision? Is it your lucky break? No way! Compared to what other companies are offering in Indonesia, your package is not only less competitive, but it does not offer any incentive to uproot the family and go offshore. However, while you would be better off financially staying at home, you must consider the long-term effect on your career.

(*Source*: Darrell Mahoney, et al, *op.cit*, p. 780)

Taxes Another component of the expat's remuneration relates to taxes. Multinationals generally select one of the following approaches to handle international taxation.

Tax equalisation The firms withhold an amount equal to the home-country tax obligation of the expatriate, and pay all taxes in the host country.

Tax protection The employee pays upto the amount of taxes he or she would pay on remuneration in the home country. In such a situation, the employee is entitled to any windfall received if total taxes are less in the foreign country than in the home country.

Allowances Allowances are an inevitable feature of international compensation. One common allowance relates to the **cost of living allowance**—a compensation for differences between the home country and foreign assignment. This allowance is designed to provide the expatriate with the same standard of living that he or she enjoyed in the home country, and it may cover a variety of expenses, including relocation, housing, education, and hardship.

Spouse assistance, housing allowance, home leave allowance, relocation allowance and educational allowance are the other allowances provided for in the expatriate compensation. **Spouse assistance** is provided to help guard against or offset the income lost by an expatriate's trailing spouse. Some firms search for jobs for spouses, often in the same firm as the assignees are employed. **Housing allowances** are paid either on an assessed or on actual basis. Alternatively, housing allowances include company provided housing, a fixed housing allowance or assessment of a position of income, out of which actual housing costs are paid. Housing issues are often addressed on a case-by-case basis, but as a firm globalises, formal policies need to be kept in place. **Home leave allowance** is offered to facilitate an expatriate to visit his or her home country atleast once in a year. Such visits help the expatriate overcome the adjustment problem when they are repatriated. Home leave allowance is often utilised by the expatriate not to visit his or her home country but undertake a foreign jaunt. MNCs may ensure that the home leave allowance is better utilised to visit once own country than undertake a foreign travel.

Education allowance is given to expatriate's children. The items covered under this category include tuition, language class tuition, enrollment fees, books and supplies, transportation, room, and board and uniforms. PCNs and TCNs usually receive the same treatment concerning educational expenses.

Education allowance is often extended to assignee's trailing spouse. If attempts to secure a job for the spouse fail, he or she may be sponsored for higher studies or for reskilling.

Finally, **relocation allowances** are offered to cover such expenses as moving, shipping and storage charges, temporary living expenses, subsidies regarding appliance or car purchase and down payments or lease-related charges. These allowances are often contingent upon tax-equalisation policies and practices in both the home and the host countries.

The most common **long-term benefits** offered to employees of MNC's are employee stock option schemes. Traditionally stock option plans were used as a means for companies to reward top management or key people of the organisation. However, it is increasingly gaining popularity amongst wholly owned technology companies to retain and reward employees across the organisations. This is stemming from the fact that all employees can create an impact on the organisation's performance and will directly impact its profitability. Hence the primary objectives for providing stock options, are to reward and improve employee performance and/or attract/retain critical talent across the organisation.

In the event that an MNC sets up its operations in a host location, it normally faces challenge from competitor in hiring/retaining the desired talent and in selling its products/services in a new market, where its brand is now emerging. It is a common practice to offer long term benefits to enable the new host unit to integrate faster with the global entity.

Tailoring the Package Working within the components described above, MNCs seek to tailor-make remuneration packages to fit the specific situation, for example, senior level managers in Japan are paid four times more than their junior staff members. This is in sharp contrast to the US, where the gap is much higher. Many senior level managers in Europe are paid much less than their US counter-parts.

In designing an expat's remuneration, firms generally follow a number of approaches. The most common is the *balance sheet approach,* which involves ensuring that the expat is "made whole" and does not lose money by taking the assignment. The basic objective is to maintain home-country living standards, plus offer some financial inducement.

Figure 22.11 illustrates the balance sheet approach more effectively. The income taxes, housing, goods and services, and reserves that the expatriate has been getting in the home country are protected so that the individual's out-of-pocket expenses remain the same. As can be seen from the figure, the overall package can be substantial. It is for this reason that some MNCs do not wish to send expatriates overseas, unless there is need for their specific services.

A second approach is called *localisation* and involves paying the expat a salary that is comparable to those of local citizens. Also called the *going rate approach,* in this method, the base salary for

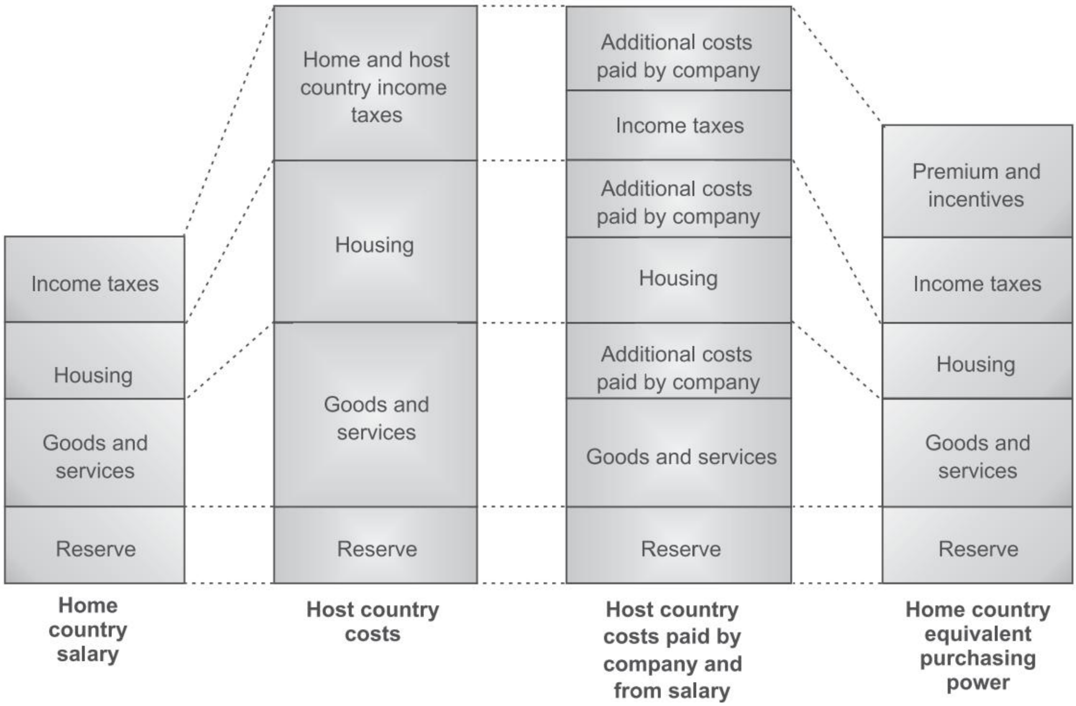


Fig. 22.11 Balance Sheet Approach to Compensation

(*Source*: C Reynolds, "Compensation of Overseas Personnel," in J J Famularo (ed), *Handbook of Human Resource Administration*, 2nd edn (New York : McGraw-Hill, 1986), p. 51)

international transfer is linked to the salary structure in the host country. The international firm usually obtains information from local compensation surveys and decides whether local nationals (HCNs), expatriates of the same nationality, or expatriates of all nationalities will be the reference point in terms of benchmarking. For example, a Japanese bank operating in New York needs to decide whether its reference point would be local US salaries, other Japanese competitors in New York, or all foreign banks functioning in New York. This is used with individuals early in their careers and who are being given long-term overseas assignment. A third approach is the *lump sum method,* which involves giving the expat a predetermined amount of money and letting the individual decide about how to spend it. Fourth is the *cafeteria approach*, which entails giving expats a series of options and then letting them decide how to spend the available funds. There is also the *regional system,* under which the MNC sets a remuneration system for all expats who are assigned to a particular region. Thus, everyone going to Europe falls under one particular system, and everyone going to South Africa falls under a different system.

Repatriation

In the previous sections, we described expatriate selection, training, remuneration, and performance appraisal. Any discussion on expatriates should include their repatriation—the activity of bringing the expatriate back to the home country. Repatriation needs careful handling, a fact which has been realised lately.

It has been the knowledge of practitioners and academics that re-entry into the home country presents new challenges as the repatriate (returning person) copes with what has been termed *re-entry* shock, or reverse culture shock. While people frequently expect life in a new country to be different, they may be less prepared for homecoming to cause problems of adjustment. As a consequence, it can be a traumatic experience for some, even more than what was encountered in a foreign location. An MNC may think that repatriation is the final phase in the expatriation process, but its ability to attract future expatriates depends on how well the firm handles its repatriation.

Repatriation Process Figure 22.12 shows the repatriation process. Before elaborating on the stages in the repatriation process, it is useful to understand that on completion of the overseas assignment, the multinational brings the expatriate back to the home-country, although not all foreign assignments end with a transfer home, rather the expatriate is reassigned to another international assignment. Some employees are made to globe-trot frequently in which case they form part of the MNC's international team of managers. Even with such managers, repatriation is essential, particularly at the retirement from work-life stage.

Preparation This involves developing plans for the future and gathering information about the new position. The firm may provide a checklist of items to be considered before the return home (e.g., closure of bank accounts and settling bills) or a thorough preparation of employee and family for the transfer home.

Physical relocation This refers to removing personal effects, breaking ties with colleagues and friends and travelling to the next posting, usually the home-country. Personalised relocation assistance reduces the amount of uncertainty, stress, and disruption experienced by the repatriate and family.

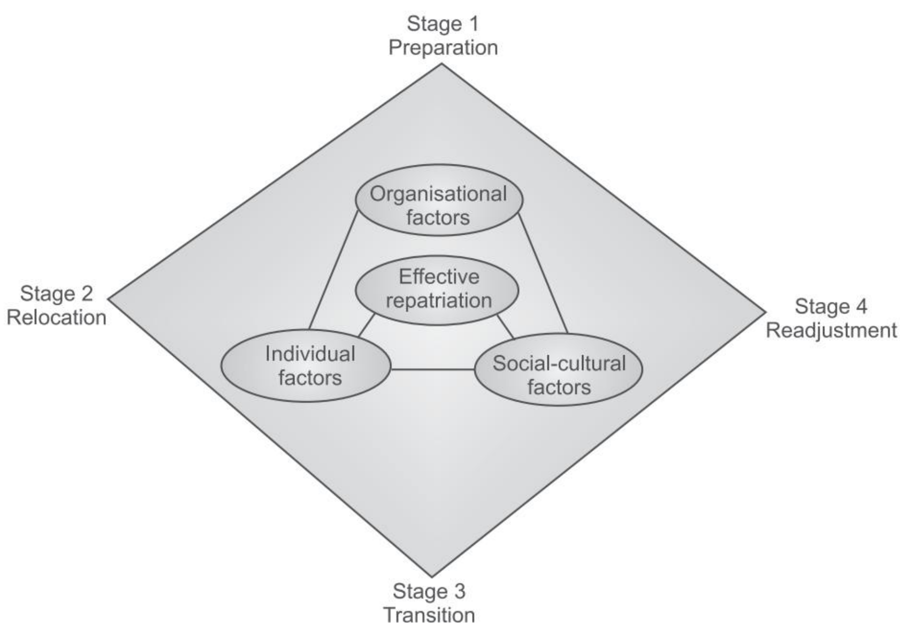


Fig. 22.12 The Repatriation Process

Transition Transition means settling into temporary accommodation where necessary, making arrangements for housing and schooling, and carrying out other administrative tasks such as renewing driving license, and opening bank account.

Readjustment This involves coping with reverse culture shock and career demands. Of all the steps in the repatriation process, readjustment is the most difficult one. The re-entry adjustment is a tough task because of multiple factors involved. In the first place, there is anxiety experienced by the expatriate when he or she returns home—the apprehension being accentuated by the uncertainty about the placement in the firm, career prospects, and a sense of isolation; feeling of devaluating the international experiences; coping with new role demands; and probable loss of status and pay.

International businesses respond to repatriation problem in several ways. Many firms have a formal repatriation programme. Exhibit 22.4 contains topics generally covered by such a programme.

Exhibit 22.4

TOPICS COVERED BY A REPATRIATION PROGRAMME

- Preparation, physical relocation, and transition information (what the company will help with).
- Financial and tax assistance (including benefit and tax changes, loss of overseas allowance).
- Re-entry position and career path assistance.
- Reverse culture shock (including family disorientation).
- School systems and children's education (including adaptation).
- Work place changes (such as corporate culture, structure, decentralisation).
- Stress management, communication-related training.
- Establishing networking opportunities.
- Help in forming new social contacts.

(*Source*: Peter J Dowling, et al, *op. cit*, p. 222)

Some companies assign the expatriate to a *mentor*, popularly called the 'godfather'. The mentor is usually in a more senior position than the expatriate and knows him or her personally. The purpose behind the use of a mentor is to remove the sense of alienation through the provision of information (e.g., workplace changes) on a regular basis, so that the expatriate is more prepared for conditions faced upon re-entry. A mentor should also ensure that the expatriate is not sidelined when important decisions are made regarding positions and promotions. Specifically, the duties of a mentor comprise the following:

- Maintaining contact with the expatriate throughout the assignment;
- Ensuring that the expatriates are kept up-to-date with the developments in the home country;
- Ensuring that the expatriates are retained in existing management development programmes; and
- Assisting expatriates with the repatriation process including helping with a repatriation position.

Repatriation Strategies

Organisations need to evolve strategies to handle repatriation successfully. Typical strategies are given in Table 22.7.

Table 22.7 Repatriation Strategies

Stage	*Strategies*
• Pre-expatriation	(i) Agreement outlining the type of position expatriates will be placed in upon repatriation.
	(ii) Agreement to contain the duration of stay overseas.
	(iii) Keeping the post back at home vacant till the assignee comes back.
• During the assignment	(i) Continuous communication with the expatriate lest 'out of sight-out of mind' syndrome occurs.
	(ii) Visit to headquarters when on vacation to maintain visibility.
• Preceding repatriation	(i) Career guidance between 6 to 12 months before the end of assignment. Career guidance helps the assignee overcome the anxiety of his or her place in the organisation.
	(ii) Ensure that all elements of the repatriation process are transparent. Such elements to include company policies with regard to travel reimbursement, leave period, shipping of household goods, and information about the mentor.
• After repatriation	(i) Training seminars to help returnees cope with reverse culture shock.
	(ii) Financial counselling and financial/tax assistance.
	(iii) Reorientation programme about the changes in the company-policies, practices, personnel and strategies.
	(iv) Reassurance that the company values international experience.

(*Source*: *www.expat exchange.com/Repatriation Checklist by Alexandra Tanski, Sept 2001*)

Tips for Successful Repatriation

The following tips will help IHR manager handle repatriation effectively:

For the employer

- Before sending an employee on a global assignment, the organisation needs to plan on how it would use the newly acquired culture- and market-specific skills of the expat during the early phases of the selection process.
- Organisations can create a repatriation contract to reduce ambiguity on both sides about the expatriate's future within the company and his or her job on return.
- Provide an intercultural repatriation program for the entire family, while making sure it is tailored to address each family member's unique needs.
- Establish a mentoring program to keep the expatriates fully in the loop with company policies and events while on global assignments. Keeping the expats connected and providing a support system is critical all along.
- Provide for company orientation program for the returning expatriates addressing all the changes that have taken place during their absence, including any company shifts in policy and strategy.
- Keep the returning expatriates feeling valued and appreciated on their return.
- Provide spousal career consulting assistance to employees with accompanying spouses/ partners. This will allow the spouse/partner to regain more control of his or her career options back home.

For the returning employee and spouse/partner

- Seek a mentor right from the moment he/she has accepted the position. This person's role is to keep the expat in the loop, assist him/her in watching out for his/her interests and career path, and facilitate the visibility of the expat within the company while he/she is away.
- Create a 'transition' fund—a secure amount that will allow for hidden costs (such as readjusting to a lifestyle with fewer company perks or transitioning back to a home without a housekeeper) that occur during the transition back home.
- Expect your values and beliefs related to how he/she view the world to have changed; do not expect old colleagues, friends, and family to immediately understand the new experiences.
- Prepare to effectively communicate how the newly acquired values and beliefs to others in the home country.
- Understand and learn to appreciate that it will take time, sometimes even longer than anyone expects, for him/her to settle into what was once a very familiar environment.
- Consider creative ways to use newly found skills and knowledge, such as assisting others through a similar relocation experience. This may offer him/her a unique opportunity to share their experiences in a setting where they will be most valued and respected.
- Be ready for a change in dynamics. Colleagues might be envious of the international experience and unsure of how he/she is different.

Expect the unexpected

- Establish the optimal time for the family to relocate—especially when considering school systems for your children and teens—and make sure your company takes this into consideration.
- Manage the expectations and expect them to be different for each member of the family. Consider what this return home will mean for each family member.
- Identify and connect with the positive aspects for this relocation. Focusing on the pros rather than the cons ultimately will create a more harmonious environment at home and work.
- Allow time to re-establish family contacts and friendships. A new set of friends have to be established and it would take time.
- Maintain ties with families and friends while away—expect what may be missed out on reunions and significant occasions while away.
- Use technology to stay in touch. Web coms, expatriate sites and chat rooms, instant and text messaging are all excellent ways for family members to stay in touch, which facilitate the transition back home.

Businesses are eager to promote international experience for their employees. Organisations take pride in touting the benefits and skills gained from a workforce steeped in frequent travel, expatriate assignments and cross-culture experiences. But while businesses continue to build intercultural highways by sending their workforce abroad, expats and international managers are lamenting the breakdown in effective communication and blame poor networking forums for expatriation as well as repatriation failure. The method adopted in designing and implementing expat assignments determine the success of expatriation as well as repatriation. While a lot of managing mobility today is less complicated than it once was, the focus has shifted to the intangible management of repatriation. There is a lot that can be done to systematically manage repatriation in large MNC's through clearly laid out policies and guidelines. It might not be as easy to achieve this in the smaller organisations, where opportunities are limited and growth is restricted. Hence the size of an MNC impacts the kind of repatriation support that is provided.

It is appropriate that we recollect cases of MNCs that have handled repatriation successfully. Exhibit 22.5 contains some such cases.

Exhibit 22.5

SUCCESSFUL REPATRIATION

- Honda, the Japanese automobile company, is a trend-setter in handling expatriates. It defines clearly the objectives of the assignment, before it starts. The objectives can range from development of a new product to improvement in vendor relations. The selected executives prepare themselves for the assignment by the analysis of their strengths and weaknesses. Well before the assignment is complied, and the expat is ready to return, Honda identities a suitable job for him/her and makes arrangements for a debriefing session to capture the important lessons from the assignment.
- Mansonto, the US based MNC is a $7.9 billion company having 30,000 employees with roughly 50 experts and 35 international employees working in the US. International human resource managers are actively involved in pre-deportee assessment, cross-cultural counseling, performance management and other administrative aspects of the overseas assignment.
- The company starts planning assignments for returning expats well in advance. The company not only arranges for their debriefing on return, but also identifies suitable assignments based on the expats' skills and organisational needs.
- Monsanto's recent programme focuses on family's return also. Often, the difficulty with repatriating has more to do with personal adjustment than with work-related matters. Precisely for this reason, the company offers returns a way to work through personal problems.
- The debriefing session of Monsant' is unique. Returnees meet for about three hours at work with several colleagues of their choice. The session is a conversation aided by a facilitator who has an outline to help the returnee cover all the important aspects of repatriation.
- Not surprisingly, Monsanto has been highly successful in reducing the quit rates of returnees.

Employee Relations

The last component of IHRM is labour or employee relations. From a strategic perspective, the key issue in international employee relations is the degree to which organised labour can limit the choices of an international business. A firm's ability to integrate and consolidate its global operations to realise the experience curve and location economies can be halted by organised labour, constraining the pursuit of a global strategy. An example to be stated here is GM, which bought peace with labour unions by agreeing not to integrate and consolidate operations, in the most efficient manner. Another example is Daewoo, which went bankrupt because of the resistance from labour to the management's move to trim the size of its labour force.

Key Issues in International Labour Relations

1. Who Should Handle Labour Relations? One issue relates to the responsibility of handling relations—headquarters or subsidiary plants. Because national differences in economic, political, and legal systems produce different labour relations systems across countries, multinationals generally delegate the management of labour relations to their foreign subsidiaries. However, a policy of decentralisation does not keep corporate office away from exercising some coordination over labour relations strategy. Generally, the corporate office will become involved in overseas labour agreements made by foreign subsidiaries because these agreements may affect the international plans of the firm and/or create precedents for negotiations in other countries.

However, the multinational headquarters involvement in host-country labour relations is influenced by several factors. First, labour relations function is centralised and is coordinated by headquarters when there is a high degree of inter-subsidiary production integration. Labour relations throughout a system become crucial to corporate headquarters when transnational sourcing patterns have been developed; that is, when a subsidiary in one country relies on another foreign subsidiary as a source of components or as a user of its output. In this context, a coordinated labour relations policy is one of the key factors in a successful global production strategy.

Secondly, nationality of ownership of the subsidiary has impact on who handles employee relations. For example, there are differences between European and US firms in terms of headquarters involvement in employee relations. US firms tend to exercise greater centralised control over labour relations than do British or European firms. Finally, subsidiary characters also influence who should handle employee relations. For example, subsidiaries that are formed through acquisition of well-established indigenous firms tend to be given much more autonomy over labour relations than are greenfield sites set up by a multinational firm. Similarly, greater intervention would be expected when the subsidiary is of key strategic importance to the firm and the firm is young. Further, where a subsidiary depends more on parent company for resources, there will be increased corporate involvement in labour relations and human resource management. Again, poor subsidiary performance tends to be accompanied by increased corporate involvement in employee relations.

2. Strategic Choices before Firms International managers are expected to make several strategic choices regarding the role of unions in the firm. The most important of them are:

- Managers must decide whether the firm should remain union-free or allow unionisation.
- Should the managers decide that the firm remain union-free, they must take steps to keep unions away.
- If unionisation should be allowed, managers must decide what type of union-management relationship they expect. Once determined, they must take appropriate steps to realise the relationship.
- The management must also choose the types of tactic to use while negotiating a new wage settlement.

3. Strategic Choices Before Unions Just as international managers are expected to make strategic choices, unions too should choose among alternative strategies. The major alternatives are:

- Bread and butter vs political objectives.
- Adversarial vs cooperative role.
- Traditional labour services vs new services.

Bread and butter issues relate to wage rates, health and life insurance and job security. These are no more demands of unions to bargain for before firms. Unions, in the past, were affiliated to political parties. But the trend has changed to de-politicisation.

In the past, the role of unions was adversarial in nature. Unions perceived their role as challenging international managers rather than cooperating with them. The adversarial role is being gradually replaced by cooperative role. Recollect the incident when CITU called for a strike to protest against the entry of an MNC and Eicher's Parwanu workers not only defied the whip but requested all the employees to get ready to face the impending competition. What happened at the Eicher's plant is not an isolated incident, it reflects the prevailing trend everywhere.

Traditional issues such as increased wages and bonus are no more attracting the attention of unions. In fact, the relevance of unions in the contemporary environment is itself at stake. Relevance of unions, in future, depends on their ability to cope with structural, economic, and social changes; and their ability to accommodate changes in social attitudes without compromising on their collective character.

4. Union Tactics Unions use several tactics to deal with international businesses. By far the most common union tactic is a strike. A strike is a concerted and temporary suspension of functions, designed to exert pressure upon others in the same unit. Strike is a very powerful ploy as it suspends production; cuts out the creation of profit; cuts off the firm from its market; sources of materials may be lost; and fixed charges such as interest, taxes, and salaries for officials continue to be incurred during the strike period. The very existence of the firm may be threatened by a prolonged strike.

Look what happend during July 2003 to Volkswagen and BMW factories in Germany. The prolonged strike by IG Metall, Germany's second most powerful union, crippled car production at the two plants. It is a different matter that the strike was called off by IG Metall without getting anything from the managements.

Unions should be cautious before resorting to a strike. An MNC enjoys formidable financial strength as it has deep pockets. It can absorb losses in a particular foreign subsidiary that is in dispute with a national union and still show an overall profit on worldwide operations. Union bargaining power may be threatened or weakened by the broader financial resources of multinationals. This is particularly evident where a multinational has adopted a practice of transnational sourcing and cross-subsidisation of products or components across different countries.

A multinational has the ability to move the production facilities to other locations from the place of industrial dispute. Ford, for example, threatened British unions with a plan to move manufacturing to continental Europe unless British workers abandoned their demands. National relative advantages provide MNCs with choice as to location of units. Threats by multinationals, whether real or perceived, to reorganise production facilities internationally, with the accompanying risk of plant closure or rationalisation will have serious impact on the striking ability of a union.

The second tactic for labour unions is to form International Trade Secretariats (ITSs). There are 15 ITSs, which function as loose confederations to provide worldwide links for the national unions in a particular trade or industry (e.g., metals, transport, and chemicals). The secretariats have mainly operated to facilitate the exchange of information. The primary goal of each ITS is to achieve transnational bargaining with each of the multinationals in its industry.

ITSs have had no real success. Although national unions wish 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 for Nissan, 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 among national unions, cooperation is difficult to establish.

The next tactic sought by the labour unions is lobbying for restrictive national legislation. The motivation for labour unions to pursue restrictive national legislation is based on a desire to prevent the export of jobs via multinational investment policies.

Finally, labour unions seek to exert pressure on MNCs through international organisations, such as the International Labour Organisation (ILO), The United Nations Conference on Trade and Development (UNCTAD), the Organisation for Economic Cooperation and Development (OECD) and the European Union (EU). The ILO has identified a number of workplace related principles that should be respected by all nations: freedom of association, the right to organise and collectively bargain, abolition of forced labour, and non-discrimination in employment. In 1977, the ILO adopted a code of conduct for multinationals. The code of conduct was influential in the drafting of the OECD guidelines for multinationals. These voluntary guidelines cover disclosure of information, competition, financing, taxation, employment, and industrial relations, and science and technology.

A key section of these guidelines is the *umbrella or Chapeau Clause*, (latter is the more acceptable term) that precedes the guidelines themselves. This clause states that multinationals should adhere to guidelines within the framework of law, regulations and prevailing labour relations and employment practices, in each of the countries in which they operate.

Organised labour met with only limited success in its efforts to get international bodies to regulate multinationals. The codes of conduct are not as far reaching as many unions would like them to be. They are purely voluntary and hence do not provide any enforcement mechanisms.

INTERNATIONAL ASSIGNMENTS FOR WOMEN

LO 6
Appreciate the role of international assignments for women and identity reasons for their low presence

The most striking feature about expatriate women is their poor numbers. (see Table 22.8)

The reasons for the low presence of female executives in global assignments are many, of which four are discussed here: (i) personality traits, (ii) family characteristics, (iii) host country's attitudes towards women, and (iv) organisational processes.

Personality traits Women have long been regarded as the weaker sex. As a group, women are generally shorter, lighter, and less muscular than men. Men's advantage in size and muscular strength has been clearly demonstrated by their performance in athletic competitions. In Olympic events in which both sexes participate, men continually outpace women. But women excel in events which demand endurance, swimming being one example.

It is also said that women have no motivation to take up international assignments. This is only a myth, as one study has proved. Adler, in her research covering 1129 graduating MBA students in Canada, the US, and Europe, found that women graduates expressed as much interest in international careers as their male colleagues. Notwithstanding the study, the myth still persists.

Apart from motivational issues, there is the problem of personality orientation. Three concepts need to be in place when one talks about personality orientation: self-orientation (stress reduction, technical competence, and reinferent substitution), others-orientation (interpersonal relations), and perceptual orientation (i.e., the ability to understand the behaviour of others).

Self-orientation is particularly important for female assignees due to the need for them to prove their competence so as to be accepted by colleagues. They should also be able to manage the stress resulting from being the only woman in the workplace.

Women's superior interpersonal skills keep them in a stronger position so far as the *others-orientation* is concerned. But socio-cultural norms can be problematic for women in this respect.

Perceptual orientation of women is important in host countries which have very few female managers. Understanding both cultural and gender differences in host countries and being flexible in one's attitudes towards these is an important factor in cross-cultural adjustment.

There is also the problem of availability. Competent women executives are not available to assume positions of responsibility. This has been articulated by Azim Premji in his interview to *The Economic Times* dated March 11, 2010. Said Premji: "We are also looking for a woman director but we're unable to find the right, qualified person. That's because we want to do some rotations on the board as some people are getting old. Yet, the same names keep coming back again and again. We'll probably settle with somebody from the social sector or with a foreign lady. There, we are heavily biased in foreign directors we are searching for, our first preference would be to find a lady director."

Family characteristics Success in overseas assignments does not depend just on the individual but also on the spouse and the family. Dual-career issues are bothering many businesses—more so in international firms. Disruption caused by geographical relocation and work-life conflict are issues which bother female overseas assignees.

Attitude of the host country In some societies, particularly those where male domination persists (for example, Japan, Saudi Arabia, and Pakistan), women are not accepted as executives, and deputing them abroad on assignments is not encouraged. India is no better. The proportion of Indian companies that have women in top positions is just 42 per cent. The proportion of senior management positions in Indian companies held by women is only 12 per cent.

Organisational processes There are impediments within organisations that contribute to the low presence of women in international assignments. While selecting candidates for expatriate assignment, considerations other than merit do play a significant role. "This is a lady—how can she cope with", "She is not the obliging type", "She is on the family way", and "She has kids at home", are the usual refrains heard against female candidates, while selecting, promoting, or deputing them.

Low numbers apart, women can be successful in international assignments. Infact low number itself is an advantage. Because, there are very few women managers in international assignments, those women who take up expatriate positions become more visible. Local business people tend to remember there limited female executives and may even prefer to transact with them more than with their male colleagues.

For certain assignments, women are preferable to men, as for instance, interpersonal relations. Inter-personal relations are essential in expatriate success. Local managers tend to be more open in communication with a woman than with a man. Local man, even from traditional cultures, can talk at ease with a woman about an array of subjects that include issues outside the domain of traditional "male only" conversations. Consequently, being an executive and a woman gives the expatriate woman a wide range of interaction options than those available to expatriate men or to local women.

What organisations should do to utilise the potential of women as expatriate managers? Organisations need to:

1. Become more strategic in their planning for international assignments in order to prevent ad-hoc and informal placements which may replicate an existing expatriate profile and prevent the adoption of alternative approaches.

2. Adopt a sophisticated approach for the determination of criteria for effective international managers. Competencies should be developed and debated in as wide and diverse a forum as possible.
3. Monitor their selection processes for international management assignments to ensure access is not unfairly restricted to specific sections of employees. This includes auditing career development systems leading up to international assignments for potential unintended bias.
4. Run selection skills training for all employees involved in selection for international assignments. This training should include raising awareness of the advantages of using diverse groups of employees on international assignments and challenging existing stereotypes relating to women and other non-traditional groups.
5. Avoid assumptions as to the likely motivation of women to accept overseas assignments and the likely success rate of women expatriates.
6. Provide flexible benefit packages, which will cater for single employee and dual-career couples as well as the traditional 'married male with family' expatriate.
7. Define the international assignment in such a way that the chances of success are high: that is, establishing full-status, permanent assignments.
8. Provide full support for alternative arrangements for the domestic aspect of international assignments, which might influence women's perceptions of accessibility.
9. Work with relocation companies to ensure the female expatriate's new residence will facilitate the possibility for social interaction.

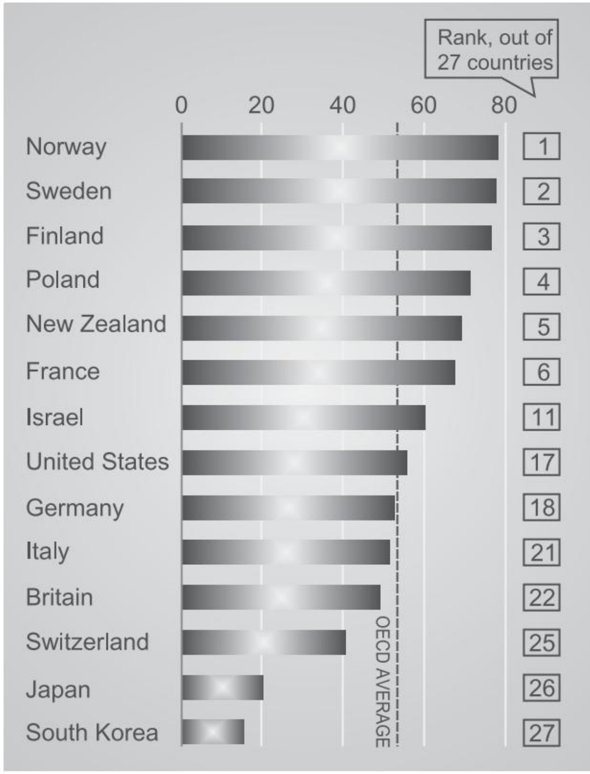
Having more women in senior positions is good business too. Plenty of research suggests that companies with lots of women in senior positions are more successful than those without.

Presence of women not only as expats but also in senior positions of corporates is not encouraging. This phenomenon is not peculiar to India. It is a worldwide phenomenon. To ascertain the status of women in general across the globe, *The Economist* has constructed and released a glass ceiling index on the occasion of the International Women's Day on March 8, 2014. The index combines data on higher education, labour-force participation, pay, child-care costs, maternity rights, business-school applications and representation in senior positions. Each country's score (of the 27 countries surveyed) is a weighted average of its performance on nine indicators. Fig. 22.13 shows the ranking of select countries.

Nordic countries come out well on educational attainment and labour-force participation. Women are also relatively well represented in their parliaments; Finland and Sweden were among the first countries to allow women to vote and stand for election. Yet, even there women are paid less than men for similar work. In Finland and Sweden, the gap is close to the OECD average of 15%, though in Norway it has fallen to 8%.

In Finland, women accounted for almost half of those who took the GMAT, an entrance exam for business schools, in 2012-13. Worldwide, the share was 43%, an increase of five points in a decade. In Norway, nearly two-fifths of board members for the largest listed companies are women, thanks largely to the introduction of mandatory quotas in 2008. that is twice the share in the European Union, which is considering bringing in quotas if the current voluntary approach fails.

At the bottom of the index are Japan and South Korea. Too few women there have jobs, few senior managers or board members are women and pay gaps are large – in South Korea, at 37%, the largest in the OECD. If, in the UN's words, "equality for women is progress for all", both countries have a long way to go.



(Source: *The Economist*, March 9, 2014)

Fig. 22.13 Not so grim up North (100-best for working women 2013 or latest)

In India (not shown in the Fig.) the glass ceiling is low, if one goes by some data. Only 6% of directors on the 1463 listed companies are women. Table 22.8 shows the number women expats in Indian companies.

Table 22.8 Female Expats (2005)

	2005	*% of women*
Wipro	43,880	24
TCS	43,681	21
Infosys	31,000	22
HCL Technologies	20,249	22
Satyam	20,000	20
Cognizant	13,000	28
Accenture	11,000	25
Patni	10,299	21
Polaris	5,980	19
i flex	4,688	20

An incident is worth recollecting in this context. When Arundhati Bhattacharya became CEO of SBI (first woman in the 208 years of the bank's history), her elevation became an issue – how to print her business card. She could not be called Chairperson as the Bank had provision only for Chairman, and not Chairperson. She now calls herself the Chairman.

From Feb 2014, presence of women in the boards of listed companies is mandated. Each listed company should have at least one woman as its director.

Summary

- Carrying the typical human resource activities across the globe is called international human resource management. (LO1)
- Increasing globalisation is accompanied by growing interest in international human resource management. (LO2)
- Essentially domestic human resource management and international human resource management are of same type. But risk factors, cosmopolitan outlook, more external influences and the like make the two different. (LO3)
- HRP, hiring, training, compensating, performance management, repatriation, managing expats are some of the functions of international human resource management. (L04)
- Life cycle of an expat proceeds on well defined stages: need assessment, selection, pre-depaturee training, managing culture shock, performance and repatriation. (LO5)
- Very few women are expatriated to overseas assignments. The phenomenon is universal, (LO6)

Review Questions

1. Define international human resource management. How does it differ from domestic human resource management? (LO1 and LO3)
2. What are the basic issues involved in recruiting and selecting managers for foreign assignments? (LO5)
3. Outline the main characteristics of the ethnocentric, polycentric, and geocentric approaches to international staffing? (LO5)
4. Why is performance appraisal important for international business? (LO4)
5. Bring out the major factors associated with appraisal of expatriate managerial performance. (LO4)
6. What are repatriation problems faced by international firms? How are they handled? (LO5)
7. Bring out the key issues in international employee relations. (LO4)
8. Explain the major activities of IHRM. (LO4)

Discussion Questions

1. How does the scope of a firm's internationalisation activities affect its HR activities? (LO1)
2. Which are easier to assess—business skills or interpersonal skills? Why? (LO5)
3. If you were being assigned to a foreign position, what specific training requests would you make of your employer? (LO5)
4. Why has there been an increasing use of third-country nationals in the foreign operations of MNCs? (LO5)

5. Why do expatriates return early? What can MNCs do to prevent this from happening? Identify and discuss three steps they can take. (LO5)
6. What selection criteria are most important in choosing people for an overseas assignment? Identify and describe the factors that you consider to be most important. (LO5)
7. What are the major common elements in an expat's compensation package? Besides basic pay, which would be most important to you? Why? (LO5)
8. What are the key differences in salary compensation for PCNs and TCNs? Do these differences matter? Discuss. (LO4)

Reinforcing Exercises

- The job of international HR manager is not always smiles and cosy. It involves making hard decisions, acting tough and staking even one's life. An American engineer Paul Johnson was beheaded in Saudi Arabia in June 2004. Two Indians – Kutty and Suryanaranana were kidnapped and killed in Afghanistan. In many countries kidnappings and terrorism are common. Now the international HR manager is expected to handle those and other similar actions. Do you think the international HR manager is responsible for the above actions?
- Coca-Cola is one company which is known for of international HRM. The soft drink major has operations in 200 countries and 80 percent of its earnings are generated outside of the US. Coca-Cola manages its global operations through 25 operating divisions that are organised under six regional groups. The corporate HRM function is charged with providing the glue that binds all the divisions and groups into Coca-Cola family. It achieves this in two ways: (1) by propagating a common HR philosophy within the company, and (2) by developing a group of internationally minded mid-level executives for future senior management responsibilities. You may compare this with the practice followed by Pepsi Co and draw conclusions.
- Kumar, with his wife and two sons, moved into Saudi as CEO of Dabur International. They got culture shock when they first arrived, and it took 7 to 8 months for the family to get over it. Getting acclimatised into Saudi is no problem as 53 percent of the people are Asian and majority are Indians. Though Saudi looks a homogeneus society but there are differences within. In all, Kumar and his family have a happy life in Saudi. Get more details covering the above
- Which is your choice? Why?
  - As a boss to women
  - As a subordinate to a woman
  - As a boss to men
  - As a subordinate to a man

CLOSING CASE 1

Doing Business in India: A Cultural Perspective

Joel stood by the windows of The Hilton and watched the lights twinkling in the harbour like tiny, glittering explosions of life. It was quarter past nine in Mumbai. Some Mumbaikers were unwinding by the beach dining at fresco, many were hurrying back home from work and the homeless were looking for a place to lay their heads for the night. The street below was bustling with activity and the loud, blaring sounds of rush hour traffic. He had landed in the subcontinent a few days ago and was now looking forward to a joint-venture with a mid-sized Indian organisation. Negotiations and meetings had happened over the past few days, but nothing concrete seemed to have been decided upon, yet. His future in this new, chaotic and strange land seemed bleak and unpromising. He couldn't seem to get a grip of events and was almost on the verge of calling it quits.

