

# INTERNATIONAL BUSINESS

THE CHALLENGE OF GLOBAL COMPETITION

BALL  
GERINGER  
MCNETT  
MINOR

13th edition



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Irwin



INTERNATIONAL BUSINESS: THE CHALLENGE OF GLOBAL COMPETITION

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## d e d i c a t i o n

**Mike** dedicates this edition to his parents, Ray and JoAnn, and his partner, Barbara, who have provided continued support and encouragement for his writing and other life activities.

**Jeanne** dedicates this edition to her finance professor, N. D. Quy; to her best friends, Nick Athanassiou and Raven McCrory; and to her research friends, ION, all of whom have helped her recognize and develop her strengths.

**Michael** dedicates this edition to his daughter, Amy, who has done an outstanding job of growing up since her mother passed away.

## About the Authors

### **Don A. Ball**

Don A. Ball, a consultant to multinational corporations, was a professor of marketing and international business for several years after leaving industry. He has a degree in mechanical engineering from Ohio State and a doctorate in business administration from the University of Florida. Ball has published articles in the *Journal of International Business Studies* and other publications. Before obtaining his doctorate, he spent 15 years in various marketing and production management positions in Mexico, South America, and Europe.

### **J. Michael Geringer**

J. Michael Geringer is a professor of strategy and international business management at California Polytechnic State University in San Luis Obispo. He earned a BS in business at Indiana University and MBA and PhD degrees at the University of Washington. He has authored or edited more than 25 books and monographs, more than 130 published papers, and more than 40 case studies; he serves on the editorial boards of several leading international academic journals including Editor-in-Chief or Associate Editor for four journals; he served as the Saastamoinen Foundation Chair at the Helsinki School of Economics in Finland; he was the founding chair of the Strategic Alliances Committee of the Licensing Executives Society; he served as the chair of both the International Business and the Strategy and Policy divisions of the Administrative Sciences Association of Canada; and he is past chair of the Academy of Management's International Management division. His research has appeared in the *Strategic Management Journal*, *Academy of Management Journal*, *Journal of International Management*, *Columbia Journal of World Business*, *Management International Review*, *Journal of Management Studies*, *Human Resource Management Journal*, *Long Range Planning*, *Organisation Studies*, *Thunderbird International Business Review*, and *Journal of Applied Psychology*, among others. He has received 11 "best paper" awards for his research, including the Decade Award for most influential article from the *Journal of International Business Studies*, and he received the *Cal Poly's Distinguished Scholar Award in 2011*. His teaching performance has earned numerous awards in the United States, Canada, Asia, Africa, Australia, and Europe, including the University Distinguished Teacher Award. He was the first recipient of the International Educator Award from Cal Poly, and he endowed a scholarship for students to work and study internationally. He has been active in a range of charitable and service activities, including spearheading the adoption of a school in Soweto, South Africa, and fund-raising for public radio. In addition to working with universities around the world, Geringer is active in consulting and executive development for multinational corporations and executives from six continents. His clients have included Nokia; Lucent; Eastman Kodak; Sonera; Northern Telecom; Rautaruukki; Eastman Chemical; UPM Kymmene; Industry, Science & Technology Canada; Jiangsu Telecom Industrial; Hewlett-Packard; California Highway Patrol; Economic Council of Canada; Perlos; YIT; California Department of Transportation; Yahoo!; and Okobank, among others.

### **Jeanne M. McNett**

Jeanne M. McNett is a researcher at Northeastern University in the College of Business Administration and formerly served as professor of management at Assumption College, in Worcester, Massachusetts, and the University of Maryland, Asian and European Divisions. She earned a PhD at the University of Massachusetts, Amherst, and an MBA at the Cass School of Business, City University, London. She has had expatriate assignments in Germany, the United Kingdom, Saudi Arabia, Japan, and Korea. Her interests include the role of culture in international business and the pedagogy of international management. Her publications include the *Blackwell Encyclopedia of Management, Vol. VI: International Management*, second edition (Oxford, UK: Blackwell Publishing, 2005), and the *Blackwell Handbook of Global Management* (Oxford, UK: Blackwell Publishing, 2004). Her teaching, research, and presentations have received many awards, including the Roethlisberger Best Paper of the Year Award from the *Journal of Management Education* and the Alpha Phi Alpha Teacher of the Year Award. Her articles have been included in journals and collections focused on teaching in the area of international business. In her “down time,” she gardens, hangs out at the gym, and volunteers in the area of women’s health care and health care policy.

### **Michael S. Minor**

Michael S. Minor is professor of marketing and international business at the University of Texas, Pan American. He was educated at the University of North Carolina and Cornell and holds a PhD from Vanderbilt University. His research focuses on comparative consumer behavior, social network behavior, political risk, and the consumption of high-technology experiential products. He has published in the *Journal of Retailing*, *Journal of Advertising*, *Journal of International Business Studies*, *International Studies of Management and Organization*, *Journal of Services Marketing*, *International Business Review*, *Journal of Psychology and Marketing*, *Cyberpsychology and Behavior*, *Journal of Advertising Research*, and elsewhere. He is the coauthor with John C. Mowen and Todd Donovan of *Understanding Consumer Behavior: From Managerial Problems to Their Solutions*. He has written for business and popular media from *PCWeek* to *Tennessee Business Magazine*. He is past chair of the Consumer Behavior Special Interest Group, past vice chair of the Technology and Marketing Special Interest Group of the American Marketing Association, and a former member of the Global Marketing Special Interest Group’s board of directors. He serves on multiple editorial advisory boards. He has won multiple teaching awards and was recently selected as the doctoral program professor of the year. His consulting experience includes work for UNCTAD’s Division on Investment, Technology and Enterprise Development and for several U.S. and state government agencies. He has reviewed grant proposals for the Research Council of Norway as well as multiple U.S. agencies. He performs on guitar, dulcimer, and harmonica with the New Hallilujah Band and also plays mandolin and bass. A member of BMI, he has written more than two dozen country and inspirational songs.

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We are pleased to present the thirteenth edition of *International Business: The Challenge of Global Competition*.

## Purpose and Scope of This Text

Whether students are advanced undergraduates or are in MBA programs, an international business course is an ideal venue for a varied number of questions. Our hope is that this book will answer these questions about business in different cultures, the impact of geography, why products are the same (or different) across cultures, why people have different practices, the effect of the Internet on international business, and many, many more. There are always new questions, and sometimes there are new answers to old questions.

*International Business*, thirteenth edition, is organized into three sections in order to maximize its utility to instructors and students alike. The opening section defines the nature of international business and the three environments in which it is conducted, as well as the nature and continuing importance of international institutions and how they affect business. Section Two focuses on the uncontrollable forces at work in all business environments and discusses their inevitable impact on business practice. We devote the final section of the book to a discussion of how managers deal with all the forces affecting international business. In the thirteenth edition, we have continued section-opening dialogues to help students better understand what they have learned and are about to learn.

## Changes for the Thirteenth Edition

With each new edition we have been blessed by an expanding network of those making helpful suggestions. Professors, reviewers, and business professionals who bought the book or received it at a conference, and our own graduate and undergraduate students have made useful and constructive comments. We believe that *International Business*, thirteenth edition, continues to offer you a solid and superior text infused with current topics relevant to current challenges. In this edition, we have extensively revised and updated the material in each chapter to reflect recent world events and new international business issues. In response to instructor and student feedback, we have also attempted to improve the succinctness with which the material is presented, in order to reduce the overall length of this text.

As with every new edition, tables, figures, and graphs have been updated to include the most current data available as of the publication of this text. Keeping an international business text topical and current is a challenge, and we have worked hard to provide you with the most recent information possible. We have also updated examples where relevant and replaced dated examples where appropriate. We have reorganized Chapter 1 to increase its emphasis on motivations for internationalizing a company's business activities. We have consolidated our previous two chapters on international trade and foreign direct investment into a single, more focused Chapter 2. We have reorganized our new Chapter 3 to increase its focus on international institutions that influence international business. Our discussion of sociocultural forces in Chapter 4 has been substantially revised to incorporate enhanced discussion of frameworks for understanding different cultures, including those of Hall, Hofstede, and Trompenaars. Based on reviewer and user comments, we have deleted our prior Chapter 7, "Economic and Socioeconomic Forces," and have moved that content into other chapters. Discussion of trade forces has been combined with our discussion of political forces, creating our new Chapter 6, "Political and Trade Forces." Based on comments from our reviewers and users, our prior Chapter 11, "Labor Forces," has been consolidated

with the chapter on human resource management, creating our new Chapter 17, “Managing Human Resources in an International Context.” Reflecting increased interest from instructors and students, we have added a new chapter, Chapter 11, which addresses “Global Leadership Issues and Practices.” As a result of these changes, we have reduced the overall number of chapters to 18 and the numbering of Chapters 2 through 18 has been modified. Learning objectives are clearly stated at the beginning of each chapter, with icons placed appropriately within the chapter text to highlight when each learning objective is addressed. We have retained our Worldview discussions to highlight key issues facing international managers and added discussion questions to each. We have added Global Debate boxes to provide the foundation for examining different perspectives on contemporary challenges that managers face in our global environment and have included discussion questions for each. To enhance the relevance of the content in the text, we have added a unique and innovative feature, The Global Path Ahead, that provides a concise vignette of a current student or recent graduate who has begun to pursue international business activities early in his or her career. The Global Path Ahead also includes a selection of global resources that students and graduates may use to pursue career opportunities related to the content of each chapter.

## **CHAPTER 1 THE CHALLENGING WORLD OF INTERNATIONAL BUSINESS**

The opening case on the importance of international business experience has been updated, as has the popular Worldview box on buying American. New and updated examples have been added throughout the chapter to enhance understanding of key issues. The tables have been updated and refocused to improve understanding of key concepts, and the emphasis on growth of international firms and international business has been enhanced. Discussion of the debate on globalization of trade and investment has been placed into a new Global Debate box within the chapter. A discussion of the motives for entering foreign markets has been added. The minicase exercise at the end of the chapter, which deals with the ownership and nationality associated with many well-known companies and brands, has been updated in terms of products and companies.

## **CHAPTER 2 INTERNATIONAL TRADE AND FOREIGN DIRECT INVESTMENT**

We have combined into a single chapter what had previously been two separate chapters addressing the empirical data and theory associated with international trade and foreign direct investment. This new Chapter 2 is now more focused, with an updated introduction and discussion of trade in goods and services. The data on international trade and investment have been updated throughout the chapter to reflect the most current figures available at the time of publication, and the presentation of these data has been improved to enhance the reader’s ability to analyze and understand trends and traits of international trade. We have revised, reorganized, and clarified the discussion of theories of international trade and investment, and we added new examples in order to facilitate student comprehension of these topics. We have added a Global Debate box dealing with the issue of offshoring service jobs from the United States to India. There is increased coverage of emerging economies, particularly the BRIC (Brazil, Russia, India, China) nations, including an updated minicase at the end of the chapter that addresses Brazil’s potential to become a global competitor in the information technology outsourcing business.

## **CHAPTER 3 INTERNATIONAL INSTITUTIONS FROM AN INTERNATIONAL BUSINESS PERSPECTIVE**

Chapter 3’s coverage of institutions includes monetary institutions, increasing its comprehensive coverage. Institutional theory is introduced to provide a framework for discussion of institutions. The general discussion has been refocused to address the actions of institutions as they affect international business rather than a descriptive summary. The World Trade

Organization (WTO) coverage summarizes the General Agreement on Tariffs and Trade (GATT), placing the WTO at the center and subordinating the historical discussion. The United Nations and EU coverage has been refocused to emphasize the impact of these institutions on the international business manager. Examples are updated, and new applications are included.

## **CHAPTER 4 SOCIOCULTURAL FORCES**

In this first chapter of our second section, on international environmental forces, we expand our discussion of frameworks for cultural analysis. In addition, an increased emphasis is placed on how cultural dimensions affect the various functions of international business, from marketing to accounting. New examples and applications are added, and all data and examples are updated as well.

## **CHAPTER 5 NATURAL RESOURCES AND ENVIRONMENTAL SUSTAINABILITY**

This chapter has been updated to reflect a direct focus on two critical challenges, global warming and depletion of energy sources. The section on geographical issues has been condensed some, while the areas included in sustainability have been expanded. The use of Porter's diamond is extended as a basis for discussion of the geographic factor conditions. New examples of sustainable practice are included. One example is a petroleum-based products business, so students gain a broader appreciation of the potentials of sustainable approaches.

## **CHAPTER 6 POLITICAL AND TRADE FORCES**

This chapter has been focused to provide a more succinct coverage of political and trade forces. Discussion of ideological forces has been removed. Discussion of government ownership of business and privatization has been updated. The terrorism discussion has been expanded and updated, with the popular Worldview on terrorism in the Second Life virtual world revised and updated. Discussion and examples of country risk assessment has been revised and updated. The material on trade restrictions has been enhanced, and the Global Debate on sugar subsidies contains updated developments. The Global Path Ahead content and supporting resources provide valuable insights for the reader.

## **CHAPTER 7 INTELLECTUAL PROPERTY AND OTHER LEGAL FORCES**

The increasing importance of intellectual property rights across the globe is further emphasized in this edition. The opening vignette provides a thought-provoking analysis of the implications of counterfeiting of pharmaceuticals. New examples and updated references are found throughout the chapter. The Worldview captures interesting new developments on the extension of intellectual property rights from within a virtual world and into the real world. Discussion of laws regarding taxation has been removed, because taxation is addressed in a more holistic manner in Chapter 18's discussion of accounting and financial management. There is new discussion of the potential threat to national sovereignty as a result of World Trade Organization decisions, as highlighted in a new Global Debate box on the 2011 decision on the American "dolphin-safe" labeling program. The discussion of the Foreign Corrupt Practices Act has been updated, along with increased discussion of anti-bribery and anti-corruption statutes elsewhere in the world.

## **CHAPTER 8 THE INTERNATIONAL MONETARY SYSTEM AND FINANCIAL FORCES**

Chapter 8 is expanded to include coverage of the international monetary system as it affects the practice of international business. A short review of the development of monetary arrangements moves from the gold standard through the Bretton Woods system, including brief coverage of the Triffin paradox and the establishment of special drawing rights. The chapter then moves to a consideration of the floating system and contemporary currency arrangements. A

new chart summarizes the evolution of the monetary system. The foreign exchange review is simplified. Taxes, inflation, and interest rates are reviewed with updated examples. Balance of payments accounts are presented in terms of their usefulness to the international manager.

## **CHAPTER 9 INTERNATIONAL COMPETITIVE STRATEGY**

Chapter 9 introduces Section Three, on the organizational environment. We have revised the opening case on the use of scenario planning to help manage the strategic uncertainties associated with international business activities, and we have condensed the overall chapter to improve comprehension. The discussion has been expanded on why firms need to engage in strategic planning if they want to compete successfully in international markets. Throughout the chapter, we have included new and updated examples to promote the reader's comprehension of international strategy concepts and tools. There is an updated discussion, with examples, of mission, vision, and values statements and their roles in international strategy. There is a new Global Debate box addressing Google's values and strategy versus the opportunities within the Chinese marketplace. The Worldview on using regional strategies to compete globally has been updated. The popular minicase on Walmart's internationalization efforts at the end of the chapter has been updated to include the company's failures in Korea and Germany, its efforts to dramatically expand operations in China through acquisitions and internal growth, and its strategic plans to enter India and other emerging markets.

## **CHAPTER 10 ORGANIZATIONAL DESIGN AND CONTROL**

The opening case on Kraft Foods has been updated to highlight the company's global reorganization of its structure in an effort to enhance Kraft's international competitiveness in a changing marketplace. The popular Worldview on Accenture's "virtual" global structure has been updated. There is a new Global Debate box on the issue of international transfer pricing and some of its implications. We have revised the minicase at the end, on SemiConnected Inc., and its potential for reorganization.

## **CHAPTER 11 GLOBAL LEADERSHIP ISSUES AND PRACTICES**

This newly introduced chapter addresses an increasingly important issue facing international companies: the recruitment, development, and management of global leaders and global teams. The opening case focuses on the challenge of finding global leaders with the "right stuff" for addressing these new opportunities. We discuss the issue and importance of developing a global mindset and then address what global leadership is, how it differs from domestic leadership, and why it is important. In addition, we include a Worldview providing the consulting company Aperian's view on key global leadership activities. There is a discussion of the competencies required for effective global leadership, including Brake's Global Leadership Triad model and the Pyramid Model of Global Leadership. The Global Debate box addresses the appropriateness of women for global leadership positions. Issues and models associated with assessing, selecting, and developing global leaders are discussed. The importance of global teams and the challenges of leading such teams is addressed, including how traditional teams differ from global teams. Challenges of virtual and geographically dispersed teams are identified, as well as the topic of performance management in global teams. The chapter concludes with a discussion of leading global change, including change models. The Global Path Ahead vignette highlights a young global leader who developed his skills through a decade of different experiences abroad, and a minicase at the end of the chapter provides a cautionary tale of how a potential global leader can have his career derailed.

## **CHAPTER 12 ASSESSING INTERNATIONAL MARKETS**

One of the points of this chapter's approach to market analysis is that it's not always obvious where potential markets are located. An example is that there is a growing market for

motivational speakers—even in Iran! We update examples and include our advice on dealing with marketing research issues frequently encountered in developing economies.

### **CHAPTER 13 ENTRY MODES**

This chapter has been reorganized in this edition. We begin with an examination of market entry through international social media, with an emphasis on social networks that are not tailored for U.S. audiences. We expand our discussion of exporting by discussing the benefits of exporting and the wide array of methods by which indirect and direct exporting can occur. The discussion of equity-based modes of entry is updated, and the discussion of joint ventures has an expanded section on benefits of joint ventures and on options for exercising control, even as a minority partner. There is an interesting new Worldview that examines challenges of forming and managing successful international joint ventures, using the Danone and Wahaha ventures in China as the focus. The Global Path Ahead has a vignette of a young international business professional who is managing market entry through a range of direct and indirect exporting options.

### **CHAPTER 14 EXPORT AND IMPORT PRACTICES**

We discuss import and export processes, with a focus on the role of the small company new to exporting. The government resources section reflects major changes in the organization of export/import-related government support. The International Chamber of Commerce Incoterms are also updated, reflecting the consolidation of terms. A comparison chart outlining seller and buyer responsibilities described by Incoterms is also added to clarify what can be a confusing area for students. All information is updated, and the Worldview focuses on the U.S. Ex-Im Bank and its new president's commitment to the support of U.S. exporters.

### **CHAPTER 15 MARKETING INTERNATIONALLY**

Current examples have an increasing focus on India and China. A new Worldview feature explores the impact of increased product development integration, involving R&D and marketing, on future locations for manufacturing. Such integration may lead to very different business models. In addition, a new minicase on Kraft's Athenos line of hummus and cheese products links to on-line advertising. Examples and data are updated.

### **CHAPTER 16 GLOBAL OPERATIONS AND SUPPLY CHAIN MANAGEMENT**

This chapter has been revised to make it more focused and succinct. The popular Zara case at the beginning of the chapter has been updated. The Worldview examines the continued success of Cognizant Technologies in using its innovative onshore/offshore approach to providing information technology services to customers around the world. The discussion of manufacturing systems has been made much more concise. In light of increasing petroleum prices and market uncertainties, we address the possibility that producing products "closer to home" is a more viable option than before. There is a much more concise discussion of the local manufacturing system. The Global Path Ahead vignette provides an overview of an effort by students to help develop intermediate technologies that may be more appropriate to emerging market contexts, such as Guatemala.

### **CHAPTER 17 MANAGING HUMAN RESOURCES IN AN INTERNATIONAL CONTEXT**

Chapter 17's discussion of human resource management issues in international business has been reorganized to incorporate a portion of our prior discussion of international labor forces from Section Two. A new opening case addresses issues associated with expatriate positions. A new Worldview box examines the role of cultural backgrounds and nationality in selecting candidates for international positions. There is also a new Worldview box on the challenges associated with finding executives with the "right stuff" for positions internationally. We have added a Global Debate box on the appropriateness of women for

international assignments, and the section on expatriates has been revised. The discussion of families of expatriates, including issues faced by trailing spouses and children, has been substantially revised. We have revised the discussion of challenges associated with repatriation, expatriate support services, and compensation and benefits for expatriates and other international personnel. A revised minicase at the end of the chapter deals with considerations facing an employee who is deciding whether to accept an international position that has been offered to her.

## **CHAPTER 18 INTERNATIONAL ACCOUNTING AND FINANCIAL MANAGEMENT**

Chapter 18 places accounting at the beginning of the chapter, then moves on to financial management. The opening vignette is on sovereign wealth funds and their influence on private equity markets. Progress toward convergence of accounting standards is summarized and the basic assumption-level differences described, using institutional theory (covered in Chapter 3) to explain the differences at the theoretical level. The Global Reporting Initiative for triple-bottom-line accounting is included as an example of the general movement toward accountability. An ethics focus is on the development of for-profit microlending, a relatively new twist in an area that had been strictly not-for-profit. The pros and cons of this shift are presented. In the area of financial management, fronting loans have been included as a way to shift funds. An effort has been extended to make the chapter reader-friendly so that the nonspecialist student will be able to appreciate the creativity of contributions in the finance area. Examples and applications are updated.

### **GLOSSARY**

The Glossary is a very extensive collection of definitions of documents, institutions, concepts, and terms used in international business. The Glossary is an extremely valuable resource for students and instructors.

### **New Features**

With the thirteenth edition, we introduce an innovative and unique set of The Global Path Ahead boxes that appear at the end of each chapter. Each of these boxes provides a vignette of international business-related activities that current students or recent graduates have pursued, providing an opportunity for readers to envision their own, unique international paths that might be followed. These boxes also present valuable tools and insights to help students build a foundation for entering and excelling in international business activities and careers, providing links to resources that cover such topics as finding international job opportunities, building international skills and experience, gaining relevant knowledge and tools to increase success in finding and performing international business jobs, and learning from the practical experience and recommendations of peers who have successfully pursued opportunities involving international business activity.

The thirteenth edition also continues to use the innovative globalEDGE™ Research Tasks, created by Tunga Kiyak and Tomas Hult of the CIBER Center at Michigan State University. These end-of-chapter exercises challenge students to solve problems similar to those faced by practicing international business managers, and they acquaint students with the tools and data real managers use. The globalEDGE™ Research Tasks are ideal for Web-based courses. For example, in working on a product launch, students may be asked to compile a list of the top 10 countries in terms of their attractiveness for potential return of FDI. Students can access all the Internet resources needed to solve the problems at [www.globaledge.msu.edu](http://www.globaledge.msu.edu).

A new video collection features original business documentaries as well as network news footage. Videos correspond to the video cases (with discussion questions) available on the text's website at [www.mhhe.com/ball13e](http://www.mhhe.com/ball13e).

Another source of new videos now available with the book is iGlobe, a ground-breaking online video website ([www.mhhe.com/iglobe](http://www.mhhe.com/iglobe)), where you can download two “on-demand” PBS videos per month about breaking stories on international business issues. The website is updated with new video selections each month, and the videos are archived monthly for easy accessibility. These streaming videos are complete with teaching notes and discussion questions. Key concepts for each video are identified to save you time! This is ideal for online courses or for homework assignments outside class.

## Other Useful Elements

- Each chapter includes a Global Debate box that addresses international business issues that involve important dimensions associated with ethical or socially responsible activity.
- Each chapter includes current, relevant examples of business activities and developments in the increasingly critical emerging markets of the world.
- Worldview boxes highlight real-world applications of key concepts to help students relate the material they are learning to their own business careers.
- Learning Objectives are clearly identified at the beginning of each chapter, with special icons placed within the text to identify when each learning objective is being addressed.
- An extensive set of maps throughout the text gives students important geographic perspectives.
- End-of-chapter tools include Summaries, Key Words, Questions, globalEDGE™ Research Tasks, and Minicases to further help students in their comprehension.

## CESIM: Global Challenge Simulation

This online simulation involving international markets for mobile handsets is packaged with new copies of the text. There are three market areas (North America, Europe, and Asia). The simulation presents a range of features that could be offered (affecting product differentiation), a choice of production sites (in Asia or North America), price options, and exposure to exchange rate fluctuations, among other issues and decisions. It can be used with 3 to 12 teams (6 to 50 students per simulation) and can involve teams from more than one class or university, if desired. There is an enhanced online support facility with the thirteenth edition, as well as an improved user interface to enhance the performance and appearance of the simulation. The simulation can be used at no additional expense for either instructors or students who use new copies of the text.

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

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

## Student Study Center

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

- Offers students quick access to lectures, practice materials, eBooks, and more.
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- Gives students access to the Personalized Learning Plan described below.

## Student Progress Tracking

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- Access an instant view of student or class performance relative to learning objectives.
- Collect data and generate reports required by many accreditation organizations, such as AACSB.

## Lecture Capture

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

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

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- Dynamic links between the problems or questions you assign to your students and the location in the e-Book where that problem or question is covered.
- A powerful search function to pinpoint and connect key concepts in a snap.

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

For more information about Connect, go to [www.mcgrawhillconnect.com](http://www.mcgrawhillconnect.com), or contact your local McGraw-Hill sales representative.

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Tegrity Campus is a service that makes class time available 24/7 by automatically capturing every lecture in a searchable format for students to

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

## Assurance of Learning Ready

Many educational institutions today are focused on the notion of *assurance of learning*, an important element of some accreditation standards. *International Business: The Challenge of Global Competition, 13e* is designed specifically to support your assurance of learning initiatives with a simple, yet powerful solution.

Each test bank question for *International Business: The Challenge of Global Competition, 13e* maps to a specific chapter learning outcome/objective listed in the text. You can use our test bank software, EZ Test and EZ Test Online, or in *Connect International Business* to easily query for learning outcomes/objectives that directly relate to the learning objectives for your course. You can then use the reporting features of EZ Test to aggregate student results in similar fashion, making the collection and presentation of assurance of learning data simple and easy.

## AACSB Statement

The McGraw-Hill Companies is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *International Business: The Challenge of Global Competition, 13e* recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the text and/or the test bank to the six general knowledge and skill guidelines in the AACSB standards.

The statements contained in *International Business: The Challenge of Global Competition, 13e* are provided only as a guide for the users of this textbook. The AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the faculty. While *International Business: The Challenge of Global Competition, 13e* and the teaching package make no claim of any specific AACSB qualification or evaluation, we have within *International Business: The Challenge of Global Competition, 13e* labeled selected questions according to the six general knowledge and skills areas.

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The **Best of Both Worlds**



To the long list of people to whom we are indebted, we want to add Professors Gary Anders, Arizona State University West; Gary Anderson, Bowling Green State University; John Anderson, University of Tennessee, Knoxville; Nicholas Athanassiou, Northeastern University; Robert T. Aubey, University of Wisconsin, Madison; Winston Awadzi, Delaware State University; Mark C. Baetz, Wilfred Laurier University; Bahman Bahrami, North Dakota State University; Rufus Barton, Murray State University; Lawrence Beer, Arizona State University; Joseph R. Biggs, California Polytechnic State University; S. A. Billon, University of Delaware; James R. Bradshaw, Brigham Young University; Sharon Browning, Northwest Missouri State University; Dennis Carter, University of North Carolina, Wilmington; Mark Chadwin, Old Dominion University; Aruna Chandras, Ashland University; John Cleek, University of Missouri, Kansas City; Gerald Crawford, University of North Alabama; Refik Culpán, Pennsylvania State University; Peter DeWill, University of Central Florida; Galpira Eshigi, Illinois State University; Christof Falli, Portland State University; Colette Frayne, California Polytechnic State University, San Luis Obispo; Prem Gandhi, State University of New York, Plattsburgh; Ellen Kaye Gerke, Alliant International University; Kenneth Gray, Florida Agricultural and Mechanical University; Robert Guffey, Elon College; Stanley D. Guzell, Youngstown State University; Gary Hankem, Mankato State University; Baban Hasnat, State University of New York, Brockport; Tom Hinthorne, Montana State University; Veronica Horton, University of Akron; Paul Jenner, Southwest Missouri State University; Bruce H. Johnson, Gustavus Adolphus College; Ahmad Karim, Indiana University–Purdue University, Ft. Wayne; Michael Kublin, University of New Haven; Eddie Lewis, University of Southern Mississippi; Carol Lopilato, California State University, Dominguez Hills; Mingfang Li, California State University, Northridge; Lois Ann McElroy Lindell, Wartburg College; Dorinda Lynn, Pensacola Junior College; Lynette Mathur, Southern Illinois University, Carbondale; Hugh J. McCabe, Westchester Community College; Fraser McLeay, University of Montana; Les Mueller, Central Washington University; Gary Odon, San Jose State University; Darrell Neron, Peirce College; Ebele Oriaku, Elizabeth City State University; Jaimie Ortiz, Florida Atlantic University; Bill Pendergast, California Polytechnic State University–San Luis Obispo; Mike Peng, University of Texas–Dallas; Susan A. Peterson, Maricopa College; Jere Ramsey, California Polytechnic State University, San Luis Obispo; Tagi Sagafi-Nejad, Loyola College, Maryland; Rakesh Sambharya, Rutgers University; Eugene Seeley, Utah Valley State College; John Setnicky, Mobile College; V. N. Subramanyam, Lancaster University; Angelo Tarallo, Ramapo College; Jesse S. Tarleton, William and Mary College; John Thanopoulos, University of Akron; Kenneth Tillery, Middle Tennessee State University; Hsin-Min Tong, Redford University; Dennis Vanden Bloomen, University of Wisconsin, Stout; Heidi Vernon, Northeastern University; George Westacott, State University of New York, Binghamton; Terry Witkowski, California State University; Habte Woldu, University of Texas, Dallas; G. Bernard Yevin, Forsythe Technical Community College; Gregg Lattier, Lee College; Mr. Haryanto, Monmouth College; John C. Ruhnka, University of Colorado at Denver and Health Sciences Center; Juan F. Ramirez, Nova Southeastern University; Linda C. Ueltschy, Bowling Green State University; Macgorine Cassell, Fairmont State University; Scott C. Hammond, Utah Valley State College; Donald L. Sparks, The Citadel; Donald Vest, Clark Atlanta University; Eugene Seeley, Utah Valley State College; Fifi Anastasiadis, Farmingdale State College; Hoon Park, University of Central Florida; Jeff W. Bruns, Bacone College; Jeffrey Kulick, George Mason University; John Ruhnka, University of Colorado at Denver; Kau C Pang, University of Alabama–Birmingham; Lilach Nachum, Baruch College; Phil Seder, Portland Community College; and Samit Chakravorti, Western Illinois University; and Yeqing Bao, University of Alabama, Huntsville. Attorney Mary C. Tolton, Esq., of the law firm Parker, Poe, Adams & Bernstein

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Hundreds of professors have reviewed this text over its thirteen editions and have shaped it into the solid textbook it is. Their suggestions and feedback have been invaluable to us, and we very much appreciate their efforts and time.

We would like to offer our special thanks to the outstanding editorial and production staff from McGraw-Hill/Irwin who have worked so hard and so well to make this project succeed and stay on schedule, particularly John Weimeister, Jane Beck, Heather Darr, Donielle Xu, Elizabeth Steiner, Harvey Yep, Keri Johnson, and Ira Roberts. We feel honored to work with such a talented and professional team.

# A World of Resources . . .

*International Business: The Challenge of Global Competition* continues to be the most objective and thorough treatment of international business available for students. Enriched with maps, photos, and the most up-to-date world data, this text boasts the collective expertise of one former and three current authors with firsthand international business experience, specializing in international management, finance, law, global strategy, and marketing—a claim no other text can make. Only Ball, Geringer, McNett, and Minor can offer a complete view of international business as diverse as the backgrounds of your business students.

## Worldview Examples

Worldview features in every chapter offer compelling examples of how international business is affected by legal, political, economic, and social issues, helping students understand how interrelated these business strategy and policy issues are.



### Are Economic and Social Development Affected by Trade and Investment?

All economies are increasingly open in today's economic environment of globalization. Trade plays a vital role in shaping economic and social performance and prospects of countries around the world, especially those of developing countries. No country has grown without trade. However, the contribution of trade to development depends a great deal on the context in which it works and the objectives it serves.



This quote is the way the United Nations Conference on Trade and Development (UNCTAD) began its groundbreaking report examining international trade and developing countries. International trade clearly has an important role in influencing nations' economic and social performance in a world of globalization. This role is even more fundamental in the case of developing countries. Yet the mere expansion of trade does not guarantee improvement for a country and its people. Rather, it is essential that trade performance be viewed in the context of its effects on employment levels, economic growth, development, and an improvement in the overall human condition.

To assist in efforts to ensure that trade plays a full and constructive role in enhancing growth and development, UNCTAD launched an ambitious initiative that included the Trade and Development Index (TDI). By capturing the interactions among a range of institutional, structural, financial, trade, and development factors underlying trade and development, the TDI attempts to provide a quantitative indication of a nation's trade and development performance and facilitate national and international strategies and policies that will enable trade to serve as an important tool for promoting development. Although UNCTAD created the TDI primarily for assessing performance in developing nations, to facilitate comparisons and insight, it also constructed the TDI for developed countries and for newly industrializing countries. Overall, 123 countries were evaluated and the 20 top- and bottom-ranked countries are listed in the accompanying table.

The average score for developed countries was 640, versus 467 for developing countries and 395 for the least developed countries. Seven major emerging economies (Brazil, Russia, India, China, Mexico, South Korea, and South Africa), which account for 45 percent of the world's population and more than 26 percent of global exports of goods and services, had an average TDI score of 693, and they have all evidenced increasing TDI scores. This indicates that the gap in development can be shrunk—and has been in the case of several nations. Overall,

compared with developed countries, developing countries evidence a continuing lag in such areas as physical infrastructure, human capital, financial intermediation, institutional quality, economic and social well-being, and trade performance.

The initial TDI evaluation revealed that the 30 highest-ranked nations were all developed countries, except for Singapore (#5), South Korea (#21), China (#25), Malaysia (#27), and Thailand (#29). This result is interpreted as evidence that few developing nations have been able to come close to the developed countries in terms of their trade and development performance.

Nine of the bottom 10 nations are sub-Saharan African countries, accentuating the severity of the trade and development problems confronting sub-Saharan Africa and least developed nations in general. The best regional performance among developing nations was that of the countries of the East Asia and Pacific region, followed by the Middle East and North Africa region and the Latin America and Caribbean region. The regions of South Asia and of sub-Saharan Africa significantly lagged behind the other three regional groups in terms of their TDI scores.

A critical factor contributing to high TDI scores is trade liberalization. The importance of this factor is highest for countries with lower TDI scores, and vice versa. This suggests that the extent of trade liberalization has much greater importance for developing countries, and especially the least developed countries, than for developed nations. In general, over the longer term and in the absence of externalities or market failures, trade liberalization is an effective policy promoting development. However, efforts to liberalize too rapidly can also result in short-term adjustment problems.

Both external and internal factors were found to influence a nation's export performance. External factors include market access conditions (e.g., transportation costs, geography, physical infrastructure, trade barriers, competition) and other factors that influence demand for imports. Internal factors

**GLOBAL DEBATE**

**Comparative Advantage and Offshoring of Service Jobs from the United States to India**

India, a nation with approximately 1 billion people, has relatively few other resources compared with developed nations. Therefore, it should have a comparative advantage in production of goods or services that require large amounts of labor and relatively little capital. However, India has an additional comparative advantage because many of its citizens speak English (which is taught in many Indian schools and universities rather than using one of the other 18 major languages and 844 dialects spoken in the country). Thus, labor has a relatively low price due to the large Indian workforce (about 450 million, with nearly 10 million additional people entering the workforce each year), high levels of unemployment or underemployment (officially an unemployment rate of 8 percent, but a poverty rate that exceeds 20 percent), and a large proportion of rural and unskilled workers. As Internet and cellular telephone communications continue to become less expensive, India increasingly is using its English-speaking pool of labor to export services—such as software engineering, telemarketing, reviews of credit or mortgage applications, preparation or review of legal documents, analysis of blood tests and other medical services, and claims processing—to foreign companies and their customers, a process known as **offshoring**.

At \$78 billion in annual revenues in 2010–2011, the Indian information technology (IT) industry generated more than 5 percent of India's GDP, and the overall size of this sector is projected to grow to \$225 billion in revenues by 2020 as a result of factors such as declining computer prices, new tax incentives, and the Indian government's efforts to connect the country's extensive and isolated rural areas with the outside world. *Fortune* 500 companies such as Amazon.com, IBM, and American Express, as well as a range of more moderate-sized firms, have already offshored millions of jobs. By 2015, it has been estimated that 3.4 million U.S. jobs, representing \$136 billion in wages, will have been offshored, and India is well positioned to capture much of this business. According to Noshir Kaka of the consulting firm McKinsey, "This industry can do for India what automobiles did for Japan and oil for Saudi Arabia."

For example, 1.8 million U.S. individual and corporate tax returns were estimated to have been prepared in India in 2011. Documents obtained from taxpayers are scanned and shipped electronically to India, where forms are completed and sent back to the United States to be examined, approved, and signed by an American accountant. While a U.S. tax preparer might cost more than \$3,000 per month during the peak tax season, a comparable Indian worker might cost less than \$300. There is no requirement that the taxpayer be informed that the tax work is done abroad, and most accounting firms charge the same fees as those charged if the job is done by accountants in the United States, thus helping to boost profitability.

Companies in financial services and insurance have also been actively pursuing offshoring. More than 80 percent of global financial services companies have an offshore facility, and the range of services being offshored is rapidly being broadened. "Offshoring has released a new competitive dynamic. Larger firms are driving change across the financial services industry and using offshoring to open up a competitive advantage over their smaller rivals," said Chris Gentile of the professional services firm Deloitte. "Offshoring is fundamentally changing the way financial institutions do business, creating a global division of labor that demands new operating models, new structures and new management skills."

"This is a global industry in the throes of flux. It is a sector where [Indian companies] are rewriting the rules of the game. That is the difference that has become apparent and increasingly accepted," says Nandan Nilekani, CEO of the rapidly expanding Indian company Infosys Technologies. The basis for this change, he says, is the "global delivery model" being pioneered in India and replicated in other low-cost nations. In the IT sector, for example, a plentiful supply of Indian software engineers can work on projects "offshore," delivering the finished product to clients "on site" in the United States. "Our business innovation is forcing rivals to redesign the way they do things."

This disruptive change is threatening to transform the business models in operation across a broad range of industries. Although many people think of low-skill jobs like telemarketing and call centers when they think of offshoring to India, the sophistication and skill levels associated with processes being outsourced are rising rapidly. A big driver for this trend is the abundance of qualified personnel in India. A NASSCOM-McKinsey study found that India has 28 percent of the overall supply of skilled services personnel in low-cost nations, and these potential employees remain amazingly inexpensive. An Indian IT engineer earns a typical annual salary of less than \$6,000 and one with a master's degree in business earns \$8,500—about one-tenth the level of their American counterparts, although salary inflation is starting to reduce that gap.

Services represent 60 percent of the U.S. economy and employ up to 80 percent of American workers, so it is not surprising that the offshoring of service jobs has generated concerns across a broad spectrum of society. John Steadman, president of the Institute of Electrical and Electronics Engineers, cautioned, "If we continue to offshore high-skilled professional jobs, the U.S. risks surrendering its leading role in innovation." Andrew Grove, former Chairman of Intel Corp., warned that "it's a very valid question" whether the United States could lose its dominance in information technology as a result of this trend, as it did in electronics manufacturing.

(continued)

## Global debate

These boxed features in every chapter illustrate challenges that have faced companies and managers involved in international business, including issues relevant to ethical and socially responsible behavior. Students find these examples interesting and valuable, and considering these issues can better prepare them for making appropriate decisions when they engage in international business activities as part of their own careers.

## The Global Path Ahead

Each box presents valuable tools and insights to help students build a foundation for entering and excelling in international business activities and careers. These boxes cover such topics as finding international job opportunities, building international skills and experience, gaining relevant knowledge and tools to increase success in finding and performing international business jobs, and learning from practical experience and recommendations from current students or recent graduates who have successfully pursued opportunities involving international business activity.

**THE GLOBAL PATH AHEAD**

**Kerry Thwing on Developing a Foundation in the International Area**



My first international solo excursion. I participated in a student exchange program to France, staying with a family in Cognac for a month and exploring Paris for a week. My life would not be the same had I chosen to stay home instead of taking a chance and leaving my comfort zone for this solo adventure. During that month abroad, I learned so much about myself and about others. I came home a wiser, more confident person. Now the travel bug had bitten me officially.

In college, I participated in three study abroad programs. My first year, I traveled to South America via a training ship as part of the Cal Poly at Sea study abroad program. We made port in Mexico, Chile, Peru, and Costa Rica. Then the summer of my second year, I studied in London, England. Finally, my fourth and final year at university, I studied in Adelaide, Australia. Though the ultimate purpose of these excursions was to complete the courses needed for my bachelor's degree in business administration, I learned so much more and such different things than I ever could have from a textbook or lecture. Travel can provide the ultimate education. Nothing can compare to the experience of leaving your comfort zone and observing your actions and the actions of others in a different environment.

Through international travel, not only will you learn about different cultures and values around the world, you will also learn many things about yourself. You can discover what you are truly capable of and you may be quite surprised by what you find. During my travels, there were many instances when things did not go as planned, but it is those times that are the most memorable for me. I was always pleasantly surprised by my ability to adapt and problem solve when put in a difficult situation. This is a skill that I learned through travel, and it has proven useful in many aspects of my life.

