

International Business environment

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Wordlist

MNE/MNC: multinational enterprise. Multinational corporations.

MNIs?

GVCs:

OECD:

NON_OECD:

GDP: Gross domestic products. the total value of goods produced and services provided in a country during one year.

Transparency International: Ranks countries by the extent of corruption.

IMF: International monetary fond

Share of service in total exports:

UNCTAD:

DVA: Domestic value added

FVA: Foreign value added

WB: World Bank

Subvert: undermine the power and authority of (an established system or institution)

Tariff: a tax or duty to be paid on a particular class of imports or exports. It is a form of regulation of foreign trade and a policy that taxes foreign products to encourage or safeguard domestic industry. Traditionally, states have used them as a source of income.

Hegemon: a supreme leader.

Cultural myopia: is the lack of interest in learning about other cultures, or to recognize what's good in other cultures

The exam

Individual 20-minute exam. The exam will test the course's learning objectives as well as the students' abilities in organizing, structuring and communicating academic arguments in a coherent way. The exam will take the form of a dialogue between the student and the examiners. At the beginning, the student will have the opportunity to use about 2-3 minutes to introduce some

thoughts on a chosen topic. Consequently, the examiners will pose questions covering the entire course syllabus.

Learning objectives

After having followed the course the students should be able to:

- Explain the differences in national or regional business environments and assess why they exist and how they impact international business operations.
- Present a thorough review of the economics and politics of the international trade and investment environment.
- Assess the important role played by multinational economic and social aid organizations such as the UN, EU, IMF and World Bank in facilitating international trade and business
- Analyze the strategies and structures of international businesses
- Assess the functions of an international business.
- Highlight the adjustments needed in the transition from domestic to international business, and the adjustments needed to operate successfully in specific foreign markets
- Assess business operations and relationships in complex international business environments.

Course Content

The aim of the course is to provide an integrated understanding of the complexity of the international business environment and the challenges it poses for firms engaged in cross-border activities. Emphasis is put on highlighting the differences among countries and/or regions in terms of their national/sub-national business environments, and how these differences are linked to the various strategic choices that firms adopt in order to compete internationally. By the end of the course students should have developed their ability to explain, interpret, and synthesize international business practices in a multidisciplinary discourse. Both theory and cases are included in the curriculum, with much of the empirical material will be drawn from recent examples of developments in the field of international business.

The main blocks of the curriculum are:

Selected cross-country differences with a potential impact on business operations, including historical, institutional, geographical, cultural, and political structure.

Global trade, foreign direct investment and global value chains, including the regulatory systems for international trade, investment, and monetary transactions.

Strategy and International Business.

Lecture 1 Globalization

Course intro. State of the IB environment (globalization, trade patterns, trade barriers, political dynamics, (un)competitive pressures, global governance, etc).

The 3th of September

Firm level analysis

Macrolevel analysis

The international economy

High degree of economic interdependence

- No nation exists in economic isolation
- All aspects of a nation's economy are linked to the economies of its trading partners
- Reflects the historical evolution of the world's economic and political order
- Complex and its effects uneven
- Steps toward international cooperation
- Protectionist pressures

Globalization of Economic Activity

- Globalization
- Greater interdependence
- Countries and their citizens
 - International flows
 - Goods and services
 - People
 - Investments in equipment, factories, stocks, bonds
 - Non-economic elements
 - Culture and the environment

Globalization: Globalization is a process of interaction and integration among the people, companies, and governments of different nations, a process driven by international trade and investment and aided by information technology. This process has effects on the environment, on culture, on political systems, on economic development and prosperity, and on human physical well-being in societies around the world.

Beginning of globalization

Social scientists (especially sociologists of globalization) see it as a very recent phenomenon, something that might go back to the period following the major economic crisis of 1973-74, perhaps to 1945.

In the Early 19th Century

Christopher Bayly claims that globalization started with the collapse of 18th century regimes. This he defines as 'modern globalization' and sees it as a process based on:

- colonialism and imperialism
- and the concept of free trade

1820-1913: The Great Phase

- **Williamson and O'Rourke** underline how
- the period from 1820 to 1870, in particular, was:
 - age of 'free trade'
 - liberalization of the state
 - increased commodity trading

Critiques:

- issues of power forgotten
- gunboat diplomacy
- colonial control
- Post 1870
- Mass migration
- infrastructure (railroads and steamships, and cables)

1914-1945: De-globalization

The interwar period saw:

- economic protectionism and autarky
- economic and monetary instability
- stagnation of the economies
- moribund empires, and start of the confrontation between the US and the Soviet Union
- lack of innovation

1945-2013: Contemporary Globalization

The key force of globalization after 1945 was the **action of institutions and governments. And of markets after 1973.**

- Liberal economic policies and regimes
- Growth of world trade and financial transactions
- Advances in Information Technologies and easier access to information
- Performance of services remotely
 - New business organizations:
 - A high degree of convergence in consumer culture

Post 2014: A second de-globalization?

Is it possible that we are going towards de-globalization once again?

- the 2008 financial crisis
- the US is overstretched
- great power rivalry (US-China) and a sclerosis of Europe
- global alliances not working; and rogue regimes

Types of globalization

What is globalized? Can't talk about there is one globalization- you have to look at different fields to see what/how/when is globalized.

Always define the type of globalization.

Financial globalizations: World's financial systems have become intimately interconnected
Stock market trading in New York stock exchange can affect Tokyo and Hong Kong.
Wave continues in European markets then back to American markets
Important to note: this reflects interconnectivity of network of world cities, **not nations**

Economic globalizations: In past, most corporations were linked/identified with a country, but today corporations are now transnational Companies move their production and capital to any market that will benefit the company (increase profits and share values): Ford has plants in Mexico, Coca Cola and Nike are all over the world

Supporters: increased global wealth means increase in standard of living

Detractors (opponent)- economic globalization tends to increase difference between the “haves and have not” and leads to the corporation having more power than countries.

Technological globalizations: Technological revolution has meant the “Global Village” has expanded to everything corner of the globe with growth in travel communication and computer technology, and mobile (smart) phones communications. I can be around the world live, in 1 second by internet or smart phone or 12 hours by plane The remotest village can now use hand crank computers to communicate via internet. Some regions have no phone networks, they have jumped ahead to cellphone networks only.

Political globalization: As countries become more economically and technologically interdependent, there is pressure to adopt uniform policies

Examples of such attempts are the European Union project, the USMCA (old NAFTA) - the re-negotiated free trade between US, Canada & Mexico, Mercosur, etc.

Cultural globalization: Harmonization of worlds cultures at the **expense** of distinctly different local cultures. We eventually all listen to the same music, watch same TV, eat same food, have the same values (Spotify, Netflix, sushi). Loss of worlds cultural diversity, replaced by primarily Americanized (Westernized) world cultures

Major issue for cultures where religion is directly connected to their culture, “western” values can often come into conflict with tradition religious beliefs.

Ecological globalization: The planet must be treated as a single ecological system (ecosystem) rather than a collection of separate ecological systems.

Ozone depletion, global warming impacts the world not just nation that did original damage. The failed Kyoto Protocol, Montreal Protocol, Copenhagen Accord, Paris Agreement are examples of this type of globalization.

Geographical globalization: Geographers don't see world in terms of relationships between countries anymore. Instead, now they see a borderless world, dominated by worldwide concerns about ecological concerns, politics, culture, economics and other relationships existing; all influenced by networks of world cities.

How globalized is the world?

One commonality between globalization's supporters and its critics is that both tend to believe the world is already far more globalized than it really is. ... The world is both more globalized than ever before and less globalized than most people perceive it to be. The intriguing possibility embodied in that conclusion is that companies and countries have far larger opportunities to benefit

from global connectedness and more tools to manage its challenges than many decision-makers recognize.

Important economic outcomes of globalization

- Acceleration in all forms of IB.
- Newer forms of IB (Service trade growth is a unique phenomenon with almost every service becoming tradable, service FDI, service sector offshore outsourcing, newer types of strategic alliances; E-commerce)
- Growing powers of MNEs; Rise of MNEs from developing countries, born global
- Proliferation of GVCs: Integration of trade, FDI and other forms of IB.
- Intensified technology-based competition

Forms of International Business

(WRITE NOTES FROM TEXT ABOUT MULTINATIONAL BUSINESS and so on)

Foreign sales, trading, movement of capital (not considered IB activity).

Trade and globalization

Over the last two centuries trade has grown remarkably, completely transforming the global economy. Today about one fourth of total global production is exported. Understanding this transformative process is important because trade has generated gains, but it has also had important distributional consequences.

Trade transactions include both goods (tangible products that are physically shipped) and services (intangible commodities, such as tourism and financial services). The production chains for these goods and services are becoming increasingly complex and global. According to recent estimates, about 30% of the value of global exports comes from foreign inputs.

Most trade theories in the economics literature focus on sources of comparative advantage. These theories postulate that all nations can gain from trade if each specializes in producing what they are relatively more efficient at producing, based on their strengths. The empirical evidence shows that comparative advantage is indeed relevant; but it is not the only force driving incentives to specialization and trade

Globalizations and competitiveness

A Typical Statement about international economics and policy:

1. "We need a new economic paradigm, because today [our country] is part of a truly global economy.
2. To maintain our standard of living, [our country] now has to learn to compete in an ever-tougher world marketplace
3. That's why high productivity and product quality have become essential
4. We need to move [our country's] economy into the high-value sectors that will generate jobs for the future
5. And the only way we can [achieve this is to] forge a new partnership between government and business"

Paul Krugman (1993) What Do Undergrads Need to Know About Trade? *The American Economic Review*. Vol. 83(2): 23–26

Competitive advantage of a firm

“competitive strategy is about taking offensive or defensive action to create a defensible position in an industry, in order to cope successfully with competitive forces and generate a superior return on investment” (Value Based Management.net)

If a firm is not competitive, it will go bankrupt

Firm’s competitiveness can be measured through profits / return on investment etc.

Competitive advantage: Countries

- Countries are not companies

While firms based in different countries sell products that compete with each other, in the country-level there are mutual benefits from trade

Success of one country is likely to benefit other countries (more demand for imports)

The only meaningful “offensive or defensive action” in the level of a country is strategic trade policy

Exports or current account are not the “bottom line” of a country in a way profits are for a firm.

Globalization and Governance

(Global governance, not firm level governance)

- The “dark side” of globalization:
 - More access to goods and services.....but greater illegal trade in arms, people, drugs, money.
 - More goods transported across the globe.....but they can bring in toxic toys, invasive species, contaminated food
 - Ease of internet access expands free speech but can put porn in children's hands, facilitate reckless investments, intellectual theft
 - Movement of people expands freedom but can spread deadly diseases.
 - Movement of capital helps built imbalances and amplify the effect of shocks and transmission across countries.

Dilemma between Governance and globalization

- Economics is global but.....
- Because globalization undermines state sovereignty
- National governments can’t protect their citizens from global “bads”
- Politics is local
- Local (national) politics can’t handle global issues.....

Could backlash

- Illiberal democracy because.....
 - Globalization → Econ. Insecurity → retreat from national identity → retreat into ethnic and sectarian identities → feeling of “belonging” and security → exclude others from democracy
- “Jihad” because.....
 - Exclusivity can lead to separation and fragmentation of political communities → who might want the same land → conflict

Globalization round up

Globalization always contains the seeds of its own destruction:

- 1) It polarizes the income distribution within countries
- 2) It leads to the rise of new antagonistic(modsatrettet) powers
- 3) It brings contagious financial instability

The world are moving towards a different type of globalization, because of nation sovereignty, the financial crisis and environmental crisis.

Lecture 2 Social differences: Culture, institutions, system

Learning goals

Societal differences: Culture, institutions, systems

Political systems

Political economy: Political, economy and legal systems interact with each other and affect the economy for a country.

Political system: The system of government in a nation.

Types of political systems

Collectivism: refers to a political system, that stresses the primacy of collective goals over individual goal. An individual right to do something, may be restricted “to the good of society”.

Socialism: Roots from Karl Marx, he advocated state ownership of basic means of production, distribution and exchange (i.e., business).

Social democracy: Denmark,

Privatization: Selling state-owned enterprises to private investors.

Individualism: A philosophy that an individual should have freedom in his or hers economic and political pursuits, fx Adam Smith, David Hume. Build on two central principals:

1. Guaranteeing individual freedom and self-expression.
2. Society is best served with people pursuing their own economic self-interest.

Democracy: A political system in which government is by the people, either directly or through elected representatives.

Representative democracy: fx. the United states, periodically people elect individuals to represent, then they form a government, whose function is to make decisions on behalf of the electorate.

Totalitarianism: One person or one party have absolute control.

Communist totalitarianism: fx Vietnam and China. These countries are only communists in name only, they adopted market-based economic reforms, but remain totalitarian states that deny many basic civil liberties.

Theocratic totalitarianism: Monopolized by a party/group/individual that governs according to religious principles, fx Iran and Saudi Arabia.

Tribal totalitarianism: It's when a political party that represents the interest of a tribe, fx Kenya.

Right-wing-totalitarianism: backed by military, some individually freedom, but no political freedom.

Pseudo-democracies: lie between totalitarianism and pure democratic systems. Fx Putins Russia.

Economic systems

Market economic: In its purest form, all productive activities are privately owned. Production is determined by the interaction of supply and demand and signaled to producers through the price system. Customers are sovereign. There must not be a monopolized market.

Command economy: the government plans the goods and services that a country produces, the quality and the prices. All business are state owned.

Mixed economy: Certain sectors of the economy are left to private ownership and free market mechanism, where other sectors are state and government owned and planned.

Legal systems

Refers to the rules, or laws, that regulate behavior and the processes by which the laws are enforced.

Differences in legal systems can affect the attractiveness of a country as an investment site or market. The government of a country defines the legal framework within which firms do business. Often the laws that regulate business reflect the ruler's dominant political ideology. Focus here is how legal systems can vary and how such variations can affect international business.

Common law: based on tradition, precedent and custom. Judges have the power to interpret the law so that it applies to the unique circumstances of an individual case.

Civil law: based on laws organized into codes. Judges rely on detailed legal codes, and only have the power to apply the law.

Theocratic law: law based on religious teachings such as Islamic law.

Differences in Contract law

Contract: is a document that specifies the conditions under which an exchange is to occur and details the rights of the parties involved.

Contract law: is what governs contract enforcement. If one party in a contract agreement feels the other is violated, it resorts to the contract law.

United Nations Convention on Contracts for the International Sale of Goods (CISG): It's when a contract dispute arises in international trade, there is always the question of which country's laws apply, the CISG establishes a uniform set of rules, that the countries adopters the conventions rules as part of its laws.

Property rights and corruption

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

Private actions: is violating property rights, theft, piracy, blackmail done by private individuals or groups fx the Mafia.

Public action: is violating of property rights which occurs when public officials (politicians and government bureaucrats).

Foreign Corrupt Practices Act (FCPA): U.S law regulating behavior regarding the conduct of international business in taking bribes and other unethical actions.

The protection of intellectual property

Intellectual property: computer software, screenplay, music score or chemical formula- a product of intellectual activity.

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

Copyrights: a legal rights of the author, composers, playwrights, artist and publishers to publish and disperse there work as they see fit.

Trademarks: are designs and names that are officially registered (fx Christian Dior clothes).

World Intellectual property organization: 185 countries agrees on intellectual property rights, because the rights differs from country to country.

Product safety and product liability

Product safety laws: safety standards to which a product must adhere.

Product liability: involves holding a firm responsible for when a product causes injury, death or damage.

High levels of corruption significantly reduce the foregin direct investment, level of international trade and economic growth rate in a country.

Differences in culture

Learning goals

Explain what is meant by the culture of a society

Identify the forces that lead to differences in social culture

Identity the business and economic implications of differences in culture

Recognize how differences in social culture influence values in business

Demonstrate an appreciation for the economic and business implication of cultural change

What is culture?

Cross-cultural literacy: how cultural difference across and within nations can affect the way business is practiced.

Culture: a system of values and norms that are shared among a group of people and that when taken together constitute a design for living- bound together by a common culture (Hofstede and Weber, Namenwitrth definition).

It's possible to talk about culture on different levels

Values: ideas about what a group believes to be good and right and desirable- shared assumptions.

Norms: Social rules and guidelines the prescribes appropriate behavior in certain situations.

Divided into to two categories by William Graham Sumner (sociologist)

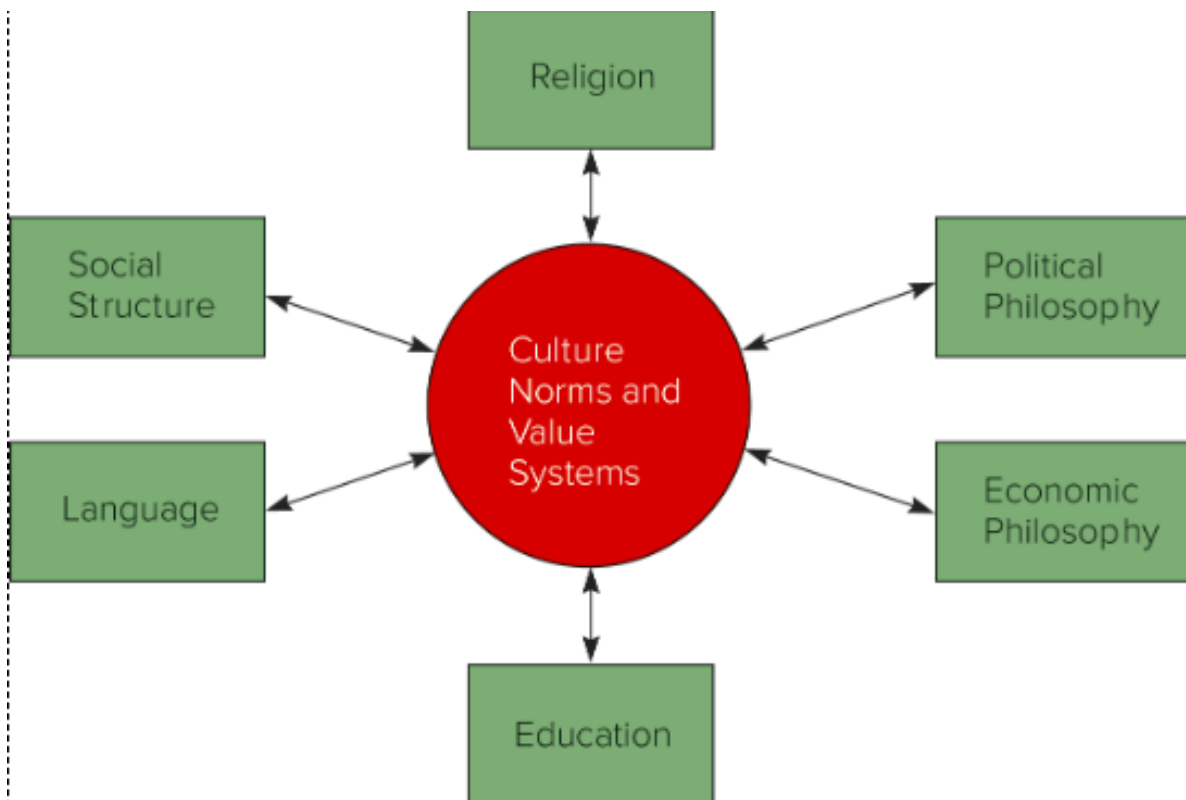
Folkways: actions of little moral significance: like dress code, eating with correct utensils so on. Rituals and symbolic behavior.

Mores: Has more significance than folkways. Might collapse a business deal. Includes theft, adultery, incest and cannibalism. Fx in USA drinking alcohol is alright, whereas in Saudi Arabia consumption alcohol is a violation to an important social mores.

Society: A group of people sharing common set of values and norms.

Nation-states: are political creations, not the same as a society. Are often studied for the national identity, so own. May contain one culture og several subcultures.

Determinants of culture



Social structure

Social structure: basic social organization. How the society is organized in terms of values, norms and relationships. First degree is the basic unit of the social organization is the individual or the group. Second degree is if the society is divided into castes or classes.

India fx: has high degree of social stratification and low mobility between strata.

USA fx: has low degree of social stratification and high mobility between strata.

Group: Two or more individuals who have a sense of identity and interacts with each other.

The individual vs the group: fx Western countries have more focus on the individual (more on page 97-98).

Social stratifications: you are born into it, and can move between the strata, but if you are born into low strata, it's harder to go up and otherwise around. Social stratification is based on four basic principles:

1. is a trait of society, not a reflection of individual differences
2. carries over a generation to the next
3. is generally universal but variable
4. involves not just inequity but also beliefs.

Social mobility: Refers to the extent to which individuals can move out of the strata they were born in.

Religion

(See on this with skepticism)

Robert Barro and Rachel McCleary: suggests that strong religious beliefs, in hell, heaven and after life have a positive impact on economic growth rates.

Max Weber: Made connection between Protestant ethics and “ the spirit of capitalism”- he noted that capitalism emerged in Western Europe, where the leaders, skilled labor and so on are overwhelmingly Protestant. He theorized there is a connection.

Culture and business

- How do operations in different countries affect the cultures values found in the workplace
- Management processes and practices may need to vary according to what culture.

Hofstede's cultural dimensions

Geert Hofstede

He isolated four dimensions that he claimed summarized the different cultures (through collected data from IBM where he worked as a psychologist)

Four dimensions of culture

- Power distance (PD)
- Individualism versus collectivism (IND)
- Uncertainty avoidance (UA)
- Masculinity versus femininity (MAS)
 - This dimension looks at the relationship between gender and work roles

He later added a fifth dimension

- Long-term versus short-term orientation

He created an index score of these five dimensions from 0-100

Power distance: how a society deals with people are unequal in physical and intellectual capabilities.

- High power distance cultures, where inequalities over time grow into inequality in power and wealth
- Low power distance cultures that tried to play down inequalities

Individualism versus collectivism: the relationship between the individual and the individual fellows.

So a culture where you look at individual freedom/achievements, or societies where people are born into group and are supposed to look after this group.

Uncertainty avoidance: it how different cultures socialized members into accepting uncertain situations.

- High uncertain avoidance cultures place premium on job security, career patterns, retirements benefits. Clear instructions from manager and tight control
- Low are characterized of readiness to take risks and less emotional resistance to change.

Masculinity versus femininity: relationship between gender and work roles

- Masculine cultures: traditional “masculine values”, sharp gender roles
- Feminine cultures: sex roles less sharply distinguished, little differentiation between men and women in the same job

Long-term versus short-term orientation: refers to what extent a culture programs its citizens to accept delayed gratification of their material, social and emotional needs.

Conclusions

The study showed the Japanese are less individual than Americans and Mexicans- and so on. Gave a basis for managers to try to figure out how cultures differ

Criticism for Hofstede work

- He assumes there is one-to-one correspondence between culture and the nation state
- The reaches team were from Europe and America- biased questions

Lecture 3 National differences in economic development

Learning goals

Explain what determines the level of economic development of a nation

- The different measurements
- GNI and GDP
- PPP
- HDI doesn't take into account the political environment
- How free the countries is
- The engines of growth entrepreneurship and innovation
- Political system
- The Freedom House

Identify the macropolitical and macroeconomic changes occurring worldwide

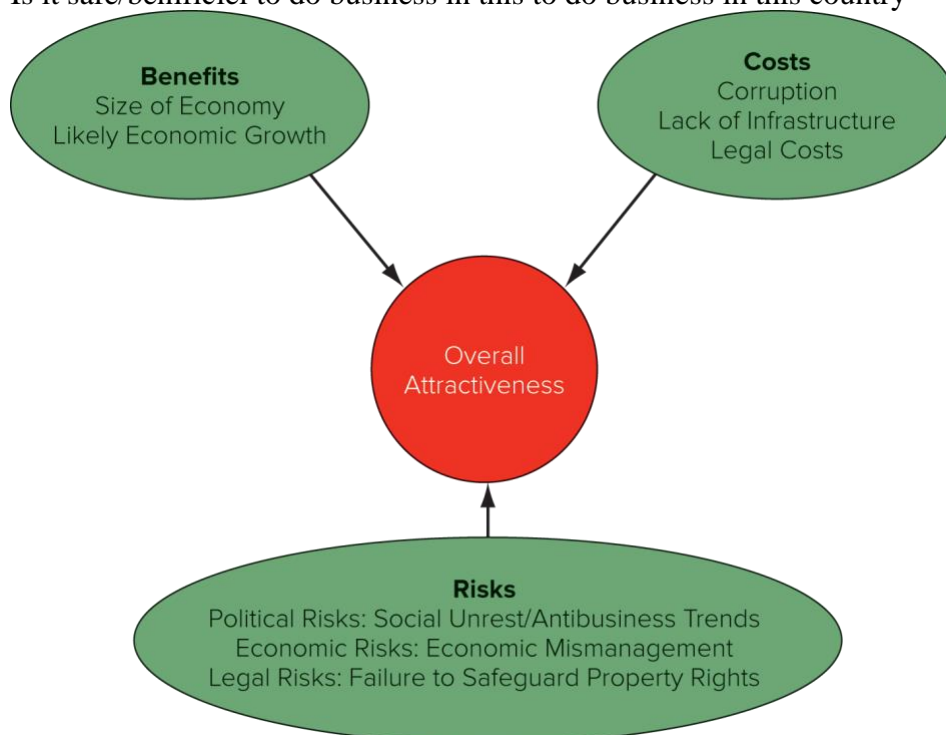
- The past 30 years a lot of countries of been democracies
- From a planned or mixed to a market free economy
- Reversing countries
 - Terrorism
 - Clash of different systems and ideology
- The Heritage foundation
- "Economic freedom does not necessarily equate with political freedom, fx:

Describe how transition economies are moving towards market-based systems

- Deregulation
- Privatization
- Creation of legal system to safeguard property rights

Explain the implications for management practice of national difference in political economy

- Is it safe/beneficial to do business in this country



Differences in Economic Development

Gross national income (GNI): income per head of population. It measures the total annual income received by residents of a nation. Doesn't account for differences in cost of living in different countries

Purchasing power parity (PPP): The PP for different countries is then adjusted depending on whether the cost of living is lower or higher than in the USA, fx in 2016 GNP pr. capita of China was \$8,260 but the PP per capita was \$15,500 suggesting that the cost of living was lower in China and that \$8,260 in China would buy as much as \$15,500 in USA.