The Indian economy had been booming for the past few years. The country held great promise for the future. Liberalised foreign policies had unleashed the entrepreneurial spirit of its people, and many multinational organisations had set up offices here.

Joel and his associates had been very excited at the prospect of entering a joint venture with the Indian organisation and were optimistic about the outcome. Negotiations had started off quite well initially, but slowly, problems and misunderstandings arose as a detriment to finalising the deal. Joel had attended several meetings in the past one week and had expected a complete deal that morning, but it seemed like the Indians didn't feel rushed to come up with a workable deal and project plan. They had spent hours debating the objectives and long-term effects of the merger, but the discussions had rambled on and on further prolonged by the necessity of going back to their senior colleagues for approval. Joel, in his frustration, tried to speed up matters, as a lot more issues had to be addressed, but the Indians felt that he was only interested in finalising and implementing the deal. They also began to question his intelligence, abilities and sincerity. His informal way of addressing them also made them feel uncomfortable and not respected. All in all, they didn't really trust him and the deal that he was proposing.

Trust had become a central issue between Joel and his Indian counterparts. Joel began to doubt the Indian' capability of actually following through on the project and getting it done on time, hence, making them a viable business partner became a huge question mark. On the other hand, the Indians were uncertain as to whether or not they could trust Joel.

This lack of trust was mainly due to a cultural difference. If Joel knew that the Indians viewed time differently from the Americans, he would have been a lot more relaxed in his interactions. The Indians in turn, instead of viewing him as a pushy American only concerned about signing on the deal, could have been a lot more understanding about the American practical way of thinking and their approach to problem solving and project implementation. If either party were aware of how culture was a major factor in shaping business deals, they would have been able to adjust a little more and make each other more comfortable. This would have led to a sense of trust between them and business would have proceeded and the deal would have been negotiated to the satisfaction and benefit of all involved.

Our cultures define our fundamental beliefs about how the world works and form ways in which we interact and communicate with others and develop and maintain relationships. Doing business in a particular nation requires a focus on a multi-dimensional understanding of its culture and business practices. Understanding these differences and adapting to them is the key.

India is a complex country, and to do business here is often not very easy. The following tips will give them an idea of the working and business norms in practice here.

In the United States of America, efficiency, adhering to deadlines and a host of other similar matters are considered normal and to be expected. But, one needs to understand that one is dealing with people from a different cultural background, who think and interact differently. As a result, what is considered to be reasonable and feasible in the USA may not work here.

Aggressiveness can be interpreted as a sign of disrespect. This may lead to a complete lack of communication and motivation on the part of the Indians. One needs to take the time to get to know them as individuals in order to develop professional trust. Indians are very good hosts and will, therefore, invite you to their homes and indulge in personal talk often. All this is very much a part of business. One is expected to accept the invitation gracefully. Taking a box of sweets, chocolates or a simple bouquet of flowers would definitely be a welcome gesture. Indians respect people who value their family. They will allow family to take priority over work, whenever necessary.

Criticism about an individual's ideas or work needs to be done constructively, without damaging that person's self-esteem. As Indians are used to a system of hierarchy in the work-place, senior colleagues are obeyed and respected. Supervisors are expected to monitor an individual's work and shoulder the responsibility of meeting deadlines. Therefore, it is important to double-check and keep track of time. Educated Indians have learnt to adapt to Western methods of monitoring one's own work and completing it on schedule.

An Indian who hesitates to say 'no' may actually be trying to convey that he is willing to try, but it may be unrealistic in nature and therefore, it may not get done. It is important to create a safe and comfortable work environment where it is okay to say no and also okay to make mistakes without the fear of repercussions.

In a group discussion, only the senior most people might speak, but that does not mean that the others agree with him. They may maintain silence, without contradicting him (or you) out of respect for seniority. Westernised Indians on the other hand, can be quite assertive and direct and should be treated in the same manner. Politeness and honesty go a long way in establishing the fact that your intentions are genuine.

Women are treated with respect in the workplace. They feel quite safe and secure in most organisations. Foreign women working here will find it easy to adapt to an Indian work environment. They need to plan their wardrobe keeping in mind the conservative dress codes here.

Humour in the workplace is something that some Indians are not used to. Most traditional Indians are teetotalers/vegetarians, so their eating habits need to be respected. Westernised Indians are more outgoings and do socialise and drink (excessively at times).

The tips mentioned above may not apply to all situations, as India is a land of contrasts and each person you meet will be unique blend of Indian/ Western values. People from different socio-economic strata, educational backgrounds, class and religion may behave very differently.

For any expatriate, the pace, pressure and protocol of living, and working in a new country can be overwhelming, but there are positive aspects to living in India too, like the valued friendships that one makes with the Indians, the beautiful and exotic places to visit, the multi-varied cuisine to experiment with and the interesting things to buy. An expatriate who is prepared to accept the differences and make the necessary adaptations will definitely be greeted with the sweet taste of success in all business endeavors.

Questions

1. List out the inputs that could be included in the CCT for Joel and similar other expats.
2. What lessons can this case offer to IHR managers?

CLOSING CASE 2

Change and the Legacy of History: The Case of British Airways

Formed as a result of a merger and brought under public ownership in 1974, the British Airways (BA) was one of a number of national 'flag carriers' that dominated the airline industry in the 1970s. Its flagging reputation (the initials BA were said to stand for 'bloody awful') continued into the 1980s and efforts were made to achieve a major turnaround in performance and culture. The apparent success of these initiatives led the government to privatise a now profitable BA in 1987. However, while there had been much change at BA, this disguised the fact that it continued to operate long-standing features of collective industrial relations – a large number of trade unions, separate arrangements for collective bargaining, complex procedural arrangements for resolving individual and collective grievances and a history of industrial relations that had not always been harmonious.

An expanding market in the second half of the1980s meant that the company could pursue its 'customer first', quality enhancement strategy based on distinctive customer service, with little disruption. Cabin crew appeared to enjoy the new emphasis, which gave them more responsibility and influence within the company as well as frequent training opportunities. However, by the early 1990s, the trading context deteriorated and the company introduced cost cutting measures, targeting staff, which did much to undermine management-staff relations. These problems and specifically the tension between the 'customer service' strategy and the perceived need to reduce the cost base have continued throughout the 1990s and into the twenty-first century and have intensified since the appointment of the current Chief Executive, Willie Walsh, in 2005.

Walsh came to BA with a reputation for cost-cutting. At his previous company, Aer Lingus, he had cut the workforce by a third and on joining BA pioneered a string of initiatives to reduce what he saw as its high cost base. These have continued since and have included redundancies, pay freezes, new pay and conditions deals for new recruits, attempts to reform the pension scheme as well as a succession of attempts to change working practices. Furthermore, the development of Terminal 5 at Heathrow was seen by Walsh as a key element in removing what he has described as outdated working practices for airport staff, and this was followed in 2008 by the new 'Open Skies' initiative, which allowed BA to fly direct to the US from airlines outside the UK. The potential significance of 'Open Skies' is that it permits the company to use staff in other countries (Spain, Italy for example) but for them not to be covered by UK collective agreements.

In late 2009, as part of its continued cost-cutting, BA found itself in a further dispute with its workforce over attempted changes to working practices and the introduction of new staff rotas. The company made a £298 million loss in the first six months of 2009, and threatened that if a negotiated agreement over changes could not be achieved, it would impose changes unilaterally from the middle of November. In the same month it announced a merger with Iberia, the Spanish airline, although the deal remains dependent on BA dealing with aspects of its pensions deficit (which at year end 2009 stood at over £2,000 million)

Questions

1. To what extent do you feel BA is a 'prisoner of its past' in terms of its employee relations?
2. Why do you feel that employee relations retain the potential for so much conflict at BA? Does the strategy being pursued by the company make such conflict more likely? Give reasons for your answer.

(Source: Adrain Murton, etal, *Human Resource Management,* Hodder Education, 2011, p.141)

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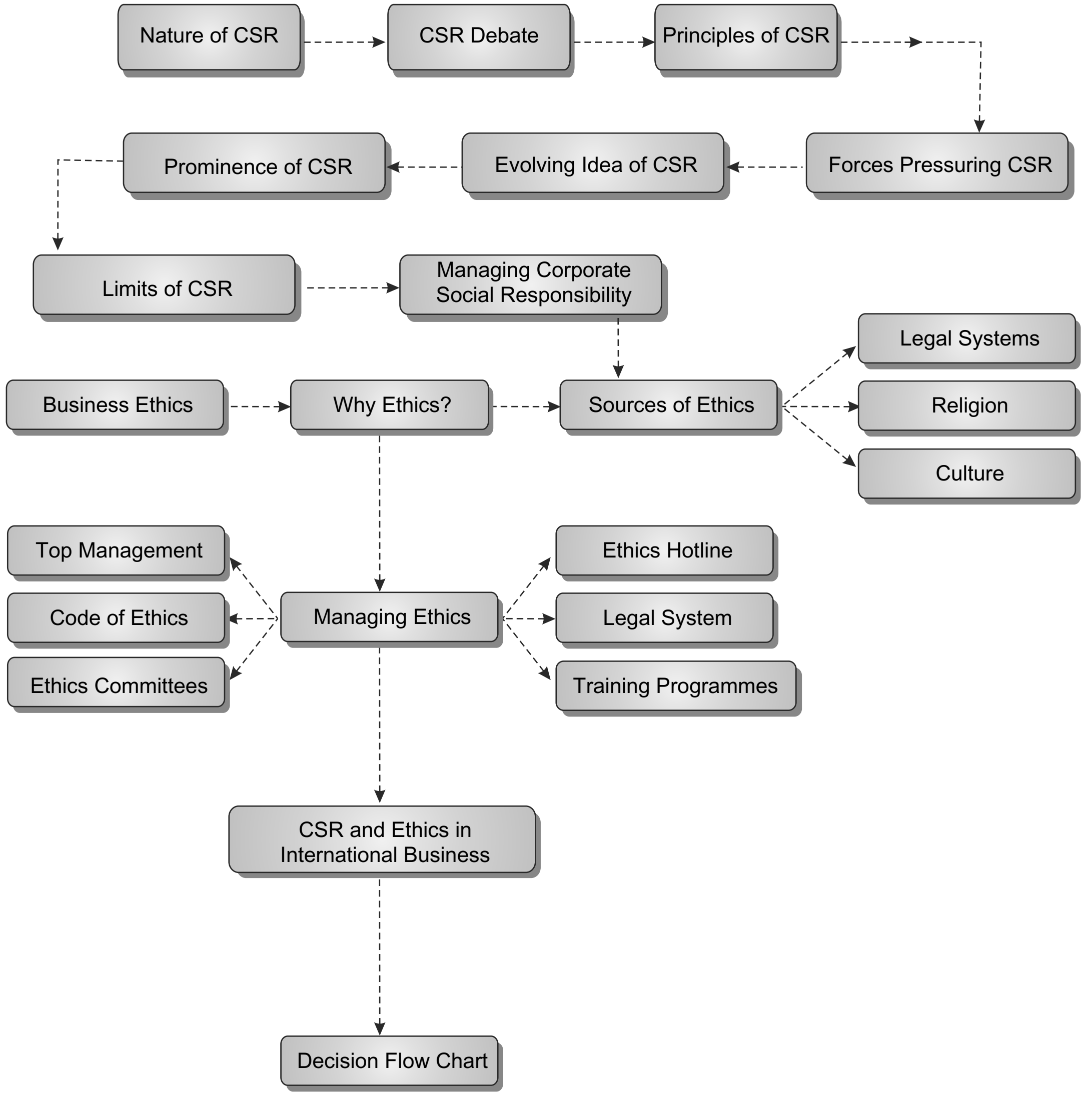
PART 5

CHAPTER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Social Responsibility and Ethics in International Business

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Assess the nature of social responsibility
- **LO 2:** Learn to debate for and against CSR
- **LO 3:** Recognise the principles of CSR
- **LO 4:** Understand the limits to CSR
- **LO 5:** Know how to manage CSR
- **LO 6:** Analyse business ethics, its sources and importance
- **LO 7:** Identify the role of social responsibility and ethics in international business
- **LO 8:** Categorise the national differences in ethics and social responsibility
- **LO 9:** Identify the code of conduct for an MNC
- **LO 10:** Analyse the decision flowchart for an MNC

Opening Case

The One-minute Moralist

Once there was a bright young businessman who was looking for an ethical manager.

He wanted to work for one. He wanted to become one.

His search had taken him over many years to the four corners of the business world.

He visited small businesses and large corporations.

He spoke with used-car dealers, chief executive officers of *Fortune 500* companies, management-science professors, vice presidents for strategic planning, and one-minute managers.

He visited every kind of office, big and small, carpeted and tiled, some with breathtaking views, some without any view at all.

He heard a full spectrum of ethical views.

But he wasn't pleased with what he heard.

On the one hand, virtually everyone he met seemed frank, friendly, and courteous, adamant about honesty even to the point of moral indignation. People were respectful of one another, concerned about their employees, and loyal to their own superiors. They paid their debts and resented the lawsuits in which they considered themselves the innocent party, victims of misunderstanding and anti-business sentiment. They complained about regulation and the implied distrust of their integrity. They proudly asserted that they were producing quality products or services that truly did satisfy consumer demand, making the world a better—even if only a very slightly better—place in which to live.

Their superiors were proud of their trustworthiness.

Their subordinated were confident of their fairness.

But, on the other hand, when they were asked for their views about ethics and business, what all of these people had to say was startling, to say the least.

The answers varied only slightly.

'You have to understand that it's a jungle out there!'

'Listen, I'm a survivor.'

'If I don't do it, the other guy will.'

"You've got to be realistic in this business."

'Profits—that's what it's all about. You do whatever you have to.'

And when our bright young businessman brought up the topic of business ethics, he invariably heard:

'There aren't any ethics in business'; or….

'Business Ethics—the shortest book in the world.'

The latter usually with a grin.

At the same time, however, many executives shook their head sadly and privately expressed the wish that it were otherwise.

He met a few unscrupulous businessmen who admitted cutting corners and making a profit and were proud of it.

He met others who had cut corners and were caught. "This is a cutthroat world," they insisted, often contradicting this immediately by complaining about the injustice of them being singled out.

He met several self-proclaimed ethical managers who insisted that everyone who worked for them—and, of course, they themselves—had to be perfectly virtuous, to the letter of the Moral Law.

These managers' subordinates generally despised them, and their departments were rife with resentment. More than one employee complained about autocratic management and dogmatic ineffectiveness; a philosophical assistant manager pointed out the difference between morality and moralising. Almost everyone pointed out that the principles that were so precisely printed out in both memos and plaques on their desks were usually impossible to apply to any real ethical issues. Their primary effect was, rather, to cast a grey shadow of suspected hypocrisy over everyday business life.

Our bright young businessman was discouraged. He could not understand why the conscientious, sociable, civilised, thoroughly ethical flesh-and-blood managers he met in the office talked, in their off moments, like the most cynical prophets of corporate Darwinism.

The flesh-and-blood managers complained that the public did not appreciate them.

The cynical prophets joked, 'There are no ethics in business,' and then wondered why people didn't trust them.

Our bright young businessman was perplexed: Could there be ethics in the real business world? He wondered. Were compromises and cuting corners inevitable? He asked. Did the untrammeled pursuit of virtue have to be either hypocrisy or damaging to the bottom line, as he now feared?

And then he met the One-Minute Moralist.

The bright young businessman presented the One-Minute Moralist with his dilemma.

The One-Minute Moralist answered him without hesitation.

'You don't understand ethics,' he said. 'And you don't understand business either.

'You set up an absurd dichotomy between

ethical absolutism and the so-called real world, and then you wonder how ethics can possibly be at home in business, and whether business can function without cutting corners and making uneasy compromises. But cutting corners presumes that there are sharply delineated corners. And talking so uneasily of compromise (that is, compromising one's moral principles rather than compromising with other people) seems to assume that ethics consists of engraved principles rather than relations between people who (more or less) share values and interests.

'But ethics isn't a set of absolute principles, divorced from and imposed on everyday life. Ethics is a way of life, a seemingly delicate, but in fact very strong, tissue of endless adjustments and compromises. It is the awareness that one is an intrinsic part of a social order in which the interests of others and one's own interests are inevitably intertwined. And what is business, you should ask, if not precisely that awareness of what other people want and need, and how you yourself can prosper by providing it? Businesses, great and small, prosper because they respond to people, and fail when they do not respond. To talk about being "totally ethical" and about "uneasy compromises" is to misunderstand ethics. Ethics is the art of mutually agreeable tentative compromise. Insisting on absolute principles is, if I may be ironic, unethical.

'Business, on the other hand, has nothing to do with jungles, survivalism, and Darwin, whatever the mechanisms of the market may be. The "profit motive" is an offensive fabrication by people who were out to attack business, which has curiously—and self destructively—been adopted by business people themselves. Business isn't a single minded pursuit of profits; it is an ethos, a way of life. It is a way of life that is at its very foundation ethical. What is more central to business—any kind of business—than taking contracts seriously, paying one's debts, and coming to mutual agreements about what is a fair exchange? Ethics isn't superimposed on business. Business is itself an ethics, defined by ethics, made possible by ethics. Two hundred years ago, Benjamin Franklin insisted that business is the pursuit of virtue. If you find yourself wondering or doubting whether virtue is possible in business, I suggest you reexamine your ideas about business.

'If you want to talk about hypocrisy, by the way, it is not just to be found in such bloated phrases as "the untrammeled pursuit of virtue". There is just as much hypocrisy in the macho, mock-heroic insistence that business is a tough-minded, amoral struggle for survival and profits rather than a staid and established ethical enterprise.

'Now you've had your Minute. When you think about business and ethics, don't worry about whether one is possible along with the other. In America, at least, nothing is more ethical than good business.'

THE opening case aptly sums up the state of business ethics today. The corporate world is full of bright young businessmen and one-minute-moralists.

This chapter examines ethical issues in their proper perspective. Before that, we propose to discuss the related topic—corporate social responsibility.

SOCIAL RESPONSIBILITY

LO 1
Assess the nature of social responsibility

Social responsibility, also known as corporate social responsibility (CSR), is understood as the obligation of decision-makers to take actions that protect and improve the welfare of society as a whole along with their own interests. Every decision the business person makes and every action he or she contemplates has social implications. Be it deciding on diversification, expansion, opening of a new branch, closure of an existing branch, or replacement of men by machines, the society is affected in one way or the other. Even routine matters like overtime and night shifts, sub-contracting, outsourcing, and laying off employees due to fall in demand have a social impact. Whether the issue is significant or not, the manager should keep his or her social obligation in mind before contemplating any action.

What is significant is that CSR makes a corporation accountable for any of its actions that affect people, their communities, and their environment.

What is equally significant is the fact that CSR extends beyond its regular activities that are carried out in a lawful manner. The social actions which a firm undertakes in the name of its CSR occur "beyond the factory gate" and will benefit the society in general. Successful companies need a healthy society. Education, health care, and equal opportunity are essential to a productive workforce. Safe products and working conditions attract customers and minimise the costs of accidents. Efficient utilisation of land, water, energy and other natural resources make businesses more productive. Ultimately, a healthy society creates additional demand for business, as more human needs are met and aspirations grow. Any business that pursues its ends at the expense of the society in which it operates will find its success to be illusory and short-lived.

A healthy society needs successful corporations. No social programme can rival the business when it comes to creating jobs, wealth, and innovation that improve standards of living and social conditions.

How does CSR differ from charity? Charity or philanthropy refers to an idea that a wealthy individual should be bountiful to the weak and poor in the society. Poor feeding and donations to temple construction constitute charity. Charity is undertaken to redeem **Karma,** a wealthy person has inherited because of misdeeds in his or her previous birth, or to accumulate **Punya** for the next birth. Charities are generally occasional, cheque-book oriented, and their end use is not monitored.

Unlike philanthropy, CSR is inspired not by self interest but the motive is the interest of the organisation. Maintaining schools, donating computers to village schools, adopting villages, promoting greenery and contributing to ecology and the like, benefit society and in turn help contribute to the growth of healthy businesses. Social actions of businesses are being systematised, are periodic and the end uses are subject to social audit.

THE CSR DEBATE

There are arguments for and against business's social responsibility. While there are Friedman, Peter Drucker and Dhirubhai Ambani who do not subscribe to CSR there are more number of people—business, government and academic—who advocate social actions. Knowledge on the debate is useful for any individual to make better judgement of social actions.

LO 2
Learn to debate for and against CSR

Arguments for CSR

There are many arguments in support of socially responsive actions. The more important of them are explained below (see Fig. 23.1).

(1) Changed Public Expectations of Business One of the most potent arguments for social responsibility is that public expectations from business have changed. It is reasoned that the institution of business exists only because it satisfies the valuable needs of society. Society gives business its charter to exist, and the charter can be amended or revoked at any time that the business fails to live up to society's needs and give the society what it wants.

Arguments for CSR	Arguments against CSR
• Changed public expectations	• Profit maximisation
• Better environment for business	• Society has to pay the cost
• Balance power with responsibility	• Lack of social skills
• Business has resources	• Business has power
• Prevention is better	• Social overhead cost
• Moral responsibility	• Lack of accountability
• Globalisation	• Lack of broad support
• Better employees	• Experts' views
• A way to resolve conflict	• Scalability of the concept
• DNA of an organisation	

Fig. 23.1 The Pros and Cons of CSR

(2) Better Environment for Business Another argument favouring social responsibility is that it creates a better environment for business. This concept rationalises that a better society produces environmental conditions more favourable for business operations. The firm that is most responsive to the improvement of community quality of life will, as a result, has a better community in which to conduct its business. Labour recruiting will be easier, and labour will be of a higher quality. Turnover and absenteeism will be reduced.

As a result of social improvements crime will decrease, with the consequence that less money will be spent to protect property, and less taxes have to be paid to support police forces. The arguments can be extended in all directions to show that a better society produces a better environment for business.

(3) Balance of Responsibility with Power Another argument for social responsibility is that the business's responsibility should be more related to its power. It is reasoned that businesses has vast amounts of social power. They do affect the economy, minorities, and other social problems. In turn, an equal amount of social responsibility is required to match their social power. If each institution is to perform its social role in an orderly relationship with other institutions, then responsibility must be accepted whenever there is power. Any other arrangement invites irresponsible behaviour.

(4) Business has the Resources Another argument for social responsibility is that business has a vast pool of resources in terms of men, talents, functional expertise, and deep pockets. Probably, business is without peers in respect of the resources it possesses. With these resources at its command, business is in a better position to work for social goals.

(5) Prevention is Better than Cure Another argument is that prevention is better than cure. If business delays dealing with social problems now, it may find itself constantly occupied with putting out social fires so that it has no time to accomplish its goal of producing goods and services. Since these social problems must be dealt with at some time, it is actually more economical to deal with them before they develop into serious social breakdowns that consume most of the management's time.

In India, CSR is mandated now. Every profitable company needs to spend atleast two percent of its profits on social activities.

(6) Moral Responsibility It is said that the acceptance of corporate social responsibility is morally the correct position. This notion suggests that our modern industrial society faces many serious social problems brought on, to a large extent, by MNCs. The corporations therefore have a moral responsibility to help solve or ameliorate these problems. It is this moral obligation that made Toyota recall 9.3 million vehicles since 2004 from the US and Japan. In July 2007, the CEO of Toyota Kaesnaki Wataneble even deeply bowed before public in apology. A corollary to this notion is that because business firms control so many of the resources in an economy, they should devote some of these resources to the overall betterment of society.

There is no gainsaying the fact that criticism of business is far-reaching. The criticism is evidenced by protests at global meetings—the Seattle meeting of the WTO in 1999, for example—as well as the actions targeting individual firms. In 2002, the accounting and governance in scandals associated with Enron, WorldCom, and other major corporations have further contributed to this criticism.

Time it is for business to become more socially responsive and accountable.

(7) Globalisation The recent globalisation of large corporations has led to firms increasingly operating in countries with very different, and generally, much lower standards of living than found in their respective home countries. More extensive media reach coupled with advances in information technology (e.g., NGO use of web sites) has allowed rapid and widespread exposure of alleged corporate abuses even in the remote parts of the globe. Both Shell (oil spills in Nigeria exposed on television documentaries) and Nike (exposure of sweatshop labour conditions in its subcontractor operations in developing countries) have learnt at their cost. Such revelations compel global firms to undertake social actions.

Failure to undertake social actions may dent the reputation and brand image of the firms. In fact, companies are likely to be penalised by consumers and other stakeholders for actions that are not considered socially responsible.

(8) Better Employees As stated earlier, labour hiring becomes easier for a socially responsible firm. Employees prefer to work for more socially responsible firms. It is well-known that tobacco companies find it difficult hiring the best talent. This has become more widespread, particularly in tight labour markets as potential and current employees value the corporate social performance of their employers.

(9) A Way to Resolve the Conflict Profit seeking firms often face a conflict between distributive and wealth creating activities. This conflict can often be resolved by invoking CSR. One way is to argue for the 'business case' for social responsibility, where the short-term costs of CSR are contrasted with its expected long-term benefits. In otherwords, if philanthropy is 'doing good to do good', the business case for CSR can be expressed as 'doing good to do well'.

(10) Organisation's DNA DNA of an organisation tends to change, thanks to CSR. CSR awakens the power of inclusion and voluntarism among employees, which rub off on the way they approach the work. They build a higher sense of purpose, see themselves as agents of change, take charge of their tasks and environment, and in some cases even drop the possibility that has so far caused them to view a working day as two swipes and a lunch. At the same time, voluntarism connects the like-minded people. Jamsetji was passionate, warm, humble and driven. These qualities have been encoded in the DNA he passed down to his sons and successors as well.

Arguments Against Social Responsibility

Arguments against social responsive actions are equally strong. Some arguments are as follows:

(1) Profit Maximisation The first and the most forceful argument disfavouring social responsibility is that business has profit maximisation as its main objective. Infact, the business is most socially responsible when it attends to its interests and leaves other activities to other institutions. Since business operates in a world of poverty and hunger, the economic efficiency of business is a matter of top priority and should be the sole mission of business. Business's function is economic, not social, and economic values should be the only criteria used to measure success. In this kind of system, managers are the agents of the stakeholders and all their decisions are controlled by their desire to maximise profits for the stakeholders while reasonably complying with law and social custom.

(2) Society has to Pay the Cost Another argument is that the costs of social responsibility will be passed on to the society, which must bear them. Can the society afford these additional costs? That society has to bear the cost has counter argument. Often, consumers refuse to buy ethically produced products, in which case, the company has to bear the burden.

(3) Lack of Social Skills Managers are best at managing matters relating to business. They are not equally good at solving social problems. Their outlook is primarily economic and their skills are the same. They really do not feel at home in social matters. If society is going to depend on someone to work with social problems, why choose a group which is so poorly qualified? Does society really want economic and technical people meddling in social affairs? Will they broaden their outlook and will their skills transfer? Can business really do the job? Is it better equipped than the government and other institutions?

(4) Business has Enough Power That business has enormous power is a known fact. This power means that every action the business takes could affect the quality of human life—for individuals, for communities, and for the entire globe. This obligation is often referred to as the **iron law of responsibility**. The iron law of responsibility says that in the long run, those who do not use power in ways that society considers responsible will tend to lose it. With such technology as global computer networks, instantaneous commercial transactions, and exponentially increasing collection and storage of information drawing the world into a tighter global village, the entire planet has become a stakeholder for all companies. All societies are now affected by corporate activities. Adding social responsibility to business means making it much more powerful.

(5) Social Overhead Cost Cost on social responsibility is considered to be a social cost, which will not immediately benefit the business. Why spend money on an object, the benefits of which will be realised only in the future? It is the heavy social overhead cost that is one of the reasons for the dismal performance of some of India's government undertakings.

(6) Lack of Accountability Another point of view is that the business has no direct accountability to the people, therefore, it is unwise to give business responsibility for areas where they are not accountable. Accountability should always go with responsibility, and it is poor social control to allow any other kind of arrangement. Until the society can develop mechanisms that establish direct lines of social accountability from business to the public, business must stand clear of social activities and pursue only its goal of profit where it is directly accountable through the market system.

(7) Lack of Broad Support Another point is that business involvement in social goals lacks support from all groups in society. If business does become socially involved, it will create so much friction among dissident parties that business cannot perform its social assignment. Although many persons desire business to become more socially involved, others oppose the idea. There is lack of agreement among the general public, among intellectuals, in the government, and even among business people themselves.

(8) Friedman and Levitt's Views The most cogent criticism has been voiced by the economist Milton Friedman. Friedman based his arguments on two principal contentions, one economic and one legal. From the economic perspective, he asserted that if managers spend corporate funds on projects not intended to maximise profits, the efficiency of the market mechanism will be undermined and resources will be misallocated within the economy. On the legal side, Friedman contended that because managers are legal agents of the stakeholders, their sole duty is to maximise the financial return to the stockholders. Hence, if they spend corporate funds for social purposes, they are essentially stealing from the stockholders. Moreover, Friedman suggested that if the stockholders want money spent on social causes, they are free to do so individually with their dividends.

Theodore Levitt argued against corporate social responsibility fearing that business values might come to dominate society. He posited that business as an institution, would become the present century equivalent of the medieval church—the all-embracing institution in society. He suggested that this would not be healthy for society.

9. Scalability of the Concept There appears to be no genuine concern for CSR from MNCs. Much of the CSR behaviour of MNCs has been characterised more by an avoidance of the stick than reaching for the carrot. The main problem with CSR is the scalability of the concept, given the limited size of the 'market for value'. If certain firms in some markets make significant improvements in labour and environmental standards in a way that is commercially viable, it does not mean that the same firms can do so in different markets, let alone that other firms would be able to do the same.

GENERAL PRINCIPLES OF CSR

LO 3
Recognise the principles of CSR

CSR does not carry any norms or benchmarks. Each firm can have its own practices. Nevertheless, all the firms need to observe the following principles:

- ***Corporations are economic institutions*** Corporations are business entities and their primary business is business. Their success is measured in terms of turnover, profit and growth. However, corporations must incur short-run costs to correct social problems that threaten long-term sustainability. Solving social problems can be profitable.
- ***Firms must observe multiple bodies of law*** including (i) the civil and criminal laws of nations, (ii) corporate laws and chartering provisions, (iii) bodies of regulation that protect stakeholders and (iv) international laws. However, obeying the law is a minimum. Law is reactive and lags behind emerging norms and duties.
- ***Firms have a duty to correct social disruptions they engender*** Corporations should bear the cost of adverse social actions. A factory letting untreated effluents into lakes, rivers, and open space is disrupting the ecology. It is the duty of the industrial establishment to treat the effluents before letting them out, even if the treatment adds to the cost.
- ***Social responsibility varies with company characteristics*** such as size, industry, strategies, marketing techniques, locations, culture, stakeholder's demands and manager's value. An MNC's social actions cannot be the replication of a domestic firm and the latter cannot afford to do what an international business does.
- ***Legitimate needs of stakeholders are a must.*** A firm has several stakeholders (see Fig. 23.2).

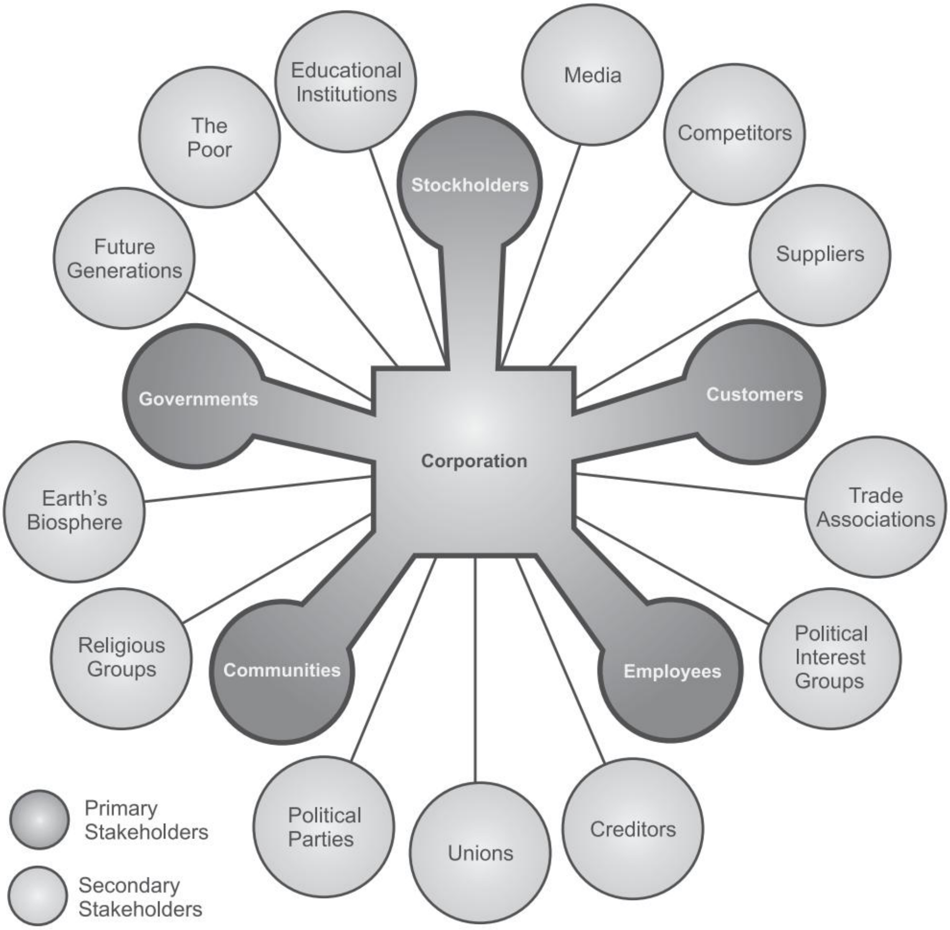

Fig. 23.2 Stakeholders of a Firm

(*Source*: George A. Stenier and John F. Stenier, *Business, Government and Society*, P.17)

But four of them are fundamental for a business and hence must be satisfied. The primary stokeholders are: customers, shareholders, government and employees. At times, multiple interests of stakeholders clash in which case the firm needs to set priorities.

- ***Corporate behavior must comply with norms in an underlying social contract*** To understand this contract and how it changes; managers can study the direction of national policies and global norms as evidenced in legislation, regulations, treaties, trade agreements, declarations and public opinion.

Prominence of Social Responsibility

Counter arguments notwithstanding, social responsibility has come to stay. In its *1981 Statement of Corporate Responsibility,* the Business Round Table, a group of 200 leaders of large corporations, said that the pursuit of profit and assumption of social responsibility were not incompatible. Social responsibility has been one of the leading topics at the World Economic Forum (WEF) meetings in 2003. A report from the WEF observes that Corporate Competitiveness, Corporate Governance, and Corporate Citizenship, and the linkages among them, will play a crucial role in shaping the agenda for business leaders in the coming decade. Similarly, the World Business Council for Sustainable Development (WBCSD), a coalition of 120 international businesses, refers to the increasing call for firms to assume wider responsibilities in the social arena and claims that social responsibility is firmly on the global policy agenda. Among the many other organisations that are advocating greater attention to social responsibility are the Business for Social Responsibility (BSR) and Business in the Community (BITC).

The UK government has appointed a minister for social responsibility. The European Commission adopted a new strategy on social responsibility in July 2002 which reads thus: 'Many businesses have already recognised that social responsibility can be profitable and social actions have mushroomed. However, the EU can add value in atleast two key ways: by helping stakeholders to make social responsibility more transparent and more credible, and by showing that social responsibility is not just for multinationals—it can benefit smaller businesses too.

Indian companies are not lagging behind in undertaking social actions. More details are provided latter in this chapter.

The Evolving Idea of Social Responsibility

The social responsibility idea evolved over a period of time. Some major stages in the long history are outlined here.