However, my favorite aspect of travel is the people that I have met, the connections to others that I have made. Throughout my time abroad, I have gained many great friends on a global

The daughter of a travel agent, I was exposed to the "travel bug" as a baby. Ever since I can remember, my mother would plan yearly family vacations. Travel became a part of my life, and I would look forward to the adventures and experiences that would come with each trip. I was 16 when I decided to set out on



FIGURE 5.7

Map of Colombia

## Instructive Maps

Numerous maps display valuable data and help students grasp geographic implications.

## globalEDGE™ Research Tasks

Using the text and the globalEDGE™ website ([www.globaledge.msu.edu](http://www.globaledge.msu.edu)), students solve realistic international business problems related to the types of tools and data sources international managers use to make informed decisions.



globalEDGE.msu.edu

### Research Task

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

1. You are working for a company that is deciding whether or not to enter South Asia. Top executives have requested a report on the natural environment in this region. Specifically, they are interested in gaining a better understanding of the main trends with respect to the land, air, and water. Using the South Asia Environment Outlook in the *South Asian Association for Regional Cooperation* website as reference, prepare a short report summarizing the key environmental trends in South Asia.
2. Your company wants to become more environmentally sustainable. Utilize resources available on the globalEDGE website regarding sustainable development and business to prepare a brief report that explains the concept of *sustainable development* and discusses why it is important for companies to engage in environmentally sustainable practices. In addition, compile a short list of steps that companies should take to become more environmentally sustainable.

## Minicase: The BlueGreen Alliance: A New Way of Thinking for Sustainability

In 2006, the United Steel Workers and the Sierra Club launched a collaboration to focus on environmental policy and expand the number of jobs and the quality of the jobs in the green economy. The collaboration surprised many because environmentalists and unions have been opposed on many issues in the past. For example, the environmentalists have opposed drilling for oil in the Alaska Arctic National Wildlife Refuge, which the unions supported. The unions have often opposed environmentalism because their belief was that it cost jobs. Yet, the collaboration found common ground and has been wildly successful, taking on many additional partners, including the Communications Workers of America, the Natural Resources Defense Council, the Service Employees International Union, the National Wildlife Federation, and the United Auto Workers. The BlueGreen Alliance unites more than 14 million members.

There are four main issues the BlueGreen Alliance is presently working on. The first has to do with increased investments in *clean energy* sources. This is a strategy to create green jobs, reduce global warming, and move the

United States toward energy independence. The second concern is *climate change*, and BlueGreen is urging passage of comprehensive climate change legislation. Such legislation would create jobs and reduce emissions. The *right trade policies* can lead, BlueGreen argues in its third concern, to a *renewal* of the American middle class if we increase trade and the jobs are located in the United States. The final concern is *green chemistry*. The BlueGreen Alliance is pushing for greater control of toxic chemicals and the development of safe alternatives through what it calls "green chemistry."<sup>44</sup>

### Questions

1. Is the BlueGreen Alliance a partnership of convenience, or do you think it has the potential to move into a new way of approaching sustainability, with limits, interdependence, and equity?
2. The right trade policies, in a union view, may mean protectionist measures to build jobs. Do you think such a policy could fit into a sustainable approach?

## Minicases

Minicases also appear at the end of each chapter. These brief scenarios challenge students to apply concepts discussed in the chapter to a real-world situation.

# Supplements for Instructors

## Online Learning Center, [www.mhhe.com/ball13e](http://www.mhhe.com/ball13e)

The Online Learning Center (OLC) is a website that follows *International Business* chapter by chapter with digital supplementary content germane to the book. As students read the book, they can go online to take self-grading quizzes, review material, and work through interactive exercises. OLCs can be delivered multiple ways—through the textbook website, through PageOut, or within a course management system such as WebCT or Blackboard.



The following supplements are available for instructors who adopt this text:

## Instructor's Manual

Written by coauthors J. Michael Geringer and Jeanne McNett, the Instructor's Manual will help save you valuable time preparing for the course by providing suggestions for heightening your students' interest in the material. Each chapter-by-chapter section presents concept previews, an overview of the chapter, a detailed chapter outline, suggestions and comments, student involvement exercises, and solutions to end-of-chapter material. The manual also includes video case teaching notes.

## Test Bank

Written by the authors, the Test Bank contains approximately 100 questions per chapter in multiple-choice, true/false, and short-answer format. Each question is ranked for difficulty level and includes page references to the text.

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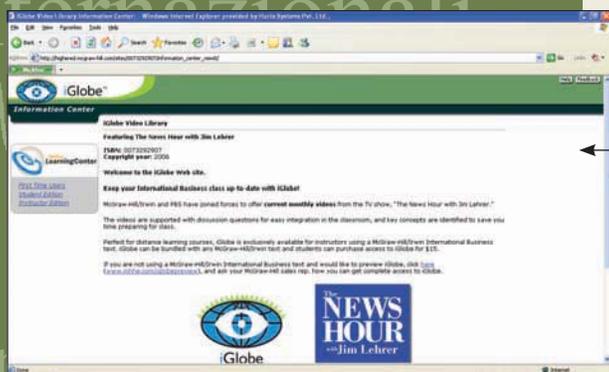
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## PowerPoint Slides

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Created by coauthors J. Michael Geringer and Jeanne McNett, this PowerPoint presentation includes key points from each chapter, sample figures from the text, and supplemental exhibits that help illustrate the main points in a chapter.

## Videos

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A new video collection features original business documentaries as well as news footage. Videos correspond to video teaching notes accessible on the instructor's side of the OLC.

## iGlobe

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iGlobe is a ground-breaking online video website ([www.mhhe.com/iglobe](http://www.mhhe.com/iglobe)), where you can download two "on-demand" PBS videos per month on breaking stories on international business issues. The website is updated with new video selections each month, and the videos are archived monthly for easy accessibility. These streaming videos are complete with teaching notes and discussion questions. Key concepts for each video are identified to save you time! This is ideal for online courses or for homework assignments outside class.

## International Business DVD Vol. 6 (ISBN 0077324676)

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A revised and expanded *International Business* DVD of company mini-documentaries and newsreels sparks classroom discussions. Classic footage joins new stories to help you engage your students in international business topics.

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# Supplements for Students

## **CESIM: Global Challenge Simulation**

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This online simulation involving international markets for mobile handsets is packaged with new copies of the text. There are three market areas (North America, Europe, and Asia). The simulation presents a range of features that could be offered (affecting product differentiation), a choice of production sites (in Asia or North America), price options, and exposure to exchange rate fluctuations, among other issues and decisions. It can be used with 3 to 12 teams (6 to 50 students per simulation and larger classes can readily be accommodated by using multiple simulations simultaneously) and can involve teams from more than one class or university, if desired. The simulation is also well-suited for many online courses. There is an enhanced online support facility with the thirteenth edition, as well as an improved user interface to enhance the performance and appearance of the simulation. Use of this online simulation is free with new copies of this text.

## **Online Learning Center, [www.mhhe.com/ball13e](http://www.mhhe.com/ball13e)**

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The Online Learning Center (OLC) is a website that follows *International Business* chapter by chapter with digital supplementary content germane to the book. As students read the book, they can go online to take self-grading quizzes, review material, and work through interactive exercises.

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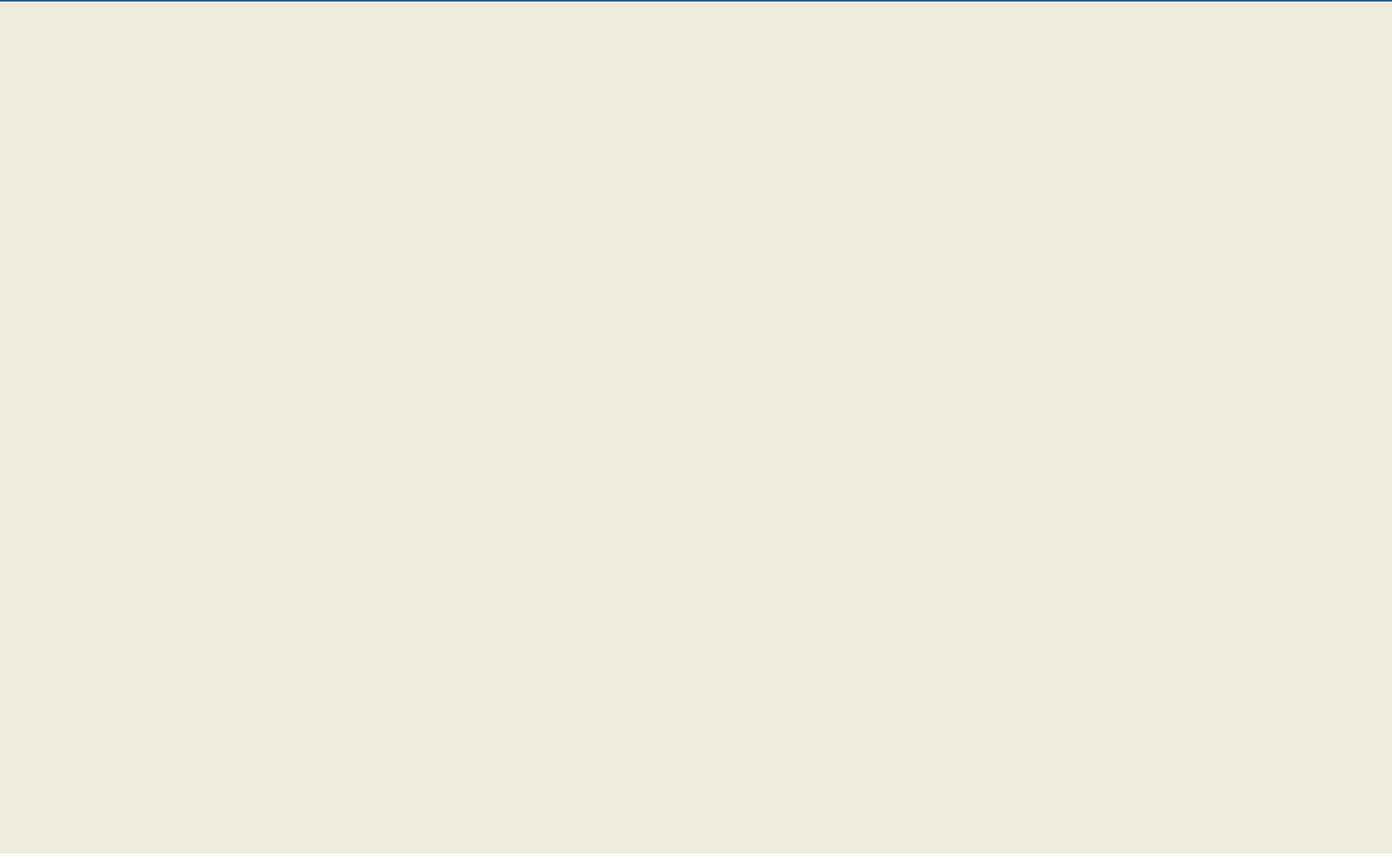
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# INTERNATIONAL BUSINESS



Affaires Internationales  
International Business  
Παγκόσμιο Business  
Gli Affari Internazionali  
العالمية  
國際商務  
Los negocios internacionales

Παγκόσμιο Business Negócios Internacionais  
التجارة العالمية Gli Affari Internazionali  
Los negocios internacionales Internationales Geschäft  
Affaires Internationales  
International Business Los negocios internacionales 國際商務  
Internationales Παγκόσμιο Business  
國際商務 Gli Affari Internazionali Interna  
Negócios Internacionais  
Gli Affari Internazionali التجارة العالمية





## s e c t i o n o n e

# The Nature of International Business

The world we share is becoming increasingly interconnected in complex and interesting ways. Section One describes the nature and scope of international business and introduces the three environments in which international business managers must operate. How well they perform in their undertakings depends in great measure on their understanding of domestic, international, and foreign environments.

Chapter 1 discusses what international business is and also presents the concepts of the three environments and their forces. From the history of international business, we learn that international firms have been in existence for centuries, but that present-day global companies—characterized by explosive growth and closer central control of foreign operations—are markedly different from their predecessors. We discuss what is driving globalization of business and why firms go abroad, and examine the debate about pros and cons of globalization of business. We also examine the seven dimensions along which managers can globalize if they take their companies international.

In Chapter 2, information is presented to help you comprehend the dynamic growth and the magnitude of both international trade and foreign investment. We also provide an overview of the major theories of international trade and investment. A basic understanding of this material will help explain the actions already taken by managers and by government officials, and provide insight into what they plan to do in the future.

Chapter 3 discusses institutions that operate in the international environment and that may affect international businesses in fundamental ways. International institutions can be both a help and a hindrance to businesses, and the international institutions and agreements discussed in this chapter are organizations of governments, along with some private organizations, whose main purpose is political, economic, or a combination of the two. Some of these organizations have large amounts of power (such as the European Union), and others have less power, but all are important to business.

# The Challenging World of International Business



In the past, complex international transactions were the domain of diplomats and international policy and business experts. Today a converging set of powerful economic, technological, demographic and geopolitical trends will demand that all citizens, not just the elite, have that kind of global fluency. Knowledge of the world is no longer a luxury, it is a necessity.

—Nicholas Platt, President Emeritus of the Asia Society

## Why You Need International Business Experience and How to Get It

Gary Ellis, a young assistant controller for Medtronic, a *Fortune* 500 manufacturer of pacemakers and other medical equipment, was considered to be on the fast track for a top management position. However, company executives felt he first needed broader experience, so they sent him to head their European headquarters in Belgium. In his new job, Gary was responsible for many top-level duties and worked with an array of officials (labor, government, production, and marketing, as well as financial). Two years later, when the corporate controller's job in the company's home office in Minneapolis became vacant, Ellis was given the job due to the belief of Medtronic's chief executive officer (CEO) that successful executives of the future will be those who have lived for several years in another nation.

Medtronic is not the only firm with this belief. At FMC Corp., a heavy machinery and chemicals producer, the vice president for human resources suggested that by the end of the decade, anyone in a general management position in his company will have had direct international exposure and experience. Evidently, the boards of directors of many other American corporations have the same policy. Companies such as McDonald's, Coke, Kellogg, Alcoa, Altria, and Schering-Plough have all appointed leaders who had extensive experience as the heads of international operations, and approximately 30 percent of the top 700 CEOs in the United States have had international experience. William Sullivan, the CEO of Agilent Technologies, commented on his three years in Singapore as an operations manager by saying, "It was a real career changer. In today's environment, having that overseas experience is a big deal."<sup>a</sup> Pfizer's CEO, Henry McKinnell, commented on the impact of his 14 years overseas by saying, "I've had hundreds of experiences I'll never forget. They were invaluable in shaping me into the manager of a global company."<sup>b</sup> As Carlos Gutierrez, who was the CEO of Kellogg before becoming the U.S. secretary of commerce (2005–2009), said, "Having a foreign perspective gives you an advantage not only for doing business outside the U.S. but domestically, where we have the most diverse society in the world. There's a built-in understanding that differences exist and are good."<sup>c</sup>

Although many American managers want their top executives at company headquarters to have years of foreign experience, do CEOs of the major firms recognize

# 1

### learning objectives

After reading this chapter, you should be able to:

- LOI-1 Understand** what international business is and why it is important.
- LOI-2 Comprehend** why and how international business differs from domestic business.
- LOI-3 Appreciate** that international business has a long and important history in the world's development.
- LOI-4 Appreciate** the dramatic internationalization of markets.
- LOI-5 Understand** the five kinds of drivers, all based on change, that are leading firms to internationalize their operations.
- LOI-6 Recognize** the key arguments for and against the globalization of business.
- LOI-7 Explain** the reasons for entering foreign markets.
- LOI-8 Recognize** that globalization of an international firm occurs over at least seven dimensions and that a company can be partially global in some dimensions and completely global in others.

the value of internationalized business education for all employees in management? Surveying the CEOs of the 162 largest firms on the *Fortune's* list of the 500 largest American corporations, we found that the CEOs strongly believed that: (1) an international orientation should be an important part of college business education; (2) international business skills and knowledge were important not merely for promotion to senior executive positions, but also for appointment to entry-level positions, and across a broad array of functional as well as cross-functional areas; and (3) the importance indicated in the preceding points was magnified for those companies that were anticipating increasing importance of international activities in the next five years.<sup>d</sup> For developing international skills, respondents believed that a number of courses in the international business curriculum are relevant to their companies. In addition to an introduction to international business, the internationally oriented courses that were viewed as being the most important for early career positions included topics related to (1) international strategy and competitiveness, (2) international legal and political issues, (3) international negotiation, and (4) foreign language. It appears from our study, then, that the CEOs of major American firms doing business overseas are convinced that the business graduates they hire should have some education in the international aspects of business. Clearly, the top executives from some of the largest corporations in the world are saying that they prefer business graduates who know something about markets, customs, and cultures in other countries. Companies that do business overseas have always needed some people who could work and live successfully outside their own countries, but now it seems that managers wanting to advance in their firms must have some foreign experience as well. As Roselinde Torres, president of U.S. operations of Mercer Delta Consulting said, "The hallmark of a great CEO is the ability to see an issue through a variety of lenses. International experience is one of the surest ways to add some new lenses."<sup>e</sup>

Did you note the reason for this emphasis on foreign experience for managers? It is increased

involvement of the firm in international business. The top executives of many corporations want their employees to have a global business perspective. What about companies that have no foreign operations of any kind? Do their managers need this global perspective? They do indeed, because it will help them not only to be alert for both sales and sourcing opportunities in foreign markets, but also to be watchful for new foreign competitors preparing to invade their domestic market. In addition, according to recruiters, foreign experience reflects independence, resourcefulness, and entrepreneurship. People who work and support themselves overseas tend to be inquisitive, adaptive, and flexible—qualities that are valuable in today's work environment. Given this need by companies for internationally experienced personnel, what can you do to improve your chances to obtain an overseas post?

It can be valuable to take classes in the area of international business, perhaps leading to a degree in an international business-related field. In addition, even while you are in school or shortly after graduation, consider going abroad to study, to work (whether as a business intern, as a teacher, or even in such positions as bartender or child care provider), or to volunteer in community development activities. The experience of living and working in another culture can be important in personal development, as well as being a career booster. As Lauren DiCioccio said of her international experience as a cook and farm worker, "When I went, I was hesitant because people looked at me and were surprised that I would graduate with a degree from Colgate and take time off to work and backpack around Australia. So when I came back and had it on my résumé, I couldn't believe all of the interviews were about my time in Australia." Brandon Steiner, a 24-year-old teaching in Japan, said, "Having international experience under your belt—employers are enthusiastic. It looks good and is not a bad step out of college. It shows you already are open-minded."<sup>f</sup> Upon your return, this experience may help you to land a job that involves international business activities. Although most positions are based in a person's home country, they may involve some international travel to see clients or

perform other job-related activities, thus, providing an opportunity for you to further broaden your international skills and experience.

If you already have a job, you can enhance your opportunities for international experience by making your boss and the human resource management department personnel aware of your interest and the fact that you have studied international business. Look for opportunities to remind them that you continue to be interested (performance review is a good time). Try to meet people in the home office who work with the company's foreign subsidiaries as well as visitors from overseas. As evidence of your strong interest in foreign employment, take additional international business courses and study foreign languages. Make sure that people in your company know what you are doing.

Throughout this book you will find examples of ways to develop, apply, and promote your international skills and experience, through features such as "The Global Path Ahead" vignettes of the international experiences of current

students and recent graduates, and the "Resources for Your Global Career" suggestions that follow the vignette in each chapter. Hopefully, through effective application of these suggestions, you will build a successful foundation for your own international experiences!

<sup>a</sup>Erin White, "Future CEOs May Need to Have Broad Liberal-Arts Foundation," *The Wall Street Journal*, April 12, 2005, p. B4, [www.uta.edu/pols/files/CEOsAndLiberalArts.pdf](http://www.uta.edu/pols/files/CEOsAndLiberalArts.pdf) (May 28, 2011).

<sup>b</sup>Justin Martin, "The Global CEO: Overseas Experience Is Becoming a Must on Top Executives' Resumes, According to This Year's Route to the Top," *The Chief Executive*, January–February 2004, [www.cristassociates.com/press/CEO\\_theglobalceo\\_020104.pdf](http://www.cristassociates.com/press/CEO_theglobalceo_020104.pdf) (May 28, 2011).

<sup>c</sup>Carol Hymowitz, "Foreign-Born CEOs Are Increasing in U.S., Rarer Overseas," *The Wall Street Journal*, May 25, 2004, <http://online.wsj.com/article/0,,SB108543349255419931,00.html> (May 28, 2011).

<sup>d</sup>J. Michael Geringer and William R. Pendergast, "CEO Views on the Value of International Business Skills and Education," *The International Journal of Management and Business*, Vol. 1, September 2010, pp. 12–35.

<sup>e</sup>Martin, "The Global CEO."

<sup>f</sup>Hillary Chura, "A Year Abroad (or 3) as a Career Move," *The New York Times*, February 25, 2006, [www.nytimes.com/2006/02/25/business/worldbusiness/25abroad.html](http://www.nytimes.com/2006/02/25/business/worldbusiness/25abroad.html) (May 28, 2011).

What about you? Are you involved in the global economy yet? Please read the nearby Worldview box, "Are You Really Buying American?" and then think back to how you began your own day. After you awoke, you may have looked at your Casio watch for the time, checked your Samsung cell phone for messages, and turned on your Toshiba TV for the news and weather while you showered. After drying your hair with a Conair dryer, maybe you slipped into some Diesel jeans, quickly swallowed some Dannon yogurt and a glass of Mott's apple juice, brushed your teeth with Close-Up toothpaste, and drove off to class in your Honda with its Firestone tires and a tank full of Shell gasoline. Meanwhile, on the other side of the world, a group of Nike-clad Japanese students may be turning off their Apple computers after watching videos on YouTube.com and debating whether they should stop for hamburgers and Cokes at McDonald's or coffee at Starbucks. As they leave, they place their books and other materials into their JanSport backpacks, put on their North Face jackets and Oakley sunglasses, and turn on their iPods.

What do you and the Japanese students have in common? You are all consuming products made by *foreign-owned companies*. This is international business.



A Starbucks coffee store in Beijing, China. Chairman Howard Schultz said China is the coffee chain's No.1 growth market.



While this may sound like a very typical evening for many Americans, foreign-owned firms produced nearly every item that the Boltons purchased or consumed:

- Trader Joe's is owned by a family trust set up by German businessman Theo Albrecht.
- Leo Burnett Worldwide is owned by Publicis of France.
- Sony Music of Japan produces and distributes Britney Spears' CDs.
- Japan's Clarion Co., Ltd. Produces Clarion car stereos.
- Italy's Fiat is the majority owner of Chrysler.
- The British-Dutch company, Royal Dutch Shell, owns Shell.
- Nestlé of Switzerland produces Alpo, Butterfinger, Carnation Instant Breakfast, CoffeeMate, Friskies, PowerBar, Stouffer's Lean Cuisine, Toll House, and Tidy Cat.
- Unilever, a British-Dutch multinational, makes Slim-Fast, Dove soap, Hellmann's, Ragu, Wishbone, Lipton, Vaseline, Axe, and Ben & Jerry's.
- Groupe Danone of France produces Dannon yogurt.
- Chicken-of-the-Sea is made by Thai Union International of Thailand.
- Japan's Kao owns Jergen's.
- Samsung cell phones are made by Korea's Samsung.
- Vodaphone Group plc of the United Kingdom owns 45 percent of Verizon Wireless.
- Bertelsmann AG of Germany owns Random House.
- Societe Bic of France produces Bic pens.
- Japan's Bridgestone owns Firestone.
- BP of the United Kingdom owns BP gas stations.

- Columbia Pictures, owned by Sony of Japan, released the *Spiderman* movies, Sony Pictures Television distributes *Jeopardy!* Sony Pictures Television distributes *The King of Queens*.
- SABMiller plc of the United Kingdom produces Miller beer.
- Amer Group of Finland owns Wilson Sporting Goods.
- Beringer Winery of Napa, California, is owned by Australia's Treasury Wine Estates.
- Philips televisions are produced and sold by Philips of the Netherlands.

This simple example reflects the impact of extensive foreign investments in the United States, especially in recent years. Even some of the best-known "American" products and brands are now produced by foreign firms.

Investments have also flowed outward from the United States. American companies such as Coca-Cola, Starbucks, McDonald's, the Gap, Microsoft, and Levi's are found in Japan, South Korea, China, Australia, Singapore, and nearly every European nation. American companies have also purchased a range of foreign companies and brands.

#### Question:

Why has there been almost no negative backlash among Americans to the flood of foreign investment into their country?

Sources: From T. R. Reid, "Buying American? Maybe Not; Many U.S. Brands European-Owned," *Washington Post*, May 18, 2002, p. E1; Nicholas Platt, "Make Global Skills a Top Priority," *Financial Times*, July 2, 2004, p. 13, <http://proquest.umi.com/pqdweb?index=0&did=658025341&SrchMode=2&sid=1&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1306613480&clientId=17870> (accessed May 28, 2011); and company websites (accessed May 28, 2011).

sometimes is used interchangeably with *international business*, although that will not be the practice in this book.

3. A **multidomestic company (MDC)** is an organization with multicountry affiliates, each of which formulates its own business strategy based on perceived market differences.
4. A **global company (GC)** is an organization that attempts to standardize and integrate operations worldwide in most or all functional areas.
5. An **international company (IC)** is a global or multidomestic company.

Although we primarily use the terms *global*, *multidomestic*, and *international* firms or companies, at times we may use *multinational enterprise (MNE)* or *multinational company (MNC)* interchangeably with *international company (IC)*, inasmuch as both terms are employed in the literature and in practice.

Although you may find those who consider *multinational corporation* to be synonymous with *multinational enterprise* and *transnational corporation*,<sup>1</sup> the United Nations and the governments of many developing nations use *transnational* instead of *multinational* to describe any firm doing business in more than one country. The specialized agency, the United Nations Conference on Trade and Development (UNCTAD), for example, employs the following definition: "A transnational corporation is generally regarded as an enterprise comprising entities in more than one country that operate under a system of decision-making that permits coherent policies and a common strategy. The entities are so linked, by ownership or otherwise, that one or more of them may be able to exercise a significant

#### **multidomestic company (MDC)**

An organization with multicountry affiliates, each of which formulates its own business strategy based on perceived market differences

#### **global company (GC)**

An organization that attempts to standardize and integrate operations worldwide in all functional areas

### international company (IC)

Either a global or a multidomestic company

### L01-2 Comprehend

why and how international business differs from domestic business.

### environment

All the forces surrounding and influencing the life and development of the firm

### uncontrollable forces

External forces over which management has no direct control, although it can exert an influence

### controllable forces

Internal forces that management administers to adapt to changes in the uncontrollable forces

influence over the others and, in particular, to share knowledge, resources and responsibilities with the others.”<sup>2</sup> More recently, some academic writers have employed the term *transnational* for a company that combines the characteristics of global and multinational firms: (1) trying to achieve economies of scale through global integration of its functional areas and at the same time (2) being highly responsive to different local environments (a newer name is *multicultural multinational*).<sup>3</sup>

## What Is Different about International Business?

International business differs from domestic business in that a firm operating across borders must deal with the forces of three kinds of environments—domestic, foreign, and international. In contrast, a firm whose business activities are carried out within the borders of one country needs to be concerned essentially with only the domestic environment. However, no domestic firm is entirely free from foreign or international environmental forces, because the possibility of having to face competition from foreign imports or from foreign competitors that set up operations in its own market is always present. Let us first examine these forces and then see how they operate in the three environments.

### INFLUENCE OF EXTERNAL AND INTERNAL ENVIRONMENTAL FORCES

The term **environment** as used here means all the forces influencing the life and development of the firm. The forces themselves can be classified as *external* or *internal*. The external forces are commonly called **uncontrollable forces**. Management has no direct control over them, although it can exert influence—such as lobbying for a change in a law and heavily promoting a new product that requires a change in a cultural attitude. External forces consist of the following:

1. *Competitive*: kinds and numbers of competitors, their locations, and their activities.
2. *Distributive*: national and international agencies available for distributing goods and services.
3. *Economic*: variables (such as gross national product [GNP], unit labor cost, and personal consumption expenditure) that influence a firm’s ability to do business.
4. *Socioeconomic*: characteristics and distribution of the human population.
5. *Financial*: variables such as interest rates, inflation rates, and taxation.
6. *Legal*: the many foreign and domestic laws governing how international firms must operate.
7. *Physical*: elements of nature such as topography, climate, and natural resources.
8. *Political*: elements of nations’ political climates such as nationalism, forms of government, and international organizations.
9. *Sociocultural*: elements of culture (such as attitudes, beliefs, and opinions) important to international managers.
10. *Labor*: composition, skills, and attitudes of labor.
11. *Technological*: the technical skills and equipment that affect how resources are converted to products.

The elements over which management does have some control are the internal forces, such as the factors of production (capital, raw materials, and people) and the activities of the organization (personnel, finance, production, and marketing). These are the **controllable forces** management must administer in order to adapt to changes in the uncontrollable environmental variables. Look at how one change in the political forces—the expansion of the European Union (EU) in 2007—affected all the controllable forces of firms worldwide that do business in or with the 27 EU member-nations. Suddenly these firms had to examine their business practices and change those affected by this new expansion. For example, some

European concerns and foreign subsidiaries in the EU relocated parts of their operations to other nations in the Union to exploit the lower wages there. Some American and Asian companies set up production in one of the member-countries to supply this giant free trade area. By doing this, they avoid paying import duties on products coming from their home countries.

## THE DOMESTIC ENVIRONMENT

The **domestic environment** is all the uncontrollable forces originating in the home country that influence the life and development of the firm. Obviously, these are the forces with which managers are most familiar. Being domestic forces, however, does not preclude their affecting foreign operations. For example, if the home country is suffering from a shortage of foreign currency, the government may place restrictions on overseas investment to reduce its outflow. As a result, managers of multinationals find that they cannot expand overseas facilities as they would like to do. In another instance from real life, a labor union striking the home-based plants learned that management was supplying parts from its foreign subsidiaries. The strikers contacted the foreign unions, which pledged not to work overtime to supply what the struck plants could not. The impact of this domestic environmental force was felt overseas as well as at home.

### **domestic environment**

All the uncontrollable forces originating in the home country that surround and influence the firm's life and development

## THE FOREIGN ENVIRONMENT

The forces in the **foreign environment** are the same as those in the domestic environment except that they occur outside the firm's home country. However, they operate differently for several reasons, including those provided here.

### **foreign environment**

All the uncontrollable forces originating outside the home country that surround and influence the firm

**Forces Have Different Values** Even though the kinds of forces in the two environments are identical, their values often differ widely, and at times they are completely opposed to each other. A classic example of diametrically opposed political-force values and the bewilderment they create for multinational managers involves the American export embargo on shipments of most goods to Cuba. This embargo meant that Cuba could not buy buses from a U.S. manufacturer. To circumvent the embargo, the Cuban government ordered the buses from the American firm's Argentine subsidiary. When word came from the firm's American headquarters that the order should not be filled because of the American embargo, the Argentine government ordered the Argentine subsidiary to fill the order. The Argentine government said that Argentine companies, of which the subsidiary was one, did not answer to the demands of a foreign government. The Argentine management of the subsidiary was in a quandary. Finally, headquarters relented and permitted its Argentine subsidiary to fill the order.

**Forces Can Be Difficult to Assess** Another problem with foreign forces is that they are frequently difficult to assess. This is especially true of legal and political forces. A highly nationalistic law may be passed to appease a section of the local population. To all outward appearances, the government may appear to be against foreign investment; yet pragmatic leaders may actually encourage it. A good example is Mexico, which until 1988 had a law prohibiting foreigners from owning a majority interest in a Mexican company. However, a clause permitted exceptions "if the investment contributes to the welfare of the nation." IBM, Eaton, and others were successful in obtaining permission to establish a wholly owned subsidiary under this clause.

**The Forces Are Interrelated** In the chapters that follow, it will be evident that the forces are often interrelated. This in itself is not a novelty because the same situation confronts a domestic manager. On the foreign scene, however, the kinds of interaction that occur and the outcomes may differ. For instance, the combination of high-cost capital and an abundance of unskilled labor in many developing countries may lead to the use of a lower level of technology than would be employed in the more industrialized nations. In other words, given a choice between installing costly, specialized machinery needing few workers and installing less expensive, general-purpose machinery requiring a larger labor force, management will frequently choose the latter when faced with high interest rates and a large pool of available

workers. Another example is the interaction between physical and sociocultural forces. Barriers to the free movement of a nation's people, such as mountain ranges and deserts, help maintain pockets of distinct cultures within a country, and this has an effect on decision making.

## THE INTERNATIONAL ENVIRONMENT

### international environment

Interaction between domestic and foreign environmental forces or between sets of foreign environmental forces

The **international environment** consists of the interactions (1) between the domestic environmental forces and the foreign environmental forces and (2) between the foreign environmental forces of two countries when an affiliate in one country does business with customers in another. This agrees with the definition of international business: business that involves the crossing of national borders.

For example, personnel at the headquarters of a multidomestic or global company work in the international environment if they are involved in any way with another nation, whereas those in a foreign subsidiary do not unless they too are engaged in international business through exporting or the management of other affiliates. In other words, a sales manager of Nokia's China operations does not work in the international environment if he or she sells cellular phones only in China. If Nokia's China operations export cell phones to Thailand, then the sales manager is affected by forces of both the domestic environment of China and the foreign environment of Thailand and, therefore, is working in the international environment. International organizations whose actions affect the international environment are also properly part of it. These organizations include (1) worldwide bodies (e.g., World Bank), (2) regional economic groupings of nations (e.g., North American Free Trade Agreement, European Union), and (3) organizations bound by industry agreements (e.g., Organization of Petroleum Exporting Countries).

**Decision Making Is More Complex** Those who work in the international environment find that decision making is more complex than it is in a purely domestic environment. Consider managers in a home office who must make decisions affecting subsidiaries in just 10 different countries (many ICs are in 20 or more countries). They not only must take into account the domestic forces, but also must evaluate the influence of 10 foreign national environments. Instead of having to consider the effects of a single set of 10 forces, as do their domestic counterparts, they have to contend with 10 sets of 10 forces, *both individually and collectively*, because there may be some interaction.

For example, if management agrees to labor's demands at one foreign subsidiary, chances are it will have to offer a similar settlement at another subsidiary because of the tendency of unions to exchange information across borders. Furthermore, as we shall observe throughout this text, not only are there many sets of forces, but there are also extreme differences among them.

**Self-Reference Criterion** Another common cause of the added complexity of foreign environments is managers' unfamiliarity with other cultures. To make matters worse, some managers will ascribe to others their own preferences and reactions. Thus, a foreign production manager, facing a backlog of orders, may offer her workers extra pay for overtime. When they fail to show up, the manager is perplexed: "Back home they always want to earn more money." This manager has failed to understand that the workers prefer time off to more money. This unconscious reference to the manager's own cultural values, called the **self-reference criterion**, is probably the biggest cause of international business blunders. Successful managers are careful to examine a problem in terms of the local cultural traits as well as their own.

### self-reference criterion

Unconscious reference to one's own cultural values when judging behaviors of others in a new and different environment

## A Brief History of International Business

While international business as a discipline is relatively new, as a business practice it is not, so let's briefly explore the history of international business.

Well before the time of Christ, Phoenician and Greek merchants were sending representatives abroad to sell their goods. Subsequently, a vast expansion of agricultural and

**L01-3 Appreciate** that international business has a long and important history in the world's development.

industrial production in China stimulated the emergence of an internationally integrated trading system. The saying that “all roads lead to China” had relevance within the international trade system, because China was the world’s leading manufacturing country for about 1,800 years, until it was replaced by Britain in about 1840.

The impact of the emerging international trading system was extensive. Politics, the arts, agriculture, industry, and other sectors of human life were profoundly influenced by the goods and ideas that came with trade. Public health was also affected. An interesting precursor to contemporary concerns about global health epidemics, such as severe acute respiratory syndrome (SARS) and the so-called swine flu, was international trade’s association with the spread of the plague, one of the worst natural disasters in history. Believed to have originated in Asia, the plague moved west with traders and soldiers, carried by oriental rat fleas that lived on rodents that stowed away on ships and caravans. Called the Black Death in Europe and repeated in waves from the mid-1300s through the 1500s, the plague ravaged cities, caused widespread hysteria, and killed one-quarter of China’s people and one-third of the population of Europe.<sup>4</sup>

The rise of the Ottoman Empire before 1300, ultimately spanning Europe, North Africa, and the Middle East, profoundly influenced the emerging trade routes for people, goods, money, animals, and microorganisms that spanned from England to China, across the Mediterranean and Northern Africa, and through Central Asia and the Indian Ocean region. The powerful central location of the Ottomans within this trading web had the effect of raising the cost of Asian trade for the Europeans. This spawned a search for sea routes to Asia, including expeditions that discovered the Americas.

In 1600, Great Britain’s British East India Company, a newly formed trading firm, began to establish foreign branches throughout Asia, an action soon followed by many of the other European nations intent on exploiting trade opportunities for national advantage, including Portugal, the Netherlands, and France. In 1602, the Dutch East India Company was formed to carry out colonial activities in Asia and to open ocean trade routes to the East. The first company to issue stock, it is also frequently identified as the world’s first multinational corporation.<sup>5</sup> By the end of the 1600s, ships commissioned by European trading companies regularly traveled to Asia via an interconnected Atlantic, Indian, and Pacific Ocean system of government-protected trade routes. Their goal was to acquire goods for sale or resale within various Asian markets and ultimately to return to Europe with valuable cargoes of cloth, spices, and other goods that would yield significant profits for investors. The 17th and 18th centuries have frequently been termed the “age of mercantilism” because the power of nations depended directly on the sponsorship and control of merchant capital, which expanded under the direct subsidization and protection of national governments. The concept of mercantilism is discussed in Chapter 2.

A number of multinational companies existed in the late 1800s. One of the first American companies to own foreign production facilities, have worldwide distribution networks, and market its products under global brands was Singer Sewing Machine. In 1868, it built a factory in Scotland and, by 1880, the company had become a global organization with an outstanding international sales organization and several overseas manufacturing plants. Other firms, such as J&P Coats (United Kingdom) and Ford Motor Company, soon followed, and by 1914, at least 37 American companies had production facilities in two or more overseas locations.<sup>6</sup> Interestingly, and quite a contrast to today’s situation, in the 1920s *all* cars sold in Japan were made in the United States by Ford and General Motors and sent to Japan in knocked-down kits to be assembled locally. European companies were also moving overseas. For example, Friedrich Bayer purchased an interest in a New York plant in 1865, two years after setting up his plant in Germany. Then, because of high import duties in his overseas markets, he proceeded to establish plants in Russia (1876), France (1882), and Belgium (1908).<sup>7</sup>

As you have just read, multinational firms existed well before World War I, and the level of intracompany trade of multinationals in 1930, as a percentage of overall world trade, may have exceeded the proportion at the end of the 20th century.<sup>8</sup> Yet only in recent years have multinationals become the object of much discussion and investigation, especially concerning the increasing globalization of their operations.

L01-4 **Appreciate**  
the dramatic inter-  
nationalization of  
markets.

## Growth of International Firms and International Business

The size and the number of U.S. and foreign international concerns have been increasing rapidly in recent years, as have the levels of foreign direct investment (FDI) and exporting.

### EXPANDING NUMBER OF INTERNATIONAL COMPANIES

UNCTAD, the United Nations agency in charge of all matters relating to FDI and international corporations, estimates that there are 82,000 transnational corporations with international production activities. These transnationals have approximately 810,000 foreign affiliates that collectively employ more than 78 million people. These transnationals account for approximately 25 percent of total global output and two-thirds of world trade. Foreign affiliates' sales have grown about 700 percent in the past 20 years.<sup>9</sup>

As a result of this expansion, the subsidiaries of foreign companies have become increasingly important in the industrial and economic life of many nations, developed and developing. This situation is in sharp contrast to the one that existed when the dominant economic interests were in the hands of local citizens. The expanding importance of foreign-owned firms in local economies came to be viewed by a number of governments as a threat to their autonomy. However, there has been a marked liberalization of government policies and attitudes toward foreign investment in both developed and developing nations since the early 1980s. Many government leaders know that local firms must obtain modern commercial technology in the form of direct investment, purchase of capital goods, and the right to use the international company's expertise if they are to be competitive in world markets.

Despite this change in attitude, there are still critics of large global firms who cite such statistics as the following to "prove" that host governments are powerless before them: In 2010, only 23 nations had gross national incomes (GNIs) greater than the total annual sales of Walmart Stores, Inc., the company with the greatest level of sales in the world.<sup>10</sup> Further, when nations and corporations are ranked by GNI and total sales, respectively, 46 of the first 100 on the list are corporations. However, a nation's GNI and a company's sales are not directly comparable because GNI is a measure of value added, not sales. If a nation's total sales were computed, the result would be far greater than its GNI because there would be triple and quadruple counting. For example, suppose a steel manufacturer sells steel wire to a tire company, which uses it to build tires. Then the tire company sells the tires to automakers, which mount them on their automobiles, which they in turn sell to the public. Sales of the wire would be counted three times. However, in calculating GNI, governments merely sum the values added in each transaction, which is the difference between the sales of the company and the costs of materials bought outside the company. If company sales were measured by value added, Walmart's revenues of \$405 billion would have been \$22 billion on a value-added basis.<sup>11</sup> While Walmart's sales are about the same as Norway's GNI, when both the economy and the company are measured by the value added, Norway's economy is more than 18 times the size of Walmart.

