

CHAPTER 4: INTERNATIONAL TRADE THEORY

AN OVERVIEW OF TRADE THEORY

Free trade occurs when a government does not attempt to influence through quotas or duties what its citizens can buy from another country, or what they can produce and sell to another country. (E.g. Smith argued that the invisible hand of the market mechanism, rather than government policy, should determine what a country imports and exports).

- Benefits of trade

A country's economy may gain if its citizens buy from other countries certain products that could be produced at home.

The gains arise because international trade allows a country to specialize in the manufacture and export of products that can be produced most efficiently in that country, while importing products that can be produced more efficiently in other countries.

- Pattern of International Trade

New trade theory stresses that in some cases countries specialize in the production and export of particular products not because of underlying differences in factor endowments, but because in certain industries the world market can support only a limited number of firms. In such industries, firms that enter the market first build a competitive advantage that is difficult to challenge. Thus the observed pattern of trade between nations may in part be due to the ability of firms within a given nation to capture first-mover advantages.

- Trade theory and government policy

The argument for unrestricted free trade is that both import controls and export incentives are self-defeating and result in wasted resources. On the other hand, both the new trade theory and Porter's theory of national competitive advantage can be interpreted as justifying some limited and selective government intervention to support the development of certain export-oriented industries.

SUMMARY OF THEORIES

Mercantilism

Mercantilists argued that it was a country's best interests to run a balance-of-trade surplus. They viewed trade as a zero-sum game, in which one country's gains cause losses for other countries.

Absolute advantage

This theory suggests that countries differ in their ability to produce goods efficiently. The theory suggests that a country should specialize in producing goods in areas where it has an absolute advantage and import goods in areas where other countries have absolute advantages.

Comparative Advantage

The theory of comparative advantage suggests that it makes sense for a country to specialize in producing those goods that it can produce relatively less efficiently from other countries - even if that means buying

goods from other countries that it could produce more efficiently itself.

So, trade may be a positive-sum game, opening a country to free trade stimulates economic growth, which in turn creates dynamic gains from trade.

Heckscher-Ohlin theory

Heckscher-Ohlin theory argues that the pattern of international trade is determined by differences in factor endowments. It predicts that countries will export those goods that make intensive use of locally abundant factors and will import goods that make intensive use of factors that are locally scarce.

Product life-cycle theory

It suggests that trade patterns are influenced by where a new product is introduced.

New trade theory

This theory argues that in those industries where the existence of substantial economies of scale imply that the world market will profitably support only a few firms, countries may predominate in the export of certain products simply because they had a firm that was a first mover in that industry.

Some new trade theorists have promoted the idea of strategic trade policy. The argument is that government, by the sophisticated and judicious use of subsidies, might be able to increase the chances of domestic firms becoming first movers in newly emerging industries.

CHAPTER 5: THE POLITICAL ECONOMY OF INTERNATIONAL TRADE

FREE TRADE: Occurs when a government doesn't attempt to influence through quotas or duties what its citizens can buy from another country, or what they can produce and sell to another country.

- Static economic gains of it FT supports a higher level of domestic consumption and more efficient utilization of resources.
- Dynamic economic gains of it FT stimulates economic growth and creation of wealth.

INSTRUMENTS OF TRADE POLICY

• TARIFFS

A tariff is a tax levied on imports, and is the oldest form of trade policy. Tariffs fall into 2 categories:

- Specific tariffs: are levied as a fixed charge for each unit of a good imported (ex. 3\$ per barrel of oil)
- Ad valorem tariffs: are levied as a proportion of the value of the imported good.

The important thing to understand about a tariff is who suffers and who gains:

- The government gains, because the tariff increases government revenues.
- Domestic producers gain, because the tariff gives them some protection against foreign competitors (by increasing the costs of imported goods).
- Consumers lose since they must pay more for certain imports.

Conclusions:

- Tariffs are pro-producer and anti-consumer: While they protect producers from foreign competitors, this restriction of supply also raises domestic prices.
- Tariffs reduce the overall efficiency of word economy because a protective tariff encourages domestic firms to produce products at home that, in theory, would be produced more efficiency abroad.
- **SUBSIDIES**

A Subsidy is a government payment to a domestic producer. Subsidies take many forms including cash grants, tow-interest loans, tax breaks, and government equity participation in domestic firms.