Gross domestic product (GDP): countries growth rate in gross domestic product.

The GNI and PPP data give a static picture of development, fx that China is much poorer than the uSA, but they do not tell if China is closing the gap.

Amartya Sen/HDI

Economist Amartya Sen argued in her thesis that the measures of development should focus on the capabilities and opportunities that people enjoy. It should be seen as a process of expanding the real freedoms that people experience, focus on:

- Basic healthcare- especially for children
- Basic education- especially for women
- Sen's thesis suggested political freedom also should be included- its not

Sen's thesis was picked by UN , which has developed the **Human Development Index (HDI)**.

HDI: Measures the quality of human life in different nation, based on 3 measurements:

1. Life expectancy at birth
2. Educational attainment
3. Average incomes (based on PPP)

HDI: It scores from 0-1:

- less than 0,5 countries are classified low human development
- 0,5-0,8 are classified as having medium human development
- 0,8-1 are high human development

Political economy and economic progress

Innovation: new progress, new products, organizations, new management and strategies. Often a product of entrepreneurial activity.

Entrepreneurs: are those who first commercialize innovative new products and processes and entrepreneurial activity.

..... (writing more? Se powerpoint).

The new world order and global terrorism

Francis Fukuyama: argued that the world wars, was wars of ideas and that is was the end, and that liberal democracy has triumphed.

Samuel Huntington: On the contrary to Fukuyama Huntington theorized that modernization in non-Western societies can result in a retreat toward the traditional, fx the resurgence of Islam in many traditionally Muslim societies.

- He saw a world split into different civilizations each of which has its own value systems and ideologies.
- Saw terrorism as a product of the tension between civilization/clash of ideologies and systems.

U.S secretary of state Colin Powell has said that terrorism represents one of the major threats to world peace and economic progress.

Heritage Foundation

Heritage Foundation: an index of economic freedom based on 10 indicators. (economic freedom does not equate political freedom) (should be viewed with caution, because of its support to the Tea Party).

The Tea Party movement is an American fiscally conservative political movement within the Republican Party

The 10. Indicators

- Governments intervene in the economy
- Trade policy
- Property rights
- Foreign investment regulation
- Labor freedom
- Freedom from corruption

Score between 100 (freest) and 0 (least free). The higher a country average score across all 10 indicators, the closer is the country to represent the pure market model.

Economic Transformation

To market based economic systems

Deregulation: its removing legal restrictions to the free play of markets, the establishment of private enterprises. Ex in communism the government commands the control over prices and output- to deregulate the have to not.

Privatization: an increase in privatizations- transfers the ownership of state property in the hands of individuals.

Overall attractiveness of doing business internationally

(Look at figure at beginning of Lecture)

Benefits: by identifying and investing early in a potential future economic star, firms may build brand loyalty and gain experience in that country's business practice.

A country's economic system and property rights regime are reasonably good predictors of economic prospect.

First mover advantage: early entrance to a market

Late-mover disadvantage: late entrance to a market

Cost: (read page 83 in book).

Risk:

Political risk: The likelihood that political forces will cause change in the business environment in the country via social unrest and disorder, strikes, terrorism and so on.

Economic risk: are not dependent on political risk, maybe the country's inflation rate, the government's debt.

Legal risk: trading partners likelihood to break contracts or property rights,

Lecture 4 International trade: theory and policy

Learning goals:

Understand why nation trade with each other

International trade theory

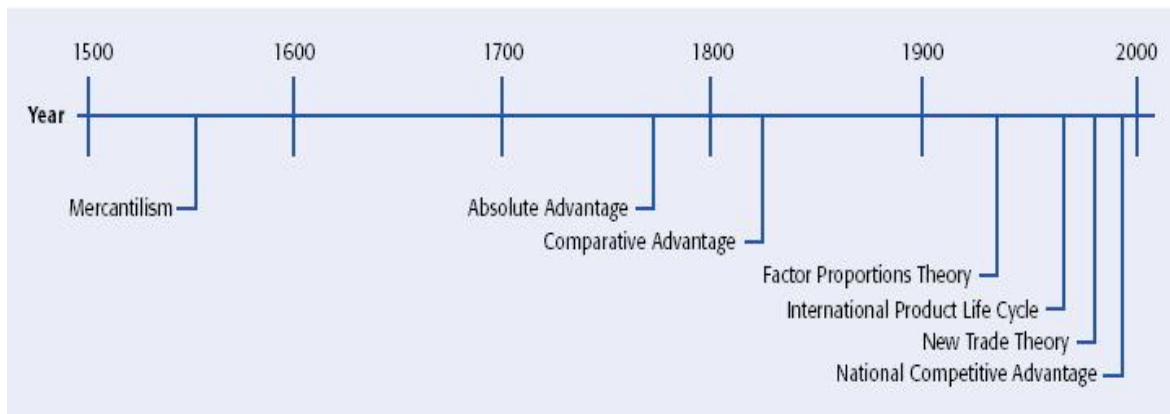
Classic theories

NAFTA: North American Free Trade Agreement

TPP: Trans Pacific Partnership

Foreign direct invest: FDI

Timeline



- Mercantilism (pre-16th century)
 - Takes an us-versus-them view of trade
 - Other country's gain is our country's loss
- Free Trade theories
 - Absolute Advantage (Adam Smith, 1776)
 - Comparative Advantage (David Ricardo, 1817)
 - Specialization of production and free flow of goods benefit all trading partners' economies
- Free Trade refined
 - Factor-proportions (Heckscher-Ohlin, 1919)
 - International product life cycle (Ray Vernon, 1966)

Mercantilism

Mercantilism: Government intervenes to achieve a surplus in export
mercantilism advocated countries should encourage exports and discourage imports. Its echoes still remains in modern political debate. It's a country's best interest to maintain a trade surplus

(export more than import). Advocated governments intervention to achieve a surplus in the balance of trade. Flaw is that:

Zero-sum game: is one in which a gain by one country (surplus) results in a loss by another.

Today neo-mercantilists (**protectionists ?**)

- Trump doctrine: he will get rid of all import
- Some segments of society shielded short term

Absolute advantage

Adams smiths theory of absolute advantage:

- the first to explain why unrestricted free trade is beneficial to a country.
- He argued that the invisible hand of the market mechanism should determine what a country exports and imports- not the government.
- Mercantilism weakens country in long run; enriches only a few

A country should:

- Should specialize in production of and export products for which it has absolute advantage; import other products
- Has absolute advantage when it is more productive (produces at lower cost) than another country in producing a particular product

An absolute advantage: a country has absolute advantage in the production of a product when it is more efficient than any other country at producing it. If another country have absolute advantage in a another product- the countries could really benefit for trading with each other.

Free trade: refers to a situation where the government does not attempt to influence trade, what a citizen can buy from another country or produce and sell to another country.

Comparative advantage

David Ricardo: Took the absolute advantage theory on another level- to when a county has an absolute advantage in the production of all goods.

The benefits of trade

- Smith, Ricardo and Heckscher-Ohlin argues that it's beneficial for a country to engage in international trade, _even for products it is able to produce for itself
 - o Because it allows a country to specialize in the manufacture and export of products
 - o While importing porudcts that can be produced more efficiently in other countries.

The concept of comparative advantage

Opportunity Cost

- The opportunity cost of good A in terms of good B is the number of unit of good B that could be produced with the same resources used to produce a given number of units of good A.
 - Opportunity costs is the largest sacrifice made to produce a given good

Comparative Advantage

- A country has a comparative advantage in producing a good if the opportunity cost of producing that good in terms of other goods is lower in that country than it is in other countries.
- A country's comparative advantage is dynamic. It might change due to the changes in both domestic and international markets.

Comparative advantage: A country to specialize in the production of those goods that it produces most efficiently and to buy the goods that it produces less efficiently from other countries, even though it could produce it more efficiently itself. Potential world production is greater with unrestricted free trade, than it is with restricted trade.

His theory suggests that a consumers in all nations can consume more if there are no restrictions on trade- even if the countries lack an absolute advantage in the production of any good.

Positive sum game: The theory suggest that trade is positive sum trade in which all countries that participate realize economic gains.

Extensions of the Ricardian Model (???)

Assumptions and Limitations

All models is build on assumptions

1. Nations strive only to maximize production and consumption
2. Only two countries produce and consume just two goods
3. No transportation costs of trading goods
4. Labor is the only resource used to produce goods
5. No role for price of resources
6. No distributional effects
7. Full specialization

Immobile resources

Diminishing returns

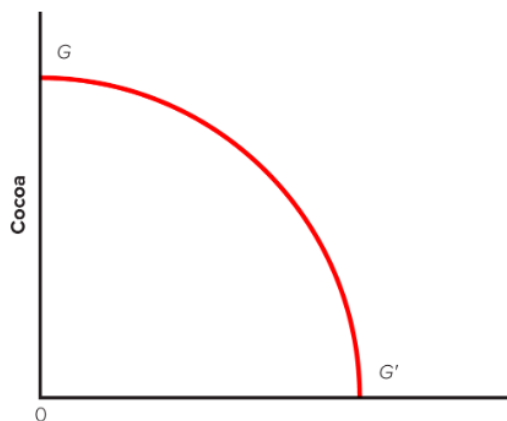
The simple comparative advantage model developed above assumes constant returns to specialization.

Constant returns to specialization: the units of resources required to produce a good, are assumed to remain constant no matter where one is on a country's production possibility frontier (PPF).

Production possibility frontier (PPF): shows the maximum possible output combinations of two goods or services an economy can achieve when all resources are fully and efficiently employed.

Diminishing returns: when more units of resources are required to produce each additional unit.

Ex: Ghana PPF under diminishing returns: more rice, less cocoa:



- When a county tries to increase its output of a good, it draw more ressources
- Different goods use resources in different proportions

Diminishing returns shows that it is not feasible for a country to specialize to the degree suggested by the simple Ricardian model.

Dynamic gain

Dynamic gain from free trade:

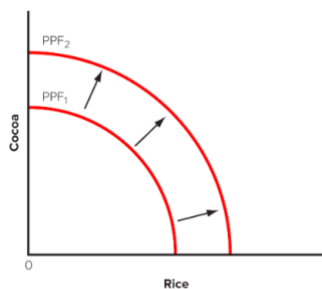


Figure 6.4 The influence of free trade on the PPF.

- Gain in the stock of a county's resources
- The county can produce more of both goods
- Opening an economy for free trade results in dynamic gain but stimulate economic growtg.

Samuelson: Argued that in some circumstances- dynamic gains can lead to an outcome that is not beneficial. Ex USA buying from poorer China- Walmart can sell cheaper- but that doesn't mean they will give a crap about the wage of the people working in Walmart.

Heckscher-Ohlin Theory

They put forward a different explanation of comparative advantage- that arises from differences in national factor endowments (explained futher up).

Nations have varying factor endowments and different factor endowments explain differences in factor costs. The larger/abundant (bigger potion) a factor the lower the cost.

They predict countries

- With will export good that make intensive use of factor that are locally abundant- USA a long substantial exporter of agricultural goods

- While importing goods that make intensive use of factor that are locally scarce- importing goods produced in China, that have relative abundance of low-cost labor in manufacturing industries.
- Argues free trade is beneficial
- International trade is determined by differences in factor endowments, and not differences in productivity

The Leontief paradox

Leontief said- because the United States was relatively abundant in capital compared to other nations, the USA would be an exporter of capital-intensive goods and importer of labor-intensive goods.- though he was wrong and its called a paradox

The product life-cycle theory

Raymond Vernon mid 1960s

Based on observation from U.S firms

The product life-cycle theory: suggests that early the life cycle, most new products are produced in and exported from the country in which they were developed- so as a new product becomes more internationally accepted- the production starts in other countries. The theory suggests the products may in the end be exported back to the country of its origin.

- He argued the size and wealth of the U.S market have U.S firms an incentive to developed new consumer products.
- Also that high laborcost gave the U.S firms an incentive to develop cost-saving process innovations.
- U.S switches from being an exporter of the product to an importer of the product as production becomes concentrated in lower-cost foreign locations.

Product life-cycle theory in the twenty first century

- Vernon's argument that most new products are developed and introduced in the U.S is outdated. Might have been true in the 1945-1975
- Many new products are now first introduced in Japan (video consoles) or South Korea (smartphones).
- Many new products are simultaneously introduced in the United states and Europa and Asia

New Trade Theories

Economies of scale

Economies of scale: are unit cost reductions associated with large scale output.

- the best way to achieve high efficiency and low unit cost, is through the mass production of a standardized output.

Diseconomies of scale (referred also as decreasing returns) refer to the property whereby long-run average total cost rises as the quantity of output increases.

- An alternative definition would be output increasing at a slower rate than the rate of increase in inputs

Constant returns to scale refers to the property whereby long-run average total cost stays the same as the quantity of output increases

- An alternative definition would be output increasing at the same rate as the rate of increase in inputs

Types of competition

Perfect competition is an economic model that describes a hypothetical market form in which no producer or consumer has the market power to influence prices, i.e., all act as price takers. The analysis of perfectly competitive markets provides the foundation of the theory of supply and demand.

Imperfect competition, is the competitive situation in any market where the conditions necessary for perfect competition are not satisfied. Forms of imperfect competition include:

- **Monopoly**, in which there is only one seller of a good.
- **Oligopoly**, in which there is a small number of sellers.
- **Monopolistic competition**, in which there are many sellers producing highly differentiated goods, but each has some power to influence prices.
- **Monopsony**, in which there is only one buyer of a good.
- **Oligopsony**, in which there is a small number of buyers.

The new trade theory

The new trade theory: Paul Krugman, in some cases, countries specialize in the production and export of particular products, not because of differences in **factor endowments**, but because in certain industries the world market can support only limited number of firms fx commercial aircraft industry- so the first firms to enter are able to build a very competitive advantage.

Factor endowments: is commonly understood as the amount of land, labor, capital, and entrepreneurship that a country possesses and can exploit for manufacturing.

Around 1970

- The ability of firms to attain economies of scale might have important implications for international trade
- Major resource of cost production in many industries fx automobile industry realize economies of scale by producing a high volume of automobiles from an assembly line, where each employee has a specialized task.

New trade theory have to important points:

1. Though the impact of economies of scale. Trade can increase the variety of goods to consumers and decrease the average cost of the goods
2. ____?

Increasing Product Variety and reducing costs

- New trade theory get a market to have variety and reducing cost of making the good
- In a world with international trade, the producing of a good is limited to the national market and economies of scale couldn't happen, making prices higher and reducing the variety of products.

Implications of New Trade Theory

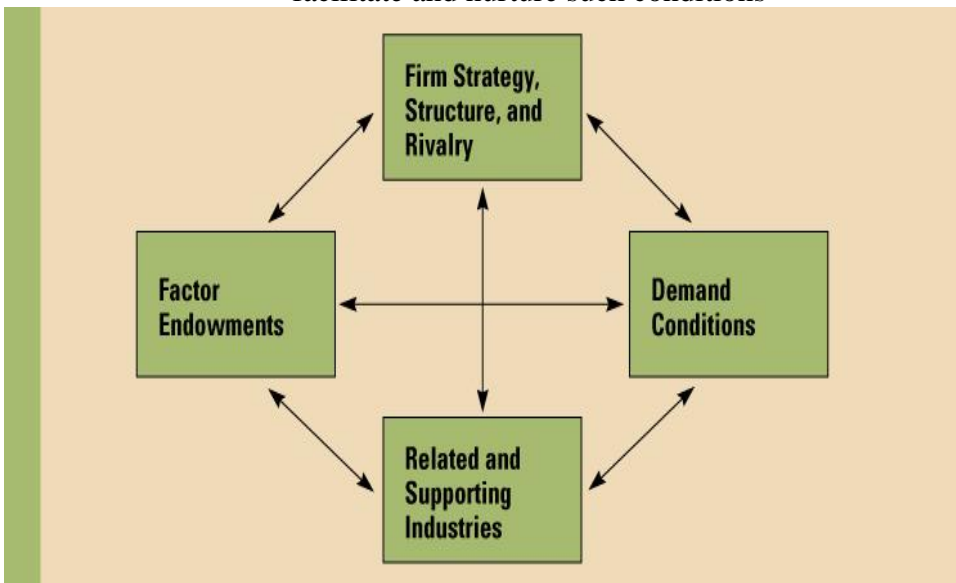
- The theory suggests nations may benefit from trade even when they do not differ in resource endowments or technology

- Trade allows a nation to specialize in the production of certain products
- Attaining scale economies
- Lowering the cost of production
- Buying specialized products from other nations
- So the variety of products increases and the average costs should fall- freeing resources to produce other goods/service
- First mover advantage is good – the first to become specialized
- Quite use in explaining trade patterns

Porter's Diamond

Porter's theory of national competitive advantage: Other than factor endowments, the importance of country factors as domestic demand, domestic rivalry is a factor to explain a nation's dominance in the production and export of a certain product.

- Factor endowments
 - land, labor, capital, workforce, infrastructure (some factors can be created...)
- Demand conditions
 - large, sophisticated domestic consumer base; offers an innovation friendly environment and a testing ground
- Related and supporting industries
 - local suppliers cluster around producers and add to innovation
- Firm strategy, structure, rivalry
 - competition good, national governments can create conditions which facilitate and nurture such conditions



International Trade and the Balance of Payments

Balance-of-payments accounts: National accounts that track both payments to and receipts from foreigners. Is divided into three main sections:

- Current account
- The capital account
- Financial account

Current account: records transactions involving the export or import of goods and services.

A current account deficit: the current account of the balance of payments is in deficit when a country imports more goods, service and income than it exports.

The capital account: records one-time changes in the stock of assets – capital transfer, such as debt forgiveness and migrants' transfers

The financial account: transaction that involve the purchase and sale of assets- fx when a German firm purchases stock in a U.S company or buys a U.S bond- the transaction enters the U.S balance of payments as a credit on the financial account.

SUM-UP

- Free Trade refers to the situation when the government does not attempt to restrict what its citizens can buy from and sell to another country.
- All classical trade theories predict that free trade leads to static **economic gains** (higher level of domestic consumption and more efficient utilization of resources) and **dynamic economic gains** (stimulates economic growth, job creation and wealth accumulation).

Lecture 5 Regional economic integration

Regional economic integration in Europe, the Americas and Asia. Economic Unions. Trade blocs and WTO.

Regional economic integration: Agreements among countries in a geographic region to reduce and ultimately remove tariff and nontariff barriers to the free flow of goods, services and factors of production between each other.

All members of WTO are required to notify the WTO about any regional trade agreements in which they participate. In 2017, there were 432 regional trade agreements in force.

Regional economic integration is an attempt to achieve economic gains from the free flow of trade and investment between neighboring countries.

Levels of economic integration

The different levels of regional economic integration

(SEE PP FOR COUNTRIES UNDER EACH ECONOMIC INTEGRATION)

Free trade area: All barriers to the trade of goods and services among member countries are removed.

In the theoretically ideal free trade area, no discriminatory tariffs, quotas, subsidies, or administrative impediments are allowed to distort trade between members.

Customs union: Eliminates trade barriers between member countries and adopts a common external trade policy. Most countries that enter into a customs union desire even greater economic integration down the road.

Common market: has no barriers to trade among member countries, includes a common external trade policy, and allows factors of production to move freely among members. Labor and capital are free to move.

Economic union: Involves the free flow of products and factors of production among member countries- requires common currency, common monetary and fiscal policy For example: EU.

Political union: move towards economic union, how to coordinate bureaucracy. In which a central political apparatus coordinates the economic, social, and foreign policy of the member states. The EU is on the road toward at least partial political union.

Known Regional Trade Agreements:

Europe

- The European Union
- The European Free Trade Association (EFTA)

North America

- The United States, Mexico and Canada Agreement (USMCA)

Latin America

- The Southern Common Market (MERCOSUR)

Asia

- The Association of Southeast Asian Nations (ASEAN)

Africa

- The Common Market of Eastern and Southern Africa (COMESA)

Case against regional integration

- Some say that the benefits of regional integration have been oversold
- The benefits of regional integration are determined by the extent of trade creation as opposed to trade diversion.

Trade creation: occurs when high-cost domestic producers are replaced by low-cost producers within the free trade area. It may also occur when higher-cost external producers are replaced by lower-cost external producers within the free trade area.

Trade diversion: occurs when lower-cost external suppliers are replaced by higher-cost suppliers within the free trade area. A regional free trade agreement will benefit the world only if the amount of trade it creates exceeds the amount it diverts.

Firm implications of regional economic integration

Opportunities

- Opens new markets
- Allows firms to realize cost economies by centralizing production in those locations where the mix of factor costs and skills is optimal

Threats

- Business environment becomes competitive
- There is a risk of being shut out of the single market by the creation of a “trade fortress”
- Growing opposition to free trade areas and agreements

Types of regional trade agreements

Consider two countries - Brazil and Argentina

- Suppose these countries initially pursue independent and non-preferential trade policies
 - Trade policies of these two countries are not coordinated in any way and do not discriminate among countries
 - There is no integration of the countries' labor, capital, and money markets
 - First-level RTA is known as preferential trade area
- Brazil and Argentina lower their trade barriers between each other, but do not eliminate them
 - Labor and capital markets remain unintegrated
- Because the two countries have not fully eliminated trade barriers between each other, this type of RTA is not allowed by the WTO

Second-level RTA is known as free trade area

- Brazil and Argentina eliminate the trade barriers between each other
- Regarding non-member countries Brazil and Argentina pursue independent policies
- Labor and capital markets remain unintegrated

Third-level regional agreement is known as customs union

- Brazil and Argentina eliminate the trade barriers between each other
- Additionally, member countries adopt common trade barriers with regard to non-member countries (often referred to as a common external tariff)
- Labor and capital markets remain unintegrated

Fourth-level RTA is known as common market

- A customs union in which labor and capital markets are integrated into a regional market
 - Any restrictions on movements of labor and physical capital (direct foreign investment) have been removed

WTO members who wish to form FTAs or CUs may do so

- However, there are certain requirements
 - Trade barriers against non-members cannot be “higher or more restrictive than” those in existence prior to the FTA or CU
 - FTA or CU must be formed “within a reasonable length of time”
 - FTA or CU must eliminate trade barriers on “substantially all the trade” among the members
 - Regarding services, the General Agreement on Trade in Services (GATS) requires that the FTA or CU involve “substantial sectoral coverage”

How to determine whether a product is from a partner country

- Suppose that Brazil and Argentina form a RTA
 - Shirt produced in Venezuela is imported into Brazil and label “Made in Brazil” is attached
 - Shirt can then be imported into Argentina with no restrictions or tariffs—product is not really made in Brazil
 - To protect against such possibilities, RTA members usually define rules of origin

- Can be defined in a number of ways, including by
 - Amount of value added in an RTA partner country
 - Degree of product transformation

Multilateralism vs. regionalism in international trade

Multilateralism: Multiple (close to all) countries working in concert on a given issue under certain international relation agreements. Examples are WTO, IMF, the World Bank, the UN.

Regionalism: Any agreement that involves two or more countries but much fewer than all possible members. Examples are the EU, G7, G20, NATO.

Economic integration: A process by which economies of separate countries merge into larger entities. The process is characterized by discriminatory removal of all barriers of economic cooperation

Regionalism and Multilateralism

Opponents of regionalism argue

- Regional agreements are discriminatory by nature
- They lead to the “spaghetti-bowl” phenomenon
 - Meaning the overlapping nature of most regional agreements, with, let say, most WTO members holding simultaneous membership in many regional economic agreements at once
 - For example, Mexico has signed free trade agreements with the United States, Canada, Nicaragua, Costa Rica, Chile, Bolivia, El Salvador, Guatemala, Honduras, Colombia, Venezuela, and the European Union
- The negotiating energies put into such regional agreements will detract from those put into multilateral agreements under the auspices of the WTO
- Is possible to lessen the tensions between regionalism and multilateralism but probably not possible to eliminate these tensions entirely

Variety of trade governance

Unilateral: Trade policy of countries not part of any multilateral or regional agreement

Bilateral: US-Canada Auto pact (geographically concentrated) or US-Japan VER's (geographically dispersed)

Minilateral (Regional): EU, MERCOSUR, NAFTA/USMCA (geographically concentrated) or The Global System of Trade Preferences among Developing Countries (GSTP) that aims of increasing trade between developing countries in the framework of the UNCTAD (geographically dispersed)

Multilateral: GATT, GATS → WTO

Lecture 6 government policy and international trade

International Financial Markets. Foreign Exchange Market. International liquidity. International Financial institutions - IMF, IBRD, IFC, ADB – and their role in managing international liquidity problems.