A firm's size may at times give it bargaining power, as in the case of a government that wants a firm to set up a subsidiary because of the employment it will offer and the purchases it will make from other firms in that country. Yet, regardless of the parent firm's size, each subsidiary is a local company that must comply with the laws in the country in which it is located. If it does not, it can be subject to legal action or even government seizure.

### FOREIGN DIRECT INVESTMENT AND EXPORTING ARE GROWING RAPIDLY

One variable commonly used to measure where and how fast internationalization is taking place is the increase in total foreign direct investment. **Foreign direct investment (FDI)** refers to direct investments in equipment, structures, and organizations in a foreign country at a level that is sufficient to obtain significant management control. It does not include mere foreign investment in stock markets. The world stock of outward FDI was \$19.0 *trillion* at the beginning of 2010, which was more than nine times larger than what it was 20 years earlier, in 1990.<sup>12</sup>

#### foreign direct investment (FDI)

Direct investments in equipment, structures, and organizations in a foreign country at a level that is sufficient to obtain significant management control; does not include mere foreign investment in stock markets

Of course, a substantial amount of international business involves exporting rather than FDI. **Exporting** is the transportation of any domestic good or service to a destination outside a country or region. It is the opposite of **importing**, which is the transportation of any good or service into a country or region, from a foreign origination point. Merchandise exports have grown faster than world output in nearly each of the past 60 years. World merchandise exports grew from \$2.0 trillion in 1980 to \$3.45 trillion in 1990, \$6.46 trillion in 2000, and \$15.24 trillion in 2010. This represents a nearly eightfold increase from 1980 to 2010, and with 2010 exports being 235 percent of the figure for 2000.<sup>13</sup> The level of service exports worldwide grew even more during this time, from \$365 billion in 1980 to \$781 billion in 1990, \$1.5 trillion in 2000, and \$3.7 trillion in 2010. This represented more than a tenfold increase between 1980 and 2010.<sup>14</sup> Trends regarding FDI and exporting, along with theories that help explain the level and location of exports and FDI, are discussed in Chapter 2. Figure 1.1 shows the growth in outward FDI and in services and merchandise exports from 1980 to 2010.

### exporting

The transportation of any domestic good or service to a destination outside a country or region

### importing

The transportation of any good or service into a country or region, from a foreign origination point

## WHAT IS DRIVING THE GLOBALIZATION OF BUSINESS?

Although globalization is discussed everywhere—television shows, Internet chat rooms, political demonstrations, parliaments, management boardrooms, and labor union meetings—so far, it has no widely accepted definition. In fact, its definition continues to broaden. Now, for example, social scientists discuss the political, social, environmental, historical, geographic, and even cultural implications of globalization.<sup>15</sup> Some also speak of technological globalization, political globalization, and the like.

## What Is Globalization?

The most common definition and the one used in international business is that of **economic globalization**—the tendency toward an international integration of goods, technology, information, labor, and capital, or the process of making this integration happen. The term *globalization* was first coined by Theodore Levitt in a *Harvard Business Review* article in which he maintained that new technologies had “proletarianized” communication, transport, and travel, creating worldwide markets for standardized consumer products at lower prices. He maintained that the future belonged to global corporations that did not cater to local differences in taste but, instead, adopted strategies that operated “as if the entire world (or major regions of it) were a single entity; [such an organization] sells the same things in the same way everywhere.”<sup>16</sup>

### economic globalization

The tendency toward an international integration of goods, technology, information, labor and capital, or the process of making this integration happen

## The Drivers of Globalization

Five major kinds of drivers, all based on change, are leading international firms to globalize their operations: (1) political, (2) technological, (3) market, (4) cost, and (5) competitive.

**Political** There is a trend toward the unification and socialization of the global community. Preferential trading arrangements, such as the North American Free Trade Agreement and the European Union, that group several nations into a single market have presented firms with significant marketing opportunities. Many firms have moved swiftly to gain access to the combined markets of these trading partners, either through exporting or by producing in the area.

Two other aspects of this trend are contributing to the globalization of business operations: (1) the progressive reduction of barriers to trade and foreign investment by most governments, which is hastening the opening of new markets by international firms that are both exporting to them and building production facilities in them, and (2) the privatization of much of the industry in formerly communist nations and the opening of their economies to global competition.

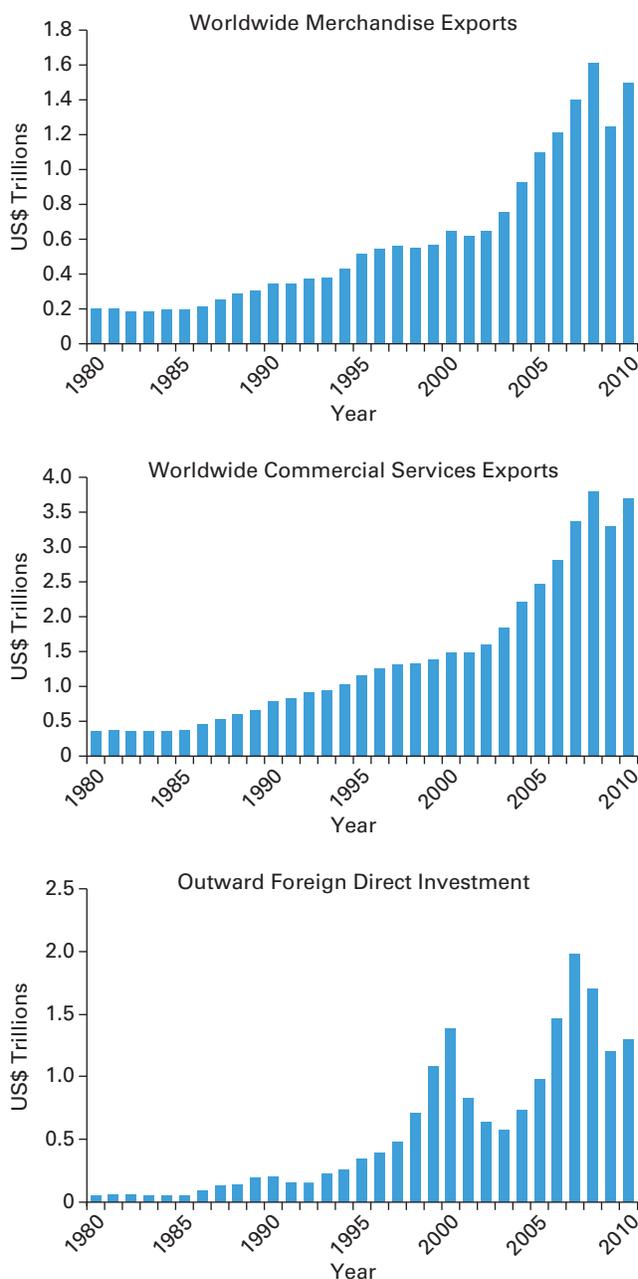
**Technological** Advances in computers and communications technology are permitting an increased flow of ideas and information across borders, enabling customers to learn

### L01-5 Understand

the five kinds of drivers, all based on change, which are leading firms to internationalize their operations.

**FIGURE I.1**

World  
Merchandise  
Exports,  
Commercial  
Services Exports,  
and Outward  
Foreign Direct  
Investment,  
1980–2010 (US\$  
trillions)



Sources: United Nations Conference on Trade and Development (UNCTAD), "FDI stock, by region and economy, 1990, 2000, 2008," *World Investment Report 2009* (New York: United Nations, 2009), p. 251; "Total Merchandise Trade," World Trade Organization, <http://stat.wto.org/StatisticalProgram/WsdbExport.aspx?Language=E> (May 28, 2011); and "Trade in Commercial Services," World Trade Organization, <http://stat.wto.org/StatisticalProgram/WSDBStatProgramSeries.aspx?Language=E> (May 28, 2011).

about foreign goods. Cable and satellite TV systems in Europe and Asia, for example, allow an advertiser to reach numerous countries simultaneously, thus creating regional and sometimes global demand. Global communications networks enable manufacturing personnel to coordinate production and design functions worldwide so that plants in many parts of the world may be working on the same product.

The Internet and network computing enable small companies to compete globally, because they make possible the rapid flow of information regardless of the physical location of the buyer and seller. Internet videoconferencing allows sellers to demonstrate their products to prospective buyers all over the world without the need to travel. It also permits

international companies to hold corporate meetings between managers from headquarters and overseas subsidiaries without expensive, time-consuming travel. In addition, communicating by e-mail on the Internet is faster and more reliable than using postal mail and much less expensive than using a fax machine. Both Internet uses have given home office managers greater confidence in their ability to direct overseas operations.

**Market** As companies globalize, they also become global customers. When Nokia announced its intention to set up a cell phone assembly plant in Chennai, India, suppliers of key components quickly confirmed that they would also establish plants adjacent to Nokia's facilities in order to avoid having a competitor capture the business. Likewise, for years, advertising agencies established offices in foreign markets when their major clients entered those markets to avoid having a competitor steal the accounts.

Finding the home market saturated also sends companies into foreign markets. According to a recent Dow Jones survey of the world's largest companies, 84 percent of the respondents expect that international markets will generate most of their growth in the next five years.<sup>17</sup> Indeed, the United States has only about 5 percent of the world's population, so the vast proportion of most companies' potential customers are located elsewhere.

**Cost** Economies of scale to reduce unit costs are a common management goal. One means of achieving them is to globalize product lines to reduce development, production, and inventory costs. Management can also move production or other parts of the company's value chain to countries where costs are lower. Dramatic reductions in the cost of generating and transmitting information due to innovations in computing and telecommunications, as well as the decline in transportation costs, have facilitated this trend toward relocating activities worldwide.

**Competitive** Competition continues to increase in intensity. New firms, many from newly industrialized and developing countries, have entered world markets in automobiles, computers, and electronics, for example. Another competitive driving force for globalization is the fact that companies are defending their home markets from competitors by entering the competitors' home markets to distract them. Many firms that would not have entered a single country because it lacked sufficient market size have established plants in

**L01-6 Recognize**  
the key arguments for and against the globalization of business.



## GLOBAL DEBATE

### The Globalization Debate and You



Demonstrators at a World Trade Organization meeting

The merits of globalization have been the subject of many heated debates in recent years.<sup>a</sup> There have been extensive public protests about globalization and the liberalization of international trade at World Trade Organization meetings and at other gatherings of international organizations and leaders. The debate is, in many respects, waged by diametrically opposed groups with extremely different views regarding the consequences of globalization. Sifting through the propaganda and hyperbole spouted by both sides is a challenge. However, it is important to recognize the various perspectives on globalization, because their arguments can generate appeal (or rejection) both intellectually and emotionally. The contributions of free trade and globalization to dramatic reductions in worldwide poverty are contrasted with anecdotal stories of people losing their livelihoods under the growing power

*(continued)*

of multinationals. Likewise, increases in service sector employment are contrasted against losses in high-paying manufacturing jobs.

## ARGUMENTS SUPPORTING GLOBALIZATION<sup>a</sup>

### Free Trade Enhances Socioeconomic Development

That free trade is the best strategy for advancing the world's economic development is one of the few propositions on which almost all economists agree, not only because it is theoretically compelling but also because it has been demonstrated in practice. Data have shown a clear and definitive link between liberalization of trade and economic growth.<sup>b</sup> On a wide range of measures—poverty, education, health, and life expectancy—more people have become better off at a faster pace in the past 60 years than at any other time in history. Evidence is strong regarding the dramatic decline in both the proportion and the absolute number of destitute people. The World Development Indicators from the World Bank show that the number of people in extreme poverty fell from 1.5 billion in 1981 to 1.1 billion in 2001. Measured as a proportion of the population in developing countries, the decline was from 39.5 percent in 1981 to 21.3 percent in 2001. Between 1981 and 1999, the proportion of people in the East Asia and Pacific region living on less than \$1 a day fell from 56 to 16 percent. In China, it plummeted from 61 to 17 percent. The proportion of people living in nations with daily food supplies under 2,200 calories per capita has declined from 56 percent in the mid-1960s to less than 10 percent. Life expectancy in the developing world has nearly doubled since World War II, and infant mortality has decreased in all of the developing regions of the world. The proportion of children in the labor force fell from 24 percent in 1960 to 10 percent in 2000. Global literacy grew from 52 percent in 1950 to 81 percent in 1999, and on average the more globally integrated countries spend more on public education, especially in developing countries. Citizens from more globally integrated countries have greater levels of civil liberties and political rights. Within a generation's time, there has been an enormous improvement in the human condition, and every one of the development success stories was based on export-led growth facilitated by the liberalization of trade.

Of course, countries can reject globalization, and some have, including Myanmar, the Democratic Republic of Congo, Sierra Leone, Rwanda, Madagascar, Guinea-Bissau, Algeria, the Republic of Congo, Burundi, Albania, Syria, and Ukraine. They are among the most impoverished countries in the world. As an article in the *Financial Times* puts it, "They are victims of their refusal to globalize."<sup>c</sup>

### Free Trade Promotes More and Better Jobs

Expanded trade is also linked with the creation of more and better jobs. Over the past two decades—a period of immense technological change and growth in trade—around 40 million more jobs were created than were

destroyed in the United States. It is true that when a country opens to trade, just as when new technologies are developed, some of its sectors may not be competitive. Companies may go out of business, and some jobs will be lost. But trade creates new jobs, and these tend to be better than the old ones. The key is not to block change but, instead, to manage the costs of trade adjustment and to support the transition of workers to more competitive employment.

## CONCERNS WITH GLOBALIZATION<sup>d</sup>

Those expressing concern with globalization have come from a range of sectors of society, and they express a correspondingly diverse set of concerns. Some fundamentally oppose the very process and outcomes of globalization on ideological grounds, while others may merely be concerned about finding ways to better manage globalization processes and the resulting outcomes. Some of the opponents' concerns may be viewed as naïve or clearly inconsistent with the preponderance of evidence. Other challenges to globalization may have theoretic merit or other supporting evidence and certainly may be worthy of discussion and the fostering of substantive change.

Although perspectives on the globalization debate may in many respects depend on one's values and ideology, thus further compounding efforts to reach a mutually agreed-on resolution, let us first ask this question: what are some of the primary concerns of the opponents of globalization? While many of the antiglobalizers concede that globalization "increases the size of the pie," they also claim that it has been accompanied by a broad array of injurious social implications. Among their concerns, let us briefly examine three primary ones here: (1) that globalization has produced uneven results across nations and people, (2) that globalization has had deleterious effects on labor and labor standards, and (3) that globalization has contributed to a decline in environmental and health conditions.

### Globalization Has Produced Uneven Results across Nations and People

In stark contrast to the positive picture presented by supporters of globalization, opponents describe the painful impact of foreign investment and trade liberalization on the people of the world. Far from everyone has been a winner, they say. The promise of export-led growth has failed to materialize in several places. For example, most of Latin America has failed to replicate Asia's success despite efforts to liberalize, privatize, and deregulate its economies, with results ranging from disappointment in Mexico to catastrophe in Argentina. Similarly, efforts in sub-Saharan Africa have produced only limited benefits, and the share of the population living in extreme poverty there rose from 42 to 47 percent between 1981 and 2001. Open world markets, it seems, may offer the possibility of economic development—but the recipe is neither easy in its implementation nor universal in its outcomes.

Many opponents of globalization have claimed that there is a huge gap between the world's rich and poor

(continued)

and that globalization has caused that gap to increase. That there is a gap between rich and poor is unquestionable, but the evidence is perhaps not so clear regarding the charge that globalization has increased this inequality. Although Martin Wolf's analysis shows that income inequality has not risen in most developing countries that have integrated with the world economy, it does show that inequality has increased in some places, most notably in China. Inequality has risen in some high-income countries as well, but he attributes that more to the nature of technological change than to globalization. When income data are adjusted to reflect relative purchasing power, the inequality in income between poor and rich nations diminishes. Wolf also notes that while globalization of trade and investment is an enabler to improved income and living standards, the results may vary if obstacles exist such as poor governance or excessive borrowing.<sup>e</sup>

#### **Globalization Has Had Deleterious Effects on Labor and Labor Standards**

The issue of the impact of globalization on labor standards has become an oft-mentioned concern of workers in the United States and other nations. With trade liberalization through the World Trade Organization and increased mobility of capital, measures to keep a country's industries within its borders have been reduced, and companies have an easier time divesting their interests in one country and moving to another. Workers in developed countries frequently voice concerns that their jobs will migrate to developing nations where there are lower standards, and thus, lower costs, leading to the infamous "race to the bottom," where developed nations with more rigorous labor standards become disadvantaged. Indeed, the Labor Secretariat for the North American Free Trade Agreement (NAFTA) commissioned a report that found more than half of firms surveyed used threats to close U.S. operations as a tool to fight union-organizing efforts. Since NAFTA's inception and the subsequent reduction in trade and investment barriers, these threats have become more plausible. As reported by Alan Tonelson, "In fact, more than 10 percent of employers studied . . . 'directly threatened to move to Mexico,' and 15 percent of firms, when forced to bargain with a union, actually closed part or all of a factory—triple the rate found in the late 1980s, before NAFTA."<sup>f</sup>

The concern can run both ways, however. Although labor standards in developing countries are usually lower than in industrialized countries, they are rising—and evidence shows that multinationals investing in host nations pay higher wages, create new jobs at a faster rate, and spend more on R&D than do local firms. Developing countries may also view the imposition of more demanding labor standards within their borders as a barrier to free trade. They may feel that lower-cost labor constitutes their competitive advantage and that if they are forced to implement more stringent labor standards, then companies may no longer have an incentive to set up operations in their countries, damaging their prospects for improved economic development. As

the authors of *Globalphobia* ask, "Is it humane for the United States to refuse to trade with these countries because their labor standards are not as high as we would prefer? The consequence of taking this position is that many third-world workers will have no jobs at all, or must take jobs that pay even lower wages and have even worse working conditions than those currently available in the export-oriented sector."<sup>g</sup> A study by the Carnegie Endowment for International Peace found that Mexico's agricultural sector, which provides most of the country's employment, had lost 1.3 million jobs in the first decade since NAFTA was implemented. In addition, far from diminishing under NAFTA, the flow of impoverished Mexicans into the United States has risen dramatically, the study says.<sup>h</sup>

#### **Globalization Has Contributed to a Decline in Environmental and Health Conditions**

Regarding concerns of antiglobalization forces that globalization contributes to declining environmental standards, former president Zedillo of Mexico stated, "Economic integration tends to favor, not worsen the environment. Since trade favors economic growth, it brings about at least part of the necessary means to preserve the environment. The better off people are, the more they demand a clean environment. Furthermore, it is not uncommon that employment opportunities in export activities encourage people to give up highly polluting marginal occupations." Yet a difficulty caused by the North American Free Trade Agreement and the maquiladora program that began before NAFTA has been the substantial increases in ground, water, and air pollution along the Mexico–U.S. border. Damage to the environment has been caused by the many new production facilities and the movement of thousands of Mexicans to that area to work in them. In addition, some health and environmental issues extend beyond the scope of trade agreements. Some of NAFTA's rules on trade in services may cause governments to weaken environmental standards for sometimes hazardous industries like logging, trucking, water supply, and real estate development. For example, to comply with NAFTA's rules on trade in services, the Bush administration waived U.S. clean air standards in order to allow trucks based in Mexico to haul freight on U.S. highways. Globalization opponents argue that this could increase air pollution and associated health concerns in border states, as the aging Mexican truck fleet pollutes more than similar U.S. trucks and these vehicles do not use the cleaner fuels required in the United States. Protesters have also claimed that, under liberalized rules regarding the globalization of trade and investment, businesses have an incentive to move their highly polluting activities to nations that have the least rigorous environmental regulations or a lower risk of liability associated with operations that can create environmental or health-related problems. On the other hand, the economic growth fostered by globalization can help generate and distribute additional resources for protecting the environment, and improved trade and

*(continued)*

investment can enhance the exchange of more environmentally friendly technologies and best practices, particularly within developing nations.

#### Questions:

As you read the preceding synopsis of the complex issues and arguments of supporters and opponents of globalization, are you convinced one way or the other? Is there a way the debate can move beyond a simplistic argument for or against globalization and toward how best to strengthen the working of the global economy in order to enhance the welfare of the world and its inhabitants?

<sup>a</sup>“ICC Brief on Globalization,” [www.iccwbo.org/home/commercial\\_practice/case\\_for\\_the\\_global\\_economy/globalization%20brief/globalization\\_brief.asp](http://www.iccwbo.org/home/commercial_practice/case_for_the_global_economy/globalization%20brief/globalization_brief.asp) (July 5, 2006); Paul Krugman, “The Good News,” *The New York Times*, November 28, 2003, p. A31, [www.nytimes.com/2003/11/28/opinion/the-good-news.html](http://www.nytimes.com/2003/11/28/opinion/the-good-news.html) (May 28, 2011); Horst Kohler and James Wolfensohn, “We Can Trade Up to a Better World,” *Financial Times*, December 12, 2003, p. 19, [www.imf.org/external/np/vc/2003/12/1003.htm](http://www.imf.org/external/np/vc/2003/12/1003.htm) (May 28, 2011); and Martin Wolf, *Why Globalization Works* (New Haven, CT: Yale University Press, 2004).

<sup>b</sup>World Trade Organization, “The Case for Open Trade,” [www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/fact3\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact3_e.htm) (May 28, 2011).

<sup>c</sup>Kohler and Wolfensohn, “We Can Trade Up to a Better World.”

<sup>d</sup>Gary Burtless, Robert Z. Lawrence, Robert E. Litan, and Robert J. Shapiro, *Globophobia: Confronting Fears about Open*

*Trade* (Washington, DC: Brookings Institution Press, 1998); Alan Tonelson, *The Race to the Bottom: Why a Worldwide Worker Surplus and Uncontrolled Free Trade Are Sinking American Living Standards* (Boulder, CO: Westview Press, 2002); Daniel Seligman, “On NAFTA’s Tenth Anniversary, Americans Demand Safe, Clean and Fair Trade,” Sierra Club, San Francisco, [www.sierraclub.org/pressroom/releases/pr2003-12-23a.asp](http://www.sierraclub.org/pressroom/releases/pr2003-12-23a.asp) (May 2, 2010); John-Thor Dahlburg, “Protesters Tell a Different Tale of Free Trade,” *Los Angeles Times*, November 20, 2003, p. A3, [www.commondreams.org/headlines03/1120-05.htm](http://www.commondreams.org/headlines03/1120-05.htm) (May 28, 2011); *Human Development Report 2003*, United Nations Development Program, New York, <http://hdr.undp.org/en/reports/global/hdr2003/> (May 28, 2011); *World Development Indicators 2004*, World Bank, [www.worldbank.org/data/countrydata/countrydata.html](http://www.worldbank.org/data/countrydata/countrydata.html) (May 28, 2011); and John Audley, Sandra Polaski, Demetrios G. Papademetriou, and Scott Vaughan, *NAFTA’s Promise and Reality: Lessons from Mexico for the Hemisphere* (Washington, DC: Carnegie Endowment for International Peace, 2003).

<sup>e</sup>Martin Wolf, *Why Globalization Works* (New Haven, CT: Yale University Press, 2004).

<sup>f</sup>Tonelson, *The Race to the Bottom*.

<sup>g</sup>Burtless et al., *Globophobia*.

<sup>h</sup>John Audley, Sandra Polaski, Demetrios G. Papademetriou, and Scott Vaughan, *NAFTA’s Promise and Reality: Lessons from Mexico for the Hemisphere* (Washington, DC: Carnegie Endowment for International Peace, 2003).

the comparatively larger trading groups (European Union, Association of Southeast Asian Nations [ASEAN], Mercosur). It is one thing to be shut out of Belgium, but it is another to be excluded from all Europe.

The result of this rush to globalization has been an explosive growth in international business. Many of the issues associated with globalization are highly complex, and there is no single measure of globalization or of integration within the world economy. Each element of global integration can have different effects. Following are some of the arguments for and against the globalization process and its outcomes.

**L01-7** Explain the reasons for entering foreign markets.

## Motives for Entering Foreign Markets

Now let us briefly examine the reasons international firms enter foreign markets, which are all linked to either (1) the desire to increase profits and sales or (2) the desire to protect these profits and sales from being eroded by competitors.

### INCREASE PROFITS AND SALES

**Enter New Markets** Managers are always under pressure to increase the sales and profits of their firms, and when they face a mature, saturated market at home, they begin to search for new markets outside the home country. They find that (1) markets with a rising gross domestic product (GDP) per capita and population growth appear to be viable candidates for their operations and (2) the economies of some nations where they are not doing business are growing at a considerably faster rate than is the economy of their own market.

**New Market Creation** As we will discuss in Chapter 12, there are many ways in which potential new markets can be identified and assessed. Sources of potential market size and overall market growth rate can be found in publications such as the annual *Human*

*Development Report* of the United Nations Development Program (<http://hdr.undp.org/en/>). Reviewing data in such reports will reveal great variety in growth rates among countries when ranked by variables such as GDP (gross domestic product) per capita.

Data from sources such as the *Human Development Report* indicate that from a macro perspective, markets around the world are growing. However, this does not mean that equally good opportunities exist for all kinds of business. Perhaps surprisingly, economic growth in a nation causes markets for some products to be lost forever while, simultaneously, markets for other products are being created. Take the case of a country in the initial stage of development. With little local manufacturing, it is a good market for exporters of consumer goods. As economic development continues, however, managers see profit-making opportunities in (1) producing locally the kinds of consumer goods that require simple technology or (2) assembling from imported parts the products that demand a more advanced technology. Given the tendency of governments to protect local industry, the importation of goods being produced in that country will normally be prohibited or discouraged through taxes, tariffs, or other means once local production of those goods has been established. Thus, exporters of easy-to-manufacture consumer goods, such as paint, adhesives, toiletries, clothing, and almost anything made of plastic, will begin to lose this market, which now becomes a new market for producers of the inputs to these “infant industries.”

**Faster-Growing Markets** Not only are new foreign markets appearing, but many of them are growing at a faster rate than is the home market. A firm looking for a market large enough to support the local production of appliances or machinery, for example, might be attracted by the wealth, growth, and population size of Japan and Spain. When you examine the low GDP per capita and negative growth rates of many of the African nations, you realize why foreign direct investment in that entire continent is so low. Clearly, market analysts will investigate other factors, such as the political and legal situations (discussed in Chapters 6 and 7), but an examination of variables such as those contained in the *Human Development Report* mentioned earlier is a good place to start. Interestingly, 83 of the 182 countries in the 2009 *Human Development Report* for which data were available (46 percent) had average annual GDP per capita growth rates that were higher than the U.S. growth rate for the period 1990–2007.<sup>18</sup>

**Improved Communications** This might be considered a supportive reason for opening up new markets overseas, because certainly the ability to communicate rapidly and less expensively with customers and subordinates by electronic mail, wireless and wired telephones, and videoconferencing has given managers confidence in their ability to control foreign operations. Advances in computer-based communications are allowing virtual integration, which permits firms to become more physically fragmented as they search the world for lower-cost inputs. For example, good, relatively inexpensive international communication enables large insurance, banking, software, and other firms to “body shop,” that is, transmit computer-oriented tasks worldwide to a cheap but skilled labor force. The clients of numerous Indian software companies are in the United States. A few years ago, software teams were required to fly back and forth between the two countries. Now, at the end of the day, customers in the United States e-mail their problems to India. The Indians then work on the solutions and have them back in the United States before the Americans have had breakfast the next day. For their work, Indian software engineers often receive only 15 to 20 percent as much pay, as do their American counterparts.

**Obtain Greater Profits** As you know, greater profits may be obtained by either increasing total revenue or decreasing the cost of goods sold, and often conditions are such that a firm can do both.

**Greater Revenue** Rarely will all of a firm’s domestic competitors be in every foreign market in which it is located. Where there is less competition, the firm may be able to obtain a better price for its goods or services. Increasingly, firms are also obtaining greater revenue by simultaneously introducing products in foreign markets and in their domestic markets as

they move toward greater globalization of their operations. This can result in greater sales volume while lowering the cost of the goods sold.

**Lower Cost of Goods Sold** Going abroad, whether by exporting or by producing overseas, can frequently lower the cost of goods sold. Increasing total sales by exporting not only will reduce research and development (R&D) costs per unit, but also will make other economies of scale possible. Another factor that can positively affect the cost of goods sold is the inducements—such as reduced taxes or subsidies for R&D—that some governments offer to attract new investment.

**Higher Overseas Profits as an Investment Motive** There is no question that greater profits on overseas investments has been a strong motive for going abroad. *Business International*, for example, reported that 90 percent of 140 *Fortune 500* companies surveyed had achieved higher profitability on foreign than on domestic assets. One study of the 100 largest multinationals showed that only 18 of them earned more than 50 percent of their revenue overseas, but 33 earned more than 50 percent of their profits from foreign operations.

Let's now look at some reasons for going abroad that are more related to the protection of present markets, profits, and sales.

## PROTECT MARKETS, PROFITS, AND SALES

**Protect Domestic Market by Following Customers Overseas** Frequently, a firm will go abroad to protect its home market. Service companies (e.g., accounting, advertising, marketing research, banking, law) will establish foreign operations in markets where their principal accounts are located to prevent competitors from gaining access to those accounts. They know that once a competitor has been able to demonstrate to top management what it can do by servicing a foreign subsidiary, it may be able to take over the entire account. Similarly, suppliers to original equipment manufacturers (e.g., battery manufacturers supplying automobile producers) often follow their large customers. These suppliers have an added advantage in that they are moving into new markets with a guaranteed customer base.

**Attack in Competitor's Home Market** Occasionally, a firm will set up an operation in the home country of a major competitor with the idea of keeping the competitor so occupied defending that market that it will have less energy to compete in the firm's home country.

**Using Foreign Production to Lower Costs** A company may go abroad to protect its domestic market when it faces competition from lower-priced foreign imports. By moving part or all of its production facilities to the countries from which its competition is coming, it can enjoy such advantages as less costly labor, raw materials, and energy. Managers may decide to produce certain components abroad and assemble them in the home country, or, if the final product requires considerable labor in the final assembly, it may send the components overseas for this activity. Many nations, especially developing countries, offer export processing zones in which firms, mostly foreign manufacturers, enjoy almost complete absence of taxation and regulation of materials brought into the zones for processing and subsequent re-export.

**Protect Foreign Markets** Changing the method of going abroad from exporting to overseas production is often necessary to protect foreign markets. Managers of a firm supplying a profitable overseas market via exports may begin to note some ominous signs that this market is being threatened.

**Lack of Foreign Exchange** One of the first signs is a delay in payment by the importers. The importers may have sufficient local currency but may be facing delays in buying foreign exchange (currency) from the government's central bank. The credit manager in the exporting firm, by checking with his or her bank and other exporters, learns that this condition is becoming endemic—a reliable sign that the country is facing a lack of foreign

exchange. In examining the country's balance of payments, the financial manager may find that the company's export revenue has declined while the import volume remains high. Experienced exporters know that import and foreign exchange controls are in the offing and that there is a good chance of losing the market, especially if they sell consumer products. In times of foreign exchange scarcity, governments will invariably give priority to the importation of raw materials and capital goods.

If the advantages of making the investment outweigh the disadvantages, the company may decide to protect this market by producing locally. Managers know that once the company has a plant in the country, the government will do its utmost to provide foreign exchange for raw materials to keep the plant, a source of employment, in operation. Because imports of competing products are prohibited, the only competition, if any, will have to come from other local manufacturers.

**Local Production by Competitors** Lack of foreign exchange is not the only reason a company might change from exporting to manufacturing in a market. For instance, while a firm may enjoy a growing export business and prompt payments, it still may be forced to set up a plant in the market if competitors have also noticed their export volumes will support local production. If a competing firm moves to put up a factory in the market, management must decide rapidly whether to follow suit or risk losing the market forever. Managers know that many governments, especially those in developing nations, not only will prohibit further imports once the product is produced in the country but also will permit only two or three companies to enter so as to maintain a sufficient market for these local firms.

**Downstream Markets** A number of Organization of Petroleum Exporting Countries (OPEC) nations have invested in refining and marketing outlets, such as filling stations and heating-oil distributors, to guarantee a market for their crude oil at more favorable prices. Petróleos de Venezuela, owner of CITGO, is one of the largest foreign investors in the United States.

**Protectionism** When a government sees that local industry is threatened by imports, it may erect import barriers to stop or reduce these imports. Even threats to do this can be sufficient to induce the exporter to invest in production facilities in the importing country.

**Guarantee Supply of Raw Materials** Few developed nations possess sufficient domestic supplies of raw materials. Japan and Europe are almost totally dependent on foreign sources for many important materials, and even the United States depends on imports for more than half of its consumption of aluminum, chromium, manganese, nickel, tin, and zinc. To ensure a continuous supply, manufacturers in the industrialized countries are being forced to invest, primarily in the developing nations where most new deposits are being discovered.

**Acquire Technology and Management Know-How** A reason often cited by foreign firms for investing in the United States is the acquisition of technology and management know-how. Nippon Mining, for example, a Japanese copper mining company, came to Illinois and paid \$1 billion for Gould, Inc. to acquire technology leadership and market share in producing the copper foil used in printed circuit boards for electronics products.

**Geographic Diversification** Many companies have chosen geographic diversification as a means of maintaining stable sales and earnings when the domestic economy or their industry goes into a slump, since the industry or the other economies may still be at their peak in other parts of the world.

**Satisfy Management's Desire for Expansion** The faster growth mentioned previously helps fulfill management's desire for expansion. Stockholders and financial analysts also expect firms to continue to grow, and those companies operating only in the domestic market have found it increasingly difficult to meet that expectation. As a result, many firms have expanded into foreign markets. This, of course, is what companies based in small countries, such as Nestlé (Switzerland) and Nokia (Finland), discovered decades ago.

## The Seven Dimensions for Globalizing a Business

**L01-8 Recognize** that globalization of an international firm occurs over at least seven dimensions and that a company can be partially global in some dimensions and completely global in others.

In organizing their international activities, there are at least seven dimensions along which management can globalize (standardize): (1) product, (2) markets, (3) promotion, (4) where value is added to the product, (5) competitive strategy, (6) use of non-home-country personnel, and (7) extent of global ownership in the firm. The possibilities range from zero standardization (multidomestic) to standardization along all seven dimensions (completely global). The challenge for company managers is to determine how far the firm should go with each one. Usually the amount of globalization will vary among the dimensions. For example, promotional activities for washing machines might be standardized to a great extent: people use them to get their clothes clean. However, for economic reasons, in poorer countries the machines must be simpler and less costly and, therefore, the product is not standardized worldwide. We return to this topic in various parts of the text, particularly in Chapter 15.

## Organization of This Book

After describing the nature of international business and the institutions associated with it in Section One, we analyze several of the key uncontrollable forces that make up the foreign and domestic environments and illustrate their effect on management functions in Section Two. In Section Three, we reverse the procedure and deal with the management functions, demonstrating how they are influenced by the uncontrollable forces.

A solid understanding of the business concepts and techniques employed in the United States and other advanced industrial nations is a requisite for success in international



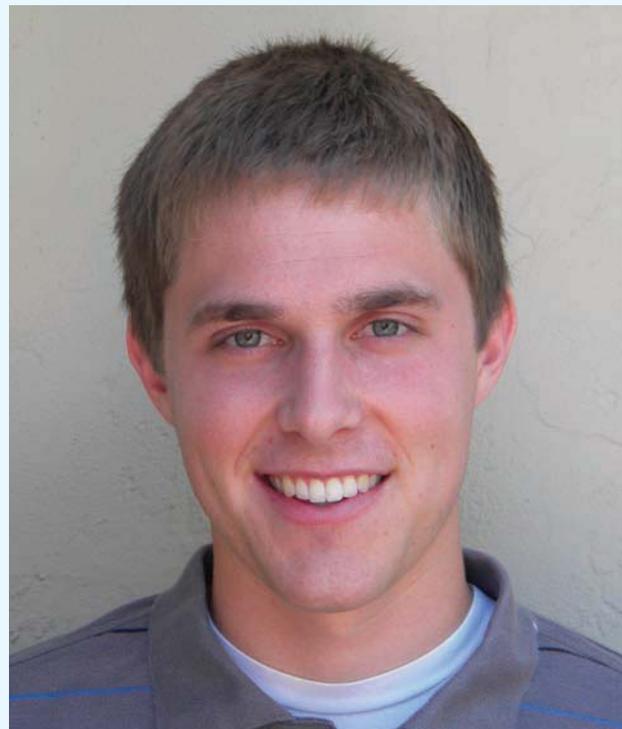
## THE GLOBAL PATH AHEAD

### Ryan Hultzman in Dalin, China: The Key Is to Get Beyond Your Comfort Zone

I was born and raised in San Jose, California. Sports have always played a big role in my life and I can't really think of a time growing up when I wasn't involved with either a baseball, swimming, or basketball team. Ever since I graduated from high school, most of my involvement in sports has been watching my favorite teams on TV, and I am hoping to find a job in San Jose upon graduation so I can get season tickets for the Sharks. I am hoping that I will get to travel a lot more after I graduate. Other than my time in China, I have only spent a week in Mexico on a cruise and five days visiting a friend in Germany. I would love to visit every continent by the time I am 30, so I hope to land a career that will allow me to do so.

I am a business major with a concentration in international management and a minor in psychology. At this point, my major career goal is to spend an extended period of time (over a year) working in another country. I know that this probably won't happen right away, but it is something that I will surely work toward. I have always been interested in traveling and learning about different cultures, and international business seemed like a great starting point to be able to eventually work with people from different parts of the world.

I worked in Dalian, China for five months during the summer and fall of my senior year. I worked with AIESEC (an acronym for the Association Internationale des Étudiants en Sciences Économiques et Commerciales and the world's largest student-led organization) to get an international internship, because I



couldn't afford to study abroad. I chose to go to China because I wanted to challenge myself. The culture is extremely different

*(continued)*

from what I grew up with in the United States, and I wanted to live somewhere that would seriously challenge how I viewed the world. China has also been developing very rapidly, so I thought it would be interesting to experience that kind of growth first-hand.

In China, I worked as an English teacher. I mostly taught children 2 to 10 years old, but I also taught one adult class for a month. I had only been accepted for this opportunity about a month before I was supposed to start, so my preparation was fairly rushed. I had no background in Mandarin, so I did what I could to learn some basic phrases before I left. I asked around and found a couple of people who had previously spent time working in China and I asked them about their experiences and if they had any advice for me. I did a lot of research on the city I was going to be living in and tried to learn all I could about everyday life in China. Since I found this opportunity through AIESEC, my living arrangements and transportation from the airport were already established before I left, which was a huge benefit.

The most important thing I did to help myself adjust to the Chinese culture when I was abroad was make a few friends that I could really trust. I ended up living in a couple of different places with some great American and Canadian friends that I made, but it was invaluable having a couple of Chinese friends who I could rely on to help me out when I needed it. If I ever needed any help—anything from finding transportation to learning how to ask for a haircut—my friends were willing to provide their assistance.

I didn't really run into any reverse culture shock upon my return to the United States. I think a large part of that was due to the fact that I only spent five months in the country. My experience abroad definitely changed the way I view certain parts of my life, but I didn't have any trouble assimilating back into the U.S. culture.

I had to leave my first job in China after two months due to a contractual problem, so one of my biggest challenges was finding another place to work so I wouldn't have to cut my time abroad short. Chinese culture is strongly based on relationships, or *guanxi*, so I knew that my best shot for finding another job was to ask everyone I knew if they were aware of any jobs that were available for me. After a month of searching, I was offered a job at a kindergarten because my friend's boss knew the owner of the school and they were in need of a foreign English teacher.

Another big challenge for me was getting around in China without really knowing the language. Hand gestures can get you pretty far in most cases, but other things like being able to order food in a restaurant with menus that are written only in Chinese characters take some time. I had a Chinese tutor for the first two months, but once I left my first job I couldn't afford it any more, so I had to become very proactive in learning the necessities. I asked my bilingual friends a lot of questions and made flash cards so I could successfully navigate around the city on my own.

My greatest enjoyment from my time abroad was probably when one of my youngest classes started calling me "gēge lǎoshī" (in Mandarin, *lǎoshī* means teacher and *gēge* means older brother). Initially, the students referred to me as the "foreign teacher," but once they started calling me brother, I couldn't help but feel like my assimilation was complete.

I think my greatest learning points from my international experience have to be the things that I learned about myself. I felt like I grew more as a person in the five months I spent in China than any other time in my life. I have always seen myself as a very independent person, but my time abroad allowed me to prove it. I learned how to put my views and beliefs on hold in order to truly understand where people from different backgrounds are coming from.

As far as recommendations for success abroad, the most important thing is to keep an open mind. People view and value things very differently around the world and unless you can understand and appreciate their perspective, you won't be successful working with people from other cultures. Also, don't be afraid to step out of your comfort zone when you're abroad. Most of the best stories that I have from my time in China have to do with situations that I wouldn't normally put myself in back home and that is what made my time abroad so great.