By lowering costs, subsidies help domestic producer in two ways:

- ◆ They help them compete against low-cost foreign imports
- ◆ They help them gain export markets.

Advocates of strategic trade policy favor the use of subsidies to help domestic firms achieve a dominant position in those industries where economies of scale are important and the world market is not large enough to profitably support more than a few firms. So, subsidies can help a firm achieve a first-mover advantage in an emerging industry.

In practice, many subsidies are not that successful at increasing the international competitiveness of domestic producers. Rather, they tend to protect the inefficient, rather than promote efficiency.

• **IMPORT QUOTA**

An import quota is a direct restriction on the quantity of some good that may be imported into a country. The restriction is normally enforced by issuing import licenses to a group of individuals or firms.

• **VOLUNTARY EXPORT RESTRAINT (VER)**

A variant on the import quota is the VER, which is a quota on trade imposed by the exporting country, typically at the request of the importing country's government.

Foreign producers agree to VERs because they fear that if they do not, far more damaging punitive tariffs or import quotas might follow. Agreeing to a VER, therefore, is seen as a way of making the best of a bad situation by appeasing protectionist pressures in a country.

As with tariffs and subsidies, both import quotas and VERs benefit domestic producers by limiting import competition. On the other hand, quotas do not benefit consumers. An import quota or VER always raises the domestic price of an imported good.

• **LOCAL CONTENT REQUIREMENTS**

A local content requirement is a demand that some specific fraction of a good be produced domestically. The requirement can be expressed either in physical terms (% of components parts of the product.) or in value terms (% of product's value).

From the view of a domestic producer of components parts, local content regulations provide protection in the same way an import quota does: by limiting foreign competition. So as with all trade policies, local content regulations tend to benefit producers and not consumers.

• **ADMINISTRATIVE TRADE POLICIES**

Administrative trade policies are bureaucratic rules that are designed to make it difficult for imports to enter a country. And with all instruments of trade policy, administrative instruments benefit producers and hurt consumers, who are denied access to possibly superior foreign products.

THE GOVERNMENT INTERVENTION

There are two types of argument for government intervention:

- **Political arguments** for intervention are concerned with protecting the interests of certain groups within a nation (normally producers) often at the expense of other groups (normally consumers).
 - ◆ Protecting jobs and industries from foreign competition
 - ◆ National security: It's necessary to protect certain industries because they are important for national security.
 - ◆ Retaliation: Some argue that governments should use the threat to intervene in trade policy as a bargaining tool to help open foreign markets and force trading partners to “play by the rules of the game”.
- **Economic arguments** for intervention are typically concerned with boosting the overall wealth of a nation (to benefit of all, both producers and consumers).
 - ◆ The infant industry argument:

Many developing countries have a potential comparative advantage in manufacturing, but new manufacturing industries there cannot initially compete with well-established industries in developed countries. To allow manufacturing to get a toehold, the argument is that governments should temporarily support new industries until they have grown strong enough to meet international competition.

- ◆ Strategic trade policy

CHAPTER 12: THE STRATEGY OF INTERNATIONAL BUSINESS

STRATEGY AND THE FIRM

The fundamental purpose of any business firm is to make a profit. It can make it if the price charged for its output is greater than its costs of producing that output. A firm must produce a product that is valued by consumers.

Firms can increase their profits in two ways: by adding value to a product (improving quality, services, customizing...) so consumers are willing to pay more for it and by lowering the costs of value creation (e.g. costs of production).

The role of strategy

A firm's strategy can be defined as the actions managers take to attain the goals of the firm.

To be more profitable in such a global environment, a firm must pay attention to both reducing the costs of value creation and to differentiating its product offering in such a manner that consumers are willing to pay more for the product.

Thus, strategy is often concerned with identifying and taking actions that will lower the costs of value creation and/or will differentiate the firm's product through offering superior design, quality, service, functionality and

the like.

PROFITING FROM GLOBAL EXPANSION

Expanding globally allows firms to increase their profitability in ways not available to purely domestic enterprises. Firms that operate internationally are able to:

- Earn a greater return from their distinctive skills/*core competences*.
- *Realize location economies* by dispersing particular value-creation activities to those locations where they can be performed most efficiently.
- Realize greater *experience curve economies*, which reduce the costs of value creation.