Instruments of Trade Policy

- Tariffs
- Subsidies
- Import quotas
- Voluntary export restraints
- Local content requirements
- Administrative policies
- Antidumping duties

Tariffs: a tax levied on imports (or export).

- Is placed on imports to protect domestic producers from foreign competition by raising the price of imported goods
- Government gains and domestic producers gain
- Consumers lose- have to pay more for certain imports

Specific tariffs: levied as a fixed charge for each unit of good imported (\$3 per barrel of oil)

Ad valorem tariffs: as a proportion of the value of an imported good

Export tariff: a tax placed on the export of a good (relatively rare)

- The goal behind this is to ensure there is sufficient supply of a good within the country.

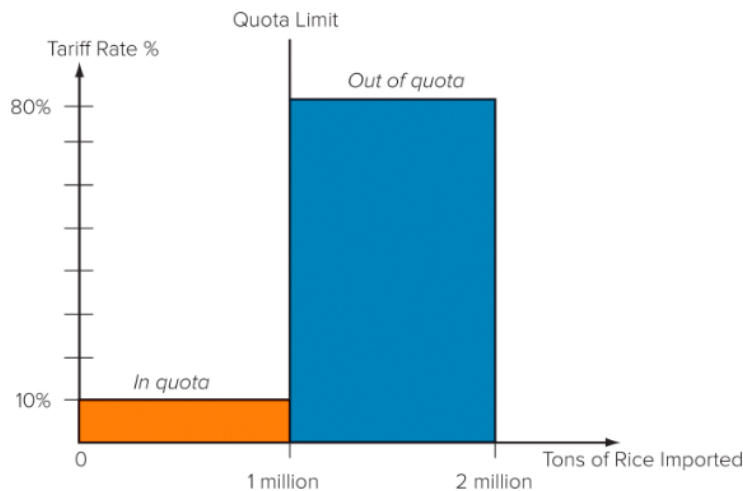
Subsidies: Government financial assistance to a domestic producer, fx cash grants, low-interest loans, tax breaks. Helps domestic producers in 2 ways:

1. Competing against foreign imports
 2. Gaining export markets
- Helps domestic firms achieve a dominant position in those industries in which economies of scale are important
 - Can help achieve a first mover advantage in an emerging industry

Import quotas: a direct restriction on the quantity of a good that can be imported into a country.

Issuing import licenses to group/individuals(firms- fx U.S has a quota in cheese imports, only firms allowed to import cheese are certain trading companies)

Hybrid between tariff and quota **Tariff rate quota:** applied to imports within the quota than those over quota.



Voluntary export restraint (VER): a quota on trade imposed from the exporting country's side, instead of the importer's usually imposed at the request of the importing country's government.

- Benefits domestic producers by limiting import competition
- Do not benefit consumers
- VER and import quota raises the domestic price of an imported good.
- Example: About 2/3 of the cost to consumers of the three major U.S. voluntary restraints in textiles and apparel, steel, and automobiles is accounted for by the rents earned by foreigners.

Export ban: Is a policy that partially or entirely restricts the export of a good.

Local content requirement (LCR): a requirement that some specific fraction of a good be produced domestically either in physical terms, percent of component parts or value terms.

- Instead, the difference between the prices of imports and domestic goods gets averaged in the final price and is passed on to consumers.
 - o Example: Suppose that auto assembly firms are required to use 50% domestic parts. The cost of imported parts is \$6000 and the cost of the same parts domestically is \$10,000. Then the average cost of parts is \$8000 ($0.5 \times \$6000 + 0.5 \times \$10,000$).

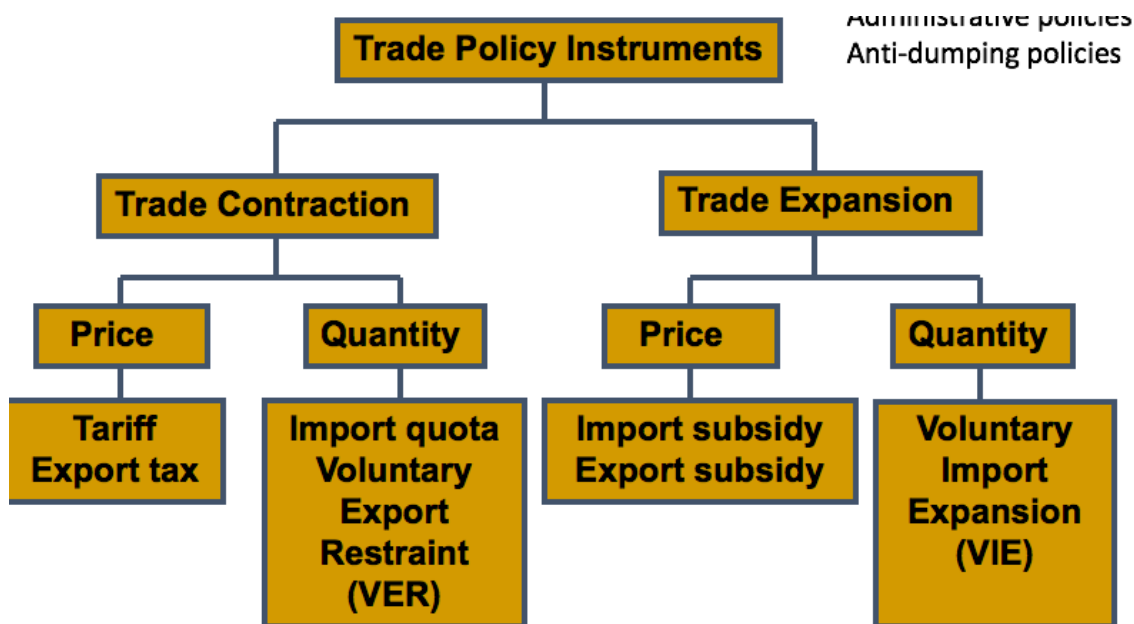
Administrative trade policies: typically adopted by government bureaucracies, that can be used to restrict imports or boost exports.

- To make it difficult for imports to enter a country

Antidumping policies

Dumping: selling goods in a foreign market for less than their cost of production or below their "fair" (profit margin) market value.

Designed to punish foreign firms that engage in dumping and thus protect domestic producers from unfair foreign competition.



Government intervention

Why needed:

- Typically concerned with boosting the overall wealth of a nation, to benefit of all both producers and consumers
- The necessary for protecting jobs and industries from unfair foreign competition.
- National security
- Intervene in trade policy as a bargaining tool to help open foreign markets and force trading partners to “play the rules of the game”
- Protect consumers from unsafe products- American beef bc of cow disease.
- Protecting human rights

Economic arguments for intervention

Infant industry argument: New industries in developing countries must be temporarily protected from international competition to help them reach a position where they can compete on world markets with firms of developed nations

Strategic trade policy

An economic justification for government intervention in international trade

Strategic trade policy: Government policy aimed at improving the competitive position of a domestic industry and/or domestic firm in the world market. Has 2 components:

1. A government can help raise national income, if it can ensure that a firm gain first-mover advantages in an industry are domestic rather than foreign.
 2. It might pay a government to intervene in an industry by helping domestic firms over barriers of entry created by foreign firms
- Support a rationale for government intervention in international trade

Development of the World Trading System

(POWERPOINT MAYBE?)

The world trade organization

- Is an umbrella organization
 - o GATT and its sister bodies

Lecture 6 Foreign exchange, monetary system, global capital market

International Financial Markets. Foreign Exchange Market. International liquidity. International Financial institutions - IMF, IBRD, IFC, ADB – and their role in managing international liquidity problems.

The Foreign Exchange market

Liquid currency

Liquid emerging market currency

Foreign exchange: what the impact on the sales profits and strategy of an enterprise

The foreign exchange market: Is a market for converting the currency of one country into that of another country.

Exchange rate: is the rate at which one currency is converted into another.

Foreign exchange risk: to insurance against the risks that arise from volatile change in exchange rates.

Depreciation: a decrease in the value of a currency relative to other currencies.

The functions of the foreign exchange market

2 main functions:

1. Convert the currency of one country into the currency of another
2. And to provide insurance against foreign exchange risk

Currency conversion

The exchange rate allows us to compare the relative prices of goods and services in different countries.

International business have four main uses of foreign exchange markets:

1. Payments received for the company's exports, the income it receives from foreign investments or the income it receives from licensing agreements with foreign firms.
Converted into the home country's currency
2. When a firm must pay a foreign company for its products or services in its country's currency
3. When a firm has spare cash, that they wish to invest for short terms in money market
4. Currency speculations

Currency speculations: involves short-term movement of funds from one currency to another in hopes of profiting from shifts in exchange rates.

Carry trade: a speculation that involves borrowing in one currency where interest rates are low and then using the proceeds to invest in another currency where interest rates are high.

Insuring against foreign exchange risk

Spot exchange: When two parties agree to exchange currency and execute the deal immediately.

Spot exchange rate: is the rate at which a foreign exchange dealer converts one currency into another currency on a particular day. Change often on a minute-by-minute basis (usually small).

Forward exchange: When two parties agree to exchange currency and execute the deal at some specific date in the future.

Forward exchange rates: rates governing such future transactions are referred to as this.

The nature of the foreign exchange market

- A global network of banks, brokers and foreign exchange dealers connected by electronic systems.
- Located in London, New York so on (open 24 hours a day)
- Most exchange deals involve the dollar- it's cheaper to buy dollars for pesos and then buy yen for the dollar.

Economic Theories of exchange rate

Basic level: exchange rates are determined by the demand and supply of one currency relative to the demand and supply of another.

ARBITRAGE

- For example: if the demand for dollars overtakes the supply of them, and the supply of Japanese yen is greater than the demand for them- the dollar/yen exchange will change.
- If we understand how the exchange rates are determined, we may be able to forecast exchange rate movements- but that is hard.

Economic theories of exchange rate agree three factors have an important impact on future exchange rate movement:

1. The country's price inflation
2. Interest rate
3. Market psychology

The law of one price

States that in competitive markets free of transportation costs and barriers to trade- identical products sold in different countries must sell for the same price- when their price is expressed in terms of the same currency.

For example:

If the rate is £1=\$2

A jacket that sells for \$80 in NY should sell for £40 in London

If the jacket cost £30 and \$60 in US

It would pay a trader to buy jackets in London and sell them in NY.

The company would make \$30 on each jacket- if they bought it for £30 (60\$) and selling it for \$80 in NY.

BUT: the increased demand for jackets in London, would raise the prices of jacket and the increased supply of jackets in NY would lower their price in US—this would continue until prices equalized.

Purchasing Power Parity

PPP theory predicts that changes in relative prices will result in a change in exchange rates

Exchange rates are prices of one currency in terms of another. So, like any price they are determined supply and demand, and the factors affecting them. In the exchange rates case, the relevant demand and supply are those of one currency relative to the demand and supply of another

In competitive markets free of transportation costs and trade barriers, identical products sold in different countries must sell for the same price when their price is expressed in terms of the same currency

- Example: US/French exchange rate: \$1 = .78Eur. A jacket selling for \$50 in New York should retail for 39.24Eur in Paris (50x.78)

By comparing the prices of identical products in different currencies, it should be possible to determine the 'real' or PPP exchange rate - if markets were efficient

In relatively efficient markets (few impediments to trade and investment) then a 'basket of goods' should be roughly equivalent in each country

The big mac theorem

The Big Mac Index is an index created by The Economist based on the theory of purchasing power parity (PPP). Over the long-term, PPP theory states that currency exchange rates should equal the price of a basket of goods and services in different countries.

Purchasing power parity is an economic theory which states that exchange rates over time should move in the direction of equality across national borders in the price charged for an identical basket of goods. In this case, the basket of goods is a Big Mac.

The Big Mac Index was created to measure the disparities in consumer purchasing power between nations.

The burger replaces the "basket of goods" traditionally used by economists to measure differences in consumer pricing.

The index was created with tongue in cheek but many economists say it's roughly accurate.

The Big Mac Index is also known as the Big Mac PPP or Burgonomics.

Understanding the Big Mac Index

According to PPP theory, any change in the exchange rate between nations should be reflected in a change in the price of a basket of goods.

One of the key insights of the Big Mac Index is that a basket of goods in one country can rarely be precisely duplicated in another country. For example, an American basket of groceries and a Japanese basket of groceries are likely to contain very different products. A Big Mac, though, is always a Big Mac, allowing for slight local differences in ingredients.

Money supply and price inflation

Price inflation: is an increase in the price of a standardized good/service or a basket of goods/services over a specific period of time (usually one year)

Cost-pull inflation happens when supply decreases, creating a shortage. Producers raise **prices** to meet the increasing demand for their goods or services. Increase in wages, monopoly **pricing**, natural disasters, government regulations, and currency exchange rates often decrease supply vis-à-vis demand.

When the growth on a country's money supply is faster than the growth in its output, price inflation is fueled.

There are several examples of the connection between country's price inflation and exchange rate position

Interest rates and exchange rates

The fisher effect

Bandwagon effects

Exchange rate forecasting

A company need to predict future exchange rate variations raises the issure of it is worthwhile for the company to invest in exchange rate:

The efficient market school

Argues that forward exchange rates do the best possible job of forecasting future spot exchange rates and therefore- investing in forecasting services is waste of money.

The inefficient market school

Companies can improve the foreign exchange market's estimate of future exchange rates by investing in forecasting services- does not believe the forward exchange rates are the best possible predictors of future spot exchange rates.

Currency convertibility

A significant number of currencies are not freely convertible

Freely convertible currency: a country's currency is freely convertible when the government of that country allows both residents and nonresidents to purchase unlimited amount of foreign currency with the domestic currency.

Externally convertible currency: limitations on the ability of residents to convert domestic currency through nonresidents can convert their holdings of domestic currency into foreign currency.

Nonconvertible currency: a currency is not convertible when both residents and nonresidents are prohibited from converting their holdings of that currency into another.

Capital flight: converting domestic currency into foreign currency most likely to occur when the value of the domestic currency is depreciating rapidly bc of hyperinflation or when the country's economic prospects are shaky. The money is more likely to hold if converted.

Countertrade: the trade of goods and services for other goods and services. Makes sense when a country's currency is nonconvertible.

Foreign exchange rate risk

Managerial implications

Transaction exposure: the extent to which income from individual transactions is affected by fluctuations in foreign exchange values.

Translations exposure: The extent to which the reported consolidated results and balance sheets of a corporations are affected by fluctuations in foreign exchange values.

Economic exposure: The extent to which a firm's future international earning power is affected by changes in exchange rates.

Lead strategy: Collecting foreign currency receivables early when a foreign currency is expected to depreciate and paying foreign currency payable before they are due when a currency is expected to appreciate.

Lad strategy: Delaying the collection of foreign currency receivables if that currency is expected to appreciate and laying payables if that currency is expected to depreciate.

The international monetary system

The international monetary system: an institutional arrangements that govern exchange rates. International monetary system comprises the set of arrangements, rules, conventions and supporting institutions that regulate key aspects of economic activity.

International monetary system's essential purpose is to facilitate the exchange of goods, services and movement of capital among countries. It generally consists of four elements:

- exchange arrangements and exchange rates
- international payments and transfers relating to current international transactions
- international capital movements
- international reserves

The International Monetary Fund is the institution required to exercise oversight of the international monetary system, and to ensure its stability and effective operation.

Types of exchange rates

Floating exchange rate: A system under which the exchange rate for converting one currency into another is continuously adjusted depending on the laws of supply and demand.

- The dollar, the euro, yen and pound are free floating.

Advantages of floating exchange rate

- Monetary independence
- Automatic adjustment to trade shocks
- Central bank retains lender of last resort capability, for rescuing banks
- Avoiding crashes that hit pegged rates

Pegged exchange rate: Currency value is fixed relative to a reference currency.

Managed float system: System under which some currencies are allowed to float freely, but the majority are either managed by government intervention or pegged to another currency. A float in theory- but the central bank of a country will intervene in the foreign exchange market- trying to maintain the value of its currency against another.

Fixed exchange rate: a mutually agreed-on exchange rate

Advantages of fixed exchange rate:

- Encourage trade <= lower exchange risk
- Encourage investment
- Provide nominal anchor for monetary policy. But which anchor? Exchange rate target vs. alternatives (inflation rates, inflation expectations, asset prices, etc.)
- Avoid competitive depreciation, i.e., currency wars
- Avoid speculative bubbles that can afflict floating

FLEXIBLE CORNER

1) Free float

2) Managed float

INTERMEDIATE REGIMES

3) Target zone/band

4) Basket peg

5) Crawling peg

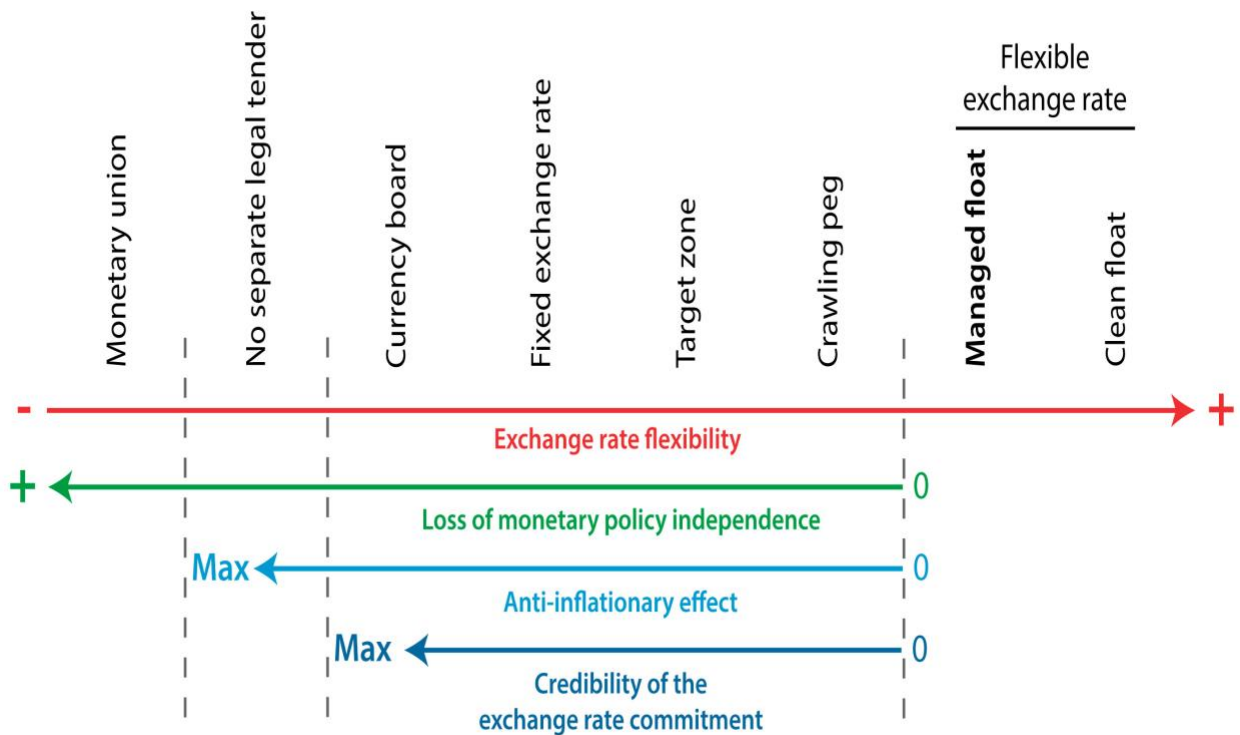
6) Adjustable peg

FIXED CORNER

7) Currency board

8) Dollarization

9) Monetary union



Exchange rate regimes in practice

Pegged exchange rates

- A country will peg the value of its currency to that of a major currency
- For example: the dollar rises in value- its own currency rises too
- Popular among small nations.
- Imposes monetary discipline and leads to low inflation
 - A country must sure the inflation rate is similar to the country their currency is pegged
 - If the country has greater inflation rate- devalue of country's currency

Currency board: Means of controlling a country's currency. Commits itself to converting its domestic currency on demand into another currency at a fixed exchange rate

Fixed vs floating exchange rates

Fixed exchanges rates	Floating exchanges rates
<ul style="list-style-type: none"> - Monetary discipline - Speculation - Uncertainty - Lack of connection between the trade balance and exchange rates 	<ul style="list-style-type: none"> • Monetary policy autonomy • Automatic trade balance adjustments • Economic recovery following a severe economic crisis

Monetary policy autonomy:

- Monetary expansion can lead to inflation
 - Puts pressure on a fixed exchange rate system

- Under a floating system, domestic inflation would have an impact on exchange rate, it should have no impact on businesses' international cost competitiveness due to exchange rate depreciation
- A government could use monetary policy without worrying about the need to maintain parity
- Each country should choose their own exchange rate

Trade balance adjustments:

- By making exports cheaper and its imports more expensive. Exchange rate depreciation should correct the trade deficit

Crisis Recovery:

- Can help a country deal with economic crises.
- For example Iceland: positive, the exchange rate was so down- they started to export a lot- so their economy recovered after 2008 crisis
- Greece (which has the euro) has fought to come back after 2008- because the euro stands so strong, and they gave up their own currency after 2001.

Monetary discipline:

- Governments too often give in to political pressures, and expand the monetary supply too rapidly- causing high price inflation
 - A fixed system would ensure this doesn't occur.

Speculation:

- Speculation can cause fluctuation in exchange rate
 - Bandwagon
 - Damage a country's economy by distorting export and import prices

Uncertainty:

- Speculation adds to uncertainty for future exchange rates
- Dampens the growth of international trade and investments

Trade Balance Adjustments and Economic Recovery

- Depreciation in a currency will lead to inflation
- It will boost price inflation

Which exchange rate regimes dominates

Which regime dominates? Advantages of fixing or advantages of floating?

Answer depends on circumstances:

No one exchange rate regime is right for all countries or all times.

Traditional criteria for choosing – *Optimum*

Currency Area

Focus is on trade and stabilization of business cycle

1990s and on criteria for choosing –

Focus is on financial markets and stabilization of speculation

Optimum Currency Area (OCA)

Broad definition: An optimum currency area is a region (not necessarily coinciding with one country's borders) that should have its own currency & own monetary policy

An OCA: a region that is neither so small and open that it would be better off pegging its currency to a neighbor, nor so large that it would be better off splitting into sub-regions with different currencies.

The historical development of the MIS

Balance-of-trade equilibrium: When the income its residents earn from exports is equal to the its residents pay to other countries for import

- The gold standard
- The Bretton woods system of fixed exchange rates 1944
 - o The creation of IMF and WB
- The collapse of the fixed exchange rate system in 1973
 - o Too much pressure on the dollar (inflation bc of printing money for the Vietnam war, and not from taxes).
- Floating exchange rate regime

The floating exchange rate regime

The rules for today's international monetary system

The Jamaica Agreement

- Floating rates were declared acceptable
- Gold was abandoned as a reserve asset
 - o IMF members were permitted to sell their own gold reserves at market price
- Total annual IMF quotas, the countries contribute to the IMF
 - o New 188 countries

Exchange rates since 1973

Exchange rates have become more volatile and less predictable than under the fixed exchange rates

Crisis management by the IMF

IMF: Original function was to provide a pool of money from which members could borrow, short term, to adjust their balance-of-payments position and maintain their exchange rate.

What the IMF helps with:

- Currency crisis
- Banking crisis
- Foreign debt crisis

Moral hazard: Arises when people behave recklessly because they know they will be saved if things go wrong

The IMF's primary mission is to ensure the stability of the international monetary system—the system of exchange rates and international payments that enables countries and their citizens to transact with each other. This includes:

- promoting international monetary cooperation
- facilitating the expansion and balanced growth of international trade
- promoting exchange stability
- assisting in the establishment of a multilateral system of payments
- making its resources available (under adequate safeguards) to members experiencing balance of payments difficulties

It carries out its mission through

- surveillance
- financial and technical assistance
- lending

IMF surveillance

- Surveillance is the **regular dialogue and policy advice** that the IMF offers to each of its members
- Once a year, IMF conducts in-depth appraisals of each member country's economic situation
- IMF **monitors national, global, and regional economic and financial developments** and advising member countries on their economic policies
- Multilateral Surveillance => IMF assessment on global and regional developments and prospects. Assessment published in two important publications: World Economic Outlook and Global Financial Stability Report
- The IMF periodically reviews its surveillance and monitoring activities helping to adapt to changes in the global economy. The 2014 surveillance review identified five operational priorities for 2014-19: risks and spillovers; macro-financial surveillance; structural policy advice; cohesive and expert policy advice; and a client-focused approach. A comprehensive Surveillance Review is planned for 2019.

