MS-97
International Business

Indira Gandhi
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School of Management Studies

Block

1

INTRODUCTION TO INTERNATIONAL BUSINESS

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BLOCK 1 INTRODUCTION TO INTERNATIONAL BUSINESS

A thorough understanding of international business is essential in order to understand the process of globalization. This block is concerned with the basic concepts of international business and its relevance to the global economy. This block has three units.

Unit 1: Dynamics of International Business gives an account of international business, which is of recent origin, but it also includes international trade, which is an old concept. International business activities have become diverse and complex due to the integration of world economy now called global economy. The evolution is from a domestic organization, to homogeneous home market, to becoming active exporter and finally international corporation. This unit discusses the reasons in support of globalization or internationalization. It tires to draw the difference between national and international business. It highlights the advantages and importance of internationalization. It also points the disadvantages but since the advantages are more, therefore this unit supports the cause of internationalization.

Unit 2 is concerned with **International Trade Theories and its Business Implications.** This unit focuses on economic interdependence of nations, which includes flow of goods, services and payments between a nation and the rest of the world and develops an understanding for current international economic problems. It deals with trade theories, trade policies, the determination of balance of payments accounts of the nation, functioning of foreign exchange market, floating foreign exchange rate and risk and uncertainty attached with foreign exchange market such that gains outweigh the risk in the larger interest of international trade. It discusses the International Monetary System (IMS), which includes rules, customs, instruments and organizations for affecting international payments.

Unit 3: Process of globalization presents different definitions of globalization and global firm by various experts. It discusses the underlying assumptions regarding Global Standardization Philosophy and the related pitfalls associated with these assumptions. The unit examines the various drivers which determine the potential for globalization of an industry namely market, cost/economic, government and competitive drivers along with the factors which affect implementation of global strategy.

UNIT 1 DYNAMICS OF INTERNATIONAL BUSINESS

Objectives

After reading this unit you should be able to understand and appreciate:

- the origin of international trade;
- the concept and dynamism of international business;
- the reasons behind firms going international; and
- the benefits and importance of international business.

Structure

1.1 Introduction

1.2 Domestic vs International Business

1.3 Importance of International Business

1.4 Benefits of International Business

1.5 Challenges in International Business

1.6 Why do Firms go International?

1.7 Summary

1.8 Key Words

1.9 Self-Assessment Questions

1.10 Further Readings

1.1 INTRODUCTION

International business as a discipline is of a recent origin. It is hard to imagine a world without international business. Virtually every nation, howsoever small it may be, has firms involved in various types of international business activities. It is through these activities that nations enjoy the benefits of international business by trading in a variety of goods and services produced around the world and made available locally. International business, conventionally called as international trade, has been known to exist ever since man learned to live in an organized manner. India, for instance, is well known for spices. Egyptians had a significant foreign trade. The fundamental basis of international trade lies in the fact that countries are endowed by nature with different resources. These differences arise from geographical, physical or climatic features. Some countries have a monopoly of certain crops, for example, Bengal (India) and have high jute production, and Punjab (Pakistan) produces best quality of basmati rice. International business is thus inevitable when there are marked differences in the countries regarding material, natural vegetation, climate, soils and other physical and geographical conditions. It is also affected by several other factors besides natural and geographical factors, such as stage of economic development, accumulation of capital by a nation and its foreign investments, technological progress, trade and financial regulations, political affiliations, education and special skills of the population (for example, software skills of India), and so on.

Though international business, as a discipline, as stated earlier, is of a recent origin, international trade is claimed to be as old as the history of mankind itself (Monye, 1993). Even at the most tribal level, communities found it in their interest to trade, albeit in a very primitive manner and involving the exchange of simple objects mostly for immediate consumption (Harrison, Dalkiran, and Elsey, 2000, 3-4). Historically trade was in the form of barter and was undertaken both for social as well as economic reasons.

Even though modern trade is conducted in far more advanced forms and for more complex reasons than ever before, the basic human need for trade remains the same. However, unlike ancient times during which trade was devised and undertaken by communities for the benefit of communities themselves, over 90 per cent of modern trade is undertaken by private firms in pursuit of their own aims and objectives (Harrison *et al.*, 2000, 4).

The growth of modern trade coincided, to a large extent, with the emergence of the modern nation state and with the consequent formation of national borders. The clear recognition and appreciation of the mutual benefits of free trade (trade without barriers and based on the principle of comparative advantage) provided sufficient incentives for nation states to seek greater opportunities in each others' domestic markets and thus to increase the volume of trade among themselves. Such mutual benefits have been largely responsible for the growth of alliances and regional integration around the world, as evidenced by the establishment of a considerable number of trading areas, such as the European Union (EU) and North American Free Trade Agreement (NAFTA). Over the years, nations have been promoting trade and international business activities by attempting to create suitable business and investment environments within their borders, not only out of political and strategic necessity but also out of a desire to attract business and foreign investment, often in competition with other nations. For example, the recent spate of liberalization, deregulation, and privatization programmes by governments around the world, in particular by those of the former Soviet republics and Eastern Europe, has given special impetus to the growth of foreign direct investment (FDI).

Many countries around the world have witnessed substantial growth in the economy in the past two decades. There has been faster growth in the international transactions especially in the form of FDIs (prathi, 2011). Not only has the total stock of capital grown rapidly, but more significantly, there has been growth in the number of subsidiaries of Multi National Companies (MNCs). There has also been growth in the number of countries in which specific firms were active.

As both, international trade and investment grew rapidly, international competition became more intense, and many national industries became global industries. Similarity of markets in different countries and intense global competition drove international competitors to coordinate their marketing and competitive strategies between countries more actively. The relevant scope of strategy thus shifted from discrete national markets to global markets. The coordination of worldwide competitive actions among the various subsidiaries of MNCs became more important.

The removal of trade barriers, especially in the last decade of the previous millennium and the growing similarity of the national markets created the potential for globalization of markets and competition. The development of global networks brought about by MNCs and alliances between independent firms on the one hand and the technology of cheap, effective transportation and global communication networks on the other hand provided the practical means necessary for the integration of supply. These conditions were necessary, though not sufficient. Intense competition in most industries was the driving force necessary for integration and globalization.

Globalization is a process by which a business looks at the world market as one single market without the barriers of social, cultural, economic, political or commercial factors which separate different country markets. For example, India and USA can be different in terms of economic factors such as the per capita income and purchasing power of the consumers, the stage of economic development etc. Since these barriers are less effective in a global scenario, it leads to the increased movement of goods and services across boundaries, namely, trade and investment, often of people through migration. We shall learn more about globalization in Unit 3 of Block.

1.2 DOMESTIC VS INTERNATIONAL BUSINESS

The basic principles of business concerning tasks, functions, and processes that apply to international business are the same as that of domestic business. However, the environment in which domestic and international firms operate varies considerably and therefore requires an international firm to modify and adapt its business practices country by country. Unlike a domestic business manager, an international manager faces greater difficulties, greater uncertainties, and more importantly, much greater risks. The tasks of an international business executive are clearly much more challenging.

These difficulties, uncertainties, and risks originate from differences in the political, economic, legal and cultural environment, and from differences in foreign exchange markets and exchange rate systems. In most cases, these problems manifest themselves as constraints which render the process of decision-making and its implementation in international business more difficult (and in some cases, more hazardous) than in domestic business. More importantly, culturally insensitive decisions often result in conflicts which are more difficult (and costly) to resolve without seriously affecting the performance of the firm, its future operations, and the effectiveness of its management. The dynamic nature of constant changes in business, economic, political, and legal environments in the host country adds still more difficulties with which the international business executive must deal on an almost daily basis.

The differentiation between domestic and international business can broadly be done on the following parameters:

Culture

Each country in which the firm operates is culturally different. To be successful, the firm must operate in a culturally sensitive manner and within the constraints of the culturally determined manners, customs, values, and norms of the host country. An international business manager must respect and empathize with cultural differences in all aspects of business and social life, seek to conform and cooperate rather than confront or behave as if operating in his/her own culture. Nike, the global sports shoe manufacturer, realized this fact in a hard way when it produced and marketed Nike Air brand of shoes for the first time. It wrote "Air" in cursive fonts and in an artistic way but it created a great problem in Saudi Arabia because it looked like the word 'Allah' in Persian. Similarly, marketing campaigns, especially the advertising may have to be adapted according to the local culture. Many years ago, campaign for 'Tuff' shoes which had shown male and female models wearing only shoes and no clothes had come under scanner. It was considered as obscene and was subsequently banned in India. However a similar campaign in some other country like France may not have evoked public outcry and might have been considered normal like any other campaign.

Fiscal and Government Policies

Conducting business across national borders involves the use of different currencies and observing different government rules and regulations limiting the firm's freedom of action; for example, restrictions on the amount of profit to be transferred. Different governments practice different exchange rate policies and systems, ranging from daily decrees about the value of the local currency in terms of the world's major currencies to fixed and floating exchange rate systems. These practices add greater risk and uncertainty to the already highly risky and uncertain nature of international financial transactions. To be successful, the firm must develop an appropriate strategy to deal with these differences and the associated problems.

Legal Environment

The legal environment differs from country to country, requiring firms to show particular sensitivity to laws, rules, and regulations which may affect operations and performance. Disregarding or disobeying the laws of the host country can be very damaging to the finances and the image of the firm. Laws pertaining to joint ownership of assets, for example, are often very complicated, bureaucratic, frustrating, and time-consuming. Legal difficulties are often the source of serious disputes between the host government and the firm, requiring protracted negotiations which may end in failure to invest or to continue the existing business.

Consumer Tastes and Preferences

Differences in consumer tastes and preferences and demand patterns arising from cultural differences require the firm to adopt appropriate production, procurement, and marketing strategies to minimize costs and maintain the firm's value. McDonald's for example, does not offer beef and pork items in India and sells only vegetarian food dishes in predominantly vegetarian state of Gujarat. Even in the case of standard global products, certain modifications may be necessary to render the product more acceptable to the consumer in the host culture. For example, the name of the product in the host country's language may be offensive or the packaging may be inappropriate.

Availability of Factors of Production

Different countries possess different factor endowments with different qualities, requiring the firm to formulate and implement suitable product development and logistics strategies consistent with the availability and quality of resources in the host country. Certain skills or supplies may be either unavailable or available in limited quantities and qualities. If unavailable, the firm must either import them or develop local sources of supply. Following its entry into the Soviet market in 1990, McDonald's, one of the first Western fast food firms, experienced serious difficulties in obtaining high-quality local food supplies consistent with its food technology. To meet its high standards in quality, delivery, and production methods, McDonald's had to transfer agricultural technology, equipment, and consultants from other countries with superior technology to work with Soviet farmers. One astonishing outcome was an increase of 100 per cent in potato output alone. It even set up its own dairy farms, cattle farms, food-processing plants, and distribution system.

Thus, international business should not be seen just as an extension of domestic business. It is quite different from the domestic business. The factors which lead to these differences are summarized in Table 1.1.

Table 1.1: Differences between International Business and Domestic Business

International Business	Domestic Business
i) Many nations, many cultures	i) One nation, one culture.
ii) Patriotism hinders trade.	ii) Patriotism helps trade.
iii) Markets are diverse and fragmented.	iii) Market is much more homogeneous.
iv) Multiple currencies, differing in stability and exchange value.	iv) Single currency
v) Varied economic (monetary and fiscal) climate.	v) Uniform economic (monetary and fiscal) climate.
vi) Political factors may play major role.	vi) Political factors are of minor importance.
vii) Government influences business decisions.	vii) Minimum Government interference in business decisions.
viii) Transport cost influences marketing decisions to a great extent.	viii) Transport cost forms/influences only to a small extent.
ix) Considerable risks, both financial and non-financial, necessitate credit and general insurance.	ix) Minimum payment and credit risk.

1.3 IMPORTANCE OF INTERNATIONAL BUSINESS

In recent years, international business has acquired additional importance for host countries in particular and world economies in general as a result of developments in the following areas:

Technology Diffusion

Technological developments are transmitted to every corner of the earth through the practice of international business. This transmission is not only in the form of products and services used every day, but also in the form of modern management, production, marketing, and logistics systems employed by domestic as well as international firms. And thanks to the dramatic developments in communication and information technology, the benefits of such transmissions are shared worldwide.

