A Framework for International Business **(Cavusgil/Knight/Riesenberger)**
Chapter 2 Theories of International Trade and Investment

1) Farm land, diamond mines, and good climate conditions would all be categorized as comparative advantages for a region.
Answer: TRUE
Diff: 1 Page Ref: 28-29
Skill: Concept
Objective: 2-1
AACSB: Dynamics of the global economy

2) The earliest efforts to explain international business emerged in the early 20th century.
Answer: FALSE
Diff: 1 Page Ref: 27
Skill: Concept
Objective: 2-1
AACSB: Dynamics of the global economy

3) Modern business executives use the term comparative advantage when referring to the assets of individual firms.
Answer: FALSE
Diff: 2 Page Ref: 25
Skill: Concept
Objective: 2-1
AACSB: Dynamics of the global economy

4) Specialization prohibits industries and laborers from being productive and profitable in the arena of international trade.
Answer: FALSE
Diff: 2 Page Ref: 144
Skill: Concept
Objective: 5.1, 5..2, 5.3, 5.4
AACSB: Dynamics of the global economy

5) In Adam Smith's opinion, mercantilism has a positive impact on a nation's wealth because it makes many wealthy people wealthier.
Answer: FALSE
Diff: 1 Page Ref: 26-27
Skill: Concept
Objective: 2-2
AACSB: Dynamics of the global economy

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6) In theory, nations which adhere to the absolute advantage principle will have higher standards of living than nations which follow principles of mercantilism.
Answer: TRUE
Diff: 2 Page Ref: 27
Skill: Concept
Objective: 2-2
AACSB: Dynamics of the global economy

7) Modern globalization is associated with efforts by many governments to develop policies intended to encourage competitive advantage.
Answer: TRUE
Diff: 1 Page Ref: 31
Skill: Concept
Objective: 2-3
AACSB: Dynamics of the global economy

8) Successful software and computer firms in the United States and India sustain competitive advantages by investing in research and development.
Answer: TRUE
Diff: 2 Page Ref: 33
Skill: Concept
Objective: 2-3
AACSB: Dynamics of the global economy

9) In the contemporary world of international trade and investment, the most important source of national advantage is a country's natural resources.
Answer: FALSE
Diff: 2 Page Ref: 31-32
Skill: Concept
Objective: 2-3
AACSB: Dynamics of the global economy

10) National industrial policies typically involve the creation of bureaucratic regulatory systems which discourage citizens from seeking advanced education.
Answer: FALSE
Diff: 2 Page Ref: 33
Skill: Concept
Objective: 2-3
AACSB: Dynamics of the global economy

11) According to the internationalization process model, internationalization takes place in incremental stages over a long time.
Answer: TRUE
Diff: 1 Page Ref: 34
Skill: Concept
Objective: 2-4
AACSB: Dynamics of the global economy

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12) The total value of assets that MNEs own abroad through their investment activities is measured in FDI stock.
Answer: TRUE
Diff: 1 Page Ref: 34
Skill: Concept
Objective: 2-5
AACSB: Dynamics of the global economy

13) Monopolistic advantage theory is a framework for determining the extent and pattern of foreign-based value-chain operations.
Answer: FALSE
Diff: 2 Page Ref: 35-36
Skill: Concept
Objective: 2-5
AACSB: Dynamics of the global economy

14) Which of the following industries in Dubai contributes less than 10 percent towards the nation's GDP?
A) shipping
B) technology
C) financial
D) oil and gas
Answer: D
Diff: 2 Page Ref: 142
Skill: Application
Objective: 5.1, 5..2, 5.3, 5.4
AACSB: Dynamics of the global economy

15) Which of the following features would be considered the primary comparative advantage for the Persian Gulf nations?
A) petroleum
B) technology
C) infrastructures
D) education
Answer: A
Diff: 1 Page Ref: 25
Skill: Application
Objective: 2-1
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16) All of the following are comparative advantages that develop with time except ________.
A) entrepreneurial orientation
B) venture capital availability
C) innovative capacity
D) natural endowments
Answer: D
Diff: 2 Page Ref: 28-29
Skill: Concept
Objective: 2-2
AACSB: Dynamics of the global economy

17) Which of the following statements is a characteristic of a competitive advantage?
A) A competitive advantage is derived from deliberate national policies.
B) A competitive advantage is difficult for competitors to imitate.
C) A competitive advantage is also known as a country-specific advantage.
D) A competitive advantage includes acquired resources, such as labor.
Answer: B
Diff: 3 Page Ref: 25
Skill: Concept
Objective: 2-1
AACSB: Dynamics of the global economy

18) Theories regarding international trade and investment are categorized into which two groups?
A) classical and national
B) firm-level and comparative
C) nation-level and firm-level
D) competitive and comparative
Answer: C
Diff: 1 Page Ref: 25-26
Skill: Concept
Objective: 2-1
AACSB: Dynamics of the global economy

19) Born globals and firm internationalization are categorized under which of the following theories of international trade and investment?
A) nation-level theory
B) firm-level theory
C) competitive advantage
D) comparative advantage
Answer: B
Diff: 2 Page Ref: 25
Skill: Concept
Objective: 2-1
AACSB: Dynamics of the global economy

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20) The idea that exports should be maximized and imports should be minimized is known by which of the following terms?
A) absolute advantage principle
B) comparative advantage principle
C) factor proportions theory
D) the mercantilist view
Answer: D
Diff: 1 Page Ref: 26
Skill: Concept
Objective: 2-2
AACSB: Dynamics of the global economy

21) Which of the following statements best explains the reason that many economists adhere to the concept of free trade between nations?
A) Unrestricted international trade increases the prosperity of poor nations.
B) Lower-cost imports reduce the expenses of firms by reducing wages.
C) Domestic product prices tend to remain lower than imported products.
D) Inexpensive exports increase consumer prosperity by reducing expenses.
Answer: A
Diff: 3 Page Ref: 26
Skill: Concept
Objective: 2-2
AACSB: Dynamics of the global economy

22) The idea that each nation is efficient in the production of some goods and less efficient in the production of other goods underlies which of the following concepts?
A) absolute advantage principle
B) comparative advantage principle
C) factor proportions theory
D) international product cycle theory
Answer: A
Diff: 2 Page Ref: 27
Skill: Concept
Objective: 2-2
AACSB: Dynamics of the global economy

23) Considering the relative efficiency held by nations led to which of the following concepts regarding the rationale for international trade?
A) monopolistic advantage theory
B) internalization theory
C) absolute advantage principle
D) comparative advantage principle
Answer: D
Diff: 2 Page Ref: 28
Skill: Concept
Objective: 2-2
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24) All of the following statements characterize the comparative advantage principle except ________.
A) the principle provides the foundation for modern international trade
B) cost of production is less important than the ratio of production
C) the exportation of labor-intensive goods should be emphasized
D) nations can trade profitably even if manufacturing costs are high
Answer: C
Diff: 3 Page Ref: 28-29
Skill: Concept
Objective: 2-2
AACSB: Dynamics of the global economy

25) Modern international trade is hindered by all of the following except ________.
A) shipping
B) tariffs
C) regulations
D) technology
Answer: D
Diff: 1 Page Ref: 29
Skill: Concept
Objective: 2-2
AACSB: Dynamics of the global economy

26) According to the factor proportions theory, nations with an ample labor supply of low-skill labor, such as Mexico, should ________.
A) export wheat and import toys
B) export automobiles and import wool
C) export textiles and import pharmaceuticals
D) export beef and import electronics
Answer: C
Diff: 2 Page Ref: 30
Skill: Concept
Objective: 2-2
AACSB: Dynamics of the global economy

27) Which of the following was the analysis revealed by the Leontief paradox in the 1950s?
A) Despite an abundant pool of labor, the U.S. was exporting capital-intensive goods.
B) Despite having abundant capital, the U.S. was exporting labor-intensive goods.
C) Despite plentiful natural resources, the U.S. was importing oil and gas.
D) Despite a large agricultural network, the U.S. was importing grains.
Answer: B
Diff: 3 Page Ref: 30
Skill: Concept
Objective: 2-2
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28) According to the international product cycle theory, inventors of a product earn the most profits at which of the following stages?
A) evolution
B) introduction
C) growth
D) maturity
Answer: B
Diff: 2 Page Ref: 30
Skill: Concept
Objective: 2-2
AACSB: Dynamics of the global economy

29) Which of the following is not an element of Porter's Diamond Model?
A) firm strategy, structure, and rivalry
B) demand conditions
C) quality of production
D) factor conditions
Answer: C
Diff: 2 Page Ref: 32-33
Skill: Concept
Objective: 2-3
AACSB: Dynamics of the global economy

30) All of the following are methods of innovation used by companies except ________.
A) design modifications
B) marketing alterations
C) production changes
D) capital outlays
Answer: D
Diff: 2 Page Ref: 32
Skill: Concept
Objective: 2-3
AACSB: Dynamics of the global economy

31) A nation's factor endowments help determine which of the following?
A) national competitive advantage
B) demand conditions
C) national comparative advantage
D) industrial clusters
Answer: A
Diff: 1 Page Ref: 32
Skill: Concept
Objective: 2-3
AACSB: Dynamics of the global economy

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32) Northern Italy is recognized as a(n) ________ for the fashion industry.
A) economic hub
B) industrial cluster
C) competitive advantage
D) diamond model
Answer: B
Diff: 1 Page Ref: 33
Skill: Concept
Objective: 2-3
AACSB: Dynamics of the global economy

33) Which of the following statements would be supported by Michael Porter?
A) Economic prosperity depends on inherited national advantages.
B) Company structure inhibits creativity and competition.
C) Excessive competition drives focal firms to rival nations.
D) Rivalry among industry competitors spurs innovation.
Answer: D
Diff: 3 Page Ref: 32
Skill: Critical Thinking
Objective: 2-3
AACSB: Dynamics of the global economy; Reflective thinking skills

34) The collaboration between public and private sectors in an attempt to initiate economic development is known by which of the following terms?
A) national endowment policy
B) national fiscal policy
C) national industrial policy
D) national globalization policy
Answer: C
Diff: 2 Page Ref: 33
Skill: Concept
Objective: 2-3
AACSB: Dynamics of the global economy

35) An industrial cluster can best be described as ________.
A) factories and their support systems in a particular location
B) a synergy of various firms and suppliers
C) Silicon Valley
D) a concentration of supporting factors in the same industry in one place
Answer: D
Diff: 2 Page Ref: 33
Skill: Application
Objective: 2-3
AACSB: Dynamics of the global economy

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36) How do nations that lack natural or other resources compete in international business and trade?
A) Governments continue to encourage the export of goods and services that have been historically profitable.
B) Competitive advantages are initiated by multinational focal firms that manufacture products in impoverished nations.
C) Nations create their own competitive advantages by investing in education, industry, and infrastructures.
D) National industries are created and large public works projects are initiated to create employment opportunities.
Answer: C
Diff: 3 Page Ref: 33
Skill: Concept
Objective: 2-3
AACSB: Dynamics of the global economy

37) A comparative advantage is also called a(n) ________.
A) country advantage
B) location-specific advantage
C) inexpensive benefit capability
D) innovative capacity
Answer: B
Diff: 3 Page Ref: 31
Skill: Concept
Objective: 2-3
AACSB: Dynamics of the global economy; Reflective thinking skills

38) In internationalization process of a firm, what is the simplest form of international activity?
A) importing technology
B) exporting products
C) planning and research
D) establishing an overseas presence
Answer: B
Diff: 2 Page Ref: 34
Skill: Concept
Objective: 2-4
AACSB: Dynamics of the global economy

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39) In the internationalization process, most firms do not engage in ________.
A) export activity
B) foreign marketing
C) cross-border transactions
D) extensive analysis and planning
Answer: D
Diff: 1 Page Ref: 34
Skill: Concept
Objective: 2-4
AACSB: Dynamics of the global economy

40) What is suggested by the increasing number of early internationalizing focal firms?
A) Born globals will become typical in the world of international trade.
B) The size of born globals cannot sustain the rigors of international trade.
C) Competition among born globals will eliminate multinational enterprises.
D) The economic stability of born globals threatens international trade.
Answer: A
Diff: 3 Page Ref: 34
Skill: Concept
Objective: 2-4
AACSB: Dynamics of the global economy

41) The importance of multinational enterprises on international trade and business ranks as a(n) ________.
A) development with much the same impact as the availability of electric power
B) historic event
C) invention not unlike manned flight
D) all of the above
Answer: D
Diff: 2 Page Ref: 34
Skill: Concept
Objective: 2-5
AACSB: Dynamics of the global economy

42) Which theory supports the idea that a firm chooses FDI as an entry strategy because an MNE can operate foreign subsidiaries more profitably than a local firm?
A) factor proportions theory
B) eclectic paradigm
C) internalization theory
D) monopolistic advantage theory
Answer: D
Diff: 2 Page Ref: 34-35
Skill: Concept
Objective: 2-5
AACSB: Dynamics of the global economy

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43) Which of the following is a benefit of internalizing foreign-based value-chain activities?
A) The MNE maintains a monopolistic presence in foreign countries.
B) The MNE eliminates the expense of freight forwarders and customs brokers.
C) The MNE oversees control of foreign operations and ensures product quality.
D) The MNE learns new manufacturing methods from foreign partners.
Answer: C
Diff: 3 Page Ref: 36
Skill: Application
Objective: 2-5
AACSB: Dynamics of the global economy

44) Which of the following is considered an important monopolistic advantage?
A) physical assets
B) skilled labor
C) inexpensive capital
D) proprietary knowledge
Answer: D
Diff: 1 Page Ref: 35
Skill: Concept
Objective: 2-5
AACSB: Dynamics of the global economy

45) All of the following are typical examples of ownership-specific advantages except ________.
A) marketing skills
B) natural resources
C) economies of scale
D) trademarks
Answer: B
Diff: 2 Page Ref: 37
Skill: Application
Objective: 2-5
AACSB: Dynamics of the global economy

46) Which of the following terms is used to refer to a collaborative venture which results in a new legal entity?
A) strategic alliance
B) collaborative partnership
C) joint venture
D) equity consortium
Answer: C
Diff: 1 Page Ref: 38
Skill: Concept
Objective: 2-5
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47) Networks are relational assets that are conducted with all of the following entities except ________.
A) government and consultants
B) buyers and sellers
C) suppliers and distributors
D) none of the above
Answer: D
Diff: 3 Page Ref: 38
Skill: Concept
Objective: 2-5
AACSB: Dynamics of the global economy

Mercantilism Assignment (Scenario)
The final assignment for Daniel Parilla's international business class involves taking an in-depth look at one of the five classical perspectives that explain the rationale for international trade. Daniel plans to present an argument in favor of mercantilism. Daniel will be attempting to convince his classmates that mercantilism leads to national prosperity. Daniel's peers will be given opportunities to counter his argument.