## Resources for Your Global Career

### Exploring International Job Opportunities

More than likely, your first job in international business will *not* come with a business class airline ticket to Shanghai, Paris, or Rio de Janeiro and a "sky's the limit" expense account. More realistically, it will come with a desk, computer, fax machine, e-mail, and smartphone (e.g., BlackBerry, iPhone). Many entry-level jobs in international business involve managing import/export documentation to move shipments across international borders; tracking shipments by boat, plane, train, and truck; and following sales to make sure orders and payments are received—as well as dealing with foreign customers by phone, fax, and e-mail. Is this the glamour of international business? Probably not. But it is business, and it is international, and it does put your career track in the international arena, which is where you need to be to start your international business career. However, entry-level jobs in some small and medium-sized enterprises will involve short international visits to client meetings, conferences, trade shows, or corporate meetings in international locations. In addition to your willingness to take that all important entry-level international job and work to be successful at it, here are several other suggestions to build your international career:

- Inform your boss and your company's human resources department about your interest in a career in international business.
- Join several international business trade associations in your city and regularly attend their meetings:
  - *International Chamber of Commerce*—[www.iccwbo.org/](http://www.iccwbo.org/)
  - *International Association of Business Communicators (IABC)*—[www.iabc.com/](http://www.iabc.com/)
  - *International Trade Administration of the U.S. Department of Commerce* seminars and workshops—<http://trade.gov/>
  - *Federation of International Trade Associations (FITA)* offers a directory of international trade associations by specialty with locations—[www.fita.org](http://www.fita.org)

(continued)

- Your state's Department of Commerce or Economic Development may offer workshops and seminars on international trade.

By attending these meetings, you will network and get to know their members so they get to know you and learn about your interest in a career in international business.

- Read international business publications and listen to international news and business broadcasts so you are current with issues, trends, and practices in international trade. Here are several:
  - *World Trade* (this is free)—[www.worldtrademag.com/](http://www.worldtrademag.com/)
  - *International Herald Tribune*—[www.ihf.com/](http://www.ihf.com/)
  - *Financial Times*—[www.ft.com](http://www.ft.com)
  - *The Economist*—[www.economist.com](http://www.economist.com)
  - *Reuters*—[www.reuters.com](http://www.reuters.com)
  - *BBC*—[www.bbc.co.uk](http://www.bbc.co.uk)
- Find a mentor to teach, guide, and assist you in building your international business career.
- Be ready to travel internationally at a moment's notice—hold a valid passport.

If you are considering an international career but not sure where to look to find one, there are numerous websites with Internet listings for private industry and government jobs. The website for this book includes a broad range of sites, such as the following:

- The *Riley Guide* has hundreds of worldwide listings for companies and governments. The Targeting and Research section has information on Business and Employer Research and Living and Working Overseas: [www.rileyguide.com](http://www.rileyguide.com)
- *GoingGlobal.com* offers a wide range of information on international careers, international job search resources, job opportunities worldwide, and information to help build your international career: [www.goingglobal.com/HotTopics.asp](http://www.goingglobal.com/HotTopics.asp)
- *Expertise in Labour Mobility* (ELM) is a knowledge provider on international work issues for companies and individuals entering the global workplace. ELM's "Looking for work in . . ." guides cover 40 countries and are "must have" tools for everybody involved in securing a job abroad: [www.labourmobility.com](http://www.labourmobility.com)
- *Escape Artist* provides a broad range of international job postings as well as related reference materials: [www.escapeartist.com/jobs/overseas1.htm](http://www.escapeartist.com/jobs/overseas1.htm)
- *International Jobs Center* provides extensive international business and international development job postings: [www.internationaljobs.org/](http://www.internationaljobs.org/)
- *Jobs Abroad* supplies listings for jobs in many nations of the world, along with other resources: [www.jobsabroad.com/](http://www.jobsabroad.com/)
- *International Careers and Jobs by Profession* provides resources for work abroad, study abroad, volunteering abroad, and international travel: [www.transitionsabroad.com/listings/work/careers/keywebsitesprofessionspecific.shtml](http://www.transitionsabroad.com/listings/work/careers/keywebsitesprofessionspecific.shtml)

- *Partnerjob.com* facilitates the geographic mobility of members' employees by helping find jobs for those employees' spouses and partners at their new location: [www.partnerjob.com/](http://www.partnerjob.com/)

### Alternatives for Working Globally—Consider International Jobs and Careers Other Than in Business

The first thought that typically comes to mind when you hear "International Careers" is a job in the corporate world working for a *Fortune 500* firm that services international markets and has a global reputation. This is not the only track into an international career. There are many outstanding international career opportunities for people with desirable interpersonal and language skills that are not in mainstream business but may require basic business expertise. Explore these options to become a part of the global workforce:

- Travel, Tourism and Hospitality—a major international industry found in virtually every country of the world.
- Engineering, Information Technology and Computer Science—experiencing major worldwide growth
- Health Professions and Health Care Management
- Translation and Language Teaching Abroad
- The Fine and Performing Arts
- Architecture
- Environmental and Natural Resource Management
- International Chambers of Commerce
- Foreign Trade Divisions of State Offices of Economic Development
- The U.S. Government
- U.S. Counselor Service
- Foreign Service—U.S. State Department
- The Central Intelligence Agency and the National Security Agency
- The Agency for International Development (AID)
- The Export-Import Bank
- The International Trade Commission
- U.S. Information Agency
- The Peace Corps
- International Education Exchange—teach abroad
- Volunteer and Social Service Agencies

The skills and experiences offered by any of these career options are highly sought after and readily transferable between the public and the private sector.

### Look for International Internship Opportunities While You Are Still in School

- *Internships Abroad* is an internship program offered through Ohio University for internships in the United Nations, in the

(continued)

U.S. Department of State, and in more than 65 countries: [www.ohiou.edu/studyabroad/internships.htm](http://www.ohiou.edu/studyabroad/internships.htm)

- *U.S. Department of Commerce* has various intern programs. For example, Student Employment Opportunities covers a broad range of student employment and internship opportunities: [www.ohrm.os.doc.gov](http://www.ohrm.os.doc.gov)
- *U.S. Department of State* holds oral prep sessions all across the United States and Asia to assist candidates for the Foreign Service oral exam. It also offers an extremely helpful description of Student Employment Programs with good information on how to apply for them: [www.careers.state.gov/index.html](http://www.careers.state.gov/index.html)

- *Organization of American States* offers a program designed for juniors, seniors, and graduate students at the university level to allow them to work within their fields of study. They must have at least a 3.0 GPA and command of two of the four official languages: English, Portuguese, Spanish, and French. The program has three sessions during the year: Fall, Winter–Spring, and Summer: [www.oas.org/EN/PINFO/HR/gen\\_information.htm](http://www.oas.org/EN/PINFO/HR/gen_information.htm)

business. However, because transactions take place across national borders, three environments—domestic, foreign, and international—may be involved, instead of just one. Thus, in international business, the international manager has three choices in deciding what to do with a concept or a technique employed in domestic operations: (1) transfer it intact, (2) adapt it to local conditions, or (3) not use it overseas. International managers who have discovered that there are differences in the environmental forces are better prepared to decide which option to follow. To be sure, no one can be an expert on all these forces for all nations, but just knowing that differences may exist will cause people to “work with their antennas extended.” In other words, when they enter international business, they will know they must look out for important variations in many of the forces that they take as given in the domestic environment. It is to the study of these three environments that this text is directed.

## Summary

### **L01-1 Understand what international business is and why it is important.**

International business is business whose activities are carried out across national borders. International business is important because of the increasing scale and scope of activities that occur across national borders

### **L01-2 Comprehend why and how international business differs from domestic business.**

International business differs from its domestic counterpart in that it involves three environments—domestic, foreign, and international—instead of one. Although the kinds of forces are the same in the domestic and foreign environments, their values often differ, and changes in the values of foreign forces are at times more difficult to assess. The international environment is defined as the interactions (1) between the domestic environmental forces and the foreign environmental forces and (2) between the foreign environmental forces of two countries when an affiliate in one country does business with customers in another

### **L01-3 Appreciate that international business has a long and important history in the world’s development.**

International business has a long and important history, extending thousands of years into the past. Politics, the arts,

agriculture, industry, public health, and other sectors of human life have been profoundly influenced by the goods and ideas that have come with international trade.

### **L01-4 Appreciate the dramatic internationalization of markets.**

Global competition is mounting as the number of international companies expands rapidly. The huge increase in import penetration, plus the massive amounts of overseas investment, means that firms of all sizes face competitors from everywhere in the world. This increasing internationalization of business is requiring managers to have a global business perspective gained through experience, education, or both

### **L01-5 Understand the five kinds of drivers, all based on change, that are leading firms to internationalize their operations.**

The five major kinds of drivers, all based on change, that are leading international firms to globalize their operations are as follows, with an example for each kind: (1) *political*—preferential trading agreements, (2) *technological*—advances in communications technology, (3) *market*—global firms become global customers, (4) *cost*—globalization of product lines and production helps reduce costs by achieving economies of scale, and (5) *competitive*—firms are defending their home markets from foreign competitors by entering the foreign competitors’ markets.

**L01-6 Recognize the key arguments for and against the globalization of business.**

Key arguments in support of the globalization include: (1) free trade enhances socioeconomic development, and (2) free trade promotes more and better jobs. Key concerns with the globalization of business include: (1) globalization has produced uneven results across nations and people, (2) globalization has had deleterious effects on labor and labor standards, and (3) globalization has contributed to a decline in environmental and health conditions.

**L01-7 Explain the reasons for entering foreign markets.**

Companies enter foreign markets (exporting to and manufacturing in) to increase sales and profits and to protect markets, sales, and profits from being eroded by competitors.

**L01-8 Recognize that globalization of an international firm occurs over at least seven dimensions and that a company can be partially global in some dimensions and completely global in others.**

The seven dimensions along which management can globalize (standardize) when organizing their international activities are: (1) product, (2) markets, (3) promotion, (4) where value is added to the product, (5) competitive strategy, (6) use of non-home-country personnel, and (7) extent of global ownership in the firm. The possibilities range from zero standardization (multidomestic) to standardization along all seven dimensions (completely global). A firm can have, and usually does have, an international strategy that is partially multidomestic in some dimensions and partially global in others.

## Key Words

**international business** (p. 8)

**foreign business** (p. 8)

**multidomestic company (MDC)** (p. 9)

**global company (GC)** (p. 9)

**international company** (p. 10)

**environment** (p. 10)

**uncontrollable forces** (p. 10)

**controllable forces** (p. 10)

**domestic environment** (p. 11)

**foreign environment** (p. 11)

**international environment** (p. 12)

**self-reference criterion** (p. 12)

**foreign direct investment (FDI)** (p. 14)

**exporting** (p. 15)

**importing** (p. 15)

**economic globalization** (p. 15)

## Questions

1. What are the differences among multidomestic, global, and international companies?
2. Business is business, and every firm has to find ways to produce and market its goods. Why, then, might managers be unable to successfully apply the techniques and concepts they have learned in their own country to other areas of the world?
3. Give examples to show how an international business manager might manipulate one of the controllable forces in answer to a change in the uncontrollable forces.
4. Although forces in the foreign environment are the same as those in the domestic environment, they operate differently. Why is this so?
5. What is the difference between the foreign environment and the international environment?
6. Why, in your opinion, do the authors regard the use of the self-reference criterion as “probably the biggest cause of international business blunders?” Can you think of an example?
7. Discuss some possible conflicts between host governments and foreign-owned companies.
8. “A nation whose GNI is smaller than the sales volume of a global firm is in no position to enforce its wishes on the local subsidiary of that firm.” Is this statement true or false? Please explain your rationale.
9. Discuss the forces that are leading international firms to the globalization of their sourcing, production, and marketing.
10. What examples of globalization can you identify within your community? How would you classify each of these examples (e.g., international investment, international trade)?
11. Why is there opposition to globalization of trade and integration of the world’s economy? Please assess the major arguments for and against such globalization efforts.
12. What are the reasons that explain why international firms would enter foreign markets?
13. You have decided to take a job in your hometown after graduation. Why should you study international business?

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

1. The Emerging Market Global Players (EMGP) Project produces annual reports ranking the top *multinational enterprises* (MNEs) in emerging markets by their foreign assets. Locate the most recent annual report of Hungary, and identify the 10 largest nonfinancial Hungarian MNEs. In what industries are they classified? In how many countries do they have operations? In which regions of the world? Do you notice any similarities or differences in terms of the industries represented in
2. The *KOF Index of Globalization*, provided by the KOF Swiss Economic Institute, measures globalization on economic, social, and political dimensions. Provide a brief description of this index and its ranking. Specifically, what factors are considered in calculating the index? Find the most recent ranking, and identify the 10 countries with the lowest and highest Globalization Index. Do you notice any trends or similarities among the countries listed?

## Minicase: Ownership of Companies and Brands

Which of the following companies or brands are owned by companies headquartered outside of the United States? Who are the owners and which country(ies) are the owners based in?

1. 7-Eleven Stores
2. Chesebrough-Pond (Vaseline)
3. Maybelline cosmetics
4. Diesel clothing
5. Aquafresh toothpaste
6. Baby Ruth candy bar
7. Holiday Inn
8. Arrowhead water
9. Columbia Pictures motion picture studios
10. Arco (gasoline)
11. Nerds candy
12. Popsicle frozen treats
13. Random House book publisher
14. Ralston Purina pet foods
15. Motel 6
16. Pinkerton National Detective Agency (Pinkertons)
17. Ban deodorant
18. RCA Records
19. Thinkpad laptop computers
20. Norelco electric shavers



# International Trade and Foreign Direct Investment



If you care about global poverty and, for that matter, about equality, your aim should be to raise the growth rates of poor countries. Successful countries have all exploited global market opportunities, predominantly international trade and, to a more variable extent, foreign direct investment, to accelerate their growth. Successful globalization has, in short, reduced both poverty and inequality.

—*Martin Wolf, global business analyst*

# 2

## Firms Invest Overseas, But They Also Export

The need for responding to such factors as (1) global competition, (2) liberalization by host governments in regard to foreign investment, and (3) advances in technology, were a major reason that American outward foreign direct investment (FDI) reached a record \$1.20 trillion from 2006–2009. These figures represent more than 1.3 times the U.S. average a decade before (1996–1999). Inasmuch as foreign direct investment generally is used to set up or acquire assets to produce goods and services abroad, we might expect U.S. exports to have dropped as a result of the more than \$2 trillion in U.S. FDI in the period 2000–2009. Have they?

Apparently not. Although some flows of exported goods and services from the United States to foreign markets have been replaced by production from these investments abroad, the overall level of American exports of goods and services increased from \$1.1 trillion in 2000 to \$1.8 trillion in 2010, an increase of 64 percent in a decade. The U.S. Department of Commerce states that approximately two-thirds of U.S. exports of goods are by U.S.-owned multinational corporations, with more than one-third of those exports being shipped by the U.S. parent to foreign affiliates.

To examine how important international business activities are for large American multinationals, we examined firms at the top of the *Fortune* Global 500 list of the largest multinationals. Among the companies examined, the ratio of foreign sales to total sales averaged nearly 60 percent. Many of these companies sell to 100 countries or more. Without sales and profits generated from foreign operations, the competitiveness of many of these companies would be seriously damaged, and some of them might be unable to remain in business. Yet, despite the fact that large international companies such as these typically have numerous production facilities overseas, it is usually not feasible for them to have a factory in every market. The foreign investment would be too great for them to attempt to set up production facilities in each market. Also, many markets are too small to support local manufacturing; they must be served by exports.

Although supplying overseas markets is essential to most major U.S. corporations, smaller firms also have activities overseas. According to the Exporter Data Base (a joint project of the International Trade Administration and the Census Bureau), small and medium-sized enterprises (SMEs) accounted for nearly 98 percent of all

### learning objectives

After reading this chapter, you should be able to:

- LO2-1** **Appreciate** the magnitude of international trade and how it has grown.
- LO2-2** **Identify** the direction of trade, or who trades with whom, and trends in such trade.
- LO2-3** **Outline** the theories that attempt to explain why certain goods are traded internationally.
- LO2-4** **Explain** the size, growth, and direction of foreign direct investment.
- LO2-5** **Explain** several theories of foreign direct investment.

U.S. exporters and nearly one-third of the total value of American exports. Categorizing SMEs as companies with fewer than 500 employees, an analysis of the Exporter Data Base reveals the following:

- The total number of American companies exporting goods in 2009 was 275,843. Of these exporters, 269,269 were SMEs. These numbers exclude companies that exported only services.
- SMEs accounted for 32.8 percent of the total value of U.S. exports.
- The total export revenues of SMEs was \$308 billion in 2009. Canada was the most frequent export market, with 92,573 SMEs exporting to that country. Mexico was the second most popular, with 46,748 SME exporters, followed by the United Kingdom, Germany, China, Australia, and Japan.
- Overall, NAFTA countries represented more than 25 percent of U.S. merchandise exports by SMEs, valued at \$90.5 billion. Canada purchased \$49.6 billion in SME merchandise exports, followed by Mexico (\$40.9 billion),

China (\$23.5 billion), Japan (\$19.6 billion), the United Kingdom (\$17.1 billion), and Germany (\$12.9 billion).

- In comparison to large companies, SMEs are highly dependent on initiatives undertaken by the U.S. government to open foreign markets to trade. Unlike large exporting companies, most SMEs lack offshore subsidiaries that can circumvent trade barriers and improve market access. More than half of all SME exporters operate from a single location in the United States.

Sources: United Nations Conference on Trade and Development, *World Investment Report*, "Annex Table 2: FDI Outflows, By Region and Economy, 1990–2009," [www.unctad.org/templates/Page.asp?intItemID=5545&lang=1](http://www.unctad.org/templates/Page.asp?intItemID=5545&lang=1) (May 10, 2011); U.S. Census Bureau, "U.S. International Trade in Goods and Services," [www.census.gov/foreign-trade/statistics/historical/](http://www.census.gov/foreign-trade/statistics/historical/) (May 10, 2011); U.S. Department of Commerce, Exporter Database, <http://ita.doc.gov/td/industry/otea/edb/index.html> (May 14, 2011); U.S. Census Bureau, "Profile of U.S. Exporting Companies, 2008–2009," April 12, 2011, [www.census.gov/foreign-trade/Press-Release/edb/2009/](http://www.census.gov/foreign-trade/Press-Release/edb/2009/) (May 10, 2011); and U.S. Department of Commerce, International Trade Administration, *Small and Medium Sized Exporting Companies: Statistical Overview, 2009*, [www.trade.gov/mas/ian/smeoutlook/tg\\_ian\\_001925.asp](http://www.trade.gov/mas/ian/smeoutlook/tg_ian_001925.asp) (May 10, 2011).

International trade and investment have become fundamental to most people's lives. For example, much of the food we eat, the clothes we wear, the vehicles we drive, and the electronic goods that we use for work and pleasure are produced in other nations. Many of our jobs are dependent on exports, imports, or foreign investment. In this chapter, we examine (1) *international trade*, which includes exports and imports, and (2) *foreign direct investment*, which international companies must make to establish and expand their overseas operations. We will briefly examine key trends and traits of international trade and investment across the globe, and we will also present an overview of some of the most prominent theories that have been developed to explain the incidence and level of international trade and investment.

The following discussion of international trade first examines the volume of trade, including which nations account for the largest volume of the world's exports and imports. We then discuss the direction of trade and the trend toward increased regionalization of international trade. We examine the issue of major trading partners and their relevance for managers, and then we finish this section of the chapter by discussing several leading theories that help to explain international trade. The final section of the chapter will address foreign direct investment.

**L02-1 Appreciate**  
the magnitude of international trade and how it has grown.

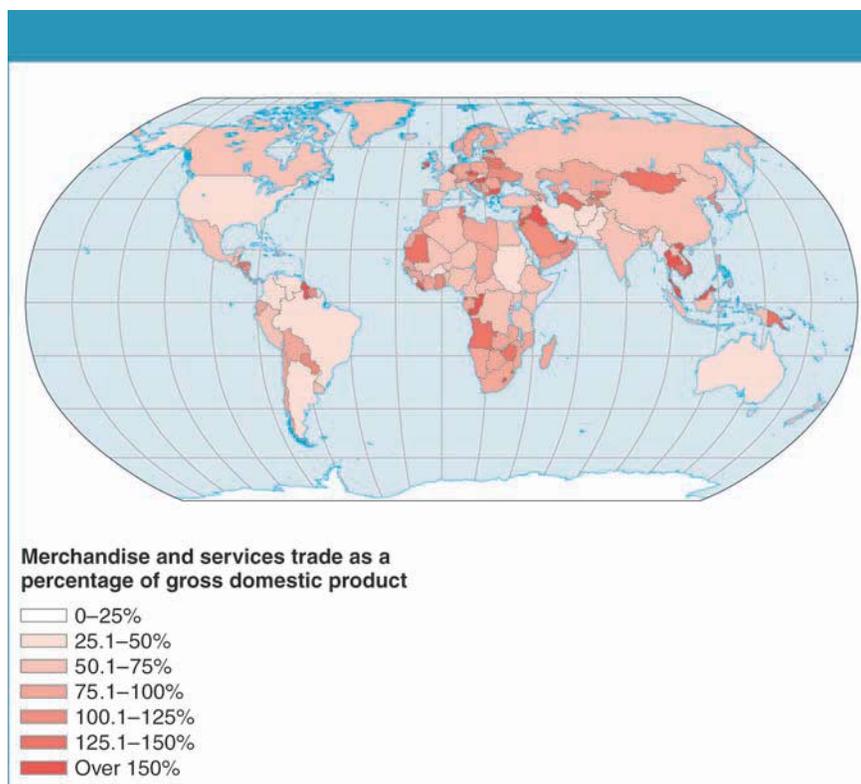
## International Trade

### VOLUME OF INTERNATIONAL TRADE

In 1990, a milestone was reached when the volume of international trade in goods and services measured in current dollars surpassed \$4 trillion. By 2010, exports of goods and services had nearly quintupled, exceeding \$18.9 trillion.<sup>1</sup> The dollar value of total world exports is greater than the gross national product of every nation in the world except the United States. One-fourth of everything grown or made in the world is now exported—another measure of the significance of international trade. Figure 2.1 illustrates the combined level of goods and services exports and imports as a percentage of gross domestic

**FIGURE 2.1**

Merchandise and Services Trade as a Percentage of Gross Domestic Product



product for various nations. As can be seen, international trade has become a critical factor in the economic activity of many, if not most, of the countries of the world.

Of the \$18.9 trillion in international trade in goods and services in 2010, exports of merchandise were \$15.2 trillion, nearly five times what they had been 20 years earlier. While smaller in absolute terms, worldwide trade in services, at \$3.7 trillion, has been growing faster than has trade in merchandise. The volume of world trade in services had reached a level that was more than 10 times what it had been in 1980.<sup>2</sup>

## HOW EVEN HAS THE GROWTH IN TRADE BEEN?

As trade has grown globally, how even has this growth been? Have some nations fared better than others? Although the absolute value of their merchandise exports increased, the proportion of exports coming from the regions of North America, Latin America, Africa, and the Middle East decreased between 1980 and 2010. For example, the level of exports from Africa grew by more than 250 percent from 1980 to 2010, yet the region's proportion of overall world merchandise exports declined by half. In contrast, the proportion of merchandise exports from Asia increased by more than 90 percent between 1980 and 2010, with China accounting for nearly two-thirds of that increase. Although the European Union increased its proportion of world trade, the increase is attributable to the expansion of the EU to 27 member-countries.

The results for services exports share some similarity with merchandise exports. The extensive growth in the level of overall worldwide trade in services means that all of the regions and essentially all of the primary nations have experienced an absolute increase in the dollar volume of services exports. The proportion of world exports of commercial services accounted for by Latin America, the European Union, Africa, and the Middle East has evidenced an overall decline since 1980. However, the United States's proportion of services exports has risen by approximately one-third from 1980 to 2010. Asia has also been increasing its proportion of services exports at an even greater rate.

The rapid expansion of world exports since 1980 demonstrates that the opportunity to increase sales by exporting is a viable growth strategy and one that can benefit the exporting nations through the creation of jobs. At the same time, however, the export growth of individual nations should be a warning to managers that they must be prepared to meet increased competition from exports to their own domestic markets. The proportion of manufacturing value added that is located in developed countries has declined across most industrial sectors between 1995 and 2010, with the largest portion of that decline occurring since 2000.<sup>3</sup> Correspondingly, developing countries' share of value added has been increasing during this time, although the location of value-adding activities has been changing substantially. For example, while Africa and Latin America have not added appreciably to their proportion of worldwide manufacturing value added, the proportion generated by South and East Asia has quadrupled since 1980. These trends have important implications for managers in terms of not merely where there may be new markets (e.g., for machine tools or other capital goods used by expanding manufacturing sectors), but also where competition in manufacturing may be intensifying or where new sources of export competition might emerge.

## WHICH NATIONS ACCOUNT FOR THE MOST EXPORTS AND IMPORTS?

Which nations are responsible for the large and growing levels of merchandise and services trade that we have seen worldwide? Table 2.1 presents the world's 10 largest nations in terms of exports and imports of merchandise and of services. As you can see, the largest exporters and importers of merchandise are generally developed countries, although China ranks in the top 5 on each list and India ranks in the top 10 for both imports and exports of services. These 10 largest exporters and importers collectively account for over half of all exports and imports for both merchandise and services.

**TABLE 2.1**

10 Leading Exporters and Importers in World Merchandise and Commercial Services, 2010 (\$ billions)

Merchandise Exporters			Merchandise Importers			Service Exporters			Service Importers		
Rank	Nation	Value	Rank	Nation	Value	Rank	Nation	Value	Rank	Nation	Value
1	China	\$1,578	1	United States	\$1,968	1	United States	\$515	1	United States	\$358
2	United States	1,278	2	China	1,395	2	Germany	230	2	Germany	256
3	Germany	1,269	3	Germany	1,067	3	United Kingdom	227	3	China	192
4	Japan	770	4	Japan	693	4	China	170	4	United Kingdom	156
5	Netherlands	572	5	France	606	5	France	140	5	Japan	155
6	France	521	6	United Kingdom	558	6	Japan	138	6	France	126
7	South Korea	466	7	Netherlands	517	7	Spain	121	7	India	117
8	Italy	448	8	Italy	484	8	Singapore	112	8	Netherlands	109
9	Belgium	411	9	Hong Kong	442	9	Netherlands	111	9	Italy	108
10	United Kingdom	405	10	South Korea	425	10	India	110	10	Ireland	106

**Sources:** Central Intelligence Agency, *The World Factbook* (Washington, DC: CIA, 2011), [www.cia.gov/library/publications/the-world-factbook/geos/xx.html](http://www.cia.gov/library/publications/the-world-factbook/geos/xx.html) (May 10, 2011); and World Trade Organization, "Trade Growth to Ease in 2011 but Despite 2010 Record Surge, Crisis Hangover Persists," [www.wto.org/english/news\\_e/pres11\\_e/pr628\\_e.htm#atable3](http://www.wto.org/english/news_e/pres11_e/pr628_e.htm#atable3) (May 10, 2011).

## Direction of Trade

What are the destinations of these merchandise exports? If you have never examined trade flows, you may think that international trade consists mainly of manufactured goods exported by the industrialized nations to the developing nations in return for raw materials. However, this is only partially correct. While more than half the exports from developing nations do go to developed countries, this proportion has been declining over the past 40 years, from 72 percent in 1970 to about 50 percent by 2010.<sup>4</sup> Also, approximately 70 percent of exports from developed economies go to other industrialized nations, not to developing countries.

### L02-2 Identify

the direction of trade, or who trades with whom, and trends in such trade.

**The Increasing Regionalization of Trade** Although the direction of trade frequently changes over time among nations or regions of the world, the overall level of world trade continues to be dominated by trade that occurs with—not between—nations. For example, in 2009, 48 percent of the exports from North American nations went to other nations in North America, 52 percent of Asian nations' exports were to other Asian nations, and 72 percent of exports from European nations went to other European countries.<sup>5</sup> This regionalization of trade is reinforced by the development of expanded regional trade agreements (discussed in Chapter 3), such as the Association of Southeast Asian Nations (ASEAN), Mercosur in South America, and the European Union, which can substantially alter the level and proportion of trade flows within and across regions. For example, most of Canada's exports go to the United States and more than 20 percent of American exports go to Canada, mainly as a result of the North American Free Trade Agreement and prior bilateral free trade treaties between these two nations.<sup>6</sup> The \$163 billion value of U.S. exports to Mexico in 2010 was approximately five times the level in 1991.<sup>7</sup> Similarly, the proportion of overall exports accounted for by members of the regional trade agreement totaled 67 percent for the European Union, 25 percent for ASEAN, and 15 percent for Mercosur. Overall, there are more than 200 regional trade agreements in operation worldwide, and the share of world trade accounted for by members of these agreements increased from 37 percent in 1980 to more than 70 percent by 2011.

It appears that American exporters have made major inroads in developing country markets, which in turn are selling more to the United States. This is due in part to their increasing ability to export manufactured goods and the growing intracompany trade among international companies' affiliates. The fact that members of trade groups are increasingly selling more to each other is a development that will influence international companies' choices of locations for their plants and other operations.

## Major Trading Partners: Their Relevance for Managers

An analysis of the major trading partners of a firm's home country and those of the nations where it has affiliates that export can provide valuable insights to management. Among the advantages to focusing attention on a nation that is already a sizable purchaser of goods coming from the would-be exporter's country are:

1. The business climate in the importing nation is relatively favorable.
2. Export and import regulations are not insurmountable.
3. There should be no strong cultural objections to buying that nation's goods.
4. Satisfactory transportation facilities have already been established.
5. Import channel members (merchants, banks, and customs brokers) are experienced in handling import shipments from the exporter's area.
6. Foreign exchange to pay for the exports is available.
7. The government of a trading partner may be applying pressure on importers to buy from countries that are good customers for that nation's exports. We have seen the efforts of the Japanese, Korean, and Taiwanese governments to persuade their citizens to buy more American goods. They have also sent buying missions to the United States.

## MAJOR TRADING PARTNERS OF THE UNITED STATES

Table 2.2 shows the major trading partners of the United States. The top 15 trade partners accounted for 73 percent of the total exports from the United States and 75 percent of the total imports in 2010. The data indicate that the United States, an industrialized nation, generally follows the tendency we found earlier; that is, developed nations trade with one another. Mexico and Canada are major trading partners in great part because they share a common border with the United States. Freight charges are lower, delivery times are shorter, and contacts between buyers and sellers are easier and less expensive. Being joined with the United States in the North American Free Trade Agreement helps ensure that the three nations' mutual importance as trading partners will remain strong.

Of the top 15 nations that the United States imports from, 9 of these nations have remained on the list over the past 45 years, including Canada, Mexico, Japan, Germany, the United Kingdom, Italy, France, Venezuela, and Brazil. However, each nation's ranking has changed over time, and some new nations have been added to replace other nations that have become relatively less important as trade partners. Nations from Asia, besides long-term trade partner Japan, have become increasingly important trade partners in recent years. China, Singapore, South Korea, Taiwan, and India are supplying the United States with huge quantities of electronic products and components as well as a variety of largely labor-intensive manufactured goods, many of which are produced by affiliates of American international companies. Between 1991 and 2010, China rose from sixth to first place in exports to the United States and it also moved up to third place as an importer of U.S. goods (although the \$92 billion level of Chinese imports was only 25 percent of the level of exports it sent to the United States).

Many of the same Asian countries appear as importers of American goods as well because (1) their rising standards of living enable their people to afford more imported products, and the countries' export earnings provide the foreign exchange to pay for them; (2) they are purchasing large amounts of capital goods to further their industrial expansion; (3) they are importing

**TABLE 2.2**

Major Trading Partners of the United States, Goods Only, 2010  
(\$ billions)

Exports			Imports		
Rank	Country	Value	Rank	Country	Value
1	Canada	\$249	1	China	\$365
2	Mexico	163	2	Canada	277
3	China	92	3	Mexico	230
4	Japan	61	4	Japan	120
5	United Kingdom	49	5	Germany	83
6	Germany	48	6	United Kingdom	50
7	South Korea	39	7	South Korea	49
8	Brazil	35	8	France	39
9	Netherlands	35	9	Taiwan	36
10	Singapore	29	10	Ireland	34
11	France	27	11	Venezuela	33
12	Hong Kong	27	12	Saudi Arabia	31
13	Taiwan	26	13	Nigeria	31
14	Belgium	26	14	India	30
15	Australia	22	15	Italy	29
Total		\$1,278			\$1,912

Source: U.S. Census Bureau, "Top Trading Partners," [www.census.gov/foreign-trade/statistics/highlights/top/top1012yr.html](http://www.census.gov/foreign-trade/statistics/highlights/top/top1012yr.html) (May 10, 2011).

raw materials and components that will be assembled into subassemblies or finished goods that will subsequently be exported, often to the United States; and (4) their governments, pressured by the American government to lower their trade surpluses with the United States, have sent buying missions to this country to look for products to import.

The analysis of foreign trade that we have described would be helpful to anyone just starting to search outside the home market for new business opportunities. The preliminary steps of (1) studying the general growth and direction of trade and (2) analyzing major trading partners would provide an idea of where the trading activity is. What kinds of products do these countries import from the United States? The U.S. Census Bureau maintains a site on the Internet with downloadable files of trade statistics. One entry, “About Foreign Trade” ([www.census.gov/foreign-trade/about/index.html](http://www.census.gov/foreign-trade/about/index.html)), contains extensive links to statistics on exports and imports, as well as information about the Exporter Database of all U.S. exporters. Another entry, “Foreign Trade” ([www.foreign-trade.com/highlights.htm](http://www.foreign-trade.com/highlights.htm)), has links to data on top trading partners by year, country, industry, product, and state. There are also tables on the Commerce Department’s Export.gov website that list imports and exports from a range of different industries. These tables present multiyear data on levels of imports and exports between the United States and the other countries of the world, providing an idea of the size and potential attractiveness of various sectors. This site also has numerous guides for “Doing Business In” various countries, to help companies in successfully exploiting trade opportunities.

We have seen that the volume of international trade is large, growing, and critical to the economic performance of most nations. But why does this trade occur, both overall and between particular nations? To answer this question, we will briefly examine several of the leading theories of international trade. Understanding these theories is essential for international managers, because they frequently will be dealing with government officials trained in economics and must therefore be prepared to speak their language. When presenting plans requiring governmental approval, managers must take care that the plans are economically sound, because they are almost certain to be studied by economists and will often need to be approved by them. Marketers proposing large projects to government planners must be aware that the key determinant now is economic efficiency rather than mere financial soundness.<sup>8</sup> Moreover, knowledge of economic concepts in the areas of international trade and investment frequently provides insight into future government action.

## Explaining Trade: International Trade Theories

Why do nations trade? This question and the equally important proposition of predicting the direction, composition, and volume of goods traded are what international trade theory attempts to address. Interestingly, as is the case with numerous economic writings, the first formulation of international trade theory was politically motivated. Adam Smith, incensed by government intervention and control over both domestic and foreign trade, published *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), in which he tried to destroy the mercantilist philosophy.

### MERCANTILISM

**Mercantilism**, the economic philosophy Smith attacked, evolved in Europe between the 16th and 18th centuries. A complex political and economic arrangement, mercantilism traditionally has been interpreted as viewing the accumulation of precious metals as an activity essential to a nation’s welfare. These metals were, in the mercantilists’ view, the only source of wealth. Because England had no mines, the mercantilists looked to international trade to supply gold and silver. The government established economic policies that promoted exports and stifled imports. Import restrictions such as import duties reduced imports, while government subsidies to exporters increased exports. Those acts created a trade surplus which would be paid for in gold and silver, in addition to protecting jobs within the mercantilist nation. Of course, another outcome of mercantilism was the generation of benefits for certain economic groups, such as domestic merchants, artisans, and shippers, albeit at a cost to other groups such as consumers and emerging industrialists.

#### L02-3 Outline

the theories that attempt to explain why certain goods are traded internationally.

#### mercantilism

An economic philosophy based on the belief that (1) a nation’s wealth depends on accumulated treasure, usually precious metals such as gold and silver, and (2) to increase wealth, government policies should promote exports and discourage imports

Although the mercantilist era ended in the late 1700s, its arguments live on. Many people still argue that exports are “good” for a country because they create jobs, while imports are “bad” because they transfer jobs from the importing country to other nations. This view essentially sees trade as a zero-sum activity, where one party must lose in order for another to gain. Similarly, a “favorable” trade balance still means that a nation exports more goods and services than it imports. In balance-of-payments accounting, an export that brings dollars to the country is called *positive*, but imports that cause dollar outflow are labeled *negative*.

In the United States and Europe, as well as a number of emerging markets in Asia, many managers believe that China remains a present-day “fortress of mercantilism” that raises barriers to imported goods while giving Chinese exporters an unfair advantage. Despite impressive economic growth and burgeoning trade surpluses, Chinese authorities have resisted efforts to revalue their currency, the yuan or renminbi. Instead, they have continued to hold the yuan within a tight trading range relative to the U.S. dollar. By limiting the extent to which the yuan can appreciate in value, the Chinese authorities have been accused of engaging in mercantilist behavior because they help the international cost-competitiveness of Chinese companies relative to that of companies from the United States and other nations. One study argues that 40 percent of the price advantage of companies from China is due to mercantilist policies of China’s central government, including an undervalued currency, export subsidies, and lax regulatory oversight.<sup>9</sup>

## THEORY OF ABSOLUTE ADVANTAGE

Adam Smith argued against mercantilism by claiming that market forces, not government controls, should determine the direction, volume, and composition of international trade. He argued that under free, unregulated trade, each nation should specialize in producing those goods it could produce most efficiently (for which it had an **absolute advantage**, either natural or acquired). Some of these goods would be exported to pay for imports of goods that could be produced more efficiently elsewhere. Smith showed by his example of absolute advantage that both nations would gain from trade.

### absolute advantage

Theory that a nation has absolute advantage when it can produce a larger amount of a good or service for the same amount of inputs as can another country or when it can produce the same amount of a good or service using fewer inputs than could another country

**An Example** Assume that a world of two countries and two products has perfect competition and no transportation costs. Suppose that in the United States and China (a) one unit of input (combination of land, labor, and capital) can produce the quantities of soybeans and cloth listed in the following table, (b) each nation has two input units that it can use to produce either soybeans or cloth, and (c) each country currently uses one unit of input to produce each of soybeans and cloth. If neither country imports or exports, the quantities shown in the table are also those that are available for local consumption. The total output of both nations is 4 tons of soybeans and 6 bolts of cloth

Commodity	United States	China	Total Output
Tons of soybeans	3	1	4
Bolts of cloth	2	4	6

In the United States, 3 tons of soybeans or 2 bolts of cloth can be produced with one unit of output. Therefore, 3 tons of soybeans should have the same price as 2 bolts of cloth. In China, however, because only 1 ton of soybeans can be produced with the input unit that can produce 4 bolts of cloth, 1 ton of soybeans should cost as much as 4 bolts of cloth.

The United States has an absolute advantage in soybean production (3 to 1). China’s absolute advantage is in cloth making (4 to 2). Will anyone anywhere give the Chinese cloth maker more than 1 ton of soybeans for 4 bolts of cloth? According to the example, all American soybean producers should because they can get only 2 bolts of cloth for 3 tons of soybeans at home. Similarly, Chinese cloth makers, once they learn that they can obtain

more than 1 ton of soybeans for every 4 bolts of cloth in the United States, will be eager to trade Chinese cloth for American soybeans.

**Each Country Specializes** Suppose each nation decides to use its resources to produce only the product at which it is more efficient. The following table shows each nation's output. Note that with the same quantity of input units, the total output is now greater (a total output of 6 rather than 4 tons of soybeans, and 8 rather than 6 bolts of cloth).

Commodity	United States	China	Total Output
Tons of soybeans	6	0	6
Bolts of cloth	0	8	8

**Terms of Trade (Ratio of International Prices)** With specialization, now the total production of both goods is greater, but to consume both products, the two countries must trade some of their surplus. What are the limits within which both countries are willing to trade? Clearly, the Chinese cloth makers will trade some of their cloth for soybeans if they can get more than the 1 ton of soybeans that they get for 4 bolts of cloth in China. Likewise, the American soybean growers will trade their soybeans for Chinese cloth if they get a bolt of cloth for less than the 1.5 tons of soybeans it costs them in the United States.

If the two nations take the midpoint of the two trading limits so that each shares equally in the benefits of trade, they will agree to swap 1.33 bolts of cloth for 1 ton of soybeans. Both will gain from specialization because each now has the following quantities:

Commodity	United States	China	Total Output
Tons of soybeans	3	3	6
Bolts of cloth	4	4	8

**Gains from Specialization and Trade** Because each nation specialized in producing the product at which it was more efficient and then traded its surplus for goods that it could not produce as efficiently, both nations benefited. China gained 2 more tons of soybeans and the United States gained 2 more bolts of cloth.

Although Adam Smith's logic helped to convince many governments to dismantle trade barriers and encourage increased international trade, it failed to calm concerns of those whose countries lacked any absolute advantage. What if one country has an absolute advantage in the production of both soybeans and cloth? Will there still be a basis for trade?

## THEORY OF COMPARATIVE ADVANTAGE

David Ricardo demonstrated in 1817 that even though one nation held an absolute advantage over another in the production of each of two different goods, international trade could still create benefit for each country (thus representing a positive-sum game, or one in which both countries "win" from engaging in trade). The only limitation to such benefit-creating trade is that the less efficient nation cannot be *equally* less efficient in the production of both goods.<sup>10</sup>

**An Example** To illustrate how this can occur, let us slightly change our first example so that now China has an absolute advantage in producing *both* soybeans and cloth. Note that compared with China, the United States is less inefficient in producing soybeans (4 versus 5 tons produced from a single unit of input, or 80 percent as efficient as China)

### comparative advantage

Theory that a nation having absolute disadvantages in the production of two goods with respect to another nation has a comparative or relative advantage in the production of the good in which its absolute disadvantage is less

than in manufacturing cloth (2 versus 5 bolts of cloth from a single unit of input, or 40 percent as efficient). Therefore, the United States has a **comparative advantage** in producing soybeans.