Stimulation to Competition

Except in the case of entry through acquisition, the arrival of an international firm in the host country, either in partnership with a local firm or on its own, may stimulate domestic competition and lead to increased entrepreneurial challenges, especially in the developing countries. International firms with superior worldwide experience, knowledge, technology, and other relevant resources have the ability to offer goods and services often at lower prices and higher quality.

Higher Standard of Living

Availability of a wide range of goods of international quality at competitive prices has brought many so called "luxury" products within the reach of common man, especially in developing countries. Thanks to international business, the standard of living in many developing countries has increased significantly.

Impetus for Standardization

Standardization refers to the adoption of norms and practices generally acceptable in world markets. In some cases, one standard product may be sold throughout the world using similar selling techniques. Common standards enable easier and more effective comparisons to be made by consumers and other interested parties, e.g., health and safety authorities. The product standardization has become an easier option due to diminishing differences in consumer tastes, preferences, and interests. This is due to advances in technology, telecommunication, transport, and advertising.

Adapting to International Environment

A business firm operates within its internal and external environment. The internal environment is one over which the firm has considerable control: the firm determines its own internal environmental factors by specifying its corporate mission, organizational structure, recruitment policy, and its relationship with suppliers, etc. The external environment is one over which the firm has little or no control. Whatever little control the firm may have is usually the consequence of its market power or collective action by a representative body, such as the Confederation of British Industries (CBI) in Britain or the Confederation of Indian Industries (CII) in India. The firm must, therefore, conform to its external environmental factors, whether they be national, international, or global, or suffer the consequences of its failure to do so. For example, changes in health and safety regulations, trade policies, and the legal environment are unavoidable. Nike, one of the world's biggest manufacturers of sports and leisure wear, was forced into cancelling its licensing agreement with one of its Asian licensees suspected of employing child labour (Harrison, *et al*., 2000 p.9).

With the increasing internationalization of business activities, the methods of dealing with internal and external environmental factors tend to become more standardized. The main reason for this development is that domestic firms aspiring to expand internationally often emulate existing international firms in adapting to environmental changes. In other words, international business acts as an instrument for domestic firms to adopt more effective business policies and techniques as a preparation for going international. For example, many US and European firms have adopted Japanese management techniques, such as quality circles, the just-in-time system (JIT), and total quality management (TQM) in order to remain competitive in their own domestic markets in general and in international market in particular.

Encouragement to Global Business and Economic Reforms

Governments play an important role in the development and promotion of international business activities. They provide a great variety of financial and non-financial incentives to attract FDI into their countries, often in competition with their neighbours. The increasing scale of liberalization of trade and investment, deregulation of domestic industries, and privatization of state-owned enterprises have the attraction of foreign business as one of its primary objectives. These measures have created immense international business opportunities. The major impact of international business in this context has been the encouragement to governments to open up their borders to international trade and investment, standardize their systems and procedures, adopt internationally acceptable values and attitudes, particularly with respect to human rights and child labour, and encourage the development of democratic institutions.

Economic Cooperation and Integration

One of the most fundamental impacts of the process of internationalization since the end of World War II has been the progressive ending of the isolation of national economies. Gradually more and more barriers to international trade and investment are being replaced with measures designed to enhance cooperation and coordination among nation states. The need to cooperate and coordinate over wider geographical areas has led to the formation of regional groupings in the form of free trade areas resulting in rapid increase in the growth of international business activities.

Activity 1

Pick up one multinational firm from the US and one from Japan and study with respect to the following:

a) Their organization structures;

b) The way they plan their activities; and

c) The way they make their marketing decisions like new product introductions, branding and advertising, pricing, etc.

Note down the differences you find in the working of the multinationals from the two countries.

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1.4 BENEFITS OF INTERNATIONAL BUSINESS

Foreign trade gives rise to several advantages, some of which are as follows:

Mutual Exchange: As seen earlier, the countries in foreign trade stand to gain by exchange of goods and services.

Higher Standard of Living: Because of mutual exchange of products, the citizens of trading countries can enjoy the goods and services which are not available or cannot be produced in their own country. For example, in the absence of international trade, the people staying in Arabian Gulf would have lived a miserable life for want of many essential items like foodstuff, clothing, etc. But thanks to the international trade, they can sell oil and in return buy whatever they need. This has helped them to improve their standard of living.

Stabilization of Prices: Prices, it is said, are a function of demand and supply. Naturally, during the time of natural calamities like flood, famine, etc. the supply of food grain will be affected. Thus, when a country cannot grow sufficient amount of food-grain required for its domestic consumption, they have to be imported to maintain adequate supply and prices. The same principle holds good when there is a surplus of production. The excess production may be exported to maintain prices in the domestic market.

Specialization: As seen earlier, a country tends to export such product in which it has comparative or absolute advantage, for example, India in Rice or Gulf countries in oil. When a country keeps on exporting the same product over a number of years, it leads to specialization.

Increased Productivity: Because of the geographical specialization and expertise attained, the country can produce more goods and better quality of goods and services which, in turn, leads to higher productivity. The excess capacity, if any, of industrial products can be utilized fully. This will lead to economies of large scale production. The shining example is of Japanese car manufacturers.

Wider Markets: Many firms are attracted towards the international market for the growing opportunities for their products in other countries. This may be because of the saturation in the domestic market or because the foreign market may be more profitable.

Economic Development: Due to foreign trade developing countries like India can earn valuable foreign exchange through exports. The income of the government in the form of customs duty can also increase. Countries like Japan, UK and USA have achieved economic growth through imports of raw materials and export of manufactured goods.

Promotion of International Peace: When countries trade with each other and depend upon each other for their requirements, the tension amongst them gets reduced and a bond of friendship may develop. This helps in developing the cultural and social relations along with the business relations.

Activity 2

Refer the latest Economic Survey and highlight the salient points in relation to promotion of export trade and India's international business.

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1.5 CHALLENGES IN INTERNATIONAL BUSINESS

As seen earlier, international trade differs from domestic trade in a number of aspects. As compared to domestic trade, foreign trade faces some peculiar/unique difficulties which are as follows:

1) **Distance and High Cost of Transport:** International trade is normally carried over a long distance between the place of manufacture (or origin) and place of consumption, the transport cost may be huge and hence distance plays a major role in decision-making.

2) **Time Lag:** Due to the above factor, it takes much more time to execute an order. It may take several months to realize the money after the receipt of an order and dispatch of goods. Further, longer the time lag more is the risk of the cargo being damaged in transit, especially if it is perishable.

3) **Language, Customs and Laws**: Every country has different social, cultural and legal practices. These differences can create a hindrance in the smooth flow of international trade. Further the difference in languages can also act as a barrier, for example, while trading with Arabian countries the knowledge of Arabic would be great advantage. Many a times these differences in language lead to misunderstanding.

4) **Currency and Measurement:** Every country has its own currency which is subject to fluctuations in exchange rates. This fluctuation must be properly understood in terms of the currency in the domestic market. Further the system of weights and measurements followed in foreign market may be quite different than the one in the domestic market. For instance, the system followed in India is Metric System, but USA does not follow the same. One must understand how to convert one into the other.

5) **Government Control, Regulation and Taxes:** Every Government sets its own rules and regulations for import of goods and services. These rules may differ from commodity to commodity and from country to country. Depending upon the country of origin, there may be different set of rules. For example, when EU (European Union) countries trade with each other, they charge negligible or no import duty. But when these countries trade with outsiders, they charge heavy duties.

6) **Risk and Uncertainty:** Because of all these difficulties mentioned above, export-import trade is full of risk and uncertainty and hence needs specialized knowledge.

1.6 WHY DO FIRMS GO INTERNATIONAL?

There are various methods of entering foreign markets, from the simplest and least costly (indirect importing and exporting) to one which is complex and risky and requires a great deal of commitment involving foreign direct investment (FDI). The various strategies for entry into foreign markets are explained in Unit 10 of Block 3. The basic question, however, still remains: why do firms want to internationalize their operations? What do they hope to achieve by going international? This section offers some answers by considering the key elements of the internationalization process which describe the sequence in which a firm evolves from a domestic organization, serving a relatively homogeneous home market, to becoming an active exporter, and then an international corporation serving a large number of diverse multinational and cultural markets.

A firm seeking to enter into foreign markets may do so through one or more of the following mechanisms/arrangements.

Exporting

At its most risk-averse phase, a firm decides to enter foreign markets through licensing arrangement with a local party. The firm is willing to accept the risks of servicing foreign markets through exports. This means exposing oneself to the risks of transit, non-payment, currency fluctuations, among others. The firm discovers that to consolidate and expand the gains of export business, it must invest on the creation of a marketing set up in the foreign market (s).

Licensing

When a Company is unwilling to take any risks for the sake of international business, it sometimes opts for licensing as the mode of entry. Licensing is, simply put, nothing but entering into a contract to allow another firm to use an intellectual property, such as, patent or a trade mark. This definition clearly brings out the fact that as an entry mode, this option is not available to all firms. Only those which have saleable technology, know-how, can use the licensing route.

The attraction of licensing lies in the fact that it involves no investment and very little up-front expenditures. And if successful, it can generate a fairly high rate of return.

Under a licensing agreement, the holder of the knowledge (technology or know-how) transfers the same to the buyer for his use against the payment of a fixed amount, which can either be a one time lump-sum payment or a percentage of sales, or a combination of the two.

Licensing arrangements suffer from several disadvantages from the standpoint of the licensor. First, the licensor does not have any management control over the licensee and is therefore unable to control either the quality or price. An unscrupulous or inefficient licensee can therefore cause damage to the long-term development of the market potential. Second, licensing is extremely limited in its scope. The licensor cannot have a share of the returns from the manufacturing and marketing operations of the licensee. Third, the life of the successful licensing arrangements is normally short, as the licensee may develop his own manufacturing capability within a reasonable short period. But the most dangerous aspect of the licensing arrangement is that sometimes the licensees, after they internalize the technology and also in some cases improves upon it, turn into competitors of the licensors.

Franchising

A similar method of entry is franchising which is globally very common in the food, soft drinks and fast food business. Franchising is a form of marketing, under which the parent company allowed the franchises to use its methods, symbols, trademarks and architecture. The contract will specify the place of operation of the franchisee and the period for which the arrangement will remain valid. Several forms of franchising are in operation. One form is hundred per cent franchisee ownership; the second form envisages a concept of area or master franchisee who in turn can appoint sub-franchisee(s). The third is where the franchise is in fact owned by the parent firm itself. This happens essentially at the market-testing stage. The principal wants initially to find out the market potential himself before deciding whether large scale franchising will be profitable.

The basic advantage of this entry method is akin to that of licensing. The upfront expenditure is minimal while the return can be substantial. The disadvantage lies in the fact that unless strict monitoring is done, franchisees may default on quality and delivery, thus affecting the reputation of the principal.

International Joint Ventures

International joint venture involves creation of a separate legal entity by an association of two or more firms. Normally, one of the partners will be a local firm though it is not necessarily so. The choice of this entry method is dictated by several important considerations. First, it reduces the cost of entry because the equity will be divided between/among the partners. The foreign firm can thus make an entry into a market even with a minority participation and still can have substantial management control. Second, having a local partner can reduce the political risks. In an environment which may not be friendly to foreign investors, having a local partner can help in creating a more acceptable public perception. Third, the local partner is expected to have a good grasp of local operating conditions and therefore can be of great help to the foreign firm which is unaware of these details.

While these advantages can be substantial, the biggest danger of international joint venture lies in the inappropriate selection of a partner. If the choice is proper, the strengths of the parties will be complementary. But if the choice is wrong, either in terms of operative attributes or management cultures, the joint ventures are bound to break up. Several surveys have shown a considerable ‘divorce’ rate among the joint venture partners or taking over of the businesses by the dominant partners.

The choice of the joint ventures as the entry mode may, however, be dictated by the host country's regulations. Some countries stipulate that foreign firms can set up facilities only in association with local firms.

Subsidiaries and Acquisitions

Wholly owned subsidiaries have been the preferred entry mode for large enterprises. The advantages of complete ownership are: avoidance of conflict of interest, as may happen in the case of joint ventures, and fullest exploitation of the market potential in terms of both manufacturing and marketing. But these advantages are to be evaluated against the large scale commitment of financial and managerial resources. Some firms which are anxious to keep their competitive edge under the strictest control, normally favour this entry mode.