Transferring Core Competences

The term core competence refers to skills within the firm that competitors cannot easily match or imitate. These skills may exist in any of the firm's value-creation activities and thus the core competencies are the bedrock of a firm's competitive advantage. They enable a firm to reduce the costs of value creation and/or to create value in such a way that premium pricing is possible.

Global expansion is a way of further exploiting the value-creation potential of the skills and product offerings by applying them in a larger market. Firms with unique and valuable skills can often realize enormous returns by applying them to foreign markets where indigenous competitors lack similar skills and products (e.g.: McDonald's, Kellogg's, Toyota...).

Realizing Location Economies

What does it mean for a firm that is trying to survive in a competitive global market? In brief, it means, trade barriers and transportation costs permitting, the firm will benefit by basing each value-creation activity it performs at that location where economic, political and cultural conditions, including relative factor costs, are most conducive to the performance of that activity.

This can both lower the costs of value creation and help the firm to achieve a low-cost position, or it can enable a firm to differentiate its product offering from the offerings of competitors.

Realizing Experience Curve Economies

The experience curve refers to the systematic reductions in production costs that have been observed to occur over the life of a product.

Two things explain this: learning effects and economies of scale.

- Learning effects refer to cost savings that come from learning by doing. Labor productivity increases over time as individuals learn the most efficient way to perform particular tasks. Learning effects tend to be more significant when a technologically complex task is repeated, since there is more that can be learnt about the task.
- Economies of scale refer to the reductions in unit cost achieved by producing a large volume of a product. The most important source is the ability to spread fixed costs over a large volume.

The strategic significance of the experience curve is clear. Moving down the experience curve allows a firm to reduce its costs of creating value. The firm that does it most rapidly will have a cost advantage vis-à-vis its competitors.

PRESSURES FOR COST REDUCTIONS AND LOCAL RESPONSIVENESS

Firms that compete in the global marketplace typically face two types of competitive pressure. They face pressures for cost reductions and pressures to be locally responsive.

Responding to pressures for cost reductions requires that a firm try to minimize its unit cost and may also necessitate that it offers a standardized product to the global marketplace to ride down the experience curve a.s.a.p.

In contrast, responding to pressures to be locally responsive requires that a firm differentiate its product offering and marketing strategy from country to country to attempt to accommodate the diverse demands that arise from national differences in consumer tastes and preferences, business practices, distribution channels, competitive conditions, and government policies. Because customizing product offerings to different national requirements can involve significant duplication and a lack of product standardization, the result may be to raise costs.

STRATEGIC CHOICE

International Strategy

Firms that pursue an international strategy try to create value by transferring valuable skills and products to foreign markets where indigenous competitors lack those skills and products (offering developed at home to new markets overseas). Accordingly they tend to centralize product development functions at home. However, they also tend to establish manufacturing and marketing functions in each major country in which they do business but head offices retains tight control over strategies.

An international strategy makes sense if a firm has a valuable core competence and faces relatively weak pressures for local responsiveness and cost reductions.

Multidomestic Strategy

Firms pursuing a multidomestic strategy orient themselves toward achieving maximum local responsiveness. They also tend to transfer skills and products developed at home to foreign markets. However, they extensively customize both their product offering and their marketing strategy to different national conditions. They also have a tendency to establish a complete set of value-creation activities in each major national market in which they do business.

As a consequence they are generally unable to realize value from experience curve effects and location economies. They have a high cost structure.

A multidomestic strategy makes most sense when there are high pressures for local responsiveness and low pressures for cost reductions.

Global Strategy

Firms that pursue a global strategy focus on increasing profitability by reaping the cost reductions that come from experience curve effects and location economies. They pursue low-cost strategy so they prefer to market a standardized product worldwide so they can reap the maximum benefit from the economies of scale that underlie the experience curve. They also tend to use their cost advantage to support aggressive pricing in world markets.

This strategy makes most sense in those cases where there are strong pressures for cost reductions and where

demands for local responsiveness are minimal.

Transnational Strategy

Firms that pursue a transnational strategy (Barlett & Ghoshal) are trying to simultaneously achieve a low cost and differentiation advantages.