IMF financial assistance

- A core responsibility of the IMF is to provide loans to countries experiencing balance-of-payments problems
- A member country may request financial assistance if it cannot find sufficient financing to meet its international payments
- The oil shock of 70s, and the debt crises of 80s were followed by sharp increases in IMF lending. Since then, transition process in former communist countries and the continuous crises in emerging markets since the 1990s have led to further surges of demand for IMF resources
- Loan is provided under an "arrangement" stipulates the specific policies and measures a country has agreed to implement to resolve its balance-of-payments problem
- Letter of Intent-Memoranda of Economic and Financial Policies are prepared by the member country, and describe the policies that a country intends to implement in the context of its request for financial support from the IMF

Foreign exchange rate determination

Exchange rate determination is complex

- The three major schools of thought are the **balance of payments approach**, **international parity conditions**, and the **asset market approach**
- The exhibit on the next slide provides an overview of the many determinants of exchange rates
- These are **not competing but rather complementary theories**, so understanding all of them can enhance our ability to capture the complexity of global currency markets and exchange rates

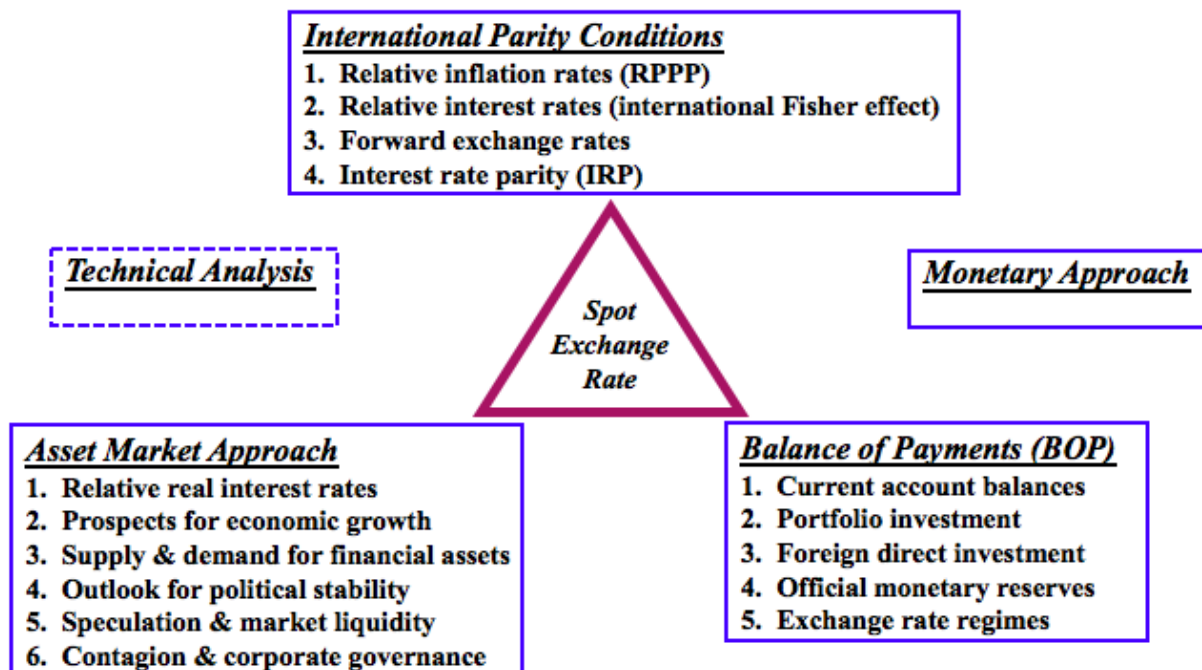
In addition to the economic theories or determining factors for the exchange rate, important factors which could affect the exchange rate markets include

1. The complexities of international political economy

- Foreign political risks have been much reduced in recent years because more countries adopted democratic (free) form of government, so capital markets became less segmented from each other and more liquid

2. Random political, economic, or social events

- For example, recent occurrences of terrorism may increase the political risks and affect the exchange rate market



The monetary approach

The **Monetary Approach** states that the **supply and demand for currency stocks**, as well as the **expected growth rates of currency stocks**, will determine the price level or the inflation rate, and thus explain changes of the exchange rate

- The arguments are all about currency stocks of residents

- The inference is to link the demand or the supply of currencies with residents' behavior to adjust the stock of currencies
- This approach acknowledges that changes in interest rates, an economy's growth rates (GDP growth rates) and money supply all affect exchange rates

The balance of payments approach

The **Balance of Payments approach** argues that the equilibrium exchange rate is determined through the **demand and supply of currency flows** from current and financial account activities

The asset market approach

The **Asset Market Approach** argues that the exchange rate should be determined by expectations about the future of an economy, not current trade flows

- Since the prospect of an economy is reflected on the demand of financial assets in that economy, the asset market approach believes that **changes of exchange rates are affected by changes of the supply and demand for a wide variety of financial assets:**
 - The asset market approach is also called the relative price of bonds or portfolio balance approach
 - More specifically, if the demand for domestic financial assets increases, the demand for the domestic currency will increase, which could result in the appreciation of the domestic currency
 - Changes in monetary and fiscal policy alter expected returns and perceived relative risks of financial assets, which in turn alter the demand and supply of financial assets and thus exchange rates

Technical analysis

Technical analysis is based on the belief that the study of past price behaviors provides insights into future price movements

- Due to the poor forecasting performance of many fundamental theories, the technical analysis has become more and more popular
- The primary assumption of the technical analysis is that the movements of **any market driven price, including exchange rates, must follow trends**
- More specifically, **technical analysts** focus on price and volume data to identify trends that are expected to continue well into the future and next exploit these trends to make profit

The global capital market

Describe the benefits of the global capital market

Generic capital market

Those who want to invest money and those who want to borrow money



Commercial banks perform an indirect connection function

- They take cash from investors and pay them a rate of interest in return
- They lend money to borrowers at a higher rate of interest
- Making a profit from the difference in interest rates (interest rate spread)

Investment Bankers perform a direct connection function

- May act as a stockbroker for an individual who want to invest money
- Will advise her to purchase the most attractive stock
- And buy the stock on her behalf
- They are charging a fee for the service

Global capital market

Benefits borrowers and investors

Borrowers

- Increasing the supply of funds available for borrowing
- Lowing the cost of capital

Investors

- Providing a wider range of investments
- Allowing the investor to build portfolios of international investments that diversify their risks

Types of financial markets

1. Debt Markets

Short-term (maturity < 1 year) Money Market

Long-term (maturity > 1 year) Capital Market

2. Equity Markets

Common stocks

1. Primary Market

New security issues sold to initial buyers

2. Secondary Market

Securities previously issued are bought and sold

1. Exchanges

Trades conducted in central locations (e.g., New York Stock Exchange, Chicago Commodity)

2. Over-the-Counter Markets

Dealers at different locations buy and sell

Growth of the global capital market

Identify why the global capital market has grown so rapidly

Factors that are driving the growth:

- Advances in information technology
 - International communication
 - Rapid data processing capabilities: market makers absorb more data
- Deregulation by governments
 - An increasing acceptance of the free market ideology

Global capital market risks

Quality and quantity information

Capital markets – Future risks and concerns

The vitality of capital markets is critical if the world is to return to an environment of sustainable economic growth. Moreover, effective capital markets are crucial to the efficient allocation of credit and investment.

In the future, capital markets will play an increasingly important role in providing everything from financing to the world's most innovative companies to generating the investment returns needed to support an ageing population in the developed world to investment needed to support sustainable and green solutions to the climate issues.

As a capital markets participant, understanding the future is imperative. Otherwise, how can you best determine whether to invest in a certain area, grow or reduce your footprint in a country, or launch or discontinue a specific product, business or strategy? As a user of capital markets one will need to develop a view of the types of products and financing options that will be available to support your business.

Both market participants (i.e. investment banks, broker-dealers, financial market utilities and the like and users (i.e. private equity firms, pension funds, hedge funds, other non-bank financial intermediaries and corporates) are concerned with the possibility of a shrinking capital markets landscape, over-regulation, the fall of traditionally powerful financial centers such as London and New York, adaptation to new technologies, rise of state-directed capitalism (which feeds into the regulatory pressure), global instability (economic, social and/or political), war for resources, etc. Users of capital markets face a number challenges – from finding yield in a period of pervasively low interest rates to adhering to complex regulations that they had not been subject to before

Lecture 7 Ethics, corporate social responsibility and sustainability issues in international business

Ethics

Ethics: to accepted principles of right or wrong that govern the conduct of a person, members of a profession or the actions of an organization. Ethics involves an active process of applying values, which may range from religious principles to customs and traditions.

Business ethics: Are the accepted principles of right or wrong governing the conduct of businesspeople.

Ethical strategy: is a strategy or course of action that does not violate these accepted principles.

The relationship between law and ethics: Law cannot codify all ethical requirements. Therefore, an action might be unethical, yet not necessarily illegal. It is unethical to lie to your friends, but it is not illegal.

- An act is illegal does not necessarily mean it is immoral
 - Honoring a contract with a totalitarian, repressive regime

Arguments:

- It is not appropriate for a multinational firm to tolerate poor working conditions of subcontractors or foreign operations (NIKE case).
- It is ethical for a multinational to do business in a nation that lacks democratic structure and human rights- bc it could create pressure for democratization.
 - During inward investments

Moral

There are four components of moral behavior

Applying moral to decisions making

- **Moral sensitivity:** which is "the ability to see an ethical dilemma, including how our actions will affect others."
- **Moral judgment:** which is "the ability to reason correctly about what 'ought' (have to) to be done in a specific situation."
- **Moral motivation:** which is "a personal commitment to moral action, accepting responsibility for the outcome."
- **Moral character:** which is a "courageous persistence in spite of fatigue or temptations to take the easy way out."

Human rights

- Freedom of association
- Freedom of speech
- Freedom of assembly
- Freedom of movement
- Freedom from political repression

Example: apartheid, segregation between whites and nonwhites

GM: General Motors

Sullivan principles: GM board of director Leon Sullivan. Argued it was okay to do business in South Africa under apartheid If two conditions were fulfilled.

- Not obey apartheid laws in SA operations
- Should do everything in their power to promote abolition of apartheid laws

Pollution

Tragedy of commons: occurs when a resource held in common by all but owned by no one is overused by individuals

Corruption

Two arguments:

- Side payments and so on enhance welfare
- Corruption reduces the returns on business investment and leads to low economic growth.

Bribes



For Bribery	Against Bribery
Necessary for profits	Wrong and illegal in most developed nations
Common practice	Compromises personal beliefs
Accepted practice	Managers should not deal with corrupt governments
Form of commission, tax, or compensation	Once started, it never stops
	One should take a stand for honesty, morality, and ethics
	Creates a dependence on corruption
	Deceives stockholders and costs customers

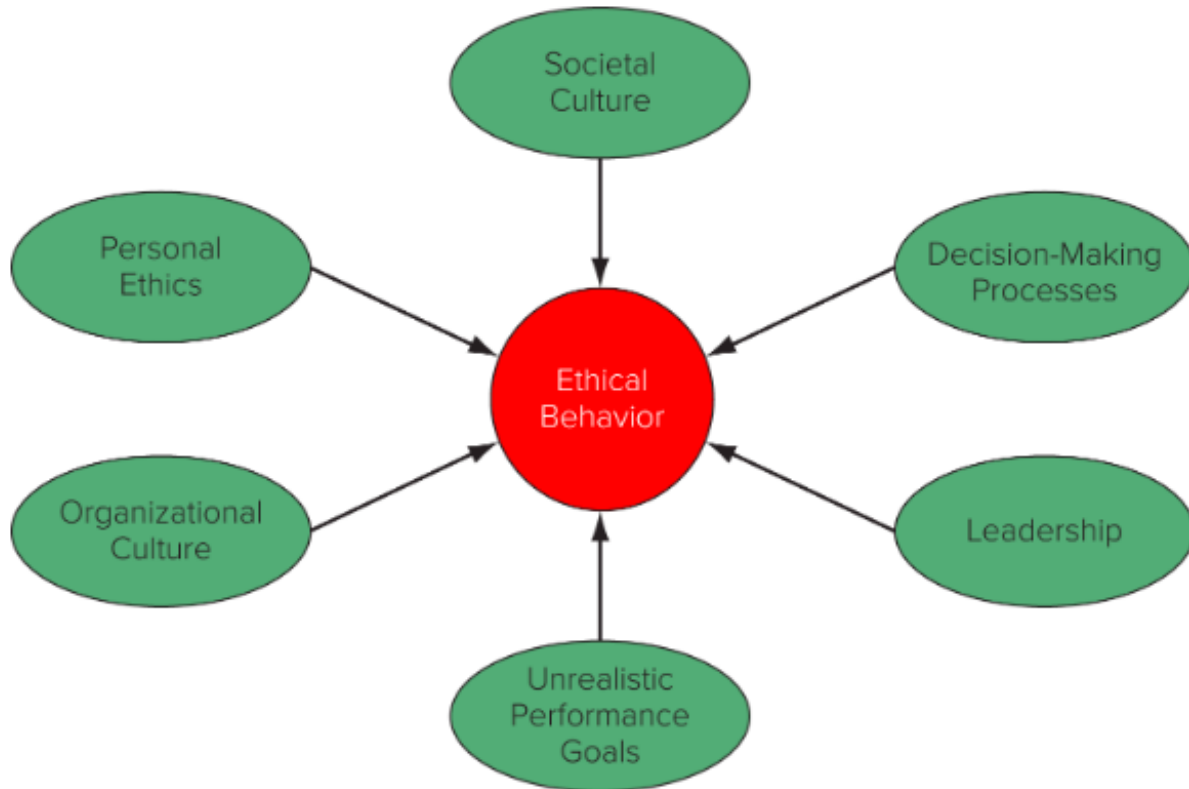
Ethical dilemmas

- More marketplace pressures from customers and stakeholders to be transparent in the business' ethical decision making
- **ethical issue** is a problem or opportunity that requires an individual or group to choose among actions that are evaluated as ethical or unethical
- **ethical dilemma** is a problem, situation, or opportunity that requires an individual or group to choose among several wrong or unethical actions
 - Examples of ethical issues and/or dilemmas:
 - conflicts of interest, bribery
 - collecting corporate intelligence
 - discrimination
 - harassment
 - fraud
 - human rights
 - environmental issues
 - privacy
 - intellectual property rights
 - product safety

- plant safety, etc.

Roots of unethical behavior

Generalization of the determinants of ethical behavior:



Personal ethics: What we as individual thinks is right and wrong.

Decision-making processes: there isn't incorporated ethical considerations into business decisions.

Organizational culture: if the organizational culture is where all decisions are purely economic or it's a norm to think about the ethical aspect of business.

Unrealistic performance goals: If the goals for the company is too much, you can violate your own personal ethics fir reaching those goals.

Leadership: helps establishes the culture of an organization.

Societal culture: There is a difference around the world in different countries

Philosophical approaches to ethics

To business ethics in the global marketplace

- All individuals adopt a process for making ethical or unethical decisions.

Straw men

- Either deny the value of business ethics or apply the concept in a bad way
 - Dismissed the straw men
- Makes the theory only to tear it down

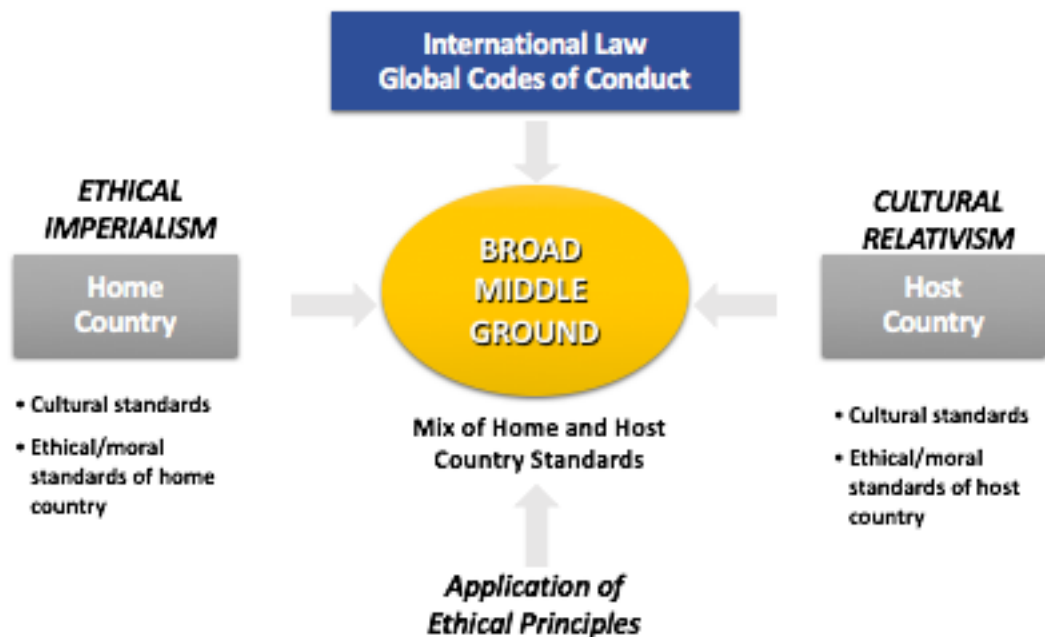
Too strawmen someone: In its simplest definition, straw man is the name of a logical fallacy, which means that if you carefully dissect the argument or statement, it doesn't make sense. ... You

put forth a straw man because you know it will be easy for you to knock down or discredit. It's a way of misrepresenting your opponent's position (taking from the internet).

The Friedman Doctrine: “ The social responsibility of business is to increase profits”- as long as the company follow the rules of the law.

Cultural relativism: ethics are nothing more than the reflection of a culture- all ethics is culturally determined and a firm should adopt the ethics of the culture in which it is operating.

Ethical choices in Home vs. Host country



The righteous Moralist: claims that a multinational’s home-country standards of ethics are the appropriate ones for companies to follow in foreign countries.

The Naive Immoralist: Says that if a manager of a multinational sees that firms in other nations aren’t following ethical norms the manager should not either. Classic example of the drug lord problem.

Utilitarian and Kantian Ethics

- Developed in the 1700/1800
- Form a tradition on which newer approaches have been constructed

Utilitarian approaches to ethics: that the moral worth of actions or practices is determined by their consequences. Actions have multiple consequences, some good and some are harmful.

Kantian ethics: The belief that people should be treated as ends and never as means to the ends of others. People are not instruments, they need to be respected as such.

Rights theories

- Human beings have fundamental rights and privileges- outside of national boundaries and cultures.

Universal declaration of Human Rights: 1948 UN,

Justice Theories

- Just distribution of economic goods and services.

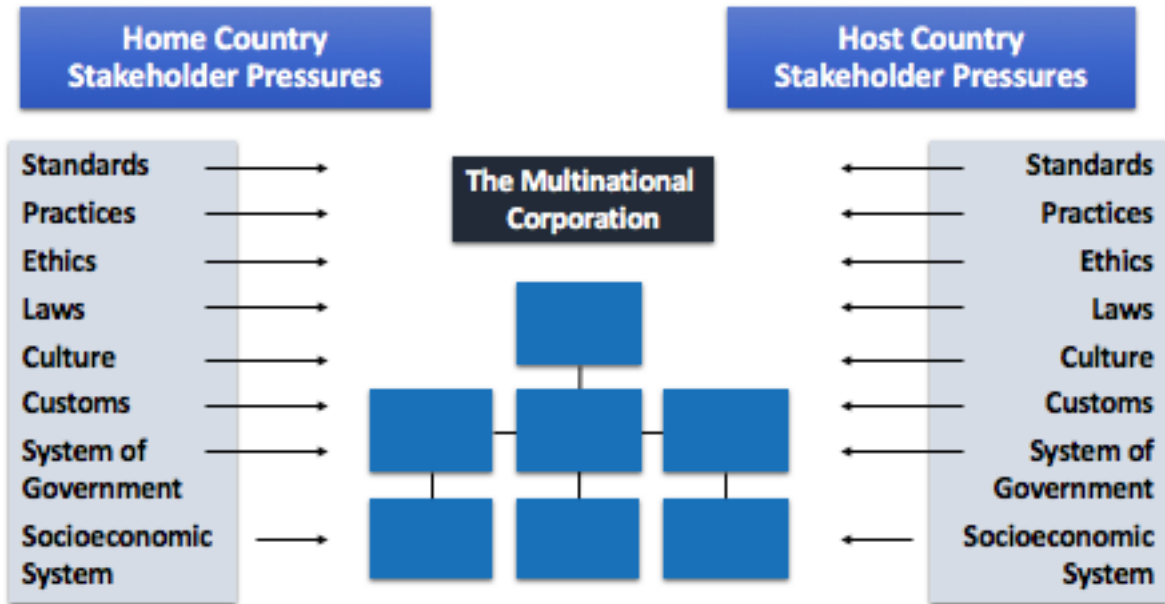
Just distribution: Is one that is considered fair and equitable.

To make sure that ethical issues are considered in international business decisions, managers should (a) favor hiring and promoting people with a well-grounded sense of personal ethics, (b) build an organizational culture and exemplify leadership behaviors that place a high value on ethical behavior, (c) put decision-making processes in place that require people to consider the ethical dimension of business decisions, (d) establish ethics officers in the organization with responsibility for ethical decision making, (e) be morally courageous and encourage others to do the same, (f) make corporate social responsibility a cornerstone of enterprise policy, and (g) pursue strategies that are sustainable.

Ethical considerations in international business

1. An additional complication is that what is ethical and “normal” in one environment may not be so in another
2. Dilemmas arise most often in the context of:
 - a. Employment practices (Hiring practices, labor relations, diversity issues, employment conditions are some specific issues that require careful thought)
 - b. Human rights (What is the responsibility of an MNC to uphold different standards of human rights? Is it ethical for MNCs to operate in countries with repressive regimes?)
 - c. Environmental policy
 - d. Corruption
 - e. An MNE’s perceived moral obligations to society

The Dilemma of the multinational corporation



An MNE seeks to be accepted into an unfamiliar society.

1. Two major challenges:
 - a. Achieving corporate legitimacy in an unfamiliar society.
 - b. Differing philosophies between Multinational corporation and host countries.

Corporate social responsibility (CSR)

CSR is:

- Being employee friendly
- Environmentally friendly
- Mindful of ethics
- Respectful of communities where firms produce
- Being investor friendly
- .. support the arts, universities etc.

CSR is:

Firm sacrificing profits in the social interest

Sacrifice = firm must go beyond legal and contractual obligations on a voluntary basis

Voluntary?

Institutional pressures?

Required by law?

CSR (Carrol, 1979)

Firms have responsibilities to societies including economic, legal, ethical and discretionary (or philanthropic).

Social Contract (Donaldson and Dunfee 1999) – There is a tacit social contract between the firm and society; the contract bestows certain rights in exchange for certain responsibilities.

Stakeholder

Any individual or group who can affect or is affected by the actions, decisions, policies, practices, or goals of the organization.

Stakeholder is a variant of the concept of stockholder/shareholder– an investor/owner of businesses

Who are stakeholders:

Primary stakeholders: Have a direct stake in the organization and its success

Secondary stakeholders: Have a public or special interest stake in the organization that is more indirect

Further distinction into **social/nonsocial** primary and secondary stakeholders

Primary nonsocial stakeholders	Secondary nonsocial stakeholders	Primary social stakeholders	Secondary social stakeholders
		Shareholders and investors	Government regulators
Natural environment	Environmental interest groups	Employees and managers	Civic institutions
		Customers	Social pressure groups
Future generations	Animal welfare organizations	Local communities	Media and academic commentators
		Suppliers and other business partners	Trade bodies
Nonhuman species			Competitors

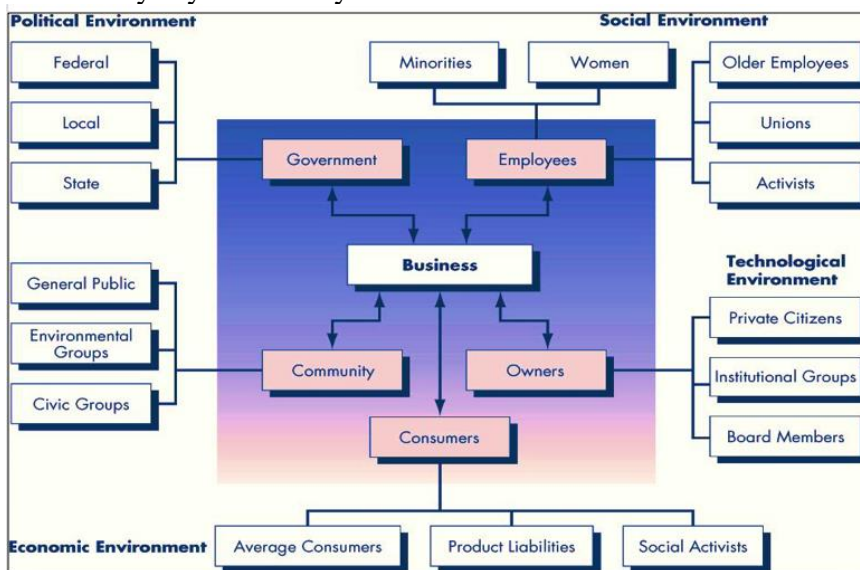
Stakeholder Theory

(Freeman, 1984)

A stakeholder is “any group or individual who can affect or is affected by the achievement of an organization’s purpose.” Argues that it is in the company’s strategic interest to respect the interests of all its stakeholders.

Basic idea: organizations are multilateral agreements between the enterprise and its multiple stakeholders:

This theory says that every decision should take into account:



Corporate social responsibility critics

“The Social Responsibility of Business Is to Increase Its Profits.” Milton Friedman New York Times (1970)

- *“there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud”*
- Social responsibility programs are “hypocritical window-dressing”
- Strong right-wing critic

Milton Friedman (right wing)	Robert Reich (Left wing)
<ul style="list-style-type: none"> • Charity with other people’s money • Top management should use their own money to give to charity • Let shareholders decide how much, where and to which cause to give 	<ul style="list-style-type: none"> • How to ensure that corporate giving gets to the right causes? • Firms should not substitute legitimately elected governments

Sustainability

Meeting our society’s needs in ways that don’t compromise the ability of future generations to meet theirs

At its core, sustainability is about being responsible with resources – people, land, energy, water, materials and capital

For human beings, sustainability means the long-term maintenance of their capacity that secures their non-declining wealth and reproduction:

- securing intergenerational equity

Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs.