The internationalization process is initiated for many different reasons. It is not simply a matter of wishing to go international and achieving success over a short period. The process of internationalization requires the following five basic ingredients if the firm has to be successful:

- A well-developed and clearly articulated mission which reflects a serious commitment to international business activities.
- The ability of the firm to identify and adjust rapidly to consumer needs and opportunities in international markets using products which clearly reflect the firm's competitive advantage.
- The ability to understand consumer behaviour in different cultures and to evaluate the nature of changes taking place.
- The ability to develop and maintain high-quality products which can withstand competition from the nearest rivals in domestic as well as overseas markets.
- A programme of serious and effective business research to identify international markets and their requirements.

Within the context of these ingredients for success in the internationalization process, it would be useful to consider the dichotomy between a *reactive firm* and a *proactive firm.* A reactive firm is a passive firm. It follows rather than leads; responds to opportunities rather than actively seeking them; it avoids risk rather than taking risk; it is content with the *status quo* rather than actively seeking ways to change it; it is inward-rather than forward-looking; and is more concerned with the present rather than with the future which requires planning and investing. In short, a reactive firm is defensive in character and its actions reflect management's response to changes in the firm's external environment and pressures from its competitors. In contrast, a proactive firm is always initiating and creating new products to stay ahead of rivals, always seeking new challenges rather than being content with what has so far been achieved. It is aggressive and is prone to taking risks, and invests for the future to take on its rivals. It is often the case that the more proactive the firm, the more likely it is to succeed in international business.

The internationalization process demonstrates a proactive firm at its best. In some instances much of the firm's FDI activity may be a reactive response to competitors' moves, basically a defensive strategy to discourage entry of new firms into the industry, to increase market concentration, or to undertake mergers and acquisitions (M&As) in order to deny rivals access to valuable assets. The process starts with the firm having a product which clearly reflects its competitive advantage over its rivals, both in home and international markets, often as a leader in its field. Its competitive advantage may be its superior design capability, the skills of its workforce, the unique talents of its management or marketing team, or simply its ability to do things better or more efficiently than its competitors. In short, to be successful in international markets, the firm must first be successful in its own domestic market. It is this success in its domestic market which often propels the firm to go international.

It has been seen, from the discussion so far, that the firm uses its firm-specific intangible assets to enter foreign markets. Its products and brand name developed over many years need to be fully exploited if the firm is not only to recover its initial research and development costs but also earn sufficient profits to satisfy its shareholders and fund future investment. So, the profit motive is the most compelling proactive motive. In cases where the domestic market is either too small or too saturated, the firm may have no real alternative but to seek markets overseas. The key difference between a reactive and a proactive firm is that a proactive firm does not wait until its domestic market is saturated, demand is showing signs of decline, or it is forced to take action before it actively seeks opportunities abroad by undertaking continuous market research and acting upon its findings.

The **major reasons** why firms go international are:

1) To Look for New Markets

International business firms are often characterized as opportunity seekers; that is, seeking to take advantage of any event or development worldwide which is likely to have a positive impact on their marketing and resource acquisition strategies. This particular attribute is especially relevant to reactive firms. One major source of such an impact has been the creation of the European Union or single European market which helped to create one of the world's largest markets by integrating the individual member states' markets into one. Consequently, many distinct opportunities have been created for international business firms to undertake market-seeking and production-seeking investments.

2) To Expand Market for their Products / Services

As a consequence of the increasing convergence of consumer tastes and preferences and demand patterns in general, firms find it necessary to establish international customer bases in foreign countries to serve the needs of existing as well as potential customers. The firm is, thus, able to expand its market internationally at a lower cost than by exporting from the home base. A firm with a declining home market may like to enter into foreign markets and extend the life cycle of its product. As the experience of many US, Japanese, and Korean MNCs demonstrates, EU member states offer many location-specific advantages to these firms to enable them to gain access to its single market with over 370 million inhabitants. Firms like Nokia, Siemens, Bayer, Johnson and Johnson, etc. went in search for foreign markets as their domestic markets were shrinking.

3) To Circumvent International Trade Barriers

Governments erect various forms of barriers for foreign firms to enter in their domestic markets. These barriers include some of the most common measures such as tariffs and quotas as well as rules and regulations to protect specific industries and markets. These measures make imports less attractive and more costly. Therefore, it makes it necessary for the firm to establish export bases or production facilities in host countries in order to avoid these protectionist measures.

4) Factor endowment

Countries are endowed with different natural and acquired resources which offer international firms yet another set of location-specific advantages, ranging from relatively low-cost labour, raw materials, land for large-scale operations and suitable climate to specific technical skills and knowledge which can only be accessed by establishing operations on location. Even if the firm's home country has similar resources, it may still be advantageous for the firm to locate facilities in another country for additional low-cost resources such as finance. For example, Japan is known for the quality of its steel; however, the Japanese firms have to look at India for the supply of iron ore – a raw material for making steel.

5) To Reap Benefits of Economies of Scale

In cases where the domestic market may be too small for efficient production, the firm may want to expand into world markets to create economies of scale (reduction in cost per unit produced as the scale of production is increased). Entry into overseas markets increases total sales and therefore, justifies larger-scale operations in production, marketing, and transport.

6) To Follow Competition

With an increasing number of firms going international, other firms feel compelled to follow their competitors into markets which may later be denied to them. In oligopolistic industries (those dominated by a few firms making interdependent decisions), it is normal to expect several firms to establish operations in a given country within a short time. The main reason is that any particular change in the internal and external business environment affecting one firm will affect the others at about the same time and, given their interdependence on each other for decision-making, will induce a similar response. For example, the liberalization of trade and investment in India produced almost an instant response by the world's most dominant car producers to establish a presence in one of the world's biggest potential markets. An associated motive might be to create synergy which would result from combining benefits from one location with those of another, especially in cases where the firm is able to combine its own managerial competence with the intimate knowledge and expertise of the local personnel in order to overcome cultural difficulties.

7) To Take Advantage of Government Incentives

Governments throughout the world offer a variety of incentives to attract international firms, especially reactive firms. These incentives range from direct financial assistance to defray part of the initial costs of operations to indirect financial schemes such as favourable corporate tax rates. All these incentives help companies to maximize their after-tax profits and thus provide additional funds to invest either in the host country, home country, or in other countries.

8) To Protect the Domestic Market

In essence this is a defensive (reactive) approach whereby the firm initiates an offensive into the competitors' home market in order to protect its own domestic market. Such an offensive may have the effect of putting pressure on the competitor to reconsider its move or, depending on the strength of the offensive, abandon it completely.

Activity 3

Identify a company in India which has internationalized its operations over the past 5-10 years. Meet an executive of its international division and ascertain the reasons/ motivations for the company going international.

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1.7 SUMMARY

International business may be defined as business carried out across national boundaries. The genesis of international business may be traced back to the ancient times when different well known communities carried on their trading activities in different parts of the world. The MNCs are the central actors in international business.

There could be several reasons behind a firm's move to internationalize its business. A firm may want to engage in international business in search of new markets, to widen its present market for goods and services, to overcome the barriers that it perceives it would confront if it goes international, to reap the benefits of economies of scale, to take advantage of the opportunities offered by other (foreign) governments, or to protect its domestic market from foreign competition, etc.

International business differs from domestic business in terms of the environment it faces. The actors in international business confront different socio-economic, cultural and physical environment in different countries. Therefore, they have to make necessary adjustments in their strategies and approaches of managing business to conform to the diverse environments in overseas markets.

There are some difficulties that are unique to international business which arise because of long distance between trading nations, different languages, customs and laws, currency measurements, different controls, regulations and tax regimes in different countries, and greater risk and uncertainty.

Important benefits of international business include higher standard of living of people in different countries, stability in prices, advantages emanating from specialization, increased productivity, wider markets, overall growth of economies, and promotion of international peace.

International business has assumed greater importance as it enables in the diffusion of new technologies, stimulates competition, provides impetus to standardization, motivates firms to adapt to international environment, encourages globalization of business, and promotes economic cooperation and integration.

International business activities have not only grown but have become much more diverse and complex. As such they require collective or multilateral efforts at global level by global agencies. One direct result has been the emergence of a new world economic order in which national economies are merging into one global economy, either on an individual basis, or as it has recently been seen, in (new) regional groupings. Globalization is a dynamic process in which world markets and the production of goods and services become integrated and interdependent. For individual governments, the most compelling reason to integrate their economies with other economies is to enable them to take collective measures to maximize the perceived gains and minimize the perceived costs of globalization.

1.8 KEY WORDS

International Business :	Business carried out across the national boundaries. Some important forms of international business are: export and import of goods and services which includes appointing foreign agents abroad, management of consulting and turn key operations, licensing, franchising, joint ventures and collaborations, and wholly owned subsidiaries.
Globalization :	Globalization can be defined as the growth of economic activity spanning politically defined national and regional boundaries. It leads to the increased movement across the boundaries of goods and services, namely, trade and investment, often of people via migration. It is driven by the actions of individual economic actors – firms, banks, and people – usually in the pursuit of profit and often spurred by the pressures of competition.
Multinational Enterprises (MNEs) :	MNEs are the central actors in international business and have played a major role in making the world market 'global'. MNEs are generally defined as organizations whose operations extend beyond the national political boundaries and operate in many nations by making FDI.
Marketing :	Marketing is an activity which advocates looking at business activities from the **customers'** point of view. It suggests that the firm should develop its products as per the customers' choice and preferences. The term market refers to the sum total of **all** the customers (which includes present and potential customers - non-users and customers of the competitors' products as well).
FDI :	Foreign Direct Investment (sometimes also referred to as DFI) means direct investment in business operations in a foreign country. Generally, take the form of either a joint venture/ collaborations or wholly owned subsidiary.
European Union (EU) :	An economic group of 15 European nations: Austria, Belgium, Denmark, Finland, France, Germany, Great Britain, Greece, the Netherlands, Ireland, Italy, Luxemburg, Portugal, Spain, and Sweden. Established as a customs union, it is now moving toward economic union (formerly known as the European Community).
North American Free Trade Agreement (NAFTA) :	Free trade area between Canada, Mexico, and the United States.

1.9 SELF-ASSESSMENT QUESTIONS

1) What do you understand by ‘proactive’ and ‘reactive’ firms? Differentiate between them by highlighting their distinguishing features.

2) What prompts the firms to internationalize?

3) What special tasks or difficulties an international manager may have to face?

4) What are the characteristics of international business? How is it different from domestic business?

5) Using examples, examine the possible reasons why a firm may trade in international markets.

6) Why should Indian firms go global? Why should they not be content with domestic market which is vast and growing so rapidly?

7) Discuss why the culture of a country might influence the costs of doing business in that country. Illustrate your answer with examples.

8) In what ways has the risk of doing business changed in Russia and Eastern Europe since the fall of communism?

9) How do you account for the vast increase in world trade since World War II?

10) What is culture? Is it important for a manager of international business to take account of it? Are the forces of globalization making culture a thing of the past? Discuss.

11) Identify the barriers to free movement of goods and services. Explain how barriers influence the development of international trade.

12) “Selecting the market entry strategy is the key decision which many companies have to take for expanding into overseas markets.” Why is it a key decision? What kind of risks and controls are involved? Explain how risk and control is affected by different entry methods.

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UNIT 2 INTERNATIONAL TRADE THEORIES AND ITS BUSINESS IMPLICATIONS

Objectives

After studying this unit, you should be able to comprehend:

- the theories and principles of international economics and their implications;
- how the nations decide on their trade policy;
- how the balance of payments accounts of a nation is determined;
- the functioning of the foreign exchange market; and
- how to minimize risks and make gains in the foreign exchange market.

Structure

2.1 INTRODUCTION

International economics deals with the economic interdependence of nations. It analyses the flow of goods, services and payments between a nation and the rest of the world, the policies directed at regulating this flow and their effect on the nations' welfare. Its main components are the pure trade theories, the trade policies, the foreign exchange markets and the balance of payments.