48) One of Daniel's classmates most likely counters Daniel's argument with which of the following statements?
A) Restrictions on exports would lead to higher prices and possibly inflation.
B) Exporting firms would lose money due to the limited number of foreign consumers.
C) Consumers would be harmed by high prices and the lack of product choices.
D) Labor unions would demand higher wages and unemployment would increase.
Answer: C
Diff: 3 Page Ref: 144
Skill: Critical Thinking
Objective: 6-2
AACSB: Dynamics of the global economy; Reflective thinking skills

49) Classmates in favor of free trade over mercantilism would most likely cite which of the following reasons?
A) Free trade increases the standard of living by reducing consumer expenses.
B) Consumers faced with numerous product choices will spend more money.
C) Focal firms benefit from free trade because they can export more goods.
D) Free trade allows firms to raise prices and reach more international consumers.
Answer: A
Diff: 3 Page Ref: 144
Skill: Critical Thinking
Objective: 6-2
AACSB: Dynamics of the global economy; Reflective thinking skills

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Kazmia Revitalization (Scenario)
The leaders of Kazmia, a small nation in the southern hemisphere, have called a meeting to discuss ways to encourage foreign firms to invest in Kazmia. The country was once a leader in diamond mining and exports; however, the diamond mines have been depleted. Meanwhile the standard of living in Kazmia has plummeted to its lowest level, and young people are fleeing the country. Government leaders must devise a plan to reinvigorate the once prosperous nation.

50) The work of which of the following experts would be the most helpful to the leaders of Kazmia in their efforts to reinvent their country?
A) Raymond Vernon
B) Paul Krugman
C) John Dunning
D) Michael Porter
Answer: D
Diff: 2 Page Ref: 31--32
Skill: Application
Objective: 2-3
AACSB: Dynamics of the global economy

51) The first stage of creating a competitive advantage for Kazmia will most likely involve which of the following?
A) developing public works projects
B) redeveloping the country's diamond mines
C) creating a national industrial policy
D) creating a marketing campaign to attract young people back to Kazmia
Answer: C
Diff: 2 Page Ref: 33
Skill: Application
Objective: 2-3
AACSB: Dynamics of the global economy

52) Which of the following actions by the government would be the most beneficial for the long-term economic security of Kazmia?
A) encouraging renewed investment in the mining industry
B) developing an infrastructure of communications, technology, and transportation
C) discouraging trade relations until the nation is fiscally stable
D) passing laws and establishing regulatory systems to monitor MNE activities
Answer: B
Diff: 3 Page Ref: 33
Skill: Application
Objective: 2-3
AACSB: Dynamics of the global economy

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53) Which of the following countries would provide the best example for Kazmia for achieving substantial national competitive advantage?
A) Britain
B) Guatemala
C) Spain
D) North Korea
Answer: A
Diff: 2 Page Ref: 32
Skill: Application
Objective: 2-3
AACSB: Dynamics of the global economy

Earth-Rite Organic Foods (Scenario)
Earth-Rite Organic Foods is an MNE based in Sweden with subsidiaries located in numerous countries around the world. Earth-Rite has annual sales of $40 billion dollars and employs more than 90,000 individuals worldwide. Earth-Rite currently dominates the organic food industry, but competitors are beginning to catch up because of a growing demand for organic food. Earth-Rite is considering a "collaborative venture" with a small chain of organic grocery stores located in Brazil, a country where Earth-Rite has no stores.

54) Which of the following would be most important for Earth-Rite executives to consider when deciding whether to collaborate with the Brazilian grocery store chain?
A) How much money will Earth-Rite save on advertising by entering a joint venture?
B) Will a collaborative venture enable Earth-Rite to internationalize rapidly in Brazil?
C) What is the density of international trade facilitators in Brazil?
D) Who will be responsible for training grocery store employees in Brazil?
Answer: B
Diff: 3 Page Ref: 38
Skill: Critical Thinking
Objective: 2-5
AACSB: Dynamics of the global economy; Reflective thinking skills

55) Which of the following would be a benefit for Earth-Rite if the MNE entered into a joint venture with the Brazilian grocery store chain?
A) low risks because no equity would be committed
B) simplified international value-chain activity
C) access to the Brazilian store's extensive assets
D) ease of navigation through foreign distribution channels
Answer: D
Diff: 2 Page Ref: 38
Skill: Application
Objective: 2-5
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56) In a short essay, describe the two leading theories of international trade and investment. What do economists and scholars hope to learn from an analysis of international trade and investment?
Answer: Two theories exist regarding international trade and investment. The first group includes nation-level theories. These are classical theories that have been advocated primarily since the 18th century. The second group includes firm-level theories. These are more contemporary theories of how firms can create and sustain superior market position.

Economists, managers, and academic scholars have offered both classical and contemporary theories in hopes of determining the economic rationale for international trade and investment. They debate why nations should promote trade and investment with other nations and also how nations create and sustain comparative advantage.
Diff: 2 Page Ref: 24-26
Skill: Concept
Objective: 2-1
AACSB: Dynamics of the global economy

57) In a short essay, explain what the world would be like without international trade.
Answer: Without international trade, most nations would be unable to feed, clothe, and house their citizens at current levels. Even resource-rich countries like the United States would suffer immensely without trade. Some types of food would become unavailable or obtainable only at very high prices. Coffee and sugar would become luxury items. Petroleum-based energy sources would dwindle. Vehicles would stop running, freight would go undelivered, and people would not be able to heat their homes in the wintertime. In short, not only do nations, companies and citizens benefit from international trade, modern life is virtually impossible without it.
Diff: 2 Page Ref: 144
Skill: Concept
Objective: 6-2
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58) In a short essay, contrast the theory of mercantilism with the theory of free trade. Why is free trade preferred by most modern nations?
Answer:
a. Mercantilism suggests that exports are good and imports are bad. Mercantilists believed that national prosperity results from a positive balance of trade, achieved by maximizing exports and minimizing imports. They argued that the nation's power and strength increase as its wealth increases. In essence, mercantilism underlies the rationale for a nation's attempt to run a trade surplus, that is, to export more goods than it imports.
b. Free-trade advocates the relative absence of restrictions to flow of goods and services between nations. Although some groups, such as labor unions and farmers, support neo-mercantilism, free trade is the preferred choice by most nations for a number of reasons.
c. Free trade is advocated because consumers and firms can more readily buy the products they want. The prices of imported products tend to be lower than for domestically produced products (because access to world-scale supplies forces prices down, mainly from increased competition; or because the goods are produced in lower-cost countries). Lower-cost imports help reduce the expenses of firms, thereby raising their profits (which may be passed on to workers in the form of higher wages). Lower-cost imports help reduce the expenses of consumers, thereby increasing their living standards. Unrestricted international trade generally increases the overall prosperity of poor countries.
Diff: 3 Page Ref: 26
Skill: Concept
Objective: 2-2
AACSB: Dynamics of the global economy

59) In a short essay, explain the "Absolute Advantage principle". Provide an example of the principle at work.
Answer: Adam Smith's absolute advantage principle states that each country benefits by producing only those products in which it has an absolute advantage, allowing it to specialize in those products that it can produce at a lower cost than other countries and exporting them, and then importing other products it needs. Thus, each country increases its welfare by specializing in the production of certain products and importing others.

A modern example of the principle at work involves the nations of Japan and Saudi Arabia. Japan has no natural holdings of oil, but it manufactures some of the best automobiles in the world. On the other hand, Saudi Arabia produces much oil, but it lacks a substantial car industry. Given the state of their resources, it would be wasteful for each of these countries to attempt to produce both oil and cars. By trading with each other, Japan and Saudi Arabia each employs its respective resources efficiently in a mutually beneficial relationship. Japan gets oil that it refines to power its cars, and Saudi Arabia gets the cars needed by its citizens. Because each country uses its own resources with optimum efficiency and engages in trade, living standards for its citizens are higher than they would be if they had not engaged in trade.
Diff: 2 Page Ref: 27
Skill: Concept
Objective: 2-2
AACSB: Dynamics of the global economy

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60) How does opportunity cost relate to comparative advantage? In a short essay, explain the connection between the two terms and provide an example for illustration.
Answer: The comparative advantage principle states that it can be beneficial for two countries to trade without barriers as long as one is more efficient at producing goods or services needed by the other. What matters is not the absolute cost of production, but rather the relative efficiency with which a country can produce the product. One way to understand the concept of comparative advantage is to consider opportunity cost, the cost of something in terms of a forgone alternative activity.

For example, if Germany decided to devote all labor resources to producing wheat, it would automatically forego the opportunity to produce cloth. In relative terms, the opportunity cost to Germany of producing wheat is higher than the opportunity cost of producing cloth because Germany can produce cloth more efficiently (and therefore in greater relative quantity) than wheat. The opportunity cost to France of producing cloth is higher than the opportunity cost of producing wheat because France can produce wheat more efficiently (and therefore in greater relative quantity) than cloth. By specializing in what they produce best and trading for the rest, for a given level of labor cost, Germany and France can each produce and consume relatively more of the goods that it desires.
Diff: 3 Page Ref: 145-147
Skill: Concept
Objective: 6-2
AACSB: Dynamics of the global economy

61) In a short essay, explain the factor proportions theory and provide an example for illustration purposes. How does the theory differ from other international trade theories?
Answer: The factor proportions theory rests on two premises: First, products differ in the types and quantities of factors (that is, labor, natural resources, and capital) that are required for their production; and second, countries differ in the type and quantity of production factors that they possess. Thus, according to this theory, each country should export products that use intensively its relatively abundant factors of production, and import goods that use intensively its relatively scarce factors of production.

For example, the U.S. produces and exports capital-intensive products, such as pharmaceuticals and commercial aircraft, while Russia produces land-intensive products, such as wheat.

Factor proportions theory differs somewhat from earlier trade theories by emphasizing the importance of each nation's factors of production. The theory states that, in addition to differences in the efficiency of production, differences in the quantity of factors of production held by countries also determine international trade patterns. Originally labor was seen as the most important factor of production.
Diff: 3 Page Ref: 30
Skill: Concept
Objective: 2-2
AACSB: Dynamics of the global economy

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62) What is the connection between the competitive advantage of a firm and the competitive advantage of a nation? In a short essay, explain the nature of the relationship between firms and nations.
Answer: The innovative capacity of a nation derives from the collective innovative capacity of its firms. The more innovative firms a nation has, the stronger that nation's competitive advantage. Innovation also promotes productivity, the value of the output produced by a unit of labor or capital. The more productive a company is, the more efficiently it uses its resources. The more productive the firms in a nation are, the more efficiently the nation uses its resources. At the national level, productivity is a key determinant of the nation's long-run standard of living and a basic source of national per-capita (per person) income growth.
Diff: 2 Page Ref: 31-32
Skill: Concept
Objective: 2-3
AACSB: Dynamics of the global economy

63) In a short essay, explain why the comparative advantage principle is the foundation and overriding justification for international trade. How does this principle support the competitive advantage of nations theory?
Answer: British political economist David Ricardo explained why it is beneficial for two countries to trade even though one of them may have absolute advantage in the production of all products. Ricardo demonstrated that what matters is not the absolute cost of production, but rather the *relative efficiency* with which the two countries can produce the products. Hence, the **comparative advantage principle** states that it can be beneficial for two countries to trade without barriers as long as one is *relatively* more efficient at producing goods or services needed by the other. The principle of comparative advantage is the foundation and overriding justification for international trade.

This principle supports the competitive advantage of nations theory. Just as scholars recognized that international business is good for individual nations, they increasingly sought to explain how nations can position themselves for international business success. An important contribution came from Michael Porter. According to Porter, the competitive advantage of a nation depends on the collective competitive advantages of the nation's firms. Over time, this relationship is reciprocal: The competitive advantages held by the nation tend to drive the development of new firms and industries with these same competitive advantages.
Diff: 2 Page Ref: 28, 31-33
Skill: Synthesis
Objective: 2-2, 2-3
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64) In a short essay, explain what appears to be the current trend in international business.
Answer: The current trend is the widespread emergence of firms that internationalize at their founding born globals and the rise of a new field of scholarly inquiry, international entrepreneurship. Despite the scarcity of financial, human, and tangible resources that characterize most new businesses, born globals progress to internationalization early in their evolution. Current trends imply that early internationalizing firms will gradually become the norm in international trade and investment.
Diff: 2 Page Ref: 34
Skill: Concept
Objective: 2-4
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65) In a short essay, explain the international product life cycle theory and the internationalization process model. Discuss the ways in which these models describe how companies expand abroad.
Answer: In a 1966 article, Harvard Professor Raymond Vernon sought to explain international trade based on the evolutionary process that occurs in the development and diffusion of products to markets around the world. In his *International Product Life Cycle* (IPLC) *Theory,* Vernon observed that each product and its manufacturing technologies go through three stages of evolution: introduction, maturity, and standardization.

In the introduction stage, a new product typically originates in an advanced economy, such as the United States. During the introduction stage, the new product is produced in the home country, which enjoys a temporary monopoly.

As the product enters the maturity phase, the product's inventors mass-produce it and seek to export it to other advanced economies. Gradually, however, the product's manufacturing becomes more routine and foreign firms begin producing alternative versions, ending the inventor's monopoly power. At this stage, as competition intensifies and export orders begin to come from lower-income countries, the inventor may earn only a narrow profit margin.

In the standardization phase, knowledge about how to produce the product is widespread and manufacturing has become straightforward. Early in the product's evolution, production required specialized workers skilled in R&D and manufacturing. Once standardized, however, mass production is the dominant activity and can be accomplished using cheaper inputs and low-cost labor and, eventually, the country that invented the product becomes a net importer. It and other advanced economies become saturated with imports of the good from developing economies. In effect, exporting the product has caused its underlying technology to become widely known and standardized around the world.