The issues

- Brought forward in view of challenges at a scale never seen before
- Demographic challenges:
 - Strong population growth, notably in the developing world
- Resource challenges:
 - An increasing usage of resources, renewable and non-renewable alike
 - Raw materials
 - Energy
 - Food
- Environmental challenges:
 - Higher levels of environmental impacts of human activities
- The capacity of this world to sustain its population is compromised.

Lecture 8 Theories of foreign direct investment

Firm level decision

FDI

Foreign direct investment (FDI): (Hill definition) Occurs when a firm invests directly in facilities to produce or market a good or service in a foreign country.

Process managerial control

Control associated with the percentage of the foreign assets owned by the main company

- 50+ or lower if the ownership of the company is widespread among many shareholders
- IMF suggests 10%
 - U.S: FDI occurs when a group takes an interest of 10 % or more in a foreign business entity.

IMF definition: Investment made to acquire a lasting interest in an economy other than that of the investor, the investors purpose being to have an effective voice in the management of the enterprise (IMF).

Two forms of FDI:

Greenfield investment: Establishing a new operation in a foreign country.

Merger and acquisitions: acquiring or merging with an existing firm in the foreign country.

Flow of FDI: The amount of foreign direct investment undertaken over a given time period (normally one year).

Outflows of FDI: Flow of foreign direct investment out of the country.

Inflows of FDI: Flow of foreign investment into a country

The stock of FDI: The total accumulated value of foreign owned assets at a given time (time span is different in the stock of FDI and Flow of FDI).

Why FDI is so big (grown faster than world trade and output growth) :

- Decline in trade barriers
- Sees FDI as a way of circumventing future trade barriers
- Political and economic changes that have been occurring in many of the worlds developing nations
 - Shift toward democratic political institutions and free market
- Globalization

What is ‘affiliates’ and ‘subsidiaries’?

“A foreign affiliate is an enterprise in which an investor, who is resident in another country, owns a stake that permits a lasting interest in the management of that enterprise (An affiliate must have at least 10% foreign ownership. To be called a subsidiary, the foreign parent must have at least 50% ownership)” (UNCTAD).

The source of FDI

- 6 countries account for 60 % of outflow

Theories of FDI

1. Why firms will favor direct investment as a means of entering a foreign market, when they could do exporting and licensing
 - When transportation costs or trade barriers makes exporting unattractive
 - Over licensing when the firm wishes to maintain control over know-how, operations and strategy.
2. Why firms in the same industry often undertake foreign direct investment at the same time, and why they tend to favor the same target markets.
3. **Eclectic paradigm (OLI): combines the other two** Argument that combining location-specific assets or resource endowments and the firm's own unique assets often requires FDI; it requires the firm to establish production facilities where those foreign assets or resource endowments are located.

First theory- internationalize theory

How do firms choose how to internationalize:

Limits of Exporting:

- Transportation costs, e.g. cement
- Trade barriers, e.g. import tariffs and threats of trade barriers, e.g. political changes
- Exporting limits a proper understanding of **local tastes and needs (see lecture 2)**
- Limits of Licensing:

Short explanation of internalization theory

Explain why firms prefer FDI over licensing as a strategy for entering foreign market (Known as market imperfections approach). Licensing has three major drawbacks:

- It may result in a firm's giving away valuable technological know-how to a potential foreign competitor
- Licensing does not give a firm the tight control over production and so on
- Often not amenable to licensing- a firm's product under license is often not as efficient as the firm could do it themselves.

Internalization theory

A firm will have an advantage to internalize foreign activities when the cost of using the market for conducting those activities is perceived to be too high i.e. higher than the cost of using the hierarchy

Tries to answer the question:

Question: why business do transactions take place within a firm (hierarchy) rather than between independent firms in a market?

Explanation: A firm will have an advantage to internalize foreign activities **when the cost of using the market for conducting those activities is perceived to be too high** (i.e. higher than the cost of using the hierarchy)

When are the cost too high?

So costs are derived from market imperfections:

- Information asymmetry (one party holds more information than the other e.g. a car sale) and uncertainty
- Opportunistic behavior (self-interest seeking, not following the contract, delivering late...)
- Asset specificity (assets that are used only for a certain purpose
→ The higher the perceived costs of using the market, the higher the need for entry modes with higher degrees of control (i.e. FDI)

Costs of using the market

- Imitation
- Reputation
- Codefication
- Specialized assets

Cost related to imitation:

Consider the transfer of know-how:

- Know-how developed in one country is often useful in another, so the firm wants the foreign unit to “imitate” it.
- However, it is difficult to transfer for the following reasons:
 - Information asymmetry requires to care for property rights (a firm wants to protect the information it has)
 - Imperfect enforcement of patent rights
 - Complementary know-how creating competition

Information asymmetry makes it difficult to “explain” KH without losing property rights (and a very specific contract)

→ costs of imitation increase, difficult to find a buyer

A patent might exist but there is imperfect enforcement (e.g. high level of counterfeit sophistication)

→ local incumbents can imitate valuable design elements or production features

The buyer might have complementary know-how that combined with licensed knowledge can originate into competitive innovation

→ costs of imitation and risk to create a competitor

Transfer of know-how within a firm can be more efficient (i.e., minimize risk/cost of imitation) than using the market

Cost related to reputation

Consider transactions involving brands:

- Franchisees can behave opportunistically: reduce quality of goods to maximize profits (free-riding)
 - Verifying a business’ partner’s behavior can be costly if quality can be hardly defined and tasks/output ill structured (fast food vs. management consulting)
 - Obtaining information about business’ partner effort might not be fully observable (e.g., international context with different languages and communication barriers)

Under conditions of high potential reputation loss, a firm will exploit its source of competitive advantage within its boundaries than using the market

Cost of codification

- Buyer and seller must have perfect knowledge of what is being sold but:
 - Tacit and complex knowledge is more difficult to describe
 - Drafting tacit knowledge into an agreement is difficult → contract related costs increase (contract may be incomplete, unforeseeable circumstances)
 - The source of the competitive advantage is embedded in the organization (e.g. resides in organizational routines developed over time that cannot be separated into “stand-alone” assets) → difficult to transfer to an outside firm

Pricing of the competitive advantage is not possible and/or its transfer within the firm can be more efficient (i.e., minimize codification costs) than using the market

Cost of asset specificity

Asset specificity: an investment in assets (e.g. technology) that is specific to a business relationship. This investment creates dependence that could be exploited opportunistically. You want to avoid investments to supply products/services that are unique to a firm.

Specific/specialized assets are not easily redeployable (e.g. requires investing in a specific type of machinery or material).

Once specialized assets are in place, trading partners will try to expropriate part of the associated rents

- **Physical asset specificity** – When one (or both parties) invests in assets specifically designed for the transaction and has lower value in other use
- **Site specificity** – Results from localizing assets geographically close in order to minimize transportation costs
- **Human capital specificity** – When an agent specializes so that his unique know-how is dedicated to a certain transaction (e.g., specific marketing skills)

For instance, consider transactions of specific components:

- Procurement contracts might not be possible because
 - The supplier has to make investments specific to the transaction (e.g. technology only fungible for the buyer’s product)
 - The buyer can opportunistically renegotiate the terms of the contract when the investment has been made (the value of the investment is conditional on the specific relationship – *locked in effect*)

Under conditions of high asset specificity, a firm will internalize the production of the specific component

Limits to internationalization

Why do hierarchical control become costly?

For example:

- Costly monitoring due to geographical distance
- Communication, and hence the use of rules, is more difficult due to cultural distance
- Subsidiaries are more knowledgeable than HQs about local conditions
- Complexity of managing a huge global operation

Costs of market transactions must be balanced against costs of hierarchies.

TRANSACTION COST THEORY

Second theory- Oligopolistic approach

Why do firms in the same industry undertake FDI at about the same time and the same locations?

- FDI flows are a reflection of strategic rivalry between firms

There are two types of investments:

- **Aggressive** investment is the establishment of the first foreign subsidiary in a given industry and given country
- **Defensive** investment is the establishment of subsequent foreign subsidiaries in the same industry and country

FDI flows are a **reflection of strategic rivalry** between firms in the global marketplace

- As risk minimizers, oligopolists react to aggressive investments by competitors by following each other into new markets, in order to safeguard their own commercial interests
- Rival's response to prevent **first mover advantage** and **access to strategic knowledge**
- Multipoint competition: when two or more enterprises encounter each other in different regional markets, national markets, or industries

The theory does not explain the **first move; timing of entry** is not of relevance to this approach

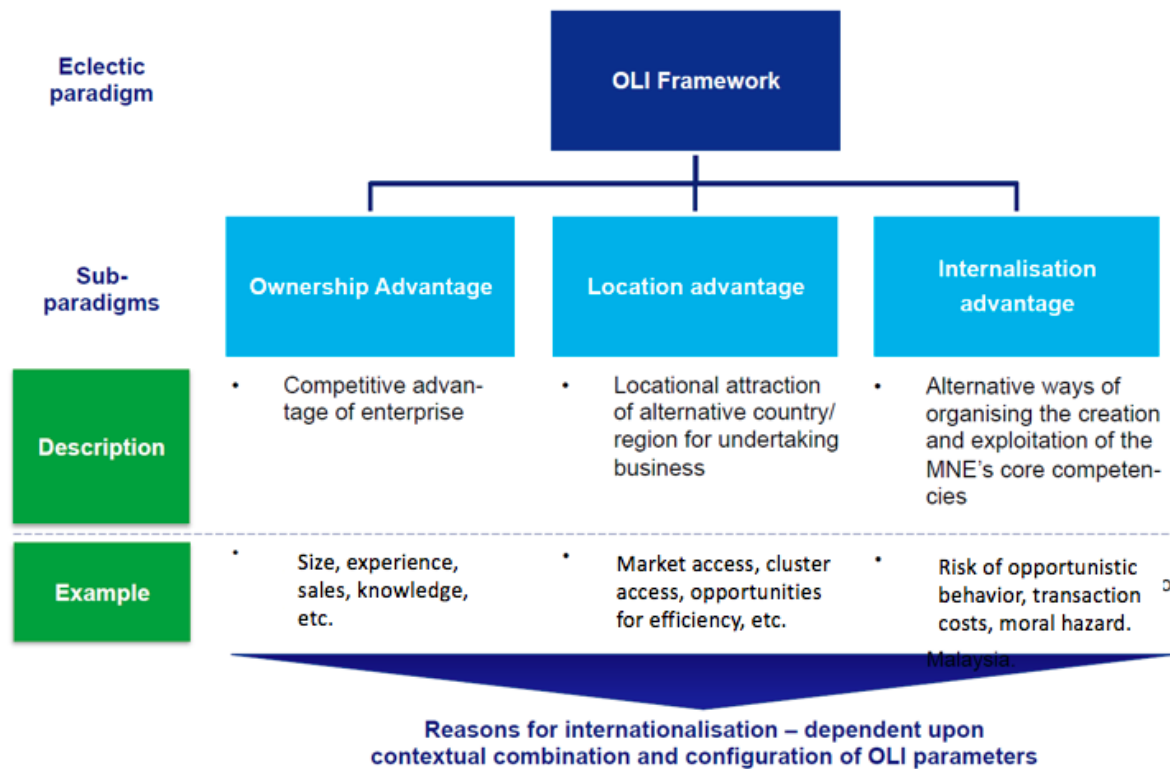
Oligopoly: an industry in which four firms control 80 % of a domestic market.

Knickerbocker's: Firms in an oligopoly tend to imitate each other's FDI.

A, B, C- Firm A establishes subsidiary in France. Firms B and C decide that if successful, this new subsidiary may knock out their export to France and give a first-mover advantage to A. Then Firm B and C decide to follow A.

Multipoint competition: arises when two or more enterprises encounter each other in different regional markets, national markets or industries.

Third theory- Dunning's eclectic paradigm (OLI)



The eclectic paradigm, also known as the OLI Model or OLI Framework (OLI stands for Ownership, Location, and Internalization), is a theory in economics. It is a further development of the internalization theory and published by John H. Dunning in 1979 (Internet).

The OLI is a conceptual framework for analyzing the determinants of international production undertaken by MNEs

The OLI framework tackles three key questions:

1. **WHY** are foreign investments possible?
2. **WHERE** do firms choose to localize their foreign activities?
3. **HOW** do firms enter a foreign market?

The OLI paradigm indicates that the extent and pattern of a firm's foreign activities will be determined by the configuration of three advantages:

1. **Ownership-specific advantages (O-advantages)**
 - Resources of the firm that are transferable across borders, and enable the firm to attain competitive advantages abroad
2. **Locational-specific advantage (L-advantages)**
 - Advantages enjoyed by firms using their ownership advantages in certain locations
3. **Internalization-specific advantages (I-advantages)**
 - Advantages of organizing activities within the firm rather than using the market

Ownership-specific advantages

What a firm does better than its competitors

The OLI paradigm moves the attention from a firm conceptualized as a “nexus of treaties/contracts” (internalization view, transaction cost theory) to that of a firm as a “bundle of resources” (penrose?)

- From a MNE as cost minimizer to a MNE as “a coordinator of a system of domestic and foreign activities”

Higher-than-average firm assets/capabilities

A firm may possess ownership advantages due to the existence of market imperfections/failures that close the market to new firms and thereby increase its market power (e.g. monopoly power)

- Examples of O-advantages include:
 - proprietary superior technologies
 - product diversification (e.g., brand loyalty)
 - credit advantages (inefficient capital markets)
 - scale economies
 - absolute cost advantages (e.g., favorable location, cheaper inputs; distribution network)
- O-advantages need to be transferable across borders (non-location-bound)
- O-advantages are a necessary condition for competing on par with local firms (in the host country)
- By exploiting their O-advantages firms overcome the costs of doing business abroad (liability of foreignness) and create more value for customers than any competitors

Location-specific advantages in bog in explaining the rational for and the direction of foreign direct investment.

Location-specific advantages

Advantages that arise from using resource endowments or assets that are tied to a particular foreign location and that a firm finds valuable to combine with its own unique assets (such as firms technological, marketing or management know-how).

Example:

- Markets
- Size and growth consumer demand (e.g., China), presence of key clients (e.g., IKEA, US FDA), high income consumers (e.g., Haier in the USA)
- Resource endowments
- Human capital, such as skilled labor force, natural resources, such as oil and gas deposits (e.g. Shell, BP) and agriculture (e.g., land in Africa)
- Agglomeration
- Geographic cluster of potential customers and suppliers (e.g., ICT in Bangalore, Hollywood movie cluster)
- Institutions
- Political risk, property rights enforcement, labor laws, attitudes toward corruption, etc.
- Government

Location characteristics *per se* are not location specific advantages

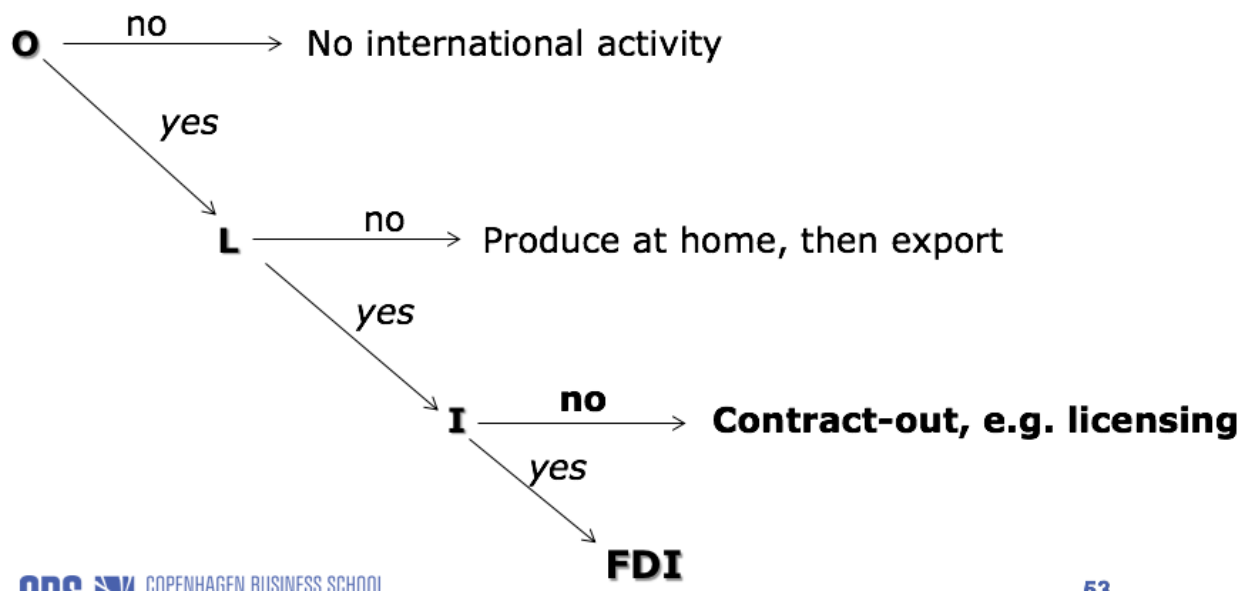
A location characteristic becomes a L-advantage when combined with a firm ownership advantage to create value

L is about the match between location characteristics and firm O-advantage
 The location needs to leverage a firm's unique capability to increase its value
 Where to locate? Location choice must fit strategically the firm's unique ownership advantages

Internalization advantages

- Those advantages firms experience when they organize their foreign activities within the boundaries of the firm rather than using the market
- How do firms enter a foreign market? They choose the entry mode that maximizes I-advantages

→ See internalization theory



O and L: a dynamic relationship

- Firm-specific strategic resources are enhanced (or reduced) differently through interactions with location advantages
 - Strategic networking
 - Interactive learning
 - Enhancing complementarities
 - Positive (or negative) agglomeration effects
- Shift from

‘Technologically advantaged MNEs go abroad to exploit their advantage’

to

‘MNEs source knowledge creation internationally through an internal network of geographically dispersed subsidiaries’

Dynamic aspect of OLI

- How do characteristics of the environment affect the different elements of the OLI paradigm?
- Examples:
 - In a new tweet, Trump promises 25% tariff on cars exported to America: What would be the effect on how car producers do IB in US?

- Big cities/regions/states are offering companies larger number of incentives to set up factories locally (see recent case of Amazon 2nd HQ): What would be the effect on firms internationalization?

Political ideology and foreign direct investment

Understand how political ideology shapes a government's attitude toward FDI

The radical view

- Roots to Marxist political and economic theory
- Argue that MNE extract profit from host country

The free market view

- Roots to classical economics and international trade theories of Adam Smith
- A international production should be distributed among countries – theory of comparative advantage
- FDI by the MNE increases the efficiency of the world economy

Pragmatic nationalism

- FDI has both benefits and costs
- The profit from the investment go abroad.
- FDI allowed so long as the benefits outweigh the costs

Benefits and Costs of FDI

Host-country benefits

- Resource-transfer effects
 - Supplying capital, technology etc: boost economic growth
- Employment effects
 - Brings jobs to a host country, that otherwise would not have been created
- Balance-of-payments effects
 - The subsidiary either export or import to the host country, helping the country not to run a deficit
- Effects on competition and economic growth
 - Can increase the number of firm in a market and the consumer choice
 - Driving prices down
 - Welfare for consumers

Host-country costs

- Adverse effects on competition in the country
 - MNE's can create a monopoly power, bc they can draw from money outside the country. The firm acquire the host-country's firms
- Adverse effects on the balance of payments
- Loss of national sovereignty and autonomy

Home-country benefits

- - balance of payments benefits from inward flow of foreign earnings
- Benefits from outward FDI from employment effects
 - Demand for home-country exports

- MNE in home country learns valuable skills

Home-country costs

- _____

International Trade Theory and FDI

When I'm reading for exam: __

Government Policy Instruments and FDI

Explain the range of policy instruments that governments use to influence FDI

Home country

Policies designed to encourage outward FDI:

- Foreign risk insurance
- Capital assistance
- Tax incentives
- Political pressure

Restricting outward FDI:

- Limiting capital outflows for country's balance of payments
- Exchange controls regulations to limit the amount of capital a firm could take out of the country
- Tax rules trying to encourage their firms to invest at home
- Prohibit national firms from investing in certain countries for political reasons

Host-country

Encouraging inward FDI

- Incentives to foreign firms to invest in their countries
 - Grants, low interest loans
 - Gain from resource-transfer and employment effects of FDI

Restricting Inward FDI

- Ownership restraints
 - Exclude foreign firms from specific fields
- Performance requirements
- Control over the behavior of the MNE's local subsidiary

MANAGERIAL IMPLICATIONS: ?

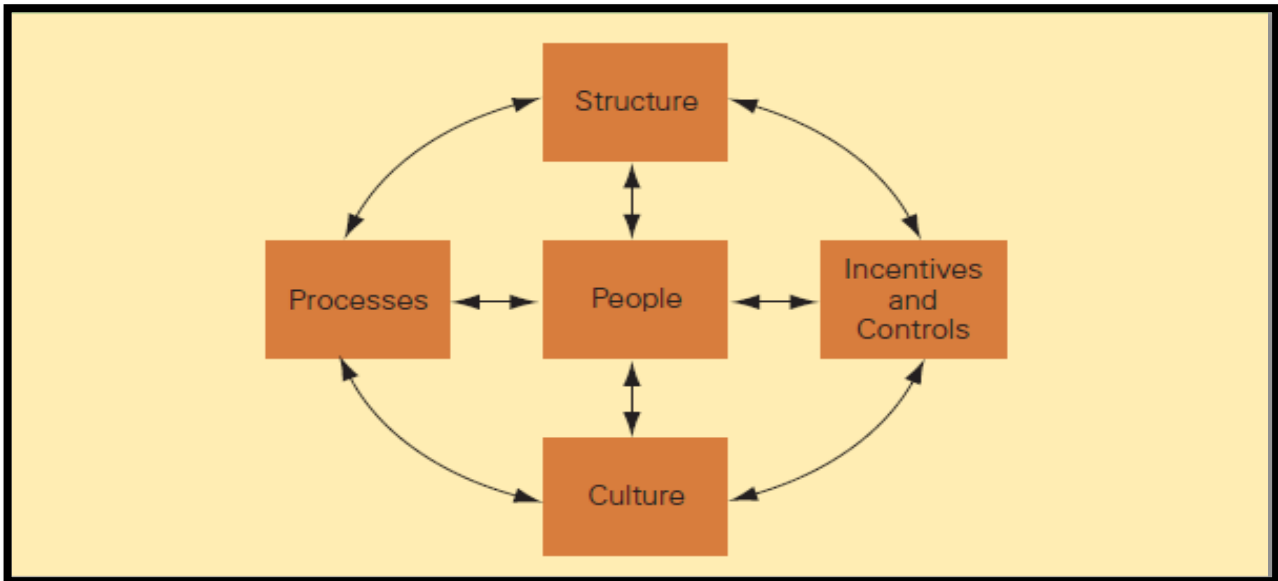
Lecture 9 -The organization of international business

Dual-listed company operates as a single business, with a shared board of directors

Organizational Architecture

Organizational architecture: the totality of a firm's organization, formal structure, control systems and incentives, processes, culture and people.

- The components of the architecture (picture) shapes each other (see arrows).



Organizational structure:

1. the formal division: organization into subunits such as product divisions, national operations and function.
2. The location of the decision-making within the structure (centralized or decentralized)
3. Integrating mechanisms to coordinate the activities of subunits

Control systems: metrics to measure performance of subunits and how well managers are running them, for example profitability are a metric.

Incentives: reward for managerial behavior, close to performance metrics.

Processes: the manner in which decisions are made and work is performed within the organization.

Organizational culture: norms and values systems that are shared between the employees.

Why important:

To succeed:

- the elements of the organizational architecture must be internally consistent
- the organizational architecture must fit the strategy
- the strategy and architecture must be consistent with each other, and consistent with competitive conditions

Organizational structure

Vertical differentiation

Vertical differentiation: the location of decision-making responsibilities within a structure/hierarchy.

Centralized decision making (at upper-level management)

- facilitates coordination
- ensures decisions are consistent with the organization’s objectives

- gives managers the means to bring about organizational change
- avoids duplication of activities

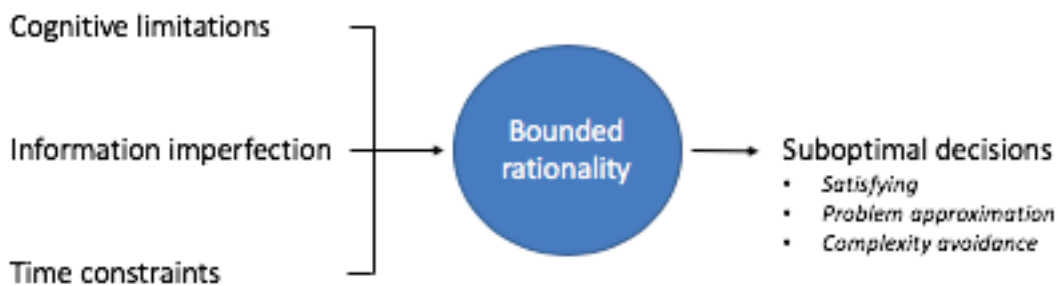
Decentralized decision making (at lower-level managers)

- relieves the burden of centralized decision making
- has been shown to motivate individuals
- permits greater flexibility
- can result in better decisions
- can increase control

How are decisions made?