The pure theory of trade examines the basis for and the gains from trade, as well as the patterns of trade. The theory of trade policy investigates the reasons for and the effects of trade restrictions. The study of foreign exchange markets gives you an idea on how one national currency is exchanged against the other, and the method of predicting the movement of a nation's currency against other currencies. Balance of payments measures a nation's total receipts from the total payments to the rest of the world, and discusses mechanisms for correcting balance of payments instability.

2.2 INTERNATIONAL TRADE THEORIES AND THEIR IMPLICATIONS

International trade theory seeks to answer two basic questions:

1) What is the **basis for trade** and what are the **gains from trade**? Since two nations trade voluntarily they must gain from trade. The question is how are these gains generated and how are they divided among trading nations/partners?

2) What is the **pattern of trade**? What commodities are traded and which nation will export and import which commodity?

We begin with the theory of absolute advantage developed by Adam Smith.

Absolute Advantage

According to this theory, when one nation is more efficient than (or has an absolute advantage over) another in the production of one commodity but is less efficient than (or has an absolute disadvantage with respect to) the other nation in producing a second commodity, then both nations can gain by each specializing in the production of the commodity of its absolute advantage and exchanging part of its output with the other nation for the commodity of its absolute disadvantage. Then the output of both commodities will rise, which measures the gain from specialization in production. The trade between two nations enables the gain to be divided between them.

We will now look at a numerical example of absolute advantage to make things clearer. Before that, however, let us define a production possibility schedule of a country by the combination of goods an economy can produce given its existing resources and the present state of technology. Table 2.1 depicts a hypothetical production possibility schedule for India and USA.

Table 2.1: Production Possibility Schedule

Labour required	One computer	One sack of rice
In India	25	5
In USA	10	10

Note that India is more efficient in rice production, while US is more efficient in producing computers. Let both countries initially have 100 units of labour. If operating separately or without trading with the other country, let us assume that both the nations devote half of their (labor) resources to manufacturing computers and producing rice. The USA will produce 5 sacks of rice and 5 computers, and India will produce 10 sacks of rice and 2 computers. The world economy as a whole produces 7 computers and 15 sacks of rice.

Now assume that by following the theory of absolute advantage, the USA and India specialize in producing computers and rice, that is, those goods where they have an absolute advantage. Then India will produce 20 sacks of rice and US will produce 10 computers. Comparing it to the no-trade case, we see that the world economy is producing more computers and more rice. Hence, if they can agree on a suitable exchange rate ratio (or terms of trade), which simply tells us how many sacks of rice will exchange for a computer in a world economy, both can gain from trade. Suppose they agree on exchanging one computer for two sacks of rice. In that case both countries can have 5 computers and 10 sacks of rice, which means they both gain from trade. Table 2.2 makes the gains clearer.

Table 2.2: Gains from Trade

Pre Trade	Production		Consumption	
	Computers	Sacks of rice	Computers	Sacks of rice
USA	5	5	5	5
India	2	10	2	10
World	7	15	7	15
Post Trade.	**Computers**	**Sacks of rice**	**Computers**	**Sacks of rice**
USA	10	0	5	10
India	0	20	5	10
World	10	20	10	20

Thus both countries gain in the sense that USA consumes as many computers as before while they consume more rice in free trade situation compared to no trade. India, on the other hand, consumes more computers in the free trade situation, while their rice consumption remains the same.

Comparative Advantage

The Absolute Advantage theory seems to postulate that if one country is more efficient than the other in the production of all commodities; it will have no gains from trade with the inefficient country, and as such should refrain from trading. David Ricardo, in his theory of comparative advantage, showed that even in such cases there could be a basis for gainful trade. According to ***the law of comparative advantage***, even when a nation is less efficient than (has absolute disadvantage with respect to) the other nation in the production of both commodities, there is still a basis for gainful trade. The inefficient nation should specialize in the production of and export the commodity in which its absolute disadvantage is smallest (called the commodity of its *comparative advantage*), and import the commodity in which its absolute disadvantage is highest (called the commodity of its comparative disadvantage). The law can be best understood from the following example. Consider this production possibility schedule, assuming India and USA have 120 and 100 units of labour respectively.

Table 2. 3: Production Possibility Schedule

Labour required	One computer	One sack of rice
In India	30	12
In USA	10	10

Here though USA has an absolute advantage introducing both the commodities, it is thrice as productive as India in producing computers, while only 1.2 times as productive in producing rice. However, the relative comparative advantage of USA in producing computers is more than the comparative advantage it has in producing rice. As such USA and India are said to have comparative advantages in producing computers and rice respectively. Thus if following the law of comparative advantage India and USA specialize in producing rice and computers respectively, they have a basis for gainful trade, as evident from the table below (we carry on with the previous assumption of dividing labour resources equally over two items of production).

Table 2.4: Gains from Trade

Pre Trade	Production		Consumption	
	Computers	**Sacks of rice**	**Computers**	**Sacks of rice**
USA	5	5	5	5
India	2	5	2	5
World	7	10	7	10
Post Trade				
	Computers	**Sacks of rice**	**Computers**	**Sacks of rice**
USA	10	0	7	5
India	0	10	3	5
World	10	10	10	10.

Thus both USA and India consume the same amount of rice in post trade compared to pre -trade, but both use/consume more computers and are hence better off trading. The logic of comparative advantage is basically this: Suppose a lawyer can type twice as fast as his secretary. Now the lawyer has a comparative advantage in both typing and law, since the secretary cannot practice law without a law degree. Suppose the lawyer earns $100 per hour by practicing law, while the hourly wage rate of typing is $20. By the theory of comparative advantage the lawyer should still practice only law and let his secretary do the typing. For, he loses $80 for each hour that he types. The reason for this is he would save $20 (since he can type twice as fast as his secretary can), but he loses $100 that he could have earned by practicing law in that hour.

Factor Proportions (Heckscher Ohlin (H-O) Model)

If labour was the only factor of production, comparative advantage could only arise because of difference in labour productivity. In the real world however, comparative advantage is also explained by differences in country resources. Canada exports forest products to the US not because its lumberjacks are more productive relative to their USA counterparts, but because sparsely populated Canada has more forested land per capita than the USA. Bangladesh is the largest producer of jute not because its labour is more productive but because of certain factors like a suitable climate, soil of appropriate quality and great abundance of cheap labour. Similarly South Africa is the largest exporter of diamond simply because natural diamonds are found there in great abundance. To highlight this importance of resource difference in trade, the H-O model considers resource differences as the only source of trade.

First we define factor intensity as the relative use of a factor proportion in producing a product. e. g., production of cars requires a lot of capital and less labour, while textiles require relatively more labour than capital. Having defined this, we are now in a position to state the H-O theorem.

Heckscher Ohlin Theorem: Trade is based on differences in relative factor endowments. Countries export those products that are relatively intensive in the nation's relatively abundant factor and import the commodities that require more intensive use of the nation's relatively scarce factor. In short, the relatively labour rich nations export the relatively labour- intensive products or commodities and import the relatively capital intensive products.

The logic of the theorem is as follows. Consider two countries, India and USA. If we assume that USA is heavily endowed with capital relative to labour, the relative price of capital will be cheaper in the USA than in India. This means, other things remaining equal it will be relatively cheaper to produce cars — a capital-intensive good – in USA than in India. Similarly it will be relatively cheaper to produce textiles – a labour-intensive commodity — in India, which is abundant in labour. As such when trade opens up, US should be exporting cars while India will be exporting textiles.

Also, the post trade prices of the two goods should settle down at a level that is between the two self sufficient price ratios. While the price of textiles will rise in India and that of cars will fall. Similarly, the price of cars in USA will rise, and that of textiles will decline. Because changes in relative prices have very strong effects in the relative earnings of resources, and because trade changes relative prices, international trade has strong income distribution effects. This is summarized by the following theorem.

Stopler-Samuelson Theorem: The countries that have abundant factors gain from trade, but the countries that have scarce factors lose. This explains that though there are always gains from trade, why there is so much opposition to opening up in all countries. Trade might benefit the country as a whole, but some sectors within the country might lose.

The International trade theories and their implications can be summarized in Table 2.5.

Table 2.5: Summary of International Trade Theories

Trade theory	Theoretical Implication	Described by
Absolute Advantage	Ability of a country to produce more of a good or service than competitors using same amount of resources.	Adam Smith (1776)
Comparative Advantage	Ability to produce a particular good or service at a lower marginal & opportunity cost over another.	David Ricardo (1817)
Factor Production	Countries tend to specialize in the production of goods and services that utilize most abundant resources	Heckscher (1919) & Ohlin (1933)

Source: en.wikipedia.org.

Activity 1

Study the pattern of current India-USA trade (for both goods and services) and analyze how the two nations stand to benefit from the bilateral trade. Analyze the physical goods and services separately in order to appreciate the results better.

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2.3 INTERNATIONAL TRADE POLICY

Practically all nations impose some restrictions on the free flow of international trade. Since these regulations or restrictions deal with a country's trade and commerce they are called Trade Policies.

Despite ample evidence that free trade is generally the best way to go about, politicians always talk of restricting trade by imposing tariffs and erecting non-tariff barriers (NTBs). It is a standard result in economics that the small countries are better off by pursuing free trade, while the large countries are better off imposing an optimal tariff.

Instruments of Trade Policy

Some important instruments of trade policy are discussed below.

Tariffs: A tariff is a tax on imports. Specific tariffs are levied as a fixed charge on each unit of goods imported. Ad-valorem tariffs are taxes that are levied as a fraction of the value of the imported goods. In either case the effect of a tariff is to raise the cost of shipping goods to a country. For example, a specific tariff of $10 on imported bicycles means that customs officials collect the fixed sum of $10 on each imported bicycle regardless of its price. In contrast, a 10% ad valorem tariff on imported bicycles would result in the payment to customs officials of the sum of $10 on each $100 imported bicycle.

Non-tariff Barriers (NTBs): Such barriers impose a physical limit on the quantity of goods that can be imported. Worldwide tariffs have been reduced steadily since 1945. Starting with the first round of GATT talks in Geneva (1947) world tariffs have been reduced from an average rate of 40% in 1947 to around 4% in 1994 on manufactured goods. The same cannot be said of NTBs, which became popular in the late 1970's and show little signs of fading away. As per the statement made at United Nations Conference on Trade and Development (UNCTAD, 2005), use of NTBs based on amount and control of price levels has decreased significantly from 45% in 1994 to 15% 2004. The use of other NTBs has increased from 55% in 1994 to 85% in 2004. A brief list of the types of NTBs is given below.

There are different classifications of non-tariff barriers. When we talk about tariff barriers related to trade then some popular NTBs are as follows:

1) Licenses
2) Quotas
3) Agreement on Voluntary Export Restraints (VERs)

Licenses: These are most common instruments of direct regulation of imports (sometimes exports). Almost all industrialized nations apply this. The license system requires that a state through a specially authorised office issues permit for international trade transaction of import and export commodities which are included in the list of licensed merchandises. The use of this system is based on international level standards agreements.

Quotas: Quotas are quantitative restrictions on imports and exports of certain goods. An import quota is a NTB that places a direct restriction on the quantity of some goods that can be imported. An export quota is the restriction on amount of goods that can leave a country. But because quotas are not permitted under current international trade rules, many countries have gone to great lengths to establish different varieties of trade restrictions that are functionally identical to quotas.

A quota rent arises because an import quota on a product raises the domestic price of that product. An alert businessman can walk away with the rent if he purchases the import at the world price and sells it to the domestic market at higher price.

Agreement on Voluntary Export Restraints (VERs): Under a VER, a foreign industry, such as the Japanese car industry, agrees to limit the quantity of products it exports to a particular country. In the early 1980s the US negotiated a VER with the Japanese car industry that limited the number of Japanese cars that could be exported from Japan to the US.

Though a quota and a VER are similar in effect, but because a VER is undertaken ‘voluntarily,’ the initiating country cannot be accused of unilaterally introducing trade restrictions – although there is always the nagging question of how much arm-twisting is necessary to get the exporting industry to volunteer to restrict its exports to a certain country. One difference is that VERs can be used to restrict imports from a particular country, not on all countries. Till now textiles, steel and agricultural products are the three products that have mostly been subjected to VERs. The European Union (EU) imposed VERs mostly on Japanese products, followed by the Korean products.