Business Social Responsibilities in Classical Economy Theory Throughout history, the classical economic theory has been the fundamental inspiration of people in business. In the classical economic view, a business is acting in a socially responsible fashion if it utilises resources as efficiently as possible to produce goods and services that society wants at prices consumers are willing to pay. The sole objective of business is to maximise profits while operating, of course, within the law. If this is done, say classical theorists, firms carry out their major responsibility.

This easily understood goal, derived from Adam Smith's *Wealth of Nations,* was never sought in business practice without reservations. Even Adam Smith voiced a surprising number of exceptions to his principles for social reasons. Throughout our history, business and business people have modified the strict profit maximisation principle to address social concerns—not much at first, but more and more over time. Nevertheless, today, this fundamental classical ideology remains entrenched.

The Eighteenth and Nineteenth Centuries In the colonial era, businesses were very small. Merchants practised thrift and frugality, which were dominant virtues then. But charity was a co-existing virtue and the owners of these small enterprises made contributions to schools, churches, and the poor.

In the early nineteenth century, companies were not effusive in their social concerns. Charitable contributions continued and grew over time as great fortunes in business were made. In most cases, wealthy entrepreneurs who gave their fortune to benefit society did so without any reference to the interests of the companies that were the fountainheads of their wealth.

For instance, John D Rockfeller, who accumulated a fortune in the second half of the nineteenth century, gave in his lifetime, more than $550 million and endowed the Rockfeller Foundation *"to promote the* *well-being of mankind throughout the world."* Andrew Carnegie gave away $350 million during his lifetime to social causes, built 2,811 public libraries, and gave 7,689 organs to American churches.

Changing Views of Social Responsibility in the Late Nineteenth and Early Twentieth Centuries During the latter part of the nineteenth century and into the twentieth, a number of forces converged to lead business leaders, especially of the larger corporations, to address social problems out of self-interest. Vigorous industrial growth has many negative social impacts. Business feared new government regulations and sought to blunt their urgency. Business leaders, many of whom by this time were not the original entrepreneurs, but owned only a small part of the stock of the companies they managed, felt freer to use corporate assets for social action. Business sought and found arguments to circumvent the *ultra vires* doctrine.

By the 1920s, three inter-related themes had emerged to justify broader business social responsibility. First, managers were *trustees,* that is, agents whose corporate roles put them in positions of power where they could enhance the welfare of not only stockholders, but others such as customers, employees and communities. Secondly, managers believed they had an obligation to *balance* the interests of these groups. They were, in effect, coordinators who reconciled the competing claims and multiple stakeholders on their enterprises. And thirdly, many managers subscribed to the *service* principle, a principle with two distinct definitions. One definition was a near-spiritual belief that business, simply by operation for profit, had the power to redeem society by creating a broad general welfare. If individual managers served society by making a business economically successful; the aggregate business system would then work to eradicate social injustice, poverty, and other ills. A second understanding of the service principle, however, was that although the capitalist system elevated humanity, individual companies and managers were still obligated to undertake social programmes to benefit or serve the public.

These three inter-related ideas—trusteeship, balancing of interests, and service—were accepted by more and more business and opinion leaders. Although uplifting, they did not foster lavish contributions for social programmes, nor did they divert most individual managers from their laissezfaire attitudes and dominant emphasis on profits.

The Contemporary View of Social Responsibility In the last forty years, the concept of business social responsibility has continued to evolve and expand. Today, the efficient use of resources to make profit is still seen as the primary social responsibility of business. But added to economic performance are the ideals of previous eras about the meaning of social responsibility. The view that total social responsibilities are broader than economic responsibilities has become more compelling, more accepted by managers and more widely put into practice than ever before.

The range of social programmes assumed by business has continuously expanded since the early years of the century. Today, corporations carry out a wide array of social actions. The span includes programmes for education, public health, employee welfare, housing, urban renewal, environmental protection, resource conservation, day-care centres for working parents and many others. In each of these areas, the programmes that different corporations have implemented run into thousands.

The fundamental reason why the concept and range of social responsiblities have expanded is that accelerating industrial activity continuously changes society. In this situation, social responsibilities arise from the impacts of corporate actions on society. And we know more today about adverse consequences of some business activities. For example, early in this century, carcinogens in industrial effluents were unknown.

Corporate social programmes also arise from a second source—intractable social problem in the corporation's environment. *"A healthy business and a sick society are hardly compatible,"* noted Peter Drucker. Racism, wars, violent crime, epidemics such as AIDS and failing schools are societal pathologies a corporation has not caused but may benefit from mitigating.

Forces Pressuring Social Responsiveness

Not all firms are vulnerable to social group pressures and social regulations. Only some firms are pressured to undertake social responsibility actions. The forces that make firms become socially responsive are: government, community interests and demands, environmental concerns, competitive pressures, shareholder/investor pressures, philanthropic requests and initiatives and crises (see Fig. 23.3).

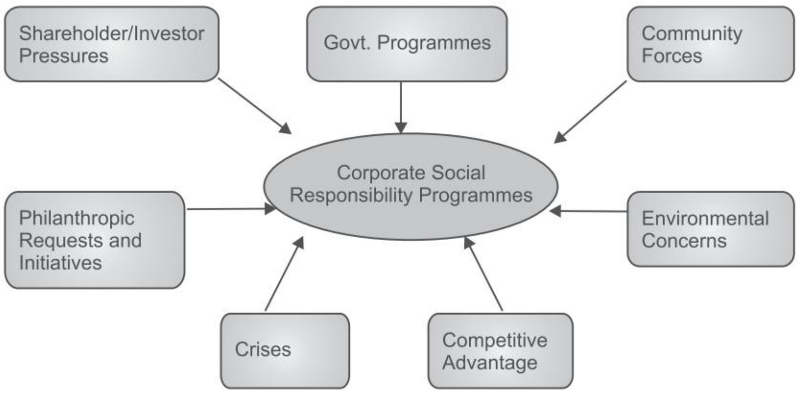

Fig. 23.3 Pressures Leading to Social Responsibility

Government Programmes Government (foreign and domestic) are the most significant forces pressuring firms for social actions. Most government pressures concern compliance with existing regulations. But governments are also major sources of potential rules, a fact which businesses need to take note of. Governments ask businesses to volunteer to help them solve their problems.

Governments mandating social actions are not new. In the 1300s, for example, Londoners who violated the city's smoke pollution ordinances were beheaded. In the US, laws that regulated the purity or quality of certain goods date from colonial times and state and federal efforts to control water pollution began in the late 1800s.

Foreign governments exert pressures on international businesses to abide by codes of conduct that they and international organisations have drafted. These codes expect businesses to respect human rights and social justice, pay fair wages, protect the environment, ensure safety and health of workers, improve worker living conditions, and behave ethically.

Community Interests and Demands Firms undertake many programmes that benefit society in general, not necessarily favouring stakeholders. Programmes can range widely, from helping rebuild disadvantaged sections to providing executive talents to run government undertakings.

MNCs from the US undertake a wide range of programmes in foreign countries, for example, creating scholarships for poor but deserving students from Korea, Malaysia, and Mexico, to pursue higher studies.

Environmental Concerns Environmental programmes of firms mainly result from standards established by government agencies. The Government of India, for example, enacted the Environment Protection Act 1986. The main objective of the Act is to protect and improve the environment and the prevention of hazards to human beings, other living creatures, plant and property. Pollution Control Boards set up under the provisions of the Act, have laid down norms that firms are expected to comply with.

Competitive Advantage Firms believe that by undertaking social actions, they can gain competitive edge. Realising this, corporations spend huge sums on social responsibility projects. US corporate spending on social responsibility shot up from $125 million in 1990 to an estimated $828 million in 2002. Additionally, spending on arts sponsorship amounted to $589 million in 2001.

Competitive advantage comprises four interdependent factors: factor conditions, demand conditions, related and support industries, and context for strategy and rivalry. (see Fig. 23.4)

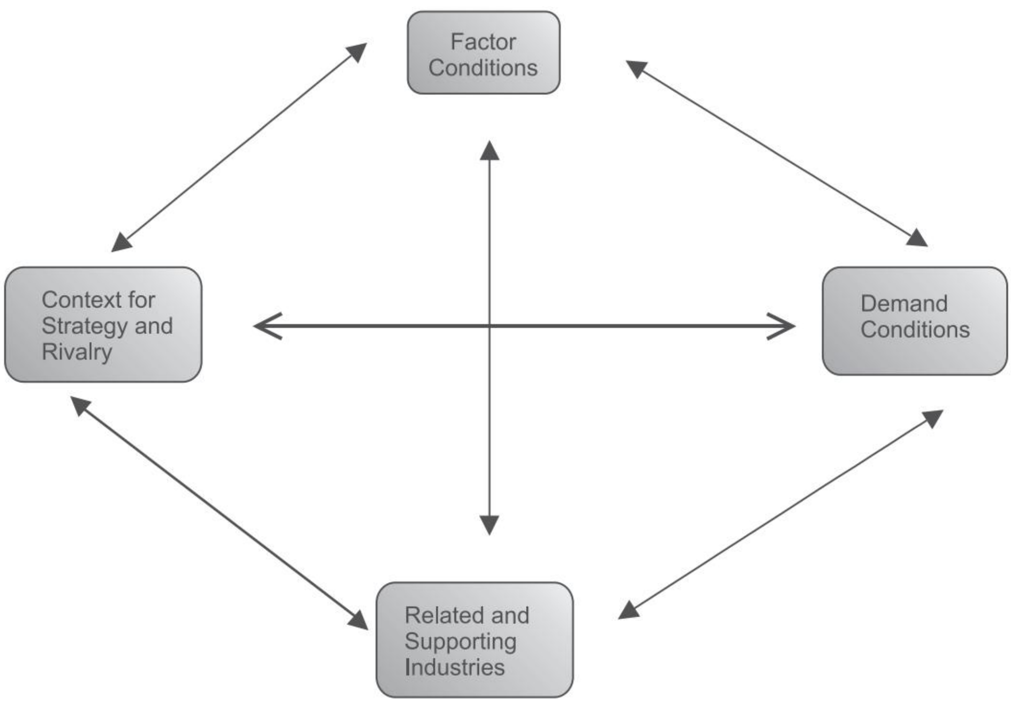

Fig. 23.4 Four Elements of Competitive Strength

(*Source*: Adapted from Michael E. Porter and Mark R. Kramer, p. 60)

Factor Conditions These include the availability of trained workers, high quality scientific and technological institutions, adequate physical infrastructure, transparent and efficient administrative processes, and natural resources. All these are the areas that social responsibility actions can influence.

Demand Conditions Demand conditions in a country or region include the size of the local market, the appropriateness of product standards, and the sophistication of local markets. Sophisticated local customers enhance the region's competitiveness by providing firms with insight into emerging customer needs and requisite pressure for innovation.

Social actions can influence both the size and quality of the local market. Apple Computer has donated computers to schools as a means of introducing its products to young people. This provides a clear social benefit to the schools while expanding Apple's potential market and turning students and teachers into more sophisticated purchasers.

Related and Supporting Industries Productivity of a firm can be greatly enhanced by the availability of high quality industries and services within easy reach. While outsourcing from distant suppliers is possible, it is not as efficient as using capable local suppliers of services, components, and machinery. Proximity enhances responsiveness, exchange of information, and innovation, in addition to lowering cost on transportation and inventory.

Social responsibility can foster the development of clusters and strengthening of supporting industries. American Express, for example, depends on travel-related spending for a large share of its credit card and travel agency revenue. Hence, in each of the countries in which it operates, it depends on the success of the travel clusters for improving the quality of tourism as well as attracting more travellers.

Context for Strategy and Rivalry The rules, incentives, and norms governing competition in a nation or region have a fundamental influence on productivity. Policies that encourage investment, protect intellectual property, open local markets to trade, break up or prevent the formation of cartels and monopolies, and reduce corruption make a location a more attractive place to do business in. Social responsibility can also have a strong influence on creating a more productive and transparent environment for competition. For example, 26 corporations from the US and 38 from other countries have joined to support Transparency International in its work to disclose and deter corruption around the world. By measuring and focusing public attention on corruption, the organisation helps create an environment that rewards fair competition and enhance productivity. This benefits local citizens while providing sponsoring companies improved access to markets.

Shareholders/Investors Pressures Large shareholders such as pension funds have long-range interests in the financial success of their investments. Some of them, obviously, exert pressure on firms to respond appropriately to community social interests. For example, shareholders of Pepsi Co launched a campaign to force the company to pull out of Myanmar because of the human rights violation of the military regime in that country. Pepsi Co did oblige the shareholders.

Philanthropic Requests and Initiatives As government funding for charitable causes has been declining, there is pressure on the corporate sector to fill the gap, to which, the firms have been responding positively.

Crises Firms that do not plan to deal with crises may suffer seriously. So crisis management is an area where proactive preparation may prevent a crisis or deal with it effectively if it comes.

LIMITS OF SOCIAL RESPONSIBILITY

LO 4
Understand the limits of CSR

The social responsibility actions of business are limited by cost, efficiency, relevance, and scope (see Fig. 23.5). As a result of these constraints, social responsibility actions fall short of public expectations.

Cost Social responsibility costs money. Whether a firm desires to adopt a village, donate to a college

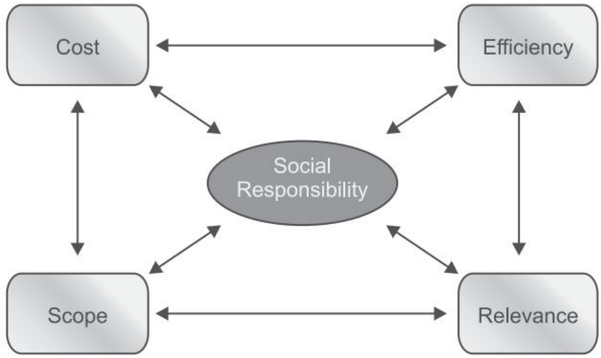

Fig. 23.5 Limits of Social Responsibility

or school, built a hospital or undertake relief operations in times of calamity, it costs money (see Exhibit 23.1 for details) and the money could be used for welfare of employees for improving business. As worthy as some social actions may be, they do impose costs either on the business or on some groups in society, or both.

Exhibit 23.1

RELIEF OPERATIONS—THE COST

Corporate India, as expected, rose to the occasion once again when Gujarat was rocked by a devastating earthquake in January 2001. Be it the Tatas, Ambanis, Ruias, Lalbhais, Mehtas, Adanis, Amins, and of course, the IT industry, all of them pressed into service, their personal fixed-wing and rotor aircraft. Besides, jeeps, cranes, bulldozers, and ambulances were mobilised, doctors were pressed into service, hospitals were erected and relief camps were organised to provide food and drinking water to the affected.

Reliance Chairman Dhirubhai Ambani visited the affected areas and wrote to the Prime Minister expressing his grief. Stressing that his company's emotional bonds with Gujarat and its people are deep and abiding, he pledged Rs 15 crore to alleviate the suffering of the victims. His elder son Mukesh flew to Ahmedabad to personally handover a cheque for Rs 5 crore to Vajpayee. Besides, Reliance is assuming the relief and rehabilitation responsibilities for Anjar, 46 km from Bhuj, with a population that had once been 80,000. It was famous for its block-printing works, nutcrackers, scissors, and penknives. More than 3,000 Reliance staffers are working round the clock to rebuild Anjar.

Tata Group Chairman Ratan Tata addressed a letter to all his employees, urging them to support the victims by donating blood, food, medicines, or personal contributions. Individual Tata companies and the group as a whole are providing relief supplies and funds, he added. He also constituted a Tata Relief Committee to ensure that contributions reach only the deserving. The Tatas also pressed into service the Lifetime Express, a mobile hospital train that travels to rural areas to aid affected people.

The Essar Group, with an equally high presence in Gujarat, had its Chairman Shashi Ruia visit the stricken district town of Surendranagar, 282 km from Bhuj, and declare his company's resolve to adopt Bhachau. "We have large investments in Gujarat and deem it our duty to provide as much relief as possible during this crucial period," he notes. "We are also involved in relief work in Jamnagar's

Nani Math village in Jodiya taluka, which has been completely devastated, and in Surendranagar we propose to build 1,500 houses to accommodate 7,500 people."

GNFC has installed VSATs at Bhuj and Anjar to provide communication facilities, Zydus Cadila has set up a 24-hour control room for free medical aid, the Hinduja Foundation has earmarked Rs 5 crore towards relief, and Blue Dart has kept one aircraft in Delhi as standby. LIC, which has claims of Rs 60 crore, has set up a special cell in Ahmedabad. It has also relaxed norms regarding death certificates by accepting death certificates issued by local authorities. L&T has committed Rs 5 crore towards reconstruction of houses. Air-India director Jitendar Bhargava says the airline has made its flights available for ferrying relief material from across the country and is also providing free air travel to people working for recognised relief organisations. "Our employees are donating a day's salary and the senior management is contributing Rs 5,000–10,000 each towards the PM's relief fund," he adds.

Efficiency The cost of social responsibility can reduce a firm's efficiency and affect its ability to compete in the market place. For example, if a firm is pressured by a local community to keep an outmoded, inefficient plant in operation because closing it would mean loss to local people, while its competitors close their old plants and move operations to other countries to take advantage of lower wages there, the business would not survive at all. The managers who place interests of local employees before the firm's survival, cannot face more efficient competitors.

Relevance According to several critics and as stated earlier, business has no obligations to society. The only obligation is to run the business successfully. Social responsibility is irrelevant. According to Friedman, for example, *"There is only and only one social responsibility of business: to use its resources and energy in activities designed to increase its profits so long as it stays within the rules of the game. (and) engages in open and free competition, without deception"*. Friedman contends that corporate officials are in no position to determine the relative urgency of social problems or the amount of organisational resources that should be committed to a given problem. He also insists that managers who devote corporate resources to pursue personal, and perhaps misguided notions of the social good, unfairly tax their own shareholders, employees, and customers. In short, business should produce goods and services efficiently and leave the solution of social problems to the concerned individuals and government agencies.

Often, social responsibility action is undertaken for wrong reasons rendering the exercise to irrelevance and ineffectiveness. Consider what has happened to Brij Mohon Khaitan, the tea giant. In the beginning of 1990s, Khaitan was under tremendous pressure from the Bodo Security Force (BSF). One of his executives was kidnapped and another was gunned down by the militants. BSF demanded hefty sums as a pre-condition for peace. It was at this time that Khaitan reflected and set up a school at a cost of Rs 22 crore. The school could not help Khaitan buy peace from the BSF.

Scope and Complexity Society's problems are too massive, and too deep-seated to be solved by even the most socially conscientious company or even by all companies acting together.

The problems such as environmental pollution—acid rain, ozone depletion, destruction of rain forests; health problems—AIDS, drug and tobacco use; racial discrimination; and the like defy solutions however conscientious one might be.

Each of these constraints influences and is influenced by other limits. All the constraints impact CSR and are influenced by corporate social responsibility.

Notwithstanding the constraints, Indian corporate is active in social actions. Indian companies have been donating considerable amounts towards social actions as Table 23.1 shows.

Table 23.1 Spending by Indian Corporate (Fiscal 2009)

	Rs. Cr
Reliance Industries	82.60
Jindal Steel	53.12
Jaiprakash Associates	33.24
Hindalco	28.87
Bharti Airtel	21.95
Ambuja Cement	21.48
Infosys Technologies	21.00
Mundra Port	17.67
Grasim Industries	15.81
Torrent Power	15.76

(*Source: The Economic Times,* Dec 2, 2009)

Contributions by Indian firms rose by 8 percent in 2009, despite worldwide economic downturn. As many as 760 companies donated Rs. 786 Cr. in 2009, up from Rs. 726 Cr. in 2008. The top 10 contributors are listed in Table 23.1. Reliance Industries tops the list of honour followed by Jindal, Jaiprakash, Hindalco and others. At the individual levels, Indian businessmen have donated considerable sums of money towards social actions. For example, Azim Premji donated ₹ 8500 cr, Ratan Tata $ 50 mn to set up Tata Hall at Harvard, Anand Mahindra donated $ 10 mn to set up Humanities Centre at Harvard, and Narayana Murthy gave $5 mn to Harvard to establish Murthy Classical Library of India. Anil Agarwal Foundation earmarked $1 bn to establish Vedanta University in Odisha.

As a percentage of GDP India gave 0.6.1 towards social actions in 2009. This compares favourably with other developing countries but unfavourably with developed nations. Figures for 2009 were–US 2.3%, UK 1.3%, Canada 1.2%, Brazil 0.31 and Chiina 0.1 of their respective GDPs.

MANAGING CSR

LO 5
Know how to manage CSR

CSR management involves actions on several fronts such as leadership, mission statements, social issues, alignment of structure and social reporting.

Leadership Any activity needs leadership and CSR is no exception. Visionary leaders lay down a philosophy for business, and the philosophy can make the organisation a socially conscious one. Whether it is J.N. Tata, Azim Premji or Narayana Murthy, there are any number of illustrious leaders who have earned profit no doubt. But they earned profit not for its sake, but for the benefit of society. John D. Rockefeller and Andrew Carnegie earned but donated their fortunes for social good. Bill Gates, the founder of Microsoft has created the Bill and Melinda Gates Foundation and endowed it with a whopping $27 billion. The Foundation's primary mission is to develop and give out vaccines for a few diseases that are the major causes of death in developing countries.

As are the leaders, so are the subordinates. When the leaders are conscious about society's welfare, subordinates too orient themselves towards the social good.

Mission Statements A mission statement sets forth, with brevity, the basic purpose of an organisation or company. The best mission statement defines the business, differentiates it from competitors, explains relationships with stakeholders, and focuses energy on critical activities and goals. The mission statement is a powerful tool for expressing priorities. If social responsibility is central to the company's mission, that should be reflected in words. The mission statement of NTPC, a PSU, for example, is explicit about its social responsibility. Its mission statement: 'Develop and provide reliable power related products and services at competitive prices, integrating multiple energy resources with innovative and eco-friendly technologies and contribution to the society'. Mission statements, as the one cited here, help direct the resources of the company towards achieving social goals.

Social Issues At any given time, a large company will confront several social issues. Managers need to detect, classify, analyse, track and prioritise issues. There are cues in the environment which signal the emergence of issues. After having prioritised, issues that top the list should be addressed early. If not addressed soon, they are likely to cause severe damage to the business.

For JSW Steel Ltd, sustainability has emerged as a social issue. CII and ITC together offer sustainability awards every year. Sustainability goes beyond the traditional CSR. It has three components: economic, environment and social. Together these three are called the triple bottom line (see Fig. 23.6).

Listed below are a few examples of triple bottom line indicators. The full list of indicators is longer and more detailed.

Economic Performance Indicators
- Net sales.
- Total payroll and benefits by country.
- Taxes paid by country.
- Donations to communities.

Environmental Performance Indicators
- Total materials use, by type.
- Percentage of materials used that are wastes.
- Energy use.
- Changes to natural habitats resulting from operations.
- Polluting emission and effluents by type.
- Environmental impacts of principal products.

Social Performance Indicators
- Net employment creation.
- Percentage of unionised employees.
- Number of work-related injuries and fatalities.
- Evidence of consideration of human rights impacts.
- Composition of senior management using male/female ratio and other indicators of diversity.
- Number and types of breaches of advertising and marketing regulations.

Fig. 23.6 The Triple Bottom Line

Alignment of Structure, Culture and Process Socially responsive actions need proper alignment of structure, culture and processes with social goals. As with any business objective, a decision by management for action on CSR is only an initial tentative step. To be carried out, that decision must be translated into specific goals and performance objectives, embedded in policies and procedures, and supported by both the formal structure and the informal elements of the corporate culture. As stated earlier, organisation should commit itself to social causes.

Corporate Social Reporting Corporate social reporting is the practice of assessing and publishing information about social performance. Reporting needs to be preceded by social audit. Social audit, as stated earlier, is a systematic study and evaluation of a firm's social performance. Social audit helps assess social performance and reporting lets the world know what the company has done. ITC publishes social report every year. Social report should meet certain criteria. Its content needs to be useful to stakeholders, clear, timely, comparable to past reports, reliable and verifiable.

BUSINESS ETHICS

Ethics refers to a system of moral principles—a sense of right and wrong and goodness and badness of actions, and their motives and consequences. *Business ethics* refers to the application of ethics to business. To be more specific, business ethics is the study of good and evil, right and wrong, and just and unjust actions of businesses.

LO 6
Analyse business ethics, its sources and importance

Business ethics does not differ from generally accepted norms of good or bad. If dishonesty is considered to be unethical and immoral in society, then any business person who is dishonest with employees, customers, shareholders or competitors is acting unethically and immorally. If protecting others from any harm is considered to be ethical, then a company that recalls a defective and harmful product from the market is acting ethically. To be considered ethical, business must draw its idea about what is desirable behaviour from the same sources as anybody else. Businesses should not try to evolve their own principles to justify what is right and wrong. Employees and employers may be tempted to apply special or weaker ethical rules to business situations. But society does not condone or permit such an exception. People who are in business are bound by the same ethical principles that apply to others.

Two theories are pertinent when one talks about the nature of ethics.

The *theory of moral unity* essentially advocates the principle that business actions should be judged by the general ethical standards of society. There exists only one ethical standard that applies to business and to non-business situations.

Opposed to the theory of moral unity is the theory of *amorality,* which argues that business can be amoral, and the actions of businesses need not be guided by general ethical standards. Managers may act selfishly because the market mechanism distills their actions into benefits to shareholders and society at large. Adam Smith argued that the 'invisible hand' of the market assures that by *"pursuing his own interest (a merchant) frequently promotes that of the society more effectively than when he really intends to promote it."* In this way, capitalism provides moral justification for the pursuit of profit through behaviour that is not purposefully ethical.

However, the theory of amorality is not acceptable to anybody. Everyone agrees that business actions should be subject to the same ethical standards as the one applicable to the society in general.

Sources of Business Ethics

Managers in every society are influenced by three repositories of ethical values: religion, culture, and law. (see Fig. 23.7). These repositories contain unique systems of value that exert varying degree of control over managers. A common thread, the idea of *reciprocity* or *mutual help,* runs through all the value systems. This idea reflects the central purpose of all ethics, which is to bind the vast majority of individuals in society into a cooperative whole. Ethical values are a mechanism that controls behaviour in business and in the other walks of life. Ethical restraints are more effective than are cruder controls such as police, lawsuits, or economic incentives. Ethical values channel individual energy into pursuits that are benign to others and beneficial to the society.

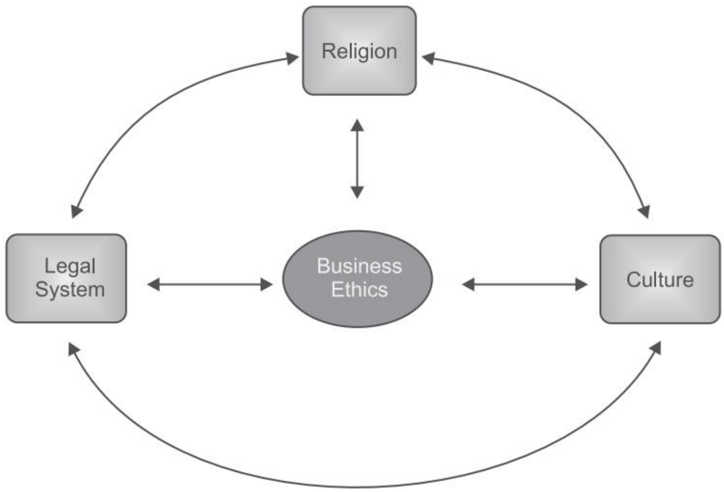

Fig. 23.7 Sources of Ethics

Religion One of the oldest sources of ethical inspiration is religion. More than 1,00,000 different religions exist across the globe. But despite doctrinal differences, the major religions converage on the belief that ethics is an expression of divine will that reveals the nature of right and wrong in business and other areas of life. The world's great religions are also in agreement on fundamental principles, which are similar to the building blocks of secular ethical doctrine. The principle of reciprocity towards one's fellow human beings is found in all major religions such as Hinduism, Buddhism, Christianity, Islam, Judaism, and Confucianism. The great religions preach the necessity for an orderly social system and emphasise social responsibility in such a way so as to contribute to the general welfare. Built upon such verities are many other rules of conduct.

Cultural Experience Culture, as was stated earlier, refers to a set of values, rules, and standards transmitted among generations and acted upon to produce behaviours that fall within acceptable limits. These rules and standards always play an important part in determining values, because individuals anchor their conduct in the culture of the group. Civilisation itself is a cumulative cultural experience in which people have passed through three distinct phases of moral codification. These stages correspond to the changing economic and social arrangements in human history.

For millions of generations in the *hunting and gathering stage* of human development, ethics was adapted to conditions in which our ancestors had to be ready to fight, face brutal foes, and suffer the hostile forces of nature. Under such circumstances, a premium was placed on pugnacity, appetite, greed, and sexual readiness, since it was often the strongest who survived. Trade ethics in the early civilisations were frequently conducted by brute force and violence.

Civilisation passed into an *agricultural stage* approximately 10,000 years ago, beginning a time when industriousness was more important than ferocity, thrift paid greater dividends, and peace came to be valued over wars, which destroyed crops and animals. These new values were codified into ethical systems, which even guide the managers today.

Two centuries ago, society entered an *industrial stage* of cultural experience, and ethical systems once more began evolving to reflect the changing physical, cultural, institutional, and intellectual environment. Large factories and corporations, population growth, capitalist and socialist economic doctrines and technologies have all assaulted the ethical standards of the agrarian stage. Industrialism has not created distinct ethics, but it has created tensions with old ethical systems based on the values of agricultural societies. It does this by changing values related to what is good and bad. For example, the copious outpouring of material goods from factories has encouraged materialism and consumption at the expense of older virtues such as moderation and thrift. Managers run an industrial enterprise on the cutting edge of cultural experience. The tensions their actions create make business more ethically complex. For existence, the widespread use of computers for data storage and communication raises new issue of privacy and individual expression unlike those present in the agrarian societies.

The Legal System Laws are rules of conduct, approved by legislatures, that guide human behaviour in any society. They codify ethical expectations and keep changing as new evils emerge. Law is reactive; new statutes and enforcement always lag behind the opportunity for corporate expediency.

Whatever ethics that law confides, it is binding on business. Society expects business to abide by law and obeying law is presumed to be ethical behaviour.

Although society expects business to be law abiding, seldom does the business adhere to the rules. Law breaking in business is common. Taxes are evaded, hundreds of employees die because of occupational diseases, many die because of industrial accidents, and million others receive disabling injuries on the job. The blame for these deaths and injuries can be shared by careless employees and by employers who fail to adhere to occupational health and safety laws.

Consumers suffer because of poor quality and high-priced products supplied by businesses. And business causes misery to the society by damaging the environment, disregarding environment protection laws.

Why is Ethics Important?

Ethics is important to business for several reasons as stated below:

(i) Ethics Corresponds to Basic Human Needs It is a human trait that man desires to be ethical, not only in his private life but also in his business affairs where, being a manager, he knows his decisions may affect the lives of thousands of employees. Moreover, most people want to be a part of an organisation, which they can respect and be publicly proud of, because they perceive its purpose and activities to be honest and beneficial to the society. Most top managers would like to respond to this need of their employees; and they (managers) themselves feel an equal need to be genuinely proud of the company they are directing. These basic ethical needs compel the organisations to be ethically oriented.

(ii) Values Create Credibility with the Public A company perceived by the public to be ethically and socially responsive will be honoured and respected even by those who have no intimate knowledge of its actual working. There will be an instinctive prejudice in favour of its products, since people believe that the company offers value for money. Its public issues will attract an immediate response. A century ago, a company could be criminal was not heard of. The prevailing assumption was as Edward Thurlow, an 18th century Lord Chancellor of England had put it, the corporates had neither bodies to be punished nor souls to be condemned, and thus they were incapable of being "guilty."

(iii) Values give Management Credibility with Employees Values are supposed to be a common language to bring leaderships and its people together. Organisational ethics, when perceived by employees as genuine, create common goals, values, and language. The management has credibility with its employees precisely because it has credibility with the public. Neither sound business strategy, nor a generous compensation policy and fringe benefits can win employee credibility; but perceived moral and social uprightness can.

(iv) Values Help Better Decision-making Another point of great importance is that an ethical attitude helps the management make better decisions, that is, decisions that are in the interest of the public, their employees and the company's own long-term goods, even though decision-making is slower. This is so because respect for ethics will force a management to take account of various aspects—economic, social and ethical—in making decisions.

(v) Ethics and Profit Ethics and profit go together. A company which is inspired by ethical conduct is also a profitable one. Value-driven companies are sure to be successful in the long run, though in the short run, they may lose money.

(vi) Law Cannot Protect Society, Ethics Can Ethics is important because the government, law, and lawyers cannot do everything to protect society. Technology develops faster than the government can regulate. People in an industry often know the dangers in a particular technology better than the regulatory agencies. Further, government cannot always regulate all activities that are harmful to society. Where law fails, ethics can succeed. An ethical-oriented management takes measures to prevent pollution and protect worker's health even before it is mandated by law.

Are business people ethical? The answwar is 'no' if one goes by recent happenings in India and elsewhere. Xerox Corporation has recently disclosed that its Indian susidiary, Xerox Modi Corp, made improper payments—an euphemism for bribes—to government officials to push its sales over the years. Cartelling in cement industry is the organised way of unethical behaviour. It was unethical practice at its worst when Parliament had to expel 11 MPs in 2006 for indulging in cash-for-questions scam.

A study (2007) called *Early Warning Signals of Corporate Frauds,* jointly conducted by the Institute of Chartered Accountants of India (ICAI) and India Forensic Consultancy Services, revealed that as many as 1200 companies listed in stock exchanges have massaged financial statements to beat market expectations. The improper accounting practices included deferring revenues, inflating expenses and avoiding taxes. Table 23.2 shows reasons for unethical practices.

Table 23.2 Reasons for Graft

Inherent nature of Industry	35
Weak anti-graft tone of top management	34
Weak law enforcement	33
Lack of adequate regulation and compliance	33
Corruption is considered acceptable	30
No due diligence on third parties	25
Poor internal controls	23
Lack of awareness among employees	16
Others	4

(Note: Numbers represent percentages of respondents. Total exceeds 100 as respondents chose multiple options)

Source: Business Today, dated March 18, 2012

Perphaps, no other example than Satyam Computer Services, can demonstrate the accounting frauds that a firm can indulge in. The way American firms-Enron and World.com-went bust and the way the president of Huyandai Motor Company, Chung Mong Koo, was jailed for three years, reinforces the belief that businesses are not ethical.

Table 23.3 shows bribes paid by the US companies to different governments across the globe.

Table 23.3 US Companies Bribing Indian Officials

Name of the Company	*Location of Time of Misconduct*	*Outome*
Dow Chemical Company	India, 1996-2001 De-Nocit, an arm of Dow, paid \$200,000 to Indian Govt. officials to expedite registration of three De-Nocial products. \$19,000 was given as gift.	Paid \$325,000 civil penalty.
York International Corporation	India, Iraq, Bahrain, Egypt, Turkey, UAE 1999-2006. The company through its arms, paid over \$7.5 mn to bag government projects in many countries, including India.	Paid a criminal fine of \$11,50,000 and civil penalty of \$2 mn to SEC.
Textron	Iraq, Bangladesh, Egypt, UAE, India, Indonesia 2000-03. The firm made 36 illicit payments of \$115,000 to officials of state undertakings, including India, to obtain contracts.	The company agreed to pay a criminal fine of \$11,50,000 and continue co-operating with the investigation.
Westinghouse Air Brake Technologies Corporation (Wabtee)	India, 2001-05. Made improper payments of \$1,37,400 to Indian Railways Board officials.	The firm paid \$300,000 as criminal penalty
Electronic Data Systems Corporation	In 2001-03. Made \$72,000 in illicit payments to officers of two Indian PSUs to retain business.	Agreed to pay \$70,000 as civil penalty.
Xerox	India, 2002, paid through its arm Modi Corp \$700,000 to Indian government customers for the supply of equipment	-----
Smirnoff and Johnywalker	Paid more than \$1.7 mn as bribe to Indian government officials from 2003-09	----
Diageo Plc	----	Agreed to pay more than \$16 mn to settle changes levelled by SEC (US)

At the macro level, countries are being ranked as honest or corrupt. Ranking is made by Transparency International, a popular think tank. Its corruption perception index (2011) is shown in Table 23.4.

Table 23.4 Some are honest and some corrupt (Score: 0=Highly Corrupt, 10=Very Clean)

Rank	Country	Score
1	New Zealand	9.5
2	Denmark	9.4
3	Finland	9.4
4	Sweden	9.3
5	Singapore	9.2
75	China	3.6
86	Sri Lanka	3.3
95	India	3.1
120	Bangladesh	2.7
134	Pakistan	2.5

Insider Trading

Insider trading made big news with the arrest of Rajat Gupta in 2011 for illegally tipping hedge fund manager Raj Rajratnam while serving on the boards of Goldman Sachs and P&G. This happened in the U.S. and India is not free from this deviant behaviour. In 2012, SEBI initiated investigation into 154 cases of wrong doing, of which 24 were related to insider trading. The corresponding figures in 2013 were 155 and 11.

Insider trading occurs when securities are bought or sold on the basis of material that are non-public information. The executives of a company and other insiders know the firm well, and as well might easily know about events that are likely to have a significant impact on the company's share price well in advance as other potential traders. Consequently, insiders are privileged over other players in the market in terms of knowledge, a privilege that they could take advantage of to reap a questionable profit. In the long run, such practice can derail investors' trust in the market – a problem that has led most stock markets (including India) to forbid the practice.

