unglamorous) innovative, high value products. Mittelstand firms often seek market niches and partner with universities in their research and development efforts. These private firms often spend a higher percentage of their total revenues on research and development than their larger public competitors, and use this investment to compete globally based on superior value. The example of the Mittelstand illustrates that innovative, high quality production can lead to global competitive advantage while at the same time keeping well-paying manufacturing jobs in the developed world.

Questions for Discussion

1. *Research successful Mittelstand firms to better understand the products they produce and the markets that they serve.*
2. *What lessons can other developed nations learn from the success of the Mittelstand?*
3. *What lessons can small businesses everywhere learn from this example?*
4. *What does this success say about the future of academics in general?*

Case Study 1.1

Transworld Minerals Inc.

John Wright reclined fully his first-class seat and pulled a sleeping mask over his eyes; he wanted to relax, he told the flight attendant, and would not have dinner for the next two or three hours. Wright was, however, anything but relaxed. A senior vice president in charge of international investment planning with Transworld Minerals Inc., a large multinational corporation based in Dallas, Texas, he was returning from a business trip to Salaysia, a small mineral-rich country in Asia. His company was considering a major investment there in a new coal-mining project, using Transworld's recently developed advanced technology that highly automated all operations. Wright had just finished a preliminary evaluation of the prospects.

On the face of it, it looked like a great investment that would generate substantial revenues in the long run. Salaysia had enormous deposits of coal in the northeastern parts of the country, located principally in Nebong Province. Most of these deposits had been recently discovered, as a result of a sustained geological exploration undertaken by Salaysia with the help of a large exploration firm from Australia. Most of the deposits were of high-quality anthracite coal, which was in considerable demand in steel manufacturing plants in China, Japan, and other newly industrializing economies of Southeast Asia.

The government seemed encouraging, primarily because it did not have the technology to exploit these reserves and was badly in need of additional export revenues to meet the deficits in its balance of payments. That meant, however, that much of the project would have to be financed by Transworld.

Transworld had substantial financial resources. Its net working capital had been expanding steadily over the past five years, and it had been on schedule in repayment of all its loans from leading international banks in four countries: the United States, United Kingdom, Japan, and China (via Hong Kong). It had an excellent credit standing, and two years ago, it had floated a successful bond issue in the UK market that raised 150 million pounds to finance a major project in Zambia. It had good working relationships with banks in Singapore and Hong Kong, two leading financial centers in the region. Wright also had had discussions with the local branches of three multinational banks in Salaysia, and they appeared to be interested, at least on a preliminary consideration basis.

Transworld was the world leader in advanced coal mining technology: its latest processes resulted in high-speed extraction; that is, the stacking and loading of coal from depths that had not been accessible to most of the existing mining techniques. Because the technology was highly automated, there were substantial economies because of saved labor costs. Most of the operations would be optimized by Transworld by using its sophisticated, computer-based optimization models that would generate the best possible sequencing, timing, and coordination of different operations, which would be at least 20 percent more efficient than the technology currently in use in Salaysia.

The company had substantial marketing strength. It ran coal-mining operations in several countries in Asia and Africa and had other mineral extraction operations in Latin America. Most of the products were sold to industrial consumers in Japan, Italy, and France. Transworld had strong business relationships with major shipping lines and considerable strength at the bargaining table while negotiating pricing for shipping its products. The world market for coal was expected to remain strong, and Transworld could reasonably expect to make at least an average level of profit on the exports of Salaysian coal.

There were, however, a few problems. Salaysia's local coal mining company was exerting substantial pressure on the home government to allow it to run the new project. It argued that it could access a similar level of technology by entering into a joint venture with Intermetals, an Australian mining company from which it could obtain the technical know-how, while the local implementation of the entire project would be in its hands. This venture would mean that Salaysia would only be buying the technical know-how from Australia, and the entire mining, extraction,

(continued)

Case Study 1.1 *(continued)*

processing, shipping, and marketing operations would be carried out by the Salaysian Coal Mining Company. The company had access to relatively dated machinery and extraction processes, but it had considerable financial strength and good relations with the labor force. Although it was relatively unknown abroad, the company was a major force in Salaysia's domestic mining industry. The management of the Salaysian Coal Mining Company also had good relations with the current minister of industries and was attempting to convince him that placing the entire project into the hands of multinational Transworld would be detrimental to the national interest and could lead to foreign domination of the domestic coal mining industry.

The Industries Ministry was weighing the two alternatives and had called for additional details before the proposals could be submitted to the Industrial Approvals Board of the Salaysian government for a final decision. John Wright indeed had much to think about as the plane headed back to Dallas.

Discussion Questions

1. What additional incentives should Wright suggest to improve the attractiveness of Transworld's proposal to the Industries Ministry?
2. What strategy should Transworld adopt to offset the political advantage enjoyed by the Salaysian Coal Mining Company?

CHAPTER 2

The Nature of International Business

"The individual serves the industrial system not by supplying it with savings and the resulting capital; he serves it by consuming its products."
—John Kenneth Galbraith

CHAPTER OBJECTIVES

This chapter will:

- Explain the difference between the domestic and international contexts of business
- Introduce the various entry methods a corporation may use to establish international business
- Describe the changes in world trade patterns in terms of countries, products, and direct investment
- Discuss the role of central governments in establishing trade policy and providing environments that support or restrict international trade

Domestic Versus International Business

The student of business is certainly familiar with the nature of doing business in a domestic market-based economy. A firm needs to identify its potential market, locate adequate and available sources of supplies of raw materials and labor, raise initial amounts of capital, hire personnel, develop a marketing plan, establish channels of distribution, and identify retail outlets. As an overlay upon this comprehensive system, the firm must also establish management controls and feedback systems, as well as accounting, finance, and personnel functions.

Not only must the novice international businesspeople contend with establishing an international component to add to domestic operations, but also they must contend with the fact that international business activities are conducted in environments and arenas that differ from their own in all aspects: in economies, cultures, government, and political systems. The differences range along a continuum. For example, economies can range from being market-oriented to centrally planned, and political systems from democracies to autocracies. The nations of Zimbabwe and North Korea would be considered centrally planned, autocratic governments. Countries are widely divergent in cultural parameters such as ethnic varieties, religious beliefs, social habits, and customs. The problems and difficulties these differences generate are exacerbated by problems of distance, which complicate the firm's ability to communicate clearly, transmit data and documents, and even find compatible business hours, because of the differences in time zones around the world. A US firm with a subsidiary operation in the Far East faces a fifteen-hour time difference. Consequently, US standard hours of 9 AM to 5 PM would be the equivalent of midnight to 8 AM overseas.

Business activities require vast investments of time, energy, and personnel on the domestic level. Adding an international component merely intensifies the number of steps necessary and the length and breadth of the firm's reach of effort and activity. Imagine establishing international components for all business functions as separate and discrete units. The prospective commitment is staggering and is generally avoided by many domestic businesses.

It is more likely that domestic firms enter foreign markets in a progressive way, beginning with exporting, which involves the least amount of resources and risk, before moving to a full-scale commitment in the form of establishing wholly owned overseas subsidiaries. A company must take many factors into consideration before deciding whether or not to move overseas. It must evaluate its own resources: personnel, assets, experience in overseas markets, and the suitability of its products or organization for transplantation overseas. It is also crucial that a firm decide on the minimum and optimum levels of return it wishes to receive, as well as the amount of risk it is willing to bear. A firm must also evaluate the level of control necessary to manage the overseas operation. These factors must be critiqued in light of competition expected in markets abroad and the potential business opportunities that are to be created by the international operation.

All of these factors must be weighted in terms of the overall short-term and long-term strategic goals and objectives of the firm. For example, a firm may have a long-term goal to build a production facility abroad to serve a foreign market within ten years. Consequently, it would be unwise to enter into a licensing agreement that would hold up its use of its rights for a long period of time.

Methods of Going International

Exporting

Exporting requires the least amount of involvement by a firm in terms of resources required and allocated to serving an overseas market. Basically, the company uses existing domestic capacity for production, distribution, and administration and designates a certain portion of its home production to a market abroad. It makes the goods locally and sends them by air, ship, rail, truck, or even pipeline across its nation's borders into another country's market.

Entrance into an export market frequently begins casually, with the placement of an order by a customer overseas. At other times, an enterprise sees a market opportunity and actively decides to take its products or services abroad. A firm can be either a direct or indirect exporter. As a direct exporter, it sees to all phases of the sale and transmittal of the merchandise. In indirect exporting, the exporter hires the expertise of someone else to facilitate the exchange. This intermediary is, of course, happy to oblige for a fee. There are several types of intermediaries: manufacturers' export agents who sell the company's product overseas; manufacturers' representatives who sell the products of a number of exporting firms in overseas markets; export commission agents who act as buyers for overseas markets; export commission agents who act as buyers for overseas customers; and export merchants who buy and sell on their own for a variety of markets.