Commodity	United States	China	Total Output
Tons of soybeans	4	5	9
Bolts of cloth	2	5	7

**Each Country Specializes** If each country specializes in what it does best, its output will be as follows:

Commodity	United States	China	Total Output
Tons of soybeans	8	0	8
Bolts of cloth	0	10	10

**Terms of Trade** In this case, the terms of trade will be somewhere between the pre-trade price ratios of 1 ton of soybeans for 1 bolt of cloth that Chinese soybean growers must pay in China and the 1/2 bolt of cloth that American cloth makers must pay for 1 ton of American soybeans.

Let us assume that the traders agree on an exchange rate of 3/4 bolt of cloth for 1 ton of soybeans. Both will gain from this exchange and specialization, as the following table shows:

Commodity	United States	China
Tons of soybeans	4	4
Bolts of cloth	3	7

Note that this trade left China with 2 surplus bolts of cloth and 1 less ton of soybeans than it had before specializing. However, the Chinese cloth manufacturers should be able to trade 1 bolt of surplus cloth for at least 1 ton of soybeans elsewhere. Then the final result will be as follows:

Commodity	United States	China
Tons of soybeans	4	5+
Bolts of cloth	3	6

**Gains from Specialization and Trade** Gains from specialization and trade in this case are 1 additional bolt of cloth for each of the United States and China, and about 1 more ton of soybeans for China.

This simple concept of comparative advantage serves as a basis for international trade, even when one nation has an advantage over another in the production of each of the goods being traded. We have presented the theory of comparative advantage without mentioning money; however, a nation's comparative advantage can be affected by differences between the costs of production factors in that country's currency and their costs in other currencies. As we shall see in the next section, money can change the direction of trade.

### offshoring

Locating activities in another nation



### Comparative Advantage and Offshoring of Service Jobs from the United States to India

India, a nation with approximately 1 billion people, has relatively few other resources compared with developed nations. Therefore, it should have a comparative advantage in production of goods or services that require large amounts of labor and relatively little capital. However, India has an additional comparative advantage because many of its citizens speak English (which is taught in many Indian schools and universities rather than using one of the other 18 major languages and 844 dialects spoken in the country). Thus, labor has a relatively low price due to the large Indian workforce (about 450 million, with nearly 10 million additional people entering the workforce each year), high levels of unemployment or underemployment (officially an unemployment rate of 8 percent, but a poverty rate that exceeds 20 percent), and a large proportion of rural and unskilled workers. As Internet and cellular telephone communications continue to become less expensive, India increasingly is using its English-speaking pool of labor to export services—such as software engineering, telemarketing, reviews of credit or mortgage applications, preparation or review of legal documents, analysis of blood tests and other medical services, and claims processing—to foreign companies and their customers, a process known as **offshoring**.

At \$76 billion in annual revenues in 2010-2011, the Indian information technology (IT) industry generated more than 5 percent of India's GDP, and the overall size of this sector is projected to grow to \$225 billion in revenues by 2020 as a result of factors such as declining computer prices, new tax incentives, and the Indian government's efforts to connect the country's extensive and isolated rural areas with the outside world. *Fortune* 500 companies such as Amazon.com, IBM, and American Express, as well as a range of more moderate-sized firms, have already offshored millions of jobs. By 2015, it has been estimated that 3.4 million U.S. jobs, representing \$136 billion in wages, will have been offshored, and India is well positioned to capture much of this business. According to Noshir Kaka of the consulting firm McKinsey, "This industry can do for India what automobiles did for Japan and oil for Saudi Arabia."

For example, 1.6 million U.S. individual and corporate tax returns were estimated to have been prepared in India in 2011. Documents obtained from taxpayers are scanned and shipped electronically to India, where forms are completed and sent back to the United States to be examined, approved, and signed by an American accountant. While a U.S. tax preparer might cost more than \$3,000 per month during the peak tax season, a comparable Indian worker might cost less than \$300. There is no requirement that the taxpayer be informed that the tax work is done abroad, and most accounting firms charge the same fees as those

charged if the job is done by accountants in the United States, thus helping to boost profitability.

Companies in financial services and insurance have also been actively pursuing offshoring. More than 80 percent of global financial services companies have an offshore facility, and the range of services being offshored is rapidly being broadened. "Offshoring has released a new competitive dynamic. Larger firms are driving change across the financial services industry and using offshoring to open up a competitive advantage over their smaller rivals," said Chris Gentle of the professional services firm Deloitte. "Offshoring is fundamentally changing the way financial institutions do business, creating a global division of labor that demands new operating models, new structures and new management skills."

"This is a global industry in the throes of flux. It is a sector where [Indian companies] are rewriting the rules of the game. That is the difference that has become apparent and increasingly accepted," says Nandan Nilekani, CEO of the rapidly expanding Indian company Infosys Technologies. The basis for this change, he says, is the "global delivery model" being pioneered in India and replicated in other low-cost nations. In the IT sector, for example, a plentiful supply of Indian software engineers can work on projects "offshore," delivering the finished product to clients "on site" in the United States. "Our business innovation is forcing rivals to redesign the way they do things."

This disruptive change is threatening to transform the business models in operation across a broad range of industries. Although many people think of low-skill jobs like telemarketing and call centers when they think of offshoring to India, the sophistication and skill levels associated with processes being outsourced are rising rapidly. A big driver for this trend is the abundance of qualified personnel in India. A NASSCOM-McKinsey study found that India has 28 percent of the overall supply of skilled services personnel in low-cost nations, and these potential employees remain amazingly inexpensive. An Indian IT engineer earns a typical annual salary of less than \$6,000 and one with a master's degree in business earns \$8,500—about one-tenth the level of their American counterparts, although salary inflation is starting to reduce that gap.

Services represent 60 percent of the U.S. economy and employ up to 80 percent of American workers, so it is not surprising that the offshoring of service jobs has generated concerns across a broad spectrum of society. John Steadman, president of the Institute of Electrical and Electronics Engineers, cautioned, "If we continue to offshore high-skilled professional jobs, the U.S. risks surrendering its leading role in innovation." Andrew Grove, former Chairman of Intel Corp., warned that "it's a very valid question" whether the United States could lose its dominance in information technology as a result of this trend, as it did in electronics manufacturing.

(continued)

Responding to the offshoring to an Indian firm of calls from New Jersey welfare recipients about their benefits, state senator Shirley Turner said, "I was outraged. Here we are in New Jersey, as we are in every state, requiring welfare recipients to go to work. And yet, we were sending these jobs overseas . . . so that corporations can make more money." She noted that unemployed people do not pay taxes, and the loss of these tax revenues exacerbates budget deficits. Ironically, widespread publicity regarding concerns about offshoring may have hastened the trend by making more companies aware of the possible cost savings from such undertakings.

On the other hand, some have argued that offshoring will help to strengthen American industry and the economy as a whole. Offshoring is not necessarily a zero-sum game, where one Indian worker substitutes for one American worker. When American firms hire lower-cost labor abroad, they often must hire other workers to complement the increased level of foreign labor. Overseas expansion can also cause companies to modify the scope of activities undertaken in the United States, placing increasing emphasis on higher-value-added activities rather than the lower-skill positions that have been offshored. Shifting work to lower-cost locations abroad has the potential to lower prices in the United States, thus raising the purchasing power of American consumers, enhancing consumer spending and economic activity, and thereby creating more jobs. As *The Wall Street Journal* editorialized, "The world economy is a dynamic enterprise. Jobs created overseas generate jobs at home. Not just more jobs for Americans, but higher-skilled and better paying ones. At the same time, trade offers consumers a greater quantity and variety of goods and services for lower prices. David Ricardo lives."

#### Questions:

1. What advantages other than profit can be gained by offshoring?
2. What are the ethical considerations, if any, that a company faces in making a decision to offshore activities?
3. What might be the long-term implications of offshoring, from the perspective of the home country? The host country?

**Sources:** Business Monitor International, *The India Information Technology Report 2008* (London: Business Monitor International, 2008), [www.businessmonitor.com/it/india.html](http://www.businessmonitor.com/it/india.html) (May 10, 2011); Meg Fletcher, "Moving Services Offshore," *Business Insurance*, June 2006, pp. 16–17; Joanna Slater, "In India, a Job Paradox," *The Wall Street Journal*, May 5, 2004, p. A12; Julie Gallagher, "Redefining the Business Case for Offshore Outsourcing," *Insurance & Technology*, April 2002, pp. A5, A8–A9; Khozem Merchant, "The Future on India's Shores," *Financial Times*, April 21, 2004, p. 8; "Outsourcing 101," *The Wall Street Journal*, May 27, 2004, p. A20; Rebecca Paley, "Fighting for the Down and Out(sourced)," *Mother Jones*, May/June 2004, pp. 20–21; Manjeet Kripalani and Pete Engardio, "The Rise of India," *BusinessWeek*, December 8, 2003, pp. 66–76; Robert Orr, "Offshoring Opens Gap in Financial Services Race," *Financial Times*, June 29, 2004, p. 9; SourcingNotes, "Offshoring Tax Returns Preparation to India," [www.sourcingnotes.com/content/view/197/54/](http://www.sourcingnotes.com/content/view/197/54/) (May 10, 2011); Heather Timmons, "India Feels Less Vulnerable as Outsourcing Presses On," *New York Times*, June 2, 2009, [www.nytimes.com/2009/06/03/business/global/03outsour.html](http://www.nytimes.com/2009/06/03/business/global/03outsour.html) (May 10, 2011); and "China Steadily Closing Gap with India as Top BPO Destination," *The Economic Times*, November 12, 2010, [http://articles.economicstimes.indiatimes.com/2010-11-12/news/27606950\\_1\\_offshore-countries-outsourcing-industry-global-outsourcing](http://articles.economicstimes.indiatimes.com/2010-11-12/news/27606950_1_offshore-countries-outsourcing-industry-global-outsourcing) (May 10, 2011).

## HOW MONEY CAN CHANGE THE DIRECTION OF TRADE

Suppose the total cost of land, labor, and capital to produce the daily output of soybeans or cloth in the example on absolute advantage is \$10,000 in the United States and 80,000 yuan in China. The cost per unit is as follows:

Commodity	Price per Unit	
	United States	China
Ton of soybeans	\$10,000/3 = \$3,333/ton	80,000 yuan/1 = 80,000 yuan/ton
Bolt of cloth	\$10,000/2 = \$5,000/bolt	80,000 yuan/4 = 20,000 yuan/bolt

To determine whether it is more advantageous to buy locally or to import, the traders need to know the prices in their own currencies. To convert from foreign to domestic currency, they use the *exchange rate*.

**Exchange Rate** The **exchange rate** is the price of one currency stated in terms of the other. If the prevailing rate is \$1 = 8 yuan, then 1 yuan must be worth 0.125 dollar.\* Using

\*If \$1 = 8 yuan, to find the value of 1 yuan in dollars, divide both sides of the equation by 8. Then 1 yuan = 1/8 = \$0.125.

#### exchange rate

The price of one currency stated in terms of another currency

the exchange rate of  $\$1=8$  yuan, the prices in the preceding example appear to the U.S. trader as follows:

Commodity	Price per Unit (dollars)	
	United States	China
Ton of soybeans	\$3,333	\$10,000
Bolt of cloth	\$5,000	\$ 2,500

The American soybean producers can earn \$6,667 more per ton by exporting soybeans to China than they can by selling locally,<sup>†</sup> but can the Chinese cloth makers gain by exporting to the United States? To find out, they must convert the American prices to Chinese yuan.

Commodity	Price per Unit (yuan)	
	United States	China
Ton of soybeans	26,664 yuan	80,000 yuan
Bolt of cloth	40,000 yuan	20,000 yuan

**currency devaluation**  
The lowering of a currency's price in terms of other currencies

It is apparent that the Chinese cloth makers will export cloth to the United States because they can sell at the higher price of 40,000 yuan per bolt. The American cloth makers, however, will need some very strong sales arguments to sell in the United States if they are to overcome the \$2,500 price differential.

**Influence of Exchange Rate** Soybeans to China and cloth to the United States will be the direction of trade as long as the exchange rate remains around  $\$1=8$  yuan. But if the dollar strengthens to  $\$1=24$  yuan, American soybeans will cost as much in yuan as do Chinese soybeans, and importation of American soybeans into China will cease. On the other hand, should the dollar weaken to  $\$1=4$  yuan, then 1 bolt of Chinese cloth will cost \$5,000 to American traders, and they will have little reason to import Chinese cloth into the United States. This example suggests that a nation can attempt to regain competitiveness in world markets through **currency devaluation** (lowering its price in terms of other currencies). Note that in many but by no means all cases, this action can leave domestic prices largely unchanged. This issue will be discussed further in Chapter 8.

## SOME NEWER EXPLANATIONS FOR THE DIRECTION OF TRADE

The international trade theory we have been discussing was essentially the only theoretical explanation of trade available to us until the second half of the 20th century. Since that time, however, several other possible explanations for international trade have been developed. We will discuss several of them.

<sup>†</sup>For example, to calculate this figure, you would multiply the American price of \$3,333 per ton of soybeans times 8 yuan per dollar, yielding a price of 26,664 yuan per ton.



### resource endowment

Theory that countries export products requiring large amounts of their abundant production factors and import products requiring large amounts of their scarce production factors

### overlapping demand

Theory that trade in manufactured goods will be greater between nations with similar levels of per capita income, and that the goods traded will be those for which consumers in both countries demand the same good

### product differentiation

The development of products that have unique differences, with the intent of positively influencing demand

### international product life cycle (IPLC)

A theory explaining why a product that begins as a nation's export eventually becomes its import

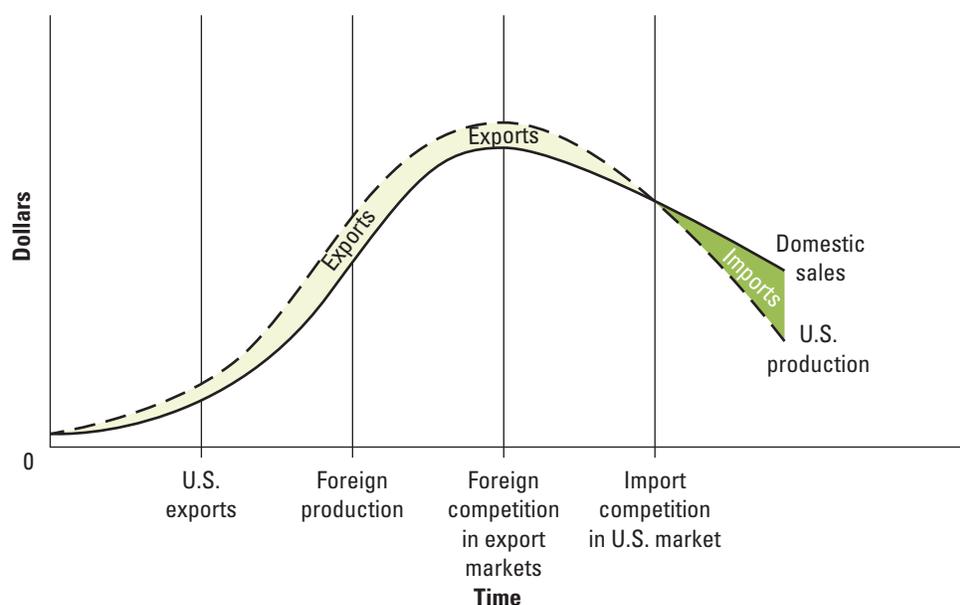
**Differences in Resource Endowments** Some countries have an abundance of resources, when compared to the endowments of other nations. For example, the United States has a large supply of fertile farmland, Chile has abundant supplies of copper, and Saudi Arabia has extensive amounts of crude oil. These differences in **resource endowments** can result in differences across countries in the opportunity cost of producing these resources. As a result, countries are likely to export those products that are less expensive for them to produce and to import products that are either unavailable domestically or that can be produced more cheaply in other nations. Theory based on differences in resource endowments would suggest that developed countries would be more likely to trade with developing countries, which have very different factor endowments, rather than with other developed countries that would have similar factor endowments. This theory can adequately explain international trade in primary products.

**Overlapping Demand** In contrast to resource endowment-based theory, Swedish economist Stefan Linder theorized that customers' tastes are strongly affected by income levels, and therefore a nation's level of income per capita determines the kinds of goods its people will demand. Because an entrepreneur will produce goods to meet this demand, the kinds of products manufactured reflect the country's level of income per capita. Goods produced for domestic consumption will eventually be exported, due to similarity of income levels and therefore demand in other countries.

The theory of **overlapping demand** thus deduces that international trade in manufactured goods will be greater between nations with similar levels of per capita income than between those with dissimilar levels of per capita income—the very situation observed in our review of trade data earlier in this chapter. Even though two developed countries may have similar factor endowments, which under the resource endowment theory would result in limited trade between them, these nations still can have a large volume of trade with each other. The goods that will be traded are those for which there is an *overlapping demand* (consumers in both countries are demanding the same good).<sup>11</sup> For example, if an American company such as Apple invents a sophisticated cell phone with advanced features for its home market, the best export opportunities for this phone will be in other advanced nations such as Japan and western European countries, even if these countries have their own domestic producers of cell phones. Note that the theory of overlapping demand differs from the theory of comparative advantage in that it does not specify in which direction a given good will go. In fact, this intraindustry trade occurs because of **product differentiation**; for example, Apple exports its cell phones to Europe and Japan and Sony-Ericsson exports cell phones to the United States, because consumers in these different markets perceive a difference in the brands.

**International Product Life Cycle** The hypothesis of an **international product life cycle (IPLC)** was formulated by Raymond Vernon.<sup>12</sup> This concept, which concerns the role of innovation in trade patterns, views a product as going through a full life cycle from the internationalization stage to standardization. The initial innovation stage of the cycle borrows from Linder's theory of overlapping demand in terms of the motivations and response of entrepreneurs to perceived market opportunities. The subsequent three stages through which a product is said to pass are illustrated in Figure 2.2 and described next. This concept can be applied to new product introduction by firms in any of the industrialized nations, but because more new products have been successfully introduced on a commercial scale in the United States, let us examine the **IPLC** as it applies to this country.

1. *U.S. exports:* Because the United States possesses the largest population of high-income consumers of any country in the world, competition for their patronage is intense. Manufacturers are therefore forced to search constantly for better ways to satisfy their customers' needs. To provide new products, companies maintain large research and development laboratories, which must be in constant contact with suppliers of the materials they need for product development. The fact that their suppliers are also in this country facilitates

**FIGURE 2.2**International  
Product Life Cycle

the contact.<sup>13</sup> In the early stages of the product life cycle, the design and the production methods are changing. By being close to the market, management can react quickly to customer feedback and more easily provide local repair services. These factors combine to make the United States a leader in new-product introduction. For a while, American firms will be the only manufacturers of the product; overseas customers, as they learn of the product, will therefore have to buy from American firms. The export market develops as the manufacturer ships products to these overseas customers.

2. *Foreign production begins:* Overseas consumers, especially those in developed nations, have similar needs and the ability to purchase the product. Export volume grows and may become large enough to support local production, especially in larger markets. The technology for producing the good has become fairly stable, and if the innovator is a multinational firm, it will often be sending its subsidiaries new-product information with complete details on how to produce it. Where there are no affiliates, foreign managers, as they learn of the product, will obtain licenses from the innovating company for producing the product (or else they may initiate efforts to imitate or invent around the innovator's technology in order to capture the market opportunity). Foreign production will begin, which also provides advantages of reduced costs for transportation and local communication. The American firm will still be exporting to those markets where there is no production, but its export growth will diminish as licensing and foreign direct investment substitute for exports as sources of supply to various international markets.
3. *Foreign competition in export markets:* Later, as early foreign manufacturers gain experience in marketing and production, their costs will fall. Saturation of their local markets will cause them to look for buyers elsewhere. They may even be able to undersell the American producers if they enjoy an advantage such as lower labor or raw material costs. In this stage, foreign firms are competing in export markets, and as a result, American export sales will continue to decline. By this stage, the innovating American firms may have developed newer versions of the product and begun scaling back production of the original product in order to begin focusing instead on the newer innovations.
4. *Import competition in the United States:* If domestic and export sales enable foreign producers to attain the economies of scale enjoyed by the American firm, they may reach a point where they can compete in quality and underprice American firms in the American market. From that point on, the U.S. market will be served exclusively (or nearly so) by imports. Televisions, footwear, and DRAM (dynamic random access memory)

semiconductor chips are examples of such products. This provides increasing pressure on the innovating company to achieve product innovation and improvement, which may correspondingly initiate a new IPLC.

Authors discussing the IPLC concept have claimed that this cycle may be repeated as the less developed countries (LDCs) with still lower labor costs obtain the technology and thus acquire a cost advantage over the more industrialized nations. Although little research has been done to substantiate the IPLC concept, a World Bank study seems to provide a plausible reason for these changes in production locations, as suggested in the following excerpt:

*With countries progressing on the comparative advantage scale, their exports can supplement the exports of countries that graduate to a higher level. . . . A case in point is Japan, whose comparative advantage has shifted towards highly capital-intensive exports. In turn, developing countries with a relatively high human capital endowment . . . can take Japan's place in exporting relatively human capital-intensive products, and countries with a relatively high physical capital endowment, such as Brazil and Mexico, can take Japan's place in exporting relatively physical capital-intensive products. Finally, countries at lower levels of development can supplant the middle-level countries in exporting unskilled labor-intensive commodities.*<sup>14</sup>

Recently, attention has been given to the emergence of companies that have been termed “born globals,” wherein companies become international in their operations almost from the beginning. Although some have argued that these firms may not internationalize their operations and products in the classic manner of the IPLC, they often increase commitment to international markets in a gradual way that may not be inconsistent with the IPLC concept.<sup>15</sup>

### **economies of scale**

Situation where the average cost of producing each unit of output decreases as a plant gets larger and output increases

### **experience curve**

Reduction of unit costs of production as accumulated volume increases, due to improved efficiency resulting from increased cumulative experience and learning

### **national competitiveness**

A nation's relative ability to design, produce, distribute, or service products within an international trading context while earning increasing returns on its resources

**Economies of Scale and the Experience Curve** In the 1920s, economists began to consider the fact that most industries benefit from **economies of scale**; that is, as a plant gets larger and output increases, the average cost of producing each unit of output decreases. This occurs because larger and more efficient equipment can be employed, companies can obtain volume discounts on their larger-volume purchases, and fixed costs such as those of research and design and administrative overheads can be allocated over a larger quantity of output. Most manufacturing is subject to economies of scale, and mining and transportation industries also tend to benefit from increasing returns to scale. Production costs also drop because of the **experience curve**. As firms produce more products, they learn ways to improve production efficiency, causing production costs to decline by a predictable amount.<sup>16</sup>

Economies of scale and the experience curve affect international trade because they can permit a nation's industries to become low-cost producers without requiring that the nation have an abundance of a certain class of production factors. Then, just as in the case of comparative advantage, nations specialize in the production of a few products and trade with others to supply the rest of their needs. International trade is promoted because a nation's companies may not be able to fully achieve the potential scale economies through serving only the domestic market, even within countries as large as the United States. Examples include semiconductors, computers, and commercial aircraft. American consumers can benefit from higher quality and lower prices for these products because companies like Intel, Hewlett-Packard, and Boeing can spread very high fixed costs over sales within foreign as well as home markets.

**National Competitive Advantage from Regional Clusters** **National competitiveness** involves a nation's ability to design, produce, distribute, or service products within an international trading context while earning increasing returns on its resources. A nation's ability to achieve sustained international success within a particular industry may be explained by variables other than the factors of production on which the theories of comparative advantage and resource endowment are based. For example, Alfred Marshall's seminal work on economic theory helped to explain why, in many industries, firms tend to cluster together on a geographic basis.<sup>17</sup> He suggested that geographic clusters appeared for three reasons: (1) advantages associated with pooling of a common labor force so that

staffing requirements can be met quickly, even with unexpected fluctuations in demand; (2) gains from the development of specialized local suppliers whose operations and skills can be coordinated with the needs of the buyers; and (3) benefits that result within the geographic region from the sharing of technological information and corresponding enhancement of the rate of innovation.

Michael Porter, an economics professor at Harvard, extended the work of Marshall.<sup>18</sup> His Diamond Model of national advantage claims that four kinds of variables will have an impact on the ability of the local firms in one country to utilize the country's resources to gain a competitive advantage:

1. *Demand conditions*: the nature, rather than merely the size, of the domestic demand. If a firm's customers are sophisticated and demanding, it will strive to produce high-quality and innovative products and, in doing so, will obtain a global competitive advantage over companies located where domestic pressure is less. This might have been the case in the past, when international firms introduced their new products in home markets first (a condition of the international product life-cycle theory), but as more firms introduce new products globally, this variable will lose importance.
2. *Factor conditions*: level and composition of factors of production. Porter distinguishes between the basic factor endowments and the advanced factors (a nation's infrastructure, such as telecommunications and transportation systems, or university research institutes). He also distinguishes between created factors (e.g., from investments made by individuals, companies, or governments) and inherited factors (e.g., natural resources, location). Lack of natural endowments has caused nations to invest in the creation of the advanced factors, such as education of a nation's workforce, free ports, and advanced communications systems, to enable their industries to be competitive globally. Various Caribbean nations have upgraded their communications systems to attract banking and other service companies that have little dependence on the basic factors of production.
3. *Related and supporting industries*: suppliers and industry support services. For decades, firms in an industry, with their suppliers, the suppliers' suppliers, and so forth, have tended to form a cluster in a given location, often without any apparent initial reason. Yet these related and supporting industries serve as an important foundation for competitive success by providing a network of suppliers, subcontractors, and a commercial infrastructure. For example, the San Francisco Bay Area in California has a range of related and supporting industries for the personal computer industry. These include research, design, production, or service operations of such suppliers as semiconductor designers, semiconductor manufacturers, technologically savvy venture capitalists, and intellectual property rights lawyers, as well as related industries such as scientific equipment, electronics (e.g., MP3 players, "smartphones" such as the iPhone), telecommunications equipment, software developers, and a wide range of Internet-related companies.<sup>19</sup>
4. *Firm strategy, structure, and rivalry*: the extent of domestic competition, the existence of barriers to entry, and the firms' management style and organization. Porter states that companies subject to heavy competition in their domestic markets are constantly striving to improve their efficiency and innovativeness, which makes them more competitive internationally. For decades, firms in oligopolistic industries have carefully watched their competitors' every move and have even entered foreign markets because their competitors had gone there. For example, Japanese automakers such as Toyota, Honda, Nissan, and Mitsubishi have competed vigorously with each other for decades in their domestic marketplace, constantly pressuring each other to improve the quality and performance of their products or else risk the loss of market share. This vigorous competition has enabled these firms to develop world-leading capabilities in auto design and manufacturing. As soon as one of these companies ventures forth into a new international market such as the United States, Europe, or Southeast Asia for the sale or manufacturing of autos, the competitors tend to be close behind in order to avoid a decline in their relative international competitiveness.

In addition to these four variables, Porter claimed that competitiveness could be affected by government and chance. For example, competitiveness may be influenced through government policies such as incentives, subsidies, temporary protection from foreign competitors, or infrastructure development, or through random events such as the location and timing of research breakthroughs or luck.

Porter argues that these factors are fundamentally interrelated, creating a “virtuous circle” of resource generation and application, as well as responsiveness in meeting the demands of customers, as depicted in Figure 2.3.

## SUMMARY OF INTERNATIONAL TRADE THEORY

International trade occurs primarily because of relative price differences among nations. These differences stem from differences in production costs, which result from:

1. Differences in the endowments of the factors of production.
2. Differences in the levels of technology that determine the factor intensities used.
3. Differences in the efficiencies with which these factor intensities are utilized.
4. Foreign exchange rates.

However, taste differences, a demand variable, can reverse the direction of trade predicted by the theory.

International trade theory shows that nations will attain a higher level of living by specializing in goods for which they possess a comparative advantage and importing those for which they have a comparative disadvantage. Generally, trade restrictions that stop this free flow of goods will harm a nation’s welfare. Chapter 6’s discussion of political forces examines a broad range of arguments that have been presented in support of restrictions on international trade of goods and services.

The topic we have been examining—international trade—exists because firms export. As you know, however, exporting is only one aspect of international business. Another—overseas production—requires foreign investment, the topic of the next section.

## Foreign Investment

Foreign investment can be divided into two components: **portfolio investment**, which is the purchase of stocks and bonds solely for the purpose of obtaining a return on the funds invested, and **direct investment**, by which the investors participate in the management of the firm in addition to receiving a return on their money. The distinction between these two components has begun to blur, particularly with the growing size and number of international mergers, acquisitions, and alliances in recent years. For example, investments

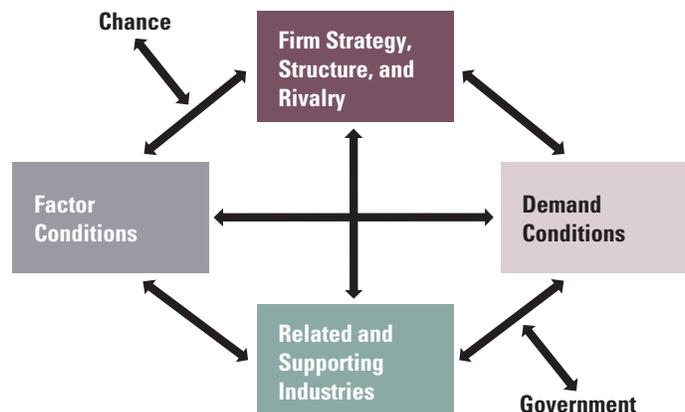
**L02-4 Explain**  
the size, growth, and direction of foreign direct investment.

**portfolio investment**  
The purchase of stocks and bonds to obtain a return on the funds invested

**direct investment**  
The purchase of sufficient stock in a firm to obtain significant management control

**FIGURE 2.3**

Variables Affecting National Competitive Advantage: Porter’s Diamond



Source: Reprinted by permission of the *Harvard Business Review*. “The Competitive Advantage of Nations” by Michael E. Porter, March–April 1990, p. 77. Copyright © 1990 by the President and Fellows of Harvard College, all rights reserved.

by a foreign investor in the stock of a domestic company generally are treated as direct investment when the investor's equity participation ratio is 10 percent or more. In contrast, deals that do not result in the foreign investor's obtaining at least 10 percent of the shareholdings are classified as portfolio investments. With the increasing pace of business globalization, it is not uncommon for companies to form strategic relationships with firms from other nations in order to pool resources (such as manufacturing, marketing, and technology and other know-how) while still keeping their equity participation below 10 percent. Financing from foreign venture capitalists also tends to be treated as a portfolio investment, although these investors frequently become actively involved in the target company's business operations, with the goal of ultimately realizing substantial capital gains when the target company goes public.

## PORTFOLIO INVESTMENT

Although portfolio investors are not directly concerned with the control of a firm, they invest immense amounts in stocks and bonds from other countries. For example, data from the Department of Commerce show that persons residing outside the United States owned American stocks and bonds other than U.S. Treasury securities with a value of \$5.3 billion at the beginning of 2010 (including \$2.4 billion in corporate stocks), nearly 11 times the level achieved 20 years earlier, at the beginning of 1990.<sup>20</sup> The very substantial proportion of the increase in the valuation of American stock held by persons residing outside this country is associated with the large number and scale of acquisitions of U.S. companies by foreign companies.

Americans, by contrast, owned \$5.5 billion in foreign securities at the beginning of 2010, which was more than 17 times the the corresponding level 20 years earlier, at the beginning of 1990.<sup>21</sup> Of the foreign securities held by Americans, \$4.0 billion was in corporate stocks. This increase reflects net U.S. purchases of foreign stocks, acquisitions of foreign companies by U.S. companies, and price appreciation in many foreign stocks. As you can see, foreign portfolio investment is sizable and will continue to grow as more international firms list their bonds and equities on foreign exchanges.

## FOREIGN DIRECT INVESTMENT

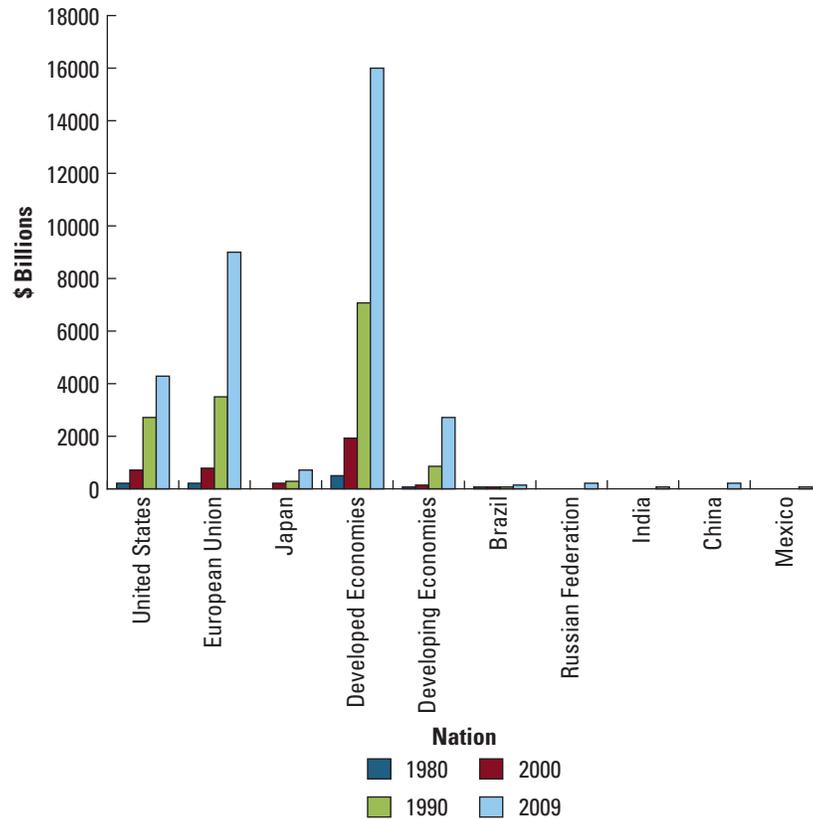
The following discussion examines the volume, level, and direction of foreign direct investment and the influence of international trade on foreign direct investment. This section discusses the overall level of foreign direct investment, as well as annual outflows and inflows of FDI.

**The Outstanding Stock of FDI** The *book value*—or the value of the total outstanding stock—of all foreign direct investment (FDI) worldwide was \$19.0 trillion at the beginning of 2010.<sup>22</sup> Individuals and corporations from the United States had \$4.3 trillion invested abroad, which was more than double the FDI of either of the next-largest investors, France and the United Kingdom. The proportion of FDI accounted for by the United States declined by 36 percent between 1980 and 2010, however, from 36 to 23 percent. During the same time period, the proportion of FDI accounted for by the European Union increased by nearly 31 percent, from 36 to 47 percent, although a portion of that increase was due to the inclusion of additional member-countries in the EU calculations. Japan's proportion of FDI declined from 12 percent in 1990 to 4 percent in 2010. Reflecting their continued economic development, developing countries have dramatically increased their share of FDI stock, from 1 percent in 1980 to 14 percent in 2010. Figure 2.4 highlights the rate of growth of FDI stock for selected nations and regions, particularly the M-BRIC emerging market economies, that is, Mexico, Brazil, Russia, India, and China.

An important development in the level of worldwide FDI is the emergence of what has been called the “bamboo network” of ethnic Chinese family businesses based outside of China. The 500 largest public companies in Asia that are controlled by overseas Chinese investors have more than \$1 trillion in total assets, and this figure excludes these families' privately owned companies.<sup>23</sup> Ethnic Chinese are reported to be the largest cross-border investors in Malaysia, Thailand, Indonesia, Vietnam, the Philippines, and Hong Kong, and they are a major source of investment capital flowing into the Chinese mainland.

**FIGURE 2.4**

Stocks of Outward Foreign Direct Investment, Selected Countries and Categories, 1980, 1990, 2000, and 2009 (\$ billions)



**Sources:** Various "Country Fact Sheets," *World Investment Report 2001*, United Nations Conference on Trade and Development, Geneva, October 2001; and *World Investment Report 2010*, United Nations Conference on Trade and Development, Geneva, [www.unctad.org/Templates/webflyer.asp?docid=13423&intltemID=5539&lang=1&mode=downloads](http://www.unctad.org/Templates/webflyer.asp?docid=13423&intltemID=5539&lang=1&mode=downloads) (May 10, 2011).

Another important development is the emergence of sovereign wealth funds, which are state-owned investment funds primarily from countries with either extensive commodity exports (e.g., petroleum) or trade surpluses. These funds were estimated to control approximately \$4.3 trillion in assets in 2011.<sup>24</sup> Some observers are concerned not merely with the level of assets controlled by these funds, but also the potential for sometimes secretive state-owned investment funds to make decisions based at least partly on political or other noncommercial criteria.

**Annual Outflows of FDI** Annual FDI outflows (the amount invested each year into other nations) hit a historical high in 2000—\$1.2 trillion, more than 250 percent of the level in 1997.<sup>25</sup> However, the slowdown that began to hit most of the world's economies in late 2000 resulted in a subsequent decline in the overall level of annual FDI flows. By 2002, the total was only \$537 billion, only about 44 percent of the 2000 figure. Outflows subsequently increased, reaching \$2.3 trillion in 2007 before declining again, decreasing more than 50 percent to \$1.1 trillion during the economic downturn of 2009.

The overall volume of outward FDI from developing nations in 2009 was 19 times the level in 1990, and the proportion of worldwide outward FDI that comes from developing nations increased from under 5 percent in 1990 to nearly 21 percent in 2009. Despite this increase, the vast proportion of outward FDI, nearly 80 percent, still originates from the developed countries. The United States and the EU have been accounting for the largest share of worldwide FDI—58 percent in 2009. The United States had been the leading source of FDI outflows through most of the 1990s and 2000s, although the proportion of worldwide outward FDI accounted for by the United States declined from an average of 21 percent in

1985–1996 to 18 percent for 2007–2009. American FDI outflows of \$248 billion in 2009 exceeded the outflows of the second-largest source of FDI, France, by 69 percent. The European Union’s proportion of outward FDI grew from an average of around 47 percent in 1985–1997 to a peak of 69 percent by 2005, before subsequently declining to 49 percent of global outward FDI from 2007–2009.

Much of this outward FDI has been associated with mergers and acquisitions. For example, historically, approximately two-thirds of the value of corporate investments made in the United States from abroad have been spent to acquire going companies rather than to establish new ones (similarly, the majority of American investments into foreign markets have gone to the acquisition of going companies). A number of reasons are responsible for this fact: (1) corporate restructuring in the United States caused management to put on the market businesses or other assets that either did not meet management’s profit standards or were considered to be unrelated to the company’s main business; (2) foreign companies wanted to gain rapid access in the United States to advanced technology, especially in computers and communications; (3) management of foreign firms felt that entrance into the large and prosperous American market could be more successful if they acquired known brand names rather than spending the time and money to promote new, unknown ones; and (4) increased international competitive pressures, including the pursuit of improved economies of scale, has led to restructuring and consolidation in many industries, and the acquisition of companies in major markets such as the United States has been a by-product of these industrial trends.

**Annual Inflows of FDI** In which countries are investments being made, and where do the investments come from? The industrialized nations invest primarily in one another, just as they trade more with one another. An average of nearly 70 percent of annual FDI investments have been going into developed countries in recent years, although the proportion has fallen from 81 percent in 2000 to 51 percent by 2009.<sup>26</sup> The United States and the EU accounted for an average of more than 60 percent of all inward FDI from 1985 to 2004, exceeding 80 percent in 1999 and 2000, before declining to 49 percent by 2008. As noted earlier, much of this inward investment has gone to mergers and acquisitions made by companies whose businesses are confronting competition and consolidation globally. Japan has not been a significant recipient of inward FDI, averaging less than 1 percent of worldwide FDI from 1985 to 2009.

Worldwide, level of FDI flowing into the developing countries as a whole was 7.3 times larger in 2000 versus 1990, and it nearly doubled again between 2000 and 2009. Although the overall dollar value of FDI going to developing countries has been increasing substantially in recent years, the proportion of FDI funds going to these nations has fluctuated widely. The average from 1985 to 1995 was 28 percent, rising to 38 percent in 1996, declining to 18 percent in 2000, rising again to 40 percent in 2004, declining to 27 percent in 2007, and then rising to 43 percent in 2009. African nations have participated relatively little in the growing flow of inward FDI, accounting for an average of less than 3 percent of all inflows from 1985 to 2009. The small nation of Singapore (population 3 million) received almost as much foreign investment as the entire African continent did during this time. An encouraging trend is that the percentage of all inflows going to Africa increased from 0.7 percent in 2000 to an average of 3.7 percent for the 2007 to 2009 time period.

In Latin America, annual FDI inflows have fluctuated substantially during the past two decades. The proportion of worldwide inward FDI flows that have gone to Latin America increased from 3.8 percent in 1990 to 8.5 percent in 1995, then declined to 5.6 percent in 2000, before rising to 7.1 percent in 2005 and an average of 5.7 percent for 2007–2009. For Asia as a whole, total inflows to the region rose to a record \$373 billion in 2008, nearly 1,300 percent of the average inward investments during 1985–1995. Asia accounted for 44 percent of all investments not directed to the United States and the European Union for the years 2008 and 2009. A particularly important trend is the proportion of Asian FDI that has been directed to China and its territories. Their combined proportion of Asian FDI was greater than 45 percent from 2007–2009, and it appears that some of the FDI previously directed toward other Asian nations might have been redirected toward these Chinese investments.