In comparison, the *internationalization process model* was developed in the 1970s to describe how companies expand abroad. According to this model, internationalization takes place in incremental stages over a long time. Typically, firms start without much analysis or planning and begin to export, the simplest form of international activity, and progress to FDI, the most complex. The gradual and incremental nature of internationalization often results from managers' uncertainty and uneasiness about how to proceed, because they lack information about foreign markets and experience with cross-border transactions.
Diff: 2 Page Ref: 149, 157-158
Skill: Synthesis
Objective: 2-2, 2-4
AACSB: Dynamics of the global economy

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66) Explain the limitations of early trade theories, and discuss why born global firms exemplify a contemporary trade approach.
Answer: While the concepts of absolute advantage and comparative advantage provide the rationale for international trade, these early trade theories fail to account for factors that make contemporary trade complex, including the following:
• Traded products are not just commodities anymore; many traded goods are characterized by strong branding and differentiated features.
• International transportation is often costly.
• Government restrictions such as tariffs (taxes on imports), import barriers, and regulations can hamper international trade.
• Large-scale production in certain industries may bring about scale economies, and therefore lower prices.
• Many services, such as banking and retailing, cannot be traded in the usual sense and must be internationalized via foreign direct investment.
• Modern telecommunications and the Internet facilitate global trade in many services at very low cost.
• Many firms are highly entrepreneurial and innovative or have access to exceptional human talent that they employ to develop superior business strategies.

Despite the scarcity of financial, human, and tangible resources that characterize most new businesses, *born global firms* internationalize early in their evolution. Among the reasons are the growing intensity of international competition, the integration of world economies under globalization, and advances in communication and transportation technologies that reduce the cost of venturing abroad and make it easier to internationalize earlier and faster than ever before. The born global phenomenon has given rise to a new field of scholarly inquiry, *international entrepreneurship*. Current trends suggest that early internationalizing firms will gradually become the norm in international business.
Diff: 2 Page Ref: 29, 34
Skill: Synthesis
Objective: 2-2, 2-4
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67) Why do some MNEs enter international markets through Foreign Direct Investment (FDI) instead of through exporting? In a short essay, explain why P&G chose FDI-based entry. How does FDI-based entry relate to internalization theory?
Answer: Before Procter & Gamble entered Japan, management considered exporting and FDI. With exporting, P&G would have had to contract with an independent Japanese distributor to handle warehousing and marketing of soap, detergent, diapers, and the other products that P&G now sells in Japan. Ultimately, P&G chose instead to enter Japan via FDI. P&G established its own marketing subsidiary and, eventually, national headquarters in Tokyo. Such an arrangement provided various benefits for P&G, such as how its products were marketed in Japan and to minimize the risk of its proprietary knowledge being dissipated to potential Japanese competitors.

This example of P&G in Japan reveals how MNEs internalize key business functions and assets within the corporate organization. Internalization theory explains the process by which firms acquire and retain one or more value-chain activities inside the firm, minimizing the disadvantages of dealing with external partners and allowing for greater control over foreign operations. By internalizing foreign-based value-chain activities, it is the firm, rather than its products, that crosses international borders. The MNE is ultimately a vehicle for bypassing the bottlenecks and costs of the international, interfirm exchange of goods, materials, and workers. In this way, the MNE replaces business activities it performs itself.
Diff: 3 Page Ref: 35-36
Skill: Concept
Objective: 2-5
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68) According to Dunning's eclectic paradigm, an MNE must meet three conditions before successfully entering a foreign market via foreign direct investment (FDI). Explain these conditions in a short essay.
Answer:
a. The MNE must possess *ownership-specific advantages* relative to other firms in the market—that is, knowledge, skills, capabilities, key relationships, and other assets that allow it to compete effectively in foreign markets. These assets amount to the firm's competitive advantages. The notion of ownership-specific advantages is related to monopolistic advantage theory.

b. The firm must have access to *location-specific advantages,* the comparative advantages available in individual foreign countries, such as natural resources, skilled labor, low-cost labor, and inexpensive capital.

c. The MNE must have *internalization advantages,* benefits it derives from internalizing foreign-based manufacturing, distribution, or other stages in its value chain. When profitable, the firm will transfer its ownership-specific advantages across national borders *within* its own organization rather than dissipating them to independent, foreign entities, such as distributors and other autonomous intermediaries abroad.
Diff: 2 Page Ref: 37-38
Skill: Concept
Objective: 2-5
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69) In a short essay, explain mercantilism and the monopolistic advantage theory.
Answer: *Mercantilism* argues that national prosperity results from a positive balance of trade achieved by maximizing exports and minimizing or even impeding imports.

In essence, mercantilism explains why nations attempt to run a *trade surplus*—that is, to export more goods than they import. Even today many people believe that running a trade surplus is beneficial. They subscribe to a view known as *neo-mercantilism*. Labor unions (which seek to protect home-country jobs), farmers (who want to keep crop prices high), and certain manufacturers (those that rely heavily on exports) all tend to support neo-mercantilism.

On the other hand, mercantilism tends to harm the interests of firms that import, especially those that import raw materials and parts used in the manufacture of finished products. Mercantilism also harms the interests of consumers, because restricting imports reduces the choice of products they can buy. Product shortages that result from import restrictions may lead to higher prices—that is, inflation. When taken to an extreme, mercantilism may invite "beggar thy neighbor" policies, promoting the benefits of one country at the expense of others.

A monopolistic advantage is one or more resources or capabilities a company possesses that few other firms have and that it leverages to generate profits and other returns. *Monopolistic advantage theory* suggests that firms which use FDI as an internationalization strategy must own or control certain resources and capabilities not easily available to competitors, that give them a degree of monopoly power over local firms in foreign markets.
Diff: 2 Page Ref: 26, 35-35
Skill: Synthesis
Objective: 2-2, 2-5
AACSB: Dynamics of the global economy

70) Collaborative ventures became a popular entry strategy in the 1980s. Describe the two major types of international collaborative ventures and explain the benefits of this internationalization approach.
Answer: A collaborative venture is a form of cooperation between two or more firms. Collaborative ventures are classified into two major types: equity-based joint ventures that result in the formation of a new legal entity; and project-based strategic alliances that do not require equity commitment from the partners but simply a willingness to cooperate in R&D, manufacturing, design, or any other value-adding activity. In both cases, collaborating firms pool resources and capabilities and share risks to carry out activities that each might be unable to perform on its own.
Diff: 2 Page Ref: 38
Skill: Concept
Objective: 2-5
AACSB: Dynamics of the global economy

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PART 1: FOUNDATION CONCEPTS

CHAPTER 1

WHAT IS INTERNATIONAL BUSINESS?
Instructor's Manual by Marta Szabo White, Ph.D.

I. LECTURE STARTER/LAUNCHER

DAY ONE

- Start and stop the class on time.
- Introduce yourself! Talk about yourself and your passion about teaching.
- Get to know each of your students and ask for their specific expectations for the class.
- Use icebreakers on first day of class.
- Go over the syllabus. It is the "contract" between you and the student; the more detailed, the better.
- Lay out your expectations clearly from the outset! What are your classroom rules? Establish your credentials and authority.

Consider having everyone in class introduce him or herself. One way to initiate introductions is to distribute random pages torn from business magazines, in which each person receives one page. Next each student circles words on the page that describe him/her. In groups of two or three, each student shares the rationale behind each word that he/she circled. Finally, one of the group members introduces another group member to the class. This process enables students to immediately know at least one other student in the class. The circled words and explanations are often humorous, which serve as icebreakers during your first classroom encounter.

GlobalEDGE (globaledge.msu.edu) assembles a collection of tools and games that will allow you to compare countries on a variety of statistical indicators, rank countries based on these indicators, and test your knowledge of country capitals from around the world.
http://globaledge.msu.edu/Global-Insights

Under Country Insights click on a region, then select a country, Zimbabwe for example.
http://globaledge.msu.edu/countries/Zimbabwe
Currency Converter
Country Comparator
Country Rankings
Country Commercial Guide
World Bank Doing Business Indicators
BBC Country Profile

Everyone in the class should be assigned a different country. Each student is then responsible for becoming an expert on that country. Twice during the term, each student could report on their country and summarize a newspaper article published in their country, i.e., an International Newspaper Memorandum assignment.

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Another exciting way to introduce your students to International Business is the *IB Knowledge Check,* sourced from the CIA World Factbook, which provides an interactive and fun tool to introduce students to international business and cultures:
http://globaledge.msu.edu/Knowledge-Tools/test-your-knowledge
International Business Knowledge Quiz
World Capitals Quiz
U.S. Business Knowledge Check
U.S. State Capitals Quiz

Also, http://globaledge.msu.edu/Knowledge-Tools provides a variety of international business tools for both the instructor and student.

Country identification - Lilly, a very young girl names the countries around the world.
Lilly and World Geography:
http://www.youtube.com/watch?v=r43yCiKlbCo
Jay Walker on the world's English mania:
http://www.youtube.com/watch?v=Z5TUpNZqjM8

Language and Customs
BBC Translator - Comic relief - Humorous (possibly offensive) introduction to IB 2:40 minutes
Katherine Tate - Translator
http://www.youtube.com/watch?v=INOL2zVv7mw

Voice-activated elevator
http://www.youtube.com/watch?v=5FFRoYhTJQQ

HSBC commercials
http://www.youtube.com/watch?v=JK_NinOmFWw&feature=autoplay&list=PL9464968B63121486&index=13&playnext=1

II. LEARNING OBJECTIVES

Learning Objectives

1. What is international business?
2. What are key concepts in international trade and investment?
3. How does international business differ from domestic business?
4. What motivates firms to go international?
5. Market globalization: An organizing framework
6. Regional integration and economic blocs

Key Themes

This chapter is the introduction to the text, as well as to the foundation concepts. The first part of this text explores globalization from a macro, environmental level, while the second part examines international business from a more micro, organizational level. The fundamental

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concepts introduced in Chapter 1 are central to both macro and micro perspectives for understanding international business. Thus, these basic concepts permeate the entire text, and students should be well acquainted with them.

In this chapter, use a macro lens to introduce students to some of the fundamental international business concepts.

International business refers to the trade and investment activities by companies across national borders. **Globalization of markets** refers to ongoing economic integration and growing interdependency of countries worldwide. Stress the dramatic growth in world trade, which now exceeds some $10 trillion annually.

There are two ways to invest internationally - passively (**portfolio investment** -financial assets) or actively (**foreign direct investment** - capital, technology, labor, land, plant, and equipment).

Also important are **importing** (global sourcing) - buying products/services from abroad and bringing them back to the home country. *Exporting* - manufacturing a product or service in one country and selling it to another.

Address the broader questions of:

Why firms go international? - Primarily to increase sales and profits!
Also - Better serve customers, access lower-cost or superior production factors, optimize sourcing activities, develop economies of scale, confront competitors more effectively, develop rewarding relationships with foreign partners, and gain access to new ideas for creating or improving products and services.

What is the difference between internationalization and globalization? Former - Expansion of international business activities vs. Latter - Integration, interdependency, & interconnectedness of internationalization (the 4 I's) Example: Increasing exports vs. Sourcing value-chain activities strategically around the globe to leverage factor efficiencies.

How international business is different from domestic business: Complexity and Risks (4)

Who participates in international business-
Multinational Enterprise (MNE)
Small and Medium-sized Enterprise (SME)
Born Global - entrepreneurial firm that is international from inception

What is **regional economic integration -** groups of countries forming alliances to promote free trade, cross-national investment, and other mutual goals.

Integration results in blocs.

What are **regional economic integration blocs** (or economic blocs) - member countries agree to eliminate tariffs and other restrictions on the cross-national flow of products, services, capital, and, in more advanced stages, labor, within the bloc.

Note that international business is **both** a cause and a result of increasing national prosperity.

Teaching Tips

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In this chapter, use a broad brush approach in generating excitement about the importance of international business activity. Ask students to examine their clothing, watches, cell phones, iPhones, and iPods and report on where they were made. This discussion underscores what students experience, as well as the profound and pervasive impact that globalization has had on all of us.

Next, ask students what they would like to do professionally, after they graduate. Once they respond, ask if they can accomplish that successfully without understanding international business and the impact of global trends on their industry and business? Of course the answer is a resounding NO!!!

These examples illustrate how the global economy has permeated our everyday lives.

International business activity is increasingly complex and impacts our everyday lives - shopping, listening to music, watching a movie, or surfing the Internet - involve international business transactions that connect us to the global economy, and influence quality of life, standard of living, and economic well-being.

Use the examples that emerge during the class discussion as a springboard for a macro introduction to international business by illustrating these countries on a world map.

Help the student perceive the course content to be **relevant, important, and interesting**.

- Take a scenario from the course and start with it. What's the burning issue?
- Find a video, article, quiz, commercial, website, etc.

Some potential hooks:

- IB is critical to my welfare, job, income, community.
- IB will equip me with tools to analyze everyday events.
- Study of cultures, negotiation patterns, and cross-cultural interaction is life enriching.
- IB is an eclectic discipline: you can gain perspectives from business, economics, economic geography, government, culture, history, and religion.

III. DETAILED CHAPTER OUTLINE

WHAT IS INTERNATIONAL BUSINESS?

International business refers to cross-border trade and investment activities by firms.

Globalization of markets (or the globalization of economies) refers to ongoing economic integration and growing interdependency of countries worldwide. Integration, interdependence, and interconnectedness are central to globalization, which has resulted in the widespread diffusion of products, technology, and knowledge worldwide.

Macro perspective - globalization of markets means intense economic interconnectedness between/among countries. Market globalization is characterized by several related trends:

Cross-border transactions - unprecedented growth rates - from $100 billion per year in1960 to current numbers of $13 trillion annually

Substantial international flows of capital, technology, and knowledge

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Development of highly sophisticated global financial systems to facilitate cross-border flows

Greater collaboration among nations through multilateral regulatory agencies such as the World Trade Organization (WTO; www.wto.org) and the International Monetary Fund (IMF; www.imf.org)

Micro perspective - firm level, activity - Companies conduct value-adding activities on a *global* scale, i.e., organize, source, manufacture, market, etc.

This text focuses primarily on the international business activities of the individual firm.

Firm international expansion is made more compelling and easier due to market and product globalization - for companies small and large.

A "level playing field" has made cross-border activities appealing to all types of firms - large and small; manufacturing and service sectors (e.g., banking, transportation, engineering and design, advertising, and retailing).

Globalization impacts everyone, as evidenced by the recent global financial crisis (2008). The economic contagion, or interconnectedness, was underscored as the crisis began in the U.S. and rapidly spread to U.S. trade partners, eventually impacting Canada, Mexico, Japan, China, and the world. This manifestation illustrates the integration and interdependency of national economies throughout the world.

WHAT ARE THE KEY CONCEPTS IN INTERNATIONAL TRADE AND INVESTMENT?

International trade and investment are the most conventional forms of international business transactions.

International Trade

International trade refers to an exchange of products and services across national borders.

Cross-border exchange of products (merchandise) and services (intangibles) typically through exporting and importing

Exporting (outbound activity) - entry strategy involving the sale of products/services to customers located abroad

Importing (**global sourcing**; inbound activity) - the procurement of products/services from foreign suppliers for consumption in the home country or a third country

Exporting and importing may include both intermediate (raw materials and components) and finished products.