Sales contacts within the foreign market are made through personal meetings, targeted mailings, telephone calls, or international trade fairs. Some of these trade expositions take unusual forms. For example, in an attempt to promote the sale of US products in Japanese markets, the Japanese government established a traveling trade show on a train. In the initial stages, the objective of the exporter is to develop an awareness of outstanding features of the firm's products, such as competitiveness against local products, innovation, durability, or reasonable prices.

The mechanics of exporting require obtaining appropriate permission from domestic governments (e.g., for food products and some technology and products considered crucial for national security); securing reliable transportation and transit insurance; and fulfilling requirements imposed by the importing nation, such as payment of appropriate duties, declarations, and inspections. Prior to the completion of the transaction, terms must be worked out for payment. The parties must establish the terms of the sale and whether the buyer will be extended credit, must open a letter of credit, pay in advance, or pay cash on delivery. In addition, the participants in the sale must also determine which currency will be used in the exchange. The currency used is especially crucial in light of fluctuations in exchange rates between countries. Sometimes the facilitation of an international transaction is difficult if the two currencies involved (of the buyer and the seller) are not actively traded on the world markets. One method of completing the transaction is to use the US dollar as an intermediary currency (the buyers convert their home currency into dollars and pay the sellers in dollars; then the sellers convert the dollars into their own domestic currency). Thus the US dollar has become a very important currency in international business today.

Advantages of Exporting

The prime advantage of exporting is that it involves very little risk and low allocation of resources for the exporter, who is able to use domestic production toward foreign markets and thus increase sales and reduce inventories. The exporter is not involved in the problems inherent in the foreign operating environment; the most that could be lost is the value of the exported products or an opportunity if the venture fails to establish the identity or characteristics of the product.

Exporting also provides an easy way to identify market potential and establish recognition of a name brand. If the enterprise proves unprofitable, the company can merely stop the practice with no diminution of operations in other spheres and no long-term losses of capital investments.

Disadvantages of Exporting

Exporting can be more expensive than other methods of overseas involvement on a per-unit basis because of mistakes and the costs of fees, or commissions, export duties, taxes, and transportation. In addition, exporting could lead to less than optimal market penetration because of improper packaging or promotion. Exported goods could also be lacking features appropriate to specific overseas market. Relying on exporting alone, a firm may have trouble maintaining market share and contacts over long distances. Additional market share could be lost if local competition copies the products or services offered by the exporter. The exporting firm also could face restrictions against its products from the host country.

While some of these problems can be addressed by establishing direct exporting capability through the establishment of a sales company within the foreign market to handle the technical aspects of export trading and keep abreast of market developments, demand, and competition, many firms choose instead to expand their operations in foreign spheres to include other forms of investments.

Licensing

Through **licensing**, a firm (licensor) grants a foreign entity (licensee) some type of intangible rights, such as the rights to a process, a patent, a program, a trademark, a copyright, or expertise. In essence, the licensee is buying the assets of another firm in the form of know-how or research and development. The licensor can grant these rights exclusively to one licensee or nonexclusively to several licensees.

Advantages of Licensing

Licensing provides advantages to both parties. The licensor receives profits in addition to those generated from operations in domestic markets. These profits may be additional revenues from a single process or method used at home that the manufacturer is unable to utilize abroad. The method or process could have the beneficial effect of extending the life cycle of the firm's product beyond that which it would experience in local markets.

Additional revenues could also represent a return on a product or process that is ancillary to the strategic core of the firm in its domestic market; that is, the firm could have developed a method of production that is marketable as a separate product under a licensing agreement. In addition, by licensing, the firm often realizes increased sales by providing replacement parts abroad. In addition, it protects itself against piracy by having an agent in the licensed user who watches for copyright or patent infringement.

The licensee benefits by acquiring the rights to a process and state-of-the-art technology while avoiding the research and development costs.

Disadvantages of Licensing

The prime disadvantage of licensing to the licensor is that it limits future profit opportunities associated with the property by tying up its rights for an extended period of time. Additionally, by licensing these rights to another, the firm loses control over the quality of its products and processes, the use or misuse of the assets, and even the protection of its corporate reputation.

To protect against such problems, the licensing agreement should clearly delineate the appropriate uses of the process, method, or name, as well as the allowable market and reexport parameters for the licensee. The contract should also stipulate contingencies and recourse, should the licensor fail to comply with its terms.

Franchising

Franchising is similar to licensing, except that in addition to granting the franchisee permission to use a name, process, method, or trademark, the firm assists the franchisee with the operations of the franchise and/or supplies raw materials. The franchiser generally also has a larger degree of control over the quality of the product than under licensing. Payment is similar to licensing in that the franchiser pays an initial fee and a proportion of its sales or revenues to the franchising firm.

The prime examples of US franchising companies are service industries and restaurants, particularly fast-food concerns, soft-drink bottlers, and home and auto maintenance companies (e.g., McDonald's, Kentucky Fried Chicken, Holiday Inn, Hilton, and Disney in Japan).[1] Only companies with models that have been successful in the domestic markets should consider franchising internationally. If the franchisor has not had success in the domestic market, it would not be wise to consider an international franchising program.

Advantages and Disadvantages of Franchising

The advantages accruing to the franchiser are increased revenues and expansion of its name brand identification and market reach. The greatest disadvantage, as with licensing, is coping with the problems of assuring quality control and operating standards.

Franchise contracts should be written carefully and provide recourse for the franchising firm, should the franchiser not comply with the terms of the agreement. Other difficulties with franchises come with the need to make slight adjustments or adaptations in the standardized product or service. For example, some ingredients in restaurant franchises may need to be adapted to suit the tastes of local clientele, which may differ from those of the original customers.

Management Contracts

Management contracts are those in which a firm basically rents its expertise or know-how to a government or company in the form of personnel who go into the foreign environment and run the concern. This method of involvement in foreign markets is often used with a new facility, after **expropriation** of a concern by a national government, or when an operation is in trouble.

Management contracts are frequently used in concert with **turnkey operations**. Under these agreements, firms provide the service of overseeing all details in the startup of facilities, including design, construction, and operation. These are usually large-scale projects, such as production plants or utility constructions. The problem faced in turnkey operations is often the time length of the contract, which yields long payout schedules and carries greater risk in currency markets. Other problems can arise in the form of an increase in potential competition in the future as overseas capacity is increased by the new facilities. Turnkey operations also face all the problems of operating in remote locations.

Contract Manufacturing

Contract manufacturing is another method for firms to enter the foreign arena. Here the MNE contracts with a local firm to provide manufacturing services. This arrangement is akin to vertical integration, except that instead of establishing its own production locations, the MNE subcontracts the production, which it does in two ways. In one case it enters into a full production contract with the local plant producing goods to be sold under the name of the original manufacturer. The other way is to enter into contracts with another firm to provide partial manufacturing services, such as assembly work or parts production.

Contract manufacturing has the advantage of expanding the supply or production expertise of the contracting firm at minimum cost. It is as if it can diversify vertically without a full-scale commitment of resources and personnel. By the same token, however, the firm also forgoes some degree of control over the production supply timetable when it contracts with a local firm to provide specific services. These problems are, however, no more substantial than operating normal raw material supplier contracts.

Direct Investment

When a company invests directly within foreign shores, it is making a very real commitment of its capital, personnel, and assets beyond domestic borders. While this commitment of resources increases the profit potential of an MNC dramatically by providing greater control over costs and operations of the foreign firm, it is also accompanied by an increase in the risks involved in operating in a foreign country and environment.

As with other forms of international activity, direct investment runs a continuum from joint ventures where risk is shared (but so are returns) to wholly owned subsidiaries where MNEs have the opportunity to reap the rewards, but also must shoulder the lion's share of the risk. Multinationals decide to make direct investments for two main reasons. The first is to gain access to enlarged markets. The second reason is to take advantage of cost differentials in overseas markets that arise from closer production resources, available economies of scale, and prospects for developing operating efficiencies. Both reasons lead to the enjoyment of enhanced profitability. Alternatively, a firm enters a foreign market for defensive reasons to counter strategic moves by its competitors or to follow a market leader into new markets.

Strategic Alliances

Strategic alliances (or **joint ventures**) are business arrangements in which two or more firms or entities join together to establish some sort of operation. Strategic alliances may be formed by two MNEs, an MNE and a government, or an MNE and local businesspersons. If there are more than two participants in the deal, it is also called a consortium operation.