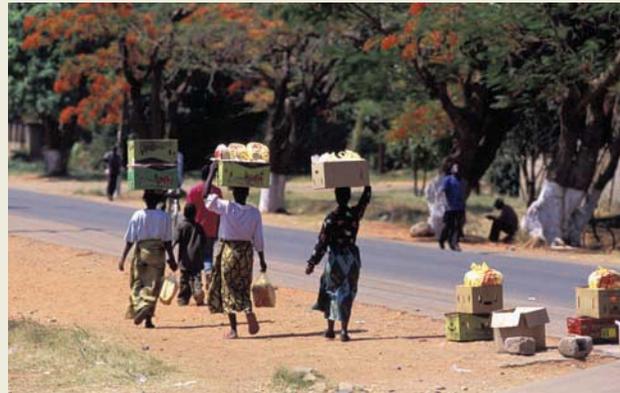
## Are Economic and Social Development Affected by Trade and Investment?

**All economies are increasingly open in today's economic environment of globalization. Trade plays a vital role in shaping economic and social performance and prospects of countries around the world, especially those of developing countries. No country has grown without trade. However, the contribution of trade to development depends a great deal on the context in which it works and the objectives it serves.**

This quote is the way the United Nations Conference on Trade and Development (UNCTAD) began its groundbreaking report examining international trade and developing countries. International trade clearly has an important role in influencing nations' economic and social performance in a world of globalization. This role is even more fundamental in the case of developing countries. Yet the mere expansion of trade does not guarantee improvement for a country and its people. Rather, it is essential that trade performance be viewed in the context of its effects on employment levels, economic growth, development, and an improvement in the overall human condition.

To assist in efforts to ensure that trade plays a full and constructive role in enhancing growth and development, UNCTAD launched an ambitious initiative that included the Trade and Development Index (TDI). By capturing the interactions among a range of institutional, structural, financial, trade, and development factors underlying trade and development, the TDI attempts to provide a quantitative indication of a nation's trade and development performance and facilitate national and international strategies and policies that will enable trade to serve as an important tool for promoting development. Although UNCTAD created the TDI primarily for assessing performance in developing nations, to facilitate comparisons and insight, it also constructed the TDI for developed countries and for newly industrializing countries. Overall, 123 countries were evaluated and the 20 top- and bottom-ranked countries are listed in the accompanying table.

The average score for developed countries was 640, versus 467 for developing countries and 395 for the least developed countries. Seven major emerging economies (Brazil, Russia, India, China, Mexico, South Korea, and South Africa), which account for 45 percent of the world's population and more than 26 percent of global exports of goods and services, had an average TDI score of 509, and they have all evidenced increasing TDI scores. This indicates that the gap in development can be shrunk—and has been in the case of several nations. Overall,



compared with developed countries, developing countries evidence a continuing lag in such areas as physical infrastructure, human capital, financial intermediation, institutional quality, economic and social well-being, and trade performance.

The initial TDI evaluation revealed that the 30 highest-ranked nations were all developed countries, except for Singapore (#5), South Korea (#21), China (#25), Malaysia (#27), and Thailand (#29). This result is interpreted as evidence that few developing nations have been able to come close to the developed countries in terms of their trade and development performance. Nine of the bottom 10 nations are sub-Saharan African countries, accentuating the severity of the trade and development problems confronting sub-Saharan Africa and least developed nations in general. The best regional performance among developing nations was that of the countries of the East Asia and Pacific region, followed by the Middle East and North Africa region and the Latin America and Caribbean region. The regions of South Asia and of sub-Saharan Africa significantly lagged behind the other three regional groups in terms of their TDI scores.

A critical factor contributing to high TDI scores is trade liberalization. The importance of this factor is highest for countries with lower TDI scores, and vice versa. This suggests that the extent of trade liberalization has much greater importance for developing countries, and especially the least developed countries, than for developed nations. In general, over the longer term and in the absence of externalities or market failures, trade liberalization is an effective policy promoting development. However, efforts to liberalize too rapidly can also result in short-term adjustment problems.

Both external and internal factors were found to influence a nation's export performance. External factors include market access conditions (e.g., transportation costs, geography, physical infrastructure, trade barriers, competition) and other factors that influence demand for imports. Internal factors

**Level and Direction of FDI** Even though it is impossible to make an accurate determination of the present value of foreign investments, we can get an idea of the rate and amounts of such investments and of the places in which they are being made. This is the kind of information that interests managers and government leaders. It is analogous to what is sought in the analysis of international trade. If a nation is continuing to receive

## Top and Bottom Ranked Countries on the Trade and Development Index

Top-Ranked Countries			Bottom-Ranked Countries		
Rank	Country	TDI Score	Rank	Country	TDI Score
1	United States	743	103	Zimbabwe	395
				Pakistan	395
2	Germany	696	105	Syrian Arab Republic	392
3	Denmark	691		Chad	392
4	United Kingdom	682	107	Côte d'Ivoire	387
5	Singapore	675		Mauritania	387
6	Japan	668	109	Burkina Faso	386
	Sweden	668	110	Benin	384
8	France	664	111	Burundi	382
	Norway	664	112	Central African Republic	381
10	Canada	650		Zambia	381
	Switzerland	650	114	Ethiopia	379
12	Belgium	642	115	Cameroon	373
	Iceland	642	116	Guinea	372
14	Finland	636	117	Yemen	370
15	Ireland	630	118	Angola	364
16	Australia	628		Democratic Republic of Congo	364
17	Austria	627	120	Niger	362
18	New Zealand	623	121	Nigeria	350
19	Spain	619	122	Guinea-Bissau	339
20	Israel	610	123	Sudan	326

include supply-side conditions within a nation (e.g., raw materials, labor and capital costs, access to technology, economic policy, institutional environment). A country's extent of market access is particularly important, because limitations on access for foreign markets are a major cause of poor export performance.

Foreign direct investment (FDI) was found to have a significant and positive impact on export performance across all of the nations studied and for every time period studied. FDI has a key role in influencing the composition of exports, including the technological content and the development of export supply capacity, and especially in knowledge-based industries. The impact of FDI is strongest for the two poorest performing groups of exporters and at their early stages of export development.

UNCTAD emphasized that merely improving trade factors, such as liberalizing the trade environment, will yield only marginal benefits for a nation unless these efforts are done in conjunction with a focus on other factors associated with development and poverty reduction. There is a strong need for integration and consistency between trade policy and other social, political, and economic undertakings. For example,

nations must act simultaneously both on domestic capacity to supply goods and services and on access to foreign markets in order to produce strong performance. At early stages of development, important factors influencing domestic supply capacity include transportation infrastructure and macroeconomic stability.

### Questions:

1. Why might trade and investment impact the social and economic development of a country?
2. What actions should a developing country take in order to enhance the potential benefits from international trade and development?

Sources: UNCTAD, *Developing Countries in International Trade 2005: Trade and Development Index* (New York: United Nations, 2005), [www.unctad.org/templates/webflyer.asp?docid=6443&intItemID=1397&lang=1&mode=downloads](http://www.unctad.org/templates/webflyer.asp?docid=6443&intItemID=1397&lang=1&mode=downloads) (May 10, 2011); and UNCTAD, *Developing Countries in International Trade 2007: Trade and Development Index* (New York: United Nations, 2007), [www.unctad.org/Templates/Page.asp?intItemID54388&lang51](http://www.unctad.org/Templates/Page.asp?intItemID54388&lang51) (May 15, 2010).

appreciable amounts of foreign investment, its investment climate must be favorable. This means that the political forces of the foreign environment are relatively attractive and that the opportunity to earn a profit is greater there than elsewhere. Other reasons for investing exist, to be sure; however, if the preceding factors are absent, foreign investment is not likely to occur.

## DOES TRADE LEAD TO FDI?

Historically, foreign direct investment has followed foreign trade. One reason is that engaging in foreign trade is typically less costly and less risky than making a direct investment into foreign markets. Also, management can expand the business in small increments rather than through the considerably greater amounts of investment and market size that a foreign production facility requires. Typically, a firm would use domestic or foreign agents to export. As the export business increased, the firm would set up an export department and perhaps hire sales representatives to live in overseas markets. The firm might even establish its own sales company to import in its own name.

Meanwhile, managers would watch the total market size closely because they would know that their competitors were making similar studies. Generally, because the local market would not be large enough to support local production by all the firms exporting to it, the situation would become one of seeing who could begin manufacturing there first. Experienced managers know that governments often limit the number of local firms making a given product so that those that do set up local operations will be assured of having a profitable and continuing business. This is especially important to developing countries that are dependent on foreign investment to provide jobs and tax revenue.

This sort of linear path to market expansion that we have just discussed is one that many international firms have taken and still take today. However, the new business environment of fewer government barriers to trade, increased competition from globalizing firms, and new production and communications technology is causing many international firms to disperse the activities of their production systems to locations close to available resources. They then integrate the entire production process either regionally or globally. As a result, the decision about where to locate may be either an FDI or a trade decision, illustrating just how closely FDI and trade are interlinked.

**L02-5 Explain**  
several the theories  
of foreign direct  
investment.

## Explaining FDI: Theories of International Investment

This section examines several of the leading theories of foreign direct investment, which comprises both ownership and control of international investments involving real or physical assets such as plants and other facilities, rather than theories regarding other types of international investment such as portfolios of stocks, bonds, or other forms of debt. Foreign direct investment involves the establishment of production or other facilities abroad, either through greenfield investment (the establishment of new facilities from the ground up) or cross-border acquisition (the purchase of an existing business in another nation). It is usually assumed that strategic motives will be the driving force for decisions to invest abroad, driven by desire to find new markets, access raw materials, achieve production efficiencies, gain access to new technologies or managerial expertise, enhance political safety of the firm's operations, or respond to competitive or other pressures in the external environment.<sup>27</sup>

### MONOPOLISTIC ADVANTAGE THEORY

The modern **monopolistic advantage theory** stems from research showing that foreign direct investment occurs largely in oligopolistic industries rather than in industries operating under near-perfect competition. This means that the firms in these industries must possess advantages not available to local firms in order to overcome liabilities associated with being a foreigner—such as lack of knowledge about local market conditions, increased costs of operating at a distance, or differences in culture, language, laws and regulations, or institutions—that cause a foreign company to be at a disadvantage against local firms. Under this perspective, the advantages must be economies of scale, superior technology, or superior knowledge in marketing, management, or finance. Foreign direct investment takes place because of these product and factor market imperfections, which enable the multinational enterprise to operate more profitably in foreign markets than can local competitors.<sup>28</sup>

**monopolistic  
advantage theory**  
Theory that foreign  
direct investment  
is made by firms in  
oligopolistic indus-  
tries possessing  
technical and other  
advantages over  
indigenous firms

## INTERNALIZATION THEORY

The **internalization theory** suggests that a firm may have superior knowledge, but due to inefficiency in external markets (i.e., transaction costs), the firm may obtain a higher price for that knowledge by using the knowledge itself, rather than by selling it in the open market. By investing in foreign subsidiaries for activities such as supply, production, or distribution, rather than licensing, the company is able to send the knowledge across borders while maintaining it within the firm. The expected result is the firm's ability to realize a superior return on the investment made to produce this knowledge, particularly as the knowledge is embodied in various products or services that are sold to customers.<sup>29</sup>

## DYNAMIC CAPABILITIES

The **dynamic capability** perspective argues that ownership of specific knowledge or resources is necessary, but not sufficient, for achieving success in international FDI. The firm must also be able to effectively create and exploit dynamic capabilities for quality and/or quantity-based deployment, and these capabilities must be transferable to international environments in order to produce competitive advantage. Companies typically develop centers of excellence in order to develop distinctive competencies that will be subsequently applied to their investments within the host countries.



## ECLECTIC THEORY OF INTERNATIONAL PRODUCTION

The eclectic theory, which combines elements of some of those we have discussed, is the most widely cited and accepted theory of FDI currently. Developed by Dunning, the **eclectic theory of international production** attempts to provide an overall framework for explaining why firms choose to engage in FDI rather than serve foreign markets through alternatives such as exporting, licensing, management contracts, joint ventures, or strategic alliances. This theory maintains that if a firm is going to invest in production facilities overseas, it must have three kinds of advantages:

1. *Ownership specific.* This is the extent to which a firm has or can develop a firm-specific advantage through ownership of tangible and intangible assets that are not available to other firms and can be transferred abroad. The three basic types of tangible or intangible ownership-specific advantages include knowledge or technology, economies of scale or scope, and monopolistic advantages associated with unique access to critical inputs or outputs. The advantage generates lower costs and/or higher revenues that will offset the added costs of operating at a distance within a foreign location.
2. *Location specific.* A foreign market must have specific characteristics, of an economic, social, or political nature (e.g., market size, tariff or nontariff barriers, or transport costs), that will permit the firm to profitably exploit its firm-specific advantages by locating to that market rather than from serving the market through exports.
3. *Internalization.* Firms have various alternatives for entering foreign markets, ranging from arm's-length market transactions to the use of hierarchy via a wholly owned

### internalization theory

The concept that to obtain a higher return on its investment, a firm will transfer its superior knowledge to a foreign subsidiary, rather than sell it in the open market

### dynamic capability

Theory that for a firm to successfully invest overseas, it must have not only ownership of unique knowledge or resources, but the ability to dynamically create and exploit these capabilities over time

### eclectic theory of international production

Theory that for a firm to invest overseas, it must have three kinds of advantages: ownership specific, internalization, and location specific

subsidiary, as we will discuss in Chapter 13. It is in the firm's best interests to exploit its ownership-specific advantages through internalization in those situations where either the market does not exist or it functions inefficiently, causing the transaction costs of using market-based (arm's-length) options to be too high.

Because of the names of these three types of advantages that a firm must have, the eclectic theory of international production is sometimes referred to as the *OLI model*. This theory provides an explanation for an international firm's choice of its overseas production facilities. The firm must have both location and ownership advantages to invest in a foreign plant. It will invest where it is most profitable to internalize its monopolistic advantage.<sup>30</sup> These investments can be proactive, being strategically anticipated and controlled in advance by the firm's management team, or reactive, in response to the discovery of market imperfections.

There is one commonality to nearly all of these theories that is supported by empirical tests—the major part of direct foreign investment is made by large, research-intensive firms in oligopolistic industries. Also, all these theories offer reasons companies find it *profitable* to invest overseas. However, as we stated in Chapter 1, all motives can be linked in some way to the desire to increase or protect not only profits but also *sales* and *markets*.



## THE GLOBAL PATH AHEAD

### Kerry Thwing on Developing a Foundation in the International Area



The daughter of a travel agent, I was exposed to the “travel bug” as a baby. Ever since I can remember, my mother would plan yearly family vacations. Travel became a part of my life, and I would look forward to the adventures and experiences that would come with each trip. I was 16 when I decided to set out on

my first international solo excursion. I participated in a student exchange program to France, staying with a family in Cognac for a month and exploring Paris for a week. My life would not be the same had I chosen to stay home instead of taking a chance and leaving my comfort zone for this solo adventure. During that month abroad, I learned so much about myself and about others. I came home a wiser, more confident person. Now the travel bug had bitten me officially.

In college, I participated in three study abroad programs. My first year, I traveled to South America via a training ship as part of the Cal Poly at Sea study abroad program. We made port in Mexico, Chile, Peru, and Costa Rica. Then the summer of my second year, I studied in London, England. Finally, my fourth and final year at university, I studied in Adelaide, Australia. Though the ultimate purpose of these excursions was to complete the courses needed for my bachelor's degree in business administration, I learned so much more and such different things than I ever could have from a textbook or lecture. Travel can provide the ultimate education. Nothing can compare to the experience of leaving your comfort zone and observing your actions and the actions of others in a different environment.

Through international travel, not only will you learn about different cultures and values around the world, you will also learn many things about yourself. You can discover what you are truly capable of and you may be quite surprised by what you find. During my travels, there were many instances when things did not go as planned, but it is those times that are the most memorable for me. I was always pleasantly surprised by my ability to adapt and problem solve when put in a difficult situation. This is a skill that I learned through travel, and it has proven useful in many aspects of my life.

However, my favorite aspect of travel is the people that I have met, the connections to others that I have made. Throughout my time abroad, I have gained many great friends on a global

scale. In fact, the majority of the relationships I have cultivated are related to my study abroad programs. It is important, especially when going with your friends to study abroad, to branch out and meet the locals. Not only will they be able to tell you about the city you are visiting, they will also teach you about the culture and may even become your new friends.

If I could give any piece of advice, I would say to take any chance you can to travel and experience new things. The only regrets I have are the opportunities that I did not take advantage of. In addition, take every chance you can *now* because you never know what will happen in the future. Personally, I decided to take the opportunity to return to Adelaide to complete my post-graduate education. I am currently residing in Adelaide and planning my next excursion abroad. I would encourage you to do the same as I do: explore every chance you can to spend time abroad.

### Resources for Your Global Career

The successful international business professional looks beyond his or her home-country borders and continually explores and learns more about the world in which he or she lives and works. It is necessary to know and understand world facts and data, and to keep current with world events that will affect his or her ability to successfully engage in global business transactions.

**Culture Cue.** In dealing with your foreign counterparts, listen as much as you talk. Feel free to talk about your home country, but also ask the people you are meeting to tell you about their country, their customs, and their way of life. This type of

conversation helps you to learn more about their part of the world, and it builds rapport. In many parts of the world, rapport and friendship must first be established before business will ever be discussed. This is a critical first step to doing business in many places in the world, including much of Latin America, the Middle East, and Asia.

#### Resources for Trade and FDI Statistics Worldwide:

**CIA—The World Factbook:** [www.cia.gov/library/publications/the-world-factbook/](http://www.cia.gov/library/publications/the-world-factbook/)

**UNCTAD—United Nations Conference on Trade and Development Trade Statistics:** [www.unctad.org/Templates/Page.asp?intlItemID=1584&lang=1](http://www.unctad.org/Templates/Page.asp?intlItemID=1584&lang=1)

**OECD—Organisation for Economic Cooperation and Development Statistics Portal:** [www.oecd.org/statsportal/0,2639,en\\_2825\\_293564\\_1\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/statsportal/0,2639,en_2825_293564_1_1_1_1_1,00.html)

**ISTIA—International Services Trade Information Agency:** [istia-services.org/](http://istia-services.org/)

**Financial Times FDI Portal:** [www.locoonline.com/](http://www.locoonline.com/)

**JETRO—Japan External Trade Organization:** <http://www.jetro.org/>

**Multilateral Investment Agency of the World Bank Group FDI in Emerging Markets Portal:** [www.fdi.net/](http://www.fdi.net/)

**FDI Intelligence:** [www.fdiintelligence.com/](http://www.fdiintelligence.com/)

**Links to English language newspapers from around the world, listed by country:** [www.thebigproject.co.uk/news/](http://www.thebigproject.co.uk/news/)

## Summary

### L02-1 Appreciate the magnitude of international trade and how it has grown.

The volume of international trade in goods and services measured in current dollars exceeded \$18.9 trillion in 2010. Merchandise exports, at \$15.2 trillion, were nearly five times what they were in 1990. Services exports were only \$3.7 trillion in 2008, but their rate of growth has been faster than that of merchandise exports.

### L02-2 Identify the direction of trade, or who trades with whom, and trends in such trade.

Developed countries tend to trade with developed countries and they account for a majority of the exports worldwide. More than half of the exports from developing countries also go to developed countries, although this proportion has been declining. The rise of regional trade agreements, as well as other factors, is transforming the volume and direction of world trade in merchandise and services. More than 70 percent of world trade now occurs between members of regional trade agreements.

### L02-3 Outline the theories that attempt to explain why certain goods are traded internationally.

Why do nations trade? Mercantilists did so to build up storehouses of precious metals. Later, Adam Smith's theory of absolute advantage showed that a nation will export goods that it can produce with less labor than can other nations. Ricardo then proved that even though a country is less efficient than other nations, that country can still profit by exporting goods if it holds a comparative advantage in the production of those goods.

Newer explanations for the direction of trade include the idea that a nation tends to export products requiring a large amount of a resource that is relatively abundant in that nation. In contrast to resource endowments, Linder theorized that because customers' tastes are strongly affected by income levels, a nation's income level per capita determines the kinds of goods they will demand. The kinds of goods produced to meet this demand reflect the country's income per capita. International trade in manufactured goods will be greater between nations with similar levels of per capita

income. The international product life-cycle theory states that many products first produced in the United States or other developed countries are eventually produced in less developed nations and become imports to the very countries in which their production began. Porter helped to explain how nations can achieve competitive advantage through the emergence of regional clusters, claiming that four classes of variables are critical in this regard: demand conditions; factor conditions; related and supporting industries; and firm strategy, structure, and rivalry. Competitiveness can also be affected by government and by chance.

#### **L02-4 Explain the size, growth, and direction of foreign direct investment.**

The book value of FDI was \$19.0 trillion at the beginning of 2010. Although the largest source of this FDI, the proportion of global foreign direct investment accounted for by the United States has been declining, while the proportion accounted for by the European Union has risen. The proportion of FDI originating from the developing nations has also been increasing. On an annual basis, more than 85 percent of the outstanding stock of FDI at the beginning of 2010 came from developed countries.

The annual outflows of FDI often vary substantially, especially in conjunction with global economic cycles. Overall, nearly 8 percent of outward FDI originates from the developed countries, with nearly three-quarters of that

money coming from the United States and the EU. In terms of destination for outward FDI, an average of nearly 70 percent of annual FDI investments have been going into developed countries in recent years, although the proportion is declining, with a majority of this investment occurring in the form of acquisitions of existing companies. The level of FDI flowing into developing countries was 7.3 times larger in 2000 versus 1990, and it nearly doubled again by 2009. The direction of FDI follows the direction of foreign trade; that is, developed nations invest in each other just as they trade with each other.

#### **L02-5 Explain several theories of foreign direct investment.**

International investment theory attempts to explain why FDI takes place. Product and factor market imperfections provide firms, primarily in oligopolistic industries, with advantages not open to indigenous companies. The internalization theory states that firms will seek to invest in foreign subsidiaries, rather than license their superior knowledge, to receive a better return on the investment used to develop that knowledge. The dynamic capabilities perspective suggests that firms must have not only ownership of specific knowledge or resources, but also the ability to dynamically create and exploit capabilities in order to achieve success in FDI. The eclectic theory explains an IC's choice of its overseas production facilities. The firm must have location and ownership advantages to invest in a foreign plant. It will invest where it is most profitable to internalize its monopolistic advantage.

## Key Words

**mercantilism** (p. 37)

**absolute advantage** (p. 38)

**comparative advantage** (p. 40)

**offshoring** (p. 40)

**exchange rate** (p. 42)

**currency devaluation** (p. 43)

**resource endowment** (p. 44)

**overlapping demand** (p. 44)

**product differentiation** (p. 44)

**international product life cycle (IPLC)** (p. 44)

**economies of scale** (p. 46)

**experience curve** (p. 46)

**national competitiveness** (p. 46)

**portfolio investment** (p. 48)

**direct investment** (p. 48)

**monopolistic advantage theory** (p. 54)

**internalization theory** (p. 55)

**dynamic capability** (p. 55)

**eclectic theory of international production** (p. 56)

## Questions

- How has trade in merchandise and services changed over the past two decades? What have been the major trends? How might this information be of value to a manager?
- Knowing that a nation is a major trading partner of another signifies what to a marketing analyst?
- Describe mercantilism, and explain why mercantilism has been argued to be a poor approach to use in order to promote economic development and prosperity.
- Explain Adam Smith's theory of absolute advantage.
  - How does Ricardo's theory of comparative advantage differ from the theory of absolute advantage?
- "The greater part of international trade consists of an exchange of raw materials from developing nations for manufactured goods from developed nations." True or false? Explain.

6. Name some products that you believe have passed through the four stages of the international product life cycle.
7. Use Porter's Diamond Model of national advantage to explain why an emerging market such as Indonesia would be expected to experience great difficulty in achieving global competitiveness in a new industry sector such as "smart" cell phones or hybrid electric-gasoline automobile engines.
8. What are the different components of foreign investment? Why has the distinction between them begun to blur in recent years?
9. How has the level and direction of FDI changed over the past two to three decades, both overall and in terms of annual outflows and inflows? Why would this information be of relevance to managers?
10. According to theories presented in this chapter, why do companies engage in foreign direct investment?



globalEDGE.msu.edu

## Research Task

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

1. A.T. Kearney's annual *Global Services Location Index* (GSLI) evaluates the attractiveness of countries as an offshore destination. Locate the most recent study, and prepare a short report addressing the following questions: How is the Global Services Location Index calculated? According to the ranking, which 10 countries are the best destinations for providing outsourcing activities? Why do you think these countries are attractive as potential location for offshore services?
2. You are working at an automotive company that is currently searching for new opportunities for investment in emerging countries. Visit the *FDI.net* web portal, and find potential investment opportunities in the automotive sector. In which countries are the opportunities being offered? Select one of these opportunities and prepare a brief report summarizing what it entails.

## Minicase: Can Brazil Become a Global Competitor in the Information Technology Outsourcing Business?

As the world becomes increasingly dependent on information technology (IT) products and services, the global IT outsourcing industry has expanded rapidly. Driven by global competitive pressures to reduce costs and focus on core competencies, corporations of all sizes have chosen to outsource and offshore many of their IT services. As a result, offshoring of IT services has been growing at a 40 to 50 percent compounded annual rate. Worldwide, India has established a strong leadership position in the IT outsourcing market, accounting for the largest share among countries. However, challenges have begun to emerge for India's IT sector, including increasing labor costs, inadequate physical infrastructure, and a daunting government bureaucracy, among other factors. Many nations, particularly emerging markets in Asia, Latin America, and eastern Europe, have been attempting to capture a share of the IT offshoring business because it is seen as a source of skilled jobs and a basis for improving overall economic development.

Although many people would associate the country with soccer or samba, Brazil has emerged as a global competitor in a range of sophisticated technology sectors. Now, Brazil has launched an active campaign to build a strong international competitive position in the IT offshoring business, trying to attract business that might otherwise be going to these other nations or regions.

Brazil's IT outsourcing sector is small relative to India's, but strong growth is projected based on the country's strengths along several dimensions. As the 5th largest country and 11th most powerful economy in the world, Brazil has a sophisticated telecommunications and network services infrastructure, one that has been rated higher than India or China on such key measures as network availability. Brazil has a tradition of strong engineering schools, capable of producing high-quality technical graduates. With nearly 300,000 people employed in IT services, the size of Brazil's domestic market for IT services is comparable to that of world-leading India, although a much smaller level of IT services are exported. The country has one of the world's most automated and sophisticated banking sectors and a dynamic domestic marketplace for IT software and support services. Brazil also offers a large base of affordable real estate for establishing corporate operations. Brazilian wage rates are about 40 percent of those for comparable hourly positions in the United States. Employee turnover is only about 20 percent, versus the 40 percent rate that has been plaguing Indian IT companies. Total operating costs, which include labor, infrastructure costs, corporate taxes and incentives, are lower than competitors from most competing low-wage and moderate to-high wage nations. Brazil also boasts only a single time zone difference to the East Coast of the United States and four time zones for the U.S. West Coast and parts of

Europe. This minimal time zone difference provides Brazil with an advantage compared to competitors in China or India in terms of ease of access and coordination with clients and the offshore project support teams. Brazilian business practices, culture, and values are more Westernized than is common for nations such as India and China, which can facilitate shared understanding and effectiveness of working relationships with companies in the United States and western Europe. “The countries share many cultural references—music, movies, television shows, etc. You wouldn’t have to explain who Mickey Mouse is to a Brazilian, but that may not necessarily be the case when it comes to somebody from India,” explained Carlos Diaz, a vice president for Meta4. “Outsourcing is not just about completing a project; it is also about having a relationship with a vendor that you know and trust. This becomes much trickier when your outsourcing partner has different cultural sensibilities and is on the other side of the world,” says Antonio Gil, Chairman of the Brazilian Association of Software and Services Export Companies. As Peter Bendor-Samuel, CEO of Everest, says, “‘Yes’ in Brazil typically means ‘yes.’ In India, it may mean ‘no.’” Encouraged by strengths such as these, companies such as Accenture, Hewlett-Packard, Electronic Data Systems, Whirlpool, Gap Inc., and IBM have been expanding their offshoring activities in Brazil. In late 2010, IT consultancy CapGemini announced an investment of \$298 million into CPM Braxis, a Brazilian IT service provider, in an effort to wrest leadership away from its other global competitors. Even competitors from India, such as Tata Consultancy Services, Infosys, and Wipro, have begun to aggressively expand into Brazil.

Despite the country’s many strengths, Brazil also has some limitations. For example, underinvestment in electrical generation could make the country prone to the brownout and blackout problems that have plagued other emerging markets, including India. The Portuguese-speaking Brazilian population has also been characterized as being weak in terms of English-language skills, and there is a shortage of international experience among Brazilian technical and managerial ranks, which could be problematic for multinationals hoping to set up operations there. Only 7 percent of

the population of nearly 190 million people has a university degree, and Brazil also suffers from a somewhat cumbersome regulatory climate, including inflexible labor laws, as well as a currency that has been prone to fluctuations over the past several decades. Even with wage inflation in India and China, Brazil’s labor costs remain 30 to 40 percent higher. Brazil also has problems in terms of crime and social inequality, especially in big urban centers such as Rio de Janeiro and Sao Paulo.

#### Questions:

1. Use the theories of international trade and investment that have been presented in this chapter to help explain Brazil’s intentions and actions regarding the international information technology sector.
2. What recommendations would you give to the Brazilian government and its outsourcing industry in order to improve their prospects for success in building a strong international competitive position in the information technology outsourcing business?

Sources: Diana Farrell, Martha Laboissiere, and Bruno Pietracchi, “Assessing Brazil’s Offshoring Prospects,” *The McKinsey Quarterly*, 2007 (special edition: Shaping a New Agenda for Latin America), pp. 7–9; Todd Benson, “Brazil Aims to be Outsourcing Giant,” *International Herald Tribune*, May 18, 2005, [www.iht.com/articles/2005/05/17/business/outsourcing.php](http://www.iht.com/articles/2005/05/17/business/outsourcing.php) (May 10, 2011); Marco Silva, “Brazil as an Outsourcing Destination,” [www.sourcingmag.com/content/c060201a.asp](http://www.sourcingmag.com/content/c060201a.asp) (May 10, 2011); Gina Ruiz, “Brazil Seeks Outsourcing Dominance,” [www.workforce.com/section/hr-management/archive/feature/brazil-seeks-outsourcing-dominance/252397.html](http://www.workforce.com/section/hr-management/archive/feature/brazil-seeks-outsourcing-dominance/252397.html) (May 10, 2011); Stephanie Overby, “Outsourcing: Brazil Blossoms as IT Services Hub,” *CIO*, September 8, 2010, [www.cio.com/article/610635/Outsourcing\\_Brazil\\_Blossoms\\_as\\_IT\\_Services\\_Hub](http://www.cio.com/article/610635/Outsourcing_Brazil_Blossoms_as_IT_Services_Hub) (May 10, 2011); and Antonio Regalado, “Soccer, Samba and Outsourcing?” *The Wall Street Journal*, January 25, 2007, [www.brazil-it.com/archives/2007/01/soccer\\_samba\\_an.php](http://www.brazil-it.com/archives/2007/01/soccer_samba_an.php) (May 10, 2011).

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# International Institutions from an International Business Perspective



Every institution not only carries within it the seeds of its own dissolution, but prepares the way for its most hated rival.

—Dean William R. Inge, 1860–1954, Dean of St Paul's, London

## The United Nations Going Forward: The Paradox of its Evolution

At the closing of World War II, the victorious Allied powers gathered to create an institution to reduce the likelihood of future wars. In their optimism, they formed the United Nations, a supranational institution. According to historian Mark Mazower, the institution had two main objectives: first, to promote peace, since nations themselves and the League of Nations formed after WWI had failed miserably at this; and second, to extend the power of the Allies.\* It is this last objective that is of special interest, because it can be understood as an attempt to institutionalize the influence of the Allied powers and to continue their control and dominance long after the war.

This last objective, Mazower argues in *No Enchanted Palace: The End of Empire and the Ideological Origins of the United Nations*, is an attempt to institutionalize their colonial approach and explains the Security Council membership (the United Kingdom, the United States, Russia, France, and China [originally the ROC, and since 1972, the PRC]) and their UN veto power.

The UN is not the empire's enforcer today, though. The major issue that has changed the UN into an organization that protects humanitarian and minority rights developed incrementally, beginning with the UN's endorsement of the creation of the sovereign state of Israel. Mazower points out that in the 1950s and 1960s, the UN supported self-determination; over time, this issue has moved the UN from a major supporter of empire to a forum for anti-colonialism. Today, political decisions are largely made by the G-20, the United States, the EU, NATO, and China—not the UN. The beauty of paradox.

The UN is still dominated by the major powers, yet rather than operate as an enforcer, its purpose centers around its members' shared appreciation of its function as a forum for discussion among all members and a place to share acceptance of legal and diplomatic norms. As a result of its role as a forum, the UN does some important things. It provides international standardization where needed, as with flight patterns and law of the sea, peacekeeping missions, disaster relief, care for refugees, and food security.

Mazower suggests that if we understand the origins and 65-year history of the UN, we will appreciate its evolution and judge it based on what it does. It is not a supranational moral force; it has not lost its moral purpose. It is not an enchanted palace. Rather, it has evolved to become an

# 3

## learning objectives

In this chapter, you will learn about areas that will enable you to:

- LO3-1** **Explain** the importance of international institutions to business decision makers and their firms.
- LO3-2** **Describe** the various types of institutions, drawing on institutional theory.
- LO3-3** **Outline** the United Nations as an institution and its relevance to international business.
- LO3-4** **Describe** the purposes of the two global monetary institutions, the IMF and the World Bank.
- LO3-5** **Discuss** the purpose of the World Trade Organization and its impact on international business.
- LO3-6** **Discuss** the resources of the Organisation for Economic Cooperation and Development.
- LO3-7** **Identify** the levels of economic integration and the effectiveness of the major trading blocs.
- LO3-8** **Discuss** the EU, its impact, and its challenges going forward.

important forum, one that nations need in order to discuss and agree on issues that matter and one whose many technical agencies provide the background support needed for peaceful co-existence.

\* Mark Mazower, *No Enchanted Palace: The End of Empire and the Ideological Origins of the United Nations*, Princeton, NJ: Princeton University Press, 2009.

We begin this chapter by examining the institutions that are most important to the international manager, moving from those that focus on global cooperation (such as the United Nations, the World Trade Organization, and the International Monetary Fund) to those whose concerns are mainly regional (such as regional trade alliances). Once we comment on why institutions

are important to the international manager, we begin with a focus on basics: what institutions are and how they influence the firm.

Strong institutions are important for international decision makers. To illustrate their importance, think about the roles of China and the United States on the global stage: one a superpower, the other a rapidly developing nation preparing for a major global role. Martin Wolfe, chief economist at the *Financial Times*, notes that both nations are fated to cooperate.<sup>1</sup> Yet look at their differences: as Wolfe points out, one is a democracy, the other an autocracy; one is “a child of the enlightenment,” the other an agrarian empire. Although working together will not be easy for either, international institutions encourage such efforts and make them more likely to succeed by developing multilateral solutions, in which all nations cooperate.

So at a basic level, institutions are important to business decision makers because they provide ways to settle conflict and resolve disagreements and they provide support and infrastructure for decision makers. For example, the World Trade Organization outlines trade practices among member nations and makes judgments when a member claims the rules have been violated.

The institutions we review in this chapter also provide opportunities for interesting careers. The United Nations and the Organisation for Economic Cooperation and Development routinely have career positions to fill in such fields as economics, languages, law, project management, and information technology. All of the institutions we cover have internship opportunities, as well. For more information, contact the specific organization through its website.

In this chapter, we examine the institutions that are most important to the international manager. The scope of these international institutions, all of which focus on various types of cooperation, is from global to regional; some are inclusive, with memberships composed of many countries, while others are exclusive and have relatively few member-nations. Most are groupings of governments, but there are private institutions that may be critically important to the international manager. Before we examine these institutions, we explore what institutions are and how we might understand their direct influence on the firm.

**L03-1 Explain**  
the importance of international institutions to business decision makers and their firms.

### **new institutional theory**

Understanding of institutions as social constructs, a collection of norms that structure the relations of individuals to one another

## **Institutions**

### **WHAT ARE INSTITUTIONS AND WHY ARE THEY USEFUL?**

Institutions are organizations constructed by a group, society, or culture to achieve a common goal that functions to “provide stability and meaning to social life.”<sup>2</sup> A contemporary understanding of institutions suggests that they are a collection of norms that “regulate the relations of individuals to each other.”<sup>3</sup> That is, institutions are socially constructed—a group, society, or culture constructs them—and they limit behavior. This approach to understanding institutions, called **new institutional theory**, suggests that decision makers in business might understand institutions as organized collections of basic rules and unwritten codes of conduct that limit and direct the decisions firms can make. Managers might well use a rules-of-the-game image to capture this view of institutions striving to reduce uncertainty in the firm’s external environment.<sup>4</sup>

## TYPES OF INSTITUTIONS

Institutions influence behavior in several ways. **Formal institutions** operate through laws and regulations, while **informal institutions** use norms, values, customs and ideologies.<sup>5</sup> Formal institutions, such as national governments, are major rule-setters, especially in the geographical area they control, but in some cases, far beyond their borders. Think of the power and the explicit rules of the European Union or of the United States tax authorities. The European Union's Directorate General for Competition is a body that influences the international firm's behavior when it wants to execute a merger or acquisition, even if the companies involved in the proposed transaction are not European. Why? Because if the merged business wants to sell into the EU, its merger or acquisition requires EU approval. The EU can also mandate product composition and computer code openness, as Microsoft has learned in regard to bundling software and sharing code. Formal institutions, then, function to constrain and regulate the firm's behavior through rules, laws, and sanctions—all mechanisms that enforce or coerce compliance. Firms comply with the rules of formal institutions because to do so makes sense; expedience is the basis of firm compliance.

While formal institutions use laws and regulations to gain compliance, informal institutions rely on norms, values, customs, and ideologies to mold behavior. We find two types of informal institutions, normative and cognitive. *Normative* informal institutions establish standards, “propagate principles, and broadly represent ‘humanity’.”<sup>6</sup> Examples of normative institutions are professional organizations and nongovernmental organizations (NGOs) that influence behavior through shared norms and values. The United Nations is also an informal normative institution. Behavior in this class of institution is influenced through shared norms; compliance is built on social obligation. For example, in the United Nations, members agree to abide by the UN's resolutions because they have so committed publicly to do so, they have accepted social obligations.

The other type of informal institution, the cognitive, is of tremendous importance to the international manager. *Cognitive* institutions use shared ideas to define reality by means of conceptual frameworks or schema. These concept-based informal institutions are often less explicit or tangible and less obvious to the non-native than are the formal institutions or informal normative institutions, because ideas are invisible. Different cognitive institutions contribute greatly to the challenges of international business. We can find examples of cognitive institutions in the contrast between the Japanese and American supplier relationship and in the Chinese concept of *guanxi*.

Supplier relationships contrast greatly between Japan and the United States. Remember our earlier image for institutions as setting the rules of the game? The “supplier game” in Japan calls for the supplier to build a relationship with the potential buyer. Such a relationship allows the firm to build knowledge about the reliability of the supplier, which is most important. Price, then, is likely to not be an early determinant of the buy decision in Japan. In contrast, in supplier relationships in the United States, the game is thought of differently. Price plays a more prominent initial role. Note, too, that the cultural custom in the United States is to share drinks after the deal is sealed, because drinks are a reward. But in Japan, drinks happen before the deal is structured, as a way to build the relationship, and continue during and after. None of these culture-based frameworks (role of price, role of shared drinks, and many other roles) that constitute the supplier process is formalized, yet these assumptions about the right way to negotiate with suppliers are institutionalized and operate to limit behavior choices and reduce uncertainty for the supplier and buyer in both Japan and the United States. Of course, they create uncertainty and confusion for those unaware that these cognitive institutions exist.

*Guanxi*, a Chinese institution that describes a type of relationship similar to a combination of social capital and mentoring, is another example of an informal cognitive institution. Difficult for non-Chinese to understand at times, *guanxi* relationships carry obligations that may be stronger than civic responsibilities and rational understandings of business situations. So delivering on a *guanxi* obligation may not make business sense to the Westerner,

**L03-2 Describe**  
the various types of institutions, drawing on institutional theory.

### **formal institutions**

Institutions that influence behavior through laws and regulations

### **informal institutions**

Institutions that influence behavior through norms, values, customs and ideologies

but doing so makes perfect psychological and moral sense to the Chinese in such a mentoring relationship.