International Investment

Cross-border investment is the transfer of assets to another country or the acquisition of assets in another country.

The ***factors of production*** (assets) include capital, technology, managerial talent, and manufacturing infrastructure.

Trade = products and services cross national borders.

Cross-border investment = the firm itself crosses borders.

Two Types of Cross-Border Investment

International portfolio investment (typically short-term) is the passive ownership of foreign securities such as stocks and bonds for the purpose of generating financial returns.

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Foreign direct investment (FDI) (typically long-term) is a foreign-market entry strategy that gives investors partial or full ownership of a productive enterprise. The firm establishes a physical presence abroad through acquisition of productive assets such as capital, technology, labor, land, plant, and equipment.

The Nature of International Trade

Macro-International Trade: Aggregate export and import flows of products and services between nations.

Micro-International Business: Cross-border transactions of an *individual* business enterprise.

Gross domestic product (GDP) is the total value of products and services produced in a country during a year.

Exhibit 1.1 contrasts the growth of total world exports and the growth of total world *gross domestic product (GDP)* since 1970.

Due to the global recession, world trade declined, ending a 27-year boom period. Globalization is manifested, however, in export growth outpacing domestic production, and world exports growing more than thirty-fold, while world GDP grew only tenfold.

The exponential growth of cross-border trade relative to world GDP is due in part to advanced economies such as Britain and the U.S. sourcing to low-cost locations, e.g., China and Mexico.

The rapid integration of world economies is fueled by factors such as the advances in information and transportation technologies, decline of trade barriers, e.g., tariffs, liberalization of markets, privatization, and the remarkable vitality of emerging market economies.

While the U.S. is the leading country in terms of the absolute volume of total merchandise trade, international trade accounts for only **23 percent** of its GDP.

Germany, China, and Japan are other high trading countries in absolute volume terms.

For other economies, merchandise trade is a much larger component of economic activity: e.g., Belgium (171 percent), Netherlands (138 percent), and Germany (72 percent).

These percentages illustrate that some economies are very dependent on international trade relative to the value of all goods and services they produce domestically.

Entrepôt economies ("intermediate depot"; exports = imports): Singapore, Hong Kong, South Korea, and Malaysia export more than 100 percent of their respective GDPs.

The Nature of International Investment

Foreign Direct Investment (FDI) - (asset ownership and long time frame) is the ultimate commitment level of internationalization, and thus this text focuses primarily on FDI as opposed to International Portfolio investment.

Motivations for firm FDI: (Notice how these fit into the value chain.)

(1) Primary Activity: Set up manufacturing or assembly facilities;
(2) Primary Activity: Open a sales/representative office or other facility to conduct marketing or distribution activities; or
(3) Support Activity: Establish a regional headquarters - a new legal business entity - recognized by the host country and subject to its regulations.

Exhibit 1.2 illustrates that the dollar volume of FDI has grown immensely since the 1980s, especially into advanced economies such as Japan, Europe, and North America.

FDI has grown dramatically since the 1980s.

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September 11, 2001 interrupted FDI inflows with the worldwide panic that ensued following the terrorist attacks in the United States.

Advanced (Developed) economies = Australia, Canada, Japan, the United States, and most countries in Western Europe.

Developing economies = Parts of Africa, Asia, and Latin America. Of particular significance is the growth of FDI into developing economies despite widespread poverty and less investment capital than advanced economies.

World trade and investment is directly linked to improving the lives of billions.

FDI and Competitive Advantage:

Large, resourceful companies with substantial international operations are able to leverage FDI to:

(1) Manufacture/assemble products in low-cost labor countries, i.e., India, Russia, Brazil, China, and Mexico:

Example-

Ford invested some $3 billion to build a new car factory in **Mexico** to manufacture Fiesta automobiles.

(2) Global challengers originating in rapidly developing economies invest in western markets:

Examples -

Turkish company Yildiz (2008) acquired the premium chocolate maker Godiva from U.S.-based Campbell Soup Company in a deal valued at $850 million.

India's Mittal Steel Co. acquired the Belgium-based Arcelor SA in August 2006, creating a $38 billion conglomerate – the world's largest steel company.

Russian oil and gas firm Lukos established thousands of service stations in the U.S. and Europe.

Services as Well as Products

Key international players: Tangible merchandise (products) and intangibles (services - e.g., banks, consulting firms, hotels, airlines, construction companies, retailers, etc.).

International trade in services accounts for about **one quarter** of all global trade and is growing faster than products; however, the value of merchandise trade is still much greater than the value of services trade.

U.S., Germany, UK, and Japan are the leading total volume in international services trade.

The Netherlands, UK, Spain, and Germany are the leaders in terms of percentage of each nation's GDP.

Services face greater challenges and barriers in cross-border trade than merchandise goods- challenges unique to services:

Not all services can be exported.

Physical presence in host country is a prerequisite for many services.

$2 trillion worth of services is sold abroad every year.

Larger, developed economies account for the greatest proportion of services.

Services typically comprising more than 2/3 of their GDPs.

eBay- The largest auction-based retailer on the Internet, earned $9 billion in 2009, of which more than 50 percent came from international sales.

China has 1.34 billion people with an estimated 400 million Internet users.

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India has 1.16 billion people with an estimated 81 million Internet users.
U.S. has 307 million people with an estimated 228 million Internet users.
eBay expanded to India, China, Korea, and Europe in anticipation of most of its future revenue growth coming from abroad.
The most important service sectors in international business are banking and finance, construction and engineering, education, publishing, entertainment, information services, professional business services, transportation, travel, and tourism.

Banking and financial services are the most active cross-border services.
Explosive growth of global capital markets is attributed to:
(1) **International Flow of Money** into pension funds and portfolio investments
(2) **Internationalization of Banks/Financial institutions** increased amount of cheap, local investment capital, stimulating local financial markets and encouraging savings.

HOW DOES INTERNATIONAL BUSINESS DIFFER FROM DOMESTIC BUSINESS?
Complexity - Macro forces differ from country to country - economic conditions, national culture, legal and political systems.
Risk - Uncontrollable variables - over which the firm has little or no control
Foreign environments involve new risks that firms must manage.
The Four Risks in Internationalization
Exhibit 1.3 summarizes the four major risks: cross-cultural risk, country risk, currency risk, and commercial risk.

Cross-cultural risk
Differences in language, lifestyles, attitudes, mindsets, customs, and religion.
Cross-cultural literacy is critical so as to not jeopardize culturally valued mindsets or behaviors.
Cultural blunders - hinder the effectiveness of foreign managers.
Language - critical dimension of culture - a window to people's values
Language differences impede effective communication.
Cultural differences may lead to inappropriate business strategies.

Country risk or political risk
Differences in host country political, legal, and economic regimes may adversely impact firm profitability.
Laws, regulations, and indigenous factors, e.g., property rights, intellectual-property protection, product liability, taxation policies, inflation, national debt, and unbalanced international trade, may encumber firm operations and performance.
Government intervention: restricts market access; imposes bureaucratic procedures hindering business transactions; and limits the amount of earned income that firms may repatriate from foreign operations.
The 2009 global financial crisis plunged many nations into a deep recession.
Economic freedom differs among nations - The 2010 Index of Economic Freedom from the Heritage Foundation ranks Hong Kong, Singapore, and Australia as the top three in terms of having the highest levels of economic freedom, see http://www.heritage.org.

Currency or financial risk

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Risk of adverse exchange rate fluctuations, inflation, and other harmful economic conditions create uncertainty of returns due to the growing interconnectedness of national economies.

When currencies fluctuate significantly, the value of a firm's assets, liabilities, and/or operating income may be substantially reduced.

Commercial risk

Poor development/execution of business strategies, tactics, or procedures, e.g., partnering selections, market entry timing, pricing, product features, and promotional themes.

Failures in international markets are far more costly than domestic business blunders.

Commercial risk is also often affected by currency risk, because fluctuating exchange rates can affect various types of business deals.

Risks: Always Present but Manageable

These types of risks are omnipresent in international business.

Managers need to understand their implications, anticipate them, and take proactive actions to reduce adverse effects.

Examples of extremely challenging risks:

The massive earthquake that struck Japan in 2011 affected supply lines worldwide. Major automakers were unable to obtain the parts they need to build cars. Firms that sell consumer products suffered significant business declines in the months following the quake. The luxury goods retailer Coach closed 20 of its 165 stores in Japan, and Tiffany shuttered some of its outlets.

Civil unrest was also a problem in 2011.

The civil war that broke out in Libya interrupted the country's oil output of more than 1.5 million barrels per day.

When Egypt experienced unrest, management at global MNEs worried the crisis would affect cargo transportation through the Suez Canal, one of the world's top shipping corridors.

The global financial crisis that emerged in the fall of 2008 spread to banks and insurance firms in Asia, Europe, and elsewhere. Many countries experienced deflation and severe declines in consumer confidence and spending power. There were sharp reductions in international commerce and shipping. Central banks worldwide sought to rally national economies by injecting billions of dollars into their financial systems.

The East Asian economic crisis of 1998 generated substantial commercial, currency, and country risks - several East Asian countries lost currency values of between 35 and 70 percent, leading to the collapse of national stock markets, deepening trade deficits, and suspension of normal business activity. Political and social unrest surged to Indonesia, Malaysia, South Korea, Thailand, and the Philippines.

WHO PARTICIPATES IN INTERNATIONAL BUSINESS?

Focal firms are those companies that directly initiate and implement international business activity.

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Two Types:

Multinational Enterprise (MNE) - Also known as Multinational Corporation (MNC).

In addition to a home office and substantial resources, an MNE owns a worldwide network of subsidiaries and affiliates located in multiple countries.

Multinational enterprises have historically been the most important type of focal firm; add value in multiple countries, through subsidiary affiliates, leveraging R&D, procurement, manufacturing, and marketing activities, to exploit economic advantages.

Examples - Alcon, Barclays, DHL, Verizon Wireless, Caterpillar, Kodak, Nokia, Samsung, Unilever, Citibank, Vodafone, Carrefour, Bechtel, Four Seasons Hotels, Disney, DHL, & Nippon Life Insurance.

Examples of *Fortune's* Global 500 - ExxonMobil, Royal Dutch Shell, BP, General Motors, DaimlerChrysler, Toyota, Ford, and Walmart.

The U.S. is home to 140 of the top 500 MNEs, a number that has declined over time as other countries' firms increase in size.

Japan is the headquarters of 68 of the top 500 firms.

The EU collectively has more top 500 firms than the U.S.

Global Challengers from Emerging Market Countries: New Contenders - Large MNEs have begun to appear in emerging market countries, such as China, India, Russia and Mexico - making the best use of home-country natural resources and low-cost labor, posing legitimate competitive challenges for advanced economy - incumbents in world markets.

Examples -

The Mexican firm **Cemex** is one of the world's largest cement producers.

Russia's **Lukoil** has big ambitions in the global energy sector.

In China, **Mobile** dominates the cell phone industry in Asia.

Small and Medium-sized Enterprise (SME)

SME is a company with 500 or fewer employees (250 or fewer in the EU).

Small firms comprise 90-95 percent of all firms in most economies.

More and more SMEs participate in exporting, licensing, and global sourcing.

Small firms:

Are the drivers for innovation.

Account for one-third of exports from Asia; a quarter of the exports from the affluent countries in Europe and North America.

Contribute more than 50 percent of total national exports in Italy, South Korea, and China.

Born-global firms - Young, entrepreneurial SMEs that initiate international business from inception, and are found in both advanced economies, e.g., Australia and Japan, as well as emerging markets such as China and India.

International business complexities are considerably more challenging for SMEs than MNEs.

SME Strategies for success:

(1) SMEs are more innovative, adaptable, and have quicker response times.

(2) SMEs are better able to serve niche markets.

(3) Smaller firms can better leverage new information and communication technologies, e.g., the Internet.

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(4) Due to limited resources, SMEs tend to minimize fixed investment costs and outsource, e.g., FedEx and DHL.
(5) Smaller firms tend to flourish on private knowledge that they cultivate through their cross-border knowledge networks and international social capital.

Non-governmental Organizations (NGOs)

Non-profit international organizations include charitable groups and non-governmental organizations (NGOs).

They serve special causes - the arts, education, politics, religion, and research.

Examples - (Nonprofit Organizations)
- Bill and Melinda Gates Foundation
- CARE - dedicated to reducing poverty
- British Wellcome Trust - supports health and education

Examples - (MNE operating charitable foundations)
- GlaxoSmithKline (GSK)-
    - Canada, France, Italy, Romania, Spain, & U.S.
    - Barretstown-Ireland and L'Envol (France) for seriously ill children
    - Slovakian children - promotes healthy eating/exercise
    - Spain - healthcare for homeless children
    - Russia - Children with disabilities
    - Ethiopia - reduction of preventable children's diseases
    - Vietnam - birthing support

WHAT MOTIVATES FIRMS TO GO INTERNATIONAL?

Firms internationalize seeking growth and profit opportunities to enhance competitive advantage.

Proactive (Strategic) motive - tap foreign market opportunities or acquire new knowledge.

Reactive motive - serve a key customer that has expanded abroad.

Nine specific motives:

1. Seek growth opportunities through market diversification.
2. Earn higher margins and profits.
3. Gain new ideas about products, services, and business methods.
4. Better serve key customers that have relocated abroad.
5. Locate closer to supply sources, benefit from global sourcing advantages, or gain flexibility in product sourcing.
6. Gain access to lower-cost or better-value factors of production.
7. Develop economies of scale in sourcing, production, marketing, and R&D.
8. Confront international competitors more effectively or thwart the growth of competition in the home market.
9. Invest in a potentially rewarding relationship with a foreign partner.

MARKET GLOBALIZATION: AN ORGANIZING FRAMEWORK

Exhibit 1.4 presents an organizing framework for examining market globalization.

The exhibit makes a distinction between:

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(1) Drivers or causes of globalization;
(2) Dimensions or manifestations of globalization;
(3a) Societal consequences of globalization;
(3b) Firm-level consequences of globalization

The double arrows illustrate the interactive nature of the relationship between market globalization and its consequences. As market globalization intensifies, individual firms respond to the challenges and new advantages that it brings.

Firms do not expand abroad solely as a reaction to market globalization. They also internationalize proactively, in order to pursue new markets, find lower-cost inputs, or obtain other advantages.

Often adverse conditions in the home market, such as regulation or declining industry sales, push firms to boldly venture abroad.

Firms that do so tend to be more successful in global competition than those that engage in international business as a reactive move.