Is insider trading unethical? The answer is both yes and no. It is yes because of at least four reasons. *First*, information is not available to every concerned individual and hence unfair. *Second*, insiders misuse valuable information about the company for personal gain. *Third*, public lose faith in stock markets, thus damaging the economy as a whole. *Four*, managers are agents of shareholders, giving rise to fiduciary relationship between the two. By resorting to insider trading, managers undermine shareholders' interests, thus breaching the fiduciary relationship.

That insider trading is not unethical carries sound reasoning. Several companies offer SOPs to their executives as a retention strategy. Now, these people may use their inside knowledge of the company to decide when to exercise their options or sell their shares. It is not uncommon to see the allotees of ESOPs spending major portion of their office time every day, on watching their share price movements. They are privy to critical information and there is no guarantee that they separate share price movement from probity.

Besides, any investor tries to receive as much knowledge about a company as possible and analysts of major investment banks would by no means treat their knowledge as publicly available.

It may be stated that insider trading is both illegal and unethical. It is illegal and hence, outlawed in India as with other countries. It is also unethical for the reason that a privileged few make enormous gains at the cost of majority of investors.

Managing Ethics

In the past, it was assumed in most companies that ethics was a matter of individual conscience. But the scenario has changed. Today, many companies are using managerial techniques that are designed to encourage ethical behaviours. Some of the managerial interventions to ensure ethical conduct are explained below: (see Fig. 23.8)

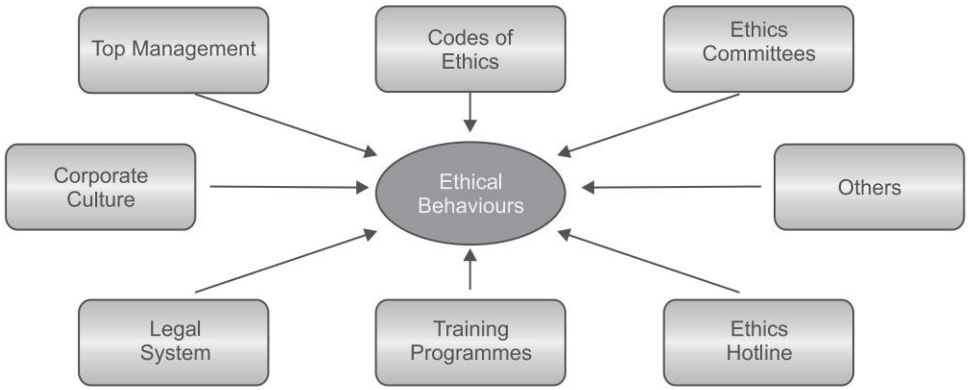

Fig. 23.8 Ways of Managing Ethics

Top Management The single most important variable that impacts ethical conduct is leadership. If Tata Group companies, WIPRO, HUL and the like are known for honest and fair dealings, credit should go to their founders and successive leaders. Leaders set formal rules, and by their behaviour can reinforce or undermine right-behaviours. Subordinates are keen observers and quickly notice if standards are upheld or evaded. Exemplary behaviour is a powerful tool available to all managers. Leadership is about communicating values (see also Exhibit 23.2)

Top management should send right signals reiterating the need to observe ethical practices. German engineering giant Siemens AG, for example, has agreed to pay a record $80 million fine to US authorities to settle a bribery investigation under the Foreign Corrupt Practices Act.

Exhibit 23.2

ETHICAL CONDUCT

The first car produced by Maruti was donated to Lord Venkateshwara, the presiding deity at the Tirumala temple in Tirupati. The donation was not made by the company, as Maruti had already formulated a policy that it would not make donations to anyone. It was feared, not without reason, that if any donation was made, either in cash or in the form of a car, there would be endless demands and refusing them would create many enemies. It was easier to say that policy, framed at the instance of the Japanese, prohibited the company from making donations. The decision to donate a car to the deity at Tirupati was taken by vendors, dealers and employees, who paid for the car. The subsequent success of the company, and all those associated with it, showed that the humble offering pleased the God!

(*Source:* R.C. Bhargava, *The Maruti Story*, p.88)

The Factories Inspector once demanded ₹ 6000/- in return of not insisting on a compliance. But the management of WIPRO, instead, invested ₹ 14 million in complying with the requirement and solving the problem on a permanent basis. In another case, Wipro operated a highly power intensive factory with self-generated power for almost two years-incurring double the normal electricity charges. After two years, when the Chief of the board changed, Wipro got the required electricity overnight since the company's proposal complied with all requirements and the new Chief was an honest person.

J&J has an interesting anecdote to tell. It was Tylenol case of 1982. Seven people were dead in Chicago after consuming extra-strength Tylenol capsules (J&J's most profitable product at the time with a market share of 37%). A known suspect had tempered with the product by replacing the drug with deadly levels of cyanide. Even though J&J was not responsible for the deaths, Tylenol was recalled from the entire country which amounted to 31 million bottles and a loss of more than $100 million in revenue. (Also see Table 23.5)

Table 23.5 Cars Recalled-Worldwide

Year	*Company*	*No. of Cars with Cause*
1971	GM	6.7 million due to engine mounts
1981	GM	5.8 million due to loose suspension bolts
1996	Ford	8 million due to defective ignition switches
1998	GM	1 million due to defective airbags
2004	GM	4 million because of corroding tallgate cable
2007	Chrysler	575000 vehicles because of defect in gear shift assembly
2008	GM	857, 735 due to defect in windshield wiper fluid system
2008	Maruti	28500 cars due to faulty drive shaft
2009	Toyota	3.8 million due to defective floor mats
2010	Honda	646000 due to faulty window switch
2010	Toyota	16000 recalled in Germany

Code of Ethics Codes of ethics have become popular. Codes vary from book-length formulations to succinct statements which, in one or two pages, express a general philosophy for managing conflicts. Nearly 95 per cent of *Fortune 500* companies have codes and the trend is visible in the Indian corporate sector also.

Industry associations too have evolved codes of conduct of their own. For example, the Council for Fair Business Practices (CFBP) established in 1966, by leading private sector industrialists in Western India, adopted the following code of fair business practices:

- *To charge only fair and reasonable prices and take every possible step to ensure that the prices to be charged to the consumer are brought to his notice.*
- *To take every possible step to ensure that the agents or dealers do not charge prices higher than fixed.*
- *In times of scarcity, not to withhold or suppress stocks of goods with a view to hoarding or profiteering.*
- *Not to produce or trade in spurious goods of standards lower than specified.*
- *Not to adulterate goods supplied.*
- *Not to publish misleading advertisements.*
- *To invoice goods exported or imported at their correct prices.*

- *To maintain accuracy in weights and measures of goods offered for sale.*
- *Not to deal knowingly in smuggled goods.*
- *Providing after-sales service where necessary or possible.*
- *Honouring the fundamental rights of the consumers—Right to Safety, Right to Choose, Right to Information, and Right to be Heard.*
- *Discharging social responsibilities and the responsibility to protect the environment and nature's infrastructure.*
- *Ensuring that the product-warranty is offered in simple, unambiguous, and concise language, highlighting the rights of the consumer under it.*

Whoever evolves the code, its purpose is to provide guidance to managers and employees when they encounter an ethical dilemma. The most effective codes are those drawn up with the cooperation and widespread participation of employees. An internal enforcement mechanism, including penalties for violating the code, adds teeth to the code.

Tatas have a comprehensive code. Every Tata employee who joins the organisation pledges to abide by the code and is given a copy of it. The Tata code provides an ethical road map for every employee including the CEO/MD, full time and independent directors. The code of conduct has 25 clauses which cover all areas of company operations including accounting, insider trading, business gifting, equal employment opportunity, prevention of harassment, conflict of interests, protecting company assets and adherence to local regulations in every country of operation.

Ethics Committees Many firms have ethics committees to advise on ethical issues. Such a committee can be high-level one comprising the board of directors, chaired by the CEO of the company.

The committee fields questions from employees, helps the firm establish policy in new or uncertain areas, advises the board of directors on ethical issues and oversees the enforcement of the code of ethics.

Ethics Hot Lines In some firms, when employees are troubled about some ethical issue but may be reluctant to raise it with their immediate supervisor, they can place a call on the company's 'ethics hot line.' A member of the ethics committee receives the confidential call and then quickly investigates the situation. Elaborate steps are taken to protect the identity of the caller, so as to encourage more employees to report any deviant behaviour. This technique is advantageous in as much as ethics hotlines encourage internal whistle-blowing, which is better for a company than to have disgruntled employees take their ethical complaints to the media.

Whistle-blowing is in the news these days. Like the blowing of whistle by a referee to indicate violations of rules in the playfield, whistle-blowing in an organisation refers to disclosure by former or current employees of any illegal, immoral, or illegitimate practices involving its employees. Table 23.6 contains some well-known cases of whistle-blowing. But whistle-blowing can lead to loss of face and job for whistle-blower as Exhibit 23.3 shows.

Measures can be taken to protect the interests of whistle-blowers as the Chennai based Murugappan group has done. Since March, 2006, the group has implemented a whistle-blower policy. As per the policy, an aggrieved worker can approach the ombudsman through letter, e-mail or call. Ombudsman shall report the matter to the Board. Three such cases have been resolved at the board level since March, 2006.

The Securities and Exchange Board of India (SEBI) mandates a whistle-blowing mechanism

Table 23.6 Whistle-blowing in Action

No.	*Organisation*	*Whistle-blower*	*Consequence*
1	Enron	Sherron Watkins	Liquidation of the company.
2	Kellogg's India	Senior executive (name not known)	Sacking of two senior executives who were promoted for excellent performance just a few months before.
3	Director, FBI, USA	Coleen Rowly	Attack on the World Trade Centre, New York.
4	WorldCom	Cynthia Cooper	Liquidation of the company
5	Xerox	Name not known	CFO made to pay $5.5 million in fines and banned by the SEC from practising accountancy.
6	Heinz India, Johnson and Johnson, Bayer India	Installed whistle–blowing system	No incident reported.
7	LG India	Names not known but 10–12 cases have been reported to head office, South Korea	Not known.
8	National Highway Authority of India	S. K. Dubey	S.K. Dubey murdered. Investigation by a commission in progress.
9	Hong Kong City Civil Service	LO Pui–Lam	Guilty disciplined but LO has been ostracised by fellow workers.
10	Modern Food Industries, Delhi	Gobind Yadav	Suspended and dismissed, however, the High Court ordered his resettlement
11	Ranbaxy, India	Thakur	Thakur will receive $48.6 mn of $500 mn Ranbaxy agreed to pay to settle dispute with the U.S.

Exhibit 23.3

THE TROUBLE WITH BUSINESS ETHICS

In the post-Enron, post-WorldCom, post-Tyco era, ethics has become one of the hottest topics in the business world. Business schools have entire courses dedicated to the topic. Companies have instituted more rigorous ethics policies and set up global ethics offices. One of the fastest-growing employment categories is chief ethics officer, as evidenced by the creation of that post at the New York Stock Exchange, Nortel Networks, Marsh & McLennan, and Hewlett-Packard.

But a recent case at Wal-Mart Stores shows how difficult it can be to push "ethics" in the corporate world. A few months after going through a new employee training session with a heavy emphasis on ethics, Chalace Epley Lowry acted on the guidance to report any activity that seemed the least bit suspicious. Lowry told the company's ethics office about what she thought could be a case of insider trading by one of her supervisors, Mona Williams, vice-president of corporate communications.

The company determined that Williams had done nothing wrong. But Lowry's identity was revealed to Williams, leading Lowry to conclude that she could no longer work in the department.

Now she's looking for another job, but there's no guarantee she'll get one at Wal-Mart. "I acted in good faith, just pointing out that there might have been some wrongdoing," says Lowry. "But it was really disheartening to see how it was handled."

Lowry's case, unfortunately, is representative of exactly how ethics complaints and whistleblowers are handled at many corporations. "Most employees are reluctant to make any complaints for fear that they will either lose their job or get redirected into another position," says Jim Fisher, Shaughnessy fellow at the Emerson Center for Business Ethics at St. Louis University. "People who go into a situation naively thinking that they are taking care of a problem often find that it doesn't turn out that way. In fact, 95% of the time, whistleblowers lose their jobs."

The emphasis on ethics is hard to miss. Many of the companies leading the way are those that have been embroiled in scandals in the past. For instance, CA, the former scandal-tainted Computer Associates, two years ago had hired Patrick Gnazzo, a former chief trial attorney for the U.S. Navy. And former Securities & Exchange Commission Chairman Richard Breeden, who was first hired to be an outside monitor of accounting firm KPMG moved into a similar role at Hollinger International, where Conrad Black stirred up trouble and ultimately a lawsuit.

Eric Dinallo and Beth Golden, alumni of former NY Attorney General Eliot Spitzer's office, were hired at Morgan Stanley and Bear Steams, respectively. Wal-Mart itself set up its global ethics office in 2004 and prides itself on having one of the strictest ethics codes in the industry. Its employees aren't allowed to accept even a drink from their suppliers.

Still, strict ethics codes can be a catch-22 for workers. "Employees who read codes of conduct have an obligation to report misconduct whether big or small," says Mark Schwartz, assistant professor of corporate governance, law & ethics at Atkinson's School of Administrative Studies at York University. "However, if you do report violations there are serious consequences."

The most famous American whistleblower, Jeffrey Wigand, had to fight a smear campaign by the company, and lawsuits after he chose to go on national television to expose how Brown & Williamson Tobacco was hiding research on the highly addictive nature of tobacco. In the days after that, Wigand lost his privacy; the intense scrutiny and pressure wrecked his marriage and family.

That could be the reason why many employees turn a blind eye to violations. A recent survey conducted by LRN, an ethics research and consulting firm, found that 73% of full-time American employees reported encountering ethical lapses on the job. However, the survey also found that of that 73%, only "one in three, or 36%, said that they have reported an incident they believed to be unethical or questionable to management." Most, or 58%, of these respondents said they didn't report it because they were not directly involved in an incident. Fourteen percent said they lacked confidence in how their employer would handle it.

Some employees would rather leave a company than report ethical lapses, points out Lindsay Thompson, assistant professor of leadership ethics at the Carey Business School at Johns Hopkins University. "Students who take the course sometimes find ethical issues that come to consciousness during class, and they change their jobs because they are certain that they will not get support from their employers," says Thompson.

Still in some cases, companies that have failed a government investigation might be required by law to beef up ethics and will transform themselves on paper. "In fact, a vast majority of companies don't take ethics seriously. Shoring up ethics is part of risk management, or an insurance policy," says Schwartz of York University. But there are companies that really care and want to send a strong message to employees and to investors. For instance, after the Dennis Kozlowski excesses at Tyco International, the company's new CEO, Edward Breen, effectively fired the entire board of directors, replacing them with more independent members.

Boeing also tightened its ethics rules, after the ouster of CEO Phil Condit for misconduct. The test of how it would apply those rules came less than two years later. A Boeing employee saw possible ethics lapses in new CEO Harry Stonecipher's amorous e-mail exchanges with a female executive. Despite the possibility of being fired, the anonymous employee reported it to the board of directors. Stonecipher lost his job in the days following that, and the board of directors clearly followed the guidelines of its post-Condit code of ethics. "It's not an employee's place to determine the significance of an ethics violation, and in this case, the board really stood up to their principles," says Schwartz.

Ethics experts are united in their view that that any company that takes its ethics seriously has the obligation to protect the identity of whistleblowers. "Some companies think they are set up to protect whistleblowers but then you have to rely on the leadership and character of individual managers and business units to implement them," says Thompson of Johns Hopkins.

In Lowry's case, Wal-Mart says that she received anonymity and confidentiality in the Ethics Office complaint process. The company says in a statement: "It was through the subsequent 'open door' process that Lowry granted permission to her supervisor to tell Williams since Lowry accessed a document in Williams' e-mail." However, Lowry says that she was never told that she had the choice not to grant permission to reveal her identity to Williams.

After she requested a transfer, Lowry moved to a temporary position at Wal-Mart. "All I want is another job," she says. "I've been made to feel like I'd done something wrong. But nothing's been done to those who violated Wal-Mart's confidentiality policy. They're not worried about whether they will have a job, come tomorrow."

(*Source*: *The Economic Times*, June 29, 2007)

in Clause 49 of the listing agreement. The provision has been around since 2003, but it has been ineffective. The Public Interest Disclosure Bill 2010 has increased awareness about whistle-blowing and the need to protect whistle-blowers.

Ethics Training Programmes Nearly all companies that take ethics seriously provide training in ethics for their managers and employees. Such training programmes acquaint company personnel with the official company policy on ethical issues, and they show how those policies can be translated into the specifics of everyday decision-making. Often, simulated cases based on actual events in the company are used to illustrate how to apply ethical principles to on-the-job problems.

Generally speaking, ethics training is most effective when it is conducted by company managers, and is steered away from abstract philosophical discussions to focus on specifics from the work environment of those attending.

Ethics and Law Law and ethics aim at one thing—defining proper and improper behaviour. But the two are not quite the same. Laws are a society's attempt to formalise—that is, to reduce to written rules—ideas about what is right and what is wrong in various walk of life. However, it is rarely possible for written rules to capture all the subtle shadings that people give to ethics. Ethical concepts are more complex than written rules. Ethics deals with human dilemmas that frequently go beyond the formal language of law and the meanings given to legal rules.

Similarities and differences apart, legal rules help promote ethical behaviours in organisations. Some of the Acts which seek to ensure fair business practices in India are the following:

The Foreign Exchange Regulation Act, 1973 now replaced by FEMA
The Companies Act, 1956
The Monopolies and Restrictive Trade Practices Act, 1969 now replaced by Competition Act, 2003
The Consumer Protection Act, 1986

The Environment Protection Act, 1986

The Essential Commodities Act, 1955

Table 23.7 shows some of the means of promoting ethics in organisations in different countries and their popularity.

Table 23.7 Means to Promote Ethical Conduct

Means	*India*	*Asia Pacific*	*Global*
Ethics/Code of Conduct	72	73	64
Pre-employment screening	54	37	50
Public source information	32	25	33
Whistle-blowing system	28	18	28
Fraud training	24	25	29
Others	23	20	27

Note: Figures indicate percentage responses from sample firms who have implemented the system.

(*Source*: Survey by Price Waterhouse Coopers, 2003)

As seen from the table, ethics/code is most popular across firms in different regions. Nevertheless, whistle-blowing as a means of promoting ethical conduct is gaining in popularity.

Of all the means of promoting ethical behaviour, whistleblowing is emerging as a preferred choice, as Table 23.8 shows.

Table 23.8 Effectiveness of Whistleblowing to Check Corruption

	% of companies using whistleblowing effectively
North America	77
Australia and Newzealand	58
Latin America	50
West Asia, India, Africa	37
Central and Eastern Europe	23
East Asia (except Japan)	15
Japan	6

(*Source*: E&Y, 10th *Global Fraud Survey*, 2008)

Firms need to protect whistleblowers as their incomes, jobs and even lives are at stake. More so, they need to be reassured and encouraged to blow whistles when frauds are committed and detected. It is desirable that companies have exclusive policies, as Tata Motors has towards whistleblowing. Following considerations should guide such a policy:

- Mechanisms for reporting violations such as hotlines and mailboxes need to be installed.
- Have a referent person (such as the Chairman of the Audit Committee in Tata Motors) to whom communication can be addressed.
- Specify clearly the procedure for whistle blowing and following action that will be initiated.
- Strong commitment from top management to encourage whistleblowing is essential.
- Creating a culture of openness, honesty and sincerity is an essential pre-requisite.
- Set a deadline on or before which follow up to the complaint should be completed.
- Ensure full protection to the whistleblower.

Corporate Culture and Ethical Climate Corporate culture is a blend of ideas, customs, traditional practices, company values, and shared meanings that help define normal behaviour for everyone who works in a firm. Every organisation has a culture and it exercises considerable influence on employee behaviour.

Hewlett-Packard is well known for a culture that stresses values and ethics. Called the 'HP Way' by employees, the most important values of the culture are confidence in, and respect for people, open communication, sharing of benefits and responsibilities, concern for the individual employees, and honesty and integrity.

In some companies, one can feel the blowing of ethical winds. People pick up subtle hints and clues that tell them what behaviour is approved and what is forbidden. This unarticulated understanding among employees is called an *ethical climate.* It is that part of corporate culture that sets the ethical tone in a company.

One way to view ethical climate is diagrammed in Fig. 23.9. Three different types of ethical yardsticks are *egoism* (self-centeredness), *benevolence* (concern for others), and *principle* (respect for one's own integrity, for group norms, and for society's laws). These ethical yardsticks can be applied to dilemmas concerning individuals, one's company, or society at large. For example, if a manager approaches ethics issues with benevolence in mind, he or she would stress friendly relations with employees, emphasise the importance of team play and cooperation for the company's benefit, and recommend socially responsible courses of action. However, if the manager uses egoism to think about ethical problems, he or she would be more likely to think first of self-interest, promoting the company's profit and striving for efficient operations at all costs. A company's ethical climate depends on which combination it has of these nine possibilities.

Ethical Criteria	*Focus of Ethical Concern*		
	Individual Person	*Company*	*Society*
Egoism (Self-centered approach)	Self-interest	Company Interest	Economic Efficiency
Benevolence (Concern-for-others approach)	Friendship	Team Interest	Social Responsibility
Principle (Integrity approach)	Personal Morality	Company Rules and Procedures	Laws and Professional Codes

Fig. 23.9 Components of Ethical Climate

(*Source*: William Frederick, et al, *Business and Society*, p. 85)

Corporate culture and ethical climate can put much pressure on people to channel their actions in certain directions by the company.

Ethical climate is often dented by peculiar circumstances as it happened to public sector undertakings in India. The Transparency International India (TII), the local chapter of the global non-profit organisation that seeks to combat corruption, accepts that lack of resources is hampering its efforts to effectively monitor agreements it has signed with 29 public sector enterprises in India. These agreements are known as ‘Integrity Pacts’. Signing the pact bounds the undertakings to guarantee transparency in their procurement deals. Besides, pacts help the signatories when they bid for international projects. TII has not started monitoring yet because of shortage of resources. The undertakings that have signed the pacts, among others, include ONGC, ISPAT Nigam, HPC, GAIL and Coal India.

Others There are some other ways of fighting graft as Table 23.9 shows.

Table 23.9 Measures to Fight Graft

(Note: Figures represent percentages of respondents. Total exceeds 100 because of multiple options.)

Source: Business Today, dated March 18, 2012

Improving Ethical Decision-Making

Ethical decisions are difficult to make as the opening case shows. They cannot be programmed like production and inventory decisions. But decisions need to be made in business. This section contains practical difficulties in decision-making and guidelines that help a manager in making a choice.

Difficulties in Decision-Making There are at least nine reasons why decision-making becomes difficult.

Firstly, managers face dilemmas in deciding on a course of action.

Secondly, managers confront a distinction between facts and values when making ethical decisions. Facts are statements about what is and values are statements about ought to be. What is can never define what ought to be. For example, the cost of researching, developing and producing a life saving drug may necessitate fixing a high price, as far as the company is concerned but the price may be perceived by users as exploitative.

Thirdly, good and evil exist simultaneously, in tandem, and interlocked. Nestlés sales of infant formula in Kenya and Zambia have led to infant deaths as mothers mixed the powedered food with contaminated local water and their babies died of dysentery. But evidence also shows that the same formula has saved lives of several other infants. Evil should be minimised, but it cannot be eliminated.

Fourthly, knowledge about the consequences of an action is limited. One of the principles of decision-making is utilitarian. This implies that if an act results in the greatest good of greatest numbers, it is taken as morally acceptable. This principle assumes that the consequences of the act are known. But in uncertain business environment, consequences cannot be easily predicted.

Fifthly, antagonistic interests frequently use incompatible ethical arguments to justify their intentions. Thus, the ethical stand of a corporation is often based on entirely different premises from the ethical stand of critics. Animal lovers may argue against slaughter on the ground that beasts are entitled to rights similar to those enjoyed by humans, including the right to life. Poultry growers, on the other hand, contend that raising food animals inure benefits to the society.

Sixthly, some ethical standards vary with the passage of time. Donations to political parties were forbidden earlier but is allowed now. In addition, certain bribes and payments are accepted practices in Asian, African, and Latin American countries but are not regarded as ethical in the US. In India some business houses have institutionalised the practice of donating to political parties. For example, Tatas have setup the Tata Sons Ltd's Electoral Trust in 1996. Aditya Birla Group has also set up the Birlas' General Electoral Trust in 1998. Doing business with close friends and family is a standard practice in the Arab world but is treated as nepotism in Western Europe.

Seventhly, ethical behaviour is moulded from the clay of human imperfection. Unethical practices abound everywhere (see Fig. 23.10 for different crimes). An honest manager finds himself or herself like a babe in the woods, not able to do anything, surrounded as he or she is, by dishonesty everywhere.

Eighthly, in the 21st century managers are presented with new and emerging ethical problems that are not solved easily with traditional ethical guidelines. For example, modern ethical theory has not yet developed an adequate principle for weighing human life against economic factors in a decision. Cancer studies may predict that workers exposed to chemicals will become ill in small numbers far in the future. How should this information be balanced against costs of regulation, capital investment, or job loss?

Finally, the growth of large scale organisations in the 21st century gives new significance to ethical problems such as committee decision-making that masks individual responsibility, organisational loyalty versus loyalty to the public interest, and preferential hiring of disadvantaged sections of society. These are ethical problems peculiar to large organisations.

Practical Suggestions for Making Ethical Decisions Individuals in business can take a number of steps to resolve ethical problems.

First, three well known principles to resolve an ethical issue are moral idealism, intuitionism, and utilitarianism.

Moral idealism postulates that certain acts are good and others are bad. Pursue those acts that are good and avoid the bad ones. Moral idealism gives definite answers to ethical issues.

Intuition leaves it to the individual concerned to sense the moral gravity of the situation. If he or she feels that his or her motives are good and that they do not intend to hurt any one, he or she is taking an intuitive approach to morally difficult situations.

Utilitarianism seeks to establish the moral focus not on the act or the motives but on the consequences. If the consequences represent a net increase in society's happiness, or at least not a net decrease, the act is morally right.

Principles of the type described above help a manager in making a decision in ethically difficult circumstances.

Secondly, consider some decision tactics that illuminate moral choices. One such device is to engage in imaginary conversations with a hypothetical opponent as an antidote for certitude. Have a conversation or debate with an intelligent person in the organisation as your adviser. Alternatively, write an essay in favour of a stand and then a second, opposed to it. Write a case study in the third person about your situation. Try to apply ethical principles in answers to questions raised by the case.

Thirdly, write down pros and cons in the form of a balance sheet. The balance sheet approach helps decision-making by presenting information in an organised way.

Fourthly, sort out ethical priorities before problems arise. Prioritisation shall help consider alternatives when one is not under stress.

Fifthly, one should commit oneself publicly on ethical issues. He or she should identify potential areas of ethical conflict and make clear his or her opposition to padding expense accounts, stealing

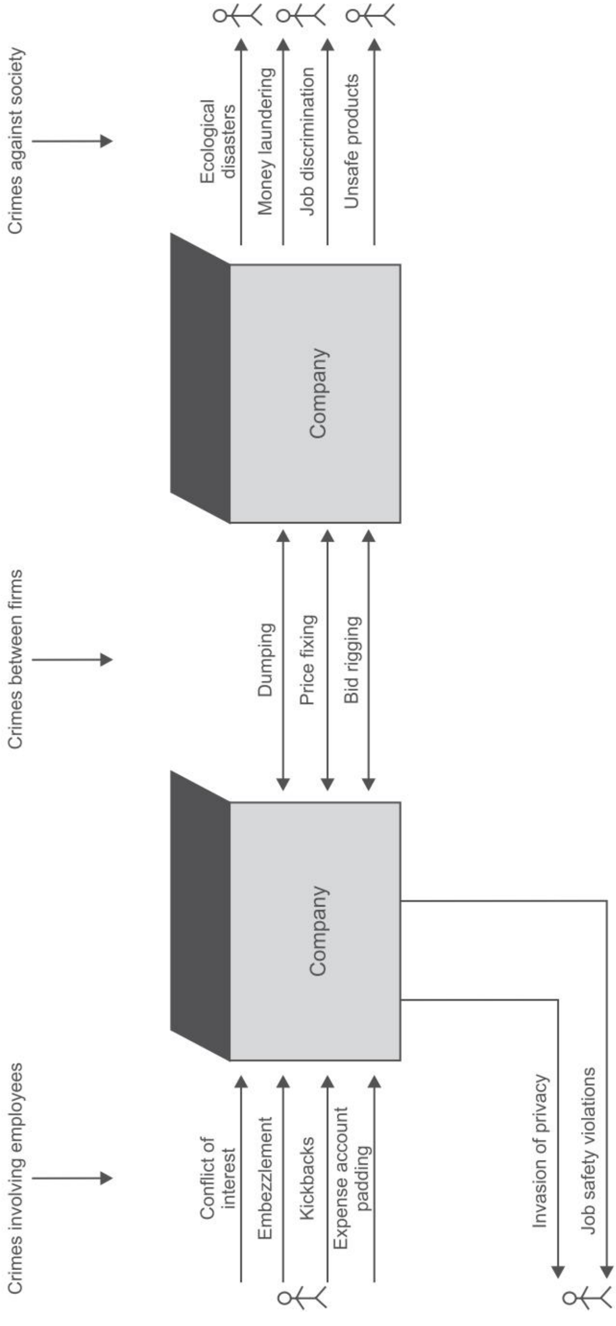

Fig. 23.10 Ethical Imperfections

(*Source*: Adapted from *Business and Society* by Frederic, Post and Davis, op. cit, p. 70) supplies from the company, price fixing, or damaging ecology. Once the stand is made clear, co-employees will be less tempted to approach with corrupt intentions.

Finally, ethical perfection, as stated earlier, is illusory. We live in a morally complex civilisation with profuse rules, norms, obligations, and duties existing like road signs that generally point in the same directions, but sometimes do not. No method of decision-making ends conflicts, no principle penetrates unerringly to the good, no manager achieves an ethical ideal (as the opening case indicates), particularly in situations as these:

A spokesman of the Animal Welfare Society revealed some telling details about the use of harmful hormones and chemicals like monosodium glutamate to fatten the chickens used by KFC (Times of India, *letter to the Editor, February 29, 1996). Earlier, Glaxo (India) had announced an incredible 175 per cent interim dividend. This is surmised to be a compensation for the UK-based company's investment of Rs 340 million to raise its equity holding from 32 per cent to 51 per cent. The declaration had come too soon after this increase to rule out such a connection. Even if this dividend were largely paid out of the sales proceeds of one of the divisions, still the question remains. Why repatriate large sums of these proceeds instead of investing them for business growth in India?* (Business Today, *January 22, 1996, p. 51) Similarly, another US company has recently patented an oil—extracted from the neem tree which grows in India. The medicinal properties of neem have been household knowledge and used in India in numerous forms from times immemorial. The implication of the above patent secured by the US companies seems to be that henceforth, neem oil cannot be used in India without paying royalty to this company.*

Realisation of the fact that there can be no ethical perfection helps a manager considerably.

SOCIAL RESPONSIBILITY AND ETHICS IN INTERNATIONAL BUSINESS

LO 7
Identify the role of social responsibility and ethics in international business

Till now we have covered the social responsibility and ethics of business in general, not particularly relating to international business. What is more important is to understand how an international business responds to society's expectations and undertakes social actions. It is equally important to understand how an international manager faces unique ethical problems while operating in overseas markets and how he or she resolves the dilemmas.

Social Responsibility and International Business

An international business faces several challenges while undertaking social actions. One such challenge relates to managing the type of government obtaining in a host country where subsidiary of an MNC is located. Militarised non-democratic governments operate in many countries of the world. Central America, for example, has been the scene of powerful military rulers and attempted takeovers in nations such as Panama, Nicaragua, Guatemala, and Elsalvador. A small, wealthy class is sometimes allied with the military government, with its members serving in high-level government posts. Human rights and democratic freedoms are generally curtailed by the government. Labour unions, religious organisations and other interest groups are watched carefully by the government authorities to keep them from becoming political opponents.

Military regimes present serious conflicts and strategic problems for international business leaders. In an effort to generate economic activity, such regimes may make attractive deals with foreign firms. Low taxes, low wages, freedom from criticism in the press, and weak environmental rules and regulations are among the attractions that a military regime can create through its power. Still, if a company knows that human rights are suppressed, that military leaders are filling their own pockets with money that should go to the country, and that corruption and abuse of power are part of the standard operating procedure, business leaders must pause and think about long-term consequences. The strategic issue in this context is: Do the benefits of doing business in such a system outweigh the economic, human and social costs?

Secondly, relations between home country and host country pose challenge to the international business. If two countries are at war, for example, there will be no trade between them. When Great Britain and Argentina went to war over ownership of the Falkland Islands, British companies, such as Unilever, found themselves in a serious dilemma. Unilever subsidiaries conducted business in Argentina but were barred by the government from doing business with the enemy—Great Britain. Similarly, Great Britain ordered all British companies to cease commercial transactions with the enemy—Argentina. Unilever was, therefore, under orders from the warring governments not to send or receive messages between its headquarters and its Argentinean businesses. The dilemma facing Unilever's managers was resolved when it was determined that the headquarters and business units could both report to Unilever's office in a neutral country (e.g., Brazil) without violating the dealing-with-the-enemy rules of the two warring nations.

Thomas J. Watson who led IBM from 1914 to 1956 firmly believed that trade between countries would help usher in peace. Hitler too convinced Watson that he (the former) did not want war. But Germany invaded France in 1940. Realising the mistake Waston tried to distance himself from the Nazis but IBM's German subsidiary provided a machine that was used in the Dachgu concentration camp. Watson had regretted this occurrence till his death.

Thirdly, social actions of an international business are influenced by host government's attitude towards foreign investment. Host countries use a variety of sanctions and incentives ("sticks and carrots") to shape and regulate foreign investment, attempting to lure investors but also trying to prevent excessive manipulation by them. Host country governments use laws, rules, and regulations to ensure that international businesses do not engage in certain types of conduct. These standards usually apply to all companies in a nation or to a specific industry. In some countries, however, national governments may wish to single out MNCs for special treatment.

Interference becomes extreme when the host government insists on becoming a partial owner of the foreign business. This has happened in basic or natural resources industries such as petroleum and mining. Resource rich countries such as Brazil, Chile, Papua New Guinea, Saudi Arabia, and Indonesia have often insisted that foreign mining and oil exploration firms share ownership with the governments.

Intervention is at its extreme when a country expropriates a foreign firm's assets. The government assumes ownership of the property, without paying compensation. Fidel Castro nationalised billions of dollars of assets from the US firms in Cuba, in 1990, Iraq seized all of Kuwait's assets, including its oil fields.

Fourthly, social problems come in the way of socially responsive actions of MNCs. Inadequate facilities may require an international business to build housing, establish schools, and create transpatation systems to ease the difficulties of employees. International business needs not only a proper physical infrastructure of airports, telephones, and fax machines but a social infrastructure as well. Whether the project is in the remote highlands of Papua New Guinea, the deep jungle of the Republic of Congo, or the desert city of Amman, Jordan, there are certain requirements that the host country must provide for the business to be successful. If the government is unable to provide these, the firm may have to do so or conclude that it cannot do business in the host country.

Fifth, international law is weak in addressing social effects on business. It strongly protects commercial rights, but norms protecting cultures, human rights, and nature are less codified. Sixth, in adapting to global economic growth, corporations have used strategies of joint ventures, outsourcing, and supply chain extension that create efficiencies, but often distance them from direct accountability for social harms. Finally, more national regulation of MNCs is unlikely. The governments of emerging nations fear that stricter rules and regulations will defer foreign investment.

Thus, an international business cannot undertake social action programmes when the government of a host country is headed by corrupt-military dictatorship, if the home country and host country are at wars, when the host country's attitude to foreign investment is negative, the host country lacks social infrastructure, international law is weak, MNCs have no accountability and developing countries are afraid of enforcing strict rules on MNCs.

But the non-governmental organisations (NGOs) have succeeded in making MNCs conscious of CSR. NGOs include a motley crowd such as human rights, animal rights, environmental, labour, consumer, antipoverty, health care and religious groups. Many of these groups developed a close association with the United Nations which, besides its peace-keeping function, promotes international human rights and the development of interests of poor countries. During the 1990s, coalitions of NGOs pushed for a series of conferences sponsored by the UN for its members. Conferences were held on the environment (Riode Janero, 1992), population (Cairo, 1993), human rights (Vienna, 1994), social development (Copenhagen, 1995), and gender (Beijing, 1995).

These conferences engendered several positives. First, a series of declarations, resolutions, statements of principles, guidelines, and frameworks were made under UN auspices that shaped international standards for the conduct of MNCs and countries. Second, the conferences provided occasions for NGOs to interact and develop strategies for confronting organisations. Finally, and most important, they helped define and launch a new wave of global corporate social responsibility.

International businesses can meet the challenges if they design a corporate social strategy. The following questions are a good place to start the process:

- Are we being socially responsible in what we do? Do we meet the expectations of our host-country as well as our home-country? Would stakeholders in either country question our behaviour?
- Are we responsive to the stakeholders in each country where we do business?
- Do we treat employees, customers, suppliers, local communities, and others in a fair and just way?
- Do we recognise emerging issues, as well as immediate social issues, in the countries and communities where we operate? Are we anticipating change rather than just reacting to it?
- Do we abide by the host government's regulations and policies? Do we have good systems for ensuring that our employees and the agents who represent us follow our corporate policies?
- Do we conduct business in ways that respect the values, customs, and moral principles of each society? Do we recognise that there may be times when they conflict with principles of other societies? Are we ready to address these conflicts in positive ways? (Also see Exhibit 23.4)

Firms that address these questions before trouble strikes are better prepared to react to global challenges to corporate responsibility. They are better prepared to prevent crises, anticipate changes, and avoid situations that compromise the values and principles for which the firm stands. A corporate social strategy helps international managers achieve both the economic and the social goals of the firm.