The flow of skills is multilateral, from home to subsidiary, viceversa and also from subsidiary to subsidiary. Distinctive competences do not just reside in the home country.

A transnational strategy makes sense when a firm faces high pressures for low cost reductions and high pressures for local responsiveness.

ADVANTAGES AND DISADVANTAGES

<u>Strategy</u>	<u>Advantage</u>	<u>Disadvantage</u>
Global	Exploit experience curve effects Exploit location economies	Lack of local responsiveness
International	Transfer core competences to foreign markets	Lack of local responsiveness and inability to realize location economies
Multidomestic	Customize product offering and marketing in accordance with local responsiveness	Inability to realize location economies. Failure to exploit experience curve effects. Failure to transfer core competencies to foreign markets.
Transnational	Exploit experience curve effects Exploit location economies. Customize product offering and marketing in accordance with local responsiveness. Reap benefits of global learning.	Difficult to implement due to organizational problems

CHAPTER 13: ORGANIZATIONAL ARCHITECTURE

This chapter identified the organizational architecture that can be used by multinational enterprises to manage and direct their global operations. A central theme of the chapter was that different strategies require different architectures; strategy is implemented through architecture. To succeed, a firm must match its architecture to its strategy in discriminating ways. Firms whose architecture does not fit their strategic requirements will experience performance problems. It is also necessary for the different components of architecture to be consistent with each other. The chapter made these major points.

Organizational architecture

Refers to the totality of a firm's organization:

- formal organizational structure
- control systems and incentives
- processes

- organizational culture
- people

Superior enterprise profitability

Requires three conditions to be fulfilled:

- Elements of the organizational architecture must be internally consistent
- Organizational architecture must fit the strategy of the firm
- Strategy and architecture must be consistent with competitive conditions

Organizational structure means three things

- Formal division of the organization into subunits (horizontal differentiation)
- Location of decision-making responsibilities within that structure (vertical differentiation)
- Establishment of integrating mechanisms
- Control systems (metrics used to measure the performance of subunits).

Incentives

They refer to the devices used to reward appropriate employee behavior. Many employees receive incentives in the form of annual bonus pay. Incentives are usually closely tied to the performance metrics used for output controls.

Processes

They refer to the manner in which decisions are made and work is performed within the organization. Processes can be found at many different levels within an organization. The core competencies or valuable skills of a firm are often embedded in its processes. Efficient and effective processes can help to lower the costs of value creation and to add additional value to a product.

Organizational culture

It refers to a system of values and norms that is shared among employees. Values and norms express themselves as the behavior patterns or style of an organization that new employees are automatically encouraged to follow by their fellow employees.

CHAPTER 14: MODE OF ENTRY AND STRATEGIC ALLIANCES

The magnitude of the advantages and disadvantages associated with each entry mode are determined by a number of factors, including transport costs, trade barriers, political risks, economic risks, and firm strategy. The optimal entry mode varies depending on these various factors.

The second topic of this chapter is that of strategic alliances. These are agreements between actual or potential competitors to cooperate.

ENTRY MODES

- **EXPORTING**
- **TURNKEY PROJECTS**

A project in which a firm agrees to set up an operating plant for a foreign client and hand over the “key” when the plant is fully operational.

- **LICENSING**

It occurs when a firm (licensor) licenses the right to produce its product, use its production processes, brand name or trademark to another firm (licensee). In return for giving the licensee these rights, the licensor collects a royalty fee on every unit the licensee sells.

- **FRANCHISING**

It is a specialized form of licensing in which the franchiser sells intangible property to the franchisee and insists on rules to conduct the business.

- **JOINT VENTURES**

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

- **WHOLLY OWNED SUBSIDIARIES**

This is a subsidiary in which the firm owns 100% of the stock.

ADVANTAGES / DISADVANTAGES OF ENTRY MODES

The advantage of **exporting** is that it facilitates realization of experience curve economies and prevents cost of setting up manufacturing operations in another country. Disadvantages include high transport costs, trade barriers and problems with local marketing agents. Turnkey projects allow firms to export their process technology where FDI is not permitted.

The disadvantage is that the firm may create competitors in the process. The main advantage of licensing is that the licensee bears the cost and risk of opening a foreign market. The disadvantages include the risk of losing technological know-how to the licensee.