Drivers of Market Globalization

Five trends have converged in recent years as causes of market globalization:

1. Worldwide reduction of barriers to trade and investment

Tariffs on the import of automobiles, industrial machinery, and countless other products have declined nearly to zero in many countries, encouraging freer international exchange of goods and services.

Falling trade barriers, facilitated by the WTO, are also associated with the emergence of regional economic integration blocs, a key dimension of market globalization.

2. Market liberalization and adoption of free markets

The collapse of the Soviet Union's economy in 1989, demolition of the Berlin Wall that same year, and China's free-market reforms all smoothed the integration of former command economies into the global economy.

East Asian economies from South Korea to Malaysia, Indonesia, and India had already embarked on ambitious market-based reforms.

Along with privatization of state-owned industries in many countries, these events opened roughly one-third of the world to freer international trade and investment.

3. Industrialization, economic development, and modernization

Rapidly developing economies in Asia, Latin America, and Eastern Europe are becoming sophisticated competitive producers and exporters of premium products such as electronics, computers, and aircraft.

Economic development is enhancing standards of living and discretionary income in emerging markets. Perhaps the most important measure of economic development is *Gross National Income (GNI)* per head.

The adoption of modern technologies, improvement of living standards, and adoption of modern legal and banking practices are increasing the attractiveness of emerging markets as investment targets.

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4. Integration of world financial markets

Integration of world financial markets via a network of international commercial banks makes it possible for internationally active firms to raise capital, borrow funds, pay suppliers, collect from customers, and engage in foreign currency transactions.

The SWIFT network connects more than 7,800 financial institutions in some 200 countries.

5. Advances in technology

Technological advances are a remarkable facilitator of cross-border trade and investment. These include discoveries and new capabilities in information technology, communications, manufacturing, and transportation.

Technological advances have made international operations affordable for all types of firms.

The cost of international communications has plummeted over time, just as the number of Internet users has grown dramatically.

Societal Consequences of Market Globalization

Major advances in living standards have been achieved in virtually all countries that have opened their borders to increased trade and investment.

The transition to an increasingly single, global marketplace poses challenges to individuals, organizations, and governments.

Low-income countries have not been able to integrate with the global economy as rapidly as others, and poverty remains a major problem.

Unintended Consequences of Globalization

Loss of National Sovereignty

Sovereignty, the ability of a nation to govern its own affairs, is a fundamental principle that underlies global relations.

One country's laws cannot be applied or enforced in another country.

Globalization can threaten national sovereignty in various ways:

MNCs exerting considerable influence on governments, by making campaign contributions

MNCs lobbying for, say, devaluation of the home currency, which gives them greater price competitiveness in export markets

Offshoring and the Flight of Jobs

Offshoring is the relocation of manufacturing and other value-chain activities to cost-effective locations abroad.

It has resulted in job losses in numerous mature economies:

The first wave of offshoring began in the 1960s and 1970s with the shift of U.S. and European manufacturing of cars, shoes, electronics, textiles, and toys to cheap-labor locations such as Mexico and Southeast Asia.

The next wave began in the 1990s with the exodus of service-sector jobs in credit card processing, software code writing, accounting, health care, and banking services.

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Effect on the Poor

MNEs are often criticized for paying low wages, exploiting workers, and employing child labor.

The International Labor Organization (www.ilo.org) reported in May 2010 that there are approximately 153 million children aged 5-14 at work around the world.

Labor exploitation and sweatshop conditions are major concerns in many developing economies, yet banning such products may produce unintended negative consequences such as loss of wages and reduced living standards.

Legislation passed to reduce child labor in the formal economic sector may have little effect on jobs in the informal economic sector, sometimes called the *underground economy* - poverty forces children to work, not go to school.

In developing countries, work conditions may improve:

The growth of the footwear industry in Vietnam translated into a five-fold increase in wages.

Globalization tends to support a growing economy.

Exhibit 1.5 illustrates that liberalization of international trade and investment positively correlates with faster per-capita economic growth. During the 1990s, developing economies that sought integration with the rest of the world had faster per-capita GDP growth than already integrated advanced economies, which, in turn, grew faster than non-integrating developing economies.

Effect on the Natural Environment

Globalization can harm the environment by promoting increased manufacturing and economic activity that result in pollution, habitat destruction, and deterioration of the ozone layer.

Example – China - economic development - construction of factories, infrastructure, and modern housing spoils pristine environments; the Three Gorges Dam construction flooded agricultural lands and permanently altered the natural landscape.

Globalization stimulates rising living standards; people focus on their environment. Governments legislate environmental protection laws.

Example - Japan - polluted rivers and cities in the early decades of its economic development following World War II. As their economy grew, the Japanese passed tough environmental standards to restore natural environments.

Corporate citizenship and concern for corporate reputations also inspire firms to reduce/eliminate harmful environmental practices.

Examples - Benetton in Italy (clothing), Alcan in Canada (aluminum), and Kirin in Japan (beverages) are examples of firms that embrace practices that protect the environment, often at the expense of profits. Conservation Coffee Alliance, a consortium of companies, has committed approximately $2 million to environmentally friendly coffee cultivation in Central America, Peru, and Colombia.

Effect on National Culture

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Market liberalization leaves the door open to foreign companies, global brands, unfamiliar products, and new values.

Homogeneity - Consumers increasingly wear similar clothing, drive similar cars, watch the same movies, and listen to the same recording stars.

Global media have a pervasive effect on local culture, gradually shifting it toward a universal norm - Advertising leads to the emergence of societal values modeled on Western countries, especially the U.S.

Cultural influence often goes both ways. Advanced Fresh Concepts is a Japanese company annually selling $250 million of Japanese favorites in U.S. supermarkets.

Religious and language differences are as strong as ever.

Globalization and a degree of cultural imperialism standardize superficial aspects of life across national cultures; people resist these forces by insisting on their national identity and taking steps to protect it.

In Belgium, Canada, and France, laws were passed to protect national language and culture.

REGIONAL INTEGRATION AND ECONOMIC BLOCS

Regional economic integration (regional integration), refers to the growing economic interdependence that results when two or more countries within a geographic region form an alliance aimed at reducing barriers to trade and investment.

The trend to cooperate, with the aim of achieving some degree of economic integration, has been ongoing since the end of World War II.

50% of world trade today is under some form of bloc preferential trade agreement.

Premise - mutual advantages for cooperating nations within a common geography, history, culture, language, economics, and/or politics.

The free trade that results from economic integration helps nations attain higher living standards by encouraging specialization, lower prices, greater choices, increased productivity, and more efficient use of resources.

Nations seek at least four objectives in pursuing regional integration.

Expand market size
Achieve scale economies and enhanced productivity
Attract direct investment from outside the bloc
Acquire stronger defensive and political posture

Regional Economic Integration Bloc or Economic Bloc - a geographic area that consists of two or more countries that agree to pursue economic integration by reducing tariffs and other restrictions to cross-border flow of products, services, capital, and, in more advanced stages, labor. (In this text, the authors use the term *bloc* instead of *block*.)

Free trade agreement - formal arrangement between two or more countries to reduce or eliminate tariffs, quotas, and barriers to trade in products and services.

Bloc advantage vs. worldwide free trade system:

Blocs involve a smaller number of countries and are much easier to negotiate than a system of worldwide free trade composed of all the nations in the world, which explains why there are hundreds of regional trade integration blocs around the world today.

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There are roughly 200 economic integration agreements in the world.
The European Union (**EU**) is the most advanced of these, comprising 27 countries in Europe.
The most notable bloc (free-trade-area) in the Americas is the North American Free Trade Agreement (**NAFTA**) - consisting of Canada, Mexico, and the U.S.

The lowest level of regional integration would be a **free trade agreement** and more advanced economic blocs, such as the EU, which permit the free flow of capital, labor, and technology among their member countries, in addition to harmonizing monetary policy (to manage the money supply and currency values) and fiscal policy (to manage government finances, especially tax revenues) and gradually integrating the economies of its member nations.

Interdependence and Synergies

Regional integration allows distinct national economies to become economically linked and interdependent through greater cross-national movement of products, services, and factors of production.

It also allows member states to use resources more productively and achieve greater output than they could individually.

Exhibit 1.6 identifies five possible levels of regional integration progressing from a low level—the free trade area—to the most advanced form—the political union, which no countries have yet achieved.

Levels of Regional Integration

Free trade area, in which tariffs and other trade barriers are eliminated

The simplest and most common arrangement

Member countries agree to gradually eliminate formal barriers to trade in products and services within the bloc.

Each member country maintains an independent international trade policy with countries outside the bloc.

Examples - NAFTA (the United States, Mexico, and Canada)

The free trade area emphasizes the pursuit of **comparative advantage** for a group of countries rather than for individual states.

Governments may impose local content requirements, which specify that producers located within the member countries provide a certain proportion of products and supplies used in local manufacturing.

Customs union, a free trade area in which common trade barriers are imposed on nonmember countries

Member states harmonize their external trade policies and adopt *common* tariff and nontariff barriers on imports from nonmember countries.

An exporter outside MERCOSUR faces the *same* tariffs and nontariff barriers when trading with *any* MERCOSUR member country.

Member countries must agree on the level of tariff and on how to distribute proceeds among themselves.

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Common market (also known as a single market), a customs union in which factors of production move freely among the members

Trade barriers are reduced or removed, common external barriers are established, and products, services, and capital, labor, and technology (*factors of production*) are allowed to move freely among the member countries.

Like a customs union, a common market also establishes a common trade policy with nonmember countries.

Example - EU is a common market. It has gradually reduced or eliminated restrictions on immigration and the cross-border flow of capital. A worker from an EU country has the right to work in other EU countries, and EU firms can freely transfer funds among their subsidiaries within the bloc.

Common markets require substantial cooperation on labor and economic policies.

Benefits to individual members can vary; skilled labor may go where wages are higher, and investment capital may flow to where returns are greater.

Example – EU - workers from Poland and the Czech Republic have flowed into Germany because they can earn substantially higher wages there than at home.

Economic union, a common market in which some economic policies are harmonized among the member states

Member countries enjoy all the advantages of early stages but also strive to have common fiscal and monetary policies.

Member countries adopt identical tax rates.

The bloc aims for standardized monetary policy, which requires establishing fixed exchange rates and free convertibility of currencies among the member states, in addition to allowing the free movement of capital. This standardization helps eliminate discriminatory practices that might favor one member state over another.

Toward achieving an economic union - Strides the EU has made:

Sixteen EU member countries have established a *monetary union* in which a single currency, the **euro**, is now in circulation.

Monetary union and the euro have greatly increased the ease with which European financial institutions establish branches across the EU and offer banking services, insurance, and savings products and have eased investment and trading for firms doing business within the bloc.

Economic Union member countries strive to eliminate border controls, harmonize product and labeling standards, and establish region-wide policies for energy, agriculture, and social services.

An economic union also requires its members to standardize laws and regulations regarding competition, mergers, and other corporate behaviors, including licensing of professionals, so that a doctor or lawyer qualified in one country can practice in any other country.

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Political union does not yet exist.

The Leading Economic Blocs

Examples of regional integration can be found on all continents.

The European Union (EU)

The EU is the world's most integrated economic bloc and has taken the following steps to becoming a full-fledged economic union:

Market access - Tariffs and most nontariff barriers have been eliminated for trade in products and services, and rules of origin favor manufacturing using parts and other inputs produced in the EU.

Common market - Barriers to the cross-national movement of production factors—labor, capital, and technology—have been removed. An Italian worker now has the right to get a job in Ireland, and a French company can invest freely in Spain.

Trade rules - The member countries have largely eliminated customs procedures and regulations, which streamlines transportation and logistics within Europe.

Standards harmonization - The EU is harmonizing technical standards, regulations, and enforcement procedures that relate to products, services, and commercial activities.

Exhibit 1.7 highlights the notable features of the member countries in the European Union—the world's most integrated economic bloc.

In the long run, the EU is seeking to adopt common fiscal, monetary, taxation, and social welfare policies.

The **2002** introduction of the euro eliminated exchange rate risk and forced member countries to improve their fiscal and monetary policies.

Since **2004**, 12 new states have joined the EU, and the recent addition of Bulgaria and Romania brought the number of member countries to 27.

Most new members are important, low-cost manufacturing sites for EU firms.

In addition to the European Union, several other trading blocs are notable:

European Free Trade Association (EFTA)

1960 - established by Austria, Britain, Denmark, Norway, Portugal, Sweden, and Switzerland - European Free Trade Association (www.efta.int) - the second largest free trade area in Europe.

Most of these countries left the EFTA to join the EU.

Current EFTA members are Iceland, Liechtenstein, Norway, and Switzerland.

EFTA promotes free trade and strengthens economic relations with other European countries and the world - i.e., the European Economic Area arrangement allows for free movement of people, products, services, and capital throughout the combined area of the EFTA and the EU.

North American Free Trade Agreement (NAFTA)

1994- NAFTA (http://www.nafta-sec-alena.org) - Canada, the U.S., and Mexico

Most significant economic bloc in the Americas

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NAFTA passage was facilitated by the ***maquiladora*** program - Since the **1960s** U.S. firms locate manufacturing facilities just south of the U.S. border and access low-cost labor without having to pay significant tariffs.

NAFTA:

- Increased market access between Canada, Mexico, and the U.S.
- Eliminated tariffs and most nontariff barriers for products/services traded in the bloc.
- Initiated bidding for government contracts by member country firms.
- Established trade rules and uniform customs procedures and regulations.
- Prohibited standards/technical regulations to be used as trade barriers.
- Instituted rules for investment and intellectual property rights.
- Provided a forum for dispute settlement regarding investment, unfair pricing, labor issues, and the environment.

NAFTA results:

- Trade among the members has more than tripled and now exceeds one trillion dollars per year.
- Early **1980s -** Mexico's tariffs averaged 100 percent and gradually disappeared under NAFTA.
- **1994-2008**: (Mexico benefited greatly)
  - U.S. exports to Mexico grew from about $40 billion to more than $150 billion.
  - U.S. exports to Canada more than doubled, to over $260 billion.
  - Canada's exports to Mexico and the U.S. more than doubled.
  - Mexican exports to the U.S. grew from $50 billion to over $215 billion per year.
  - Access to Canada and the U.S. helped launch numerous Mexican firms in industries such as electronics, automobiles, textiles, medical products, and services.
  - Annual foreign investment in Mexico rose from $4 billion in 1993 to nearly $20 billion by 2008 as U.S. and Canadian firms invested in their southern neighbor.
  - Mexico's per capita income rose to about $11,000 in 2007, making Mexico the wealthiest per capita income country in Latin America.
  - Member countries now trade more with each other than with former trading partners outside the NAFTA zone.
  - Both Canada and Mexico now have some **80 percent** of their trade with, and **60 percent** of their FDI stocks in, the United States.
  - By increasing Mexico's attractiveness as a manufacturing location, firms like Gap Inc. and Liz Claiborne moved their factories from Asia to Mexico during the 1990s.
  - IBM shifted much of its production of computer parts from Singapore to Mexico.