Herbert Simon

What information consumes is rather obvious: it consumes the attention of its recipients. Hence a wealth of information creates a poverty of attention, and a need to allocate that attention efficiently among the overabundance of information sources that might consume it.”



Horizontal differentiation

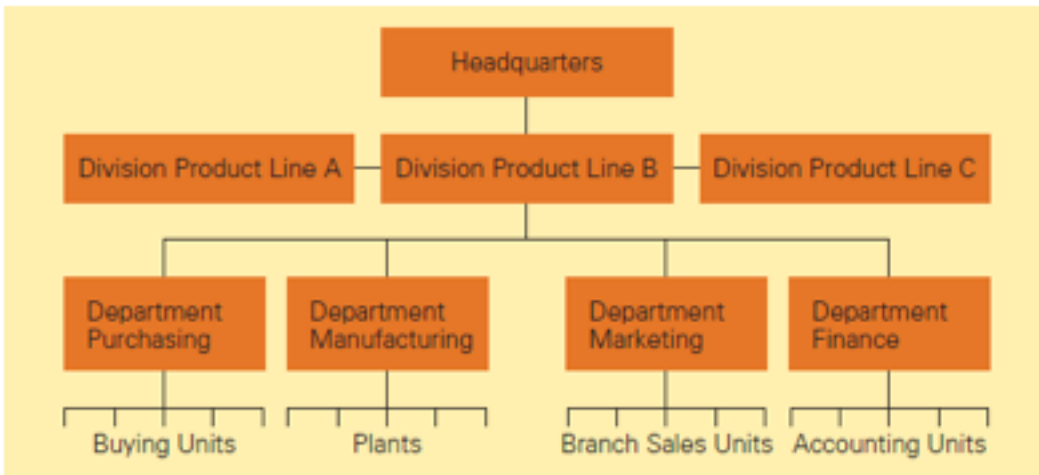
Horizontal differentiation: the formal division of the organization into subunits

Functional structure:



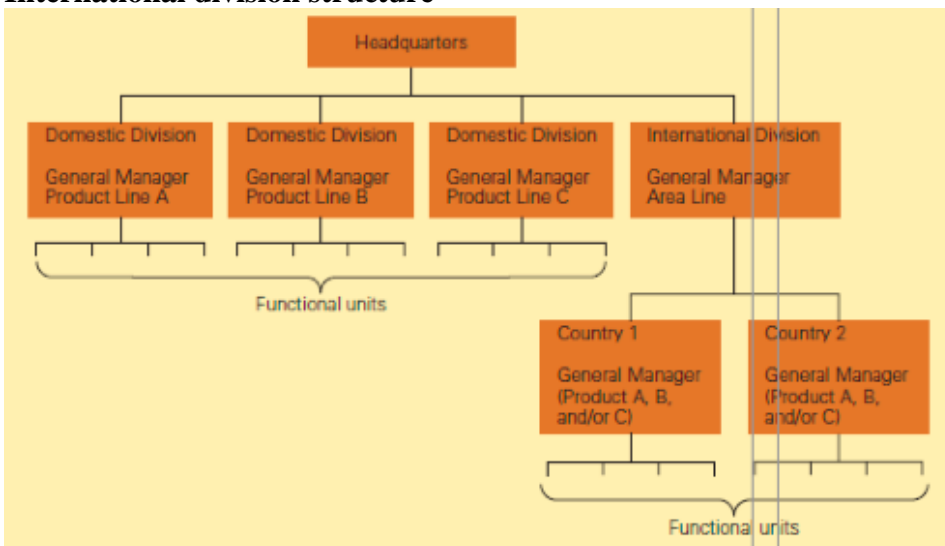
- decision making tends to be centralized

Product divisional structure



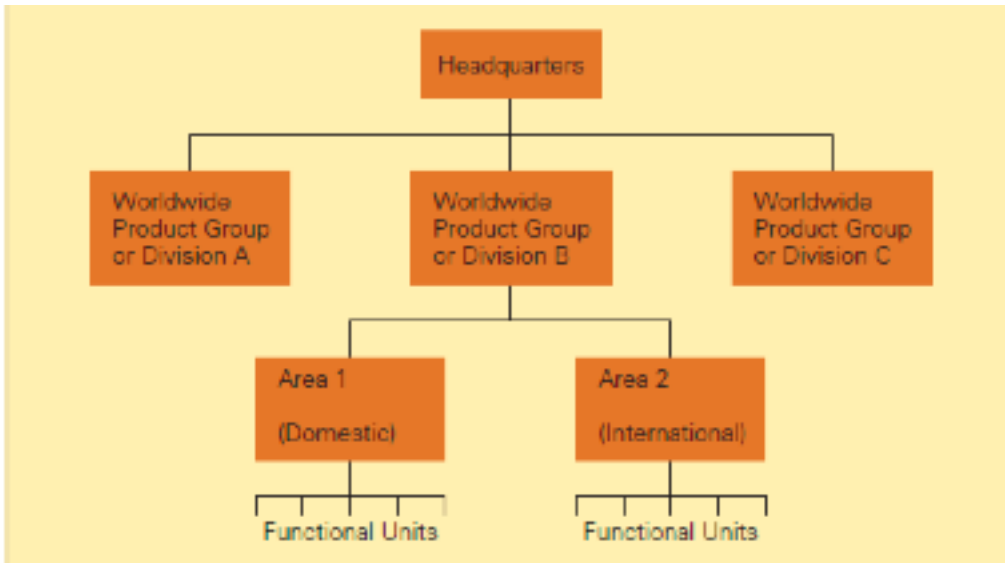
- when there are different business areas managed
- going from functional to product divisional structure when coordination and control are to problematic
- each product divisional structure is responsible for a distinct product line

International division structure



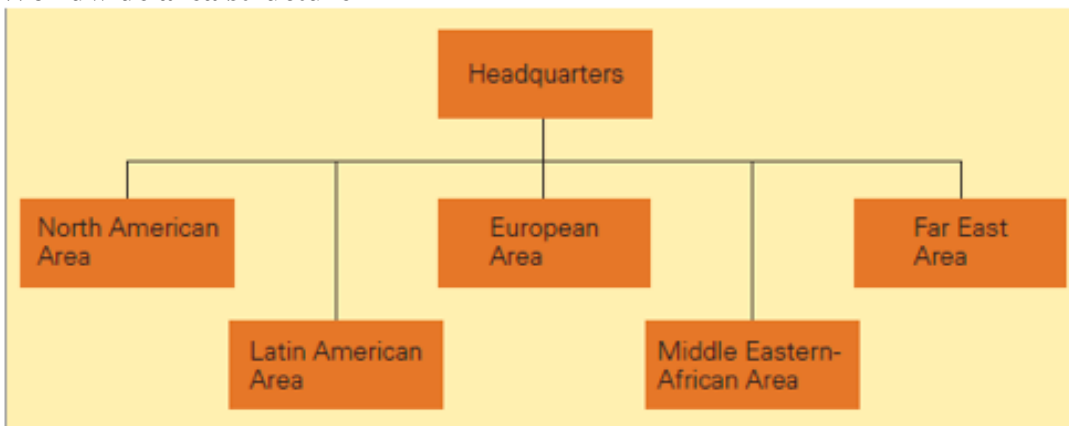
- tends to expand into international division, when a firm is organized on the basis of functions and for firms organized on the basis of product division
- the international division tends to be organized on geography
- exporting the product manufactured at home to foreign subsidiaries
- The dual structure tends to create conflict and coordination problems between domestic and foreign operations
 - The subsidiaries are not given a voice
 - Lack of coordination

Worldwide product division structure



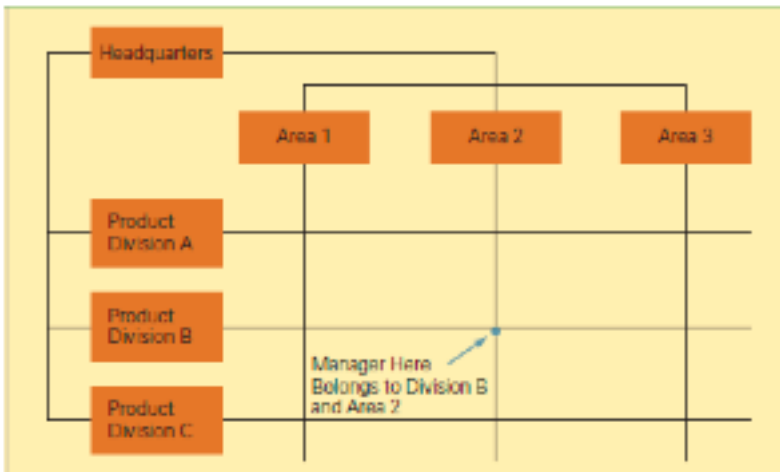
- Firms that are reasonably diversified and originally had domestic structure based on product division
- Headquarter retain responsibility for the overall strategic development and financial control
- Limited voice of area/country managers- they are seen as subservient to product division managers-> can lead to lack of local responsiveness

Worldwide area structure



- Low degree of diversification and a domestic structure based on functions
- Area may be county or group of countrues
- Self-contained
 - Own production, R&D, HR and finance functions
- Decentralized to each area with headquarters have overall strategic direction of the firm and financial control
- Can be hard to transfer core competencies and skills between areas
- Localization strategy

Global matric structure



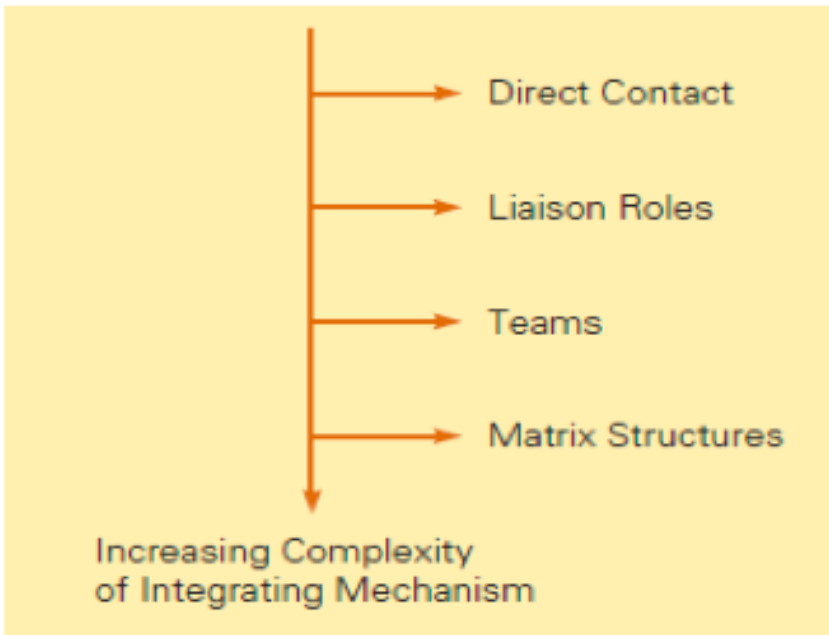
- Horizontal differentiation proceeds along two dimensions: product divisions and areas
- The products produced by division A, are determined by conciliation between division A and area 1 management.
- The dual decision-making responsibility should enable the firm to simultaneously achieve its particular objectives
- Individual managers belong to two hierarchies and have two bosses (a divisional and area)
- Doesn't work as well in real life as in theory
 - It requires many meetings
 - Slow decision making and produce inflexible organization- no quick response to market shifts or innovation.
- “flexible” matrix based on enterprise wide management knowledge networks: shared vision and culture (big focus of informal structure).

Integrating mechanisms

Integrating mechanisms: the mechanisms for coordinating subunits

- Formal and informal

Formal integration mechanisms



- Varies from simple direct contact to teams to matrix structures
 - The greater the need for coordination, the more complex the formal integrating mechanisms need to be.
1. Direct contact between employee and manager
 2. Liaison roles: a person in each subunit responsible for coordinating with another subunit on a regular basis.
 3. Temporary or permanent teams of individuals from the subunits that need to achieve coordination: product development and introduction, useful also when strategy and aspect of operations requires the cooperation of two or more subunits
 4. Need for integration is very high, where all roles are viewed as integrating roles

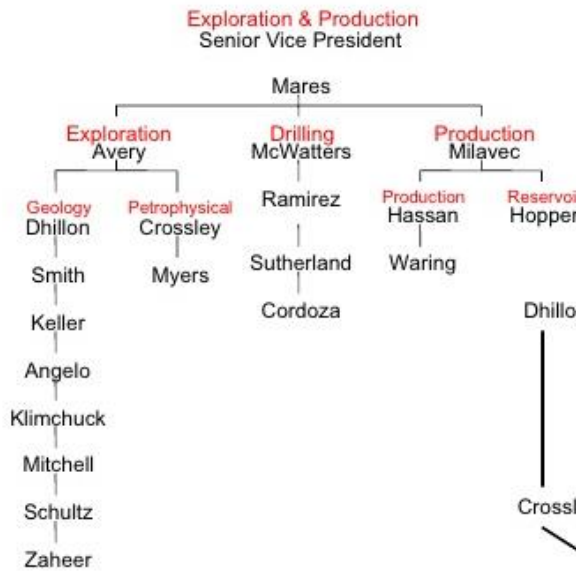
Informal integrating mechanism

Networks that are supported by an organizational culture that values teamwork and cross unit cooperation

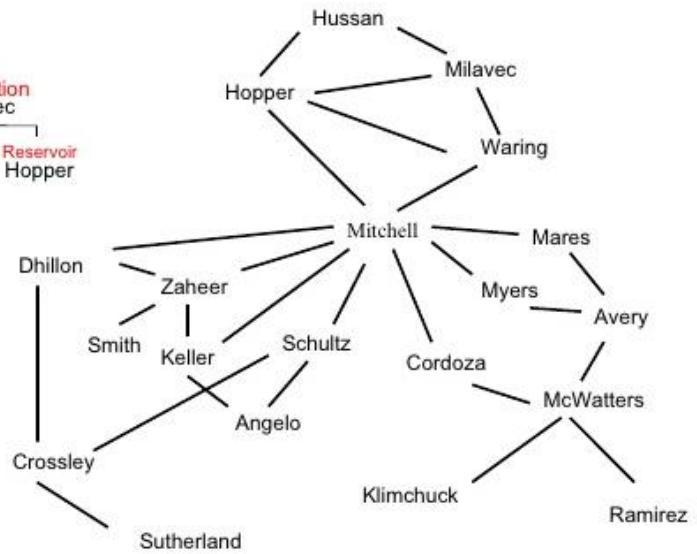
Informal contacts between managers within and enterprise

Knowledge networks: Network for transmitting information within an organization that is based on informal contacts between managers within an enterprise and on distributed information systems

Formal Structure (Org Chart)



Informal Structure (revealed in ONA)



Implications of integrating activities in an international context?

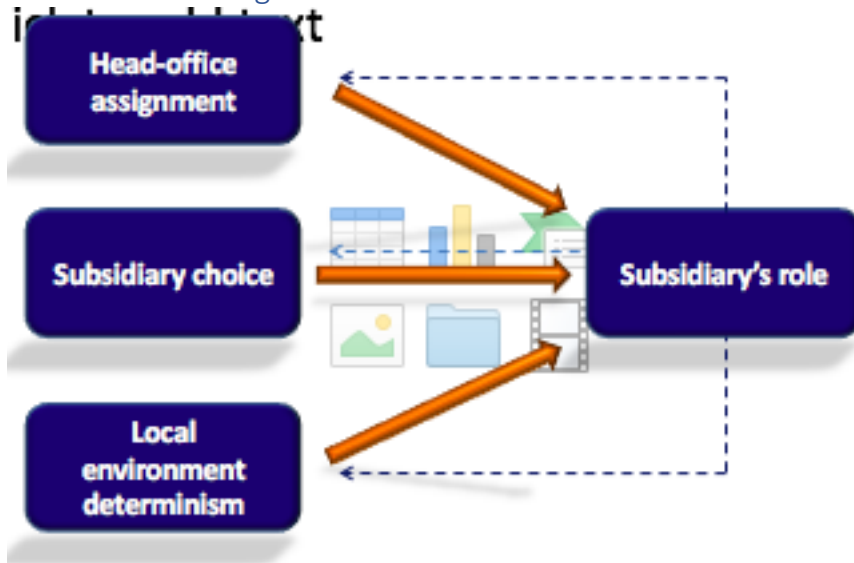
Cage framework

Ghemawat, 2001

- Cultural distance
- Administrative/political distance
- Geographic distance
- Economic distance

	Cultural Distance	Administrative Distance	Geographic Distance	Economic Distance
<i>attributes creating distance</i>	different languages	absence of colonial ties	physical remoteness	differences in consumer incomes
	different ethnicities; lack of connective ethnic or social networks	absence of shared monetary or political association	lack of a common border	differences in costs and quality of: <ul style="list-style-type: none"> • natural resources • financial resources • human resources • infrastructure • intermediate inputs • information or knowledge
	different religions	political hostility	size of country	
	different social norms	government policies	weak transportation or communication links	
<i>industries or products affected by distance</i>		institutional weakness	differences in climates	
	products have high linguistic content (TV)	government involvement is high in industries that are: <ul style="list-style-type: none"> • producers of staple goods (electricity) • producers of other "entitlements" (drugs) • large employers (farming) • large suppliers to government (mass transportation) • national champions (aerospace) • vital to national security (telecommunications) • exploiters of natural resources (oil, mining) • subject to high sunk costs (infrastructure) 	products have a low value-to-weight or bulk ratio (cement)	nature of demand varies with income level (cars)
	products affect cultural or national identity of consumers (foods)		products are fragile or perishable (glass, fruit)	economies of standardization or scale are important (mobile phones)
	product features vary in terms of: <ul style="list-style-type: none"> • size (cars) • standards (electrical appliances) • packaging 		communications and connectivity are important (financial services)	labor and other factor cost differences are salient (garments)
	products carry country-specific quality associations (wines)		local supervision and operational requirements are high (many services)	distribution or business systems are different (insurance)
			companies need to be responsive and agile (home appliances)	

Factors influencing subsidiaries



Control systems

Firms leadership have a major task of controlling the various subunits of the firm To ensure their actions are consistent with the firm's overall strategic and financial objectives.

1. Personal controls –personal contact with subordinates
 - most widely used in small firms
2. Bureaucratic controls –a system of rules and procedures that directs the actions of subunits
 - budgets and capital spending rules
3. Output controls – setting goals for subunits to achieve and expressing those goals in terms of objective performance metrics
 - compare actual performance against targets and intervene selectively to take corrective action
4. Cultural controls – exist when employees “buy into” the norms and value systems of the firm
 - strong culture implies less need for other forms of control

Incentive systems

- Incentives - devices used to reward behavior
 - usually closely tied to performance metrics used for output controls
 - should vary depending on the employee and the nature of the work being performed
 - should promote cooperation between managers in sub-units
 - should reflect national differences in institutions and culture
 - can have unintended consequences

Performance ambiguity: occurs when the causes of good and bad performance are not clearly identifiable (example for: subunits)

How to succeed internationally

”Within many industries, multinational corporations are no longer able to compete as a collection of nationally independent subsidiaries. Rather, competition is based in part on the ability of the

corporation to *link or integrate its subsidiary activities across geographic locations*” (Roth and Morrison, 1992: 715)

Basic strategies for MN firms

Explain how the organizational architecture can be matched to global strategy to improve performance

- localization
 - focus local responsiveness
- international
 - attempt to create value by transferring core competencies from home to foreign subsidiaries
- global
 - focus on the realization of location and experience curve economies
- transnational
 - focus simultaneous attainment of location and experience curve economies, local responsiveness and global learning (multidirectional transfer of core competencies or skills)

Table 14.2

A Synthesis of Strategy, Structure, and Control Systems

Strategy				
Structure and Controls	Localization		International	
	Global Standardization	Transnational		
Vertical differentiation	Decentralized	Core competency more centralized; rest decentralized	Some centralization	Mixed centralization and decentralization
Horizontal differentiation	Worldwide area structure	Worldwide product divisions	Worldwide product divisions	Informal matrix
Need for coordination	Low	Moderate	High	Very high
Integrating mechanisms	None	Few	Many	Very many
Performance ambiguity	Low	Moderate	High	Very high
Need for cultural controls	Low	Moderate	High	Very high

- fit between strategy and architecture is necessary for a firm to achieve high performance
- firms strategy must consistent with the environment in which the firm operates
- firms organizational architecture must be consistent with its strategy

How can firms implement organizational change?

Organizational inertia: is the tendency of a mature **organization** to continue on its current trajectory (Internet)

Implement organization change

- Organizations can be difficult to change because of
 - the existing distribution of power and influence
 - the current culture
 - managers' preconceptions about the appropriate business model or paradigm
 - institutional constraints

Implement organization change

1. Unfreeze the organization through shock therapy
 - requires taking bold actions like plant closures or dramatic structural reorganizations
 - Move the organization to a new state through proactive change in architecture
 - requires a substantial and quick change in organizational architecture so that it matches the desired new strategic posture
2. Refreeze the organization in its new state
 - requires that employees be socialized into the new way of doing things

Management by objectives

- Purpose: MBO is a process of defining objectives within an organization so that management and employees agree to the objectives and understand what they need to do in the organization in order to achieve them.
- Introduced by Peter Drucker (1954) in 'Practice of Management', closely linked to The Balanced Scorecard.
- An approach to employee evaluation and motivation
- Outline of goals related to productivity, i.e. output and how employee performs in the organisation

A five-step MBO process



1. **Set or Review Organizational Objectives**
 - If the organization isn't clear where it's going, no one working there will be either
2. **Cascading Objectives Down to Employees**
 - SMART: Specific, measurable, agreed, realistic, time related
3. **Monitor Progress**
 - Create a monitoring system that signals when things are off track
4. **Evaluate**
 - Employees should be given feedback on the progress of fulfilling the objectives.
5. **Reward Performance**
 - Rewards/bonuses based on employees fulfillment of objectives

An alternative: goal setting

1. Focus attention on the activities that matter
2. Clarify expectations
3. Motivate
4. Hold individuals and groups accountable

Examples:

- Operating profits
- Sales growth
- Market share
- Profit-to-sales ratio
- Cash flow from operations
- Return on investments
- New product development
- Market development
- R&D activities
- Cost reduction
- Personnel development

Lecture 10 Forms of international business

Apple (Case from PP)

Apple: AppleComputers. Deals with the production of iPhone. Value chain. The most adding activities replied R&D. lower value in the chain (assembly).

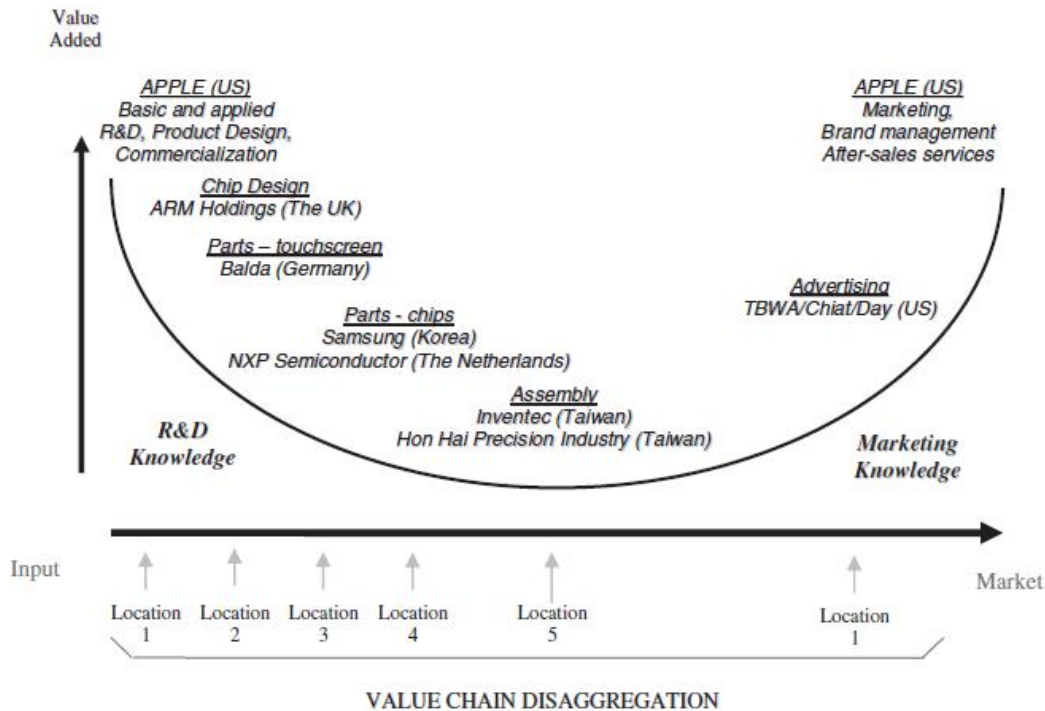


Figure 3. Value creation in the iPhone.

Number of suppliers, US alone 60, 360 in China. Most in Asia and China.

Suppliers for Apple: Peagatron, Foxconn

Human rights violations: allegations toward employees committing suicide because of orders they couldn't do.