Embargo: It is a specific type of quotas prohibiting the trade. Usually this is introduced for political reasons but has an impact on the economy of a nation.

Orderly Marketing Agreements (OMA): Under such an arrangement two or more countries agree to limit the quantity of exports from each other country. Such agreements are framed to ensure that the future increase in trade may not disrupt or impair competitive industries.

Standards: The standards are usually imposed on classification, labeling and testing of products. These are some times used to protect the health and safety of local population.

Quotas versus Tariffs: Tariffs are generally believed to be better than quotas because of the following reasons. **First,** under a tariff, the government gets the revenue, which it can spend on projects benefiting the society in general or which it may use to reduce overall tax rates. In contrast, if the quota revenue ends up in the hands of the importers, the government will subsidise a lucky few at the expense of all citizens. If foreign firms end up with the quota rent, the government will in effect have taxed its citizens and transferred wealth to foreigners.

Second, quotas benefit the (domestic) producers at the expense of the domestic consumers. If tariffs are $10 per unit of one good, and the international price of that good is $100, then domestic producers cannot price the good at more than $110. But under a quota, they can charge a higher price; since consumers do not have the choice to shift to imports even if domestic prices are very high once the quota amount is sold out of the market.

2.4 BALANCE OF PAYMENTS

The balance of payments (BoP) of a country is a summary statement in which all transactions between ‘residents’ of the country concerned and those of other countries are recorded during a particular period of time, usually a calendar year. However, in the context of BoP, it is important to note that :

- Millions of transactions of a nation with rest of the world cannot appear *individually* in the BoP – it aggregates all trade into a few major categories.
- By residents we mean all citizens of a country. A corporation is a resident of a nation in which it is incorporated, but its foreign branches/subsidiaries are not. International Institutions like IMF, World Bank etc. are not residents of the nations where they are located.

- It is always with reference to certain time period. BoP considers flow of goods, services, gifts and assets between residents of a country with residents of other nations *during a particular period of time, usually a year.*

Debits and Credits in International Transactions: Debit transactions involve payment by domestic residents to foreigners. Credit transactions involve the receipt of a payment from foreigners by domestic citizens.

Examples of Debit transaction items are imports of goods and services, dividend, interest and debt payment on foreign owned capital, unilateral gifts or transfers made to foreigners and foreign investment by domestic citizens. Similarly some of the credit transaction items are exports of goods and services, unilateral transfers (gifts) received from foreigners and domestic investment by foreigners. Thus, while export of commodities is considered a credit transaction since it fetches receipt of payment, outflow of capital like buying a plant or shares abroad is considered a liability since domestic residents make a payment to foreigners for it.

Double-Entry Book keeping: BoP accounting is based on double entry book keeping, which means that a credit item on the BoP should be offset by a corresponding debit item. Hence the BoP always balances, or the debits always equal credits in the BoP account. A nation's balance of payments consists of two main accounts: the **current account** and the **capital account**. There is also an **official reserve account.**

The Current Account: It essentially records exchanges in goods and services. It consists of three sub accounts. The *goods or merchandise account* records the trade in visible commodities like cars, food grains, machinery etc. The *service account* records the transactions in invisibles that are bought or sold internationally, like royalties, banking, shipping insurance, tourism services, etc.

The trade balance or the balance of trade equals the sum of the merchandise account and the service account. Thus, it is basically the sum of exports of goods and services minus the sum of imports of goods and services. *Unilateral transfers,* the final item on the current account, are payments made by private citizens and governments of one country to another. If India sends so many dollars to Somalia to help fight famine, it will be listed as an official unilateral transfer on India's BoP.

The Capital Account: The capital account records the net changes in a nation's international financial assets and liabilities over the BoP period. Its first sub-accounts are as follows.

The *Foreign Direct Investment* (FDI) consists of building a plant overseas or acquiring what is deemed to be a 'controlling' interest in an established overseas firm.

The *Foreign Portfolio Investment* consists of purchase of shares of a foreign firm or bonds issued by a foreign government. The difference between these two types is somewhat arbitrary. If one buys 10% or more stocks of a foreign company, as prescribed under the applicable regulations, it will be called FDI, assuming then one gains a controlling interest in the firm. If one acquires less than 10% of the outstanding stock the capital export is regarded as portfolio investment.

Official Reserve Account: It deals with (a) gold imports and exports, (b) increases or decreases in foreign exchange and SDRs (Special Drawing Rights) and (c) increases or decreases in liabilities to foreign central bank. Thus, if they are current dollars, since we receive rupees, it is regarded as a credit item.

BoP — Surplus and Deficit: All transactions in current and capital account are said to be **autonomous** because they take place for business or profit motive, independent of BoP considerations. They are sometimes called '*items above the line*'. Transactions in Official Reserve Account are called **accommodating** transactions, or '*items below the line*' because they are determined by the net consequence of autonomous terms – they result from and are needed to balance international transactions. If the sum of current and capital account are in deficit, then foreign exchange or gold or loan must be taken from official reserve account to balance the BoP.

Therefore, the BoP is said to be in surplus (deficit) if the autonomous account is in surplus (deficit). A deficit in BoP can be measured by the excess of debits over credits in the current and capital accounts, or the corresponding drop in official reserves.

Activity 2

Study the relevant provisions of the latest budget presented to the Parliament and fill in the specific data/figures against each of the following subjects:

a) Balance of Payments surplus/deficit

b) India's Total Foreign Exchange Reserves

c) Main classification of Current Account Transactions

d) Main classification of Capital Account Transactions

e) Balance of Trade surplus/deficit

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2.5 FOREIGN EXCHANGE MARKET

The **foreign-exchange market** refers to the organisational setting within which individuals, business, governments, and banks buy and sell foreign currencies and other debt instruments. It is the largest financial market in the world. The major trading centres are in London, New York and Tokyo. Roughly 30%, 16% and 10% of the average daily volume of foreign exchange trading takes place in London, New York and Tokyo trading centers. The next in line in terms of importance are Singapore, Switzerland and Hong Kong, each of which accounts for approximately 6% of the daily volume. The actual trades are carried out by large commercial banks such as Citibank, Deutsche Bank, JP Morgan and HSBC/Midland – the top five foreign exchange dealers in 1995, in that order.

A typical foreign-exchange market functions at three levels: (1) in transactions between commercial banks and their customers, who are the ultimate buyer and sellers of foreign exchange; (2) in the domestic inter-bank market conducted through brokers; and (3) in active trading in foreign exchange with banks overseas.

Exporters, importers, investors, and tourists buy and sell foreign exchange from and to commercial banks rather than each other. As an example, consider the import of German autos by a U.S. dealer. The dealer is billed for each car it imports at the rate of 50,000 Euros. The U.S. dealer cannot write a cheque for this amount because it does not have the needed account denominated in Euros. Instead, the dealer goes to the foreign exchange department of, say, Deutsche Bank to arrange payment. If the exchange rate is 1.76• marks per $1, the auto dealer writes a cheque to Deutsche Bank for $65789.47 per car. Deutsche Bank is able to do this because it has the needed deposit in Euro at its branch in Bonn.

The major banks that trade foreign exchange generally do not deal directly with one another but instead use the services of *foreign-exchange brokers.* The purpose of a broker is to permit the trading banks to maintain desired foreign exchange balances. If at a particular moment a bank does not have the proper foreign-exchange balances, it can turn to a broker to buy additional foreign currency or sell the surplus. Brokers thus provide wholesale inter-bank market, in which trading banks can buy and sell foreign exchange.

The third tier of the foreign-exchange market consists of the transactions between the trading banks and their overseas branches or foreign correspondents. Although several dozen U.S. banks trade in foreign exchange, it is the major New York banks that usually carry out transactions with foreign banks. The other inland trading banks meet their foreign-exchange needs by maintaining correspondent relationships with the New York banks. Trading with foreign banks permits the matching of supply and demand of foreign exchange in the New York market. These international transactions are carried out primarily online.

Types of Foreign Exchange Transaction

When conducting purchases and sales of foreign currencies, banks promise to pay a stipulated amount of currency to another bank or customer on an agreed-upon date. Banks typically engage in three types of foreign-exchange transactions: ***spot, forward, and swap***.

Spot Transaction: It is an outright purchase and sale of foreign currency at the prevailing exchange rate or the **spot rate** for cash settlement not more than two business days after the date the transaction is recorded as a spot deal. The two-day period, known as *immediate delivery,* allows time for the two parties to forward instructions to debit and credit bank accounts at home and abroad.

Forward Transaction: These involve an agreement today to buy or sell a specified amount of a foreign currency at a specified future date at a rate agreed upon today – the **forward rate**. In many cases, a business or financial institution knows it will be receiving or paying an amount of foreign currency on a specific date in the future. For example, in August an Indian importer may arrange for a special Diwali season shipment of Japanese radios to arrive in October. The agreement with the Japanese manufacturer may call for payment in Yen on October 20. To guard against the possibility of the yen's becoming more expensive in terms of the rupee, the importer might enter in a contract with a bank to buy yen at a stipulated price, but not actually receive them until October 20 when they are needed. When the contract matures, the U.S. importer pays for the yen with a known amount of rupees. This is known as a **forward transaction.**

Forward transactions differ from spot transactions in that their maturity date is more than two business days in the future. "A forward-exchange is usually available at 30, 60, 90 or 180 day basis. If the forward rate is below the present spot rate (i.e. it will be cheaper to buy a foreign currency 30 day's later than today), the foreign currency is said to be at a **forward discount** with respect to the domestic currency**.** On the other hand, if the forward rate is above the present spot rate, the foreign currency is said to be at a **forward premium**.

Currency Swap Transaction: It is the conversion of one currency to another currency at one point in time, with an agreement to reconvert it back to the original currency at a specified time in the future. The rates of both exchanges are agreed to in advance. Swaps provide an efficient mechanism through which banks can meet their foreign-exchange needs over a period of time. Banks are able to use a currency for a period in exchange for another currency that is not needed during that time.

Foreign Exchange Risks, Hedging and Speculation

Foreign Exchange risks are the risks resulting from changes in exchange rates over time and faced by anyone who expects to make or to receive a payment in a foreign currency at a future date.

Hedging is the avoidance of a foreign exchange risk by buying the currency today at the forward market to insure oneself against exchange rate fluctuations – it is called taking a **covered position**. If the individual does not buy the currency today in the forward market and thus exposes himself against the risk, he is taking an **open position**. Hedging is the most common way to avoid the risks involved in transactions involving foreign exchange.

Speculation is the opposite of hedging. A speculator accepts and even seeks out a foreign exchange risk, or an open position in the hope of making a profit e.g. if a speculator believes that the spot rate of dollars will be higher in 3 months than its present 3-month forward rate, he purchases a specified amount of the foreign currency forward for delivery in 3 months. After three months, if he is correct, he receives delivery of dollars at the lower agreed rate and immediately resells it at the higher spot rate, thus realizing a profit. However, if he is wrong and the spot rate in 3 months is lower than the agreed forward rate, he will make a loss. Speculation, essentially, is a kind of betting concerned with the movement (up or down) of exchange rate. When a speculator buys a foreign currency spot or forward in the expectation of reselling it at a higher future spot rate he is said to take a **long position**. When he borrows or sells forward a foreign currency in the expectation of buying it at a future lower price to repay his loan or honour his forward sale contract, the speculator is said to take a **short position** (i.e. he is selling what he does not have now).

2.6 DETERMINATION OF A FLOATING FOREIGN EXCHANGE RATE

In a floating exchange rate system, the central bank allows the exchange rate to adjust to equate the supply and demand of foreign currency. In a free market, the unregulated forces of supply and demand determine currency values as long as central banks do not attempt to stabilize them. The supply and demand for a currency arise from private individuals, corporations, banks, and government agencies other than central banks. In a free market, the equilibrium exchange rate occurs at the point at which the quantity demanded of a foreign currency equals the quantity of that currency supplied. To say that supply and demand determine exchange rates in a free market is at once to say everything and to say nothing. If we are to understand why some currencies depreciate and others appreciate, we must investigate the factors that cause the supply and demand schedules of currencies to change. These factors include **market fundamentals** (economic variables) and **market expectations:**

Market fundamentals include (i) Real income; (ii) Real interest rates; (iii) Inflation rates; and (iv) Consumer preferences for domestic or foreign products.