The advantage of **franchising** is similar to that of licensing and the disadvantage is that the franchiser has to keep strict control over the franchisee. The advantage of joint ventures is the partners share the costs and risk of opening a foreign market and of gaining knowledge and political influence. The disadvantage is the risk of losing control over technology.

The advantages of **wholly owned subsidiary** include tight control over operations and technology. However, the firm has to bear all the costs and risks of opening a foreign market. We have also seen that the multiple measures of risk should be taken into consideration while selecting an entry mode. We also discussed strategic alliances and its advantages and disadvantages.

The advantage of **strategic alliance** is that it facilitates entry into foreign market and enables partners to share the fixed costs and risks associated with new products and processes. The disadvantage is that firms may sometimes have to give away technological know-how and market access to the alliance partner.

To make the alliance work, factors to be taken into consideration are selection of partner, structure of the alliance and management of the alliance. The key issues involved in managing alliances are building trust and learning from each other.

SELECTING ENTRY MODE BY DEFINING CORE COMPETENCIES

Technological Know-How

If this is the firm's forte, then a wholly owned is ideal except if:

- ◆ The venture is created to reduce risk of loss of technology
- ◆ Technology advantage is transitory

Then licensing or joint venture would be more suitable.

Management Know-How

Franchising and subsidiaries (wholly owned or joint venture) are the best choice.

Pressure for cost reduction

Combination of exporting and wholly owned subsidiary is the best.

ACQUISITIONS OR GREEN-FIELD?

CHAPTER 16: ADDING VALUE

This chapter explained how efficient manufacturing and materials management functions can improve an international business's competitive position by lowering the costs of value creation and by performing value creation activities in such ways that customer service is enhanced and value added is maximized.

Where to manufacture

The choice of an optimal manufacturing location must consider:

- *Country factors* include the influence of factor costs, political economy, and national culture on manufacturing costs, along with the presence of location externalities.
- *Technological factors* include the fixed costs of setting up manufacturing facilities, the minimum efficient scale of production, and the availability of flexible manufacturing technologies that allow for mass customization.
- *Product factors* include the value-to-weight ratio of the product and whether the product serves universal needs.

Foreign factories can improve their capabilities over time, and this can be of immense strategic benefit to the firm. Managers need to view foreign factories as potential centers of excellence and to encourage and foster attempts by local managers to upgrade factory capabilities.

What to make and what to buy

Making components in-house facilitates investments in specialized assets and helps the firm protect its proprietary technology. It may improve scheduling between adjacent stages in the value chain, also. In-house production also makes sense if the firm is an efficient, low-cost producer of a technology.

Buying components from independent suppliers facilitates strategic flexibility and helps the firm avoid the organizational problems associated with extensive vertical integration. Outsourcing might also be employed as part of an "offset" policy, which is designed to win more orders for the firm from a country by pushing

some subcontracting work to that country.

How to coordinate globally dispersed manufacturing /supply system

Vertical integration it can be used to avoid its associated organizational problems by entering long-term strategic alliances with essential suppliers.

“The firm that enters a strategic alliance may find its strategic flexibility limited by commitments to alliance partners.

Materials management

It encompasses all the activities that move materials to a manufacturing facility, through the manufacturing process, and out through a distribution system to the end user. The materials management function is complicated in an international business by distance, time, exchange rates, custom barriers, and other things.

Just-in-time systems generate major cost savings from reducing warehousing and inventory holding costs and from reducing the need to write off excess inventory. It also helps the firm spot defective parts and to remove them from the manufacturing process quickly, thereby improving product quality.

Information technology, particularly Internet-based electronic data interchange, plays a major role in materials management.

CHAPTER 18: HUMAN RESOURCE MANAGEMENT

HRM POLICIES

Firms' success require them to be congruent with its strategy and with its formal and informal structure and controls.

Staffing policy

It is concerned with selecting employees who have the skills required to perform particular jobs. It can be a tool for developing and promoting a corporate culture.

- **Ethnocentric**

It fills all key management positions in an international business with parent-country nationals. The policy is congruent with an international strategy. A drawback is that ethnocentric staffing can result in cultural myopia.