Peagatron: people sleeping on breaks, no ID card.

Discuss and provide keywords on the following topics:

- Apple's choice of China:** cheap labor, higher efficiency, high number of suppliers-prices will fall-suppliers can do much better.
- Apple's entry mode in China (Licensing):**
 - Flexibility
 - No value to production (in Apples chain) therefor licensing production, and not R&D and so on.
 - Less risk that the knowledge of iPhone will be stolen
 - Strategic alliance
 - 60 % of the revenue of Peagatron
 - non-eq mode of entry suppliers in China
 - Internalization theory- cheaper to use the market (not cheap to use foreign direct investment)
- The responsibility for the alleged human rights violations:** Apple, all moral agents, Peagatron (legally independent, have own board, so on)

Documentary (2014) the man undercover is expelled from China, caused harm to the image of China (less attractive for foreign firms)

Vesta (Case PP)

Global, market-leading producer of high-technology wind power solutions (HQ in Jutland, Denmark).

- 12.5% of the global wind energy market.
- 23,000 workers around world.
- Wind turbine portfolio from 850kW to 12MW.

Driving innovation forward

Had all R&D in Denmark until 2014, they started internationalizing R&D: Singapore, India, US, UK.

Two type of internalization

Vestas had greenfield in R&D, 2007 sending backoffice to India (also Greenfield). They established Greenfield in other parts of the world and used those areas intelligence and expertise (Outside of EU).

Suzlon: same industry, they engage in technology license, acquisition, joint venture (Mostly EU).

Vesta: protect their knowledge, have more capital.

Suzlon: second-mover, the ability to produce low-cost, didn't have a strong R&D to begin with.

Entry strategy and strategic alliances

1. Which markets to enter?
2. When to enter them and on what scale?
3. Which entry mode to use?

Roots to chapter 2 and 3

- The choice of entry mode
- the role of strategic alliances

Strategic alliance: Cooperative agreements between potential or actual competitors.

- Cross-shareholding deals
- Licensing arrangements
- Formal joint ventures
- Informal cooperative arrangements

Basic entry decisions

1. The decision of which foreign markets to enter
2. When to enter them
3. On what scale to enter them

Which foreign markets?

- Must be based on a nation's long-run profit potential
 - The economic and political factors that influences the potential attractiveness of a foreign market (chapter 2 and 3).
- Balancing the benefits, cost and risks associated with during business in that country
- The size of the market
- Purchasing power of the consumers
- Living standards and economic growth
- Suitability if its products to that market
- The nature of indigenous competition
- EIU: economist intelligence unit, gives a country report

Market selection:

Favorable markets

- are politically stable
- have free market systems
- have relatively low inflation rates
- have low private sector debt

Less desirable markets

- are politically unstable
- have mixed or command economies
- have excessive levels of borrowing

Where do firms actually enter?

World investment report 2019: what's happening around the world.

Global FDI inflows 2018 \$1,4 trillion, more FDI developing countries than developed countries.

2015 the election of Trump FDI went up, Brexit 2016 FDI went down.

US by far the largest recipient for FDI China, Brazil, Korea,

Africa not a major part of the FDI, clearly this will increase, much inflow of FDI from China, France, UK.

What is an emerging economy?

Brics: Former developing economies that achieved substantial industrialization, modernization, and remarkable economic growth; e.g., Indonesia, Mexico, Poland, Turkey, and Brazil, Russia, India, China (so called BRIC countries) (cf. IMF, 2011).

- They occupy a middle ground between advanced economic and developing economies.
- Perhaps their most distinguishing characteristics are rapidly improving living standards and a growing middle class with rising economic aspirations.

Emerging economy: "low-income, rapid growth countries using economic liberalization as their primary engine of growth" (Hoskisson et al., 2000: 249).

- Cheap mass labour
- High-growth domestic markets
- Vast available natural resources

Advanced economy: characterized by their high level of gross domestic product per capita and degree of industrialization (cf. IMF 2011).

During business in emerging countries.

Timing of entry

Entry is early when a firm enters a foreign market before other foreign firms

Entry is late when a firm enters after other international businesses have established themselves

- First-mover advantages
 - The ability to preempt rivals by establishing a strong brand name.
 - The ability to build up sales volume and ride down the experience curve ahead of rivals and gain a cost advantage over later entrants.
 - The ability to create switching costs that tie customers into products or services making it difficult for later entrants to win business.
- First-mover disadvantages
 - **Pioneering costs**
 - The costs of business failure if the firm, due to its ignorance of the foreign environment, makes some major mistakes.
 - The costs of promoting and establishing a product offering, including the cost of educating customers.

Pioneering costs: : what an early entrant has to bear that a later entrant can avoid.

arise when the business system in a foreign country is so different from that in a firm's home market, that it takes considerable effort, time and expense to learn the rules of the game. Arise when the foreign business system is so different from that in the home market that the firm must devote considerable time, effort and expense to learning the rules of the game.

Scale of entry and strategic commitments

- Entering market on a large scale involves the commitment of significant resources and a rapid entry
 - The consequences are associated with the value of the resulting strategic commitments- have a long-term impact and is difficult to reverse
- Entering on small scale and build slowly to become familiar with the market

Entry modes

Six different modes to enter foreign markets

- Exporting
- Turnkey projects
- Licensing: manufacture companies
- Franchising: service companies
- Establishing joint ventures with a host-country firm
- Set up a wholly owned subsidiary in the host country

Exporting: a common first step for many manufacturing firms

- later, firms may switch to another mode

Turnkey projects: the contractor handles every detail of the project for a foreign client, including the training of operating personnel

- at completion of the contract, the foreign client is handed the "key" to a plant that is ready for full operation

Licensing: a licensor grants the rights to intangible property to the licensee for a specified time period, and in return, receives a royalty fee from the licensee

- patents, inventions, formulas, processes, designs, copyrights, trademarks

Franchising: a specialized form of licensing in which the franchisor not only sells intangible property to the franchisee, but also insists that the franchisee agree to abide by strict rules as to how it does business

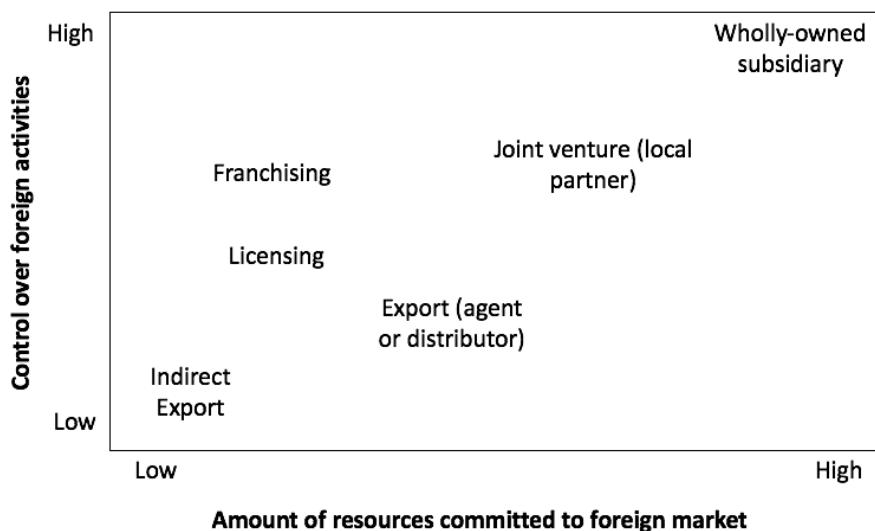
- used primarily by service firms

Joint ventures with a host country firm: a firm that is jointly owned by two or more otherwise independent firms

- most joint ventures are 50–50 partnerships

Wholly owned subsidiary: the firm owns 100 percent of the stock

- set up a new operation
- acquire an established firm



	Exporting	Licencing	Franchising	Joint venture	Wholly owned subsidiary
Advantages	Scale economies	Lower development costs	Lower development costs	Local knowledge	Maintains control over technology
	Consistent with pure global strategy	Lower political risks	Lower political risks	Shared costs and risks	Maintains control over operations
				May be the only option	Maintains control over quality
Disadvantages	No low-cost sites	Loss of control over technology	Loss of control over quality	Loss of control of technology	High costs
	High transportation costs			Conflict between partners	High risk
	Tariff barriers				

(THE AMERICAN FACTORY)

Greenfield venture or acquisition

Greenfield strategy: building a subsidiary from the ground up

Acquisition: acquiring an enterprise in the target market- for example: buying a firm in the country of entry and a merging it together with the original firm.

Why do acquisition fail?

- Acquiring firms overpay for the assets of the acquired firm
- Too optimistic about the value that can be created via an acquisition (hubris hypothesis)
- Clash between cultures
- Differences in national culture can slow the integration of operations
- No thoroughly analyzation if the potential benefits and costs

hubris hypothesis: postulates that top managers typically overestimate their ability to create value from an acquisition, primarily because rising to the top of a corporation has given them an exaggerated sense of their own capabilities.

Strategic Alliances

Strategic alliances are cooperative agreements between actual or potential competitors. The advantage of alliances are that they facilitate entry into foreign markets, enable partners to share the fixed costs and risks associated with new products and processes, facilitate the transfer of complementary skills between companies, and help firms establish technical standards.

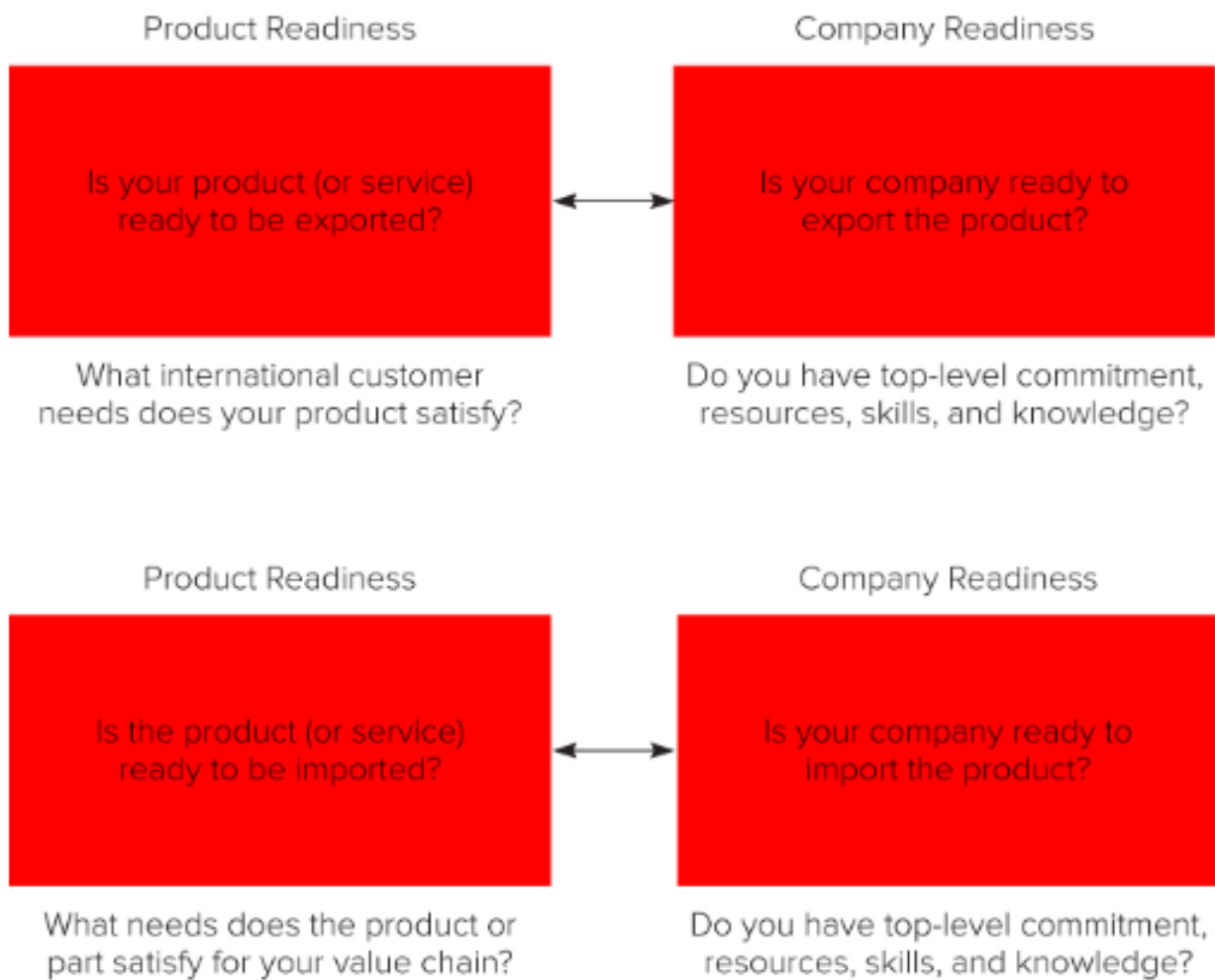
The disadvantage of a strategic alliance is that the firm risks giving away technological know-how and market access to its alliance partner.

The disadvantages associated with alliances can be reduced if the firm selects partners carefully, paying close attention to the firm's reputation and the structure of the alliance to avoid unintended transfers of know-how.

Exporting, importing and countertrade

SMEs: small and medium-sized enterprises

The logic for both exporting and importing is very similar. Readiness to export and/or import is a large part of the story, as illustrated in



Promise and pitfalls of exporting

Promise:

- Large revenue
- Profit opportunities
- Can enable a firm to achieve economies of scale- lowering unit costs

Pitfalls:

- Poor market analysis
- Poor understanding of competitive conditions in a foreign market

- A failure to customize the product
- Lack of an effective distribution program
- Poor promotional campaign
- Problems securing financing

Improving export performance

An export management company (EMC): Offers services to companies that have not previously exported products.

Piggyback marketing: is an arrangement whereby one firm distributes another firm's products.

Export strategy: help with a successful export startup

1. Particularly for the novice exporter, it helps to hire an EMC or at least an experienced export consultant to identify opportunities and navigate the paperwork and regulations so often involved in exporting.
2. It often makes sense to initially focus on one market or a handful of markets. Learn what is required to succeed in those markets before moving to other markets. The firm that enters many markets at once runs the risk of spreading its limited management resources too thin.
3. The result of such a shotgun approach to exporting may be a failure to become established in any one market.

Export and import financing

The letter of credit: Issued by a bank at the request of an importer. Issued by a bank at the request of an importer.

Bill of exchange/draft: used in international commerce to effect payment- is simply an order written by an exporter instructing an importer, or an importer's agent, to pay a specified amount of money at a specified time.

The person or business initiating the draft is known as the maker. The party to whom the draft is presented is known as the drawee.

Two categories:

- **Sight draft:** is payable on presentation to the drawee.
- **Time draft:** allows for a delay in payment—normally 30, 60, 90, or 120 days. It is presented to the drawee, who signifies acceptance of it by writing or stamping a notice of acceptance on its face.

Bill of lading: is issued to the exporter by the common carrier transporting the merchandise. It serves three purposes: it is a receipt, a contract, and a document of title.

Countertrade

- A government may restrict the convertibility of its currency to preserve its foreign exchange reserves
 - problematic for exporters.
- No convertibility implies that the exporter may not be paid in his or her home currency

Countertrade: its principle is to trade goods and services for other goods and services when they cannot be traded for money. Example: Saudi Arabia agreed to buy ten 747 jets from Boeing with payment in crude oil, discounted at 10 percent below posted world oil prices.

5 types of countertrade:

- Barter
- Counterpurchase
- Offset
- Switch trading
- Compensation or buyback

Barter: The direct exchange of goods or service between two parties without cash transaction.

Counterpurchase: a reciprocal buying agreement. Example: Suppose a U.S. firm sells some products to China. China pays the U.S. firm in dollars, but in exchange, the U.S. firm agrees to spend some of its proceeds from the sale on textiles produced by China.

Offset: one party agrees to purchase goods and services with a specified percentage of the proceeds from the original sale. The difference is that this party can fulfill the obligation with any firm in the country to which the sale is being made.

Switch trading: Use of a specialized third-party trading house in a countertrade arrangement.

Buyback: occurs when a firm builds a plant in a country—or supplies technology, equipment, training, or other services to the country—and agrees to take a certain percentage of the plant's output as partial payment for the contract.

Pros and cons

The main attraction of countertrade is that it gives a firm a way to finance an export deal when other means are not available. A firm that insists on being paid in hard currency may be at a competitive disadvantage vis-à-vis one that is willing to engage in countertrade.

The main disadvantage of countertrade is that the firm may receive unusable or poor-quality goods that cannot be disposed of profitably.

Lecture 11 Global business operations

Conclusion from PP

- Offshoring/outsourcing as an irreversible business practice in a growingly competitive landscape.
- Essential tool to cut costs, access resources, gain new markets.
- Substantial (unforeseen) challenges that potentially undermines the rationale of offshoring.
- New requirements for integration and coordination of international activities.

Case LEGO

LEGO's approach to global business operations

- Established in 1932

- One of the world's largest manufacturer of toys
- DKK39.9 billion in revenue (2016)
- DKK9.4 billion in profits (2013)
- 11,755 employees (2013)
- Chairman: Jørgen Vig Knudstorp
- CEO: Bali Padda

Troubles ahead

Major financial crisis in 2003/4

- Net loss of DKK888 million in 2003 and DKK1.8 billion in 2004
- Sales fallen by 30-40 percent
- Alternative costs: DKK2.2 million EVERY day from 1998 to 2004
- **LEGO was on the verge of going bankrupt**

Shared vision

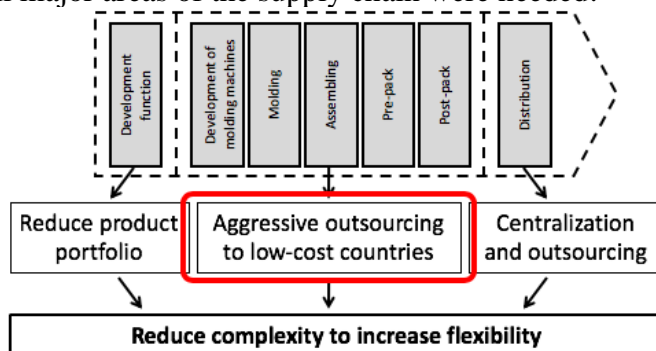
Restrategizing business platform:

- Be best at creating value for our customers and sales channels
- Refocus on the value we offer our customers
- **Increase operational excellence**

Include customers in the business model – what do they actually want? Focus more on the direct relationship with the customers. Sold off Lego land. Focus only on LEGO BRICKS. (an english firm is now owning lego land – but they want to buy it back)

Operational excellence

A comprehensive analysis of the company initiated in 2004 revealed that urgent transformations in all major areas of the supply chain were needed:



- Lego used so many suppliers so produce. Way to complex, too many information channels. It had to be simplified.
- 14 000 different products, they reduced this in order to focus.
- Before: almost all the production was in Billund – now they decided to do aggressive outsourcing

What to outsource?

Long-term contract of outsourcing up to 80 percent of production to Flextronics:

- Parts of the production facility in Denmark and Switzerland was transferred to Flextronics plants in Hungary.
- The operating control of the Kladno site in the Czech Republic was handed over to Flextronics.
- LEGO's Enfield plant in the US was closed in favor of using Flextronics newly opened facilities in Juarez, Mexico

Flextronics

Some facts

- A leading multinational electronics manufacturing services (EMS) provider, HQ in Singapore
- A network of manufacturing facilities in 30 countries on four different continents
- Net sales of \$31bln in 2009
- 160,000 employees
- Six core areas
 - Automotive
 - Computing
 - Industrial
 - Infrastructure
 - Medical
 - Mobile and consumer
- Major clients: *Cisco systems, Hewlett-Packard, Microsoft, Sony-Ericsson, etc...*

Outcome of collaboration

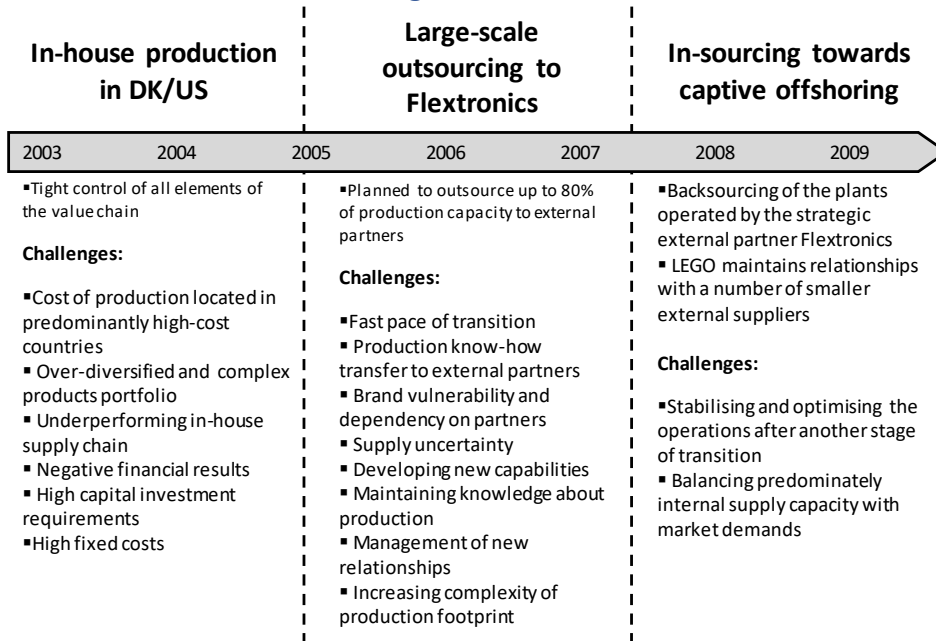
Improvement through Flextronics:

- Standardization and documentation of work processes ("modularization") □ e.g. S&OP process.
- The value of supply chain transparency.
- Reduction of component portfolio from appr. 12,000 in 2004 to 6,000 in 2008.
- 70% evergreens in 2008.

A sudden decision in 2008 to phase out the cooperation with Flextronics and to in-source everything again.

- LEGO gained ownership and control of the facilities in Kladno, Czech Republic, and Sarvar and Nyíregyháza, Hungary.
- Juarez facilities closed in favor of using LEGO's new, fully owned, facilities in Monterrey, Mexico.

Sum UP of LEGO- was it all a good descion?



Was outsourcing the right decision in 2004?

Was insourcing the right decision in 2007?

What drove these decisions and did the company act after these theories?

2004: Outsourcing their production is a cheap way to go, by moving it to external partners they could make the production cheaper and focus on turning the company around. BUT; as always with outsourcing – it’s difficult to do proper quality control.

Was the decision right?

2004:

– There were locational disadvantages having their production in Denmark. (50 years earlier the case was not the same)

East Europe – close to west/south Europe – Mexico – close to US.

The bricks are quite easy to produce, so it was easy to find an outsourcing partner. **Short: YES, this was probably the right decision.**

2008:

- Maybe it could have something with the expired patents to do?

Global Production and Supply Chain Management

A total cost focus of a global supply chain ensures that the goal is not to strive for the lowest cost possible at each stage of the supply chain (each node in the chain) but, instead, strive for the lowest total cost to the customer—and, by extension, greatest value—at the end of the product supply chain.

Strategy, Production, and Supply Chain Management

Production: Activities involving creation of a product (or service).

Supply chain management: The integration and coordination of logistics, purchasing, operations and market channel activities from raw material to the end-customer. Linked closely to production.

Purchasing: Includes worldwide buying of raw material, component parts, and products used in manufacturing of the company's products and services.

Logistics: Plans, implements, and controls the effective flows and inventory of raw material, component parts, and products used in manufacturing.

Upstream: The portion of the supply chain from raw materials to the production facility.

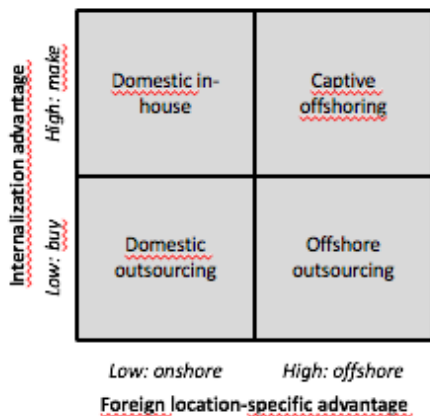
Downstream: From the production facility to the end-customer.

- To secure a finished product with no defects and performs well, this should be embedded in both the upstream and downstream portions of the global supply chain.

Offshoring

- The **global relocation** of firm tasks and activities supporting domestic or global operations/markets.
- From home country (typically) to foreign location offering attractive **location-specific advantages**.

Both **in-house** and **outsourced**, depending on internalization advantages



Foreign location-specific adv.