Let us first briefly discuss how economic fundamentals affect exchange rate. Consider for example the effect of real inflation rate on the exchange rate. If the Indian rate of inflation exceeds the American rates of inflation, the price of Indian goods will increase relative to the price of U.S. goods. As a result, the demand for U.S. commodities will rise relative to the demand of Indian products. In the foreign exchange market, this will lead to an increased demand for dollars and a decreased demand for rupees, and at the same time, an increased supply of rupees and decreased supply of dollars. As a result, the rupee will fall in terms of dollars. Similarly, if the real interest rate is higher in U.S. than in India, capital will flow from U.S. to India, and lead to a similar effect as above, that is, rupee will fall against the dollar.

Market expectations

If the supply and demand for a currency were determined solely by market fundamentals, foreign exchange dealers would have far less stressful jobs. However, the fact that exchange rate, like share prices, is affected by day to day developments or in other words market sentiments makes their task difficult. In the short run, 'herd behavior' dominates the exchange rate movements. Currency values shoot up and down not so much because of market fundamentals but because of the prevailing sentiment that the price of a currency is rising, and therefore one should buy it to make a profit, or vice versa sell the currency if the feeling is that its price is going to fall. Sometimes, a panic like situation prevails. At times, the participants in the foreign exchange market attempt to avoid losses rather than seeking speculative profits, particularly when they observe that the price of a certain currency is incessantly declining. This kind of a situation creates what is known as a panic run. The currencies rise or fall not necessarily dictated by fundamentals.

2.7 INTERNATIONAL MONETARY SYSTEM (IMS)

The International Monetary System (IMS) refers to the rules, customs, instruments and organizations for affecting international payments. IMS can be classified according to the way in which exchange rates are determined or according to the form that international reserve assets take.

Types of Exchange Rates

There are various types of exchange rates which may be in operation.

Fixed exchange rate: In this system, the central bank of a country officially fixes the price of its domestic currency in terms of other currencies, and (in principle) stands ready to buy or sell its domestic currency at a fixed price in terms of some other currency.

Floating exchange rate: Here the central bank of a country allows the exchange rate to adjust to equate the supply and demand of foreign currency.

Dirty/Managed Float: Under managed floating, Central Banks intervene to buy and sell foreign currencies in attempts to influence the speed of adjustment and fluctuation of the exchange rate. Most countries in the world, including India, now have a managed float.

Peg system: It is a form of fixed exchange rate, where the domestic currency is pegged to some major currency, e.g. rupee may be fixed in terms of dollars. Note that here if the dollar value rises or falls in terms of some other currency, so does the rupee's value in terms of that currency. There can be some different forms of pegged exchange rate system as discussed below:

- **Adjustable Peg:** Here the exchange rate is pegged to some major currency, with the stipulation that the exchange rate will be adjusted periodically.

- **Crawling Peg:** Mexico in early 1990's used this system. Here the Mexican peso was pegged to the U.S. dollar, but the exchange rate – pesos per dollar – is adjusted by small pre-announced amounts at regular clearly specified intervals (say 6% devaluation per year). This takes care of inflation rate differences.

Depreciation refers to an increase in the domestic price of foreign currency. **Appreciation** refers to a decline in the domestic price of foreign currency. These terms are used in case of floating exchange rate system.

Devaluation takes place when the price of foreign currencies is increased by official action under a fixed exchange rate system. The opposite of devaluation is **revaluation**.

International Reserves

They are a sum of funds that a country sets aside to finance trade imbalances or intervene in the foreign exchange market to strengthen its currency when it comes to face pressure. In most cases a country's international reserves consist of its holdings of major foreign currencies plus its line of credit at the IMF plus its holdings of SDRs.

Types of International Reserves

Gold Standard (1880-1914): Gold is the only international reserve asset. Each country sets a certain number of units of its currency per ounce of gold, and the composition of the number of units per ounce from country to country is the exchange rate between any two countries on the gold standard. Thus it was a fixed exchange rate system. Each country was ready to buy or sell gold at a particular number of currency units.

Gold Exchange Standard (1944-1971): The US maintained the price of gold fixed at 35$ per ounce, and stayed ready to exchange, on demand, dollars for gold at that price. Thus the US $ became the *central reserve asset.* Other economies were assigned par values in relationship to the US $. It was still a fixed exchange rate system.

Present International Monetary System: In the present international monetary system, operational from 1971, dollar, or for that matter no currency is convertible into gold in any country's central bank. Many of the nations have moved away from the fixed exchange rate system and adopted the 'managed float'. Under such a system, a nation's monetary authorities are entrusted with the responsibility to intervene in foreign exchange markets to smooth out short-term fluctuations in exchange rates without affecting the long–term trends. Therefore the nations still need international reserves to intervene in the foreign exchange markets to smooth out short-run fluctuations. While such interventions are still made with foreign exchange, most of planned increase in international reserves can take place in the form of SDRs.

Special Drawing Rights (SDRs)

SDRs, sometimes called paper gold, are accounting entries in the books of the IMF, which were conceived at the IMF annual meeting at Rio in 1967. The objective then was to make SDR the principal reserve asset in the IMS. Upon approval from 85% of its members the IMF issues SDRs to its member countries who can use them as international reserves to settle international debt. The IMF voting is weighted in such a manner that big nations who have larger deposits in the IMF have more clout. Once the decision to create SDR has been made, the IMF credits each member nation's account with its allocation, which is based on a nations importance to world economy.

There is a limit on the amount of SDRs a creditor nation must accept in settling debts. This limit is up to three times their allocation. That is, if one country is allocated 200 SDRs, till it has not accepted up to 600 SDRs as international debt repayment, it cannot refuse to take SDRs as debt repayment from its debtor countries. SDRs are not backed by gold or any other currency but represent genuine international reserves created by the IMF.

Value of SDR: The value of SDR was initially set equal to one US $, but rose above $1 as a result of the devaluation of the dollar in 1971 and 1973. Starting in 1974, the value of the SDRs was tied to a basket of currencies. At present, it consists of dollar (41.9%), yen (9.4%), Euro (37.4%) and the pound (11.3%) (Wikipedia)

Uses of SDR: Like any form of international liquidity, they primarily benefit nations with balance-of-payments deficits. Some economists argue that it is beneficial to the nations and that SDR creation is one way by which rich nations could help the poor nations.

Secondly, its value remains more stable than that of any single currency. So it is more attractive as a unit of denominating international transactions e.g. future payment on a contract can be agreed to be made in a National currency at its rate in terms of the SDR. Some Swiss and British banks now accept accounts denominated in SDR's.

Despite these obvious advantages of SDRs as central reserve assets, there has been, in general, lack of enthusiasm about them. In 1993, SDR holdings by member countries are only 4% of their non-gold reserves. The reason is that dollar and other hard currencies are more flexible and have more uses, usually yield higher interest returns, and can officially be credited or debited to any one in contrast to the limited numbers with official access to SDRs.

Activity 3

In the Indian context study the depreciation of Rupee from time to time and attempt the following questions:

Identify the sections of Indian industry which were most affected globally. Justify.

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2.8 SUMMARY

International economics deals with flow of goods, services and payments between nations, and the policies directed at regulating this flow and the effect of international transactions on the welfare of nations. Its main components include trade theories, trade policies, foreign exchange markets and the balance of payments.

International trade theory seeks to answer the basis of trade and the pattern of trade. There are various theories that seek to explain the basis of international trade and how nations stand to benefit from it.

According to Absolute Advantage Theory, nations mutually stand to gain if they concentrate on the production of those goods/commodities in which they have absolute advantage, that is, in which they are more efficient than other nations. Mutual exchange of goods between the nations will facilitate the overall world production to the maximum and each nation will benefit from specialization. The Comparative Advantage Theory postulates that nations stand to mutually benefit in the exchange of goods between themselves where each country exports those products in which it is relatively more efficient in production than other countries. Heckscher-Ohlin Model states that it is not merely the labour (or cheap labour) as a factor of production, but also several other factors in which a nation has special or natural advantages/endowments, such as suitable climate, quality soil, availability of capital or high technology, etc which would determine its advantage in foreign trade.

International trade policy deals with Tariffs, Non-tariff, Barriers, Import Quotas, Voluntary Export Restraints, Orderly Market Agreement, etc.

Balance of payments (BoP) of a country is a summary statement of its transactions with other countries during a defined period. While debit transactions involve payments to foreigners, credit transactions involve receipts from foreigners. While the Current Account records exchanges in goods and services, the Capital Account records the net changes in a nation's international financial assets and liabilities over the BoP period.

Foreign exchange market consists of individuals, businesses, governments, banks, and other institutions that buy and sell foreign exchange/currencies and other debt instruments. Foreign exchange transactions include spot, forward, and currency swap transactions. Hedging and speculation are some of the ways by which parties involved in international trade can take care of the risks.

A floating foreign exchange rate is determined by market fundamentals and market expectations.

International monetary system refers to rules, customs, instruments, and organizations that affect international payments. The system deals with various types of exchange rates, peg system, and international reserves.

2.9 KEY WORDS

Absolute Advantage : Advantage arising to a nation from absolute efficiency in the production of a certain commodity/good.

Comparative Advantage : Advantage arising to a nation from (relative) greater efficiency in the production of a certain commodity/good compared to the other nation.

Heckscher-Ohlin Theorem : A postulation that a nation gains by exporting those goods/commodities in the production of which it has abundance of factors(s) of production, and by importing those good/commodities in whose production it has scarcity of factor(s) of production.

Tariff : A tax on imports, e.g., custom duty.

Non-tariff Barriers : Quantitative restrictions imposed on the volume of imports, e.g., quotas, voluntary export restraints (VERs), antidumping restrictions, subsidies, local content requirements, procurement policies etc.

Import Quota : A non-tariff barrier that places a direct restriction on the quantity of a certain good that can be imported from a country, e. g., textile quotas (called the multifibre agreement).

Balance of Payments : A statement that summarizes all payments and receipts of a nation from transactions with other nations.

Current Account : An account that records exchanges in goods and services.

Capital Account : An account that records net changes of a nation's international financial assets and liabilities over the BoP period.

Spot Transaction : Purchase and sale of foreign currency at the prevailing (spot) exchange rate.

Forward transaction : A transaction as a result of an agreement in the present to buy or sell a certain amount of foreign currency at the agreed rate at a specified future date.

Hedging : An arrangement entered into to avoid/minimize foreign exchange risk by buying/selling currency in the present for use at a future date, i. e., to protect from exchange rate fluctuations.

Fixed Exchange Rate : An exchange rate fixed officially by the central bank of a country for converting domestic currency into foreign currencies.

Floating exchange Rate : An exchange rate that is allowed by the central bank to adjust so as to equate supply and demand for a foreign currency.

Peg System : A form of fixed exchange rate where domestic currency is pegged to some major foreign currency, e. g., rupee to dollars.

Special Drawing Rights (SDRs) : Drawing rights issued by the IMF to its member countries for using as international reserves to settle international debt.

2.10 SELF-ASSESSMENT QUESTIONS

1) Discuss the theory of comparative advantage and compare and contrast it with the theory of absolute advantage.

2) What are the main instruments of trade policy? Why are 'tariffs' thought to be superior to 'quotas'?

3) If the balance of payments always balances, how do surpluses and deficits in the balance of payments arise?

4) What are the major foreign exchange markets in the world? What are the most common types of foreign exchange transactions?

5) What are foreign exchange risks and how can they be avoided? What is speculation? Discuss its role.

6) How are exchange rates determined in a floating exchange rate system?

7) What are the main types of foreign exchange regimes?

8) Write a short note on SDRs.

2.11 FURTHER READINGS

i) Daniels, D. John; Radebaugh, H. Lee (2000). International Business- Environments and Operations, New Delhi: Addison Wesley Longman Pte. Ltd. (Chapter 9, 10).

ii) Sundaram, K. Anant; Black, J. Stewart; (2000). The International Business-Environments, New Delhi: Prentice Hall of India. (Chapter 3, 4, 5, 6).

UNIT 3 PROCESS OF GLOBALIZATION

Objectives

After reading this unit you should be able to:

- explain the concept of globalization;
- describe the evolution of globalization in various phases;
- identify the factors which influence the process of globalization;
- describe the importance of industry globalization drivers; and
- explain the strategic implications of global strategy.