These examples illustrate that informal institutions, which consist of voluntary agreements or a set of shared assumptions, a bit like the mind's software,<sup>7</sup> exert a powerful influence on how decision makers in the firm understand their environment, and thus, the choices open to the firm in international activities. An international business scholar, Mike Peng, noted that in developing economies, informal institutions tend to play a greater role than in developed economies. One way to think of this relationship is that the informal institutions emerge to bring added order to the chaotic, unstructured environment in the developing economy, which lacks well-developed formal institutions.<sup>8</sup>

Richard Scott developed the framework we are using to describe the types of institutions international managers encounter. Figure 3.1 describes these types of institutions in more detail, including the basis of compliance to their rules or norms, how they institutionalize, the inherent logic at work in them, the basis of their legitimacy, and their indicators or evidence.<sup>9</sup>

To illustrate the importance of strong international institutions, let's think again about the roles of China and the United States on the global stage, one a rapidly developing nation preparing for a major global role, the other a superpower. As Martin Wolfe points out, one is a democracy, the other an autocracy; one "a child of the enlightenment," the other an agrarian empire. Although working together will not be easy for either, international institutions encourage such efforts and make them more likely to succeed by developing multilateral solutions, in which all member nations cooperate. For individual nations, agreeing to abide by a mutually negotiated UN resolution or a World Trade Organization rule is much more acceptable than agreeing to a bilateral negotiation, which tends to be zero sum, with a winner and a loser, and in which power and prestige are at stake. There is no humiliation at stake with a negotiated UN resolution that applies to all nations' behavior. Figure 3.2 shows the influence of institutions on firms, their managers and their behavior.

**L03-3 Outline**

the United Nations as an institution and its relevance to international business.

**United Nations (UN)**

192-member organization dedicated to the promotion of peace and stability of the world

## The United Nations

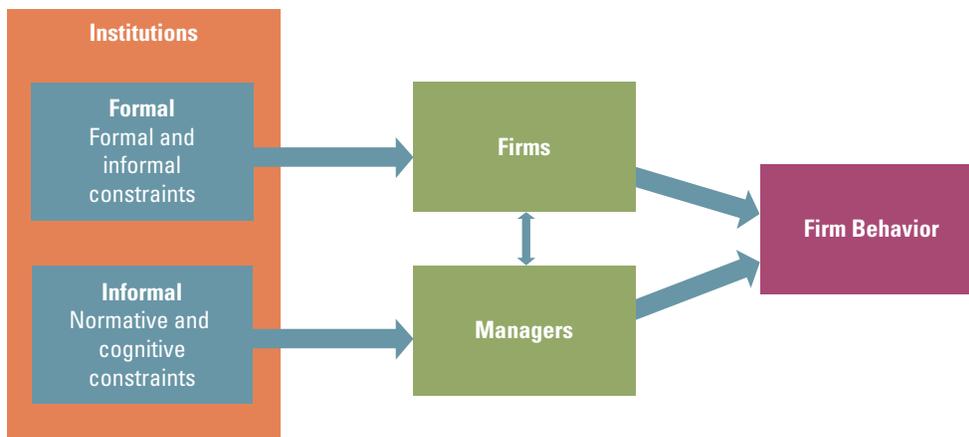
The **United Nations (UN)** is probably the best-known worldwide organization. Its 192 member-nations are dedicated to the promotion of peace and global stability. Many of its activities relate directly to business and to the infrastructure on which business operations depend. For example, the UN is responsible for international agreements that directly affect commercial relationships, including much of the body of international law. In addition, as a stabilizing force in the world economy, the UN contributes to the conditions under which international business is conducted. Because the UN operates with voluntary agreements,

**FIGURE 3.1**

Institutions:  
Characteristics

Institution type:		Formal	Informal	
Social agreement is:		Regulative	Normative	Cognitive
Attributes	Compliance based on	Expedience	Social obligation	Predisposition (taken for granted)
	Institutionalization based on	Coercion	Norms	Imitation
	Logic based on	Means to an end	Appropriateness	Conformance, orthodoxy
	Legitimacy based on	Legal enforcement	Moral governance	Cultural support, concept correctness
	Indicators/Evidence	Rules, laws, sanctions,	Certification, accreditation	Prevalence, similarity

Source: J. McNett after W. R. Scott (1995) p. 10.

**FIGURE 3.2**

Influence of  
Institutions on  
Firms, Managers,  
and Firm Behavior

Source: Influenced by W. R. Scott (2008) and W. M. Peng (2002, 2008).

it is largely an informal institution. Here are some general areas in which the UN plays a significant role for international business:

- UN agreements set technical standards and norms. These standards and norms function as the “soft infrastructure” for the global economy. The United Nations Center for Trade Facilitation and Electronic Business (UN/CEFACT) has standardized trade documents and developed standards for electronic data exchange.
- UN efforts prepare the ground for investment in emerging economies and the development of their workforce through a focus on areas such as health, education, governance, and political stability. The United Nations Educational, Scientific, and Cultural Organization (UNESCO) actively promotes literacy for the world’s approximately 1.25 billion adults and children (18 percent of the world’s total population) who cannot read and write.
- Various UN agencies address the downsides of globalization, such as terrorism, crime, drugs, and arms traffic. Treaties that focus on areas of terrorism such as the taking of hostages have been developed so that agreed-upon responses among UN members exist.
- UN efforts to seek solutions to global environmental problems include the work of the UN Environment Programme (UNEP), the agency that laid the groundwork for the Climate Change Convention, leading to the Kyoto Protocol to reduce greenhouse gases. The UNEP has developed many initiatives that support sustainable business practices.
- The UN addresses education and health issues that require global-level solutions arrived at in partnership with businesses, through the Global Compact, an effort to partner private industry with groups in developing nations.
- The UN promotes social justice and human and labor rights. Central to these concerns is the UN Economic and Social Council.
- Efforts of the UN build the cornerstones of an interdependent world: trust and shared values. The Global Compact provides a framework for businesses that are committed to aligning their operations and strategies with 10 universally accepted principles in the areas of human rights, labor, the environment and anticorruption. This is one example of UN efforts to build trust and shared values.<sup>10</sup>

In addition to the general areas of impact on business just described, the UN has direct impact on the conduct of business in quite specific ways, because UN committees negotiate the global “rules of the game” for the international exchanges of goods, services, money, and information.

- When ships sail freely across the seas and through international straits, they are protected by rules legitimized in UN conferences.

- Commercial airlines have the right to fly across borders, and to land in case of emergency, due to agreements negotiated by the International Civil Aviation Organization, part of the UN system.
- The World Health Organization sets criteria for pharmaceutical quality and standardizes drug names.
- Universal Postal Union protocols prevent losses and allow the mail to move across borders.
- The International Telecommunication Union allotment of frequencies keeps the airwaves from becoming hopelessly clogged, and thus avoids interference among radio transmissions.
- Data collected and redistributed from member-states by the World Meteorological Organization make possible worldwide and country-specific weather forecasts.
- The UN Sales Convention and the UN Convention on the Carriage of Goods by Sea help to establish rights and obligations for buyers and sellers in international commercial transactions.<sup>11</sup>

In terms of direct business engagement with the UN, the site <http://business.un.org/> lists collaborations with business, so you can see how many firms, including the National Basketball Association (NBA), Nike, Nestlé, Microsoft, and Starbucks partner with the UN.

## UN ORGANIZATION

The work of the United Nations is carried out through five active bodies, called *organs* in UN terminology. All UN member-nations are members of the **General Assembly**, the main deliberative body in which each nation has one vote regardless of its size, wealth, or power. The General Assembly acts by adopting resolutions that express the will of the member-nations. General Assembly decisions are normative and carry the heavy weight of world opinion, yet they have no legally binding force for governments or citizens in the member-nations. We are presently in the 65th session of the General Assembly, and its open meetings are available via webcast. The daily business of the General Assembly is contained in the *Journal of the United Nations*, available at [www.un.org/en/documents/journal.asp](http://www.un.org/en/documents/journal.asp) in the six UN languages, Arabic, Chinese, English, French, Russian, and Spanish.

The **UN Security Council** has responsibility for maintaining international peace and security. Membership is five permanent members—China, France, the Russian Federation, the United Kingdom, and the United States—each having veto power, and 10 nonpermanent members elected by the General Assembly and representing specific regions to ensure every area is represented. This is the organ that historian Mark Mazower argues was intended to ensure that the Allies continued their political and economic domination after WWII, an effort which, he concludes, has achieved its opposite, the support of minorities and human rights. Presently, the Security Council's peacekeeping operations are active in 14 locations in Africa, the Americas, Europe, Asia and the Pacific, and the Middle East. The UN also sends political missions, such as the one now active in Afghanistan.<sup>12</sup> Current Security Council peacekeeping is illustrated in Figure 3.3 and includes more than 84,000 troops donated by 15 UN members.

The **Economic and Social Council (ECOSOC)** is concerned with economic and social issues, including trade, transport, industrialization, economic development, population growth, children, housing, women's rights, racial discrimination, illegal drugs, crime, social welfare, youth, the human environment, and food. ECOSOC makes recommendations on how to improve education and health conditions and promotes respect for and observation of the human rights and freedom of people everywhere. These are all actions that contribute to a high-quality workforce.

The **International Court of Justice (ICJ)**, also known as the World Court, makes legal decisions involving disputes between national governments and gives advisory opinions. Because only nations litigate before the court, governments often intervene on behalf of corporations and individuals in their countries. Even though the court has worldwide

### General Assembly

Deliberative body of the UN made up of all member-nations, each with one vote regardless of size, wealth, or power

### Security Council

Main peacekeeping body of the UN, composed of 15 members including 5 permanent members

### Economic and Social Council (ECOSOC)

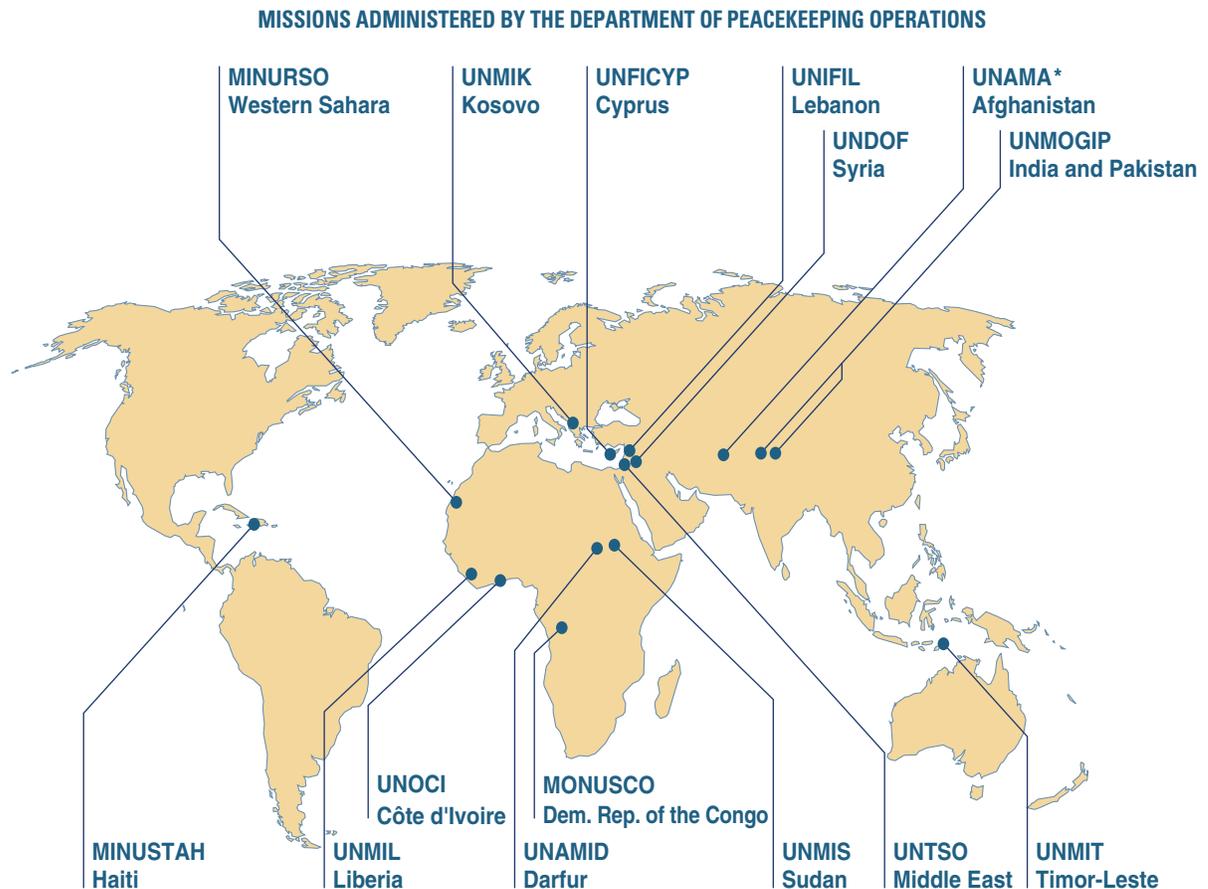
UN body concerned with economic and social issues such as trade, development, education, and human rights

### International Court of Justice (ICJ)

UN body that makes legal decisions involving disputes between national governments

**FIGURE 3.3**

Missions Administered by the Department of Peacekeeping Operations



Map No. 4259 Rev. 12(E) UNITED NATIONS  
January 2011

\* political mission

Department of Field Support  
Cartographic Section

United Nations, *On the Front Line*, p. 13, [http://www.unaids.org/en/media/unaids/contentassets/documents/document/2011/20110519\\_OnTheFrontLine.pdf](http://www.unaids.org/en/media/unaids/contentassets/documents/document/2011/20110519_OnTheFrontLine.pdf). (accessed May 10, 2011).

jurisdiction to hear disputes between governments, it hears relatively few cases. There are presently three cases being heard and 16 cases pending.<sup>13</sup> The ICJ has 15 judges, who come from 15 different countries and serve nine-year terms, appointed by majorities of the General Assembly and the Security Council.

The **Secretariat**, headed by the secretary-general of the United Nations, is the UN's staff. The secretary-general is appointed by the General Assembly on the recommendation of the Security Council for a five-year renewable term. The eighth secretary-general, Ban Ki-Moon of Korea, began his first term in 2007. About 44,000 people from around the world make up the UN Secretariat staff.

### Secretariat

The staff of the UN, headed by the secretary-general

## UN MILLENNIUM DEVELOPMENT CAMPAIGN

The UN's Millennium Development Campaign was launched at the millennium, 2000. Its goal is to end poverty by 2015. The eight goals include ending hunger, gender equity, universal education, child health, maternal health, combat HIV/AIDS, environmental sustainability, and global partnership. One hundred eighty-nine government leaders have signed on to the Millennium Declaration and endorsed the urgency "to free our fellow men, women and children from the abject and dehumanizing conditions of extreme poverty, to which more than a billion of them are currently subjected."<sup>14</sup> The Millennium goals have fostered



**L03-4 Describe**  
the purposes of the two global monetary institutions, the IMF and the World Bank.

**Bretton Woods**  
1944 conference at which allied nations' treasury and central bank representatives met to establish the International Monetary Fund and the World Bank

**International Monetary Fund (IMF)**  
Institution that fosters global monetary cooperation, financial stability, international trade, high employment and sustainable economic growth, and reduction of poverty

much institutional collaboration, both at the process and technical levels (e.g., the IMF) and the program levels (World Bank loans, UN development work, nongovernmental groups). These collaborations often involve businesses, both as contributors and suppliers to aid programs.

## International Monetary Institutions

There are two global monetary institutions, the International Monetary Fund and the World Bank, both established at the Bretton Woods conference, called by the UN in 1944, near the end World War II and held at the Mount Washington Hotel in Bretton Woods, New Hampshire. **Bretton Woods** is significant because it resulted in the world's first negotiated agreement among independent nations to support trade through monetary institutions. These meetings, attended by representatives of the 44 allied nations, set up the **International Monetary Fund (IMF)** to establish rules for international monetary policies and their enforcement and the **World Bank** to lend money for development projects. Since then, the IMF purpose has gained depth and breadth, and now, in addition to fostering global monetary cooperation, it helps nations secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty.

### INTERNATIONAL MONETARY FUND

The premise of the International Monetary Fund, which operates as a collaboration of nations, is that the common interest of all nations in a workable international monetary system far transcends their conflicting national interests.<sup>15</sup> The IMF promotes international monetary cooperation, including orderly exchange arrangements and payments

systems, and makes funds available for balance-of-payments corrections. Each of the 187 members contributes funds, known as *quotas*, determined by the nation's relative size in the world economy. The number of votes a nation has is also determined by its quota. Currently, the quota formula is a weighted average of GDP (50 percent), openness (30 percent), economic variability (15 percent), and international reserves (5 percent).<sup>16</sup> Quota changes in 2011 included increases for 54 countries, including China, Korea, Turkey, Brazil, and Mexico, and was approved by IMF members in order to give these dynamic, developing economies a greater role in institutional decision making. Under the new quota system, China has become the third largest vote-holding nation with 6.07 percent of the total votes, while the United States has 16.479 percent, Germany has 5.308, and Japan 6.138.<sup>17</sup>

Quotas are denominated in **Special Drawing Rights (SDRs)**, the IMF's unit of account that also serves as an international reserve asset. SDRs are like a paperless currency. The largest member of the IMF is the United States, with a current quota of SDR 37.1 billion (about \$58 billion), and the smallest member is Tuvalu, with a current quota of SDR 1.8 million (about \$2.7 million). The SDR's value is linked to a basket of currencies: the euro, Japanese yen, pound sterling, and U.S. dollar. The U.S. dollar equivalent of the SDR is posted daily on the IMF's website; the SDR value on July 5, 2011, was \$1.60042.

The aggregate quotas form a pool of money from which the IMF can lend. Although the IMF officially deals solely with governments, it also collaborates with many other international institutions because IMF policies and actions have a profound impact on business worldwide. They set the monetary framework for trade. In this chapter, we discuss the major institutions the IMF works along side of in collaborative relationships, including the World Bank, the World Trade Organization and the UN. With the UN, collaboration is especially significant in relation to the UN's Millennium Goals. The IMF also collaborates with various civil society organizations that have complementary interests such as trade unions, non-governmental organizations, governments, religious organizations, and other civic groups, in order to support their efforts to build financial stability and thereby create the conditions necessary to reduce poverty.

## IMF AND EXCHANGE RATES

The IMF Articles of Agreement, which took effect in 1945, set up fixed exchange rates among member-nations' currencies, with **par value** based on gold and the U.S. dollar, which was valued at \$35 per ounce of gold. Previously, the gold standard, which had used gold as the common denominator among currencies, had undergone severe pressure, such as during the Great Depression (1929–1933). To illustrate the Bretton Woods system, the British pound's par value was set at US\$2.40, the French franc's at US\$0.18, and the German mark's at US\$0.2732. There was an understanding that the U.S. government would redeem dollars for gold and that the dollar was the only currency to be redeemable for gold. This new system, which lasted from 1944 to 1971, was a dollar-based gold exchange standard. Through it, the U.S. dollar became both a means of international payment and a reserve currency. Later, we will discuss the effects of this arrangement on the U.S. economy and how the currency exchange rate system has evolved. In 1971, President Nixon took the United States off the gold standard by literally closing the gold window at the U.S. Treasury, where people would queue to exchange currency for gold. As the IMF struggles today with core issues related to its purpose in a changing world, some economists think that exchange rates may be an area for renewed IMF focus.

## CURRENT IMF ISSUES

The recent global financial crisis has broadened the criticism of the IMF's role in globalization. The IMF works to help economies manage the risks inherent in globalization such as globalized capital markets whose unpredictable and rapid changes challenge economies. IMF economists focus on providing technical assistance with exchange rate issues, macroeconomic policy and financial sector stability. And therein lies the issue.

### World Bank

Institution that lends money for development projects

### Special Drawing Rights (SDRs)

An international reserve asset established by the IMF

### par value

Stated value

IMF aid is often tied to a country's following IMF advice for achieving increased financial stability, which often includes a reduction of both budget deficits and inflation. These measures, monetarist in their approach, actually tend to increase local poverty short term. They also inhibit the governments of developing nations that are implementing these monetarist measures from making significant progress in areas that are important to social development such as public health, poverty reduction, and education.

Important to note is the position the IMF is in. Its purpose is to help governments manage their economic adjustment to globalization, yet it has influence only on the nations to which it lends. The IMF does not presently lend to either China or the United States. Yet the U.S. deficit and the Chinese surplus (along with an overvalued currency) are the result, many argue, of major currency imbalances that have contributed to the global financial and economic crisis. In addition, when IMF advice to devalue currency was taken by borrowers in the past, it created domestic problems, and, China argues, was the leading cause of Japan's decline as a global power.<sup>18</sup> IMF intervention, although at times successful, has also led to significant social unrest, as it did in Argentina and Kenya.

Rebalancing the global economy is a critical IMF goal, and so far, the recovery has been uneven, with increased growth in developing economies and slower recovery in developed economies.<sup>19</sup> Going forward, the IMF realizes it needs to develop better tools and measures. In a post-financial crisis rethink, it has committed to questioning all of its traditional approaches and indicators.

Other criticisms of the IMF include that it has helped to strengthen the economies of dictatorial regimes, thereby contributing to the growth of markets attractive to American and European multinational firms. This critique is accurate. The IMF does not apply a political litmus test, but rather, an economic one. Presently, the IMF is changing its quota allocation to give developing nations a louder voice in decision making and undertaking a serious rethink of all that it does. These and other actions suggest that the IMF appears to have recognized at least the partial validity of these criticisms and is addressing them.

## THE WORLD BANK

The World Bank was established along with the IMF at the Bretton Woods meeting in order to address development issues. Organized into two major and three smaller institutions, it functions as a nonprofit cooperative for its member-nations, able to pass on its ability to borrow funds at low rates to developing nations. Membership in the World Bank Group varies by institution, and the two major institutions, the International Bank for Reconstruction and Development (IBRD), also known simply as the World Bank, and the International Development Association (IDA) have 187 and 170 members, respectively. Both institutions loan to countries to support their development. The IBRD's focus is on middle-income nations with GDPs from \$1,000 to \$10,000 per capita, where 70 percent of the world's poor are located, and creditworthy poor nations. IDA focuses on the 79 poorest nations, 39 of which are in Africa. IDA provides interest-free loans, called *credits*, and grants for development projects, with the largest number of projects in the water, sanitation and flood protection, transportation, health, education, agriculture, and law and justice sectors. Begun in 1960, it has conducted projects totaling \$221.9 billion,<sup>20</sup> saving lives and improving standards of living for hundreds of thousands of people. In recent years, IDA credits and grants have averaged \$13 billion per year, and more than 50 percent have gone to Africa.<sup>21</sup> The healthy growth of these nations is important to business because billions of people are joining the world economy as their living standard rises. Developing nations account for more than half the increase in import demand since 2000; their share of global gross domestic product has risen to 43.4 percent in 2010, according to the World Bank.<sup>22</sup> The World Bank interactive map at <http://geo.worldbank.org/> has map, satellite, and hybrid views of current World Bank projects.

There are three more institutions that participate in the World Bank Group. The International Finance Corporation (IFC) invests in companies and financial institutions in developing countries to build domestic capital markets so that local entrepreneurs have access to funding. The Multilateral Investment Guarantee Agency (MIGA) encourages FDI in

developing economies and guarantees private-sector investment through political risk insurance, technical assistance, and dispute mediation. Finally, the International Centre for the Settlement of Investment Disputes (ICSID) helps to resolve disputes between governments and foreign investors, and, in that way, helps build foreign direct investment. Presently there are 121 cases being heard, and their procedural details are available for review. Among the cases is one filed by former Zimbabwean farmers against the Republic of Zimbabwe for the taking of their property, and another involves several tobacco companies, including Philip Morris, against the Republic of Uruguay.<sup>23</sup>

## World Trade Organization

The **World Trade Organization (WTO)** is the only global international organization designed to establish and help implement rules of trade between nations. Since its beginning in 1995, the WTO's goal has been to reduce or eliminate trade barriers and restrictions worldwide to help producers of goods and services, exporters, and importers conduct their business by reducing costs. The WTO is a rules-based, member-driven organization with decisions negotiated by all the member governments. It negotiates member agreements to establish rules for equitable trade—rules that limit the possible actions governments may take in their trade relationships, thereby increasing trade flows. The WTO currently has 153 members, which represents 97 percent of world trade. All of these members sign on to every WTO agreement.

### WTO PRINCIPLES

In WTO negotiations, members have established five basic principles, norms on which the global trade system rests.<sup>24</sup>

1. *Trade without discrimination.* This is the most-favored nation (MFN) principle, and it requires that nations treat all WTO members equally. If one nation grants another nation a special trade deal, that deal has to be extended to all WTO members. Another aspect of nondiscrimination is that foreigners and locals should be treated equally. In practice, this means that imported goods, once they are in the market, should not face discrimination.
2. *Freer trade, gradually, through negotiation.* Lower trade barriers encourage trade growth. WTO agreements establish “progressive liberalization” through gradual changes. Developing economies are given longer to make adjustments.
3. *Predictability, through binding and transparency.* Predictability helps businesses know what their real costs will be. The WTO operates with tariff “bindings,” or agreements to not raise a specific tariff over a given time period. Such promises are as good as lowering a tariff because they give businesspeople realistic data. Transparency, making trade rules as clear and accessible as possible, also helps businesspeople anticipate a stable future.
4. *Promotion of fair competition.* Although many describe the WTO as a “free trade” organization, and it certainly does work toward trade liberalization, the WTO also realizes that trade relationships among nations can be exceedingly complex. Many WTO agreements support fair competition in agriculture, services, and intellectual property, discouraging subsidies and the dumping of products at prices below the cost of their manufacture.
5. *Encouragement of development and economic reform.* Three-quarters of WTO members are developing economies and those transitioning to market economies. These nations are active in the WTO's current **Doha Development Agenda** or extended conference. One of Doha's goals is that developed countries provide market access to goods from the very least developed countries and increase technical assistance for them. Developed countries have started to allow duty-free and quota-free imports for many products from the least developed countries, but agriculture remains a difficult area in which to build agreement.

#### L03-5 Discuss

the purpose of the World Trade Organization and its impact on international business.

#### World Trade Organization (WTO)

An international organization that deals with rules of trade between nations

#### Doha Development Agenda

WTO extended conference on trade

At 2001, WTO talks begun in Doha, Qatar, member governments agreed to launch a new agenda and to work on trade-related issues between developed and developing economies. The WTO membership has recognized that developing nations face constraints that limit their ability to benefit from the WTO trading system, especially on issues around trade in textiles, clothing, agriculture, and fish. The WTO initiated an aid program, the Aid for Trade initiative, in 2007 to provide assistance to WTO members for infrastructure, technical support, and productive capacity—three areas that affect a developing nation’s ability to gain from trade agreements. In 2008, Aid for Trade received approval from all WTO members and its implementation over the last three years appears to have been effective. Yet the Doha Development Agenda has seen discord on many other issues connected to the trading needs of developing nations. Doha talks held in 2003 in Cancun, Mexico, collapsed when delegates from developing nations in Africa, the Caribbean, and Asia left the meeting over disagreement with the developed nations over agricultural issues. Twenty-one nations banded together to make the case that the agricultural subsidies wealthy nations pay to their own farmers undermine poor farmers around the world. In June 2004, the WTO delegates agreed to debate a proposal from the developing nations calling for the reduction and elimination of agricultural tariffs. Then in 2005, Brazil successfully sued the United States in the WTO over cotton subsidies. The United States and the EU have each agreed in principle to reduce agricultural subsidies. Ongoing Doha discussions were held in 2010 and are scheduled for 2011.

In addition to agriculture, property rights remain a difficult negotiation area for WTO members. We discuss intellectual property rights in Chapter 7, but we mention them here because, although they are a sticking point in the Doha discussions, some progress has been made in this area. Discussion of **trade-related intellectual property rights (TRIPS)** has so far led to agreement on 20-year patents and 50-year copyrights. Intellectual property rights violations are endemic in several industries, such as music, software, and pharmaceuticals, and tend to occur in a small group of developing countries, with music and software piracy rampant in China and pharmaceutical patent violations legendary in India, China, and Brazil. The WTO has negotiated a basic agreement that property rights should not take precedence over public health. Any country that adopts TRIPS will have the right to copy drugs patented before 1995. The WTO has also established a system of compulsory licensing that mandates that copyright holders license producers in developing countries. From 1972 to 2005, India did not have property rights protection for pharmaceuticals, which led to a huge generic drugs export market. India’s joining the WTO agreement has provided patent protection for pharmaceuticals there while, at the same time, ensuring that its citizens have access to health care.

The Doha Round’s discussions continue to be contentious. The recent global financial crisis, which the bloc of developing nations understands to have been caused by problems in developed nations yet solved largely by their own developing economies, has added some animosity and distrust to the discussions. Yet the major players are still in the discussions and have committed to moving Doha forward.<sup>25</sup> There are many issues of concern for WTO members, including farmers, women, and entrepreneurs all trying to build success in developing economies. China and India offer a sense of the WTO’s possibilities. Together, they account for one-third of the global population, and in both countries, as a result of increased trade, absolute poverty has declined. All WTO members realize that for global trade to work, the rising tide must lift all boats. The future growth of world trade and the economic health of developed nations depend on getting globalization right so that all participants benefit from trade. New markets, an educated workforce, economic growth, and political stability in emerging nations are all important for international business.<sup>26</sup>

We must mention, though, the more cynical view of these international institutions that is touched on in this chapter’s opening. It may be the case that the current problematic issues in many international institutions—including the IMF’s lack of effectiveness in the global crisis, the World Bank’s seeming loss of purpose, and the WTO’s inability to resolve the problems in the Doha Round—are signs of the final efforts of the major post–World War II powers to maintain control of the global economy. If that is the case, true multilateralism lies ahead of us, with the fuller participation of India and China.

### trade-related intellectual property rights (TRIPS)

Refers to the WTO agreement that protects copyrights, trademarks, trade secrets, and other intellectual property matters



## IMF Sees a Growing Africa and So Does China

The IMF has increased its growth predictions for Africa in both 2010 and recently in 2011. Presently the IMF has forecast 5.5 percent growth for sub-Saharan Africa for 2011 and as much as 5.8 percent for 2012. Although African economies suffered in the recent financial crisis, with their growth cut at around 50 percent, they had resilient comebacks, largely based on increased trade with China and with other countries in Asia and Latin America. Most sub-Saharan African economies were able to avoid slipping into recession. African growth comes at a time when the United States and Europe are still dealing with recovering from the global recession.<sup>a</sup>

Africa's major trading partner is the EU, based on relationships from former colonial ties in many cases, but China has become one of Africa's major trading partners in the past few years, especially in the oil, minerals, and banking sectors. China is also active in FDI for infrastructure projects such as dams and highways. China is interested in Africa for energy-related natural resources, of course, but China also recognizes that Africa is online to emerge as a powerful, large market following India and China. China is good at taking a long-term view!



### Questions:

1. What could China's activity in Africa mean for the U.S.?
2. What are some of the cultural issues a Chinese expat might face in Beijing?

<sup>a</sup>IMF, [blog-imfdirect.imf.org/category/economic-outlook/](http://blog-imfdirect.imf.org/category/economic-outlook/) (accessed March 14, 2011).

Recently, in part, because WTO progress on trade liberalization and addressing the inequities of globalization has been slow, regional trade agreements have grown, to fill the gap. The WTO reports that in mid-2010, more than 474 regional trade agreements were in existence.<sup>27</sup> Agreements such as the European Union and the North American Free Trade Agreement may weaken the WTO, because they disrupt or limit the trade of excluded nations. Because most of these trade agreements are among developed nations, the impact on developing nations could be substantial. After a short focus on the Organisation for Economic Development, we will look at these trade agreements and the process they represent, economic integration.

## Organisation for Economic Cooperation and Development

The **Organisation for Economic Cooperation and Development (OECD)** is often called the "rich man's club" because today it is composed of 34 of the wealthiest nations in the world (see Table 3.1).<sup>†</sup> Discussions leading to membership, though, are open to all nations committed to a market economy and a pluralistic democracy. The OECD supports governments in their efforts to increase economic growth, fight poverty, maintain financial stability, and help non-member-nations' economic development.<sup>28</sup>

Developed from an earlier World War II collaboration that administered distribution of the U.S. Marshall Plan aid in Europe, the OECD provides information on economic and other activities within its member-nations and is a forum through which to discuss shared economic and social policy issues. OECD publishes extensive research on a wide variety of international business and economic subjects. These publications and resource materials are valuable to researchers and businesspeople.

<sup>†</sup>Note that OECD uses the British spelling of *organisation* in its name.

### L03-6 Discuss

the resources of the Organisation for Economic Cooperation and Development.

### Organisation for Economic Cooperation and Development (OECD)

Group of developed countries dedicated to promoting economic expansion in its member-nations

**TABLE 3.1** OECD Member Countries

Australia	France	Korea	Slovenia
Austria	Germany	Luxembourg	Spain
Belgium	Greece	Mexico	Sweden
Canada	Hungary	Netherlands	Switzerland
Chile	Iceland	New Zealand	Turkey
Czech Republic	Ireland	Norway	United Kingdom
Denmark	Israel	Poland	United States
Estonia	Italy	Portugal	
Finland	Japan	Slovak Republic	

The OECD has been instrumental in many areas, including encouraging member-nations to eliminate bribery, to establish a code of conduct for multinational companies, and to propose the adoption of specific legislation. The Business and Industry Advisory Committee (BIAC) of OECD, created in 1962 to represent business and industry, works in various areas that concern business, such as trade liberalization, sustainable development, e-commerce, taxation, and biotechnology. Information about the BIAC can be found at [www.biac.org](http://www.biac.org). OECD's highly regarded individual country surveys are found at [www.oecd.org](http://www.oecd.org). They are a good complement to the Central Intelligence Agency's *World Factbook*, found at [www.cia.gov/library/publications/the-world-factbook/](http://www.cia.gov/library/publications/the-world-factbook/), for reliable demographic and economic information. These sites are a good place to begin country-level research.

**L03-7 Identify**

the levels of economic integration and the effectiveness of the major trading alliances.

**free trade area (FTA)**

Area in which tariffs among members have been eliminated, but members keep their external tariffs

**customs union**

Collaboration that adds common external tariffs to an FTA

**common market**

Customs union that includes mobility of services, people, and capital within the union

**complete economic integration**

Integration on economic and political levels

## Economic Integration Agreements

Often, economic cooperation begins with an agreement to have a free trade area, such as the North American Free Trade Agreement (NAFTA) among Canada, Mexico, and the United States. In a **free trade area (FTA)**, tariffs are abolished among the members, but each member-nation maintains its own external tariffs on goods from countries in the rest of the world. So members have free trade among themselves but have their own individual trade restrictions with nonmember nations. Within the FTA, restrictions generally remain on the movement of services (such as accounting, insurance, and legal services), people (labor), and capital. An example of an FTA in addition to NAFTA is the Central American Integration System (Belize, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama). There are also many FTAs (e.g., with South Korea) being negotiated but not yet in effect.

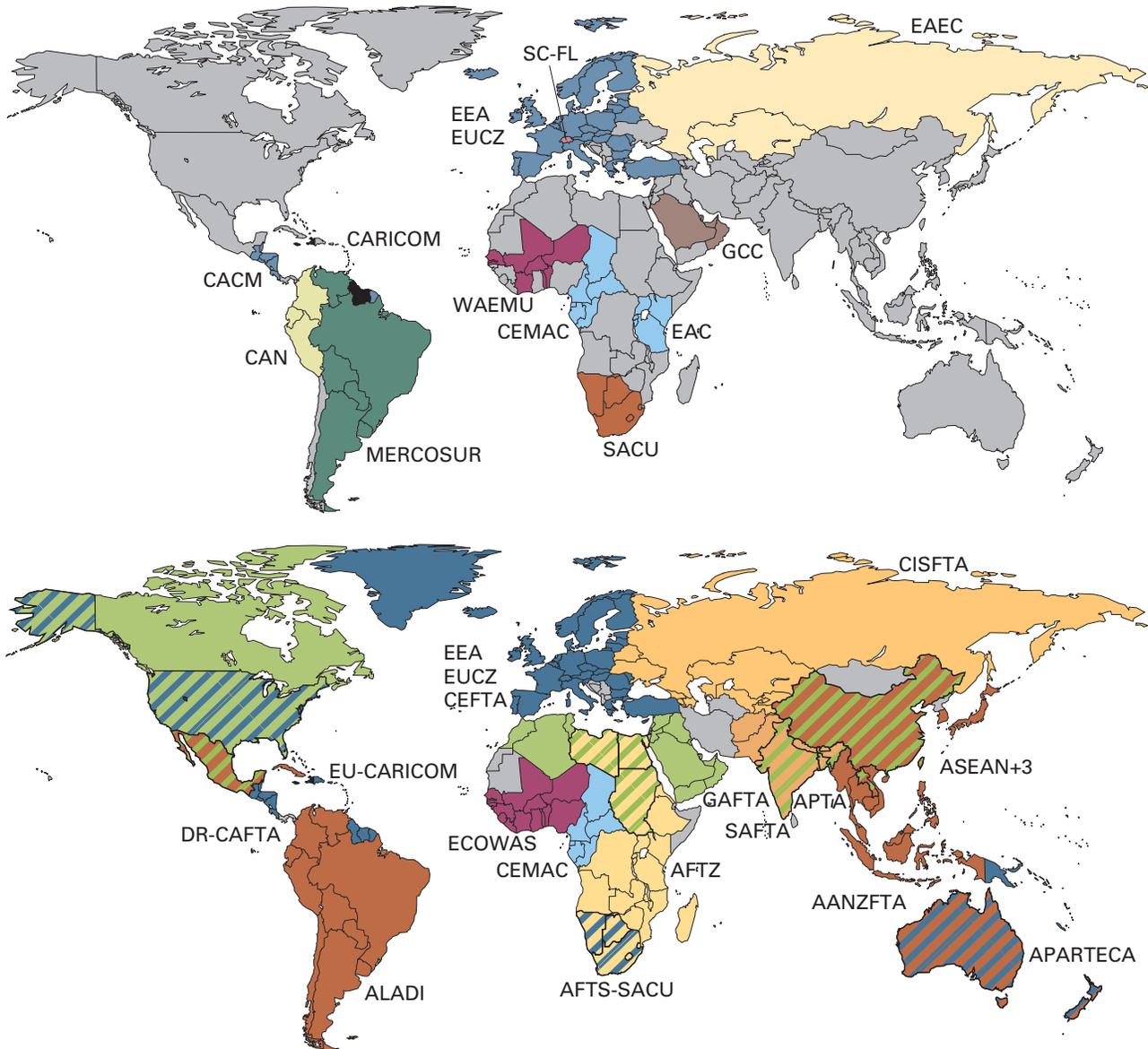
An FTA often develops into a **customs union**, an agreement that adds common external tariffs to the FTA. Examples are the Southern African Customs Union (SACU), with membership of South Africa, Lesotho, Namibia, Swaziland, and Botswana; the Common Market of the South (Mercosur or Mercosul), with membership of Argentina, Brazil, Paraguay, and Uruguay, plus the anticipated joining of Venezuela in 2011; and the Andean Community (Peru, Ecuador, Bolivia, and Colombia). FTAs are illustrated in Figure 3.4.

Progressing from the FTA and the customs union, the next level of economic integration is a **common market**, created when a customs union lifts restrictions on the mobility of services, people, and capital among the member-nations. Mercosur plans to develop in this direction. A common market is essentially a single market, so all of the barriers to trade, such as standards, borders, and taxes, become common. To achieve this level of economic integration, common market members establish common economic policies, an achievement that requires a great deal of political will.

Eventually the common market agreement may move toward an agreement for **complete economic integration**, as has happened with the EU. Such integration involves a high degree of political integration, which requires member-nations to surrender important elements of their sovereignty. For example, in the EU a central bureaucracy is responsible for coordinating and harmonizing tax rates, labor systems, education systems, and other social and legal

**FIGURE 3.4**

Free Trade Areas and Customs Unions



Source: [http://en.wikipedia.org/wiki/File\\_Customs\\_unions.png](http://en.wikipedia.org/wiki/File_Customs_unions.png).

systems for all EU members, while the European Central Bank develops monetary policy. A single currency, the euro, has been established to replace member-nations' currencies and is used in 17 of the member-states. It is also used by at least six non-EU countries or entities (such as the Vatican) as official currency.

Trading blocs such as FTAs and common markets impact the international firm due both to the cost reductions they bring to those inside the integrated area, through reductions in tariffs, quotas, and other trade barriers, and to the cost increases they bring to those firms outside the trading bloc. Table 3.2 compares the relative sizes of the major trading blocs and trading nations.

**EXAMPLES OF ECONOMIC INTEGRATION AGREEMENTS**

The **North American Free Trade Agreement (NAFTA)** created a free trade area among Canada, Mexico, and the United States that came into existence on January 1, 1994. Since its establishment, NAFTA has paved the way for strong economic growth

**North American Free Trade Agreement (NAFTA)**

Agreement creating a free trade area among Canada, Mexico, and the United States

TABLE 3.2

Major Regional Trading Blocs and Trading Nations

Regional Bloc	Area (sq km)	Population	GDP (US\$)	GDP per Capita	Members
EU	3,976,372	492,387,344	\$14.9 trillion	32,900	27
NAFTA	21,783,895	460,986,859	17.62 trillion	38,222	3
China	9,596,960	1,336,718,015	9.872 trillion	7,400	—
India	3,287,590	1,189,172,906	4.046 trillion	3,400	—
Russia	17,075,200	138,739,892	2.229 trillion	15,900	—
Canada	9,984,670	34,030,589	1.335 trillion	39,600	—
Mexico	1,972,550	113,724,226	1.56 trillion	13,800	—
ASEAN	4,435,830	591,841,000	1.496 trillion*	4,873	10
United States	9,826,675	313,232,044	14.72 trillion	47,400	—
World	6,928,198,253	6,790,062,216	74.43 trillion (2010 est.)	11,110 (2010 est.)	