NAFTA resulted in North American labor market **restructuring**:

- Falling trade barriers triggered job losses in the North as factories were "exported" to Mexico to profit from its low-cost labor.
- Increased purchasing power of Mexican consumers meant that they could afford to buy U.S. and Canadian imports.
- Workers in the NAFTA zone gained the right to unionize.

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The accord helped to improve working conditions and compliance with labor laws.

NAFTA also includes provisions promoting sustainable development and environmental protection.

Quebec is easing commerce and labor barriers with France, and Canada is in negotiations to join the European Union.

Compared to the EU or NAFTA, the remaining blocs are less stable and have been less successful - located in Latin America, Asia, the Middle East, and Africa.

El Mercado Comun del Sur (MERCOSUR)

1991- MERCOSUR or (the Southern Common Market) has become the strongest economic bloc in South America (www.mercosur.int).

MERCOSUR established the free movement of products and services, a common external tariff and trade policy, and coordinated monetary and fiscal policies.

Priority - construction of reliable infrastructure—roads, electricity grids, and gas pipelines

MERCOSUR eventually aims to become an economic union.

Trade tripled among member countries during its first six years.

MERCOSUR may be integrated with NAFTA and the Dominican Republic-Central American Free Trade Agreement (DR-CAFTA) as part of the proposed Free Trade Area of the Americas (FTAA). If implemented, this integration would bring free trade to the entire western hemisphere.

Caribbean Community and Common Market (CARICOM)

1973 - Composed of roughly 25 member and associate member states around the Caribbean Sea.

CARICOM was established to lower trade barriers and institute a common external tariff (www.caricom.org).

In recent years, the bloc has made more progress toward establishing the Caribbean Single Market, a common market that allows for a greater degree of free movement for products, services, capital, and labor, and gives citizens of all CARICOM countries the right to establish businesses throughout the region.

Comunidad Andina de Naciones (CAN)

1969 - Long called the Andean Pact, the CAN includes Bolivia, Colombia, Ecuador, Peru, and Venezuela (www.comunidadandina.org).

CAN is expected to merge with MERCOSUR to form a new economic bloc that encompasses all of South America.

Geography (Andes mountain range) has hindered intra-bloc trading - reaching only 5 percent of bloc members’ total trade.

Association of Southeast Asian Nations (ASEAN)

1967 - One of the few examples of economic integration in Asia, ASEAN was created with the goal of maintaining political stability and promoting regional economic and social development (www.aseansec.org).

ASEAN created a free trade area in which many tariffs were reduced to less than 5 percent.

Economic diversity has slowed further regional integration.

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Example - Oil-rich Brunei has a per capita income of over $50,000, while Vietnam's is less than $3,000.

The mass movement of workers from poor to prosperous countries that would likely result with further ASEAN integration **reduces** the likelihood that this bloc will become a common market or an economic union.

ASEAN aims to incorporate powerhouses like Japan and China, whose membership would accelerate the development of extensive trade relationships.

Note that Singapore's exports as a percent of its GDP exceed 100 percent. The reason is that Singapore is an entrepôt nation, an import-export platform for Asia, trading far more goods than it manufactures.

Asia Pacific Economic Cooperation (APEC)

APEC aims for greater free trade and economic integration of the Pacific Rim countries.

It incorporates 21 nations on both sides of the Pacific, including Australia, Canada, Chile, China, Japan, Mexico, Russia, and the U.S. (www.apec.org).

Its members account for **85 percent** of total regional trade, as well as **one-third** of the world's population and over **half its GDP**.

APEC aspires to remove trade and investment barriers by 2020.

Members have varying national economic priorities, and the composition of less affluent Asian countries alongside strong international traders like Australia, Japan, and the U.S. makes it difficult to achieve agreement on a range of issues.

Australia and New Zealand Closer Economic Relations Agreement (CER)

1966 - Australia and New Zealand reached a free trade agreement that removed 80 percent of tariffs and quotas between the two nations, but was relatively complex and bureaucratic.

1983 - The CER sought to accelerate free trade, leading to further economic integration of the two nations.

The CER gained importance when Australia and New Zealand lost their privileged status in the British market as Britain joined the EU.

Many believe the CER has been one of the world's most successful economic blocs.

2009 - Members concluded important negotiations on creating a free trade agreement with the ASEAN countries.

Management Implications of Regional Integration

Strategies for regional economic integration management:

Internationalization by firms inside the economic bloc

Rationalization of operations

Rationalization is the process of restructuring and consolidating company operations following regional integration to reduce redundancy and costs and increase the efficiency of operations.

Mergers and acquisitions

Regional products and marketing strategy

Internationalization by firms from outside the bloc

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PART 1: FOUNDATION CONCEPTS

CHAPTER 2

THEORIES OF INTERNATIONAL TRADE AND INVESTMENT

Instructor's Manual by Marta Szabo White, Ph.D.

I. LECTURE STARTER/LAUNCHER

Question: What do a Scottish Political Economist (Adam Smith), a British Political Economist (David Ricardo), two Swedish Economists (Eli Heckscher and Bertil Ohlin), a Russian-born Economist (Wassily Leontief), two Harvard Professors (Raymond Vernon and Michael Porter), a Rutgers University Professor (John Dunning), and an American Economist (Paul Krugman) have in common? BTW, initially do not share the names in parentheses with your students.
Answer: They each contributed to our understanding of internationalization, and their specific theories may be identified in **Exhibit 2.1**.

Question: The development of electric power or the invention of the aircraft is ranked commensurately with______________ as one of the transformational events of modern history.
Answer: The rise of the MNE.

Question: What do Nestlé, Unilever, Sony, Coca-Cola, Caterpillar, and IBM have in common?
Answer: Since the 1950s, they have invested abroad on a substantial scale, shaping the global competitive landscape for investment, trade, and technology transfer. They are NOT *Born Globals*.

II. LEARNING OBJECTIVES

Learning Objectives

1. What theories explain international trade and investment?
2. Why do nations trade?
3. How can nations enhance their competitive advantage?
4. Why and how do firms internationalize?
5. How can internationalizing firms gain and sustain competitive advantage?

Key Themes

In this chapter, the underlying economic rationale for international business activity is examined. Why does trade take place, and what are the gains from trade and investment?

Why do firms and nations such as Dubai trade and invest internationally and how do firms acquire and sustain competitive advantage in the global marketplace?

What are the leading theories of why firms pursue internationalization strategies as exporting, importing, investing, franchising, or licensing?

Sony Corporation (www.sony.com) is used as a recurring example to illustrate chapter theories on international trade and investment.

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Teaching Tips

As an overview, tell students that there are lots of theories about why and how firms and nations internationalize and sustain competitive advantage. **Exhibit 2.1** does a good job of providing an overview of these theories. Emphasize the three broad categories to be discussed - Classical, Contemporary, and Firm Internationalization. At the end of this discussion, ask your students which of these theories makes the most sense and why. The common thread throughout this chapter is global competitive advantage for nations and firms - how to achieve and sustain it. Contemporary Trade Theories and FDI/Non-FDI-Based Explanations address this issue for nations and firms respectively.

To create a more interactive environment, divide your class into groups of four or five students per team. Give each group ten minutes to share their ideas about one/two of the theories to be discussed, then invite a student representative from each group to explain their group's main points on their assigned theory. You may want to ask this representative to "drive" through the PowerPoint slides relating to their theory, and possibly share a graphic illustration on the board, particularly for absolute and comparative advantage. In light of the expressions that students sometimes make when the word "theory" is shared, this interactive teaching style may infuse excitement to an otherwise less than stimulating discussion (for students).

III. DETAILED CHAPTER OUTLINE

WHAT THEORIES EXPLAIN INTERNATIONAL TRADE AND INVESTMENT?

Comparative advantage - Superior features of a **country** that provide it with unique benefits in global competition, derived from either natural endowments or deliberate national policies.

Competitive advantage (*firm-specific advantage)* - Distinctive assets or competencies of a **firm** that are difficult for competitors to imitate - typically derived from specific knowledge, capabilities, skills, or superior strategies.

The authors have adopted the more recent view where *competitive advantage* refers to the advantages possessed both by nations *and* firms.

Exhibit 2.1 categorizes leading theories of international trade and investment into:

Nation-level Explanations

Explanations of international trade addressing two questions: (1) *Why* do nations trade? (2) *How* can nations enhance their competitive advantage?

1. Classical Theories
2. Contemporary Theories

Firm-level Explanations

Explanations of international business addressing two additional questions: (3) *Why* and *how* do firms internationalize? (4) *How* can internationalizing firms gain and sustain competitive advantage?

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1. Firm Internationalization
2. FDI-Based Explanations
3. Non-FDI-Based Explanations

WHY DO NATIONS TRADE?

The short answer is that trade allows countries to use their national resources more efficiently through ***specialization***.

Trade:

Facilitates industries and workers to be more productive

Allows countries to achieve higher living standards

Keeps the cost of everyday products low

Without international trade, most nations would be unable to feed, clothe, and house their citizens at current levels.

Even resource-rich countries like the U.S. would suffer immensely without trade.

Not only do nations, companies, and stakeholders benefit from international trade, but modern life would be virtually impossible without it.

Classical Theories

There are six classical perspectives explaining the underlying rationale for trade among nations:

Mercantilism

Absolute Advantage Principle

Comparative Advantage Principle

Factor Proportions Theory

International Product Life Cycle Theory

New Trade Theory

The Mercantilist View - 1500s

Mercantilism: the belief that national prosperity is the result of a positive balance of trade, achieved by maximizing exports and minimizing imports.

The earliest explanations of international business emerged with the rise of the European nation states in the 1500s, when gold and silver were the most important sources of wealth and nations sought to amass as much of these treasures as possible.

Thus, in the 16th century, *mercantilism* emerged as a dominant perspective of international trade.

In essence, mercantilism perceives exports as good, imports as bad, thus explaining a nation's effort to run a *trade surplus*, i.e., maximize exports and minimize imports.

Neo-mercantilism - the contemporary belief that running a trade surplus is beneficial is supported by labor unions (that seek to protect home-country jobs), farmers (who want to keep crop prices high), and certain manufacturers (those that rely heavily on exports).

Mercantilism may harm consumers, because restricting imports reduces the choices of products they can buy. Product shortages that result from import restrictions may lead to higher prices, i.e., inflation.

Free Trade - the relative absence of restrictions on the flow of goods and services is generally preferred, as this provides the greatest good for the greatest number, i.e., a utilitarian perspective.

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Free Trade Outcomes:

Consumers and firms can more readily buy the products they want.

Imported products are usually cheaper than domestically made products because access to lower-cost production forces prices down.

Lower-cost imports reduce the expenses of firms, raising their profits (which may be passed on to workers in the form of higher wages).

Lower-cost imports help reduce costs to consumers, increasing living standards.

Unrestricted international trade generally increases the overall prosperity of poor countries.

Absolute Advantage Principle, Adam Smith – 1776

A country benefits by producing only those products in which it has absolute advantage, or can produce using fewer resources than another country.

In 1776, **Adam Smith** published a seminal book, *An Inquiry into the Nature and Causes of the Wealth of Nations,* in which he attacked the mercantilist view by suggesting that nations benefit most from *free trade*.

By trying to minimize imports (Mercantilist view), a country inevitably wastes much of its national resources in the production of goods that it is not suited to produce efficiently, and these inefficiencies end up reducing the wealth of the country as a whole while enriching a limited number of individuals and interest groups.

Relative to others, each country is more efficient in the production of some products and less efficient in the production of other products.

Absolute Advantage Principle: A country benefits by producing primarily those products in which it has an absolute advantage, or can produce using fewer resources than another country. Each country gains by specializing in producing certain products, exporting them, and then importing the products it does not have an absolute advantage in producing.

Specialization and trade allow for increased consumption.

Factors of Production: resources used in the production of goods and services, including natural resources, labor, capital, and technology.

Exhibit 2.2 illustrates the absolute advantage principle. France should produce cloth and import wheat; and Germany should produce wheat and import cloth. Thus, each country employs their resources with maximum efficiency, and living standards rise in both countries.

Explanation -

Consider two nations, France and Germany, are engaged in a trading relationship. France has an absolute advantage in the production of cloth, and Germany has an absolute advantage the production of wheat.

Assume that labor is the only *factor of production* used in making both goods.

Each country benefits by specializing in producing the product in which it has an absolute advantage and then securing the other product through trade. France should specialize in producing cloth exclusively and import wheat from Germany, and Germany should specialize in producing wheat exclusively and import cloth from France.

Thus, each country employs its labor and other resources with maximum efficiency and living standards in each country rise.

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Examples **-**

Japan has no natural holdings of oil, but it manufactures some of the best automobiles in the world. **Saudi Arabia** produces much oil, but it lacks a substantial car industry. By trading with each other, Japan and Saudi Arabia each employ their respective resources efficiently in a mutually beneficial relationship.

Brazil can produce coffee more cheaply than Germany; **Australia** can produce wool more cheaply than **Switzerland**; and **Britain** can provide financial services more cheaply than **Zimbabwe**.

While absolute advantage provided the earliest sound rationale for international trade, it failed to account for more subtle advantages that nations may hold.

Later it was revealed that countries benefit from international trade even when they lack an absolute advantage.

Comparative Advantage Principle, **David Ricardo – 1817**

In 1817 **David Ricardo** published *The Principles of Political Economy and Taxation*, in which he explained why it would be beneficial for two countries to trade, even though one of them may have absolute advantage in the production of all products.

Comparative Advantage Principle: It can be beneficial for two countries to trade without barriers as long as one is more efficient at producing goods or services needed by the other. What matters is not the absolute cost of production, but rather the *relative* efficiency with which a country can produce goods or services needed by the other.

Ricardo demonstrated that what matters is not the absolute cost of production, but rather the *ratio of production costs* between two countries.

A country benefits from international trade even if its production advantages are only *comparatively* superior to those of other countries; having an *absolute* advantage is not necessary.

The principle of **comparative advantage** remains the foundation and overriding justification for international trade.

Exhibit 2.3 illustrates the comparative advantage principle - Here Germany should produce cloth and import wheat; France should produce wheat and import cloth.

Explanation -

Suppose now that Germany has an absolute advantage in the production of both cloth *and* wheat.

Even though Germany could produce both items more cheaply than France, it is still beneficial for Germany to trade with France.