International Business and Ethics

Two ethical issues are prominent in international business: bribery and corruption and work practices and worker remuneration.

Exhibit 23.4

AREAS OF ETHICAL AND SOCIAL RESPONSIBILITY CONCERNS FOR THE MULTINATIONAL

Stakeholder Affected	Ethical/Social Responsibility Issue	Example Problems for the MNC
Customers	Product safety	Should an MNC delete safety features to make a product more affordable for people in a poorer nation?
	Fair price	Should a sole supplier in a country take advantage of its monopoly?
	Proper disclosures and information	Should an MNC assume the cost of translating all its product information into other languages?
Stockholders	Fair return on investment	If a product is banned because it is unsafe in one country, should it be sold in countries where it is not banned to maintain profit margins?
Employees	Fair wages	Should a company pay more than market wages when such wages help people living in poverty?
	Safety of working conditions	Should a company be responsible for the working conditions of its suppliers?
	Child labour	Should an MNC use child labour if it is legal in the host country?
	Discrimination by sex, race, colour, or creed	Should a company assign a woman to a country where women are expected to remain separate from men in public?
Host-Country	Impact on local economies	Should an MNC use transfer pricing and other internal accounting measures to reduce its actual tax base in a foreign country?
	Following local laws	Should an MNC follow local laws that violate home-country laws against discrimination?
	Impact on local social institutions	Should an MNC require its workers to work on religious holidays?
Society in General	Environmental protection	Is an MNC obligated to control its hazardous waste to a degree higher than local laws require?
	Raw material depletion	Should MNCs deplete natural resources in countries that are willing to let them do so?

(*Source*: John B Cullen, *Multinational Management*, p. 570)

Bribery and Corruption Bribery is a deliberate attempt to persuade someone (usually in position of power and authority) to act improperly in favour of the briber by offering money or gifts or any other material gain. Bribery has been at the root of corruption in many countries.

Corruption is understood as the abuse of public office for private gain. The issue of bribery is controversial mainly because it depends on how it is defined and practised. In some Middle East countries, it would be perfectly acceptable to give a gift to an official or host as a token of appreciation for the time and consideration given. In Britain and US, however, such an act might be considered as an attempt to bribe for personal gain and might therefore be considered unlawful. The EU is in the process of legislating against any attempt by EU firms to offer bribes to their customers, wherever they may be. There are stories about dictators taking their share of business deals made with foreign companies as a bribe in return for a promise of favourable treatment for the firm concerned. The greater the value of a contract, such as a huge defense contract, the greater is the temptation to bribe in order to clinch the deal.

Bribery may be *malign* or *benign*. A benign bribe is one which benefits an economy by expediting and simplifying procedures, reducing bureaucracy, and reducing or eliminating unnecessary costs, thereby reducing prices and improving society's welfare. Malign bribery does the opposite and, in addition, leads to widespread corruption and a decline in public morals. So should an international firm offer a bribe to gain an unfair advantage over its rivals, bearing in mind that the firm offering the bribe may not necessarily be the one offering the best deal the host-country can afford? The answer obviously depends on the definition and practice of bribery adopted and observed in different countries and on the laws of the MNC's home-country.

Roots of Corruption Mere knowledge about the concepts is not enough. International managers should know why corruption occurs in the first place. He or she should know that corruption and decadence were first invented in ancient Rome. Knowing about the origins of corruption is the first step towards fighting unethical practices. There are quite a few occasions which increase the probability of indulging in corrupt practices. First, where legal framework and other anti-corrupt institutions are weak or non-existent, corrupt practices tend to originate as has been witnessed in many of the North-African countries. Second, high level and scope of government involvement in and regulation of economic activites make the officials become corrupt, particularly when their salaries are low.

Third, high levels of confidentiality prevailing with regulatory agencies leads to unethical practices. The Right to Information Act (RTI) which is in force in India is a welcome step towards making files transparent. Finally, culture tends to add to the corrupt practices. Uncertainty avoidance, power distance and masculinty tend to unethical decision-making. Corruption tandems with high uncertainity because unethical practices act as uncertainty reduction mechanisms. Masculinity tends to promote corrupt practices because they act as the means to gain wealth and power. Power distance is associated with paternalism, a system where a superior grants favours to subordinates in return for loyalty, permitting arbitrary judgement and hence corruption.

Work Practices and Worker Remuneration One of the main reasons for international firms to invest in production facilities abroad is to take advantage of the availability of relatively low cost labour in order to remain competitive in international markets. Indeed, they are actively encouraged to do so by host governments. The ethical dilemma facing an international firm is what type of technology it should employ in the host country. Inappropriate technology, especially in a Third World country, may fail to make sufficient use of the host-country's resources and increase its technology-dependence. Employing capital-intensive instead of labour-intensive methods of production may be cost-effective for the firm but fail to create many jobs in the host-country. One way out of this dilemma might be to bring in the appropriate technology that would create employment. However, increasing global competition might force the firm to employ the most cost-effective technology and production methods to remain competitive.

Because of the cultural differences explained thus far, one might expect an international firm to vary its work practices to suit the local culture and avoid ethnocentrism. But does this mean the firm should abandon its well-founded and efficient work practices developed at home for the sake of 'doing the right thing' in the host-country? For example, should Britain have denied Japanese firms the right to insist on single-union representation on the shop floor in Britain? What if the country in question is so desperate to attract foreign investment to help develop its economy that it is prepared to waive the usual health and safety regulations and workers rights? Should an MNC succumb to such an attraction? What happens if host-country work practices conflict with the firm's home practices? In many Western countries there are child labour laws preventing firms from employing children under a minimum age. But in other countries like India, Indonesia, and Thailand, there are few such laws and firms are free to employ children as young as 6 or 7. Should an MNC take advantage of the laxity of these rules or abide by its own ethical values?

MNCs are often criticised for exploiting workers in Third World countries. This criticism is particularly forceful in the case of MNCs paying unskilled or semi-skilled women workers' wages well below those in their own countries. MNCs argue that they create job opportunities for women who would otherwise remain dependent and continue their traditional subservient roles in society.

Many MNCs adhere to their own strict business ethics no matter where they operate. They insist that their licensees, franchisees, and other affiliates fulfill strict contractual obligations by observing minimum standards concerning working conditions, minimum age and wages of their employees, and health and safety regulations. This means the MNCs assume increasing responsibility not only for their own actions and business practices but also those of their suppliers. Levi and Nike, for example, guarantee their products to be manufactured by their foreign contractors under conditions acceptable to their global customers. International businesses have come under increasing pressure from various groups and agencies of global governance, such as the World Trade Organisation (WTO) and International Labour Organization (ILO), to observe and maintain acceptable standards of working practices and pay, and assume greater moral responsibility for their sub-contractors.

In addition, corporate strategy of the MNC must contain ethical orientation. An ethics-centered strategy requires a firm to do the following:

- Pursue business goals within the bounds set by society's values and moral principles. Business decisions and policies that show disrespect for these cherished beliefs are generally condemned by most members of general public.
- Respect human value diversity that is found among people and groups at home and abroad, in the workplace, and the community. People's notions of right and wrong vary considerably among societies, religions, historical periods, and ethnic groups. The wise corporation knows this and acts with care and understanding.
- Accept responsibility for nurturing ethical attitudes in business operations and for any negative impacts caused by the company. Business pressures that lead employees into unethical practices are a common problem. Ways exist for reducing these episodes.

NATIONAL DIFFERENCES IN ETHICS AND SOCIAL RESPONSIBILITY

LO 8
Categorise the national differences in ethics and social responsibility

Cultural differences affect the social and ethical practices of MNCs considerably. Figure 23.11 gives a single model of the relationships among national culture, social institutions, and business ethics.

Cultural norms and values influence important business practices—such as how women and minorities are treated on the jobs, attitudes towards gift giving and bribery, and expectations regarding conformity to written laws. Religion and the legal system are the key social institutions that affect what ethical issues are important in a society and how they are typically managed.

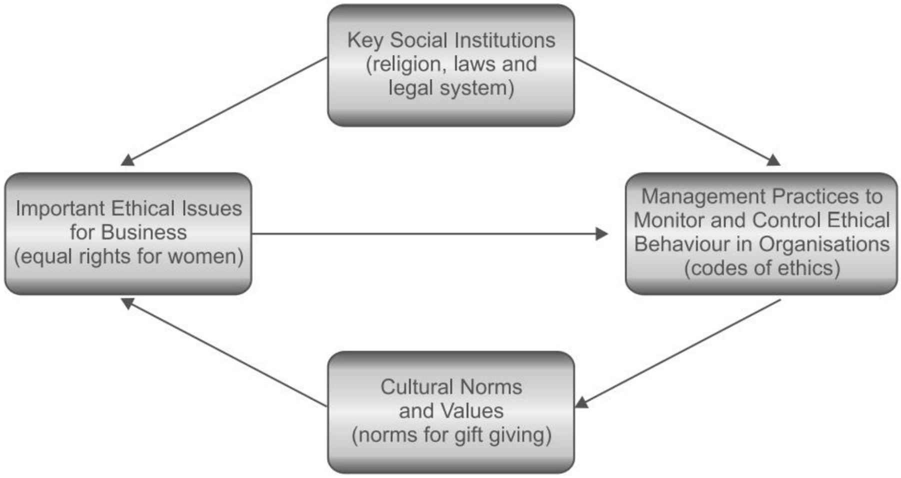

Fig. 23.11 Institutional and Cultural Effects on Ethics and Management

The international manager lacks a comprehensive body of knowledge identifying exactly how national culture and social institutions affect business ethics and under what circumstances. Instead, most of the existing knowledge comes from anecdotal evidence from practitioners and the few research studies that have been conducted on the subject. Thus, the international manager can only infer from his or her knowledge of a country's social institutions and culture what ethical issues are important and how they are best managed.

Ethical Relativism or Ethical Universalism?

This question, at the outset, seems to be irrelevant because ethical behaviours are universal and are expected from all businesses, cultural differences notwithstanding. But the international manager often comes across a situation wherein he or she needs to "Do as the Romans do, when in Rome." He or she cannot impose his or her country's ethical values on people of other countries. Hence the concept *ethical relativism.*

Ethical relativism means that each society's view of ethics must be considered legitimate and ethical. This implies, if bribery is not unethical in a society, it is okay for an MNC to follow local practices, even if it is illegal at home. Ethical relativism, therefore, means that when doing business in a country, international managers need only follow local ethical conventions. The concept of ethical relativism is almost like that of ethical amorality explained earlier. But there is a difference. The theory of amorality justifies unethical actions if they benefit business. The theory of relativism suggests that business should follow local ethics, but not necessarily unethical actions.

The opposite of ethical relativism is *ethical universalism.* This principle holds that there are basic moral principles that transcend cultural and political boundaries. All cultures, for example, have rules that prohibit murder.

The theory of moral unity and the concept of ethical universalism seem to convey the same meaning. The theory of moral unity advocates the principle that business actions should be judged by the general ethical standards of society. There exists only one ethical standard that applies to business and non business situations in a given society. Ethical universalism stretches beyond the boundaries of a society. According to the universalism principle, there exist principles that are applicable to all societies.

For an MNC there are practical problems for following either ethical relativism or moral universalism. Ethical relativism is criticised by ethicists as a convenient way for indulging in unethical practices, using the excuse of cultural differences. They cite the example of abusing child labour in many developing countries to produce products that are used by MNCs.

Extreme moral universalism too has pitfalls. The assumption that one can identify universal ethics that all societies should follow can lead to cultural imperialism. Cultural imperialism makes international managers view cultures of other countries as inferior or immoral. This is particularly dangerous when the international business is a powerful one and has affiliates in developing countries.

Pressures for Ethical Convergence

Cultural differences notwithstanding, there are growing pressures on international businesses to follow the same rules in managing ethical behaviour and social responsibility. This is called *ethical convergence.* There are three reasons for ethical convergence.

1. The growth of international trade and trading blocks, such as the NAFTA and the EU, creates pressures to have common ethical practices that transcend national cultures and institutional differences. Predictable interactions and behaviours among trading partners from different countries make trade more efficient.

2. Interaction between trading partners creates pressures for imitating the business practices of other countries. As to people from different cultural backgrounds increase their interactions, exposures to varying ethical traditions encourage people to adjust to, imitate, and adopt new behaviours and attitudes.

3. MNCs that do business across the world have employees from varied cultural backgrounds who need common standards and rules regarding how to behave. Consequently, MNCs often rely on their corporate cultures to provide consistent norms and values that govern ethical issues.

CODE OF CONDUCT FOR AN MNC

LO 9
Identify the code of conduct for an MNC

Just as domestic businesses have codes of conduct, so do the MNCs. These codes contain both proscriptive as well as prescriptive rules to guide the multinationals' behaviour. Prescriptive rules tell international managers and firms what they should do, while proscriptive rules tell them what they should not do. Exhibit 23.5 is a typical code of conduct for MNCs. The exhibit summarises ethical stipulations for the international firm derived from the following sources:

- The United Nations Universal Declaration of Human Rights
- The United Nations Code of Conduct on Transnational Corporations
- The European Convention on Human Rights
- The International Chamber of Commerce Guidelines for International Investment
- The OECD Guidelines for Multinational Enterprises
- The Helsinki Final Act
- The ILO Tripartite Declarations of Principles concerning MNEs and Social Policy

Exhibit 23.5

MNC'S CODE OF CONDUCT

Respect Basic Human Rights and Freedoms

- Respect fundamental human rights of life, liberty, security, and privacy
- Do not discriminate on the basis of race, colour, gender, religion, language, ethnic origin, or political affiliation
- Respect personal freedoms (e.g., religion, opinion)

Minimise any Negative Impact on Local Economic Policies

- Conform to local economic and development policies
- Avoid adverse effects on currencies and balance of payments
- Follow policies regarding local equity participation
- Provide truthful information for accurate taxation
- Pay fair taxes
- Source raw materials locally
- Reinvest profits in local economy

Maintain High Standards of Local Political Involvement

- Avoid illegal involvement in local politics
- Don't pay bribes or other improper payments
- Do not interfere in local government's internal relations

Transfer Technology

- Enhance the transfer of technology to developing nations
- Adapt technologies to local needs
- Conduct local R&D when possible
- Grant fair licences to use technology

Protect the Environment

- Follow local environmental-protection laws
- Actively protect the environment
- Repair damage to the environment done by company operations
- Help develop local standards
- Provide accurate assessments of environmental impact of the company
- Provide complete disclosure of the environmental effects of operations
- Develop standards to monitor environmental effects

Consumer Protection

- Follow local consumer-protection laws
- Ensure accurate and proper safety disclosures

Employment Practices

- Follow relevant manpower policies and employment laws of host nation
- Help create jobs in needed areas
- Increase local employment opportunities and standards

- Provide local workers stable employment and job security
- Promote equal employment opportunities
- Give priority to local national residents when possible
- Provide training opportunities at all levels for local employees
- Promote local nationals to management positions
- Respect local collective-bargaining rights
- Cooperate with local collective-bargaining units
- Give notice of plant closings
- Do not use threat of leaving country in collective-bargaining dealings
- Provide income protection to terminated workers
- Match or improve local standards of employment
- Protect employees with adequate health and safety standards
- Provide employees information on job-related health hazards

DECISION FLOWCHART FOR AN MNC

LO 10
Analyse the decision flowchart for an MNC

International manager, like his or her counterpart in domestic business, faces ethical dilemmas. Figure 23.12 contains a typical model that helps an international manager solve an ethical conflict.

The first task for an international manager is to consider the ethical and legal consequences of his or her actions. The legal consideration includes not only a test of whether a behaviour or its consequences meet legal standards in the home and host countries, but also a comparison against international standards. These standards come from the international agreements, treaties and conventions among nations.

The ethical analysis has three components: one's organisation, the national culture in which the business operates, and personal ethical beliefs.

In the organisational ethical analysis, managers must look to their written codes of ethics and the unwritten norms of the company culture. Many firms have ethical codes which guide managers' behaviours. In addition, all organisations have company cultures that have unwritten rules which prescribe or proscribe behaviours.

International managers are guests in other nations. As such, their ethical decision-making must go beyond legal constraints and follow company rules and cultural norms. The manager must ask himself or herself whether what they are doing is consistent with and respectful of local cultural norms.

An international manager may begin these analyses at different points. For some issues, one may consider personal moral beliefs first. For other issues it may make more sense to consider the law. At some point, however, either after considering all the forgoing or at any stage in managerial decision-making, the manager must make a personal moral judgement.

SUMMARY

- Social responsibility, also called corporate social responsibility, refers to the actions taken by businesses which benefit society along with their own interests. (LO1)
- Social responsibility has both supporters and opponents. Arguments apart, CSR has come to stay

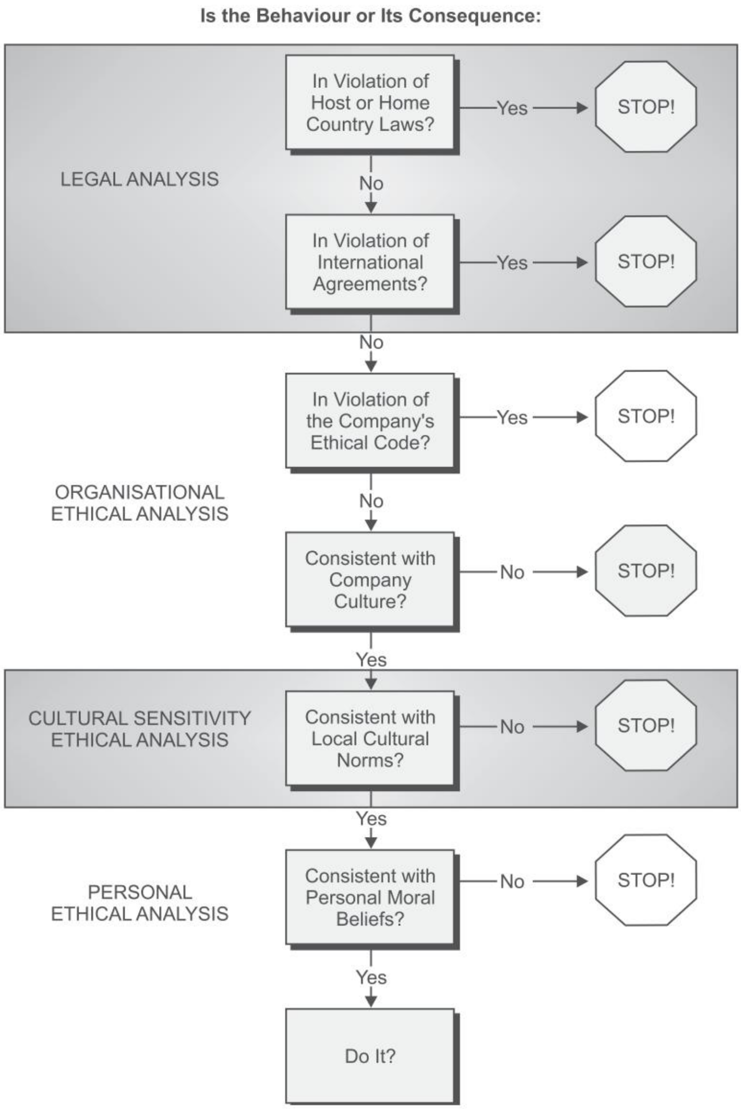

Fig. 23.12 Decision Flow Chart for an MNC

(*Source*: John S. Culllen, *Multinational Management*, p. 588)

and even mandated also. (LO2)

- CSR is based on certain principles such as corporators are economic entities, and the like. (LO3)
- Cost, efficiency, relevance, and scope are the typical limits of CSR. (LO4)
- CSR management involves action on several fronts such as leadership, mission statements, social issues and the like. (LO5)
- Business ethics refers to good or bad and fair or unfair. Ethics have sources. (LO6)
- MNCs need to be socially conscious and ethically fair while conducting business across countries. (LO7)

- Cultural differences affect the social and ethical practices of MNCs considerably. (LO8)
- MNCs have their own codes. The codes contain dos and don'ts for international businesses. (LO9)
- Decision flow chart is of great help to know whether or not an act is ethical, and if unethical what needs to be done. (LO10)

Review Questions

1. What is social responsibility? Advocate why social responsibility is important? Irrelevant?
2. Define social responsibility. Trace the evolution of the concept of social responsibility.
3. Bring out the pressures leading to social responsibility.
4. How do firms implement socially responsive actions?
5. What are the limitations of social responsibility?
6. Define business ethics. Explain the sources of ethics.
7. What are ethical dilemmas? How are they resolved?
8. How does a firm manage its ethics?
9. Why is ethical decision-making difficult? How can the decision-making be made effective?
10. What is ethical relativism? Universalism?

Discussion Questions

1. "Doing international business poses challenges to managers so far as social actions are concerned." Elaborate this statement.
2. "Two ethical issues are prominent in international business: bribery and corruption and work practices and worker remuneration." Substantiate this statement.
3. "Corporate culture and ethical climate can put much pressure on people to channel their actions in certain directions." Discuss.
4. "Business's function is economic, not social, and economic values should be the only criteria to measure success." Elaborate this statement.
5. You are the head of purchasing department in a multi-crore firm. Point out the ethical conflicts you encounter. How do you resolve them?

Reinforcing Exercises

- The main reason behind Tata's massive social works is the ownership structure of the conglomerate. Tata trusts were established for the purpose of funnelling the personal wealth of the Tata family into CSR activities. Owners of Tata Sons, the holding company, are the trusts not individuals. Trusts get funds from dividends paid by Tata Sons every year. Tata Sons would not be known for its social work, was its ownership structure be like that of any corporate. What is your take on this?
- Social responsibility carries with itself moral dimension. It is immoral on the part of owners of a factory to allow untreated effluents into the open lake and make the water therein unsuitable for public consumption. It is equally immoral on the part of an automobile manufacturer to release unsafe cars, causing accidents that kill people. Precisely realising this moral obligation Toyota recalled 16000 cars from Germany in 2010. In 2007, the CEO of Toyota bowed before public in apology. Can you debate on the point that CSR has moral orientation.

- Corporate frauds in India have grown in size and number since 2008-09 as shown in Table 23.10. Comment on the contents of the Table.

Table 23.10 Value of fraud

	Total value of fraud (₹ crore) per year
2012	15,440
2011	66,880
2010	30,403
2009	1,38,074
2008	10,739
2007	2,803
2006	2,790
2005	1,500
2004	75,831
2003	3,030
2001	4,476
1997	26,000

Source: Mint, February 4th, 2014

CLOSING CASE 1

Conscience or The Competitive Edge

The plane touched down at Mumbai airport precisely on time. Olivia Jones made her way through the usual immigration bureaucracy without incident and was finally ushered into a waiting limousine, complete with uniformed chauffeur and soft black leather seats. Her already considerable excitement at being in India for the first time was mounting. As she cruised the dark city streets, she asked her chauffeur why so few cars had their headlights on at night. The driver responded that most drivers believed that headlights use too much petrol! Finally, she arrived at her hotel, a black marble monolith, grandiose and decadent in its splendour, towering above the bay.

The goal of her four-day trip was to sample and select swatches of woven cotton from the mills in and around Mumbai, to be used in the following season's youth-wear collection of shirts, trousers, and underwear. She was thus treated with the utmost deference by her hosts, who were invariably Indian factory owners or British agents for Indian mills. For three days she was ferried from one air-conditioned office to another, sipping iced tea or chilled lemonade, poring over leather-bound swatch catalogues, which featured every type of stripe and design possible. On the fourth day, Jones made a request that she knew would cause some anxiety in the camp. "I want to see a factory," she declared.

After much consultation and several attempts at dissuasion, she was once again ushered into a limousine and driven through a part of the city she had not previously seen. Gradually, the hotel and the Western shops dissolved into the background and Jones entered downtown Mumbai. All around was a sprawling shantytown, constructed from sheets of corrugated iron and panels of cardboard boxes. Dust flew in spirals everywhere among the dirt roads and open drains. The car crawled along the unsealed roads behind carts hauled by man and beast alike, laden to overflowing with straw or city refuse—the treasure of the ghetto. More than once the limousine had to halt and wait while a lumbering white bull crossed the road.

Finally, in the very heart of the ghetto, the car came to a stop. "Are you sure you want to do this?" asked her host. Determined not to be faint-hearted, Jones got out of the car.

White-skinned, blue-eyed, and blond, clad in a city suit and stiletto-heeled shoes, and carrying a briefcase, Jones was indeed conspicuous. It was hardly surprising that the inhabitants of the area found her an interesting and amusing subject, as she teetered along the dusty street and stepped gingerly over the open sewers.

Her host led her down an alley, between the shacks and open doors and inky black interiors. Some shelters, Jones was told, were restaurants, where at lunchtime people would gather on the rush mat floors and eat rice together. In the doorway of one shack there was a table that served as a counter, laden with ancient cans of baked beans, sardines, and rusted tins of a fluorescent green substance that might have been peas. The eyes of the young man behind the counter were smiling and proud as he beckoned her forward to view his wares.

As Jones turned another corner, she saw an old man in the middle of the street, clad in a waist cloth, sitting in a large tin bucket. He had a tin can in his hand with which he poured water from the bucket over his head and shoulders. Beside him two little girls played in brilliant white nylon dresses, bedecked with ribbons and lace. They posed for her with smiling faces, delighted at having their photograph taken in their best frocks. The men and women moved around her with great dignity and grace, Jones thought.

Finally, her host led her up a precarious wooden ladder to a floor above the street. At the top Jones was warned not to stand straight, as the ceiling was just five feet high. There, in a room not 20 feet by 40 feet, 20 men were sitting at treadle sewing machines, bent over yards of white cloth. Between them on the floor were rush mats, some occupied by sleeping workers awaiting their next shift. Jones learned that these men were on a 24-hour rotation, 12 hours on and 12 hours off, every day for six months of the year. For the remaining six months they returned to their families in the countryside to work the land, planting and building with the money they had earned in the city. The shirts they were working on were for an order she had placed four weeks earlier in London, an order of which she had been particularly proud because of the low price she had succeeded in negotiating. Jones reflected that this sight was the most humbling experience of her life. When she questioned her host about these conditions, she was told that they were typical for her industry—and for most of the Third World, as well.

Eventually, she left the heat, dust, and din of the little shirt factory and returned to the protected, air-conditioned world of the limousine.

"What I've experienced today and the role I've played in creating that living hell will stay with me forever," she thought. Later in the day, she asked herself whether what she had seen was an inevitable consequence of pricing policies that enabled the British customer to purchase shirts at £12.99 instead of £13.99 and at the same time allowed the company to make its mandatory 56 percent profit margin. Were her negotiating skills—the result of many years of training—an indirect cause of the terrible conditions she has seen?

Once Jones returned to the United Kingdom, she considered her position and the options open to her as a buyer for a large, publicly traded, retail chain operating in a highly competitive environment. Her dilemma was twofold: Can an ambitious employee afford to exercise a social conscience in his or her career? And can career-minded individuals truly make a difference without jeopardising their future?

Olivia Jones described her subsequent decision as follows:

The alternatives for me were perfectly clear, if somewhat unrealistic: I could stipulate a standard of working conditions to be enforced at any factory employed, and offer to pay an inflated price for merchandise in an effort to fund the necessary improvements. This would mean having to increase the margins in other sections of the range and explaining to my controller exactly why prices had risen.

'There was no guarantee that the extra cash would make its way safely into the hands of the worker or improve his working conditions. Even exercising my greatest faith in human nature, I could see the wealthy factory owner getting increasingly fatter and some other keen and able buyer being promoted into my highly coveted position'.

'I could refuse to buy from India. This would mean I would have to find alternative sources at equally low prices to justify my action. There was always Macau, where I knew conditions were worse if anything, or Hong Kong, where conditions were certainly better, from what I had seen, but prices were much higher. I had to ask myself if I would truly be improving the plight of the workers by denying them the enormous orders that I usually put through their factories. Or would I simply be salving my own conscience by righteously congratulating myself at not dealing in slave labour? Doubtless my production schedule would be snapped up eagerly by the next buyer who was hungry for cheap labour and fast turn around.'

'I could consider speaking to the powers that be and ask their advice. After all, the group was proud of its philanthropic reputation and had promoted its charity work and sponsorship of various causes, including Wimbledon Football Club and Miss World. This in mind, I approached my line manger, who laughed at my idealistic naivety and made it quite clear that I should hold my tongue if I knew what was good for me.'

'It seemed I had but two choices. Either I quit the company and look for an employer which would be more responsible in its attitude towards sourcing merchandise, or I could continue to buy as before, but aware of the consequences and exercising a conscience wherever possible. I won't bother to list my excuses for opting for the latter choice.

'I believe that there is no solution, or generalisation which can be used as a precedent in this type of scenario. I don't know to this day what action I could have taken to improve the lives of those individuals who I felt I had compromised.'

'Every day, in various work situations, employees, and specifically managers, come up against questions of conscience versus the status quo. You may be encouraged to show prejudice against an individual or group of employees due to their race, colour or clique; may be your boss asked you to lie to camouflage an embarrassing error and insinuate that the fault lies with someone else; may be your employer's policy requires you to screw a client or a supplier to close a deal and maintain the bottom line.'

'Each case is different and demands its own evaluation. Each man and woman must draw their own set of rules and regulations to suit their own situation and conscience.'

'It takes brave individuals to jeopardise their careers for a cause but it is thanks to those who do take a stand that great feats of humanitarian work are successfully undertaken and completed. We should all evaluate the choices that are open to use and be true to ourselves. Let your conscience be your guide within the realms of reality.'

'The most important lesson that I learned from the episode was that above all, you have to learn to live with the choices that you make'.

Questions

(i) What ethical dilemmas did Jones encounter?

(ii) Do you think that the lesson Jones learnt is the right one.

CLOSING CASE 2

One-Minute Moralist Revisited

Here are certain issues on which the international manager does not have definite answers:

1. International Telephone and Telegraph (ITT) is an extreme example of an MNC interfering in the local affairs of a host country. ITT had a profitable subsidiary company in Chile. It feared reduced profits in anticipation of nationalisation by the government if a Marxist candidate for President, Salvador Allende, were elected.

   ITT attempted to block Allende's election through a series of manoeuvres: ITT bankrolled Allende's opposition, including conservative newspapers. It lobbied Chilean legislators who would play a role in confirming the next President. It sought the support of the CIA in creating economic disruptions that would prevent Allende's ascent to presidency. Even after Allende assumed office in 1970, ITT continued its attempts to undermine him through economic disruption by limiting credit, by political propaganda, and even through a boycott of Chile's important copper export trade. Allende was eventually overthrown by a right wing military coup in 1973.

2. Developing countries need to have access to markets in high-income countries to sell their products. Many emerging economies have domestic markets of limited size, and their trade with each other is not significant. For example, Latin American countries, on an average, export only about 10 per cent of their products to other countries in the region, but almost 20 per cent of them to the US. However, politicians in rich countries are sensitive to increased imports which could lead to unemployment. That could lead to protectionist measures to limit low-cost imports from low-wage developing countries.
3. It is often argued that nations should use trade policies to pressure other countries to change certain policies. For example, countries engage in limited trade with Iraq in order to weaken its repressive dictatorship; with India to protest against its nuclear tests; with Malaysia so that it will prohibit abuse of child labour; with Taiwan so that it will curtail trade of endangered animals; and with Brazil so that it will restrict the cutting down of Amazon forests.
4. Acme Boots announced it was moving out of the US in order to gain tax advantages in Puerto Rico. The move stranded its US employees, some of whom had 30 years of service with the company. Many critics of FDI argue that it is unethical for governments to lure companies away from existing locations by offering them lucrative incentives to move.
5. The US government often gives aid as a bribe, with an understanding that the host country will grant political concessions in return. Governments use high-level official visits and lobby aggressively to help their home-based companies to gain foreign business. For example, the US government has paid for ministry heads of countries to visit the United States when a US company is bidding for a contract, and has given scholarships to family members of officials who can ensure business opportunities to their companies.
6. Tobacco giant Philip Morris spent $75 million on charitable contributions in 1999 and then launched a $100 million advertising campaign to publicise them.
7. The Queen of England wished to buy chocolates from the grandfather of Sir Adrian Cadbury to be sent to each soldier serving in the Anglo-Boer war in South Africa. But Cadbury was opposed to the war and was uncomfortable reaping a profit from such a transaction. On the other hand, he was striving to take the company forward, and this would mean additional business for the firm. He decided to accept the order, but supplied the goods at cost price with no profit. The firm benefited from the order, but he did not reap a financial gain at the expense of the war.
8. Milan magistrates are investigating Europe's biggest and spectacular corporate scandal, where an equivalent of some ₹ 25,000–50,000 crore cash in euros, have just vanished from the company's Cayman Island (tax haven) accounts. According to the investigating magistrates, the founder of the Parmalat Company, which employs about 39,000 staff, himself instigated a fraud plan which has led the company to the verge of bankruptcy.

   The Italian authorities investigating Parmlat's slide into bankruptcy have accused Calisto Tanzi, its founder, of initiating a complex chain of financial schemes that has brought the huge dairy and food chain giant crashing down. Tanzi has now admitted to misappropriating about euro 500 million over seven or eight years, according to Italian investigating authorities.

9. An US apparel designer sells to major US department stores and retailers. Several years ago the firm decided to procure clothing sewn in India and Pakistan, resulting in tremendous cost savings when compared to having the work done in the United States. In making this decision, the firm considered its impact on the American families which depended on the income from these jobs. The firm, however, opted for cost savings, seeing its responsibility to produce a profit for shareholders as more important than providing jobs at home. Now, however, it finds that its contractor in India is overworking and abusing child labour in violation of internationally accepted standards for the treatment of children in the workplace. The Indian government shows little interest in policing its own labour policies. The sad story of these Indian children is run on national television and appears in the national press.
10. A firm enters into a contract to sell drilling equipment to a Korean company. The contract is sealed when the Korean company president is visiting the US plant. Subsequently the Korean executive points out that all imports to Korea must be channeled through a registered "local agent". He quickly suggests that a wholly-owned trading company that he owns could handle all of the paperwork—for a fee.

Assuming you are the one-minute moralist, offer your views on each of the above case situations.

CLOSING CASE 3

A True CSR

What India needs most and what has been regrettably neglected till now is primary education. Large number of people do not know how to read and write as a result. Now that the right to education has been mandated, things are likely to improve in the years to come. But we have to wait for long to see the improvement.

However, Sunil Mittal had no patience. The man who has built a telecom empire with above 140 million subscribers is all set to build 550 schools to educate 100,000 poor children, deep inside India's villages. "I knew we needed to do something that would create an impact. My mind was working at building a core around our giving activities.

When I discussed this with Rakesh (elder brother) and others, we wondered what kind of activity would have a multiplier effect. And I knew it would be education, especially in villages where schools are not available for the poorest of the poor. I firmly believe that if you teach a child, chances are that eventually this benefits the whole family.

Another factor also set me thinking. We had given crores to the Indian Institute of Technology (IIT), New Delhi, and while it (Bharti School of Telecommunication Technology and Management) was and is a great project, I felt that the output was very poor – in the sense that the number of students who qualified on that money was no more than 100 a year. In effect, we were spending very large amounts of money on high-quality education but it benefited a few.

I like scale; everything we do is done on a large scale. I felt that the money that had gone to IIT would have worked much longer had we done primary education.

This is where our shift in focus came, and we decided the Bharti Foundation would build and run 500 primary schools across the country.

If we wanted to scale up our philanthropic activities, then we had to have focus on one area. We decided to put in ₹ 200 crore from our own funds into the Bharti Foundation corpus towards this and started the programme around 2006."

Table 23.11 shows the progress made till now towards eradication of illiteracy.

All these schools are being run by Bharti Foundation set up in 2000 with a corpus fund of ₹ 200 crore. The foundation is the philanthropic

Table 23.11 Scaling up

Schools:	
Primary	233
Elementary	12
Sr. Secondary	5
States Covered: Punjab, Haryana, W.Bengal, UP, Rajasthan, Tamil Nadu	
Owned by Bharati Foundation	187
Adopted from Rajasthan Government	49
Student Strength	30,000
Fee	Free
Number of backward caste students	21,000
Teachers	1,100
Other support staff	500
Number of backward caste teachers	770
Initial cost of starting a school	₹ 20 lakh
Initial cost of renovating an adopted school	₹ 5 lakh
Annual running costs	₹ 12 lakh per school
Number of shifts	2
Number of teachers/school	5-7
Average teacher salary per month	₹ 4,500
Average head teacher salary/month	₹ 7,000

arm of Bharti Group. Cost incurred to run the schools amount to ₹ 28 crore per annum. This project is the largest intervention by a business house and the largest affirmative action initiative in the country.

All the schools are built according to a blue print drawn up by a Delhi-based architect. Each school is located in half an acre of land and has five classrooms (for standards 1 to 5) and a staff room. Other facilities include toilets, a vegetable garden and a playground. Every school has Internet connection.

The Bharti Group's managerial skills are evident in the way these schools are run. Like every group company, the Bharti Foundation has a CEO, under whose leadership all the schools are administered. Sunil Mittal, of course, visits them at random. His elder brother, who heads the group's CSR activities also takes interest in running the schools.

A boy or a girl can study up to secondary school and what happens next remained a big question. The Foundation has found an answer too. Skill building initiatives are undertaken for all the students in their final years in the secondary school. Boys and girls can pursue their studies, if they can, or take up jobs based on the skills they have acquired.

The Sathya Bharti School programme (name of the umberella running the schools) now works like an organisation; each school follows the standard operating model. Each school is a photo copy of another. Curriculum is developed by the Foundation and is applicable to all the schools.

Teacher training is accorded lot of importance. Teachers are trained to teach through visual effects. They are discouraged to adopt the rote method.