\*nominal, not PPP

Sources: CIA, *World Factbook*, 2011, [www.cia.gov/cia/publications/factbook/](http://www.cia.gov/cia/publications/factbook/), figures are estimates; ASEAN Trade Database, February 2011, [www.asean.org](http://www.asean.org).

and prosperity based on liberalized trade among the three members. Through NAFTA, the three countries have created one of the world's largest free trade zones—one of the most powerful productive forces in the global economy. Trade in North America is now virtually tariff free. The last trade area to have tariffs dropped was U.S. corn exports into Mexico, where the many small farmers have had transitional protection from U.S. corn imports.<sup>29</sup>

African countries have formed regional trade groups to promote economic growth throughout the continent. Most African countries, though, have their main trade relationships with developed countries, in many cases with former colonial powers. One exception to that observation must be made. China's increasing involvement in African trade and FDI is an interesting development that may lead to economic growth for Africa.<sup>30</sup> When China began its current reforms targeted toward development in the 1970s, it was poorer than Africa and faced more challenging institutional issues. Its education system was worse and its agricultural issues more daunting.

Except for South Africa and Nigeria, African economies are small and underdeveloped and, therefore, marginalized. Their governments face daunting challenges: infrastructure development; public health needs connected to HIV/AIDS, tuberculosis, and malaria; corruption; and insurgencies and civil wars. Their unstable environment is not conducive to economic growth, yet the economic collaborations persevere. Five of these groups are the Economic Community of West African States (ECOWAS), the Common Market for Eastern and Southern Africa (COMESA), the Southern African Development Community (SADC), the African Free Trade Zone (AFTZ), and the African Union (AU).

**Mercosur** (Spanish) or **Mercosul** (Portuguese) is an acronym for the Common Market of the South, whose members are Argentina, Brazil, Paraguay, and Uruguay. Their goal is a common market and their alliance has made progress. Most trade within Mercosur is tariff free, and members have adopted a common external tariff on most products. Venezuela has been approved for membership and may join Mercosur soon. Regional trade agreements in Central and South America are mapped in Figure 3.5.

The Central American Free Trade Agreement (DR-CAFTA) includes the United States, Guatemala, Honduras, Nicaragua, El Salvador, Costa Rica, and the Dominican Republic. Although there is criticism of DR-CAFTA because it is asymmetrical (the aggregate GDP of the Central American members is equal to around 0.5 percent of the U.S. GDP), trade figures report substantial growth in the DR-CAFTA economies, a solid portion of which is attributable to the influence of this free trade area. Other Central and South American trade agreements include the Andean Community (CAN), whose members are Colombia, Peru,

### Mercosur or Mercosul, the Common Market of the South

A South American customs union of Argentina, Paraguay, Brazil, and Uruguay

**FIGURE 3.5**

Regional Trade Agreements in Central and South America



Ecuador, and Bolivia. Venezuela decided in 2006 to withdraw from the Andean Community and is now on the threshold of membership in Mercosur.

In Asia, the **Association of Southeast Asian Nations (ASEAN)** was formed to foster peaceful relations among members and offer mutual protection against the growth of communism in their region. So it began as a cooperative military and security arrangement, something like the North American Treaty Organization (NATO). Military alliances have an impact on trade, so it is not surprising that ASEAN's security cooperation has led to economic cooperation. Because Southeast Asia is one of the fastest-developing and most dynamic economic regions in the world, ASEAN (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar [formerly Burma], the Philippines, Singapore, Thailand, and Vietnam) has increasing significance. ASEAN's initial agreement to noninterference in each other's internal affairs has allowed them to overcome conflict among themselves and to build the cohesion and mutual values needed for a common market. A subsidiary group, ASEAN+3 adds China, Japan, and South Korea to foster Asian cooperation and financial stability. ASEAN is mapped in Figure 3.6.

The European Union, which we look at next, has developed from a customs union to a common market and then beyond, with added political integration. Our review looks at the EU's development, then its basic organization, and finally, its impact and prospects.

## The European Union

### EU DEVELOPMENT

Left in a shambles by World War II, Europeans faced rebuilding their society aware that previous economic and political systems had failed them. Out of this awareness slowly developed a willingness to relinquish some aspects of national sovereignty for the greater

### Association of Southeast Asian Nations (ASEAN)

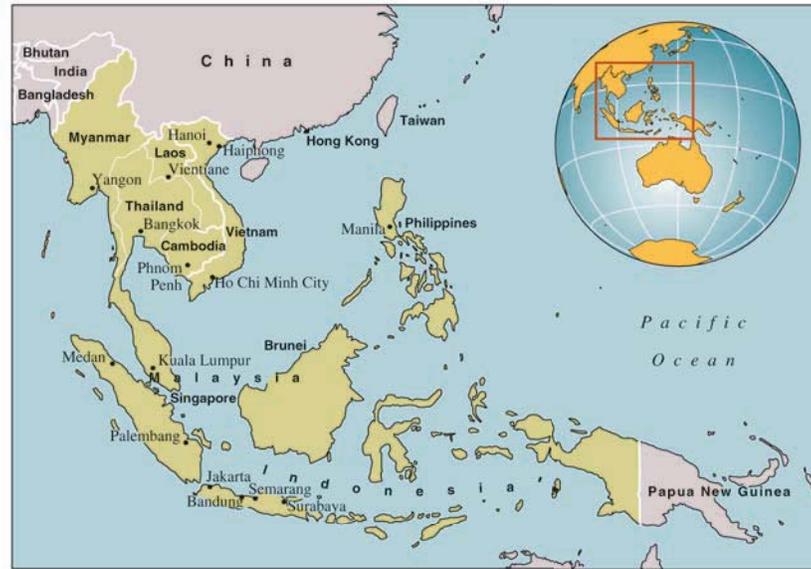
Agreement among Southeast Asian nations that began as a security agreement and has developed toward a common market

#### L03-8 Discuss

the EU, its impact, and its challenges going forward.

**FIGURE 3.6**

ASEAN Members



● Members of Association of Southeast Asian Nations (ASEAN).

Source: Association of Southeast Asian Nations

**European Union (EU)**

A body of 27 European countries committed to economic and political integration

economic and political good. In 1950, French foreign minister Robert Schuman began the process with the integration of the coal and steel industries into a common market, the European Coal and Steel Community (ECSC). The initial six members—Belgium, West Germany, France, Italy, Luxembourg, and the Netherlands—signed the Treaty of Rome in 1957, which established a common market among the six members. By 1967, this core group had established the European Community (EC), with a European Parliament, a European Commission, and a Council of Ministers. Then, in 1993, the EC members signed the Maastricht Treaty, which established the **European Union (EU)**, with three areas of integration: the economic community, foreign policy, and domestic affairs. Denmark, Ireland, and the United Kingdom joined the EU's six founding members in 1973, followed by Greece in 1981; Spain and Portugal in 1986; and Austria, Finland, and Sweden in 1995. The European Union welcomed 10 new countries in 2004: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia. In 2007, Bulgaria and Romania joined. Presently there are four candidate countries: Croatia, the former Yugoslav Republic of Macedonia, Iceland, and Turkey—all of which have been approved for accession with entry dates still to be set, and Serbia, Albania, Bosnia and Herzegovina, Montenegro, and Kosovo (under UN Security Council Resolution 1244) are in talks to join the candidates. Today, the European Union's 27 member-countries constitute most of the economic, industrial, and population strengths of Europe.<sup>31</sup> The population of the EU is about 500 million people, just under 60 percent larger than that of the United States. The EU has 7.3 percent of the world's population, and it is the largest trader in the world, with 17.1 percent of merchandise trade. In comparison, the United States is the second-largest trader, with 16 percent.<sup>32</sup> Notable are the western European countries that have rejected membership in the EU—Switzerland and Norway—both of which made the decision not to join based on national elections. Figure 3.7 shows a map of the present EU.

**European Monetary Union (EMU) or Economic and Monetary Union**

EU group that established use of the euro in the 17-country euro zone

The EU is a supranational body that has become a regional government. With passage of the Lisbon Treaty, which came into effect in 2009, the EU has modernized its institutions, made them more democratic, and moved forward with integration in the areas of foreign affairs, security, and justice. The **European Monetary Union (EMU)**, or **Economic and Monetary Union**, as it is known in Europe, already has established a common currency used in 17 of the EU member-countries. The euro (€) is also used widely as a reserve currency, as an alternative to the dollar. The EU represents its members at the WTO and has

**FIGURE 3.7**

European Union: Current Member-Nations and Candidate Nations



Source: European Union, [http://europa.eu/abc/maps/index\\_en.htm](http://europa.eu/abc/maps/index_en.htm), 12 March, 2011 © European Commission.

both the European Commission and the European Council presidents representing it at the G20 (Group of 20 nations' finance and central bank officials who meet to discuss key economic issues), in addition to the individual national representatives from France, Germany, Italy, and the United Kingdom. Recently, the European commissioner for economic and monetary affairs called for EU representation at the IMF as well.<sup>33</sup> EU members use EU passports and can move and work freely among EU countries, for the most part; the EU can tax member-nations directly and implement legislation directly in each of the member-nations; and the European Court of Justice has power to impose fines and other sanctions on individuals, companies, and member-nations that are found to violate EU agreements. A regional government is well under way.

The EU is organized into nine main institutions with functions similar to those performed by a national government. The **European Parliament** represents the people of Europe and is elected from member-states. Its sessions are available live at [www.europarl.europa.eu](http://www.europarl.europa.eu). The **Council of the European Union** represents the member-states and is the

**European Parliament**

EU legislative body whose members are popularly elected from member-nations

**Council of the European Union**

The EU's primary policy-setting institution



### Katie Emick: International experience can target both inside and outside



I was born and raised in Morgan Hill, CA, until leaving for college in 2008. I spent much of my childhood travelling to our ranch in Oregon and going on annual camping trips, which instilled in me a deep love for the outdoors. I was very active in sports my whole life and went on to be MVP of the league for my varsity basketball team. I also participated in many triathlons, half-marathons, and other outdoor sporting events, trying to keep up with a family of professional athletes. My strong passion for the mountains has led me to become an active backpacker and snowboarder, and I hope to summit some of the world's tallest peaks during my lifetime.

While studying international business at Cal Poly in San Luis Obispo, I developed a more comprehensive understanding of the frameworks that govern international business and the many forces that drive the global arena. My most immediate goal following graduation is to work abroad as an intern or employee of an international company and gain tangible experience in dealing with the complexities of foreign environments. Given my partial fluency in Spanish and my strong interest in Latin America, I am pursuing opportunities in Spanish-speaking countries. I believe that to develop my full potential, I must immerse myself in an unfamiliar setting and harness the abundant learning opportunities that arise from living and working abroad.

Regarding long-term goals, my ideal profession would be in international management, coordinating strategic activities across a broad range of functions and countries. I hope to establish myself as a valuable asset in a multinational corporation by leveraging my ability to organize tasks, build cohesive networks, and respond to cultural diversity. I am also an active supporter of sustainable development and business practices, and will pursue a career that allows me to incorporate these values and foster sustainable solutions. At this stage in my life, my desire to pursue an international internship is inspired by a compelling drive to continue exploring, learning, and integrating myself into the global network. The opportunity to gain hands-on experience will enhance my business skills and cultural responsiveness, making me more qualified and better prepared for a career in international business.

I was exposed to the world of international business at an early age. My mother, a VP of Global Services for IBM, was constantly on international assignment, travelling to more than 30 countries a year. I became accustomed to the idea of a truly

global career and was introduced to the inner workings of one of the world's largest and most global corporations. My mom has been very active in promoting the role of women in international business and implementing sustainable solutions around the world. With this upbringing, I developed a keen passion for travel, international networking, and sustainable development, and thus set my course towards a dynamic and geographically dispersed career.

In 2010, my mom, sister and I founded Rooted In Hope, a non-profit organization dedicated to environmental awareness and sustainable growth. Although the organization is still in its early stages, we have successfully completed our first two international projects and are currently raising funds for future endeavors. The projects were based in Kenya, where Rooted In Hope volunteers and members of the local community planted over 3,000 trees. As Vice President and CFO of this organization, I have played an active role in global networking, project management, and financing operations, all of which have allowed me to apply and further develop my skills as an international business student.

Along with a lifetime of exposure to international business, my desire to pursue a career in the field has also been stimulated by my countless experiences travelling abroad. Prior to deciding on a college or a field of study, I travelled to Brazil and several countries in Europe and the Caribbean. These trips further heightened my interest in travel, and by the time I was admitted to Cal Poly, I was fully committed to studying international business. In my last year as an undergraduate, I travelled on Semester-at-Sea, where I had the opportunity to simultaneously study international business (on board the ship) and witness the context and concepts of what I was studying first-hand (in 13 countries).

During the Semester-at-Sea voyage, I visited 13 countries and over 30 major cities, many of which face the challenges of rampant poverty and overpopulation. To prepare for the voyage, and also out of interest and curiosity, I researched the locations where I would be travelling and made a "guide book" for myself. In addition, I spoke with many personal contacts who had experience in these foreign countries and who gave me important travel advice for each of the locations. I approached the voyage with adequate preparation and set off confidently with an open mind. The voyage confirmed my belief that, in order to make the most out of an international experience, one should enter foreign cultures filled with anticipation rather than expectation.

One of the many profound experiences I had during my trip was a visit to Varanasi, the oldest living civilization on Earth and the heart of the Hindu religion. At the banks of the river Ganges, Hindus engage in religious rituals and perform ceremonial cremations. While we were rowing down the river in a small boat, two corpses floated by (one baby and one adult male). Just yards away, Hindus were bathing and drinking the same sacred water. I allowed myself to take in the moment and absorb the images through a new set of eyes, trying to see life as these people see it. Shortly after, we weaved our way through the narrow crowded alleys, making way for cows and battling off overzealous vendors. I was lucky enough to be standing directly under a local Indian using his second story window as a lavatory. Talk about a tangible experience! (don't worry-no parasites transmitted . . .) The atmosphere painted a vivid contrast between the

*(continued)*

rapid development of Western society and the unchanged perpetuity of ancient traditions. My experiences in Varanasi penetrated and transformed my entire perspective of the world and existence, directly exposing me to the vast disparities that exist among cultures. This allowed me to expand my whole realm of consciousness and taught me more in the blink of an eye than I have learned in all my years as a student.

One of the biggest challenges I faced abroad was transportation within the countries, particularly the densely populated cities with weak infrastructure. The language barriers present obvious complications and the chaotic flow of traffic can be overwhelming to foreigners accustomed to the advanced transportation systems of developed countries. Even in advanced countries such as Japan, language barriers presented significant challenges. In many places, Americans are vulnerable targets for exorbitant pricing by locals, and it is difficult to dispute prices while avoiding confrontation. In some cases, I quickly learned the public transit systems and used them effectively to get around the large cities. However, I spent many times trying to cope with being utterly lost, completely ripped off, or trying to communicate using only gestures and drawings. Like learning foreign transit systems, most of the challenges I confronted abroad are ones that can only be understood and appreciated by experiencing them first-hand.

Another challenge I encountered while travelling with 600 other American students was witnessing the cultural insensitivity of some of the students I travelled with. Although this rarely resulted in immediate problems (unfortunately there are some exceptions), it left a lasting impression, which made me more conscious of my respect and behavior in foreign countries. The following is an excerpt from my travel journal, describing an experience on a bus from Casablanca to Marrakech:

*I watched out the window as we passed primitive Berber villages, with huts made of mud and sand, donkeys pulling carts for miles, and children making games out of sticks and stones . . . I found it very upsetting that I was sitting by people talking about TV shows and trivial gossip, and complaining incessantly about the heat and the dust and everything in between. Meanwhile, our kind bus leader was giving detailed and fascinating information about the country and the landscape outside our windows. His accent was thick and it made each passing scene more meaningful. Unfortunately, it was difficult to hear him over the nonsense gibberish that filled the bus. The indifference, ignorance, and unwillingness to learn about the people and culture surrounded me, and made me even more appreciative of my journey. I was so grateful that I was one of the students on the bus struggling to hear what Abdul had to say, and I could sense the chasm between myself and those around me. I was here to learn, to grow, to rip myself from my comfort zone and plunge headfirst into an unforeseen world.*

—September 15, 2010

It is difficult to sum up the enjoyment and gratification that has come from my international experiences. Each country offers a unique mix of cultures, religions, languages, laws, norms, landscapes, infrastructures and countless other defining characteristics. However, I found universal enjoyment in immersing myself

in unfamiliarity, and the thrill of independently setting out on a dynamic and spontaneous adventure. The most indelible gratification came from my interactions with the people, who left lasting impressions throughout my entire journey.

Looking back, my greatest enjoyment was not bungee jumping off the tallest bridge in the world, shark diving with 18-foot great whites, sky-diving over the townships of South Africa, tobogganing down the Great Wall of China, or riding camels and ATVs through the Sahara desert. Although these were unforgettable and exhilarating experiences, they do not compare to the profound and irreplaceable interactions that I shared with people around the world, which impacted me in a way that is indescribable on paper. Two occasions worth mentioning are among my most meaningful and rewarding experiences abroad. I made it a point to visit the townships of South Africa and the slums of India during my travels. I did not want to spend my time solely as a tourist, and believed that experiencing first-hand the extreme poverty in these neighborhoods was an essential part of my learning experience.

In both countries, I decided to embark on a solo visit to these areas, despite the danger and risk of not being accompanied by an organized group. I went with another student, and in both cases, we were taken to the homes of our cab drivers. It was sketchy, to say the least, as we got further from the relative safety of the city and deeper into the maze of shantytowns. However, with increased risk came increased rewards. In South Africa, we were treated as celebrities throughout the neighborhood, and spent the afternoon simply living with the locals, sharing beers at the tavern, playing jump rope with the kids, and visiting the one-room shacks that serve as homes. This particular township is one of the most crime-ridden in the area, and therefore, its residents are not accustomed to visits by foreigners. I handed out stickers to the children, and was astonished by the excitement and appreciation that such a small gesture can evoke.

In Chennai, we visited the home of our cab driver who lived deep in the slums up a flight of stairs in a densely crowded neighborhood. The tuk-tuk made its way in the dark through a maze of narrow corridors lined with people, and I entered the unfamiliar world filled with a sense of subdued apprehension and overwhelming curiosity. We shared hours in the company of the residents, who humbly invited us into their one-room homes. My experience interacting with the children of these neighborhoods was one of compassion and mutual understanding. The following is an excerpt about my experience in the slums of Chennai:

*I held a one month old baby who had her face painted, danced with the toddlers, played with a baby goat, and left the neighborhood singing the ABCs with a trail of kids following us. It was an absolutely surreal and amazing experience that left an indelible mark on me.*

—November 1, 2010

During my travels abroad, I learned as much about myself as I did about the people and places I visited. One of my greatest learning points from my experience is just that . . . LEARN! Although I experienced and learned more during my travels than many people may in a lifetime, there is still an infinite amount of knowledge out there to discover and endless opportunities to explore. To make the most of my experiences abroad, I removed  
*(continued)*

all self-imposed limitations and went into every experience with an open mind and a willingness to learn. I was reminded that the world can be very dangerous, and to be an international traveller, I must always be astute and remain constantly aware of my surroundings. I also learned that the world is kind, and that even as a foreigner, I can rely on the good human nature of people around the world to assist me in whatever way I may need. I learned to be more appreciative and grateful for the hand I was dealt, and to contribute to improving the livelihoods of the billions around the world who are not as fortunate. Most importantly, I embarked on a path of self-discovery that reminds me of my infinitesimal existence on this planet. However, I was also reminded that each and every person has the potential to create a positive impact and change the world for the better. Here are my recommendations for your international career development:

- Remove all self-imposed limitations and be whole-heartedly open to self-discovery.
- Embark on your journey with anticipation, not expectation!
- Be respectful and considerate of your surroundings. Understand fully where you are and be fully engaged in the setting. Don't be distracted by the trivial, irrelevant, or inconvenient . . . let your imagination take hold of the international experience and live in the moment.
- Keep a journal. Try to interpret events and record thoughts about intangible experiences. Photos can tell the story of what you did; use the journal to tell what you learned.

#### RESOURCES FOR YOUR GLOBAL CAREER

In addition to the major international institutions, the IMF (<http://www.imf.org/>), the World Bank (<http://www.worldbank.org/>), the WTO (<http://www.wto.org/>), others are playing increasingly

important roles in world development. For a detailed list of recognized international organizations written in English, French, German and Spanish, refer to: <http://intosai.connexcc-hosting.net/blueline/upload/3listintinstite.pdf>.

Paul Volcker stresses the need for international currency coordination and predicts the need for one global currency: [http://www.deu.edu.tr/userweb/muge.tunaer/dosyalar/Volcker\\_Intl\\_Instit.pdf](http://www.deu.edu.tr/userweb/muge.tunaer/dosyalar/Volcker_Intl_Instit.pdf).

The International Financial Institutions Research Site at Wellesley College: <http://www.wellesley.edu/Economics/IFI/>

University of Wisconsin Directory of International Institutions: <http://info.gradsch.wisc.edu/admin/gradcoordinators/iadmiss/index.html>

From The World Bank—blogs, broadcasts and multimedia presentations on global issues and institutional initiatives worldwide: <http://youthink.worldbank.org/>

Broadcast speeches on globalization, international institutions, and the international economy from the “Conversations with History” series from the Institute of International Studies, University of California, Berkeley: <http://globetrotter.berkeley.edu/PubEd/research/globalization.html>

Podcast: American Higher Education Is Going Global: Implications for CIOs, National Networks, and Federal Policymakers: <http://www.educause.edu/blog/gbayne/PodcastAmericanHigherEducation/167670>

IBM's Global CEO Study: The Enterprise of the Future: <http://www.ibm.com/ibm/ideasfromibm/us/ceo/20080505/>

Organizations addressing issues of business ethics, institutional governance, corporate responsibility, ethical treatment of employees, and anticorruption worldwide:

International Business Ethics Institute: <http://www.business-ethics.org/>

Ethics World: <http://www.ethicsworld.org/>

#### European Commission

Body responsible for the EU's day-to-day operations

#### European Central Bank

The central bank for Europe's single currency, the euro

#### European Court of Justice

The highest court of the EU, it interprets EU law

primary policy-setting institution of the EU. When the Council meets, the nation's minister who represents the specific area being discussed serves as the representative of the member-nation. For example, when financial matters are discussed, the 27 finance ministers of all member-nations participate. Council decisions are supranational and are set forth in regulations and directives. Recent directives deal with foreign policy issues (terrorism, weapons of mass destruction control, Burma/Myanmar) and issues of health and safety (flu tracking and precautions, disaster planning, workplace safety equipment, computer use rules, and environmental safety for workers). The **European Commission** administers the daily operations of the EU. It consists of 27 commissioners, one from each member-nation. Commission members are nominated by their countries, appointed by the Commission president-elect, and then approved by a vote of the European Parliament. The remaining six EU institutions focus on financial and social issues and include the **European Central Bank (ECB)** and the **European Court of Justice (ECJ)**.

### THE EU'S IMPACT ON INTERNATIONAL BUSINESS

The EU is a major world political and economic force. Its directives have superseded 27 sets of national rules and harmonized hundreds of thousands of national standards, labeling laws, testing procedures, and consumer protection measures covering everything from toys to food, stock brokering to teaching. The 27 nations have scrapped more than 60 million customs and tax formalities at their shared borders and are on the verge of implementing a harmonized patent system. The EU is the world's largest trading economy, a large source of FDI

outflows, and the source of approximately 20 percent of the world's total output. The introduction of the euro is one of the most significant achievements of the EU.

These EU successes significantly impact how managers conduct business in several ways. The use of a common currency and common import and export processes have reduced the cost of doing business within the EU. A number of EU regulations have major impacts in the United States, Japan, China, and elsewhere because of the EU's size and importance as a trading partner. EU standards are advanced, especially in environmental and sustainability requirements. For example, in an effort to prevent electronic equipment waste, the EU requires recycling of all equipment, including cell phones, computers, household appliances, and televisions. It requires 80 percent recovery by weight for larger appliances, 75 percent for IT and telecommunications equipment, and 70 percent for small appliances. In addition, the manufacturers are required to provide collection for the waste that is not from private households. We may expect even more progress with continued European integration.

Microsoft is an example of a company whose business practices have been substantially influenced by the EU. In 2004, the European Commission ordered the company to pay €497 million, share its software code with competitors, and offer an unbundled version of the Windows operating system. Microsoft complied. Then, in 2005, the EU ruled that Microsoft would be fined \$2.37 million per day if the software code it provided competitors didn't have better documentation. In 2008, the EU imposed a \$1.35 billion fine, because Microsoft had not complied fully with its 2004 order to share code. In 2009, the EU announced that it would investigate Microsoft's Internet Explorer bundling with Windows operating systems, an investigation that was settled when Microsoft agreed to allow consumers to choose from among 12 competing browsers, including Explorer, all accessible on a choice screen. The point is clear: if foreign companies want access to the EU market, they must conduct business by the European Union's rules, often at the global level as well as within the EU.



## THE EU GOING FORWARD

The EU has evolved beyond a free trade agreement, such as NAFTA and Mercosur, and made substantial progress in economic and political integration. It has, as the *CIA World Factbook* points out, "its own flag, currency (for some members), and law-making abilities, as well as diplomatic representation and a common foreign and security policy in its dealings with external partners."<sup>34</sup> The global financial crisis hit some European countries hard, though, and created challenges for the financial health and stability of the EU, especially within the Eurozone.

As the financial crisis began to recede, largely due to infusions from the European Central Bank (ECB) into banks, the concern focused on a sovereign debt crisis in some of the eurozone countries, including Greece, Spain, Ireland, Portugal, and Italy. This development points out the EU's lack of a federal treasury and budget. The fiscal policies of the EU are contained in the Stability and Growth Pact, an agreement that sets limits on member-nations' debt and deficits, with fines for violation. Yet the fines are voted in the European Council and have not been enforced on the larger economies, France and Germany, when they ran deficits. Clearly, this is an area for EU development. The EU did vote to support Greece and other endangered economies with a plan administered by the ECB and loans.



## Do International Institutions Weaken the Nation-State?

One of the major forces of opposition to global institutions such as we have reviewed in this chapter are groups concerned with their nation's *sovereignty*, briefly understood as the authority of their nation to govern itself. Many groups hold that supranational agreements are an assault on the nation's independence. Their concern is that, for example, UN treaties and conventions would weaken the power of their nation to make its own decisions. A specific example of this is found in the U.S. refusal to ratify the UN Convention on the Rights of the Child, which would, the claim is, hold international law over state and federal laws protecting the rights of parents to make decisions related to their children's upbringing and education. The Kyoto Protocol on Climate Change is another example. The argument here is

that such an international agreement on emissions would modify the power of the state and federal government to regulate in this area. Ratification of foreign treaties and agreements requires a two-thirds vote in the Senate.

One of the counterarguments to the sovereignty position is that the benefits gained from joining in such supranational agreements far outweigh their trade-offs. This is especially the case with issues whose limits do not fall on international borders, such as climate change and pollution.

### Questions:

1. Do international institutions such as the UN weaken the power of nation-states?
2. What might be the consequences of a world without international institutions?

This chapter has reviewed major global institutions and focused on their importance to managers engaged in international business. Institutions matter to the conduct of international business because they operate to limit the available choices, thereby simplifying the environment. An international manager can benefit greatly by being aware of their strengths and contributions. Next, we move from institutions to address the environmental forces to which the international manager has to adjust, beginning with sociocultural forces.

## Summary

### L03-1 Explain the importance of international institutions to business decision makers and their firms.

Institutions exist to limit and direct choices decision makers can make, so they limit the choices open to the firm. Institutions accomplish this constraint by simplifying the external environment. Whether the institution is formal or informal, it establishes rules, ways of acting, and ways of thinking (formal, informal normative, and informal cognitive) that achieve compliance through force, social norms, and shared assumptions that have the effect of reducing the number of options open to the firm or establishing the rules of the game. Their importance to business is that they simplify the external environment in ways that can help business understand and operate in their external environment.

### L03-2 Describe the various types of institutions, drawing on institutional theory.

Institutions are divided into formal and informal, based on how they influence behavior. Formal institutions use laws and regulations, while informal institutions use customs and ideologies. Informal institutions may be either normative or cognitive. Normative institutions work through values and norms, while the cognitive institutions work through schema or shared sets of assumptions that shape our meaning-giving.

We have reviewed the United Nations, the World Trade Organization, and the two monetary institutions—the World Bank and the International Monetary Fund—as examples of global institutions. We have also looked at OECD. Many other global institutions exist, of course, at all levels, including firms and nongovernmental organizations. Among these are the economic integration agreements. There are many other bases for regional institutions. Our focus has been on those of broadest significance to the international firm.

### L03-3 Outline the United Nations as an institution and its relevance to international business.

The United Nations is an informal, normative institution. Governments comply with their UN agreements based on moral principles and social obligation. At the same time, looking at the parts of the UN, the Peacekeeping Force could be seen as a formal institution that uses the regulatory power of coercion to extract compliance. The UN's work is carried out through five main bodies or organs: the General Assembly, the Security Council, the Economic and Social Council, the International Court of Justice, and the Secretariat. The General Assembly is a forum in which every nation has one vote; the Security Council focuses on peace and security and has permanent members and elected members; the Economic

and Social Council addresses issues related to trade, education, health, and other economic and social issues; the International Court of Justice hears cases between nations; and the Secretariat, headed by the secretary-general, is the administrative arm of the UN. The UN has a variety of agencies throughout the world that work to promote peace and stability and to facilitate trade and economic activity. International organizations such as the United Nations can have profound influence on international businesses. By providing a forum for governments to talk to each other, the United Nations contributes toward peace and stability, conditions that stimulate international business. Such dialogue also results in collaborative efforts that support multilateral cooperation in areas of immediate concern to business, such as maritime agreements, communication accords, and other rules and standards. In addition, many of these institutions support development projects, which stimulate business directly, through their contracts and also through their support of the development of markets.

**L03-4 Describe the purposes of the two global monetary institutions, the IMF and the World Bank.**

The basic idea of the IMF is that a workable monetary system is in the interests of all nations. Its Articles of Agreement outline the purpose of the fund in six points: to promote international monetary cooperation, to facilitate the expansion and balanced growth of international trade, to promote exchange stability and orderly exchange arrangements among members, to assist in the establishment of a multilateral system of payments, to make the fund's resources available for balance-of-payments corrections, and to shorten the duration and lessen the disequilibrium of members' balance of payments. The World Bank, including the IBRD and the IDA, lends money for development projects in middle-income and creditworthy poor countries. In the poorest countries, it provides low-interest loans and grants for projects designed to help them develop infrastructure, health and education, and other areas connected to development.

**L03-5 Discuss the purpose of the World Trade Organization and its impact on international business.**

The WTO attempts to reduce trade barriers worldwide in order to facilitate trade. Its membership is composed of the world's major trading countries, so it has the potential to significantly influence world trade. The WTO routinely issues decisions on trade disputes between countries. The Doha Development Agenda of the WTO has been stalled and faces

difficult negotiations in the areas of agricultural subsidies of developed nations, enforcement of rules and rulings, and intellectual property rights.

**L03-6 Discuss the resources of the Organisation for Economic Cooperation and Development.**

The OECD conducts extensive research on a wide variety of international business and economic subjects, and it produces highly regarded individual country surveys. These resource materials are valuable to researchers and businesspeople as they develop an understanding of markets.

**L03-7 Identify the levels of economic integration and the effectiveness of the major trading blocs.**

The four major forms of economic integration are the free trade area (tariffs abolished among members), the customs union (a free trade agreement plus a common external tariff), the common market (a customs union plus mobility of services, people, and capital), and complete integration (a common market plus a common currency and additional economic and political integration). NAFTA has been quite effective, while Mercosur, whose goal is a common market, has faced difficulties recently. African economic integration efforts have faced difficulties, as well, and they endure. The EU has been markedly successful and able to weather the instability of the recent financial crisis and the ensuing fallout in its weaker economies.

**L03-8 Discuss the EU, its impact, and its challenges going forward.**

The EU is a supranational entity with 27 European member-nations, 17 of which share a common currency. Its purpose is to integrate the economies of its member-nations, creating a trading region where goods, services, people, and capital move freely. In recent years, the EU has made major steps toward political union as well. The EU is a regional government and has regulatory power over social and environmental matters, including mergers and business operations, in Europe. The depth and breadth of its market gives the EU de facto influence on businesses worldwide. The EU's success at monetary integration reduces the risk for businesses within the EMU. The EU can be seen as one large market with fewer restrictions than existed among the 27 nations before integration. The recent financial crisis severely challenged the EU, especially when several of its weaker economies approached default on sovereign debt. So far, the EU appears to have weathered these challenges.

## Key Words

**new institutional theory** (p. 64)  
**formal institutions** (p. 65)  
**informal institutions** (p. 65)  
**United Nations (UN)** (p. 66)  
**General Assembly** (p. 68)

**Security Council** (p. 68)  
**Economic and Social Council (ECOSOC)** (p. 68)  
**International Court of Justice (ICJ)** (p. 68)  
**Secretariat** (p. 69)

**Bretton Woods** (p. 70)  
**International Monetary Fund (IMF)** (p. 70)  
**World Bank** (p. 71)  
**Special Drawing Rights (SDRs)** (p. 71)

par value (p. 71)

**World Trade Organization (WTO)** (p. 73)

**Doha Development Agenda** (p. 73)

**trade-related intellectual property rights (TRIPS)** (p. 74)

**Organization for Economic Cooperation and Development (OECD)** (p. 75)

**free trade area (FTA)** (p. 76)

**customs union** (p. 76)

**common market** (p. 76)

**complete economic integration** (p. 76)

**North American Free Trade Agreement (NAFTA)** (p. 77)

**Mercosur or Mercosul** (p. 78)

**Association of Southeast Asian Nations (ASEAN)** (p. 79)

**European Union (EU)** (p. 80)

**European Monetary Union (EMU) or Economic and Monetary Union** (p. 80)

**European Parliament** (p. 81)

**Council of the European Union** (p. 81)

**European Commission** (p. 84)

**European Central Bank (ECB)** (p. 84)

**European Court of Justice (ECJ)** (p. 84)

## Questions

1. What are the characteristics of informal cognitive institutions, and why are they of special significance to international business managers?
2. The UN may be best known for its peacekeeping missions, but it also has many agencies involved in activities that directly impact business. Comment on the UN's influence on a single trade transaction.
3. Sovereign wealth funds and high reserves are held by many developing nations today, and they were the major market for IMF loans in the past. How might the IMF adjust to a world in which fewer countries need their loans?
4. In your judgment, do bilateral trade agreements such as NAFTA and Mercosur undercut the WTO?
5. The U.S. Congress approved NAFTA, despite strong trade union and labor opposition. Do you agree with labor's opposition? Explain.
6. Mercosur's main trading partner is with the EU rather than the United States. Why might this be the case?
7. Why is OECD known as "the rich man's club"? Does it impact only rich countries?
8. Using concepts from new institutional theory, describe three bodies or organs of the EU.
9. What impact can the EU have on businesses external to the EU?
10. Criticism of international institutions such as the UN or the EU often goes to sovereignty, the authority of the state to govern itself. The argument is that the institution violates the sovereignty of the nations. One of the counterarguments to this assertion is that the benefits gained from joining the international institution can be positive and outweigh the sacrifice in sovereignty. Give several examples of this counterargument, drawing on institutions we have reviewed.

## Research Task



globalEDGE.msu.edu

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

1. You work at a company that manufactures low-cost computers and is currently considering entering India. Use the *World Development Indicators*

(WDI)—the World Bank's premier data compilation of data on development—to gather information on this country. Prepare a short report focusing on the economic policy and external debt, education, and infrastructure of India as it applies to your company's product.

2. The *Organisation for Economic Cooperation and Development* (OECD) publishes an Economic Survey, approximately every two years, for each OECD country. Each survey provides OECD's assessment and recommendations on the main economic challenges faced

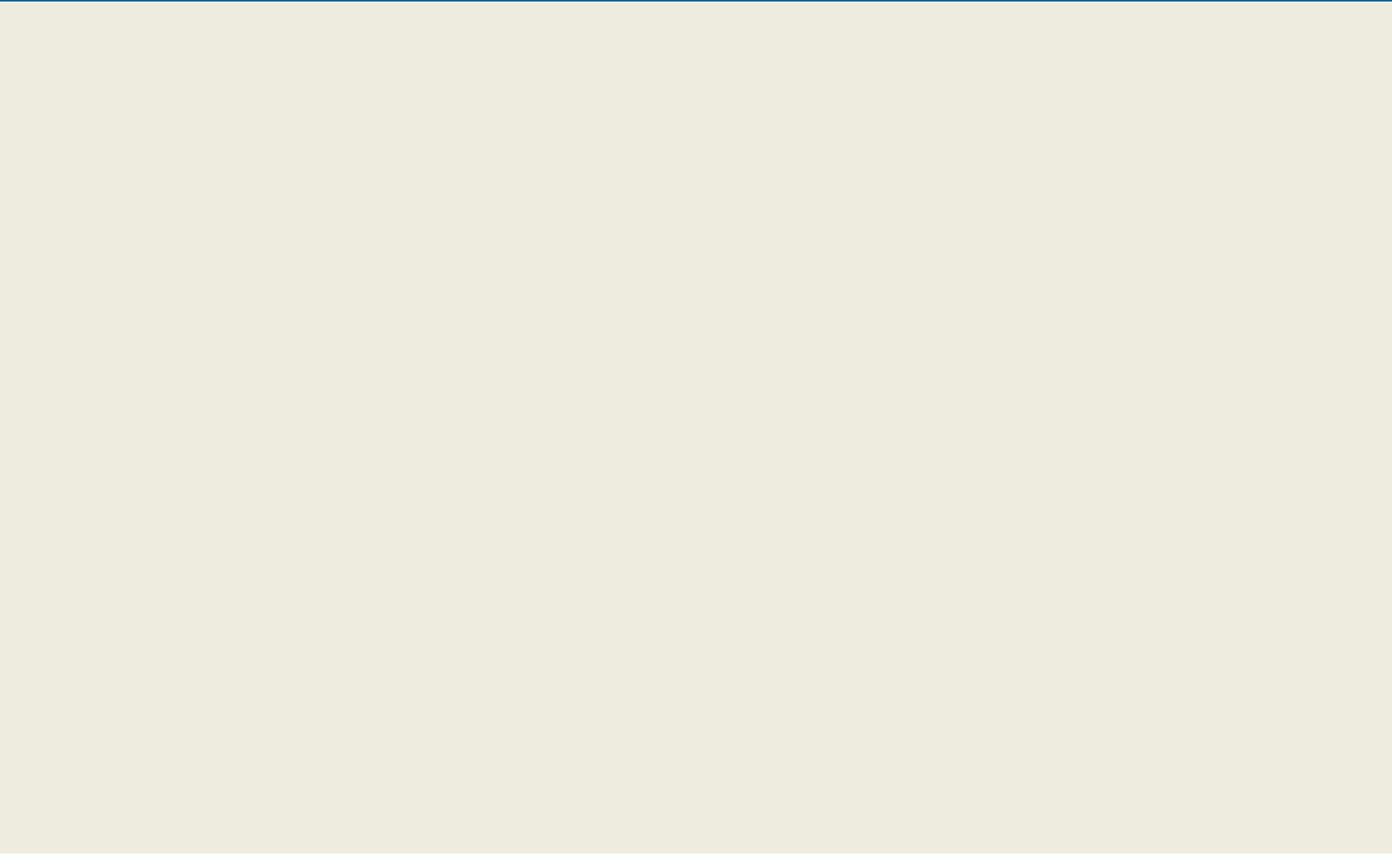
by the individual country. Find the Economic Surveys of France, Italy, and the United Kingdom for the most recent year. Summarize the key challenges facing each economy. Do you notice any similarities among the countries in terms of the challenges they are facing?

## Minicase: Use of International Institutions— Setting Up a 100 Percent Owned Subsidiary

You are researching direct foreign investment possibilities in African countries in the energy sector, either 100 percent owned or with a local partner. Which organizations discussed

in this chapter would you look to for help in developing a list of criteria for your decision?

Παγκόσμιο Business Negócios Internacionais  
التجارة العالمية Gli Affari Internazionali  
Los negocios internacionales Internationales Geschäft  
Affaires Internationales  
International Business Los negocios internacionales 國際商務  
Internationales Παγκόσμιο Business  
國際商務 Gli Affari Internazionali Interna  
Negócios Internacionais  
Gli Affari Internazionali التجارة العالمية





## s e c t i o n   t w o

# International Environmental Forces

In Chapter 1, we stated that many practices followed at home can be transferred intact to other countries. However, we also mentioned that because of the differences in environmental forces, some ways of doing business must be adapted to local conditions or changed completely.

In Section Two, we examine these forces to see how they differ from those we encounter at home. We begin Section Two with Chapter 4, which discusses cultural forces and points out that the variety of attitudes and values among cultures affects managers of all the business functions in ways that can require them to behave differently than they would have done at home. Next we look at the physical forces—location, topography, and climate,

along with natural resources and environmental sustainability (Chapter 5).

In Chapter 6, we investigate the political forces that affect the success or failure of a foreign venture, including their influence on international trade. Some of these are nationalism, terrorism, unstable governments, trade restrictions and government-owned businesses.

Intellectual property and other legal forces, the subject of Chapter 7, represent an additional set of constraints within which firms must operate.

Finally, our discussion moves to the international monetary system and financial forces in Chapter 8. Topics here include currency exchange risks, currency exchange controls, taxation and inflation, and the balance of payments accounts.