Each party to these ventures contributes capital, equity, or assets. Ownership of the joint venture need not be a 50–50 arrangement and, indeed, it ranges according to the proportionate amounts contributed by each party to the enterprise. Some strategic alliances may be for only a short period of time, while others can endure for longer periods. Often the successful alliances are those whereby all parties stand to gain from the new alliance. Some countries stipulate the relative amount of ownership allowable to foreign firms in joint ventures. Vietnam is an example of a country that has historically had foreign ownership limits with regard to joint ventures. In July 2001, the United States and Vietnam signed a bilateral trade agreement. The agreement restricted United States citizens' ownership in joint ventures to 49 percent for three years. After six years, this requirement was lessened in the majority of industries, allowing US persons to own 51 percent of the joint venture. In some industries, such as hotels, restaurants, and travel agencies, the US will have no equity-limit restrictions after five years.[2]

Advantages of Strategic Alliances

Strategic alliances provide many advantages for both local and international participants. By entering a local market with a local partner, the MNE finds an opportunity to increase its growth and access to new markets while avoiding excessive tariffs and taxes associated with the entry of products. At the same time, joining forces with local businesses often neutralizes local existing and potential competition and protects the firm against the risk of expropriation because local nationals have a stake in the success of the operations of the firm. It is also frequently easier to raise capital in local markets when host-country nationals are involved in the operation. In some cases, host governments provide tax benefits as incentives to increase the participation of foreign firms in joint enterprises with local businesspersons.

Disadvantages of Strategic Alliances

The involvement of local ownership can also lead to major disadvantages for overseas partners in strategic alliances. Some of the problems faced by the MNE partners are limits on profit repatriation to the parent office; successful operations becoming an inviting target for **nationalization** or expropriation by the host government; and problems of control and decision-making. For example, different partners might have different objectives for the joint ventures. An MNE might have a goal of achieving profitability on a shorter timetable than its local partner, who might be more concerned about long-term profitability and maintaining local employment levels. It is a necessity, therefore, that firms establish guidelines regarding the objectives, control, and decision-making structures of joint ventures before entering into agreements.

Joint ventures tend to be relatively low-risk operations because the risks are shared by individual partners. Nevertheless, not having full control of the operation remains a predominant problem for the overseas participants in these ventures. A firm can achieve full control over operations, decision-making, and profits only when it establishes its own wholly owned subsidiary on foreign soil.

Wholly Owned Subsidiaries

By establishing its own foreign arm, a firm retains total control over marketing, pricing, and production decisions and maintains greater security over its technological assets. In return, it is entitled to 100 percent of the profits generated by the enterprise. Although it faces no problems with minority shareholders, the firm bears the entire risk involved in operating the facility. These risks are the same as those customarily encountered in domestic operations, but with an additional layer of special risks associated with international operations, such as expropriation, limits on profits being repatriated, and local operating laws and regulations, including the requirement to employ local labor and management personnel. In these cases, the MNCs do not have the benefit of local shareholders to run interference for them with local governments.

In establishing a subsidiary, a firm must choose either of two routes: acquire an ongoing operation or start from scratch and build its own plant. Buying a firm (also known as the **brownfield strategy**) has the advantage of avoiding startup costs of capital and a time lag. It is a faster process that is often easier to capitalize at local levels and generally cheaper than building. Buying also has the advantages of not adding to a country's existing capacity levels and of improving goodwill with host-country nationals. Downsides for the brownfield strategy are that any existing labor issues at the acquired site will remain after acquisition and that the purchased facility may no longer be state-of-the-art in use and design.

A company may decide to build a new plant (also known as the **greenfield strategy**) if no suitable facilities exist for acquisition or if it has special requirements for design or equipment. Although building a plant may avoid acquiring the problems of an existing physical plant, the firm may face difficulties in obtaining adequate financing from local capital markets and may generate ill-will among local citizenry.[3]

Globalized Operations

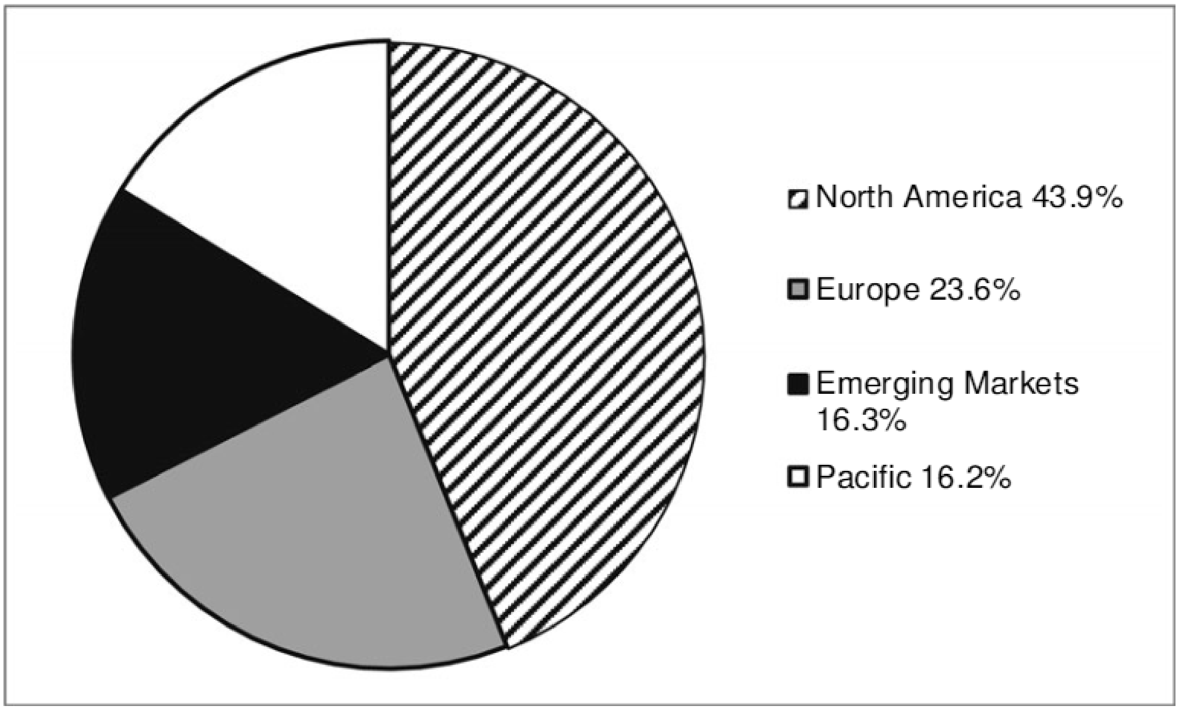
Some theorists believe that consumers around the world are becoming increasingly alike in their goals and requirements for products and product attributes.[4] As a result, the world is becoming a global market in which products would be standardized across all cultures, enabling corporations to manufacture and sell low-cost reliable products around the world. Such firms would be characterized by globalized operations, as distinct from multinational operations. A firm that has globalized operations would be able to take advantage of business opportunities occurring anywhere in the world and would not be constrained to specific sectors. Indeed, some firms have been able to achieve substantial globalization of operations as their products cross national borders without being adapted to individual country preferences. Prime examples include Levi-Strauss & Company, PepsiCo, Coca-Cola, and several other companies ranging from consumer goods to fast food.

Portfolio Investments

Portfolio investments do not require the physical presence of a firm's personnel or products on foreign shores. These investments can be made in the form of marketable securities in foreign markets, such as notes, bonds, commercial paper, certificates of deposit, and non-controlling shares of stock. They can also be investments in foreign bank accounts or foreign loans. Investors make decisions to acquire securities or invest money abroad for several reasons, primarily to diversify their portfolios among markets and locations, to achieve higher rates of return, to avoid political risks by taking their investments out of the country, or to speculate in foreign exchange markets.