It is typical of Sunil Mittal as a professional. He tried several models of CSR. For instance, he wrote cheques in favour of NGOs and extended financial support to governments. He was not convinced. Sunil Mittal studied the US model where individuals and corporates had pledged long-term commitments towards social responsibility. In 2006, he even visited the Gates Foundation in Seattle and had lunch with Bill

Gate's father. He also went to the Rockfeller Foundation. He was inspired and was convinced that direct intervention would do. He precisely did that.

Bharti's business partners pitched in to supplement the Foundation's initiatives. IBM is installing a computer in every school with games and other features that are meant for education. PWC and E & Y are auditing the Foundation books of accounts free. Deutsche Bank has adopted four schools and WalMart has accepted one. Sunil Mittal's is a true and genuine CSR initiative.

Questions

1. Do you think what Mittal has done is on the right lines? If not, what suggestions can you offer?
2. Can other organisations replicate Mittal's model of CSR?

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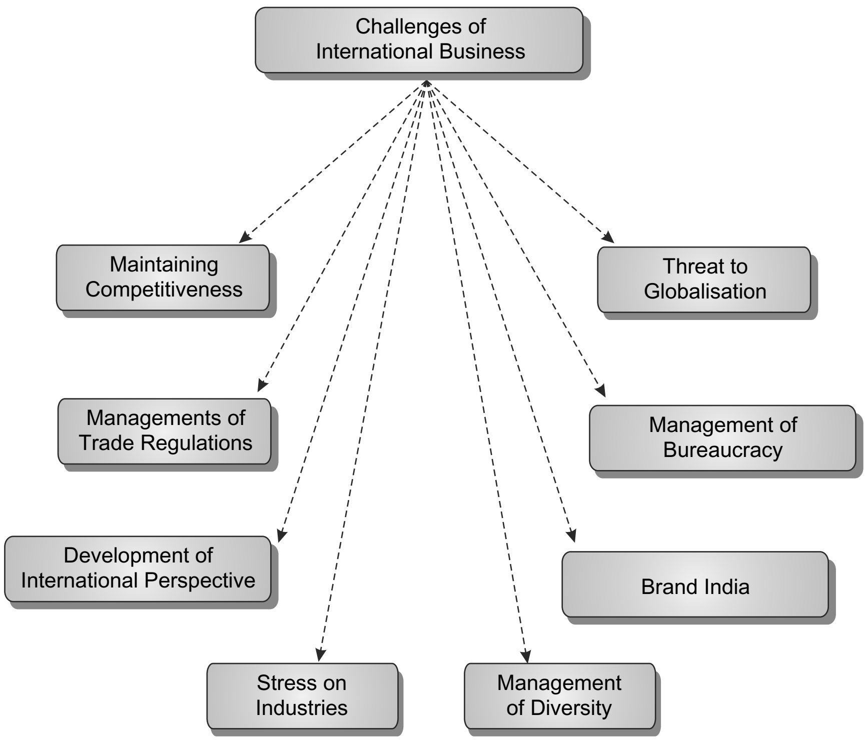
CHAPTER


Challenges of International Business
Maintaining Competitiveness
Threat to Globalisation
Managements of Trade Regulations
Management of Bureaucracy
Development of International Perspective
Brand India
Stress on Industries
Management of Diversity

24

Future of International Business

Learning Objectives

After reading this chapter, you should be able to:

- **LO 1:** Identify future direction of international business
- **LO 2:** Assess the challenges for international business

Opening Case

100 Years, Still Growing Strong

Age	:	Founded in 1911 by the merger of three small producers of mechanical accounting machines, scales and time recorders, and 13 years later the present name was given.
Must name in business circles	:	Most cited name in business books, literature and academic class rooms. A must reference in discussions on multicultural management. As long as Geert Hofstede's name is green, the company's name tandems.
Honours	:	• 18th largest firm in the US by *Fortune* • 7th most profitable company by *Fortune* • 31st largest global firm by *Forbes* • First company for leaders by *Fortune* • 2nd best global brand • First green company worldwide by NewsWeek • 12th most admired company by *Fortune* • 18th most innovative company
R & D establishments	:	9 research centres located in Almaden, Austin, Brazil, China, India, Haifa, Tokyo, Zurich, Watson (New York)
No. of employees	:	427000 in over 200 countries • 10500 in the US

		• 75000 in India
Employee credentials	:	• 5 Noble Lauriates • 4 Turning Awards • 9 National Medals of Technology • 5 National Medals of Science
Famous inventions	:	ATM, floppy disk, hard disk drive, magnetic stripe card, relational data-base, universal product code, DRAM, Watson artificial intelligence, financial swap, SABRE airlines reservation system.
Closing value	:	\$214 bn (Sept 29, 2011)
Turnover	:	Around \$100 bn
Nick Name	:	Big Blue

Your guess is correct. We are talking about the International Business Machines (IBM). Though 100 years old, IBM is not the world's oldest company. There are Japanese hotels dating back to the 8th century, German breweries that hail from the 11th century and an Italian bank with roots in the 15th century.

Headquartered at Armonk, New York, US, IBM manufactures and sells computer hardware and software, and offers infrastructure, hosting and consulting services in areas ranging from main-frame computers to nano-technology.

What is unique about IBM? Why a storey on it in this book? Following seek to answer the questions.

First, IBM's strategy is that it has been built around an idea that transcends any particular product or technology. Its strategy has been to package technology for use by businesses. To begin with, this meant making punch-card tabulaters, but IBM moved on to magnetic-tape systems, main frames, PCs, and a company around an idea, rather than a specific technology, make it easier to adapt when industry "platform shifts" occur.

Second, IBM believes in customer connectivity. It has huge service organisation, which employees more than half the total workforce of nearly 427,000. IBM often "co-creates" products with customers. With the state of New York, for instance, IBM developed a method of detecting tax evasion which has saved tax payers \$1.6 bn since 2004.

Third, IBM has become much less hierarchial and more open. Its smarter planet initiative (which is intended to inject more intelligence into power grids and transport systems) is said to have originated in one of IBMs online brainstorming sessions where all employees and sometimes even family members are involved.

Fourth, IBM tries to ensure that the output of its 3000 strong research division remains relevant to its business. Researchers are regularly embedded with teams from the services unit to give them on-the-ground experience. Often, they co-operate with customers, for example, in creating a system that constantly monitors the vital signs of new born babies to indicate when they acquire an infection. Once a year, they must produce a "Global Technology Outlook', an attempt to spot important trends early.

Fifth, IBM is no longer a collection of independent national subsidiaries, but a globally integrated company. It has a common IT infrastructure, which allows it to use the same accounting, and other business processes all over the world.

Sixth, IBM ditches businesses that are about to become commoditised and no longer yield a sufficient profit margin. Since 1999, Big Blue hived off half a dozen businesses, including PCs and printers. It also believes in acquisition. In 2002, it bought the consulting arm of PriceWaterhouseCoopers, an accounting firm, and is constantly trying to push its services business into higher-value territory and even created something called "services science" to study ways to automate them.

Seventh, IBM effectively answered the question – How is the world different because a company existed? Yes, IBM has made world different. By its 50th birthday, Big Blue was one of America's leading firms, earning profits of \$254 mn on revenues of \$2.2 bn and employing 116,000 people. Those jobs, as well as products are in themselves a measure of IBM's achievement. Because firms sell something that people want, they make the world a better place to live.

IBM also spends a lot of money on research. By 1935 it employed 300 engineers, and some 95% of its profits were generated by innovations introduced since 1917. This effort soon expanded through partnerships with universities and embraced pure research as well as more applied commercially driven sort. IBM's benefits to society include the bar code, IBM's version of which became the standard. The company also associated itself with America's space programme.

Finally, in employee welfare, IBM is like Tatas. It introduced employment practices that became norm in the US. In 1915 itself, the company made it a policy to treat all employees equal. Women received equal pay for equal work since 1935. From 1945, all IBM workers received pensions.

Thus, 100 years after its incorporation, IBM appears fairly well in control of its destiny. IBM became a global company, much before people started taking about globalisation. Globalisation will be secure and can become meaningful in the hands of players like IBM. We wish 100 years of new life for IBM.

DOUBTING Thomases are highly sceptical about the future of international business. But the doubts appear to be more for argument sake. In reality, globalisation (synonym for international business) has come to stay and is irreversible. Globalisation is judged by what it delivers. It has delivered both good things but also generated fears and anxieties. At one extreme, globalisation is seen as an irresistible and benign force for delivering economic prosperity to people throughout the world. At the other, it is blamed as a source of all contemporary ills. The pros and cons of globalisation were highlighted in the first chapter. In chapter 16, we had pointed out that globalisation as of now is gated, but the gates should be dismantled. In this chapter, we propose to discuss challenges and future of globalisation.

FUTURE DIRECTION

LO 1
Identify future direction of international business

The dominant perspective on globalisation must shift more from a narrow preoccupation with markets to a broader preoccupation with people. Globalisation must be brought from the high pedestal of corporate board rooms and cabinet meetings to meet the needs of people in the communities in which they live. There is a need for —

- a commitment by the developed countries to pay the developing countries fairly for their natural resources — and to extract them in ways that do not leave behind a legacy of environmental degradation.
- a renewal of the commitments already made by the developed countries to provide financial assistance to the poorer countries of 0.7 per cent of GDP—a renewal accompanied this time by actions to fulfill that commitment. If America can afford a trillion dollars to fight a war in Iraq, surely it can afford less than $100 billion a year to fight a global war against poverty.
- an extension of the agreement for debt forgiveness made in July 2005 to more countries: too many countries' aspirations of development are being thwarted by the huge amounts they spend on servicing their debt – so large, in fact, that, net flows of money in some recent years have been going from developing countries to the developed.
- a host of institutional (legal) reforms – to ensure, for instance, that new global monopolies do not emerge to handle fairly the complexities of cross-border bankruptcies both of sovereigns and

companies, and to force multinational corporations to confront their liabilities and from their damage to the environment.

- if the developed countries have been sending too little money to the developing world, they have also been sending too many arms; they have been part and partners in much of the corruption; and in a variety of other ways, they have undermined the fledgling democracies.
- the developed countries to ensure that a final agreement is reached on GATS, at the earliest.

The following also should guide the future course of action:

A focus on people: The cornerstone of a fairer globalisation lies in meeting the demands of all people for: respect for their rights, cultural identity and autonomy; decent work; and the empowerment of the local communities they live in. Gender equality is essential.

A democratic and effective state: The state must have the capability to manage integration into the global economy, and provide social and economic opportunity and security.

Sustainable development: The quest for a fair globalisation must be underpinned by the interdependent and mutually reinforcing pillars of economic development, social development and environmental protection at the local, national, regional and global levels.

Productive and equitable market: This requires sound institutions to promote opportunity and enterprise in a well functioning market economy.

Fair rules: The rules of the global economy must offer equitable opportunity and access for all countries and recognize the diversity in national capacities and developmental needs.

Globalisation with solidarity: There is a shared responsibility to assist countries and people excluded from or disadvantaged by globalisation. Globalisation must help to overcome inequality both within and between countries and contribute to the elimination of poverty.

Greater accountability to people: Public and private actors at all levels with power to influence the outcomes of globalisation must be democratically accountable for the policies they pursue and the actions they take. They must deliver on their commitments and use their power with respect for others.

Deeper partnerships: Many actors are engaged in the realisation of global social and economic goals — international organisations, governments and parliaments, business, labour, civil society and many others. Dialogue and partnership among them is an essential democratic instrument to create a better world.

An effective United Nations: A stronger and more efficient multilateral system is the key instrument to create a democratic legitimate and coherent framework for globalisation.

CHALLENGES OF INTERNATIONAL BUSINESS

LO 2
Assess the challenges for international business

Increasing globalisation poses its own challenges to trading countries. There are eight areas in which each country must excel in order to emerge as a strong global player. *First*, the country must maintain competitiveness. *Secondly* it must influence trade regulators so that other countries open their doors for its goods and services, being willing to buy from as well as sell to the country. *Thirdly*, the country's businesses must develop a global outlook that allows them to operate as true MNCs, not just as local firms doing business overseas. *Fourth*, an MNC should know how to manage diversity in the global business canvas. *Fifth*, a global firm needs to maintain a good image—an honest and socially responsible firm. *Sixth*, threat to globalisation needs to be met. *Seventh*, businesses, particularly Indian, need to manage bureaucracy. *Eighth*, there should be emphasis on industrial sector. *Finally*, brand India needs to be sustained.

Maintaining Competitiveness

Competitiveness is the relative strength that one needs to win over others. Such relative strength can be gained by a firm and by even a nation. Factors which earn such strength differ from level to level. In other words, factors that help gain competitiveness of a firm differ from those that contribute to a country's strength. We will examine the different factors of competitiveness in this section.

Country competitiveness A country is said to achieve competitiveness when it can generate more wealth than others, optimally using the resources. At the core of country competitiveness is productivity. Productivity is the value of the output produced by one unit of input. It is the prime determinant of a nation's long-term standard of living and is the root source of national per capita income.

Four major factors contribute to country competitives: (i) technology, (ii) economic soundness, (iii) finance, and (iv) internationalisation (See Fig. 24.1)

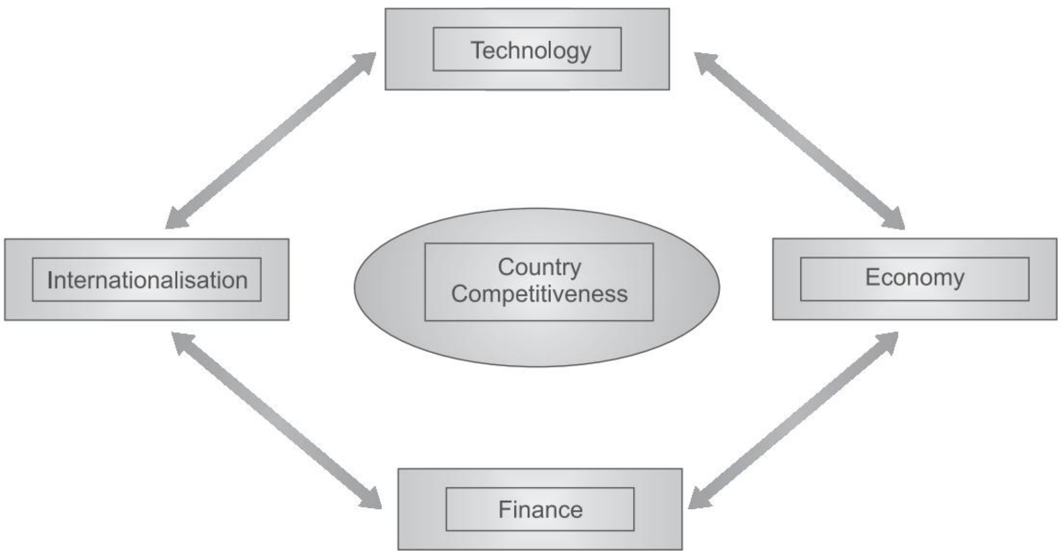


Fig 24.1 Four Factors of Competitivenss

Technology Chapter 9 was devoted to a detailed discussion of the nature and impact of technology. What needs emphasis in this context is that technological innovation is the primary source of competitiveness. The US is ahead of other nations and is, notwithstanding the ongoing financial mess, a super power economically. The country is the home for world's top MNCs which are inventors of new ideas, products and services. Apple, Google, IBM, Microsoft, GE, and Dell, are but only a few names that come to one's mind. Not to forget is the Silicon Valley. 3M generates 30 percent of its annual income from products that were brought to market in the last four years, and the number of patents issued to the company keeps on rising every year. 3M also has managed to accelerate the product life cycle by reducing cost and waste and bringing new products to frution in record time.

Growth of technology cannot take place in isolation. It needs several supporting enablers. Qualified and competent scientists, R & D establishments, high level educational institutions, patenting regime, fast commercialisation of new inventions, and technology – absorption capability of the economy are only a few such infrastructural facilities that promote technology.

Economy The economic soundness determines the competitiveness of a country. Economic soundness refers to the sum total of several micro economic factors such as industrial production, agriculture, inflation, GDP, investment, per capita income and natural resources (Read Ch.10).

Finance Finance is an important determinant of a nation's competitiveness. Specific financial indicators that affect strength of a nation includes currency valuation and solvency of the banking system. *Currency valuation* concerns the extent to which a home currency is valued or priced properly to reflect the situation of market supply and demand pertaining to this currency. A country with a price level exceeding its national income level is said to have an overvalued currency. A country with an income level exceeding its price level is said to have an undervalued currency. High overvaluation or undervaluation can be a source of instability and is unhealthy for long-term economic growth.

Sound economy needs strong *banking sector*. So much is the role of banks in an economy that collapse of banks in the US triggered major worldwide financial crisis in the recent past. An MNC's dependence on banks is almost total. Be it a transaction relating to export, import, repatriation or borrowing, the MNC should approach one or the other bank.

Internationalisation Internationalisation refers to the extent to which a firm's activities are based across the globe. An MNC operating across the globe enjoys vast market, gains multicultural knowledge, earns huge revenues, and is crowned with a high degree of brand image. The more broad based are the above factors, more competitive the MNC becomes.

What does country competitiveness matter to an MNC? There are atleast four implications. First, country competitiveness determines selection of host country to set up a subsidiary. Two, country competitiveness affects an MNC's industry selection. For an MNC, it is important to choose a foreign industry that is in sync with the firm's global product portfolio and benefit from industry structure differences between home and host countries. Generally, industry competitiveness is country-specific, implying that no country is equally strong in all industries. India's strength lies in software and BPO, China has strength in manufacturing and Japan in automobiles. Message is clear for the international manager. If the MNC is into automobiles, Japan is obvious choice for location of a subsidiary and if it were BPO India is the clear option.

Third, country competitiveness affects an MNC's innovation and capability building. Finally, country competitiveness affects an MNC's global strategies. Typical global strategy of an MNC can be global integration or local responsiveness. Global integration strategy demands that a product is sold across the globe without changing features to suit local needs. Worldwide integration strategy is possible if all the countries possess competitiveness more or less in equal proportion. Local responsiveness necessitates customisation of a product to meet unique local needs. Customisation strategy shall become relevant when competitiveness of countries differ.

The World Economic Forum releases ranking of countries every year. The latest ranking is shown in Table 24.1.

Table 24.1 Top 20 Competitive Nations

	Rank	
	2013-14	2014-15
Switzerland	1	1
Singapore	2	2
US	5	3
Finland	3	4

(Contd.)

(Contd.)

Germany	4	5
Japan	9	6
Hong Kong SAR	7	7
Netherlands	8	8
UK	10	9
Sweden	6	10
India	60	71

Source: World Economic Forum

India's ranking among 144 countries has fallen for the sixth consecutive year to 71 from 60 in the last survey. India has the lowest ranking among the BRICS countries. According to the Forum, India performs best in more complex areas such as innovation, and business sophistication but lags behind in the more fundamental drivers of competitiveness such as health and primary education. China continues to lead the BRICS countries with 28th rank, followed by Russia (53), South Africa (56), and Brazil (57).

Firm's competitiveness Country competitiveness needs to percolate down to the strength of individual firms operating in a country. Not necessarily so. There are weak firms in a strong economy and competitve companies in a not-so-sound country. What then makes a firm very strong?

Core competence is one such factor. Core competencies are the strengths that allow a company to out-perform rivals in areas such as efficiency, quality, innovation, or customer service. Core competencies stem from two related sources: resources and capabilities. *Resources* are the inputs into a company's production or services processes. Resources can be tangible assets such as borrowing capacity, buildings, land, equipment, and highly skilled employees. They can be intangible assets such as reputation with customers, patents, trademarks, organisation knowledge, and innovative research abilities. *Capabilities* represent the ability of companies to assemble and coordinate their available resources in ways that lead to lower costs or differentiated output.

Resources and capabilities lend core competencies to a firm. What needs further emphasis is that these competencies must be sustainable. Sustainability means the company's competencies are not neutralised or attacked by rivals. Sustainability can be achieved when a firm's resources and capabilities are rare, valuable, difficult to imitate and are unsubstitutable. Sustainable competencies help an MNC achieve competitive advantage and higher profits (See Fig 24.2).

Yet another factor that contributes to a firm's competitiveness is a set of *critical success factors*. Critical success factors are those product features that are particularly valued by a group of customers. The firm must excel in them to beat competition. The product features include price, reliability, delivery time and the like. Customer preferences vary. Some may be interested in price, others in reliability and so on.

Since different customer groups value different product features, firms need to compete on different bases and through different resources and capabilities. For example, the way small retail shops competing with supermarkets in grocery retailing. The major super markets are pursuing strategies which provide lower prices and 'one-stop-shopping' to consumers through their resources (store location, product range) and competencies (knowledge of merchandising, securing lower-cost supplies and computerised logistic systems). Theses lend competitive advantage to the supermarkets over smaller shops with those customers who particularly value low prices and one-stop-shopping. It is difficult for smaller shops to imitate these resources and competencies. So a 'corner-shop' grocery store gains competitive advantage over supermarkets by focusing on those customers whose critical success forms are different aspects of service (for example, personal style and customer relationships sustained by the owner).

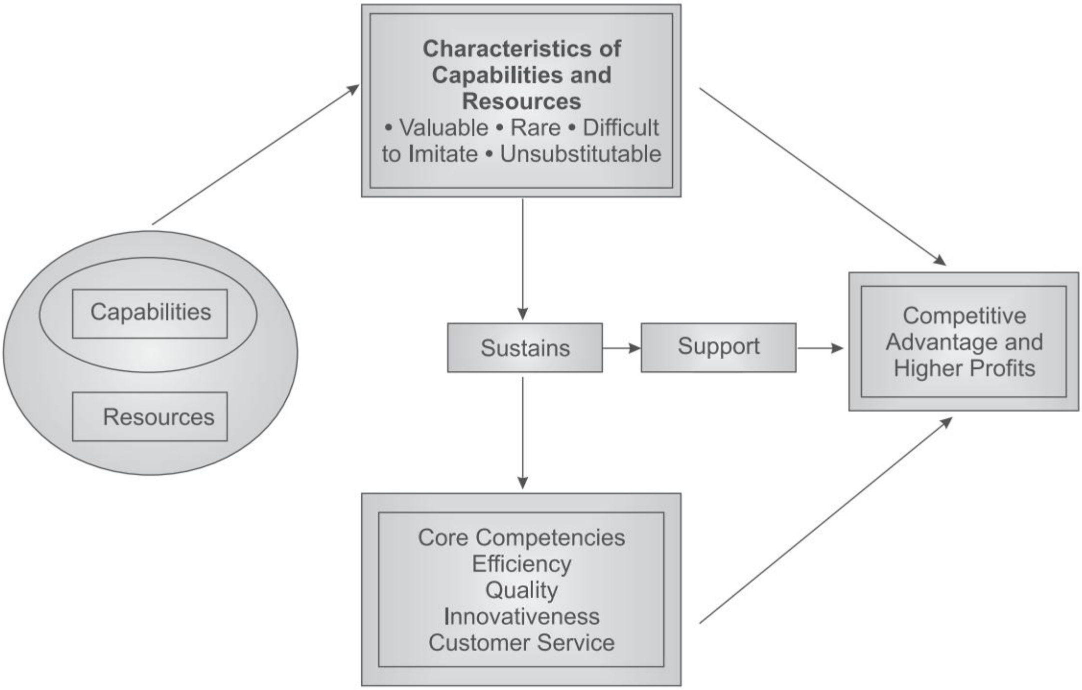


Fig 24.2 Core Competencies Leading to Competitive Advantage and Higher Profits

(*Source:* Adapted from *Multinational Management* by John B Cullen, Thomson,2002, p.169)

Superior process innovations, quality control systems, organising principles and excellent employee relations also add to the firm's competitiveness.

Government and Trade Regulations

The government of any country can influence its international business significantly. For example, government intervention for the purpose of protecting domestic industries usually results in less movement of goods and services across borders.

A government's major role in global business may stem from its being a world trade negotiator. Many people believe that their government should limit competition from foreign goods in the interest of protecting local business and the jobs they offer. In the US, people question why the Japanese are allowed to set up auto plants in the US, while the country's farmers cannot sell rice in Japan even though imported rice would cost less than Japanese-produced rice.

Negotiations among countries to ease trade restrictions and prevent unfair trade practices are ongoing. WTO has been established to negotiate trade concessions among member countries. The members meet periodically and discuss the ways of minimising trade barriers.

Developing an International Perspective

Firms operating in cross border markets need to develop an international perspective. Three areas need special attention: experience, focus and attitude.

Experience One way to acquire international perspective is to hire people with global exposure. A company cannot become a true MNC without having managers with an overseas perspective.

Focus The second way to develop an international orientation is by emphasising global orientation to human resource activities such as hiring, remunerating, performance appraisal, promotions and the like.

Attitude People's attitude, in general, is parochial in spite of the spread of higher education, worldwide connectivity, presence of MNCs, improved incomes and increased standard of living. China has a closed society but an open mind. When Deng has cast aside decades of communist dogma, Indian politicians and policy makers are still repeating shibboleths like MNC's hegemony, cultural degradation, socialism, nationhood, holy cows and the like. Indian society is open, but people's minds are closed. This attitude should change. It is time that Indians think rationally, give up supernatural beliefs, have faith in their competencies, be bold and dream big. Indians can do, nay, they have already done but as NRIs in the U.S. and Europe. The fact is that 200 years of colonial rule has sapped India's cultural self-confidence. Britishers left us seven decades ago. Let us regain our self-confidence.

Stress on Industries

Indian corporates should realise the need for investing on industries. The industrial map of the country is dominated by Tatas, Birlas, Mahindras, Podars, Bajajs, Goenkas, Murugappans and public sector undertakings. All these owe their birth to more than 60-70 years. In the last 2 to 3 decades, no industrial enterprise worth the name came into being either in the government sector or in the private sector.

What India needs is more of industries and not of BPOs, telecommunications, financial services, real estate, and e-business ventures. Flipkarts, Facebooks, and Twitters may make billionaires out of a few elites but cannot give jobs to millions. And from 2012 to 2020, every year close to 10 mn people would be added to the labour market. The country needs to create more than 150 mn jobs in the next 10 years to absorb those numbers.

It is relevant here to state that the present government's dream of 'Make In India' is most welcome. But when one looks at the reality, the dream may remain a dream only. One dimension is the share of manufacturing in GDP.

India's share of manufacturing in GDP is lower than even Pakistan, and is lower than many of the lower middle income countries (see Fig. 24.3). Obviously, we have to go a long way to realise the dream.

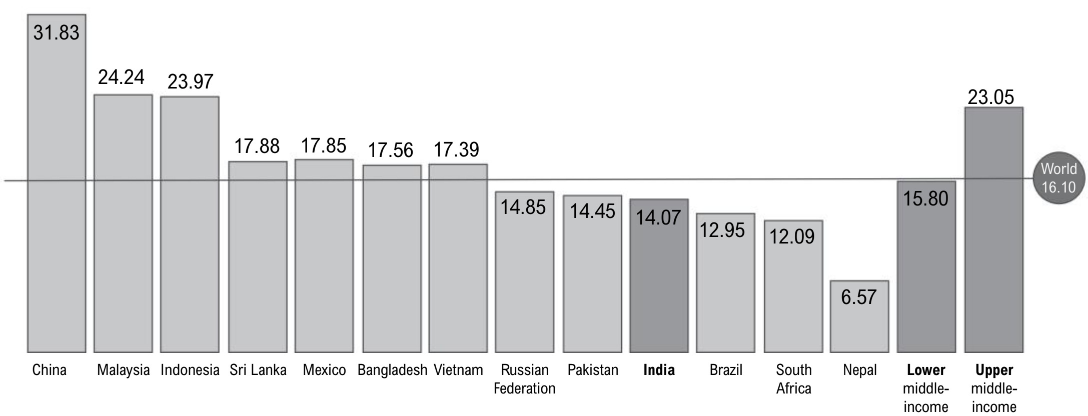


Fig. 24.3 Share of manufacturing in GDP of different countries (2012)

(Source: *Mint*, Dec. 22, 2014)

Managing Diversity

Diversity is the outcome of globalisation. Workforce of any MNC comprises people from different countries. Within this diversity of national origins, there is even wider diversity of culture, religions, languages and dialects, educational attainment, skills, values, ages, races, genders and other differentiating variables. Managing such a cosmopolitan workforce is a challenging task for any executive.

Before examining how to manage a multi-cultural workforce, it should be noted that diversity has both functional as well as dysfunctional consequences.

Among the potential problems associated with diversity is the likely absence of cohesion among workers. Where group lacks cohesion, members become less productive, and it becomes difficult to create a work environment that is conducive for efficiency and effectiveness. Another problem of diversity relates to inaccurate communication which may result from different meanings assinged to words; and different interpretations assigned to situations. Yet another problem resulting from diversity relates to sexual harassment. Many women are victims of sexual harassments in the workplaces. Sexual harassment consists of any unwanted sexual behavior, including but not limited to suggestive looks, sexual jokes, touching, or pressure for sexual favours. Finally, earning gaps exist in multi-cultural work groups. Earning gaps refer to discrepancies between the earning power of workers of similar educational background but different races. An American or a German is paid much more in an MNC than his/her Indian counterpart.

While there are some potential problems associated with diversity, there are a host of benefits to be gained. Culturally diverse groups can enhance creativity, lead to better decisions and result in more effective and productive performance. A significant benefit from diversity relates to prevention of groupthink, which is a social conformity and pressures on individual members of a group to conform and reach consensus. Another benefit of diversity stems from the possibility of generating more and better ideas. Because group members come from a host of different cultures, they are able to create a greater number of creative and unique solutions and recommendations.

Figure 24.4 outlines seven specific spheres of activity that together help manage diversity more effectively.

Need to Maintain Corporate Citizenship

As MNCs disperse their activities-worldwide, they become highly visible and are required to operate under diverse compulsions such as cultural, political, economic and legal factors of different host countries. An international business will be successful if only it creates and sustains the image of a good corporate citizenship—the two hall marks of which are honesty and social responsiveness. Quite often, MNCs confront issues and conflicts of the type described below.

It was on December 2, 1984 that disaster struck residents of Bhopal. Deadly methyl isocyanite (MIC) leaked from the pesticide plant of Union Carbide killing 4000 in the night of December 2, and crippling for life more than 100,000 people.

The people of Bhopal are yet to get an answer as to why the Union Carbide Corporation set up an outmoded plant in Bhopal when they had already developed an advanced computerised safety system for their West Virginia plant in the US. The refrigeration system was faulty; the valve lines and vent lines in the Bhopal plant were old and worn out. Parts that should have replaced had not been changed for more than two years.

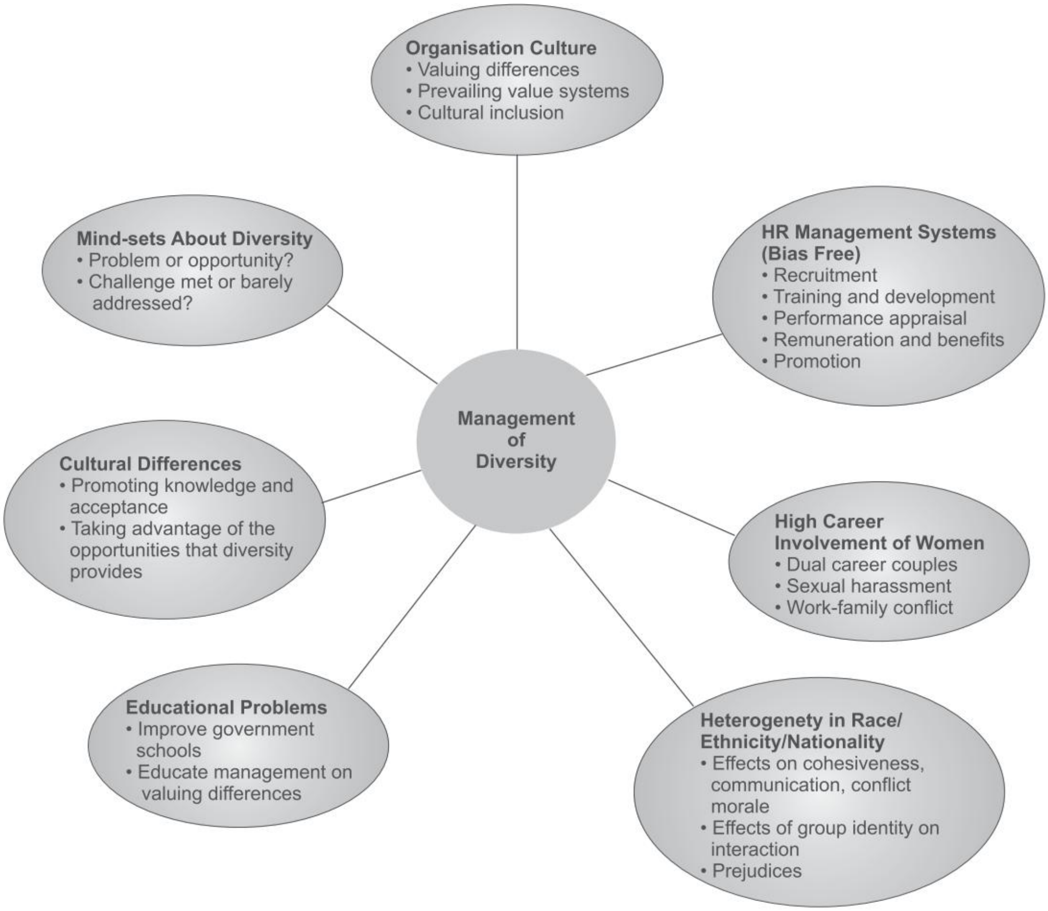


Fig. 24.4 Seven Spheres for Managing Diversity

Though the accused in the criminal case linked to the Carbide disaster are facing the charge of "causing death not amounting to murder", citizens and activist groups continue to hold the multinational corporation guilty of "mass homicide" because, even though it was aware of the hazards of MIC and took safety precautions in its West Virginia plant, it did not take adequate steps here.

People here still want to know why the Government of India and the Government of Madhya Pradesh did not care to get adequate information about the hazardous nature of MIC and permitted Union Carbide to use such a deadly and lethal gas within city limits and store it in such huge quantities. At the time of the leak, more than 30,000 gallons of MIC had been stored. In contrast, the storage capacity in the West Virginia Plant was not more than 5000 gallons.

The Milan magistrates are now investigating Europe's biggest and spectacular' corporate scandal, where equivalent of some ₹ 25,000 crores to ₹ 50,000 crores cash assets in euros, have 'just vanished' from the company's Cayman Island (tax haven) accounts. According to the investigation magistrates, the founder of the Parmlat Company, which employs about 39,000 staff, himself' instigated fraud plan which has led the company on the verge of bankruptcy.

The Italian authorities investigating Parmlat's slide into bankruptcy have accused Calisto Tanzi, its founder, of instigating a complex chain of financial scams that has brought the huge dairy and food chain giant crushing down. Mr. Tanzi has now admitted misappropriating about euro 500 million over seven or eight years, according to Italian investigating authorities.

An international manager represents a US apparel designer that sells to major US department stores and retailers. Several years ago the firm decided to have clothing sewn in India and Pakistan, which resulted in tremendous cost savings as opposed to having the work done in the United States. In making the decision, the firm considered its impact on US families who depend on the income from these jobs. It opted for the cost savings, seeing its responsibility to produce a profit for shareholders as more important than providing jobs in the United States. Now, however, it finds that its contractor in India is abusing child labour in violation of internationally accepted standards for the treatment of children in the workplace. The Indian government shows little interest in policing its own labour practices. The sad story of the Indian children is run on national television and appears in the national press.

A firm enters a contract to sell drilling equipment to a Korean company. The contract is closed while the Korean company president is visiting the US plant. After closing, the Korean executive points out that all imports to Korea must be channeled through a registered "local agent." He quickly suggests that a wholly owned trading company that he owns could handle all of the paperwork-for a fee.

US Government frequently gives aid as a bribe, with an understanding that the host country will grant political concessions in return. Governments use high level official visits and lobby aggressively for their home-based companies to help them gain foreign business. For example, US Government has paid for ministry heads to visit the United States when a U.S. company is bidding for a contract, and has given scholarships to family members of officials that can provide business to US companies.

How far an MNC can come out unscathed from such testing and conflicting conditions is the proof of its corporate citizenship.

Social Actions Firms need to undertake social actions that help contribute to corporate citizenship. Following are a few examples.

Wegmans Food Markets The US based 90-year-old retail giant (named by *Fortune* in 2004 as the best employer to work for) has its own credo and lives by it: “Good people working towards a common goal can accomplish anything they set out to do”. The family owned business pays its employees more than industry average and offers additional retirement benefits. The company does not mind sacrificing profits for a belief, and in 2008, it stopped selling tobacco products.

Tata Steel Though already told about Tata Group, it is essential to narrate what Tata Steel has done in the name of CSR.

One of the ‘Articles of Association’ of Tata Steel says: “The company shall be mindful of its social and moral responsibilities to consumers, employees, shareholders and the local community.” Keeping that thought in mind, Tata Steel built the city of Jamshedpur to house people working in the company’s plant there. All civic amenities in the 103-year-old city are managed by Tata Steel’s subsidiary Jusco. It spends about Rs.100 crore a year on the city’s development and maintenance.

Jamshedpur was built from scratch. Today, the focus is on displacement of people for projects. Tata Steel, which has captive iron ore and coal mines, has a policy for minimum displacement. In 1979, it set up Tata Steel Rural Development Society (TSRDS) as a subsidiary to address the needs of people near its plants and mines in Jharkhand and Orissa.

Funded by Tata Steel, TSRDS promotes integrated rural development. Its goals include drinking water, health and hygiene, education, environmental awareness, youth development and income-generation programmes. For instance, 75% of the population in Ganjam district in Orissa depended on agriculture, but they were migrating to cities due to lack of water.