It is not the *absolute* cost of production, but rather the *comparative* cost of production between the two countries that matters.

Germany is comparatively more efficient at producing cloth than wheat: it can produce three times as much cloth as France (30/10), but only two times as much wheat (40/20).

Germany should devote all its resources to producing cloth and import all the wheat it needs from France.

France should specialize in producing wheat and import all its cloth from Germany.

Both countries benefit by producing the product for which it has a comparative or relative advantage and then securing the other product through trade.

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Comparative Advantage - Opportunity Cost - the value of a foregone alternative activity

In **Exhibit 2.3**, if Germany produces 1 ton of wheat, it forgoes 2 tons of cloth. However, if France produces 1 ton of wheat, it forgoes only 1.33 tons of cloth. Thus, France should specialize in wheat. Similarly, if France produces 1 ton of cloth, it forgoes 3/4 ton of wheat. But if Germany produces 1 ton of cloth, it forgoes only 1/2 ton of wheat. Thus, Germany should specialize in cloth. The opportunity cost of producing wheat is lower in France and the opportunity cost of producing cloth is lower in Germany.

Optimistic view - The comparative advantage view is optimistic because it implies that a nation need not be the 1st, 2nd, or 3rd best producer of a product to benefit from international trade. Trade depends on differences in *comparative* cost, and any nation can profitably trade with another even if its real costs are higher for every product that it produces. It is generally advantageous for all countries to participate in international trade.

At the firm level, the benefits of specialization and division of labor are almost universally accepted. Comparative advantage simply applies the same principle to international trade.

Natural advantages – Natural (inherited) resources, e.g., fertile land, abundant minerals, and favorable climate were the initial areas of focus for comparative advantage.

Examples **-**

South Africa has extensive natural deposits of minerals; it produces and exports diamonds.

Argentina has much agricultural land and a suitable climate; it grows and exports wheat.

Russia has vast forests; it makes and exports wood products.

Acquired Advantages - **Over time, countries can also** *create* **or** *acquire* **new, comparative advantages - or such advantages emerge over time.**

Each nation's bundle of advantages evolves over time.

Nations overcome their relative inefficiencies through modernization, reduction of excess capacity, training, upgrading human resource skills and global sourcing.

Examples -

Germany had to relocate much of its mass manufacturing to Eastern Europe, to secure lower production costs.

Japan built an automotive industry originally at home, but had to seek lower cost production factors in Southeast Asian nations, Mexico, and Brazil.

Hitachi, Panasonic, and Sony – **Following WWII, these companies and others systematically** invested massive resources to acquire the knowledge and skills needed to become world leaders in consumer electronics. Today Japan accounts for approximately half the industry's total world production, including digital cameras, flat-screen TVs, and personal computers.

South Korea made similar investments in knowledge capital, giving rise to leading-edge firms like LG and Samsung.

Limitations of Early Trade Theories

While the concepts of absolute advantage and comparative advantage provided the rationale for international trade, they did not fully capture other realities of complex trade phenomena.

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Myriad of factors impact the existence and the extent of international trade including:

Transportation
- International transportation is costly yet fundamental for cross-border trade.

Government Intervention
- Cross-border trade may be hampered by tariffs (taxes on imports), import restrictions, regulations, and other forms of government intervention.

Economies of Scale
- Large-scale production in certain industries may bring about scale economies, and therefore lower prices, which can help offset national comparative disadvantages.

Public Sector Investment
- Governments may target and invest in certain industries, build infrastructure, or provide subsidies, all of which will serve to boost competitive advantage of firms.

International Services
- Contemporary cross-border business includes many *services* (such as banking and retailing) that cannot be "traded" in the usual sense and must be internationalized via foreign direct investment (FDI).

Technology
- Modern telecommunications and the Internet facilitate global trade in many services at very low cost.

Diversity
- The primary participants in cross-border trade tend to be more entrepreneurial, innovative, and have access to exceptional human talent that they employ to advance superior business strategies.

More recent scholars have incorporated such additional considerations into their theories.

Factor Proportions Theory, Eli Heckscher and Bertil Ohlin – 1920s

Eli Heckscher and his student Bertil Ohlin in the 1920s proposed the **Factor Proportions Theory** (sometimes called the factor endowments theory).

This view rests on two premises:

(1) Products differ in the types and quantities of factors (that is, labor, natural resources, and capital) that are required for their production; and

(2) Countries differ in the type and quantity of production factors that they possess.

Each country should export products that concentrate on its relatively abundant factors of production, and import goods that concentrate on its relatively scarce factors of production.

Examples -

The **U.S.** possesses much capital; it specializes in the production and export of capital-intensive products, such as pharmaceuticals and commercial aircraft.

China possesses an ample labor supply; it specializes in the production and export of labor-intensive products such as textiles, kitchen utensils, and electronic components.

Australia and **Canada** possess a great deal of land; they specialize in the production and export of land-intensive products such as meat, wheat, and wool.

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Argentina possesses much land; it produces and exports land-intensive products, such as wine and sunflower seeds.

Sony leverages China's abundant labor by manufacturing circuit boards, mobile phone handsets, and other components there. Sony conducts much of its R&D in Taiwan, to profit from the many skilled electronics engineers there.

Factor proportions theory differs from earlier trade theories by emphasizing the quantitative importance of each **nation's factors of production**.

The theory states that, in addition to differences in the *efficiency* of production, differences in the ***quantity* of factors** of production held by countries also determine international trade patterns.

As labor is considered a critical factor of production, then that explains why China and India are targets for foreign direct investment (FDI), i.e., manufacturing centers which leverage inexpensive, abundant labor.

Leontief Paradox, Wassily Leontief – 1950s

In the 1950s, t*he Leontief Paradox* suggested that, because the U.S. has abundant capital, it should be an exporter of capital-intensive products.

However, Leontief's analysis revealed that, despite the U.S. having abundant capital, its exports were labor-intensive and imports capital-intensive, which contradicts the Factor Proportions Theory.

Perhaps in Leontief's time, U.S. labor was relatively more productive than labor elsewhere in the world.

The main contribution of the Leontief Paradox is its suggestion that international trade is complex and cannot be fully explained by a single theory. While the Factor Proportions Theory explains international trade patterns, it cannot account for all trade phenomena.

Subsequent refinements note that country-level resources—knowledge, technology, capital—are instrumental in explaining international trade processes.

Examples -

Taiwan is home to a significant number of information technology workers, resulting in Taiwan's leadership in the global computer industry.

Brazil has an abundance of workers in various industries, which give rise to national advantages.

International Product Life Cycle Theory [IPLC], Raymond Vernon – 1966

In a 1966 article published in the *Quarterly Journal of Economics*, *"International Investment and International Trade in the Product Cycle,"* Harvard Professor Raymond Vernon described the evolutionary process that occurs in the development and diffusion of products to global markets.

Vernon built upon Ricardo's comparative advantage, a static framework, which argues that the highest added value dictates labor specialization, and integrated this with the product life cycle [introduction, growth, maturity, and decline] to explain dynamic trade patterns.

The **International Product Life Cycle theory** [IPLC] consists of three stages of evolution: **introduction, maturity, and standardization**.

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In the **Introduction** stage, a new product originates in an advanced economy with abundant capital, specialized labor, and R&D capabilities. It enjoys a temporary monopoly.

In the **Maturity** phase, innovating country firms will engage in mass production and seek export markets to other advanced economies.

As its production becomes more standard and the innovator's monopoly power dissipates, foreign firms are prompted to produce the standardized product which by now enjoys narrower margins.

In the **Standardization** phase, knowledge capital has disseminated and mass production is the dominant activity. Production shifts to low-income countries where the imitators enjoy a competitive advantage by using cheaper inputs and low-cost labor to serve export markets worldwide.

By now, the original innovating country may be a net importer of the product. It and other advanced economies become saturated with imports of the good from developing economies.

In effect, exporting the product has caused its underlying technology to become widely known (knowledge transfer) and standardized around the world.

Early in the evolution of a product, manufacturing requires highly skilled knowledge workers in R&D.

When the product becomes standardized, mass production is employed, requiring access to less expensive raw materials and low-cost labor.

As a product evolves through its international product life cycle, comparative advantage in its production shifts from country to country.

Examples -

Televisions - The United States invented the television in the 1940s. U.S. sales grew rapidly for many years. Once TVs became a standardized product, television production shifted to China, Mexico, and other countries that offer lower-cost production.

Sony – Inventor, innovator, and patent holder of the aperture grille technology, in 1968, initiated production of the Trinitron aperture grille cathode ray tube televisions (very bright TV images) and dominated the market for Trinitron TVs until the 1990s. As the technology became standardized and Sony's patents expired, manufacturing shifted to lower-cost countries such as China, Mexico, and Pakistan. In later years, Trinitron TVs were imported into Japan. Commensurate with the product cycle theory, the sequence of introduction, growth, and maturity came full circle for Sony.

Learning Point: The IPLC illustrates that national advantages are dynamic; they do not last forever. Firms worldwide are continuously creating new products and others are constantly imitating them. The product cycle is continually beginning and ending.

Model Assumption: Vernon assumed the product diffusion process occurs slowly enough to generate temporary differences between countries in their access and use of new technologies. Not true.

Globalization and technology have shortened the IPLC from innovation to maturity, and standardization, which explains the rapid spread of new consumer electronics such as digital assistants and cell phones around the world.

Technological leapfrogging remains prevalent. Emerging market consumers are eager to adopt new technologies as soon as they become available.

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This trade theory is in Exhibit 2.1, but not in the text.
New Trade Theory, Paul Krugman – 1970s

New Trade Theory argues that increasing returns to scale, especially ***economies of scale***, is a key factor for superior international performance, and would explain why trade grew fastest between industrial countries that held similar factors of production - something that previous theories failed to explain.

A nation imports the products that it does not produce itself, resulting in:

Increased variety of products available to consumers, *and*

Lower cost of these goods, due both to international trade and economies of scale achieved in domestic industries.

Example - Sony developed large-scale factories, creating economies of scale (productivity increased and per unit costs decreased), thereby ensuring maximum productivity and profitability.

New Trade Theory provides additional incentives for international trade:

Small domestic markets may not be conducive to generating economies of scale. However, exporting provides access to the larger global marketplace, where increasing returns to scale would allow for specialization in a small number of industries, without requiring a factor or comparative advantage.

Critics of the New Trade Theory argue that the desire to develop industries that prosper based on economies of scale might encourage inappropriate government intervention.

HOW CAN NATIONS ENHANCE THEIR COMPETITIVE ADVANTAGE?

Contemporary Theories

Globalization of markets has fostered a new type of competition – a race among nations to reposition themselves as attractive places to invest and do business.

The most advantaged nations today possess *national competitive advantage*, which is maximized when several industries collectively possess firm-level competitive advantages *and* when the nation itself has comparative advantages that benefit those particular industries; see **Exhibit 2.4.**

Governments often embark upon proactive policies designed to create competitive advantage, often by developing world-class economic sectors and prosperous geographic regions, i.e., policies aimed at developing acquired advantages. Three key modern perspectives help explain the development of national competitive advantage: Competitive Advantage of Nations, Michael Porter's Diamond model, and National Industrial policy.

The Competitive Advantage of Nations, Michael Porter – 1990

According to Michael Porter, in his 1990 book, *The Competitive Advantage of Nations,* the competitive advantage of a nation is dependent upon the collective competitive advantages of its firms.

Over time, this relationship is reciprocal: the competitive advantages held by the nation tend to drive the development of new firms and industries with these same competitive advantages.

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Examples -

Britain has achieved substantial national competitive advantage in the prescription drug industry due to its first-rate pharmaceutical firms, including GlaxoSmithKline and AstraZeneca.

The **U.S.** is considered to possess national competitive advantage in service industries because of many leading firms such as Goldman Sachs (investment banking), Marsh & McLennan (insurance), Dreamworks (movies), and Booz & Company (consulting). U.S. prowess in the service sector has engendered overall national competence in the global services sector.

Germany has achieved substantial national competitive advantage in engineering-intensive fields due to its first-rate engineering firms, including Bosch, Siemens, and Daimler-Benz.

Sony developed the Blu-ray high definition video disc format. After Blu-ray won the backing of virtually all major movie studios, Sony solidified its position as the dominant format. Sony introduced numerous other product standards, including the Compact Disc in 1982, Digital Betacam in 1990, and the Memory Stick in 1998. In 2008, Sony introduced "Green TV," a flat-panel television that consumes little energy while providing a high-quality image.

As national competitive advantage theory would predict, the contributions and distinctive competences of **Sony, Hitachi, Toshiba**, and other indigenous firms have been pivotal to the success of Japan in high-technology industries.

Competitive advantage - An individual firm has a competitive advantage when it possesses one or more sources of distinctive competence relative to others, enabling it to perform better than its competitors.

Examples -

Walmart's/Tesco's low-cost operations have allowed them to surpass other mass retailers.

Nokia's superior technology and design leadership have allowed it to stay abreast and often surpass key rivals in the cell phone industry.

Innovation

At both the firm and national levels, competitive advantage and technological advances grow out of *innovation*.

Research and development (R&D) sustain innovation (and by extension, competitive advantage).

Firms innovate by continually searching for better products, processes, services, marketing approaches and new ways of organizing/training - thus sustaining innovation and competitive advantage.

Example- Australia's Vix ERG (fare collection equipment and software systems for the transit industry) has won numerous awards for its innovative products that enabled the firm to internationalize quickly.

Innovation is driven by R&D. Vix ERG invests 23% of revenue in R&D.

Globally, more researchers are engaged in R&D than ever before.

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Industries highly dependent on technological innovation: Biotechnology, information technology, pharmaceuticals, robotics, medical equipment, fiber optics, and various electronics-based industries.

Most top European, Japanese, and U.S. firms spend more than half of their total R&D expenditures abroad, as documented by the *Global Innovation 1000*.

Rationales:

Access to talent - gifted engineers and scientists located around the world, e.g., China and India.

Cost cutting by replacing higher-paid, home-country engineers and scientists with lower-paid replacements

Proximity to key markets is central to incorporating target market insights during product development. This also explains why Europe and the U.S. are popular sites for R&D by foreign companies - creating/launching new products for the world's most lucrative markets.

The more innovative firms a nation has, the stronger its competitive advantage.

Innovation also promotes *productivity*, which translates to efficiency.

At the national level, productivity is a *key* determinant of the nation's long-run standard of living and a basic source of national per-capita income growth.

South Korea and the U.S. have been among the world's most productive nations.

Innovation and process improvements are particularly critical in impacting productivity, which received a huge boost with the widespread introduction of information and communications technologies in the 1990s.