Portfolio investments can be made either by individuals or through special investment funds. These investment funds pool local resources for investment in overseas stock and financial markets. Many mutual fund companies, such as Fidelity and Vanguard, have funds with an international focus. These funds invest in companies in a specific region of the world for investors in the United States. This allows both individuals as well as institutional investors to diversify their investments geographically. The Vanguard Global

Figure 2.1 **Global Diversification**



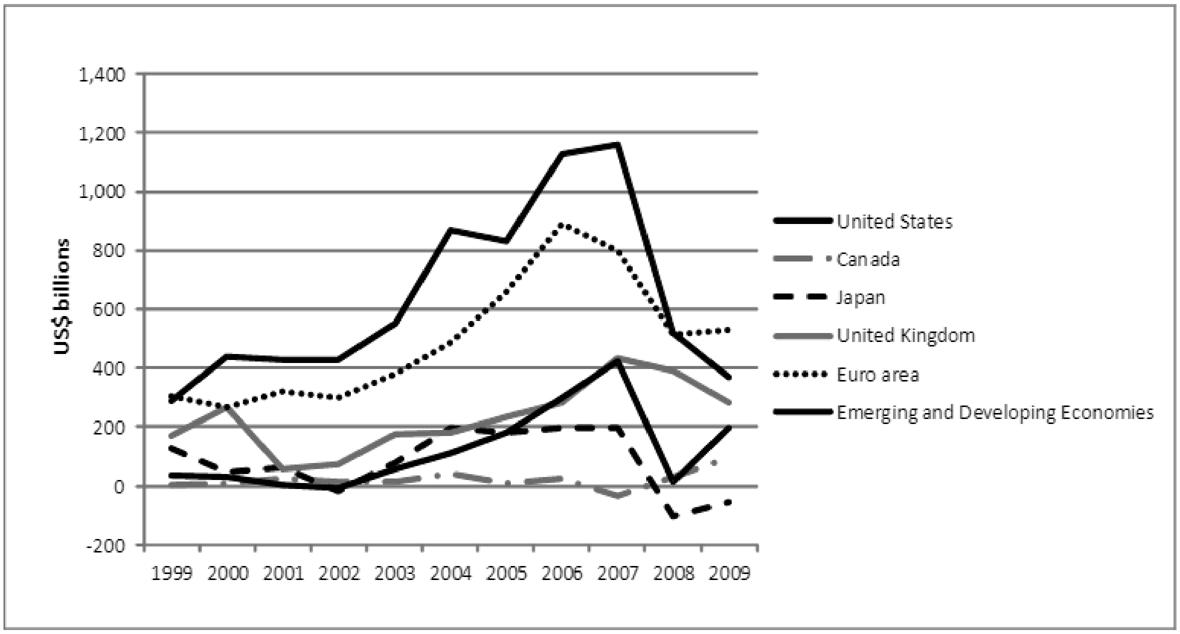
Source: Vanguard Group, *Vanguard Global Equity Fund: Annual Report, September 30, 2011* (Valley Forge, PA: Vanguard Group), www.vanguard.com/funds/reports/q1290.pdf. © The Vanguard Group, used with permission.

Equity Fund, for example, as of its annual report of September 30, 2011, invests in a total of 897 companies worldwide and has net assets of $3.329 billion. Figure 2.1 shows how this fund is geographically disbursed in terms of its portfolio of investments.[5]

Over the last few years, some emerging economies have reformed the rules and regulations to encourage foreign investment.[6] Most developed countries allow free access to their stock markets to overseas investors. Other developing economies allow less access to their stock markets. Overall, the developing world ranges from being less restrictive than it has been in the past to operating an open market system.

There are several factors that determine the degree to which a particular country will be able to attract portfolio investments. Political stability and economic growth are the most basic factors. The size, liquidity, and stability of stock markets, the level of interest rates and government taxes, and the nature of government regulation are also important determinants. The degree of restrictions on repatriation of income and capital invested are other major variables that affect the attractiveness of a country to overseas portfolio investors. Historically, most of international portfolio investment has been concentrated in the industrialized countries; the United States, Japan, France, the United Kingdom, Switzerland, the Netherlands, and Canada receive substantial amounts of portfolio investments in their markets. In recent years, some emerging stock markets, such as China,

Figure 2.2 **Portfolio Investment Inflows**



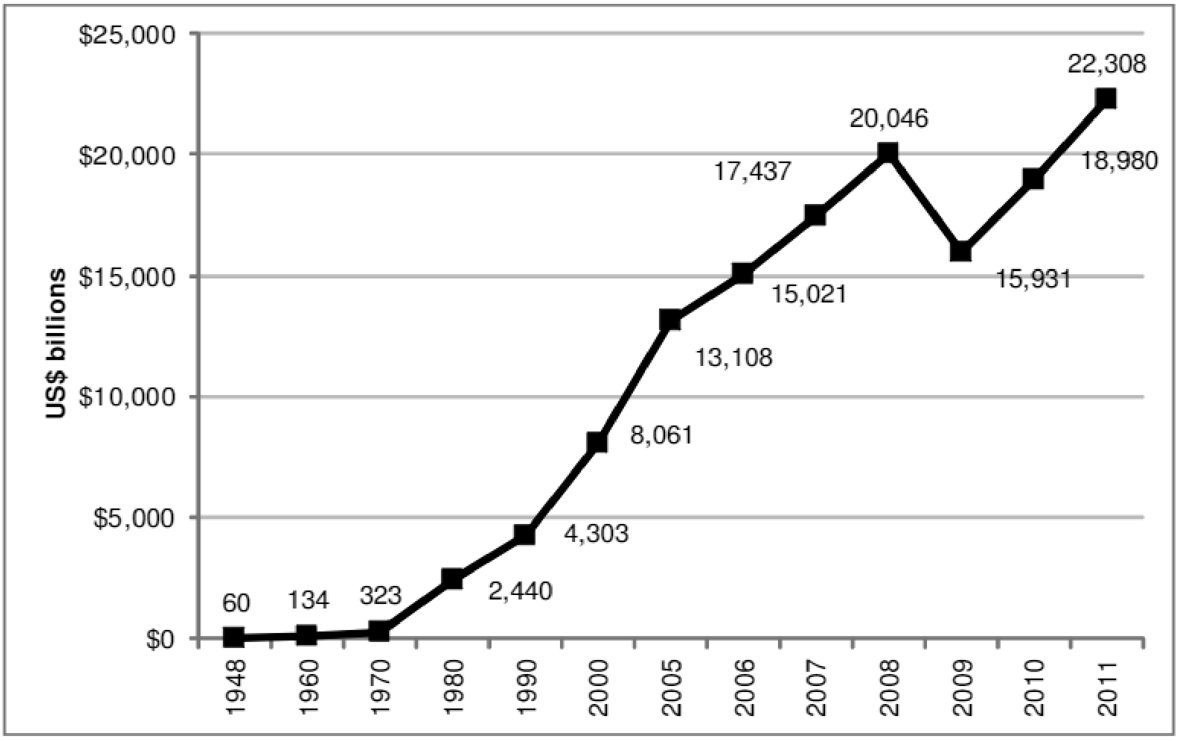
Source: International Monetary Fund, *Global Financial Stability Report: Statistical Appendix* (October 2010), www.imf.org/external/pubs/ft/gfsr/2010/02/pdf/statappx.pdf.

India, Malaysia, Indonesia, and Taiwan, have been able to attract significant amounts of foreign portfolio investment. Between 1999 and 2007, portfolio investments increased in the United States, reaching a peak of $1,156.6 billion, before falling to $520.1 billion in 2008 and $366.7 billion in 2009. Similarly, in the United Kingdom, portfolio investment peaked in 2007 at $435.9 billion in 2007 before falling to $389.2 billion in 2008 and $284.1 billion in 2009. The Euro area reached a peak of portfolio investment in 2006 at $890.5 billion before declining over the following three years. In contrast, in the emerging markets and developing countries of the world, portfolio investment dramatically increased between 2002 and 2007, reaching a peak of $421.1 billion, and then dropping to $12.7 billion as a result of the global financial crisis. The fluctuations of portfolio investments are illustrated in Figure 2.2.[7]

Recent Trade Patterns and Changes in Global Trade

As the world has become more and more industrialized and as markets have become global entities, trade has increased proportionately and grown tremendously both in volume and dollar terms. Concomitantly, patterns in trade have also changed, as new nations enter the world-trading arena. In 1948 world trade totaled $60 billion. This figure rose to $323 billion in 1970 and $2,440 billion in 1980. As the world opened up to trade following economic and political reforms in eastern Europe and Asia, the volume of world trade

Figure 2.3 **Growth in World Trade**



Source: WTO Statistical Database.

has increased 366 percent from $4,303 billion in 1990 to $20,045 billion in 2008.[8] As a result of the global financial crisis, world trade volume fell by more than 20 percent between 2008 and 2009, before rebounding to $22,307 billion in 2011.[9] Total world trade volume is the aggregate of each country's average trade volume, which is the average of a country's merchandise exports and imports plus the average of the country's commercial services exports and imports, calculated in current dollars. This increase in world trade volume can be best illustrated by the chart in Figure 2.3.[10]

Most of the world's trade is carried out between the industrialized countries and traded within the region where the goods are produced. Less-developed countries tend to be exporters of commodities and importers of finished goods. In 2011, China was the world's biggest exporter of goods and services, followed by the United States, at 9.3 percent and 9.2 percent respectively, as a percentage of the world's global exports (see Table 2.1). Trade flows tend to be intraregional, with a great amount of trade remaining in the region in which it was produced.[11] For example, in 2011, the European Union exported $7,790 billion worth of goods and services; 37.5 percent was exported outside of the region, while 62.5 percent remained within the European Union. In 2010, Western Europe, North America, and Japan accounted for 56.3 percent of merchandise exports sent to other countries and received 61.3 percent of all merchandise imports.[12] In 2010,

Table 2.1 **World's Leading Exporters, 2011**

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

Source: World Trade Organization (WTO), "Statistical Database," 2012, www.wto.org.