Structure

3.1 INTRODUCTION

Globalization has long been considered similar to internationalization. However, globalization is a broader concept which extends beyond integration of market and influences all aspects of international economy. Its evolution can be traced to the beginning of 19th century and it has developed in different phases to the present times. It has led to the integration of the world economy which has added an element of interdependence. The process of globalization deals with the integration of global economies, global strategies, global industry and global markets. There are certain globalization identifiers which have been termed as industry globalization drivers. These include all major industry external drivers which affect the potential for globalization. Globalization also has strategic implications which are in the form of international alliances, organizational challenges, Government relations and competition. In this Unit we will discuss different aspects of globalization.

3.2 CONCEPT AND MEANING OF GLOBALIZATION

'Globalization may be hard to define, because the term "globalization" could be defined from different points of view. Globalization is perhaps the most important force at work in contemporary society, business, management and economics (Stonehouse et. al., 2004). While some people think of globalization as primarily synonym to global business, it is much more than that. *Economic globalization* has been joined by *political globalization*, leading to providing opportunities to respond to globalization challenges. *Technological globalization* accelerated the rapid diffusion of free enterprise through new means of communication. Many new opportunities are coming from advances in computer technology. E-commerce and Internet are changing many a selling and purchasing process. The Internet has emerged as a vital tool linking enterprises/firms internally and externally with customers, strategic partners and critical suppliers. The computer network expanded technological possibilities of data exchange with 200 countries (Krajewski et.al. 2005). Together, economic, political and technological globalization has spawned a new phenomenon called *psychological globalization* which is defined as deepening relationships and broadening interdependence among people from different countries (Kluyver et al., 2003; Daniels et al., 2002; *Grazina J and Marija K., Ekonomika 2006).*

As per UNESCO globalization can be defined as a set of economic, social, technological, political and cultural structures and processes arising from the changing character of production, consumption and trade of goods and assets that comprise the base of the international political economy.

Globalisation can also be defined as the world-wide spread of production and technology promoted by unrestricted mobility of capital and freedom of trade. It involves the interconnection of countries, as well as an increase in the impact of international situations on all aspects of economic activity. The spread of globalisation has also resulted in the coming together of disparate cultures, political systems and patterns of economic development (www.exampleessays.com).

In recent years, globalization has become a key concept/theme in every research or conference relating to international business/international marketing strategy. Ever since Levitt's (1983) article on globalization of markets was published, academics and practitioners have debated whether international markets are becoming homogenous, and if the international marketing paradigm ought to change from highlighting national differences to exploring international similarities. In the field of management, the term globalization has often been used interchangeably with internationalization.

For managers, globalization is not only a curiosity, but also an actuality that has to be dealt with on a daily basis. Managers, like scholars, however, are also diverse in their thinking and attitudes toward globalization. Christopher Rodriguez, the then CEO of Thomas Cook Group, views globalization in a very narrow way as "running a global business from a global center." Similarly, Richard Grasso, the then Chairman and CEO of the New York Stock Exchange, treats globalization as an economic trend: "Global markets when they are realized in their entirety, are the ultimate result of a trend now under way … called globalization."

Percy Barnevik, CEO of Asia Brown Boveri, goes further in his view of globalization: "What I mean by globalization is not only that you export to other markets and compete with people there - but also that you have a presence in [product] development and indeed, in manufacturing in many markets". Harry Stonecipher, President and CEO of McDonnell Douglas, views globalization as "the whole movement toward a single world economy and a single world society." Previously, Edwin Artzt, Chairman and CEO, P&G, provided a more comprehensive definition of globalization in the business world:

> Globalization means doing a better job than your competitors at satisfying consumers' needs and their demand for quality, no matter where they live. It means creating the network and infrastructure to efficiently compete in the increasingly homogeneous worldwide marketplace. Globalization has special meaning to Procter & Gamble. It means that we will continue to change from a United States-based business that sells some of its products in international markets to a truly world company. A company that thinks of everything it does - including the development of products – in terms of the entire world.

Keeping in view the various interpretations discussed in the preceding paragraphs, globalization may be defined as a process which is built on the collective understanding of the need to establish a world community that is prosperous and tolerant, and on the respect for and equitable treatment of people across the globe. It is a process that enhances and strengthens global understanding and improves the quality and effectiveness of business, professional, and personal interactions through unrestricted access to world commodities, technology, and information. Thus, globalization can be defined as a set of beliefs that foster a sense of connectivity, interdependence, and integration in the world community. It highlights commonalties without overlooking differences, and it extends benefits and responsibilities on a global scale. At the firm level, globalization should mean the ability of a corporation to conduct business across borders in an open market, maximizing organizational benefits, without inflicting social damage or violating the rights of people from other cultures.

In today's business environment, global corporations stress objectivity in the treatment of issues across the globe and have the courage to confront biases and prejudices. They should not behave like a "colonial entity" that is interested only in making profits and reinvesting them in the "home market." Global corporations should treat globalization as a view and outlook that broadens and energizes human minds and perspectives. Practically and spiritually, globalization must be an inclusive, rather than an exclusive, endeavor.

Globalization reflects the growth of economic activities spanning politically defined national and regional boundaries. The firms in globalization aim at the 'world' market and do not restrict themselves to the country or regional markets; they aim at developing products for the whole world, i.e., global products which can be standardized across the world to reap the benefits of economies of scale in production and marketing. It leads to increased movement of goods and services, namely trade and investment, and often of people via migration across the boundaries. It is driven by the actions of individual economic actors – firms, banks, people – usually in the pursuit of profit and often spurred by the pressures of competition. Thus, globalization looks at the world as a whole and considers it as a single unified market. It often involves the creation of a single strategy for a product or service by a company for the entire global market. It encompasses many markets or countries simultaneously and is aimed at leveraging the commonalities across many markets.

According to Theodore Leavitt (1983), the emergence of global markets has come up because of advances in technology, communication, transport, etc. The global corporations are geared to what he calls 'the new reality'. These firms attempt to benefit from enormous economies of scale in production, distribution, marketing and management which can result in reduced prices for consumers all over the world. A firm that is involved in global business is a **global firm** and is often characterized by standardized products, specialized activities like R&D performed usually at the headquarters, uniform market positioning, and an integrated competitive strategy across the markets in the world.

A word of caution is in order. Though a global firm usually aims at standardization as a part of its corporate philosophy, however, in implementing such a strategy, firms are careful and selective in their approach and recognize their limitations. Few companies pursue the extreme position of complete standardization in regard to all the elements of the marketing mix and business functions such as R&D, manufacturing and procurement in countries throughout the world. Some degree of adaptation is likely to occur relative to certain aspects of the firm's operations or in certain geographic areas. In addition, the feasibility of implementing a standardization strategy will depend on certain factors which can be categorized into four major groups: market characteristics, industry conditions, marketing institutions, and legal restrictions.

Having discussed the concept of globalization in sufficient detail, we now turn our attention to another aspect, i.e., the origin and evolution of globalization.

Activity 1

Identify two firms which have expanded their operations from domestic to global market and analyze how they have gained due to globalization.

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3.3 THE EVOLUTION OF GLOBALIZATION

Origin of Globalization

Globalization is the process which was completed in the 20th century when the Capitalist world system had spread across the globe. Globalization is not a new phenomenon as the world system has maintained some of its main features over several centuries. In the beginning of 14th century modern world system originated in parts of Western Europe which was experiencing long term crisis of feudalism. This paved the way to the rise of market institutions and technological innovation. Europeans reached other parts of globe through the long-distance trade and advances in production. Accumulation of wealth took place in Europe as a result of superior military strength and improved means of transportation which further facilitated in establishing economic ties.

During 16th century a process of colonization has started in which colonies provided unskilled labour, raw material and market for goods while capital intensive production was the prerogative of the Europeans who acted as capitalists. The Capitalists thus succeeded in geographic and occupational division of labour.' (Source: www.sociology.emory.edu/globalization/theories01.html)

Stages of Globalization

There are various stages of globalization.

Cavusgil et. al., (2009) have identified four distinct stages of globalization beginning the 1800s. Each stage of the evolution is marked by changes in technological innovations and international trends.

The ***first stage of globalization*** which started in 1830 became more stabilized by 1880. This period was marked by the growth of global business due to development of railroads, ocean transport, manufacturing and trading companies. Telegraph and telephone were newly invented which gave further impetus to information flows between nations and facilitated the management of supply chains by the companies.

The ***second stage of globalization*** which started around 1900 was marked by the increase in electricity and steel production. This stage of globalization reached its climax during the Great Depression of 1929. Western Europe was the most industrially developed region of the world in 1900. Multinational firms were established as a result of European colonization of Asia, Middle East and Africa. Companies like Seimens, Nestle, Shell and British Petroleum had established their subsidiaries in various parts of the world. Before 1914 (First World War), many companies were established at the global level.

The ***third stage of globalization*** started around 1945 after World War II when Europe and Japan were devastated by war and USA emerged as a dominant power. During the war the trade barriers were high. Soon the developed countries wished to lessen the barriers to international trade. This led to Bretton Woods Conference of 1947 in which 23 countries participated and culminated in the setting up of General Agreement on Tariffs and Trade (GATT) which sought to liberalize trade and investment by reducing barriers. This gave impetus to industrialization, modernization and improving the standard of living. GATT was subsequently replaced by another multilateral agency, that is, World Trade Organization (WTO) which was also established to regulate international trade and investment and to introduce equity and fairness in global exchange. To further facilitate international co-operation, two international organizations - International Monetary Fund and World Bank - were set up. This was followed by the rise of multinational corporations (MNC's) like Coco-Cola, Philips and IBM who established their global presence by the virtue of technological and competitive advantages and started outsourcing their business to developing countries to reap the benefits of cheap labour and easy access to wide markets.

By 1960's the increase in the process of liberalization by removing trade barriers and currency controls led to increase in international trade and investment and integrated international financial markets. This was followed by increasing competition between US, European and Japanese MNCs.

1980s marked the beginning of the ***fourth and present stage of globalization*** which experienced increasing global trade and investment. This stage witnessed use of computer, Internet, and development of information and communication technologies. This period saw the disintegration of Soviet Union, emergence of market economies of Europe and development of countries like China, Brazil, India and Mexico. Technological advancements in transportation, information and communication led to integration of world economy and also facilitated development of services like insurance, banking, entertainment, retailing and tourism. This was followed by strategic alliances like mergers and acquisitions among corporate units and the world came to be known as a 'global village'.

The four stages of globalization, with their triggers and key characteristics are presented in Table 3.1.

Table 3.1: Stages of Globalization

Stages of Globalization	Period	Triggers	Key Characteristics
First Stage	1830 to late 1800s, peaking in 1880	Introduction of railroads and ocean transport	Rise of manufacturing, cross-border trade of commodities, largely by trading companies
Second Stage	1900 to 1930	Rise of electricity and steel production	Emergence and dominance of early multinational enterprises (primarily European and North American) in manufacturing, extractive, and agricultural industries
Third Stage	1948 to 1970s	Formation of General Agreement on Tariff and Trade (GATT); End of World War II; Marshall Plan to reconstruct Europe	Concerted effort on the part of industrializing Western countries to gradually reduce barriers to trade; rise of multinational companies from Japan; cross-border flow of money paralleling the development of global capital markets.
Fourth Stage	1980s to the present	Radical advances in information, communication, manufacturing, and consultation technologies; privatization of state-owned enterprises in developing countries; remarkable economic growth in emerging markets	Unprecedented rate of growth in cross-border trade of products, services, and capital; participation in international business of small and large companies by investors from many companies; focus on emerging markets for export, FDI, and sourcing activities.

Source: Cavusgil S.T, Knight G., Riesenberger J.R (2009), International Business: Strategy, Management and the new Realities, Pearson.

Now you have a fair idea of how present day globalization evolved. We shall now briefly discuss the effects of globalization.