Ganjam is close to Gopalpur, where Tata Steel faced opposition to its steel project in the nineties. In 2005, TSRDS started reviving 29 lift irrigation projects there, which it completed in 2009-10.

PepsiCo India In 2009, PepsiCo India used 5.17 billion litres of water for its products. The same year, it saved or put back 6 billion litres, 830 million litres more than what it consumed into the system, according to figures released by the company and verified by audit firm Deloitte Touche Tohmatsu India.

PepsiCo India has achieved a 'positive water-balance' through three steps. One, the company helped its contract farmers change the way they planted paddy. Instead of flooding the fields, it gave them a direct-seeding machine, which could be mounted on a tractor. This reduced water consumption by 30-40%. The direct-seeding programme, which covered 6,500 acres across five states, saved about 4.7 billion litres of water.

Two, it built check dams and recharge ponds around its plants. It trapped rain water, and diverted some of it to people around the area for farming or drinking. For instance, in Aurangabad, a water-scarce area where it has a plant, it constructed 13 check dams and recharged over 100 wells. This has created the potential to recharge 700 million litres of water and benefited 12,000 villagers. Three, all its plants have rain or roof water harvesting, which brings in 133 litres.

In 2002, PepsiCo India started 'revaluing' water as a resource. In 2009, it became the first company in PepsiCo to become water-positive. The Indian arm now plans to extend its outreach to its bottling franchisees and supply-chain partners. It also plans to replicate this in other water-scarce markets like China.

Corporate Governance

Good corporate citizenship also comes from corporate governance. *Corporate governance* refers to the mechanism to monitor activities of managers of a firm to ensure that they are fulfilling their legal obligations and are meeting the owner's objectives for the company.

Governance rests primarily on the board of directors. But since the composition of boards differs across countries, the Kumara Mangalam Birla Committee, the Cadbury Committee in the UK, the Dey Report in Canada, the Hilmer Report in Australia, and the Veinot Report in France have suggested ways of constituting boards. The committees have also suggested measures for disclosure of information.

The various recommendations include the separation of the roles of chairman and CEO, the inclusion of more non-executive directors, the setting up of codes of best practices, compensation to executives, disclosure of information, and the like. All these measures are designed to protect the interests of minority shareholders and weaker organisational stakeholders whose interests may be too fragmented to be assertive.

Governance norms vary across the countries as Table 24.2 shows. Accounting standards, employment laws and tendency of countries to impose their norms on others and the latter resisting them are the major reasons why governance norms vary across the countries.

The following mechanisms help ensure corporate governance:

- SEBT
- Capital market
- Independent directors
- Statutory audit

Table 24.2 Corporate Governance Practices in the G7 Countries

Britain	*Canada*	*France*	*Germany*	*Italy*	*Japan*	*United States*
Auditors have to be independent from management consultancy arm						
Recommended	Yes	Voluntary	No	Yes	Yes	Yes
Rotation of auditors						
Voluntary:	Yes	No[a]	No	Yes	Yes	Yes[b]
5–7 yrs	7 yrs			9 yrs	7 yrs	5 yrs
Shareholders vote on executive pay						
Advisory	Yes	No	No	Yes	Yes	No
Shareholders may elect own slate of independent directors						
No	No	No	No[c]	Yes	Yes	No
Independent directors in a majority on board						
Recommended	No	voluntary	Recommended	No	No	Yes
Separate chairman and CEO?						
Recommended	voluntary	voluntary	Yes[d]	voluntary	voluntary	voluntary

Notes

a. Auditors have maximum term of 6 years, but it can be renewed by the board
b. Partners, not firm
c. According to company's size, shareholders nominate all, two-thirds, or one-half of the supervisory board
d. Refers to the separation of Chairman of the supervisory board and the management board

(*Source*: Adrian Haberberg and Alison Rieplel, *Strategic Management*, Oxford, 2008, p. 84)

- Code of conduct
- Companies Act

Each of these was dealt in detail in the previous chapters. Regulatory measures to ensure corporate governance are outlined in Exhibit 24.1.

A study by Institutional Investor Advisory Services (IIAS) maps the perceptions of institutional investors about corporate governance in India. Fig. 24.5 shows the companies with the best governance. Fig. 24.6 shows the best board composition.

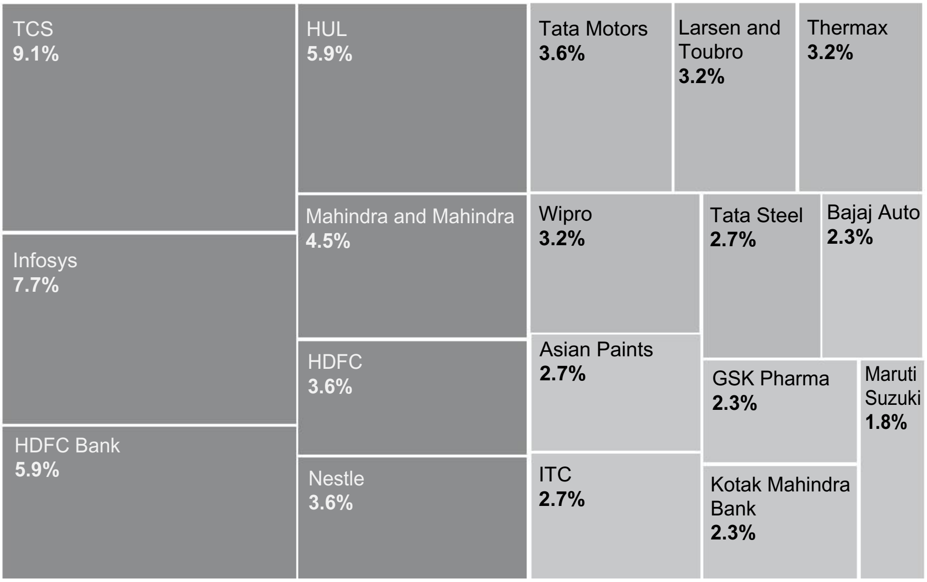


Fig. 24.5 Companies with best corporate governance.

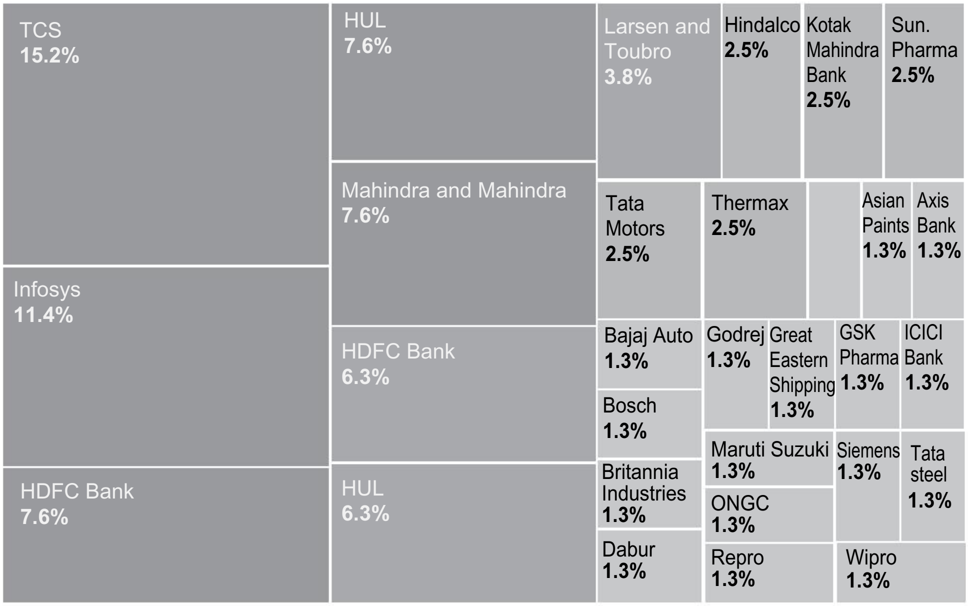


Fig. 24.6 Best Board Composition

(Source: Figs 24.5 and 24.6 are based on *Mint*, Feb. 20, 2014)

Exhibit 24.1

REGULATORY FRAMEWORK

A. US Corporate Governance

- Delaware Corporate Law
- Employee Retirement Income Security Act, 1974
- Sarbanes-Oxley Act, 2002
- Commission on Public Trust and Private Enterprises

B. UK

- Cadbury Report (1992)
- Greenbury Report (1995)
- Hampel Report (1998)
- Combined Code (1998)
- Turnbull Report (1999)
- Myners (2001)
- Higgs (2003)
- Smith (2003)
- Revised Turnbull Guidance (2005)
- Company Law
- Financial Services Authority Review
- Financial Reporting Council

C. India

- The Companies Act
- SEBI

- Kumara Mangalam Birla Committee Report
- Narayana Murthy Committee Report
- Naresh Chandra Committee Report
- Environment Protection Act, 1949
- Bureau of Indian Standards Act, 1986
- All Commercial Tax legislations
- Coal Mines Act, 1973
- Contract Labour Act, 1970
- All Commercial Tax legislations
- Essential Commodities Act
- Foreign Exchange Management Act
- Consumer Protection Act, 1986
- Income Tax Act, 1961
- Contracts Act, 1882
- Telecom Regulatory Authority Act, 1997

D. Others

- OECED Principles of Corporate Governance 1999, as revised in 2004
- Commonwealth Association for Corporate Governance
- Basel Committee (particularly for banking sector)
- Suggestions for better corporate governance include the following:
- Striving to ensure that the code of conduct is understood and adhered to by all members of the organisation.
- The performance management system should recognise and reward ethical behaviour.
- Exclusive background checks should be carried out on senior managers joining the organisation.
- Companies should screen third parties (customers, vendors, JV partners) with whom it does business for their commitment and adherence to ethical practices.
- The scope of whistle-blower policies should be extended to the wider stakeholder group.
- Investors, lenders and analysts should proactively question/challenge management on areas pertaining to corporate governance.
- While the corporate governance framework in the country is seen at par with other developed markets, the same has to be implemented in letter and spirit.
- Additionally, shareholders should ensure that the composition of the board is a balanced mix of independent directors and management appointees.

Threat to Globalisation

The economic crisis that has gripped the nations in the recent past has made people conclude that the era of globalisation is over and it is under fire. Countries are no more enthusiastic about free trade. Doha round of negotiations has lost its urgency. Infact countries are becoming protectionists.

Look at the following instances:

- 'Buy Chinese'—China wants to keep foreign companies out from its $586 billion stimulus package.
- Australia has decided to source $ 4 billion worth of goods and services from its own companies-goods such as stationery, uniforms and cars. The purpose is to save jobs for the Australians.
- 'Hire American' and 'Buy American' provisions in the US stimulus bill.
- 'Buy French'—France wants car makers to commit to buying from local suppliers as part of a government aid package for the industry.

For a long time, policy makers every where believed that the US economic model is the best. But American-style of capitalism is under fire because of the financial crisis, and the US government bailout has changed the system so much that it is scarcely recognisable. As a result, politicians and administrators in the developing world are likely to slow down the pace of deregulation and consider creating European-style welfare states. For a long time, "capitalism with local characteristics" has been the much discussed topic in China; it may soon become one in other developing countries.

Investment and demand from OECD countries have fallen dramatically forcing developing countries-including Brazil, China, India and South Africa—depend less on international trade. Their governments are investing in infrastructure and reducing taxes, particularly on products for low-income consumers. If they succeed in increasing consumption at home, developing countries will be able to sustain themselves even without depending on OECD nations.

Thus, one can go on digging into arguments to predict doomsday for globalisation. But a little out-of- the-box thinking convinces us that globalisation will not perish. The pace may be halved but cannot be stopped. The spread of products, plants, capital, technology and people across the globe is so ingrained that it is well- nigh impossible to reverse it. Future of international business is bright, but the roles of players may be different. In the days to come active players will no more be developed countries but the emerging economies.

Managing Bureaucracy

Any country, more so the developing one, shall carry huge bureaucracy and for the international manager, managing it remains a big challenge. India has 10 million strong civil service army, equalling the population of countries like Belgium and Czech Republic. The time it takes to obtain a licence in India ranges from 159 days in Bhuvaneshwar to 522 days in Ranchi. On average, it takes 225 days to obtain a building permit. The Four Season's Hotel opened in Mumbai in 2008 required 165 government permits, including special licence for the vegetable-weighing scale in the kitchen and one for each of the bathroom scales put in the guest rooms.

No wonder that the International Finance Corporation (part of the World Bank) 2012 on "ease of doing business" in different countries ranked India at 122. For Indian businesses and executives, conducting business in India requires patience and ingenuity to manage bureaucracy (See Table 24.3). Besides, bureaucracy places additional transactional costs on global companies operating out of India.

Table 24.3 Ease of Doing Business, 2012 Rank

Top Ten	*Bottom Ten*
1. Singapore	174. Haiti
2. Hong Kong	175. Benin
3. New Zealand	176. Guinea-Bisaau
4. United States	177. Venezuela
5. Denmark	178. Congo
6. Norway	179. Guinea
7. Britain	180. Eritrea
8. South Korea	181. Congo-Brazzaville
9. Iceland	182. Central African Rep.
10. Ireland	183. Chad
	122. India

(Source: World Bank / IFC)

The top heavy government machinery is not peculiar to India. It is there in the US, and in UK which are said to be paragons of free economy. Infact, the recent financial crisis has contributed to the rise of the government. Governments have spent trillions propping up banks and staving off depression. In some countries, governments now play a large role in the financial sector, and thanks to bail-outs, stimulus and recession, the proportion of GDP made up by state spending and public deficits have touched the roof. Britain's public spending is 52 percent of GDP, that of France 55 percent, that of Germany 48 percent and of the US, it is 42 percent.

Brand India Challenge

Worldwide, Brand India is presently receiving good publicity. Yet Brand India is weak in several ways. In the developed countries, India still conjures up visions of snake charmers, beggars, cows, poverty and dust and dirt. Obviously, this is a source of much frustration to Indians, who would prefer that Brand India be associated with progress, modernity and resplendent with world-class businesses, malls and skyscrapers.

Compared to China, India may be weak in certain areas. But when it comes to areas like functional democracy; autonomous institutions like Election Commission; rich heritage; long history; skills, values and innovations; knowledge of English and diversity; India is much ahead of other nations. Not surprisingly, when confronted by a takeover, many Western companies and their managements prefer an Indian company as an acquirer compared to a potential Chinese, Russian or Middle Eastern suitor. Over time, perceptions of India as being associated with the Third World will fade away. As Sir Martin Sorrell, chief executive of ad agency WPP remarked, "India and China might have been on the wrong side of history for the past 200 years but for the next 200 years they will be on the right side of it".

Two others need careful observation from international managers. They include energy policy and global resource depletion.

Energy Policy

Energy consumption has shot up in the recent years, China being the leader in this respect. Table 24.4 gives details about oil production and consumption.

Table 24.4 Oil Production and Consumption (thousands of litres per day)

Production		*Consumption*	
Saudi Arabia	11,545	United State	18,554
United States	11,133	China	10,232
Russia	10,397	Japan	4,728
China	4,4`6	India	3,417
Canada	3,868	Russia	3,250
Iran	3,538	Saudi Arabia	2,989
UAE	3,213	Brazil	2,759
Iraq	2,936	Germany	2,337
Mexico	2,936	Canada	2,292
Kuwait	2,797	South Korea	2,268

(*Source:* Riad A Azami and Jason Goddard, *International Business*, Jaico, 2014, p.355)

A close look at the table reveals interesting phenomena. United States tops the list in oil consumption but is 2nd in production. Production and consumption of oil are matching. So also is in the case of China. Japan and India are big consumers, but hardly any oil comes from these two countries. Kuwait produces more and does not consume as much. Both producing and consuming countries need to sit together and evolve a policy towards energy as the demand for it is going to rise in the days to come.

Resource Depletion

The next few decades will witness far-reaching changes in the world economy that will influence international business in a variety of ways. Natural resources of the world are likely to be depleted and nations need to discover their substitutes. The depletion of such resources as oil, metallic ores, and minerals will weaken the economies of those countries that rely solely on export of such commodities. On the other hand, exclusive monopoly over the technology used to manufacture substitutes could be acquired by MNCs which would further consolidate their clout on world economies.

Summary

- Contrary to popular perception, globalisation is never on the decline. It has recovered from 2008 crisis and is on the move. What needs emphasis is that, in order to sustain globalisation, developed countries must focus on poor countries and not on markets. (LO1)
- Maintaining competitiveness, developing international perspective, emphasis on industrial sector, managing diversity, corporate governance, managing bureaucracy, brand India challenge and corporate citizenship are a few challenges of international business that are covered in this chapter. (LO2)

Review Questions

1. How can Indian companies maintain competitiveness? (LO2)
2. What is international perspective? How to gain it? (LO1)
3. What is diversity? What are the ways of managing diversity? (LO2)
4. What is corporate citizenship? How can a company become so? (LO2)
5. What is corporate governance? Where do Indian companies stand in this respect? (LO2)
6. What brand challenges do Indian companies face? (LO2)

Discussion Questions

1. Do you think that India cannot realise the dream of 'Make in India'? (LO2)
2. We have a chain of enforcement agencies to ensure better governance. Yet, frauds do occur (Satyan, for example). Why? (LO2)

Reinforcing Exercises

- "The typical CEO is more than six feet tall, has a deep voice, a good posture, a touch of grey in his thick, lustrous hair, and for his age, a fit body. Bosses spread themselves out behind their large desks. They stand tall when taking to subordinates. Their conversation is laden with prestige, pauses and declarative statements. And they are men". (*The Economist* dated Sept 27, 2014 p.67)

What are your views on the above?

- Is global business heading towards the end of a road? Answer seems to be 'No', if one goes by the following:
  - In today's world, some $3 trillion in foreign exchange transactions are made everyday.
  - Everyday $15 trillion worth of goods and services are traded across the globe.
  - WTO and the most powerful economies are relentlessly pursuing for a free global trade.
  - The car you are driving is parts manufactured in one country, assembled in another country, painted in yet another country, marketed by a different and is delivered to you in your country.
  - World is almost becoming a one nation, one culture, one language, one taste and one style of living.

Any comments from you?

- Recently the Securities and Exchange Board of India (Sebi) barred India's largest real estate firm DLF Ltd from accessing the capital market for three years. A regulatory probe had found the company and its top officials guilty of violations which included the non disclosure of related party transactions, nondisclosure of financial details related to subsidiaries and inadequate disclosure of outstanding litigation. The company has challenged the order at the Securities Appellate Tribunal (SAT).

  In another instance, Financial Technologies (India) Ltd (FTIL) is under the scanner of Sebi and the ministry of corporate affairs for its alleged role in the ₹5,574.34 crore payment crisis at National Sport Exchange Ltd (NSEL), in which the company holds a 99.9% stake. Among the many allegations against FTIL and its management are charges of a number of related-party contracts executed that may not have been in the best interest of shareholders of its group entities such as Multi Commodity Exchange of India Ltd (MCX) with whom these contracts were signed.

Where is corporate governance?

- In 2013-14, India imported $31bn worth of electronic items, representing 65% of the current demand in the country. Of the $31bn imports, smart phones accounted for $10.9bn. (India buys most of her electronic equipment, including smart phones from China). Thus heavy imports resulted in a high trade deficit of $16.68bn.

As of now, import bill on electronic items is next only to that of oil. If the current trend continues, buy 2020, tables may turn. Import of electronic items may exceed that of oil.

Look at China. It was in 2007, that Apple launched its iPhone, to start with in America. Soon iPhones appeared in Chinese shops, and soon they started rolling out of Xiaomi, a premier producer of electronic items in China, with major components manufactured in-house. As of now, China is the largest producer of smart phones in the world with 6mn pieces shipped every month.

Why India cannot do likewise?

CLOSING CASE 1

The Juggernaut Rolls on—but The Road ahead is Humpy and Bumpy

It all started with the takeover of Tetly in 2000. Then became Daewoo Commercial Vehicles (2004); Tyco Global (2004); Natsteel (2005); Teleglobe (2005); Brunner Mond (2005); Milliennium Steel (2006); Eight 0'Clock (2006); Ritz Carlton (2006); Corus (2007); PT Bumi Resources with 30 per cent stake (2007); and General Chem Partners (2008). The latest in the acquisition spree is the takeover of Jaguar and Land Rover (March 2008). The stake involved in all these buyouts is a whopping Rs. 81,527 crore.

It is a moment of glory which any Indian should be proud of—particularly because of the timing of the Jaguar and Land Rover deal. Compared to the Corus deal, which carried a price tag of Rs 53,850 crore, the buyout of the two brands, with Rs 9223 crore, is miniscule. But what makes it breath taking? First, the deal has been struck when the world economy is dipping and companies everywhere are facing falling fortunes. Viewed against this background, Tata deal demonstrates how resilient and vibrant Indian companies are. Second, the brands acquired are no mean "also rans". Jaguar and Land Rover are world's top class brands with a long history. Land Rover was born in 1880s and Jaguar in 1930s. Third, the acquisition of the two brands marks a paradigm shift of the balance of power in financial and technological arenas. The power is shifting from West to East. Finally, from now onwards, Tata's name (read India) will be seen and heard on the premier markets of Europe and Americas.

There are a few other feathers in the cap of Tata Motors. With a whopping turnover of ₹123,133 cr (2010-2011), and a head-count of 25,000, the flagship of Tata Group is the leader in commercial vehicles, in each segment, and one among the top three in passenger vehicles. The company is the world's fourth largest bus manufacturer.

Tata Motors is a dual-listed company traded both in Bombay Stock Exchange and New York Stock Exchange.

In 2010, Tata Motors surpassed Reliance to win the coveted title of 'India's Most Valuable Brand' in a survey conducted by *Brand Finance* and *The Economic Times. Business Week*' ranked Tata Motors 17th among the '50 Most Innovative Companies'.

Tata Motors is not sitting pretty. It is focussing on new technologies and bringing out path-braking vehicles. Indiga is the first 100 percent indigenously designed car. The *Nano* is another brilliant engineering marvel.

Tata Motors has set up facilities in Jamshedpur, Pantnagar, Sanand, Dharwad and Pune. It has facilities in Argentina, South Africa, Thailand, and the UK. Tata Motors has produced and sold over four million vehicles since 1954.

Established in 1947 and earlier called TELCO, Tata Motors has its wheels traversing through length and breadth of India. It has made Tata Sons richer and India proud.

Sentiments apart, challenges before Tata's are going to be hard nuts. Tata Motors, the flagship company of Tatas which is deemed to have acquired Jaguar and Land Rover, has no experience in managing luxury brands. The Indian car maker is well-known for offering rugged cheap cars, buses, and trucks suiting to Indian buyers and Indian roads. Its costliest passenger vehicle, the Safari Dicor, is about Rs 1 lakh cheaper than the least expensive Land Rover. Will Tata Motors be able to sustain the quality of the two brands?

The Indian market for luxury cars is growing but is still small. The cheapest luxury cars available in India, such as Honda Siel Cars cost around ₹ 15.5 lakh. It is believed that some 5000 luxury cars are sold in India every year. True, some Indians do own and use high-end foreign brands, such as BMW, Mercedes-Benz, Audi and Lxus, but their numbers are still in the thousands, a fraction of the 1.4 million cars sold each year in the country's exploding automobile market. Nor the markets in Europe and America are promising because of the recession in their economies.

The not so profitable brands (Jaguar has been making losses) and commitments made to British labour unions in a slowing economy could compound problems for Tata Motors. Trade unions, representing the 16,000—strong Ford workforce in UK, have in a way paved the way for Tata takeover. It is these unions that, in principle, picked up Tatas as their "preferential choice" as the bidder. The Tatas have now assured job security and better working conditions to the British workforce. Going by the domestic track record of Tatas, the British workers feel reassured about their future under the Indian management.

Ford has agreed to use its finance arm to help its dealers and Tatas sell their cars for another 12 months. It will also supply engines, transfer some intellectual property and offer engineering support. Inspite of this, Tata might be required to pump in more money to develop new and improved products as the EU gets tougher about controlling pollution, especially from cars made and driven in Europe.

Also, refinancing debt is likely to pose a big challenge to Tata Motors. The Company may find it difficult to raise long-term debt in the current environment. While Tatas managed to get a bridge loan of $3 billion for a period of 12 months, it may have trouble raising debt to repay that loan as lenders have grown jittery over extending credit.

Thus, the road ahead of Tata Motors is humpy and bumpy

But going by the clout enjoyed by Tata Motors, the challenges may not be insurmountable. Tata Motors is a $ 5.5 billion company and is the leader in commercial vehicles in each segment, and the second largest in the passenger vehicles market with winning products in the compact, midsize car and utility vehicle segments. The company is the world's fifth largest medium and heavy commercial vehicle manufacturer.

The foundation of the company's growth over the last 50 years is a deep understanding of economic stimuli and customer needs, and the ability to translate them into customer-desired offerings through leading edge R&D. With 1,400 engineers and scientists, the company's Engineering Research Centre, established in 1966, has enabled pioneering technologies and products. The company today has R&D centres in Pune, Jamshedpur, Lucknow, and in South Korea, Spain, and the UK.

Questions

1. Do you think that the challenges listed above are genuine? If yes, how do you think that Tatas will face them?
2. With the widest range of cars (from the cheapest to the costliest) under its belt, how do you think Tata Motors will manage and sustain?

CLOSING CASE 2

Whither Corporate Governance?

For decades what it did was the best. It was infallible and invincible. Its lean production system, respect for people, and continuous improvement (Kaizen) became mangement *mantras*, benchmarked and replicated throughout the world. Business writers sang paeans through their books and articles. Look at the way it beat all American car makers and became number one in the world. It was this company that came out with its own 14 principles of management humbling Henry Fayol. Companies all over the world sent delegates to tour the company's factories in the hope that some of its magic would rub off on them. Within its country, the firm was considered the nation's industrial champion, as the sun seemed to set on other giants as Sony and Hitachi.

Your guess is right. We are referring to Japan and her car maker – Toyota.

Sadly, all the above accolades have gone into history. Problems with "unintended acceleration" of its cars, which Toyota has only belatedly taken seriously, have triggered on escalating crisis and the recall of whopping 8 million vehicles. Toyota's woes were compounded when it said (and did), it would recall 440,000 hybrid cars, including the celebrated Prius to fix a problem with their breaks. The company's reputation for quality, on which the business was built, stands shattered. Its market capitalisation has dropped an amount roughly equal to the entire value of Ford.

Product recalls are common among FMCG companies. Most are handled quickly and quietly. The companies involved suffer little harm to their reputation and often may actually win praise from customers who feel their concerns have been acted upon promptly.

Recollect how Ratan Tata handled Taj Hotel's crisis. Immediately after the terrorists were killed, he appeared on TV channels and assured citizens of India that the hotel would be rebuilt shortly. He requested the people not to panic. His brief talk reassured people. One should benchmark the way ICICI managed its crises. It was the thick of global financial meltdown. Rumours were spread about ICICI's exposure to global mortgage funds and other risky assets. Consequently, there was a run on the bank. Customers began queuing up at the bank's ATMs to withdraw cash fearing that ICICI would fail soon. Luckily, rumours and withdrawals were confined to only Gujarat. Nevertheless, the management kept the branches open over the weekends all over India, and the bank's ATMs were constantly replenished with cash. The crisis was finally diffused when RBI stepped in to say ICICI had enough liquidity.

In Toyota's case, it is different. Though defects in its vehicles existed for more than 10 years, and numerous complaints were lodged with itself and with the America's National Highway Traffic Safety Administration (NHTSA), it was only in 2009, that the company acknowledged the existence of a problem, that too after a gruesome accident. Worst, amid the eruption of the blogosphere, media coverage and criticism from politicians in America and even in Japan, Toyota's senior leadership went missing and surfaced only after six months. The company's president publicly acknowledged defects in their company's vehicles, bowed in apology and assured that the company would do everything to put matters right. The company obviously misjudged and mishandled a crisis and this has landed it in deep trouble.

Toyota's problems are its alone, but they highlight broader failings in Japanese corporate governance that make large companies particularly vulnerable to mishandling a crisis in such a way. Toyota and its ilk typically have a rigid system of seniority and hierarchy in which people are reluctant to pass bad news up the chain, thus keeping information from those who need to hear it in a misguided effort to protect them from losing face. In many companies including Toyota, family ties make challenging the boss all but impossible. Any attempt to short-circuit the hierarchy is deemed an act of disloyalty and violation of the traditional consensual corporate culture. Groupthink becomes entrenched because there is so little mobility between companies: hiring from outside is thought to disrupt and an executive willing to move will be stained as a disloyal "Job-hopper". This further hinders firms' ability to take bold and decisive action. The preference for harmony crowds out alternative view points.

The lack of an outside perspective is particularly striking in the case of Toyota's board. It is composed of 29 Japanese men – all of them Toyota insiders, none of them independent. Most Japanese companies similarly lack diversity, apart from a few honourable exceptions, such as Sony and eAccess. Indeed, there is greater percentage of women on boards in Kuwait than in Japan.

For years, Japanese executives rebuffed the idea of appointing outside directors on the grounds that Toyota seemed to be getting on perfectly well without them. That argument holds water no longer. True, Western style corporate governance has its own defects, highlighted by the Enron and World.com scandals and the failure of boards to monitor the activities of risk-taking financial institutions in the runup to the financial crisis. But outsiders at least bring in new ideas, and because they have not been brought up in the company culture, are more likely to question the way things work. If Toyota's board had included, say a female German executive, a former American Senator, a high flying Hong Kong lawyer and a first generation Indian entrepreneur, its response to the crisis might have been different.

Japan ranks 33rd among 38 countries for corporate governance, according to GMI a firm that measures such things, making it worse than Russia, Brazil, and China. See also the table given below.

Recent Japanese Corporate-governance problems

TEPCO	2011	Ineffectual managers kept in place after nuclear disaster
Toyota	2010	Quality problem; board of 29 insiders fails to act. Market cap falls $ 34bn in two weeks
Livedoor	2006	Internet entrepreneur cooks books; currently in prison
Nikko Cordial	2006	Accounting scandal, chairman and CEO resign
TEPCO	2002	President resigns over falsified nuclear–safety tests

Questions

1. Why do huge corporations as Toyota, Enron, World.Com and Satyam Computer Services commit such errors?
2. What lessons does one learn from Toyota's misjudging and mishandling a crisis?

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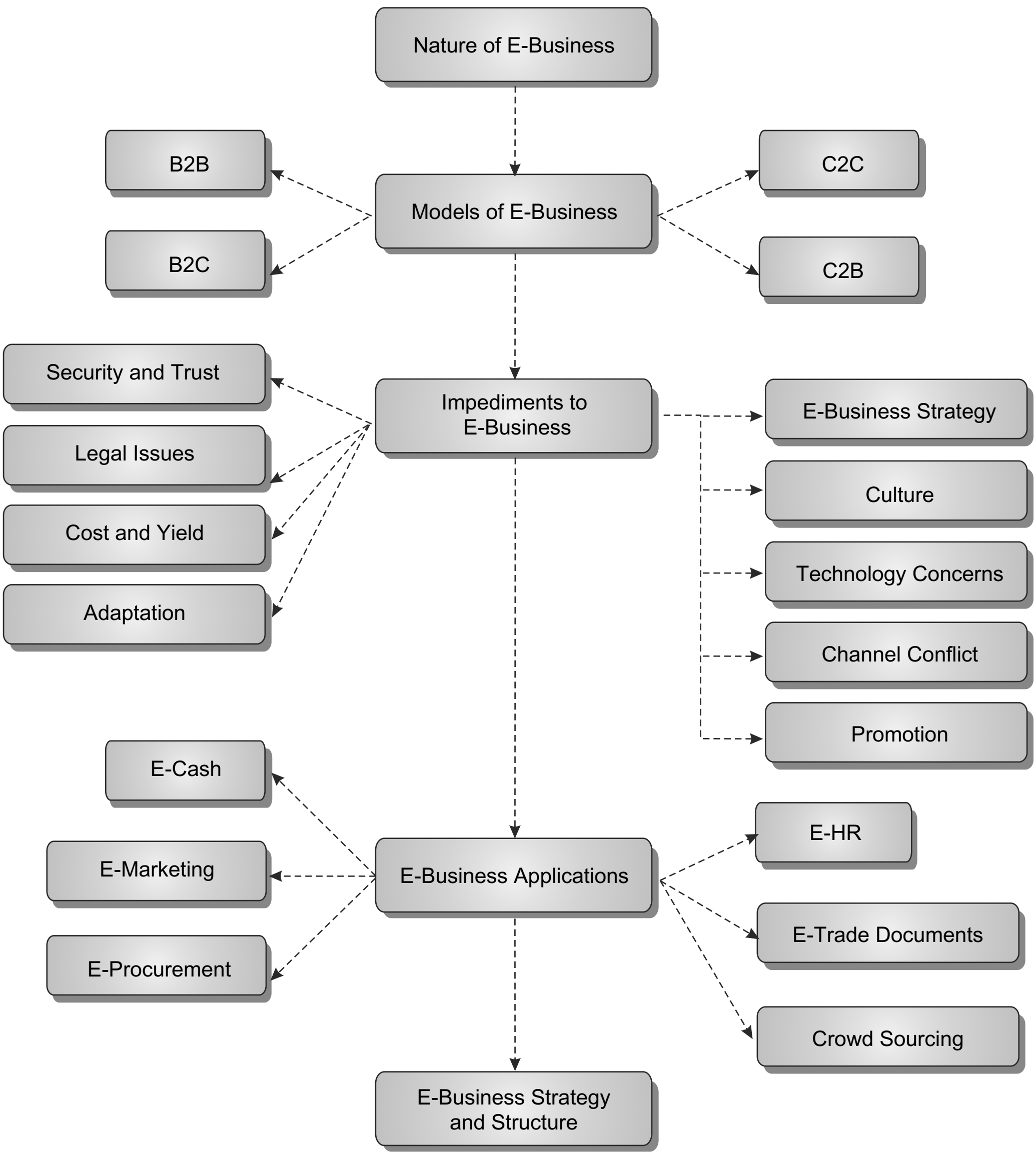
CHAPTER



Nature of E-Business
Models of E-Business
B2B
B2C
C2C
C2B
Impediments to E-Business
Security and Trust
Legal Issues
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Adaptation
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E-Cash
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E-Procurement
E-HR
E-Trade Documents
Crowd Sourcing
E-Business Strategy and Structure

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E-Business

After reading this chapter, you should be able to:

- **LO 1:** Define the nature of E-business
- **LO 2:** Identify the requirements of E-business
- **LO 3:** List the models of E-business
- **LO 4:** Analyse the impact of E-business
- **LO 5:** Asses the impediments to E-business
- **LO 6:** Outline the applications of E-business
- **LO 7:** Illustrate the strategy and structure of E-business

Opening Case 1

It Can Go Anywhere

The above caption refers to Amazon, the other name for e-commerce. The cover story in *The Economist,* dated June 21^{st}-27^{th} 2014 was titled "How far will Amazon go"? The answer is simple. Amazon can go anywhere!

The story of Amazon reads like a fiction. Within 20 years, the American based e-retailing firm created history in terms of sales volume, influencing the buying habits of people, market capitalisation, and employee strength.

It was in 1994 when the 30-year-old Jeffry Preston Bezos quit a promising job as vice president in a financial services firm, and left for Seattle to start a business of his own. He rented a house with a garage; the likes of HP and Apple were borne, to reiterate the myth that tech creators were sired in garages. Although he started selling books, Bezos called his firm Amazon because the great river reflected the scale of his ambitions.

As of now, Amazon is one of the tech giants with a customer base of 244 mn, employee strength of 110,000, revenue of $74.5 bn (2013) and market capitalisation of $149.4 bn. Amazon now carries 230 mn items for sale in America, some 30 times that number sold by Wal-Mart, the world's biggest retailer.

Amazon sells everything, from diapers to toys and from electronics to grocery. Books, e-books, smart phones, jewellery, furniture, you name and it is available. The growth of Amazon is triggered by three fundamentals: choice, price and delivery. A vast stock selection, low prices, and fast and reliable delivery rolled into value and convenience for customers.

In the U.S., Amazon is a retailer who sells directly to customers, and also a market place where other retailers can list and sell their products. In India, where FDI in multi-brand retailing is not allowed, Amazon only has a market place.

This does not mean Bezos does not have his eyes on India. For one thing, India has more than 200 mn internet users. Amazon has become a household name for neo-rich Indians. A lady from West Bengal ordered and bought jewellery, a professor from Bangalore gets a management book from the U.S., both via Amazon, and the list goes on. No other firm has created so much a brand value than Amazon within so short a period. Amazon will flood Indian market once the hurdle is cleared. Meanwhile, Amazon has entered a joint venture with Narayana Murthy of Infosys to help out small and medium businesses.

On top of its on-line retail success, Amazon has produced two other transformative businesses. The Kindle e-reader pioneered the shift from paper books to electronic ones, creating a market that now accounts for more than a tenth of spending on books in America and which Amazon dominates. Another transformative is the invention of cloud-computing in 2006 as a pay-as-you-go service, now a $9 bn market. That venture called Amazon Web Services (AWS), has slashed the technology costs of starting an enterprise or running an existing one.

Amazon's ascent has left a trial of enemies and sceptics, including competitors who were forced to sell their firms to the company because of ruthless price cuts. It has been attacked for driving workers at warehouses too hard, and making them pay for vehicles parking. It has also been criticised for avoiding tax in America, Britain, France and Germany.

Amazon remains one of the most highly valued companies in the U.S., yet the business is losing some of its sheen because of continuing losses it is incurring. Bezos is investing on areas which might fetch returns in the long-run, but investors are losing faith in such investments.