- **Polycentric**

It uses host-country nationals to manage foreign subsidiaries and parent-country nationals for the key positions at corporate headquarters. This approach can minimize the dangers of cultural myopia, but it can create a gap between home- and host-country operations. The policy is best suited to a multidomestic strategy.

- **Geocentric**

It seeks the best people for key jobs throughout the organization, regardless of their nationality. This approach is consistent with building a strong unifying culture and informal management network and is well suited to both global and transnational strategies. Immigration policies of national governments may limit a firm's

ability to pursue this policy.

Expatriate failure

Expatriate failure is the premature return of an expatriate manager to his or her home country. The costs of expatriate failure can be substantial.

How to reduce expatriate failure?

- *Selection procedures that screen out inappropriate candidates* The most successful expatriates seem to be those who have high self-esteem and self-confidence, get along well with others, are willing to attempt to communicate in a foreign language, and can empathize with people of other cultures.
- *Training* can lower the probability of expatriate failure. It should include cultural training, language training, and practical training, and it should be provided to both the expatriate manager and the spouse.
- *Management development programs* attempt to increase the overall skill levels of managers through a mix of ongoing management education and rotation of managers through different jobs within the firm to give them varied experiences. Management development is often used as a strategic tool to build a strong unifying culture and informal management network, both of which support transnational and global strategies.

Approach to expatriate pay

Balance sheet approach This approach aims to equalize purchasing power so employees can enjoy the same living standard in their foreign posting that they had at home.

CHAPTER 20: FINANCIAL MANAGEMENT

Capital budgeting techniques

We use them to evaluate a potential foreign project.

- A distinction must be made between cash flows to the project and cash flows to the parent. The two will not be the same thing when a host-country government blocks the repatriation of cash flows from a foreign investment.
- The firm needs to recognize the specific risks arising from its foreign location. These include political risks and economic risks (including foreign exchange risk).
- Political and economic risks can be incorporated into the capital budgeting process either by using a higher discount rate to evaluate risky projects or by forecasting lower cash flows for such projects.
- The cost of capital is typically lower in the global capital market than in domestic markets. Consequently, *ceteris paribus*, firms prefer to finance their investments by borrowing from the global capital market.
- Borrowing from the global capital market may be restricted by host-government regulations or demands. In such cases, the discount rate used in capital budgeting must be revised upward to reflect this.
- The firm may want to consider local debt financing for investments in countries where the local currency is expected to depreciate.

Global money management

It is used to utilize the firm's cash resources in the most efficient manner and to minimize the firm's global tax

liabilities.

Techniques to transfer funds across borders

Dividend remittances are the most common method used for transferring funds across borders

Royalty payments and fees they have certain tax advantages over dividend remittances.

Manipulation of transfer prices is sometimes used by firms to move funds out of a country to minimize tax liabilities, hedge against foreign exchange risk, circumvent government restrictions on capital flows, and reduce tariff payments. Manipulating transfer prices in this manner runs counter to government regulations in many countries, it may distort incentive systems within the firm, and it has ethically dubious foundations.

Fronting loans involve channeling funds from a parent company to a foreign subsidiary through a third party, normally an international bank. Fronting loans can circumvent host-government restrictions on the remittance of funds and provide certain tax advantages. By holding cash at a centralized depository, the firm may be able to invest its cash reserves more efficiently. It can reduce the total size of the cash pool that it needs to hold in highly liquid accounts, thereby freeing cash for investment in higher-interest-bearing (less liquid) accounts or in tangible assets.

Types of exposure to foreign exchange risk

- *Transaction exposure*
- *Translation exposure*

Tactics that insure against transaction and translation exposure include buying forward, using currency swaps, leading and lagging payables and receivables, manipulating transfer prices, using local debt financing, accelerating dividend payments, and adjusting capital budgeting to reflect foreign exchange exposure.

- *Economic exposure* Reducing a firm's economic exposure requires strategic choices about how the firm's productive assets are distributed around the globe. To manage foreign exchange exposure effectively, the firm must exercise centralized oversight over its foreign exchange hedging activities, recognize the difference between transaction exposure and economic exposure, forecast future exchange rate movements, establish good reporting systems within the firm to monitor exposure positions, and produce regular foreign exchange exposure reports that can be used as a basis for action.