Table 2.2 **OPEC's Share of the World Market, 2010** (in percent)

	Crude oil	Natural gas
Reserves	81.3	49
Production	41.8	18

Source: Organization of the Petroleum Exporting Countries (OPEC), *OPEC Annual Statistical Bulletin, 2010/2011.*

China accounted for 10.6 percent of the world's merchandise exports and 9.3 percent of the world's merchandise imports.[13] The United States is the biggest exporter and importer of commercial services. The top four exporters and importers of commercial services in 2010 were the United States, Germany, China, and the United Kingdom, which in aggregate, exported 31 percent and imported 27.7 percent of global commercial services.

OPEC's participation in world trade declined in the second half of the 1980s because prices and demand for oil have fallen since the early 1970s. Given the recent upswing in the demand for oil (due to the expansion of the Chinese economy and the continued demand of the United States) and the price per barrel of oil, OPEC retains a major proportion of the share of developing countries' exports in world trade (see Table 2.2). OPEC nations[14] represented 7 percent ($1,077 billion) of world merchandise trade in 2010. Of that total, energy exports accounted for $745.066 billion. Without the contribution of OPEC, the share of the remaining developing countries exports in world trade is only 28 percent.[15]

This pattern of trade is changing, however, as the fortunes of nations change in different trading regions. While high-income developed countries continue to hold the lion's share of world trade, greater portions of activity are being taken over by new entrants into the world market. The most notable, historically, is Japan, which completely reversed its fortunes, prospects, and future since its reconstruction and growth after World War II.

In 1950 Japan had merchandise exports of $820 million and imports of $974 million; by 1970 this level had risen to exports of $19.318 billion and imports of $8.881 billion. By 2003 Japan was exporting $542 billion worth of products and services in world markets and importing products and services valued at $493 billion.[16]

Japan is being joined by other countries that are nipping at the heels of the wealthy, industrialized world by rapidly increasing their levels of industrialization, production, and exports. Increased competition from other Asian countries that follow the export model for growth has reduced some of Japan's export growth. China has taken the world by surprise in its rapid growth in exports since the turn of the millennium. The value of Chinese exports of goods and services rose from $483 billion in 2003 to more than $2.080 trillion in 2011, while its imports had a value of $467 billion in 2003, rising to over $1.979 trillion in 2011. Given China's strong projected GDP growth over the next decade, this trend is sure to continue. Instead of Japan being the dominant Asian economy, China has now taken over that role. Other challengers to China and Japan include the so-called **newly industrialized countries (NICs)** of South Korea, Taiwan, Singapore, and Hong Kong, along with the developing nations of Vietnam, the Philippines, and Indonesia. Trade activity by these nations is slowly moving the focus of international trade patterns away from traditional *north-north* routes between developed countries to increased trade between *north and south*—that is, between developed and developing nations. Similarly, the growth in trade by less-developed countries is increasing, as economic development and increases in standards of living provide citizens of those nations with higher incomes and surplus resources to spend on goods other than basic necessities.

These trends in trade patterns indicate a reduction of US and European dominance in the world trade arena. On the other hand, the Asian and Middle Eastern countries are increasing their participation in world trade, because of their rapid industrialization and the importance of petroleum and petroleum products. US trade with these countries has also been increasing significantly, marking a departure from its traditional trading pattern that relied to a very large extent on trade with European trading partners. Furthermore, changes in the international political climate, especially the thawing of relations with formerly centrally planned economy countries as they move toward market economies, have led to marked increases of US trade with Russia and the former Soviet bloc countries and the People's Republic of China. Rapid and far-reaching technological developments have also affected trade patterns; for example, monopolies in raw materials such as rubber and metals have been shattered by high-tech substitutes, such as synthetic products. Countries that were major exporters of such raw materials have had to look for other products to export, and export market shares in these commodities have shifted dramatically.

Product Groups

In world trade, the major product categories of goods are exports of manufactured goods, machinery, and fuels, which account for 80 percent of all world commodity trade. The remaining 20 percent of commodity types are crude commodities, agricultural products, and chemicals. Until 1972 manufactured goods continued to increase in relative importance in world trade. After that, they began to decline in importance because of the increase in oil prices and the worldwide recession that followed. The developed countries account for the largest proportion of goods traded in world markets. The Euro Area emerged as the world's leading exporter, but China was the largest single-country exporter of goods. The United States is the world's leading exporter of services.

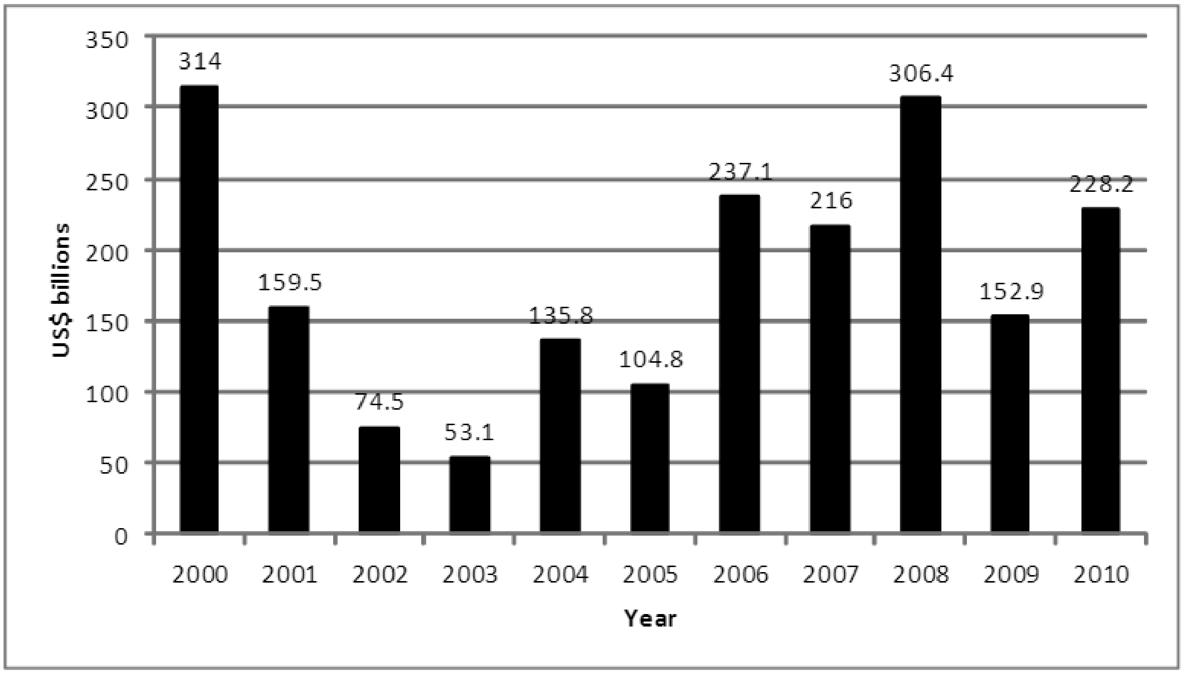
Lesser-developed countries have increased their relative shares of world trade. Non-Middle-Eastern Asian countries have slightly increased their exports from the period of 1980 to 2003 (to roughly 9 percent of world commodity exports), as compared to an overall decline in total Middle East exports over the same period. The regions of Africa and Central and South America stayed relatively constant over the last two decades, with each accounting for less than 3 percent of the world's commodity exports. China's portion of world commodity exports rose by 35 percent from 2002 to 2003, and it now accounts for 6.0 percent, while China's imports rose in the same time period by 40 percent and now account for 5.5 percent of world totals.

Patterns of Direct Investment

As trading patterns in merchandise continue to change, so do the patterns of countries investing in resources abroad. Many believe that direct investment activity is a natural adjunct to trading activities in different locations; that is, investment funds follow trade activity. Direct investment can be measured according to the source country of funds or ownership. Generally, foreign direct investment of capital is differentiated from portfolio investments according to levels of managerial involvement and control by owners. Some countries distinguish effective control according to a level of percentage ownership. The United States, for example, has used a level of 10 percent as a criterion.

World foreign direct investment inflow levels were $1,243 billion by the end of 2010 (see Figure 2.4). These figures are misleading, however, because they reflect the book value of the investments, which is the value at which they were acquired; these are historical figures that do not account for appreciation in value over time or for inflation. According to recent studies, the bulk of world direct investment is within the industrialized countries of the world. The United States, France, and the United Kingdom in 2003 together accounted for about 43 percent of the world total foreign direct investment outflow, while they received 20 percent of the world foreign direct investment inflow.[17] By 2010, the United States, France, and the United Kingdom accounted for 32 percent of the foreign direct investment outflow and received 25 percent of the foreign direct investment inflows. China is also a major source of foreign direct investment outflows and recipient of inflows. In 2010, China was the source of 10.9 percent of the world foreign direct investment outflows and the recipient of 14 percent of the world foreign direct investment inflows. Foreign direct investments are generally made according to two patterns: geographically between countries in close proximity to each other, and

Figure 2.4 **World FDI Level**



Source: UNCTADstat.