Amazon's lack of profits stands in stark contrast to Alibaba Group Holding Ltd., a Chinese e-retailer. The Chinese web-retailer made a profit of $2.8 bn in 2013 on a revenue of $6.5 bn. Amazon earned $247 mn on sales of $74.5 bn. Alibaba has better margins.

Opening Case 2

Otis Elevator

Founded in 1853, Otis Elevator – a wholly owned subsidiary of United Technologies Corporation – is the world's number one manufacturer of elevators and escalators. With 1.2 million installations in more than 200 countries, Otis has a 22 percent share of the global elevator market. Based in Connecticut, nearly 80 percent of its sales are outside the United States as are 55,000 of the company's 63,000 employees.

Integration of computer technology at Otis began in 1979, with the installment of micro-processors in elevators to detect problems and improve maintenance. In 1983, Otis started OTISLINE, a computerised dispatch service for North American elevators. In 1988, REM allowed the firm to monitor elevator performance from distant locations in North America. Otis then extended those innovations globally. In 1999, Otis introduced e-Display, an Internet-based information display in an elevator car, e-Direct, which allows customers to order elevators online, and e-Service, an on-line customer service website.

By the summer of 2000, Otis was taking on-line orders in 49 countries in 29 languages. The company expects on-line business to account for 25 percent to 30 percent of its growth between 2000 and 2003. In selected markets such as France, the Otis site permits architects to submit their building specifications and have Otis engineers determine the type of elevators required.

(Source: Oded Shenkar and Yadong Luo, *International Business*, Wiley India, 2004, p.469)

ONE of the characteristics of contemporary business is global competition. Businesses, domestic or global, compete among themselves for enhanced market shares, increased sales volumes and raised profit figures. Towards these objectives, businesses, particularly MNCs, are evolving and implementing different strategies. One of such strategies is e-business (e-stands for electronic). E-business is like a magic wand which almost revolutionises the way business is done. Behind the success of e-business is the advancement in information and communication technology. Infact, there cannot be e-business without the communication and information technology.

NATURE OF E-BUSINESS

LO 1
Define the nature of E-business

It was IBM which was the first company to use e-business when it launched a thematic campaign built around the term in 1997. Until then, the widely used term was e-commerce. The shift in terms also meant a shift in paradigm; selling and selling support were the only experiences that companies could reproduce on the web. Broadening the approach to allow more types of business on the web created the new term e-business. E-business can be defined as the conduct of automated business transactions by many electronic communication networks (e.g., via the Internet), end to end.

The term end-to-end business transaction signifies that a series of automated business processes and information systems of different companies, which are involved in an inter-company business transaction, is successfully integrated. The aim is to provide seamless interoperation and interactive links between all the relevant members of an extended demand and supply chain—ranging from product designers, suppliers and their partners to end-customers. An end-to-end process involves integrating designers, suppliers, buyers, trading partners, logistics providers and end-customers in the entire planning and execution process.

E-business promotes inter-company business relationships. Infact e-business subsumes the term collaborative business.

The other term often mixed up with e-business is e-commerce. Many people use these terms interchangeably. In a strict sense, e-business refers to all business activities conducted on the Internet by a company. In contrast, e-commerce is a part of e-business; the term refers only to the activities involved in buying and selling online. These activities may include identifying suppliers, selecting products or services, making purchase commitments, completing financial transactions and obtaining service. Obviously, e-business is a more comprehensive term and hence is used in this book.

Instituting e-business in an organisation demands several facilities. To start with, online business needs human resource – people who can design, create and maintain websites. Most basic requisite is the infrastructure which includes a combination of systems inside an enterprise such as client/ server, networking facilities, and technology required to integrate systems and processes between collaborating enterprises. Three layers of infrastructures are required to launch successful e-business. The bottom layer includes networking topologies, the Internet, and protocols such as the Transmission Control Protocol (TCP). The second layer (known as the basic infrastructure layer) contains client/

server and tiered architectures. The layer above the basic infrastructure is called the web technologies and applications layer, and contains technologies that are required to develop web-based applications. Finally, the top layer contains collaborative technologies such as Electronic Data Interchange (EDI) and work flow technologies. The infrastructure, of all the three layers, directly affects the quality of the service experienced by end users.

Three groups of firms form part of e-business: those that create telecommunication infrastructure, Internet software producers, and online sellers and content providers.

Telecommunications Infrastructure

Telecommunications hardware and equipment producers, computer hardware manufacturers and Internet Service Providers supply the telecommunications infrastructure of the Internet. Lucent Technologies and Cisco Systems produce most of the telecommunications equipment and hardware that allows the Internet to work. IBM, HP, Dell Computer, Lenovo and Apple Computers produce computers. Internet Service Providers (ISPS), which buy their technological capability from the makers of telecommunications hardware, provide customers with the necessary technology to connect to Internet. The last link to the Internet, provided by local telephone and cable television companies, is the shortest, in the global electronic network.

Internet Software Producers

Producers of software are the second group of e-business firms that have emerged since the beginning of online commercial activity. Searching the Internet, browsing websites, sending e-mail messages, shopping online, viewing multimedia content, and other online activities are performed by this group of firms. Browser software is the single most basic product for user interaction on the Internet. Currently, the dominant browser are Microsoft's Internet Explorer and Google Crome.

Online Sellers and Content Providers

This group comprises all firms that customers actually interact with on websites. This category of companies (eBay and Amazon) vary from those that offer products and services only online to those that carry some of their activities on the Internet. They use the Internet simply to provide information and supplement their regular business activities. Although it is not clear what content and activities will eventually make their way to the Internet, the trend is clear that the business is witnessing a significant move away from traditional business towards Internet popularly known as market space.

What is significant is that all the three categories of firms are in a race to globalise themselves. They have largely succeeded in their attempts going by the way companies like Google, Microsoft, Apple Computers, Amazon and the like have become household names across the globe.

E-BUSINESS REQUIREMENTS

Not all organisations are equally poised to adopt e-business. They need to be e-ready to leverage the benefits of on-line business. Enabling facilities for launch of e-business include clear objectives, connectivity, supply chain, e-leadership, security, flexible IT architecture, human capital and e-climate.

LO 2
Identify the requirements of E-business

Objectives and Processes Organisations must accurately measure the impact of the e-business initiative on their business processes. This is necessary to reassure the worthiness of the initiative which also carries sustainable long-term effect.

Connectivity Connectivity refers to the extent of wiring of an organisation. Organisations need to have internet facility and should be accessible to all the employees. Online business has not caught up as much as it should be considering the size of India, reason being that a large number of people have no access to computers, forgetting Internet facility.

E-Leadership E-leadership refers to the extent to which e-business is a national priority. It is not enough that a given government accords priority, but does not provide adequate infrastructure to facilitate e-business application. Table 25.2 gives ranking of countries on e-readiness scope. At the top of the heap are USA, Hong Kong, Sweden, Australia and Denmark. Some of the low e-business users today, such as Russia, have the technological potential to grow e-business substantially.

Information-Security This refers to the existence of security and protection pertaining to information dissemination. Security concerns remain the main obstacle in the way of an internet user who is considering shopping on-line. Confidentiality is a product of the availability of secure servers as well as of transcription technologies. Not all governments are eager to assist. In the meanwhile, losses due to inadequate security can be debilitating as the entire enterprise network can easily be compromised if suitable security methods and procedures are not put in place. Evolving and initiating e-business initiatives not only involve updating oneself about the technology but also managing and responding to security-related vulnerabilities, risks and threats. Different kinds of security technology are now available that can effectively support e-business initiatives. Organisations should not entertain any reservation in procuring and installing security safegaurds.

Flexible IT Architecture Organisations need to be aligned with a flexible IT architecture. In response to demands for end-to-end e-business solutions, organisations are expanding their applications to include advanced integration capabilities. The solutions required reflect the need to integrate business processes at different levels from applications and data, and finally across (and within) organisations in a way that embraces all possible sources of complexity. This also necessitates automating business processes that encompasss a diverse range of packaged applications and systems within enterprises. A big challenge is the creation and adoption of new infrastructures and enabling technologies that will be used to facilitate e-business integration.

Human Capital and E-Climate Successful e-business application demands army of people to instal, operate and maintain technological infrastructure. An e-business climate is composed of the institutional and regulatory frameworks that facilitate or hinder e-business. E-business demands the use of plastic currency. Credit card usage is low in China. In some countries such as Japan, credit card processing fees are extremely high, deterring the use of plastic currency. As with the Japanese, 80 percent of Germans do not use credit cards.

MODELS OF E-BUSINESS

LO 3
List the models of E-business

A business model refers to a group of shared characteristics, behaviours and methods of doing business that enables a company to generate profits through higher revenues and lower costs. Viewed from this backdrop, certain models of e-business present themselves: business to business, business to consumer, consumer-consumer, and consumer to business.

Business-to-Business

Also called B to B or B2B, this model involves inter-business transactions using an electronic network. Here both buyers and sellers are businesses only. In B2B model, some firms use the Internet mainly to conduct business with other businesses. B2B transactions make up to 75 to 80 percent of online business.

B2B application is wide and varied. Major uses include purchase order processing, inventory management, distribution management, channel management and management of payments.

B2B offers several benefits to its users. Elimination of intermediaries is one benefit the buyer and the seller gain. Buyers, for example, place orders directly on the seller's website. The seller produces and delivers products to the buyers directly. Saving cost is another advantage. Seller need not carry inventory thereby saving on carrying costs. The buyer is freed from all hassles that arise from intermediaries. How far cost can be saved may be appreciated by taking the example of Ford Company, the online leader in the auto industry. The auto major links 30,000 auto parts suppliers and 6900 dealers in its network, resulting in an estimated $8.9 billion savings each year from reduced transaction costs, materials and inventory. This $8.9 billion savings represents about a quarter of the retail selling price for an average new car, rendering a significant competitive advantage to the company.

Transparency in pricing and other deals and gaining economies of scale and network effect are the other benefits of B2B.

Business to Consumer Model

Popularly called B to C or B2C in its acronym, this model involves purchase of books, for example, online. B2C is active in products and services such as personal finances and investments, books, toys, music, air, train and bus tickets, clothing, videos, hotel reservations, flowers, and consumer electronics. The most popular online retailers include Amazon.com, eBay.com, Wal-Mart.com, Goggle.com, Sears.com, Overstock.com and Kohls.com.

These online retailers provide round-the-clock global access to their products and services. They also make special efforts to build long-term relationships with their customers. The Internet is of great help to build customer relationships.

Consumer-to-Consumer Model

Unlike the B2B and B2C models, which focus on business transactions and communications, the consumer-to-consumer (C2C) model involves the growing popular use of peer-to-peer (P2P) software that facilitates the exchange of data directly between the individuals over the Internet. E-Bay is a global player in the C2C business of auctions. Anyone can sell and buy something online by placing bids.

Consumer-to-Business Model (C2B)

Examples of these firms include price comparison websites such as http://www.addall.com which search online bookstores throughout the world to provide price comparisons and shipping and delivery information. In addition, professionals like lawyers, accountants, consultants, architects and astrologers offer their services to business online.

IMPACT OF E-BUSINESS

LO 4
Analyse the impact of E-business

Benefits from e-business are several. E-business speeds up business transactions, eliminates paper work, connects people instantly and collects and stores information. Electronic connectivity improves efficiencies across the full value chain and has power to transform the conventional business models totally. Benefits from e-business include high productivity, reduced transaction costs, improved competitive position, wide reach, harmonisation and standardisation of processes, and improved customer service, and international business.

Efficiency and Productivity Operational efficiency enhances, thanks to e-business initiatives. By using online technologies to interact with trading partners, organisations can streamline their operations and increase their effectiveness at the same time. By eliminating operational waste and automation of inefficient business practices, organisations can realise productivity gains.

Reduction in Operating Costs E-business enables minimisation of transaction costs. Activities such as procurement of goods and services, processing purchase orders, order and delivery tracking, and so on are more efficiently done and at the same time collaborating with external partners. Collaboration with suppliers, customers, distributors and trading partners raises opportunities for transactional exchange of information. E-business technologies help lower the cost of communication and collaboration between trading organisations in a supply chain. Organisations must communicate and collaborate in connection with the exchange of orders, billing and payment information, shipment dates, sharing product information and forecasting. Such collaborative activities can create tighter links among business partners, improving the efficiency of various support functions involved in bringing products to the market.

Improved Competitive Position E-business initiatives add to the competitive strength of a firm. Global reach, rapid growth, reduced cycle time, and optimum distribution channels help gain competitive strength.

Market Penertation E-business initiatives help reach out to the remotest markets. Infact, internet-business knows no political boundaries. Forests, mountains, terrains and deserts are no hindrances to reach customers.

Harmonisation and Standardisation of Processes E-business facilitates application of standardised processes cutting across regions and religions. A catalogue of common business processes is created and reference models are specified according to international, e.g., UN, trade facilitation recommendations, and business processes and procedures are defined independent of the resulting implementation technologies. This ensures cross-domain harmonisation of business processes with significant implications for conduct of transactions across company barriers.

Customer Service Online business not only facilitate reach of customers far and wide, it also helps maintain cordial relations with customers. E-business enables sharing of information and business processes across multiple organisations for stronger, and more profitable relationships. Just-in-time deliveries, and made-to-order manufacturing systems are possible through e-business and these help serve customers better.

Implications for International Business E-business facilitates business across countries considerably. Internet removes barriers to communication with customers and employees created by geography, time zones and location, creating a frictionless environment. More specifically, for an MNC, the Internet creates an opportunity for rapid global distribution of products. This can also become a curse. Competitors can quickly imitate the products. Structure of business practices of MNCs and interaction between them are bound to change, thanks to internet connectivity.

Certain strategic decisions of an MNC are influenced by on-line systems. Strategic selection of a host country to locate a subsidiary, for example, is no longer subject to conventional factors such as resource and labour availability. These are the days of "virtual FDI" which could challenge basic assumptions about location decisions. Resources delivering digitised content can be remotely accessed, as for instance, animation of graphic design labour. Nearness to customer is no longer a competitive strength. Customer connectivity can easily be established through digital channels (e.g.,Amazon). Knowledge-centric locations too are no more a deciding factor in choosing a host country/location. Tacit knowledge spillover tends to be localised, but codified knowledge is available throughout.

In short, e-business initiatives carry potential benefits like reduced cost, availability of technology to reach out, efficiency, convenience and speed of access.

IMPEDIMENTS TO E-BUSINESS

LO 5
Asses the impediments to E-business

What type of businesses generally go-in for e-business? It is the large firms that tend to join the bandwagon. These large firms seeking to develop and implement e-business tend to include small- and medium-sized enterprises in their supply chains. For these large firms, the rate at which small and medium enterprises adopt e-business and enhance their capabilities could affect the scope and timing of their e-business implementation. By implication, those small- and medium-sized firms that do not keep pace with e-business may be marginalised as suppliers.

The impediments in the way of e-business include lack of clear e-business strategy, technology concerns, security worries, privacy legal issues, high cost of computing technology, culture adaptability, adaptation, channel conflict and promotion. Small and medium enterprises too tend to face the same constraints while going in for online transactions.

E-business Strategy

Ideally, e-business should integrate with the business strategy. This requires clarity about the e-business strategy itself. E-business strategy provides a clear mind map so that its implementation and measurement can be monitored. Often, traditional organisation structure acts as a stumbling block. Barriers are often erected between departments to inhibit sharing of information. The e-business implementation process requires evaluating a company's supply chain, its customer relationship and an e-business assessment survey. This enables a company to benchmark e-business progress against that of similar companies. To identify business opportunities, risks and process improvements, a company requires good understanding of how suppliers, distributors, retailers, end-users, alliance and joint-venture partners and even competitors interrelate. This requires organisational changes so that companies can better integrate with each other.

Technology Concerns

Business process integration is what is widely regarded as the ultimate objective of e-business. With business process integration, interactions between enterprises are achieved electronically according to some predefined process which ensures that the business transactions are both meaningful and reliable. At the core of the business process integration is technology, specifically the Internet. Internet technology comprises five primary components: backbones, digital switches (routers), servers, point of presents (POPs), and finally individual (client) users' devices, generally connected to the Internet through telephone modems, DSL ISDN lines, or cable television modems. The backbones are the mainline telecommunications channels of the Internet, built with high-capacity fiber-optic cables that move data at the speed of light.

E-business requires the above and many more technological facilities. Now the challenges are: investments involved, returns expected and realised, obsolescence, servicing and maintenance, privacy and intellectual property rights.

Security and Trust Issues

Security—many firms are afraid to move to Internet-based trading systems because of the potential for theft of business information and funds, alteration of financial documents, as well as the potential for illicit transactions and concerns over payment security. Potential losses due to inadequate security can be crippling as the entire enterprise network can easily be compromised if appropriate security methods and procedures are not built into the e-business technology infrastructure.

Lack of trust is a severe barrier to the use of e-business. If organisations do no trust those companies which provide goods and services, they will not engage in e-business transactions. E-business transactions occur at a distance where the buyer cannot see the products, unless they are digital, and cannot take possession unless it is paid. The buyer, therefore, needs to trust the seller to supply the goods as promised, to ship them correctly and in timely manner. In addition, the buyer must trust the seller to describe the goods faithfully (for spot buys) and to fairly resolve any disputes that may arise.

Legal Issues

Legal issues tend to prevent firms from entering e-business. When we say legal issues, we refer to the lack of awareness about the statutory provisions affecting online business transactions. Few companies are familiar with the rules and regulations that apply to online business, leading to much uncertainty for e-business companies and users alike. Many firms feel insufficiently informed about legal provisions applicable to e-business. This lack of awareness may be attributed to the growing number of rules applicable to e-business. In addition, many are of the opinion that e-business is too sophisticated, too complex and too distant for an ordinary business unit.

Culture E-business demands high degree of technology connectivity. Yet local culture should not be overlooked. The website and the product must be culturally neutral or adopted to fit the local cultural nuances. In Japan, the pickiness of Japanese consumers about what they buy and their reluctance to deal with merchants at a distance must be addressed when marketing on the Web. To many Europeans, American sites come off as having too many bells and whistles because European sites are more consumer oriental. The different cultural reactions to colour can be a potential problem for websites designed for global markets. While red may be highly regarded in China or associated with love in the US, in India and Spain, it is associated with socialism. Cultural nuances need to be integrated while designing a website.

Cost and Yield Cost of on-line business can be very high. Translating text into different languages, both on a one-time and ongoing basis is a costly affair. Website construction and maintenance in multiple languages, currencies, and tax locations add to the cost. Related matter is the return on investment

(ROI). E-business must guarantee better return on the investments made on physical infrastructure, software, human resources, maintenance and servicing, and telecomunications.

Adaptation Website needs to be translated into the languages of the target markets. If a Website does not have multiple languages, the company loses its sales. It is the responsibility of the company to bridge the language and cultural gap. A given customer is language sensitive. He or she visits a site of his or her language. A country—specific website is what is needed.

Promotion E-business providers need to advertise their presence and the products or services offered. One should attract visitors from other countries to visit its website. Search engine registration, press releases, local news groups and forums, mutual links, and banner advertisements are made for promoting one's website. A website should be seen as a retail store, with the only difference between the two being that a customer does not visit a site by foot. And promoting website is an expensive affair.

Channel Conflict Distributors and retailers that sell a company's products may be undermined by competition from a company's website that sells directly to end users. This is a major worry for many automobile dealers if the manufacturers were to sell directly from the factory.

Constraints notwithstanding, e-business has come to stay and is going to be the business model in the years to come as Table 25.1 shows.

As shown in Table 25.1, Republic of Korea has the highest extent of Internet use for businesses with a score of 6.1 and Chad has the least with a score of 1.9. UK is bracketed with Korea with a similar score of 6.1.

Table 25.1 Internet Use for Business

Country	*Score*
Republic of Korea	6.1
UK	6.1
Sweden	5.7
Germany	5.6
US	5.5
Japan	5.4
Australia	5.2
Thailand	4.7
India	4.6
China	3.5
Chad	1.9

Note: 1-least, 7-highest

(*Source: The Global Competitiveness Report,* 2006–07)

Internet can be accessed round the clock anywhere in the world. Convenience of use, low transaction costs and possibility of customisation have made Internet a highly popular medium of business.

But not all countries exhibit equal e-business readiness as Table 25.2 shows. E-business readiness is a measure of the quality of a country's technology infrastructure and the absorbing capacity of its e-business uses. The Economist Intelligence Unit annually publishes e-readiness ranking for the world's 70 largest economies based on nearly 100 criteria to assess countries' technology infrastructure, their business environment, the degree to which e-business is adopted by users, social and legal environmental factors and government's policies and visions.

Table 25.2 E-Business Readiness

Country	*Score*
US	8.95
Hong Kong	8.91
Sweden	8.85
Australia	8.83
Denmark	8.83
Singapore	8.74
UK	8.68
Germany	8.39
Japan	8.08
South Africa	5.95
Brazil	5.65
Thailand	5.22
India	4.96
China	4.85
Russia	4.42

Note: 10 indicates the highest score on e-readiness and 1 indicates the least readiness

(*Source:* E-readiness Ranking, 2008, *The Economist Intelligence Unit*)

As shown in Table 25.2, expectedly US is at the top of the heap with a score of 8.95, followed by Hong Kong with 8.91, Sweden (8.85), Australia (8.83), Denmark (8.83) and India (4.96). The Economist Intelligence Unit has a word of appreciation for India's emergence as the power centre of IT and ITES. India has emerged as the benchmark for all other countries in South Asia.

E-BUSINESS APPLICATIONS

E-business has wide application. Any business transaction can be carried through Internet. More specifically, e-business application in the following areas is being explained here.

LO 6
Outline the applications of E-business

E-Marketing

Otherwise called e-commerce, e-marketing is most visible among all e-business models and applications. Representing B2C model of e-business, e-commerce enables firms reach out world markets through internet much easily.

E-commerce is a new comer to India but has made huge impact with millions of consumers in the country driving growth in the $11 bn sector.

Consumers in India are shopping online buying blowers, blankets, designer watches, grocery, books, toys, costume jewellery and the list goes on. Many young men and women working in the office districts of Gurgaon, Bengaluru and Mumbai are ordering their breakfast and lunch online. Strapped for time, these people order cut fresh fruits, salads, juices and other health foods to be delivered to their office desks during the day.

If Amazon (see opening case 1) is the pioneer in e-commerce, Indian players are no less active. Flipkart, and Snapdeal are the leaders as of now, with many waiting to reach the top. E-commerce firms are attracting funds from all quarters. Flipkart and Snapdeal were not heard of a decade back. They now talk of billions of dollars everytime.

E-Cash

E-cash refers to a prepaid stored monetary value that can be used to buy online. Electronic cash transfers have replaced conventional payment and receipt systems. Traditionally, payments were made through money orders and cheques. Electronic cash, on the other hand, involves payment and receipt through credit cards, debit cards, smart cards, and electronic cheques. Of all, smart card is more in use. A smart card is a handy plastic card which contains a micro-processor and a storage facility. The term electronic purse is referred to the money value that is being loaded on to the microprocessor of the smart card which can be used for payments. Another method for online payments is the electronic cheque. In this, the payer (individual or an organisation) instructs the financial institution to pay a specific amount to the payee. The Value Added Networks (VANs) facilitate those EDI transfers. The new generation electronic cheque provide internet websites with the ability to perform money transfers more efficiently.

E-receipts and payments go beyond mere transfer of funds. There is the Electronic Invoice Presentment and Payment (EIPP) system that facilitates invoicing and payments needs of businesses. It allows the electronic delivery of complex business invoices while accommodating highly variable billing data. EIPP offers an interactive system to support online dispute resolution, automatically matches invoices to purchase orders, creates internal audit trials, accepts payments over the internet, and posts the results to the accounting system. EIPP solutions are offered by specialist EIPP suppliers and traditional financial institutions, and can be integrated with e-markets.

E-procurement

Procurement, also called purchasing, is the external acquisition of goods, services and materials (including machinery, tooling) that are needed for production, sales and maintenance. This implies optimising not only the costs of goods and services themselves, but of the organisation involved as well. In doing so the purchasing function contributes to the company's competitive edge.

Conventional purchasing involves series of activities as stated below:

- Anticipating or recognising a problem (need) and proposing a general solution;
- Determining the characteristics and the quantity of the item needed;
- Describing the characteristics and the quantity of the item needed;
- Searching for and qualifying potential supply sources;
- Acquiring and analysing proposals;
- Evaluating proposals and selecting suppliers;
- Selecting an order routine;
- Performance feedback and evaluation.

E-purchasing has replaced the conventional purchasing activities stated above. E-procurement is the purchase of supplies and services over the Internet. The Internet has provided instant access to thousands of buyers, suppliers and market places around the world. E-procurement covers the entire purchasing process from gathering information to delivery. Consequently, the process includes inbound logistics such as transportation, goods-in, and warehousing before an ordered item is used. E-procurement utilises electronic catalogues, automatic routing of an electronic requisition through approval process, and electronic transmission of the completed purchase order to the vendor. Thus, an end-to-end integration of the purchasing cycle is created by e-procurement.

An e-procurement solution offers the following key advantages:

- Anticipating or recognising a problem (need) and proposing a general solution;
- *Reduced costs:* e-procurement empowers aggregated, cross-enterprise spending, resulting in lower prices through higher volume purchasing;

- *Improved process efficiency:* e-procurements make it easier for companies to increase purchasing control and work with preferred suppliers;
- *Increased control:* e-procurement provides a consistent method for handling all purchasing orders;
- *Global reach:* e-procurement provides access to a global supplier base, allowing companies to work with suppliers who better fit their needs and reduce material costs by strengthening existing supplier relationships.

E-HR

People management has travelled a long way. From mere handling of industrial disputes, human resource management (HRM) grew into personnel management with managers of personnel going beyond firefighting to activities such as welfare, compensation administration, promotions, works councils, suggestion schemes and the like. Over time, from personnel management, the subject matured into HRM elevating the status of HR professionals to strategic partners and change agents. Of late, HRM is transforming itself into human capital management (HCM).

Along with the journey of people management, technology too travelled and covered several milestones. If HR's role has been to deliver workforce support and management based on the needs of the business, the role of technology has been one of enabler. During the past several years, HR activities, processes and procedures have been supported by everything from complicated file-folder systems to automation, going from usage of multiple systems and databases to a single version of the whole system. These are the days of e-HR. HR professional needs to be aware of and be knowledgeable enough to adopt the new technology for the benefit of his or her organisation.

When HR department makes use of the Internet and related technologies to support its activities, the process becomes online or e-HR. E-HR is the total integration of all HR systems and processes based on common HR data and information and on interdependent tools and processes. Fully developed e-HR could provide the data gathering tools, analysis capabilities and decision support resources for HR professionals to hire, pay, promote, terminate, transfer, assign, develop, appreciate and reward employees in ways that fully engage them in managing their own outcomes, maximise the contribution of each employee and support execution of company's strategy.

E-HR has the potential to change all conventional HR activities. Table 25.3 shows major implications of Internet-based HR activities. Employees in different geographic locations can work together. Use of Internet enables companies to search for talent cutting across time and distance constraints. Recruiting

Table 25.3 E-HR Implications

HRM Activities	*Implications of e-HR*
Analysis and design of work	Employees in geographically dispersed locations can work together in virtual teams using video, e-mail and the Internet
Recruiting	Post job openings online, candidates can apply for jobs online
Selection	Online simulations, including tests, videos, and e-mail can measure candidates' abilities to deal with real-life business challenges
Training	Online learning can bring training to employees anywhere, anytime
Compensation and benefits	Employees can review salary and bonus details and seek information about and enroll in benefit plans

(*Source:* Raymond A. Noe, *Fundamentals of Human Resource Management,* TMH, 2007, p. 52) can include online job postings, applications and candidates screening from the company's websites or the websites of recruiting firms, such as monster.com, naukri.com and clickjobs.com. Employees from different geographic locations can all receive the same training over the company's computer network.

E-trade Documents

Earlier both buyers and sellers in international trade were required to prepare hard copies of trade related documents and submit them to different government agencies. Such a system not only delayed the process of buying and selling but there were corrupt practices indulged in by dealers and government officials.

The electronic data interchange (EDI) has done away with the tedious and manual ways of trade documentation. Besides, trade procedures are being streamlined and automated so that a single form could be used for all trade documentation requirements. An ideal single electronic window system provides a one point of data entry to achieve a number of completed transactions with the multiple government agencies.

Crowd Sourcing

Crowd sourcing is gaining momentum and several businesses like P&G, Dell, WIPRO and Happiest Minds have benefited from electronic-business. For naming a product or a new start-up, or for an innovative idea public response is sought, obtained and used, all on-line. This process is called crowd sourcing. P&G has a dedicated website – P&G Connect + Develop - to solicit ideas for products, technologies, businesses and innovation from one and all. The consumer goods major has 85 'needs' like new ingredients or products that reduce the severity of common cold. Dell too has an exclusive site to tap ideas relating to its business from public. The US major has received 11000 ideas of which 350 were implemented. These include making USB 3.0 port a standard feature on its PCs and laptops, a common charger for devices and introduction of antiglare on notebook screens. "Happiest Minds" for Soota's new venture has come from public through online. SMEs are popular users of crowd sourcing platforms. Parle Agro uses crowd sourcing platforms to find supply chain gaps.

E-BUSINESS STRATEGY AND STRUCTURE

LO 7
Illustrate the strategy and structure of E-business

E-business strategising is a new and evolving management challenge. The international manager must build on sound, basic strategising as a prelude to multinational operations. Building a successful e-business strategy involves the following steps:

- **Threats and opportunities:** Development of e-business should be preceded by identification of business opportunities and threats in the external environment, assessment of internal strengths and weaknesses, and an understanding of the impact of technological change.
- E-business initiative should be built on the strengths of the organisation and should take full advantage of the opportunities in the market.
- **Build on current models and experiment with new e-business models:** Search for ways to use the e-business to reduce costs or enhance services offered by the traditional business. E-business can be less costly, yet it can add value to customers.
- **Meet the challenge of developing an e-business organisation:** The basic choice involves a distinction between either a separate autonomous entity for e-business or a seamless integration into the current model. Best results may be obtained when there is integration.

- **Allocate resources to the e-business:** To succeed e-business requires commitment of financial, infrastructural and human resources. If these resources do not exist, some of the e-business activities can be outsourced to alliance partners or to third parties.
- **Build a superior e-business infrastructure as a basis of a differentiation strategy**: This needs building websites with superior online experiences. Each customer may be personalised. Streamlining and simplifying transaction are also needed.
- **Make sure the entire management team aligns with e-business agenda**: With regard to e-business structure, each organisation needs to decide how e-business fits into its existing organisational design and management systems. In other words, companies must decide how much to integrate their evolving Internet operations into their traditional business operations. In e-business jargon, traditional business operations are often called the "brick and mortar" part of the company.

The degree of integration between brick and mortar operations and the online business can occur anywhere in the value chain from procurement of raw materials to after-sale service. Again, the degree of integration can range from the near seamless operation to the mostly independent operations.

Each choice has merits. The independent operations can move faster and be entrepreneurial when freed from corporate bureaucracy. The integrated system, on the other hand, can benefit from cross-promotion of shared products, shared customer information, and increased large quantity purchasing leverage and economies of scale by using the same distribution channels.

The choice between seamless integration and a fully autonomous unit is not all that simple. The best option for most companies is something in between. As with most strategy implementation issues, managers must evaluate their company's particular situation to make an informed decision. Figure 25.1

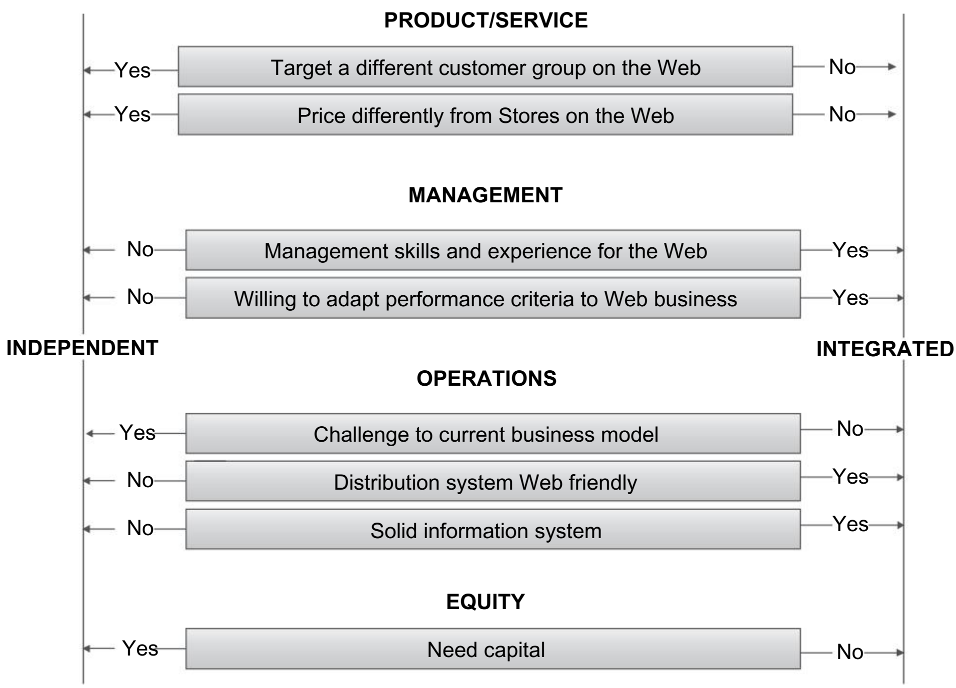

Fig. 25.1 Key Decisions in the Web Business Integration Versus Separation Decision

(*Source:* John B. Cullen, op.cit. p. 371) is a typical decision model with the questions that managers must consider in choosing the best level of integration of the e-business unit.

Summary

- Business conducted online is e-business. Firms are active players in online business. (LO1)
- E-business to function effectively needs connectivity, information security, IT architecture, human capital and e-climate (LO2)
- Models which present themselves are: B2B, B2C, C2C, and C2B. (LO3)
- E-business brings along with it, such benefits as productivity, reduced operating costs, enhanced competitive position, market penetration, and customer service. (LO4)
- Technology concerns, trust and security issues, legal issues and culture are the major impediments to e-business. (LO5)
- E-business has several applications. Major ones are: e-commerce, e-cash, e-procurement, e-trade documents, and crowd sourcing. (LO6)
- International manager needs to build e-business strategy and structure. (LO7)

Review Questions

1. Bring out the nature of e-business. Explain the different models of e-business.
2. Review the impediments of e-business.
3. Explain the areas of application of e-business.

Discussion Questions

1. Is the choice between brick and mortar model and brick and click model easy? If not, how to resolve the issue?
2. What are the advantages and disadvantages of e-business over traditional brick and mortar business?

Reinforcing Exercise

- Though a late comer, India is making big strides in e-commerce. This was demonstrated on the hefty discount sales announced by Flipkart on Oct 6, 2014. The response was unprecedented with the e-retailer clocking $100mn in sales in just 10 hours. Flipkart is not only e-commerce player. There are others as well. Now what is the future for small kirana shops dotted across the streets of India?

CLOSING CASE

AOL and Time Warner Team–Up

Difficult as this may be to comprehend today, America Online (AOL) started out in 1985 as simply one of many service firms providing customers with a way to connect to the Internet. Remarkably only fifteen years later AOL entered the new millennium as the world's leading online service firm, with more than 20 million paying subscribers and a phenomenal growth in revenue. By merging with the world's leading media company, Time Warner, AOL has transformed itself into an Internet colossus. With combined revenues of $36 billion, the new firm, AOL Time Warner, is being touted as "the world's first media and communications company of the Internet age."

The union of AOL and Time Warner illustrates how partnerships and megers between firms can benefit Internet-related businesses. Partnerships and mergers can be quicker and less expensive ways for firms to grow. By merging with Time Warner, AOL has enhanced its delivery of Internet content, since it can now offer its customers some of Time Warner's rich variety of entertaining and informative products, such as CNN online news services and journals. By the same token, Time Warner has found a partner that can deliver its internationally appealing content to a large existing audience—the audience that AOL has built up through earlier mergers and acquisitions, as well as through the introduction of its internally developed products and services. For instance, in 1998 AOL acquired ICQ from Israel-based Mirabiiis, the world's largest communications community, comprising more than 50 million registered users. ICQ's free access service allows users to locate and chat with individuals and groups online regardless of which Internet service provider they use. More than two-thirds of ICQ registrants live outside the United States, and so AOLs acquisition of ICQ has helped the company open the door to the customers worldwide. Given that people living in North America are still the dominant users of the Internet, this strategic merger continues to make sense in the race to enlist customers globally and build brand recognition on the Internet.

According to AOL's research, 70 percent of all online consumers regularly or occasionally receive their news through the Internet. The synergy of the fit between AOL and Time Warner (www.aoltimewarner.com) thus becomes even more obvious. With the merger, both parties have made considerable progress in their efforts to grow their e-business. AOL's exclusive access to Time Warner content, which may attract new customers, gives the company a major competitive advantage over other Internet service providers that lack access to this content. The merger may also increase the number of consumers of Time Warner's magazines (*Business 2.0, inStyle, Time, Sports Illustrated, People, Teen People, Entertainment Weekly*) and other products, including music (Atlantic Records, Rhino Records, Warner Brothers Records), cable television (WB, TNT, Cartoon Network, Turner Classic Movies, CNN, HBO), films (Warner Brothers, New Line Cinema), and the accompanying websites. Furthermore, the variety of communication products AOL Time Warner offers—such as telephone service through cable, e-commerce products, and cross-promotion of variety of consumer products—will generate many more new opportunities for growth.

Questions

1. What lessons can other businesses learn from the success of e-business in AOL Time Warner?
2. Do you think that AOL Time Warner achieved the present progress only through e-business? Could not the same success have been achieved through brick-and-mortar model?

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