This is basically the same as the OLI-framework

Where to produce

Where to locate production activities to minimize cost and improve product quality

- Country factors
- Technological factors
- Production factors

Country factors

Firms should consider

- the availability of skilled labor and supporting industries
- formal and informal trade barriers
- expectations about future exchange rate changes

- transportation costs
- regulations affecting FDI

Technological factors

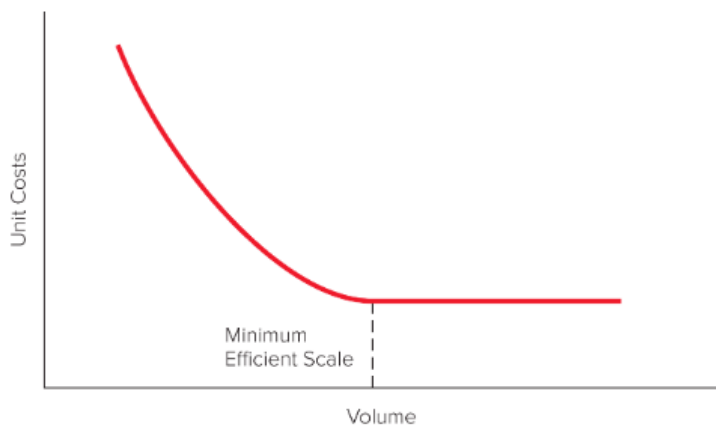
Firms should consider

1. The level of fixed costs
 - if fixed costs are high, produce in a single location or a few locations
 - when fixed costs are low, multiple production plants may be possible

allows firms to respond to local

Minimum efficient scale: The level of output at which most plant-level scale economies are exhausted. The unit cost curve (figure) declines with output until a certain output level is reached, at which point further increases in output and little reduction in unit costs.

Minimum efficient scale is the scale of output a plant must operate to realize all major plant-level scale economies. (?) words, I don't know.



- The larger the minimum efficient scale of a plant relative to total global demand, the greater the argument for centralizing production in a single location or a limited number of locations.
- When the minimum efficient scale of production is low relative to global demand, it may be economical to manufacture a product at several locations.

Example: For example, the minimum efficient scale for a plant to manufacture personal computers is about 250,000 units a year, while the total global demand exceeds 35 million units a year.

From PP

The minimum efficient scale

- the level of output at which most plant-level scale economies are exhausted
 - when minimum efficient scale is high, choose centralized production in a single location or a limited number of locations
 - when minimum efficient scale is low, respond to local market demands and hedge against currency risk by operating in multiple locations

The flexibility of the technology

flexible manufacturing technology or lean production

- reduces set up times for complex equipment
- increases the utilization of individual machines
- improves quality control

allows firms to produce a wide variety of end products at a relatively low unit cost

- mass customization
- flexible machine cells

Flexible manufacturing technology: Manufacturing technology designed to improve job scheduling, reduce setup time and improve quality control. It is challenging the view of production efficiency. It allows the company to produce a wider variety of end products at a unit cost.

Mass customization: The production of a variety of end products at a unit cost that could once be achieved only through mass production of a standardized output.

Flexible machine cells: Flexible manufacturing technology in which a grouping of various machine types, a common materials handler, and a centralized cell controller produce a family of products.

Production factors

Two production features affect location decisions

1. Product value-to-weight ratio: influences transportations costs
 - a. if the value-to-weight ratio is low, there is greater pressure to manufacture the product in multiple locations across the world
2. Whether the product serves universal needs, needs that are the same all over the world-

Locating production facilities (Table 17.1 p 496)

Basic strategies for locating production facilities

1. Concentrating them in a centralized location and serving the market from there
2. Decentralizing them in regional or national locations that are close to major markets
 - Depends on various country-specific
 - Technological factors
 - Product factors

Concentration of production makes most sense:

- Differences among countries in factor costs, political economy, and culture have a substantial impact on the costs of manufacturing in various countries.
- Trade barriers are low.
- Externalities arising from the concentration of like enterprises favor certain locations.
- Important exchange rates are expected to remain relatively stable.
- The production technology has high fixed costs and high minimum efficient scale relative to global demand or flexible manufacturing technology exists.
- The product's value-to-weight ratio is high.
- The product serves universal needs.

Decentralization of production makes most sense:

- Differences among countries in factor costs, political economy, and culture do not have a substantial impact on the costs of manufacturing in various countries.
- Trade barriers are high.
- Location externalities are not important.
- Volatility in important exchange rates is expected.
- The production technology has low fixed costs and low minimum efficient scale, and flexible manufacturing technology is not available.
- The product's value-to-weight ratio is low.
- The product does not serve universal needs (i.e., significant differences in consumer tastes and preferences exist among nations).

Strategic roles for production facilities

What is needed to think about, when making a decision to open up a new production facility outside home base, and where to locate the facility.

Managers need to think about:

- **Global learning:** valuable knowledge may also be found in foreign subsidiaries.
- **Offshore factory:** developed for producing component parts og finished good at a lower cost than at home (or any other market).
- **Source factory:** drive down costs in the global supply chain, have more say in certain decisions (more strategic role than offshore factory).
- **Server factory:** linked into the global supply chain for a global firm to supply specific country or regional markets around the globe (overcome tariff barriers, reduce taxes etc.).
- **Contributor factory:** serves a specific country or world region, has responsibility for product and process and development.
- **Outpost factory:** an intelligence-gathering unit. Can be placed near competitor headquarter, demanding customers, key supplier or so own. Based on the countries' strategic importance.
- **Lead factory:** create new processes, products, and technologies that can be used throughout a global firm in all parts of the world.

Hidden costs of foreign locations

- High employee turnover
- Poor product quality
- Low productivity

Internalization theory

where do firms go

Psycic distance – firms will locate their prod to markets that are psychic closer (easier to manage production where you know)

Product life cycles – locally until the life cycle is secure

John Dunning – OLI

Question: why business transactions take place within a firm (hierarchy) rather than between independent firms in a market?

Explanation: A firm will have an advantage to internalize foreign activities **when the cost of using the market for conducting those activities is perceived to be too high** (i.e. higher than the cost of using the hierarchy)

- Information asymmetry (one party holds more information than the other e.g. a car sale) and uncertainty
- Opportunistic behavior (self-interest seeking, not following the contract, delivering late...)
- Asset specificity (assets that are used only for a certain purpose)

Why make/vertically integrate?

1. Lowers costs
 - if a firm is more efficient at that production activity than any other enterprise, manufacturing in-house makes sense
2. Facilitates investments in highly specialized assets
 - internal production makes sense when substantial investments in specialized assets are required
3. Protects proprietary technology
 - in-house production makes sense when component parts contain proprietary technology
4. Facilitates the scheduling of adjacent processes
 - planning, coordination, and scheduling of adjacent processes can be easier with in-house production

Why buy/externalize?

1. Gives the firm greater flexibility
 - important when changes in exchange rates and trade barriers alter the attractiveness of various supply sources over time
2. Helps drive down the firm's cost structure
 - avoids challenges of coordination and control of additional subunits
 - avoids the lack of incentive associated with internal suppliers
 - avoids the difficulties with setting appropriate transfer prices
3. Helps the firm capture orders from international customers
 - can help firms gain orders from suppliers' countries

Global supply chain functions

Understand the functions of logistics and purchasing (sourcing) within global supply chains

Logistics

The core (logistics) activities performed in logistics are:

- Global distribution center
- Management inventory management
- Packaging and materials handling
- Transportation (of all parts in the production)
- Reverse logistics

Global distribution center: (warehouse) that positions and allows customization of products for delivery to worldwide wholesales or retailers or directly to customers.

Global inventory management: The decision-making process regarding raw materials, work-in-process(component parts) and finished goods inventory. The decisions include how much inventory to hold, in what form to hold it, and where to locate it in the supply chain.

Packaging: Comes in all shapes, sizes, forms, and uses. It can be divided into three different types: primary, secondary, and transit

- Primary is the product itself.
- Secondary is designed to contain several primary packages.
- Transit comes into use when a number of primary and secondary packages are assembled on a pallet or unit load for transportation.

Reverse logistics: The process of moving inventory from the point of consumption to the point of origin in supply chains for the purpose of recapturing value or proper disposal. Optimize the after-market activity or make it more efficient- saving money and environmental resources.

Global purchasing

Outsourcing	A multinational corporation buys products or services from one of its suppliers that produces them somewhere else, whether domestically or globally. In that sense, it also refers to external purchasing in relation to purchasing strategy.
Insourcing	A multinational corporation decides to stop outsourcing products or services and instead starts to produce them internally; insourcing is the opposite of outsourcing. Thus it refers to internal purchasing in the context of purchasing strategy.
Offshoring	A multinational corporation buys products or services from one of its suppliers that produces them somewhere globally (outside the MNCs home country). Offshoring is thus a form of global external purchasing in terms of purchasing strategy.
Offshore outsourcing	A multinational corporation buys products or services from one of its suppliers in a country other than the one in which the product is manufactured or the service is developed. This again is a form of global external purchasing in terms of purchasing strategy.
Nearshoring	A multinational corporation transfers business or information technology processes to suppliers in a nearby country, often one that shares a border with the firm’s own country. While nearshoring is not a purchasing activity per se, it involves facilitating global external purchasing.
Co-sourcing	A multinational corporation uses both its own employees from inside the firm and an external supplier to perform certain tasks, often in concert with each other. This applies to all four forms of purchasing strategy. It implies that the relationship between the firm and its supplier is rather strategic in nature—often, this involves the top suppliers in a particular product or component category.

Managing a global supply chain

Four areas of concern in managing a global supply chain:

- Role of just-in-time inventory
- The role of information technology
- Coordination in global supply chains
- Interorganizational relationship

Global marketing and R&D

R&D: research and development

Marketing mix: choices about product attributes, distribution strategy, communication strategy, and pricing strategy that a firm offers its targeted markets.

Globalization of markets and brands

Theodore Levitt: Ancient differences in national tastes or modes of doing business disappear. The commonality of preference leads inescapably to the standardization of products, manufacturing, and the institutions of trade and commerce.

- More standardized around the world, even though you can get a McArabia in the Arabic countries.
- Young people tend to want the same products all around the world.

Market segmentation

Refers to identifying distinct group of consumers whose needs, wants, and purchasing behavior differ from others in important ways.

Firms often adjust their marketing mix from segment to segment

Markets can be segmented in numerous ways by:

- Geography
- Demography (e.g., gender, age, income, race, education level)
- Sociocultural factors (e.g., social class, values, religion, lifestyle choices)
- Psychological factors (e.g., personality).

Goal is to optimize the fit between the purchasing behavior of consumers in a given segment and the marketing mix- maximizing sales to that segment.

Intermarket segment: A segment that spans multiple countries, transcending national borders.

Product attributes

Product: can be viewed as a bundle of attributes for example: hamburger: taste, texture, and size.

- A product sells well when their attributes match consumer needs (and price)

What influences product attributes:

- Cultural difference
- Economic development
 - Consumers in the most developed countries are often not willing to sacrifice their preferred attributes for lower prices.
- Product and technical standards

Distribution strategy

- The way a product is delivered is determined by the firm's entry strategy
- Different from country to country

4 main differences between distribution systems worldwide:

- Retail concentration
- Channel length
- Channel exclusivity
- Channel quality

Communication strategy

Communications channels:

- Direct selling
- Sales promotion
- Direct marketing
- Advertising

A strategy is defined by its choice of channel

The barriers to international communication:

- Cultural barriers
- Source effects
- Noise levels

Source effects: effects that occur when the receiver of the message (potential consumer) evaluates the message on the basis of status or image of the sender. Example when a potential consumer have a bias against foreign firms.

- Firms try to deemphasize their country of origin.

Noise levels: number of messages competing for a potential consumer's attention. Example: USA noise level is extremely high (developed countries).

Push vs pull strategies

Push strategy: personal selling, rather than mass media advertising.

Pull strategy: mass media advertising to communicate to potential consumers.

Push strategies tend to be emphasized:

- For industrial products or complex new products.
- When distribution channels are short.
- When few print or electronic media are available.

Pull strategies tend to be emphasized:

- For consumer goods.
- When distribution channels are long.
- When sufficient print and electronic media are available to carry the marketing message.

Pricing strategy

Explain why and how a firm's pricing strategy might vary among countries.

Price discrimination: is when consumers in different countries are charged different prices for the same product or different variations of the product.

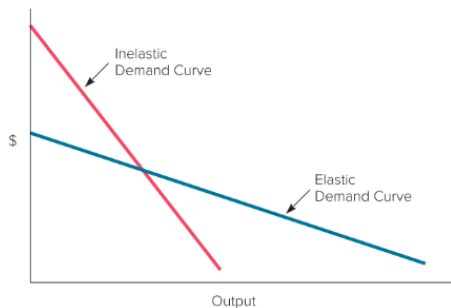
- Low prices in a competitive market
- Higher prices in a market where the firm has monopoly

Different price elasticities of demand in different countries

The price elasticity of demand: a measure of the responsiveness of demand for a product to change in price (???)

Demand is elastic: when a small change in prices produces a large change in demand. So when the demand goes up or down.

Demand is inelastic: When a large change in prices produces only a small change in demand



- Generally, a firm can charge a higher price in a country where demand is inelastic
- Price elasticity tends to be greater in countries with low income levels
- Many competitors cause high elasticity of demand.

Strategic pricing

1. Predatory pricing
2. Multipoint pricing
3. Experience curve pricing

(PP)??

International market research

Defined as the systematic collection, recording, analysis, and interpretation of data to provide knowledge that is useful for decision making in a global company.

International market research is one of the most critical aspects of understanding the global marketplace.

Product development

Describe how globalization is affecting product development.

The location of R&D: Ideas for new products often come from where:

- There are interactions of scientific research
- Demand conditions
- Competitive conditions

High failure rates for new R&D projects, and can be helped with:

1. Product development projects are driven by customer needs.
2. New products are designed for ease of manufacture.
3. Development costs are kept in check.
4. Time to market is minimized.

Global human resource management

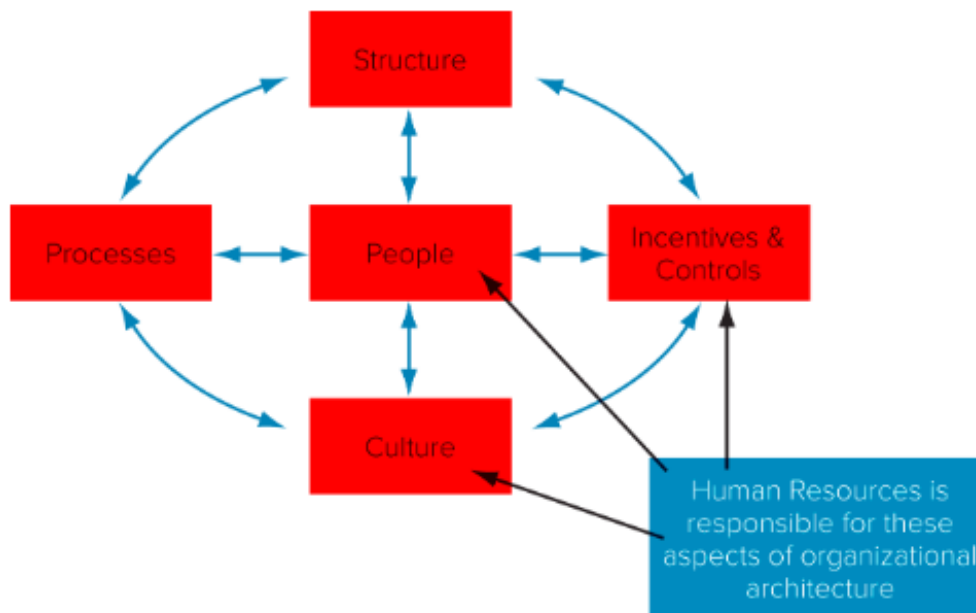
- A diverse workplace helps the performance

Human resource management (HRM): the activities an organization carries out to use its human resources effectively.

- Is related to the global strategy of the firm

Expatriate manager: a citizen of one country who is working abroad in one of the firms subsidiaries.

Firms architecture and HR



Staffing policy

3 types of staffing policies in international businesses:

- The ethnocentric approach
- The polycentric approach
- The geocentric approach

Staffing Approach	Strategic Appropriateness	Advantages	Disadvantages
Ethnocentric	International	Overcomes lack of qualified managers in host nation Unified culture Helps transfer core competencies	Produces resentment in host country Can lead to cultural myopia
Polycentric	Localization	Alleviates cultural myopia Inexpensive to implement	Limits career mobility Isolates headquarters from foreign subsidiaries
Geocentric	Global standardization and transnational	Uses human resources efficiently Helps build strong culture and informal management networks	National immigration policies may limit implementation Expensive

Mendenhall and Oddou

They saw a major problem with many firms that HR; tend to equate domestic performance with oversea performance. An executive who performs well in a domestic setting may not be able to adapt to managing in a different cultural setting

They identified four dimensions that seem to predict success in foreign posting:

- Self-orientation
- Others-orientation
- Perceptual ability
- Cultural toughness

Performance appraisal systems: are used to evaluate the performance of managers against some criteria that the firm judges to be important for the implementation of strategy and the attainment of a competitive advantage.

Are MNCs good or bad?

(and can organized labor limit the choices available to an international business?)

Concerns of organized labor

1. Multinationals can counter union bargaining power by threatening to move production to another country
2. Multinationals will farm out only low-skilled jobs to foreign plants making it easier to switch production locations
3. Multinationals will import employment practices and contractual agreements from their home countries and reduce the influence of unions

Firm response

Many firms are centralizing labor relations to enhance the bargaining power of the multinational vis-à-vis organized labor

- in the past, labor relations were usually decentralized to individual subsidiaries

The way in which work is organized within a plant can be a major source of competitive advantage so it is important for management to have a good relationship with labor

A pessimistic view

"A world in which consumerism is equated with economic policy, where corporate interests reign, where corporations spew their jargon on to the airwaves and stifle nations with their imperial rule. Corporations have become behemoths, huge global giants that wield immense political power. [...] Business is in the driver's seat, corporations determine the rules of the game, and governments have become referees, enforcing rules laid down by others" (Hertz, 2003: 7-8)

An optimistic view

"MNEs are [...] increasingly being evaluated by both home and host countries in terms of their contribution towards **upgrading the quality of indigenous resources and capabilities, and advancing long term comparative advantage**. This change in philosophy is leading to a **less adversarial and more symbiotic relationship** between many governments and MNEs" (Dunning, 1993: 362).

Diverging effects

- Agents of change and 'creative destruction'
- Increase competitive pressures
- Demonstrate and diffuse new technologies
- Necessary agents of globalization
- Negative impact on environment, labor and human rights
- Profit maximizing goals in violation with economic development
- Footloose firms in constant pursuit of cheapest resources – a race to the bottom

Lecture 12 The strategy of international business

HOW THE FIRM CREATE MORE VALUE

- Explain the concept of global strategy.
- Recognize how firms can profit by expanding globally.
 - By lowering costs
 - Adding value to their product offering through the attainment of location economies
 - By exploiting experience curve effects
 - By transferring valuable skills between their global network of subsidiaries
 - The firm's managers may elect to hold prices low in order to increase global market share and attain greater scale economies

- Understand how pressures for cost reductions and local responsiveness influence strategic choice.
- Identify and choose the different global strategies for competing in the global marketplace.

Focusing on the firm itself

- How organizations can increase revenue and profitability by expanding their operations in foreign markets.

The concept of global strategy

SME: small and medium sized enterprise: fewer than 500 (U.S) and fewer than 250 (E.U.). Their strategy differ from larger firms.

Strategy: the actions that managers take to attain the goals of the firm

- The preeminent goal to maximize the value of the firm for its owners and shareholders
 - Increase profitability
 - Rate of profit growth over time

International expansion may enable a firm to earn greater returns by transferring the product offerings derived from its core competencies to markets where indigenous competitors lack those product offerings and competencies.

Profitability: Books define it- the rate of return that the firm makes on its invested capital (ROI), which is calculated by dividing the net profits of the firm by total invested capital.

Profit growth: the percentage increase in net profits over time.

Value creation

- Generally measured by the difference between the cost of production and the quality that consumers perceive in its product
 - The more value to customers- the higher firm can charge for those products.

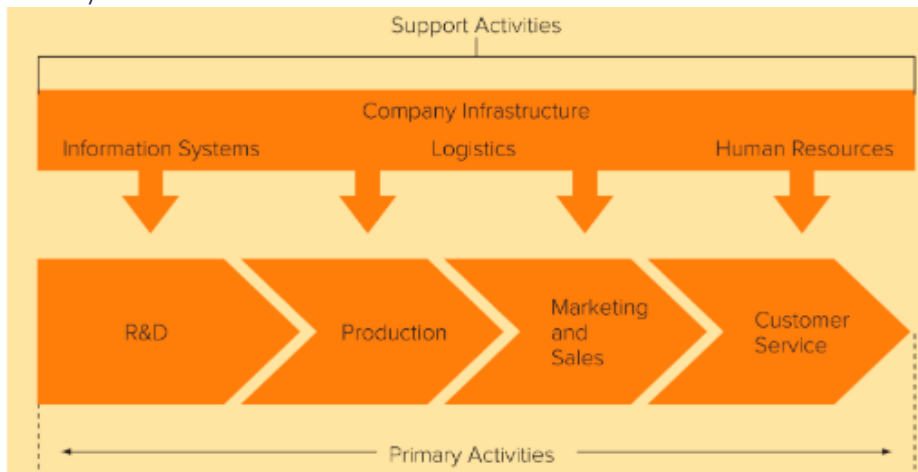
Firms value creation: can create more value

1. Either by lowering production costs or aking the product more attractive through design, styling so on.
2. The consumer then places a greater value on it
3. Willing to pay a higher price

Porter: differentiation and low-cost

Firm as a value chain

Primary activities



Production for a service company: service is delivered to a customer, Walmart: selecting merchandise, stocking store and so on.

Support activities

- Information systems
- Systems for managing inventory
- Pricing products

Global expansion, profitability, and profit growth

International expansion may enable a firm to earn greater returns by transferring the product offerings derived from its core competencies to markets where indigenous competitors lack those product offerings and competencies.

Firms operating internationally are able to:

1. Expand their market
2. Value creation activities to locations with the most efficiently and effectively performances
3. Greater cost economies from a location reducing the costs of value creation
4. Earn greater return by leveraging valuable skills to foreign operation

Core competence: skills within the firm that competitors cannot easily match or imitate.

Competitive advantage

Experience curve/effects

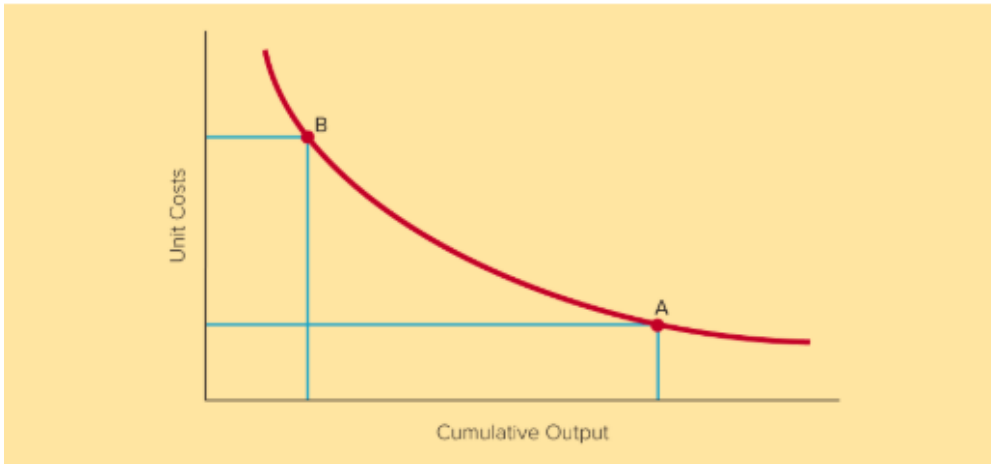
By rapidly building sales volume for a standardized product, international expansion can assist a firm in moving down the experience curve by realizing learning effects and economies of scale.

Experience curve: a systematic reduction in production costs that have been observed to occur over the life of a product.

Generally, the production of any good or service shows the experience curve effect. Each time cumulative volume doubles, value added costs (including administration, marketing, distribution, and manufacturing) fall by a constant percentage (internet).

Cumulative output (the relationship is for cumulative output over time and not output in any one period, such as a year)

Akkumuleret (cumulative): efterhånden opsamle og lagre noget så den samlede mængde forøges.



(??? KHAN ACADEMY?)

- Moving down the experience curve allows a firm to reduce its cost of creating value-> increase profitability
 - The firm that moves down the curve most rapidly will have a cost advantage compared to its competitors
 - Firm A has a cost advantage over firm B
 - A key to move downward the curve rapidly is to increase volume produced by a single plant

Learning effects: to cost saving that come from learning by doing. It is suggested that learning effects are important only during the start-up period of a new process and that they cease after two or three years

Economies of scale: refer to the reductions in unit cost achieved by producing a large volume of a product. Attaining economies of scale lowers a firm's unit costs and increases its profitability

Strategies:

It may pay a firm to base each value creation activity it performs at that location where factor conditions are most conducive to the performance of that activity. We refer to this strategy as focusing on the attainment of location economies.

A multinational firm can create additional value by identifying valuable skills created within its foreign subsidiaries and leveraging those skills within its global network of operations. These leverage issues are part of the firm's global value chains.

The best strategy for a firm to pursue often depends on a consideration of the pressures for cost reductions and for local responsiveness.

Firms pursuing an international strategy transfer the products derived from core competencies to foreign markets while undertaking some limited local customization.

Firms pursuing a localization strategy customize their product offering, marketing strategy, and business strategy to national conditions.

Firms pursuing a global standardization strategy focus on reaping the cost reductions that come from experience curve effects and location economies.

Many industries are now so competitive that firms must adopt a transnational strategy. This involves a simultaneous focus on reducing costs, transferring skills and products, and boosting local responsiveness. Implementing such a strategy may not be easy.