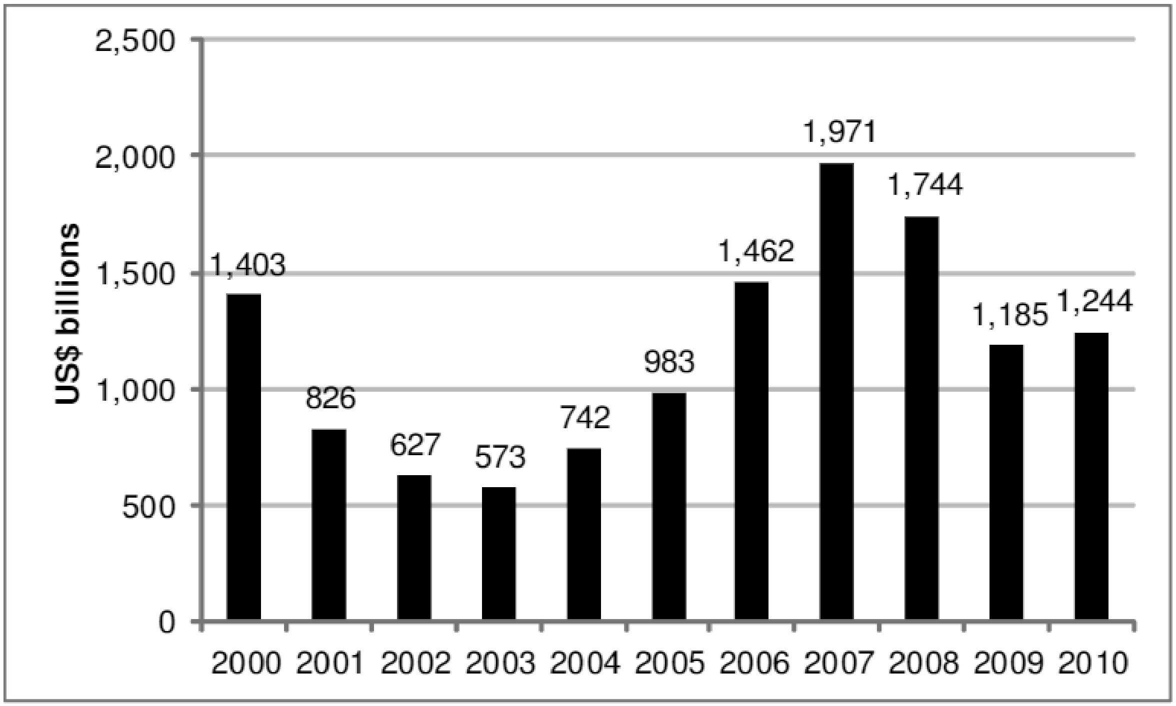
along traditional lines based on the strength of historical or political alliances or the ties between countries and their former colonies. While foreign direct investment into the United States has been trending downward over the last few years, as was discussed in Chapter 1, this was due primarily to a worldwide recession and historically low interest rate levels in the United States (see Figure 2.4). Another explanation is that with the arrival of China and India on the world stage, there are now many other destinations for foreign direct investment. While the portion of the US share of foreign direct investment inflows is decreasing, foreign direct investment is flowing to developing countries at an increasing rate, which was impacted by the beginning of the 2007 financial crisis, peaking at $1,907 billion (see Figure 2.5).

Investments, in general, are made by very large firms and have seen the highest growth in the areas of manufacturing, petroleum, and industries that require high levels of capital assets. The investments are made primarily in industrial countries with the lowest level of risk and the largest possible markets.

Government Involvement in Trade Restrictions and Incentives

All governments attempt to restrict or support international trade or transfers of resources. This intervention can take the form of controlling the flow of trade and transfer of goods,

Figure 2.5 **FDI into the United States**



Source: UNCTADstat.

controlling the transfer of capital flows, or controlling the movement of personnel and technology. Rationales for intervention vary but fall into several patterns, all of which are based on the notion that the governmental actions will promote the best interests of the nation.

Governments may be motivated by economic goals, such as increasing revenues or the supply of hard currency in the country. They also may have economic or monetary considerations in equalizing balances of trade or keeping inflation to a minimum. They may cite country objectives, such as maintaining self-sufficiency, economic independence, and national security. There may be specific concerns in the country regarding the welfare of the populace, such as health and safety considerations or full employment goals. Political objectives also play a major role in establishing trade policy by governments.

Protectionism

Protectionism refers to government intervention in trade markets to protect specific industries in its economy. Impetus for protecting industries comes from special-interest groups within different sectors of the economy who plead their case for protecting domestic capacity and production facilities. Many believe that calls for protectionism should be interpreted as a need for the country to make structural changes in its industrial base in order to increase its competitiveness in foreign markets, rather than have the government intervene in order to support inefficient industries.

One rationale promulgated for protecting industry is to ensure full employment. This argument holds that the substitution of imports for domestic products causes jobs to be lost at home and that protecting industries is necessary for a strong domestic employment base.

A second rationale is protecting **infant industries**, which is especially true in less-developed and developing countries. The infant-industry justification holds that newly established industries cannot compete effectively at first against established giants from industrialized nations. Consequently, the industry is protected (theoretically) until such time as it can grow to achieve economies of scale and operational efficiencies matching those of its major competitors. Under this scenario, difficulties occur when the time comes to withdraw such protection, which by then has become institutionalized and is vociferously defended by industry participants. This argument was first made by Alexander Hamilton, the first US secretary of the Treasury, in 1792. Hamilton wanted to protect the fledgling industries of the new nation from European competition (he also advocated the idea of not recognizing foreign patents and copyrights for similar competitive reasons).

A third rationale for protecting specific industries is that the industrialization objectives of a country justify a promotion of specific sectors of the economy in order to diversify the economic structure. Thus, protection and incentives are given to those industries that are expected to grow quickly, bring in investment dollars, and yield high marginal returns. For this reason, many developing countries attempt to promote the growth of industries that provide high value-added materials and emphasize the use of agricultural or locally available primary raw materials.

The ultimate rationale for protectionism is more accurately based in emotionalism than in sound economic arguments, and its cost is high. Protectionism leads to higher prices for consumers for imported products and components. It may lead to retaliation by importing countries, which may reduce the home country's exports abroad and employment in local markets. Protectionism also may increase opportunity costs by allocating the resources of a country inappropriately and at the expense of other sectors of the industrial base of the economy.

Governmental intervention in markets takes several different forms. The primary and most direct method is through the application of tariffs to exports or imports. A less direct method is the application of nontariff barriers.

Tariffs

Tariffs or **duties** are a basic method of intervention that may be used to protect industries by raising the price of imports, to bring import prices even with domestic prices, or to generate revenues. Tariffs may be placed on goods leaving the country as export duties or on goods entering the country as import duties. They are the most typical controls on imports. Tariffs are assessed in three different ways:

1. **Ad valorem duties** are assessed on the value of the goods and are levied as a percentage of that value.
2. **Specific duties** are assessed according to a physical unit of measurement, such as per ton, per bushel, or per meter, and are stipulated at a specific monetary value.
3. **Compound tariffs** are a combination of ad valorem and specific duties.

Determining Tariffs

Tariffs have an advantage as a tool for government intervention in international markets because they can be varied and applied on a selective basis according to commodity or country of origin. Some countries can be assessed higher duties on their imports than others. These duties are prescribed according to tariff schedules. Single-column schedules are those in which the duties on products and commodities are the same for everyone. Multicolumn schedules list tariffs rates for different products and different countries accorded to trade agreements between the two countries.

Some countries that are treated separately are those that have most-favored-nation (MFN) status accorded to them. These countries have entered into agreements under which all the signatories are accorded the same preferential tariff status. Countries enter into these agreements to facilitate entry of their own exports and for political and other economic reasons. There are many groups of trading partners in the world, the largest and most important of which was the General Agreement on Tariffs and Trade (GATT), which was established soon after World War II with an original membership of nineteen countries. GATT was replaced by the World Trade Organization (WTO) in 1995. The WTO was expanded to include discussions on services (in addition to merchandise exports) and now includes 155 member nations and 29 observer nations.[18]

World Trade Organization

The purpose of the WTO is to establish an umbrella under which its signatory members can meet to establish reciprocal reductions in tariffs and the liberalization of trade in a mutual and nondiscriminatory manner. A major objective of the body is to extend tariff accords and most-favored-nation status to all members. Under the WTO, methods and rules of trade liberalization are established with provisions for monitoring trade activity, enforcement, and the settling of disputes. WTO rules allow for certain exceptions to reduce trade barriers, such as allowing countries to continue to provide support for domestic agriculture and for developing countries to protect infant industries.