3.4 EFFECTS OF GLOBALIZATION

In Section 3.2 we have examined several definitions of globalization given by various thinkers. You might have noted a common feature of the definitions by these thinkers who regard globalization as a process of increasing the economic, political, cultural and technological interdependence among nations and countries. Globalization is a process by which there is an increase in inter-connection and dependence between nations, people and businesses through greater cross-country mobility, communication and cross-cultural exchanges. Thus globalization process has given impetus to greater global production and distribution of products and services of a homogeneous kind on a world-wide basis. Now we can demarcate the separate areas of the effects of the process of globalization. These areas of effects of globalization are as follows:

1) **Integration of Economies**: This is due to the increase in interdependence between countries on a world-wide basis.

2) **Integration of Strategy**: A global strategy would require establishing the brand name and products in prominent markets world wide, in order to reap the benefits of competitive advantage. This further facilitates integration of global vision, business strategy and business activities throughout the world.

3) **Integration of Industries**: This facilitates the increase in integration of production activity and distribution of value added goods world wide on the basis of competitive advantage enjoyed. Global industries are interdependent industries which enjoy location advantages by virtue of their presence in host, parent or third world countries.

4) **Integration of Markets**: The name and brand of products are popularly known in various markets. This has created homogeneity in tastes and liking of end users for a product in specific markets.

The process of globalization integrates global economies, global strategy, global industries, global markets, global drivers and global players in order to create organizations for global environment. It has created integration of services, resources and products thus creating a boundary-less environment (Grazina J., Marija K., 2006).

3.5 INDUSTRY GLOBALIZATION DRIVERS

An industry globalizes because of the occurrence of certain factors. From that standpoint every industry cannot be a global one. There are certain drivers which determine the potential for industry globalization.

There are four broad groups of industry globalization drivers – M**arket**, **Cost, Government and Competition** (Table-3.2). Together, these four sets of drivers cover all the major critical industry conditions that affect the potential for globalization. The drivers are primarily uncontrollable by the worldwide business. Each industry has a level of globalization potential that is determined by these external drivers.

Table 3.2: Industry Globalization Drivers

Market Drivers	Cost/ Economic Drivers
• Convergence of lifestyles & tastes • Increased travel creating global consumer • Growth of global and regional channels • Establishment of world brands • Push to develop global advertising • Shortening product life cycle	• Continuing push for economies of scale • Accelerating technological innovation • Advances in transportation • Emergence of Newly Industrialized Countries (NICs) • Increasing cost of product development

Government Drivers	Competitive Drivers
• Reduction of tariff barriers • Creation of trading blocks • Decline in role of government • Reduction in non-tariff barriers • Shift in open market economies	• Increase in level of world trade • Increase in foreign acquisition of corporations • Companies becoming globally centered • Increased formation of global strategic alliances • Globalization of financial markets

Source: Yip, G.S. (1992). Total Global Strategy: Managing for Worldwide Competitive Advantage. Englewood Cliffs, NJ: *Prentice Hall*.

Proponents of global marketing argue that because market needs are homogenous, country differences are less relevant to international marketing planning. Yet, others assert that the existence of global markets is a "myth". They point to the many contradictory trends around the world, suggesting stark differences in national markets and hence the need for adaptation and customization of international marketing, based on individual country differences.

The removal of trade barriers and the growing similarity of national markets created the potential for globalization of markets and competition. The development of MNCs, or of global networks allying independent firms, and the technology of cheap, effective transportation and communication provided the practical means necessary for the integration of supply. These conditions were necessary, but not sufficient. Intense competition in most industries was the driving force necessary for integration and globalization.

A discussion on globalization (for example, Cavusgil and Zou, 1994) has shifted the attention to a more fundamental issue: the underlying motives of the firm. Jain (1989) asserts that strategy adaptation (versus globalization) is the means to an end - the establishment of a firm's economic assets and competitive position in the marketplace. The fundamental question is 'when a firm operates in an overseas market, what are its ultimate objectives?' The need to broaden the discussion to include the firm's strategic perspective in this debate has been articulated by several authors (e.g., Walters; Douglas and Craig; and Szymanski, Bhardwaj and Vardarajan).

Until recently, studies have treated a firm's choice of its global or local strategy, as the outcome variable, that is the result of a firm's marketing plan. Recent studies have expanded this limited scope, to study how global or local strategies affect the overall position of the firm. Douglas and Wind and Jain point out that one key payoff of the decision on globalization and adaptation is the competitive advantage of the firm. While discussing alternative product policy options for firms, Walters and Toyne, emphasize the need to evaluate such options in the context of the competitive strategy of the firm.

The following four factors affect a company's ability to formulate and implement global strategy:

- **Organization structure** comprises the reporting relationships in a business - the 'boxes and lines'.
- **Management process** comprises the activities such as planning and budgeting that make the business run.
- **People** comprise the human resources of the worldwide business and include both managers and all other employees.

- **Culture** comprises the values and unwritten rules that guide behavior in a corporation.

Figure 3.1 elaborates the above factors further. The figure gives an overview about the external drives of industry potential for global strategy.

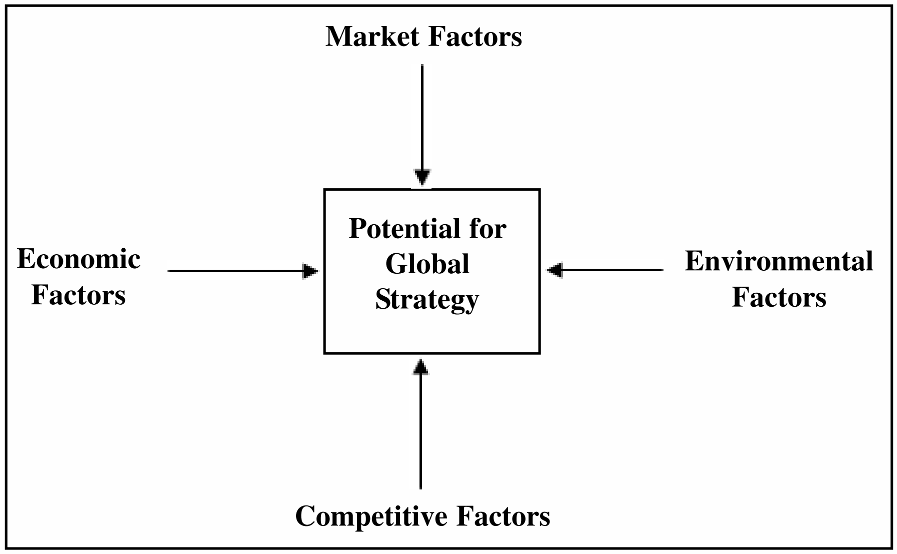

Figure 3.1: External Drivers of Industry Potential for Globalization

The potential for global strategy include following four **factors:**

- **Market Factors:** These include the homogenous market needs, the global customers/consumers, transferable brands and promotional strategies and internationalization of the distribution channels. These factors affect the competitiveness of the industry.
- **Economic Factors:** These factors include the global economies of scale in manufacturing and distribution, world wide sourcing efficiencies and significant differences in country costs.
- **Environmental Factors:** The factors like falling transportation costs, improved networking thereby improving the communication, changes in government policies and frequent technological advances act as external drivers for the industry.
- **Competitive Factors:** The factors like competitive interdependence among countries, global moves of competitors and the prevailing opportunities to pre-empt the global moves of the competitors work as an aid for developing a global strategy.

Besides these, to become globally competitive, the company needs to focus on the following:

- Developing a marketing plan with universal appeal.
- Help employees understand the company's global vision.
- Learning from mistakes that others have made in the past.
- Select the right partners for joint ventures overseas.

Activity 2

Identify a MNC of your choice and analyze the factors which helped it to formulate its market plan and select partners for joint ventures.

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3.6 STRATEGIC IMPLICATIONS OF GLOBALIZATION

As pattern of international competition shifts towards globalization, there are many implications for strategy formulation. In a global industry, functions of finance, marketing, business and Government relationship change according to global configuration and coordination.

a) **International Alliances:** International alliance is an implication of globalization. International coalition, linking firms of the same industry based in different countries have become an even more important part of global strategy.

b) **Organizational Challenges :** The need to configure and co-ordinate globally in complex ways creates some obvious organizational challenges such as organizational structure, reporting hierarchies, communication linkages and reward mechanisms.

c) **Relations with Government:** In the globalized era, the selection of foreign markets to enter and the mode of entry will, by and large, depend on the negotiations with the foreign Government. The 'muscle power' of the global firm can be crucial in determining the shift of power equilibrium. A global firm must 'manage' its relationship with the foreign Government to its advantage. A shining example of what happens if it fails to do so is Enron in India.

d) **Competition:** A global firm may be in a better position to compete with its global rivals as it can augment its resources globally.

These implications of globalization will lead companies to take care of these issues forcing them to formulate an appropriate strategy to handle them. Levitt (1983) has given an illustration of various forces affecting global integration. These are summarized in table 3.2.

Table 3.2: Forces Affecting Global Integration

Global Integration	
Driving Forces (Drivers)	**Restraining Forces**
Technology	Culture
Culture	Market Differences
Market needs	Costs
Costs	National Controls
Free Markets	Nationalism
Economic Integration	War
Peace	Management Myopia
Management Vision	Organization History
Strategic Intent	Domestic Forces
Global Strategy and Action	

The remarkable growth of the global economy over the past 50 years has been shaped by the dynamic interplay of various driving and restraining forces. During most of those decades, companies from different parts of the world in different industries achieved great success by using global strategies. During the 1990s, changes in the business environment have presented a number of challenges to established ways of doing business. Today, the growing importance of global business stems from the fact that driving forces have more momentum than the restraining forces.

It is, however, important to recognize that in the near future financial and trade activities will still be the dominant forces and features of globalization. Nevertheless, it is essential to point out that trade is only one of the myriad of worldwide activities related to globalization. Free movement of capital, goods, and labour and the establishment of a civil society, where cultural and political tolerances are the norms, are the foundations for true globalization.

3.7 SUMMARY

To sum up, the pillars of globalization are open trade and vital civil and legal institutions that uphold individual and group rights while facilitating social and economic integration. The benefits of international trade are numerous, e.g., job creation, improving customer welfare, stimulating economic growth, and so on. Nevertheless, limiting globalization only to trade and the profits associated with increasing trade volumes does not do justice to growing beliefs and practices that aim at establishing a prosperous and stable world. In other words, globalization cannot just be synonymous to trade volume and export profits. It is an orientation that seeks to enhance and strengthen global understanding and effective business, professional, and personal interactions. The focus on trade volume and on export limits the ability and capacity of people to become involved in activities that release energy and stimulate global thinking and behavior. In addition, focusing on trade volume alone may prevent individuals and organizations alike from moving forward in advancing causes and programs that are not profit-oriented. While it is a misjudgment to discount the importance of profit-oriented activities in furthering globalization aims, it is equally a mistake to disregard non-business activities. These activities are expected to be crucial for strengthening global thinking and practice in the decades to come.

3.8 KEY WORDS

Globalization : Globalization can be defined as the growth of economic activity spanning politically defined national and regional boundaries. It leads to the increased movement of goods and services across boundaries, namely, trade and investment, often of people via migration. It is driven by the actions of individual economic actors – firms, banks, and people – usually in the pursuit of profit and often spurred by the pressures of competition.

Strategy : Actions managers take to attain the firm's goals during a particular period.

Standardization : As a policy, a MNE offers standardized, that is, same marketing-mix (product, price, promotion and place) across all the markets that it operates all over the world. It considers world as a single market and hence offers identical marketing-mix all over.

Adaptation Policy : Adaptation policy suggests that the country markets are different due to socio-cultural, economic, political and legal environmental forces. Hence, a firm must offer differentiated marketing-mix as per the specific requirements of the country market that it operates in.

3.9 SELF-ASSESSMENT QUESTIONS

1) Define globalization in your own words.
2) Discuss the different stages of globalization and give two examples for each stage that facilitated the process of globalization.
3) What have been the effects of globalization? Explain with examples.
4) "A global shampoo company should make a global shampoo, a global automobile company should make a global car and a global tractor company should make a global tractor". Do you agree with this statement? Why or why not? Discuss in terms of globalization.
5) What forces have been driving the development of globalization? Discuss.
6) How do global products, functional area and customer approaches to organizations differ? How are they similar? Explain in relation to the industry globalization drivers.
7) What are the strategic implications of globalization? Discuss by citing a recent example.
8) What are the main challenges that are faced by international managers in managing and controlling a global business activity? What advice would you like to give to a manager who is involved with global operations?

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