Reductions in trade barriers are achieved through the meeting of the signatories in negotiating sessions, or trade rounds. These meetings are held periodically to discuss the further lowering of barriers to trade. In recent rounds, WTO members have attempted to deal with nontariff problems and other current issues, such as trade in agriculture and services, technology transfer, and nonmonetary barriers put up by countries to discourage free trade.

Regional Trade Groups

Trade groups organized along regional or political lines are less pervasive and influential. Two major regional trading groups are the European Union (EU), which is composed of twenty-eight European countries, and the North American Free Trade Agreement (NAFTA), which consists of the United States, Canada, and Mexico.

Traditionally, trade groups have also been organized according to specific commodity types and agreements that allow for monitoring and/or controlling the supply of those commodities. Ten such basic commodities have been identified by the United Nations: coffee, cocoa, tea, sugar, cotton, rubber, jute, sisal, copper, and tin. Some of these commodities are traded on open and free markets, where their prices fluctuate to a great degree. Sales of other commodities—such as sugar, rubber, tin, cocoa, and coffee—have historically come under the aegis of international commodity agreements that promote use of import and export quotas and a system of buffer stocks. In today's marketplace, prices are subject to market pressure, so these types of groups are less meaningful than they have been in the past. Other trade groups are organized among producers, consumers, or both.

Generally, under these agreements prices are allowed to move up and down within a certain range, but if the price moves above or below that range, an outside collective agency is authorized to buy or sell the commodity to support its price. Similarly, a commodity agreement may provide for quotas on exports from individual supply countries to limit supplies of the commodities on world markets, thus shoring up prices.

Cartels

Another form of a commodity agreement group is the **cartel**, in which a group of commodity-producing countries join forces to bargain as a single entity in world markets. A cartel can be formed only when there is a relatively small group of producers who hold an oligopoly position—that is, they control the bulk of the commodity supply. The most notable cartel in recent years has been the **Organization of Petroleum Exporting Countries (OPEC)**, which has a membership of twelve oil-producing nations. It is composed of six Middle Eastern countries—and six other oil-producing countries in the world.[19]

In the early 1970s, OPEC was able to raise the price of crude oil from $3.64 per barrel to $11.65 per barrel within a single year. It was able to do so because it had a great deal of leverage in the world marketplace; its members controlled more than half of the world production of oil in 1973. World demand for oil was very high and the top oil-consuming countries were not able to meet the demand with domestic supplies.[20] There were few suitable energy substitutes being utilized around the world. The cartel was also successful because its members adhered to their production and pricing agreements.

Frequently, cartels fail because members violate their agreements by dropping prices or raising production and forcing the other members back into a competitive position. Although this did not occur with OPEC, the cartel's hold on world markets began to slip in the mid-1970s as a worldwide recession, conservation, and the use of energy substitutes reduced the demand for oil. In addition, non-OPEC producers increased their production to take advantage of price escalations in world markets. Political turmoil, the emergence of the Chinese economy, and an insatiable demand for oil by the United States led to an increase in the price of oil to more than $50 per barrel in 2003, peaking to $140 per barrel in 2008. In 2011, world oil demand was 87.79 million barrels per day. Non-OPEC countries produced 52.390 million barrels per day, and OPEC produced 29.942 million barrels per day, totaling 82.332 million barrels per day. North America (led by the United States) accounted for 23.37 million barrels a day or 26.67 percent of the total demand, but only 15.52 million barrels a day or 19 percent of world oil supply. China, demonstrating its significant growth, now contributes 5 percent to the world oil supply but is responsible for 11.17 percent of world oil demand.[21]

Nontariff Barriers to Merchandise Trade

Nontariff barriers have become a controversial topic in trade activity over the past decade. They are a matter of concern because they are not traditional methods of discouraging imports through the application of duties. Instead, they work to slow the flow of goods into a country by increasing the physical and administrative difficulties involved in importing.

Nontariff barriers can take a number of forms that provide effective restraints on trade.

- Government discrimination against foreign suppliers in bidding procedures
- Highly involved and rigorous customs and country-entry procedures
- Excessively severe inspection and standards requirements
- Detailed safety specifications and domestic testing requirements
- Required percentages of domestic content material

Some nations regulate the consumption of certain products that they deem harmful to their citizens. Canada, for example, has strict entry requirements for individuals and companies that are bringing tobacco products into the country. Other countries attempt to control the amount of a certain product being imported by returning entire shipments of goods just because one sample failed to meet the acceptable standards. In the aftermath of the Canadian mad cow disease scare in May 2003, Japanese officials discussed the possibility of requiring that all imported Canadian beef products had to be inspected, rather than following the typical sampling procedures. Rather than incurring the cost of such inspections, the government of Japan decided to ban future shipments of Canadian beef until any problem in Canada could be resolved.

Some countries have restrictions on services, such as prohibiting transportation carriers from serving specific destinations or only allowing advertising that features models of that country's nationality.

Quotas

The most widely used method of restricting quantity, volume, or value-based imports are the imposition of quotas upon imports into a country. These quotas may be unilateral according to commodity and stipulate that only a certain aggregate amount of the import from any source may enter a country. Alternatively, they can be selective on a country or regional basis. A type of quota is an **embargo**, which prohibits all trade between countries. Another type, encountered only in recent trade history, is the voluntary entry restriction, in which foreign countries that agree to restrict their exports to a country are actually forced into compliance through the use of direct or subtle political pressure by major trading partners.

While the imposition of quotas may impede the flow of imports into a country, it does little to help that country find a level of readjustment; that is, it does nothing in the way of leading to lowered domestic prices. It often leads to higher import prices.

The imposition of quotas also causes serious administrative problems for the authorities of both the importing and exporting countries. Once quotas are imposed, the amount of goods to be sent from the exporting country is not determined by market demand but by an arbitrary ceiling. The quantity of goods allowed to be exported under the quota ceilings are often much lower than the normal export levels, which implies that all exporters of the affected country cannot export at their previous levels. The new levels have to be determined by the authorities, which for large, widespread export industries is an expensive and cumbersome process. Problems arise for the importing country because the imported quantities under the quota rules are not adequate to meet market demand, so the government has to take over the role of the market in allocating the available goods imported under quota rules. Apart from the expense and delays of the administrative process that is required to accomplish nonmarket distribution of imported goods, there is also the danger of creating inequities, because it is often difficult to verify genuine needs and claims.

Nontariff Price Barriers

Nontariff and competitive barriers can also be implemented as adjustments in prices. For example, some countries use **subsidies** to enhance the competitiveness of their exports in international markets. In a well-known WTO dispute, the United States insisted that Canada had subsidized its soft wood lumber industry, a charge that Canada denied. The subsidized industry would have then been able to sell its product in the United States at a much reduced cost, thereby gaining a competitive advantage. The WTO decided in favor of Canada in July 2004, although the result was disputed by the United States. Some subsidized services, such as export promotion, are permissible according to trade conventions. Others, such as special tax incentives or government provisions of fundamental research, are contested by trading nations as being against free trade. Other governmental intervention strategies such as "buy domestic" campaigns are less subtle attempts to influence purchases in favor of domestic producers.

Some countries raise the effective costs of exporting by assessing special fees for importing, requiring customs deposits, or establishing minimum sales prices in foreign markets, thereby making it less profitable for exporters to send goods to their markets. Similarly, the manipulation of exchange rates can affect the position of a country's goods in overseas markets because undervaluing one's currency exchange rate will make that country's goods more competitive abroad.

Another type of nontariff price barrier is erected by valuing imports at customs under the ad valorem method of assessing tariffs. Countries can vary their valuation criteria and value goods at their own country's retail prices rather than at the wholesale/invoice prices being paid by the importer.

In determining the appropriate pricing levels for tariffs in the event of disputes, one would first use the invoice price, then the price of identical goods, then similar goods. A particular problem arises when goods are entering a market-based economy from a centrally planned or nonmarket economy where there is no established pricing structure or valuation procedure. An example of this recently has been the Chinese furniture industry. Many US manufacturers have accused China of **dumping**[22] its furniture in the US market in an effort to unfairly gain market share. A similar case occurred when nonmarket economies tried to bring chemical fertilizers into the United States at below market prices, which was achieved by undervaluing the costs of crucial inputs such as natural gas.

Government Restriction of Exports

In addition to controlling or taxing national imports, governments often have laws and regulations that limit certain types of exports generally or to specific countries. Governments apply these limits to maintain domestic supply and price levels of goods, to keep world prices high, or to meet national defense, political, or environmental goals. In the United States, under the Export Administration Act of 1969 and its amendments of 1979, US export licenses could be limited to promote foreign policy objectives, to protect the economy from a drain of limited or scarce resources, or to prevent military use by the recipient nations. Licenses are required for the export of items on the US-controlled commodity list and for the export of any product to communist countries. The administration of these licenses is overseen by the US Department of Commerce in tandem with the Departments of State and Defense.

Summary

International business requires the same basic functional and operational activities as domestic business activities. As international business crosses borders, however, it encounters different economies, cultures, legal systems, governments, and languages, which must be integrated into business policies and practices. Entry into international business varies along a continuum from the simplest form, exporting, through other entry methods, including licensing, franchising, contract manufacturing, direct investment, joint ventures, wholly owned subsidiaries, globalized operations, and portfolio investments.

Recent changes in global trade patterns reveal a reduction in the dominance of the United States and Europe, while Asian (especially China and Japan) and Middle Eastern countries are increasing their levels of output. Direct investment, 32 percent originated in United States, France, and the United Kingdom in 2010, is generally located in the industrialized countries, where risks are lowest and potential returns are high.

The governments of host countries play an important role in either restricting or supporting international trade. Often, international trade policies are determined in order to achieve economic or monetary goals; maintain national security; improve health, safety, and employment levels; or support specific political objectives. Protectionism, tariffs, nontariff barriers, and government restrictions on exports are direct and indirect methods of restricting international trade.

Discussion Questions

1. Which factors should a firm consider before it decides to conduct business internationally?
2. Which method of going international would you use if you were

    - an automobile manufacturer?
    - a software developer?
    - an oil exploration and production company?
    - an electrical power plant builder?
    - a farmer with large surplus of wheat?
    - a restaurant operator with a new barbecue rib recipe?

Discuss the reasons that determined your decision.

3. When might a corporation go international using a joint venture approach rather than a wholly owned subsidiary approach? Give an example.
4. What type of business transaction generally uses a turnkey operation approach?
5. Identify the top five leading exporting countries.
6. What are the differences between foreign direct investment stock, portfolio investment, and foreign direct investment inflows and outflows?
7. Which country is the leading provider of services in the world?
8. Give a recent example in which China invested directly in the United States.
9. How might multinational direct investment help or hurt the country receiving the investment?
10. Discuss the methods governments use to protect their domestic business environments.

Notes

1. D.A. Bell, *Business America*, 1986.
2. U.S.–Vietnam Trade Council, "Vietnam Trade Agreement: Summary of Key Provisions."
3. Kitching, "Winning and Losing with European Acquisition," 81.
4. Levitt, "Globalization of Markets."
5. Vanguard Group, *Vanguard Global Equity Fund*.
6. International Finance Corporation, *Emerging Stock Markets Fact Book,* 2004.
7. International Monetary Fund, *Global Financial Stability Report*.
8. World Trade Organization, "Statistical Database," May 2012.
9. World Trade Organization, "Statistical Database."
10. World Trade Organization, "Statistical Database."
11. World Trade Organization. *World Trade Organization International Trade Statistics 2012*.
12. World Trade Organization, *World Trade Report 2004*, Appendix, Table 1A.1.
13. World Trade Organization, International Trade Statistics.
14. OPEC members include Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, and Venezuela.
15. OPEC *Annual Statistical Bulletin*, 2003; OPEC *Annual Statistical Bulletin*, 2011; World Trade Organization, "Statistical Database."
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17. United Nations Conference on Trade and Development, Country Fact Sheets, 2004.
18. www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm.
19. www.opec.org/opec_web/en/about_us/25.htm.
20. Daniels and Radebaugh, "The Middle East Squeeze on Oil Grants," 56.
21. OPEC, *Monthly Oil Market Report*, July 2012, p. 20.
22. In international trade, dumping is defined as one country selling a product in another country at a price that is less than the cost of production of that same product in the destination country.

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Globalization at the Crossroads: Is Securitization the Enemy?

In the wake of the "Yes Era" (i.e., the start of the recent global recession) there were many comments in the financial press that probable cause for the economic calamity lay at the feet of bankers who created securitization products which package mortgages together for sale to investors. Securitization comes in many forms but typically involves the packaging of residential or commercial mortgages, or other loans such as automobiles and student loans, into bonds sold to the public. As many securitized pools of residential and commercial mortgages contained loans of dubious quality, securitization itself was seen as the enemy of continued global progress. If economies such as Iceland, Ireland, and Spain could be placed on the brink of economic calamity from purchasing highly risky pools of mortgages, something is awry in the securitization model itself; or at least so it seems. Residential mortgage backed securities (RMBS) and commercial mortgage backed securities (CMBS) came crashing down in 2009 from the heights just a few years before. Lost in the blame game was the fact that covered bonds in Europe, which represent pools of bank approved mortgages held on the balance sheets of financial institutions, had not experienced a default in over 200 years. A basic difference between the covered bond model (known as pfandbriefe in Germany) and the stateside version of mortgage backed securities was that the government legislation in Europe allows for the banks to remove poorly performing assets from the covered bond pools, while such laws do not yet exist in the RMBS and CMBS models. The securitization of mortgage and other debt allows for banks to free up their balance sheets so that they can continue to lend. This added liquidity in the market has the effect of lowering the cost of lending for everyone. The question for debate is whether securitization is the enemy or if the benefits outweigh the costs.

Questions for Discussion

1. *Research the current state of the securitization industry. Has the industry made a comeback?*
2. *Based on your research, is the securitization model inherently flawed?*
3. *Why was mortgage securitization seen as the culprit in the recent financial crisis?*
4. *What role does regulation play in both the blame game and the recovery of the market?*

Case Study 2.1

Electronics International Ltd.

Electronics International Ltd. is a large consumer electronics manufacturer based in Southampton, England. Its product line consists of compact disk players, DVD players, home entertainment systems, and so on. Annual sales in 2012 were $186 million, 44 percent of which came from overseas sales. Most of the company's exports go to developing countries in Asia and Africa, with a small percentage of its products going to Turkey and Greece. Its most important export market is Zempa, a relatively prosperous developing country in the western part of Africa. Exports to Zempa total nearly 26 percent of all export revenues and have been showing an upward trend for the past six years.

Total sales to Zempa in 2012 were $140 million, up from $120 million in 2011 and $110 million in 2010. The company controls approximately 20 percent of the audio products market in Zempa, with the rest taken up by other competitors, all of whom are overseas corporations. Zempa has no audio products manufacturing industry, so all domestic requirements are met through imports. Electronics International is the third biggest player in the Zempa market, with the top two slots occupied by a German company and a Japanese company, respectively. Electronics International's products are well-established and enjoy considerable customer loyalty.

Recently, the government of Zempa has become increasingly concerned about the relatively backward state of its manufacturing industry and wants to rapidly industrialize the economy by attracting overseas investment in key sectors. One of the important priorities for the Zempan government in this connection is the consumer electronics industry. As part of its policy to develop the local economy by

(continued)

Case Study 2.1 *(continued)*

stimulating domestic manufacturing activity, the Zempan government queries each of the major exporters of consumer electronics products about setting up domestic production facilities in Zempa. The managing director of Electronics International receives a letter from the Zempa government, inviting the company to set up a manufacturing facility in Zempa and promising considerable official assistance should the company decide to do so.

Electronics International is asked to evaluate this offer and to reply within three months. The government also acknowledges that the other leading suppliers are also considering setting up local manufacturing establishments in Zempa.

The idea of setting up a manufacturing operation in Zempa does not appeal initially to the managing director. The company is doing well in Zempa as an exporter: sales have been increasing each year. There have been no difficulties in shipping its products; most of the goods are transported by sea and costs are acceptable. True, there are some problems with the local customs authorities, but they are not insurmountable. The distributors are good, reliable people who are pushing sales hard and meeting their contractual obligations to the company without any major problems. The Zempan government's regulations regarding remittance of payments for imports/exports are tedious and at times a little frustrating, but with the help of the company's local agents, most of the issues regarding repatriation of exchange proceeds are resolved in reasonable time. Therefore, why should the company think of setting up manufacturing operations in Zempa? The infrastructure for industry in Zempa is relatively undeveloped. The electricity supply is especially unreliable. There is little trained manpower, and the production of electronic products requires workers who are adept at carrying out the delicate assembling tasks. On the verge of dictating a letter thanking the Zempan government for its invitation to set up a factory but conveying the company's decision to stay on only as an exporter, the managing director decides to consult Bill McLowan, the strategic planning director at Electronics International. A couple of days later, McLowan presents a seven-page executive memo that differs from the thoughts of the managing director. The memo raises five main points:

1. Zempa is a valuable market for Electronics International, and as the economy of the country develops, the market size is likely to continue to grow rapidly. What is therefore needed is an increase not only in sales volume, but also an increase in market share. The memo points out that although the sales of Electronics International's products have risen steadily over the past six years, its market share has stagnated while those of its main competitors have increased.