Michael Porter's Diamond Model

Porter's *Diamond Model* depicted in **Exhibit 2.5** explains competitive advantage at both the firm and national levels and originates from the presence and quality in the country of the following four major elements:

1. ***Firm Strategy, Structure, and Rivalry*** refer to the nature of domestic rivalry, and conditions in a nation that determine how firms are created, organized, and managed. The presence of strong competitors in a nation helps create and maintain national competitive advantage.

2. ***Factor Conditions*** describe the nation's position in factors of production, such as labor, natural resources, capital, technology, entrepreneurship, and know-how. Consistent with the Factor Proportions Theory, every nation has more of certain factor endowments and less of others -- a situation that determines the nature of national competitive advantage.

3. ***Demand Conditions*** refers to the nature of home-market demand for specific products and services. The strength and sophistication of buyer demand facilitates the development of competitive advantages in particular industries.

4. ***Related and Supporting Industries*** refers to the presence of clusters of suppliers, competitors, and complementary firms that excel in particular industries. Operating within a mass of related and supporting industries provides advantages through information and knowledge synergies, economies of scale and scope, and access to appropriate or superior inputs.

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Industrial Cluster: A concentration of businesses, suppliers, and supporting firms in the same industry at a particular geographic location, characterized by a critical mass of human talent, capital, or other factor endowments.

Examples -

Silicon Valley, **California**
Wireless Valley, in **Stockholm, Sweden**
IT industry in **Bangalore, India**
Fashion industry in **northern Italy**
Pharmaceutical industry in **Switzerland**
Footwear industry in **Vietnam**
Medical technology industry in **Singapore**
Consumer electronics industry in **Japan**

The most important sources of national advantage are the **knowledge and skills** possessed by individual firms, industries, and countries.

Knowledge and skills determine where MNEs locate economic activity.

Some argue that knowledge is the only source of sustainable, long-run competitive advantage.

National Industrial Policy

Perhaps the greatest contribution of Michael Porter's work has been to underscore the notion that **national competitive advantage** does not derive entirely from the store of natural resources that each country holds. Moreover, *inherited* national factor endowments are relatively less important than in the past.

Porter's Diamond Model implies that *any* country can *create* economic prosperity by systematically cultivating new/superior factor endowments (infrastructure, education, capital generation).

Nations can develop these endowments through proactive ***national industrial policy***.

This economic development plan, initiated by the government and often in collaboration with the private sector, aims to develop or support particular industries within the nation by developing high-value adding industries that generate substantial wealth through corporate profits, higher worker wages, and tax revenues.

National industrial policy building blocks:

(1) Tax incentives to encourage citizens to save and invest, which provide capital for public and private investment in R&D, plant, equipment, and worker skills
(2) Monetary and fiscal policies, such as low-interest loans, which provide a stable supply of capital for company investment needs
(3) Rigorous higher-educational systems that ensure a steady stream of competent workers in the sciences, engineering, and business administration
(4) Development/maintenance of strong national infrastructure in areas such as IT, communication systems, and transportation
(5) Institutionalization of strong legal and regulatory systems to ensure citizens are confident about the soundness and stability of the national economy

National Industrial Policy in Practice - Examples: **Dubai, Ireland**, and **Japan**

Dubai pursuing a national industrial policy to become an international commercial center in the information and communications technology (ICT) sector by focusing (as

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progressive nations do) on high value-adding, knowledge-intensive industries such as IT, biotechnology, medical technology, and financial services - which lead to the development of supplier and support companies that further enhance national prosperity.

Ireland - The **Irish Miracle**: From one of Europe's stagnant economies to one of its most dynamic - proactive country repositioning implemented through a collaborative effort via public and private sectors.

The "Irish miracle" resulted from a combination of efforts:

- ***Fiscal, monetary, and tax consolidation*** – The Irish government lowered the basic corporate tax rate to zero, helping to foster entrepreneurship and increasing the nation's attractiveness for inward investment from foreign MNEs. Personal taxes were sharply reduced, boosting consumer spending power. Government cut spending and borrowing, leading to lower interest rates and economic stimulus.
- ***Social partnership*** – The Irish government initiated earnest dialogue with labor unions, getting them to accept wage cuts. Improving labor relations and increased coordination between government and industry improved the quality of the work force and strengthened the Irish labor pool.
- ***Emphasis on high value-adding industries*** – Ireland created a national infrastructure and investment climate that fosters the development of industries in high value-adding fields -- pharmaceuticals, biochemistry, and IT.
- ***Membership in the European Union*** – The emergence of the European single market provided Ireland with a huge market for its exports. Falling trade barriers opened a giant market of 400 million consumers to Irish firms.
- ***Subsidies*** – Ireland received subsidies from the European Union that allowed it to offset debt, invest in key infrastructure projects, and develop a range of key industries, particularly in the IT sector.
- ***Education*** – The country invested heavily in education, providing a steady supply of skilled workers, including scientists, engineers, and business school graduates.

Annual GDP growth in Ireland averaged nearly 7 percent throughout the 1990s.

The Irish *Industrial Development Authority* emphasized attracting desirable firms in software, semiconductors, personal computers, pharmaceuticals, medical devices, and other knowledge-intensive industries.

Lured by the positive developments in Ireland, many foreign manufacturers began investing in the country.

Ireland has become a major player in world trade and is now host to more than **1,000 MNEs**.

International trade, inward FDI, and economic development dramatically raised living standards.

Property prices had risen more rapidly than in any other advanced world economy for the decade leading up to 2006.

With arrival of the **global financial crisis** (2008-2010), economic activity dropped sharply and Ireland experienced a recession for the first time in many years, with the main problem being collapsing real estate markets.

Ireland's economy remains strong, with one of the world's highest per capita income levels.

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Despite the collapse of the property bubble, the country's growth model based on international trade and investment remains sound.

Japan – Sony - emerged as the global leader in consumer electronics in large part due to the *Japanese miracle* - creation of superior national infrastructure, first-rate education systems, low taxes and interest rates, trade liberalization, and close cooperation with manufacturers and banks to create high-value adding industries. Japan developed various acquired advantages – skilled labor, cheap capital, and strong R&D capabilities.

WHY AND HOW DO FIRMS INTERNATIONALIZE?

Earlier theories focused on why and how international trade occurs. Beginning in the 1960s, scholars became more interested in the managerial and organizational **processes** of firm internationalization.

Internationalization Process of the Firm, 1970s

The ***Internationalization Process Model*** explains the process of internationalization as a gradual process that takes place in incremental stages over a relatively long period of time, which is attributed to uncertainty and inadequate information about foreign markets and lack of experience with cross-border transactions.

Firms start without much analysis or planning and begin to export, the simplest form of international activity, and as they acquire experience and information about foreign markets, they progress to the most complex form, FDI.

Stages: *domestic focus* phase, *pre-export* stage, *experimental involvement* (exporting), *active involvement* (increased commitment), and progress to *committed involvement* (value-chain activities/FDI).

Example - Sony's increasing international commitment levels serve to illustrate the internationalization process:

In the 1950s, Sony exported transistor radios and other products to Australia, Europe, and North America.

In the 1960s, Sony entered joint ventures with CBS, Texas Instruments, and various other international partners.

Also in the 1960s, Sony used FDI to establish sales offices in Hong Kong, Switzerland, and the United States.

Sony later set up factories in several countries, to manufacture the consumer electronics that made Sony famous.

In 1972, Sony set up its first television factory in the U.S. - in San Diego.

Currently, Sony has joint ventures and wholly-owned operations in hundreds of locations worldwide. In Europe, Sony operates five R&D centers, as well as nine plants that produce computers, game consoles, personal navigation devices, and portable audio players.

In this example, Sony has evolved from the *experimental involvement* (exporting) stage to the most complex form of international activity, i.e. *committed involvement* (value-chain activities/FDI).

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Born Globals and International Entrepreneurship

International entrepreneurship - Scholarly inquiry in light of the born global phenomenon - recently scholars have questioned the slow and gradual process proposed by the internationalization process model.

Initially, theory and practice of international business was the domain of resource-rich, large MNEs.

The **Internationalization Process Model** was developed prior to:

- Growing intensity of international players
- Integration of world economies, a function of globalization
- Advances in communication and transportation technologies enabling faster internationalization at reduced costs
- Emergence of a new global business landscape with a different set of rules

Born Globals are global at their founding, or shortly thereafter.

Over the past two decades, many smaller/entrepreneurial firms have sought internationalization early in their evolution.

Their inexperience, small size, and scarce resources (financial, human, and tangible) is offset by strong international entrepreneurship, reliance on the Internet, and the ease with which international business can be conducted in an increasingly integrated global economy.

Growing interconnectedness of national economies suggests that even more firms will internationalize their value-chain activities early in their evolution.

HOW CAN INTERNATIONALIZING FIRMS GAIN AND SUSTAIN COMPETITIVE ADVANTAGE?

The rise of the MNE is commensurately ranked with the development of electric power or the invention of the aircraft as one of the major events of modern history.

Since the 1950s, MNEs such as Nestlé, Unilever, Sony, Coca-Cola, Caterpillar, and IBM have been investing abroad on a massive scale, shaping the landscape for global trade, investment, and technology flows.

Definition - MNE is a large, resource-rich company whose business activities are performed by a network of subsidiaries in numerous countries, and whose value chains span multiple countries.

They are the foremost agents in disseminating new products, new technologies, and business practices worldwide, contributing to ongoing globalization of markets.

Example -

- **Sony** is based in Tokyo, has annual sales of roughly $100 billion, and has more than 170,000 employees worldwide.
- Sony's PlayStation dominates the game console market with about 50 percent of global sales. They also make Vaio computers, digital cameras, Walkman stereos, and semiconductors.
- Japan only accounts for a quarter of Sony's worldwide sales.
- Sony's global value chain is extensive, with over 20 R&D centers outside Japan, in Europe, Mexico, and the United States.
- Sony conducts business in emerging markets such as Argentina, Brazil, China, Turkey, Indonesia, Vietnam, and the Philippines.

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Sony is a *borderless* MNE that locates its activities wherever it can maximize competitive advantages.

FDI-Based Explanations

FDI stock refers to the total value of assets that MNEs own abroad via their investment activities.

Exhibit 2.6 shows total stock of inward FDI (**Leading FDI Destinations**).

Exhibit 2.7 shows total stock of outward FDI (**Leading Sources of Outward FDI**).

Total inward FDI stock now constitutes some **30 percent of global GDP**, which is a significant amount.

Historically - most of the world's FDI was invested both by and in Western Europe, North America, and Japan. In recent years, MNEs have begun to invest heavily in emerging markets such as China, Mexico, Brazil, and Eastern Europe.

Three Theories in **Exhibit 2.8**: FDI is such an important entry strategy that three alternative theories are provided for explaining why firms choose it to gain and sustain competitive advantage: the Monopolistic Advantage Theory, Internalization Theory, and Dunning's Eclectic Paradigm.

Monopolistic Advantage Theory

Monopolistic advantage refers to resources or capabilities a company possesses that few other firms have and that it can leverage to generate profits and other returns.

This theory suggests that firms use FDI as an internationalization strategy, and own/control certain resources and capabilities (e.g. proprietary technology; brand name) that give them a degree of monopoly power relative to foreign competitors.

Conditions:

Returns obtainable in the foreign market should be superior to those available in the home market.

Returns obtainable in the foreign market should be superior to those earned by its domestic competitors in its industry in the foreign market.

Assumptions:

Local firms do not possess these advantages.

MNCs maintain ownership of these advantages by internalizing them.

Advantages should be firm-specific rather than location-specific.

The most important monopolistic advantage is **superior knowledge**, which includes intangible skills possessed by the MNE that provide a competitive advantage over local rivals.

Examples -

Sony - Illustrates the superior knowledge example - Through its focus on leading edge innovation, Sony accumulated a large body of superior, proprietary knowledge, which it monopolistically leveraged to develop products such as the Walkman, PlayStation, and Blu-ray disc format. Monopolistic advantages enabled Sony's market dominances.

South African SAB plc became the second largest beer brewer in the world by acquiring the Miller Brewing Company of the United States. SAB attained this status by leveraging a near monopoly in its home country, relying on extensive international

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business expertise, and offering a relatively unique line of beers to customers around the world.

Internalization Theory

What are the specific benefits MNEs derive from FDI-based entry?

When **Procter & Gamble** entered Japan, management initially considered two entry modes: exporting and FDI.

Due to trade barriers imposed by the Japanese government, the strong market power of local Japanese firms, and the risk of losing control of proprietary knowledge, P&G chose instead to enter Japan via FDI.

P&G established its own marketing subsidiary and, eventually, national headquarters in Tokyo. The benefits from this arrangement would not have accrued to P&G via exporting.

The ***Internalization Theory*** explains the process by which firms acquire and retain one or more value-chain activities inside the firm, thus minimizing the disadvantages of dealing with external partners, reducing the risk of partners becoming competitors and allowing for greater control over foreign operations and their proprietary knowledge.

FDI should be compared in terms of a cost/benefit analysis (including risk/control issues) to other entry modes - exporting, licensing, etc.

By internalizing foreign-based value-chain activities, it is the firm, rather than its products, that crosses international borders. The firm *replaces* business activities performed by independent suppliers in external markets with business activities it performs itself.

Examples -

Intel

Internalizes production of its leading-edge computer chips, to prevent potential competitors from gaining access to its latest technology

Sony

1950s - Sony followed a policy of exporting its products to Europe and North America.

1960s - To improve international performance, Sony internalized much of its global production and distribution channels by establishing company-owned subsidiaries in Europe, the United States, and other key markets.

To ensure product quality, Sony internalized semiconductor and circuit boards production for use in making PlayStations, cell phones, etc.

To improve supply chain management, Sony recently transferred production of camcorders from a joint venture plant run by a partner in China to a wholly-owned Sony plant in Japan.

Sony has long been a major player in the movie industry, through its subsidiary Sony Pictures Entertainment (SPE). In **1989**, SPE acquired the Loews chain of movie theaters, enabling Sony to internalize a substantial portion of the distribution channel for its film business.

Since founding in **1946**, Sony consistently internalized key units in order to maintain **control** over the most important links in its global value chains.

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Dunning's Eclectic Paradigm

John Dunning –

Framework for determining the extent and pattern of global value-chain operations

According to this paradigm, MNE activity leverages both the **competitive** advantages of firms and the **comparative** advantages of countries (using the pre-Porter terminology).

Dunning builds on previous works, including comparative advantage, factor proportions, monopolistic advantage, and internalization advantage theories.

The Eclectic Paradigm specifies three **conditions** that determine whether or not a company will internationalize via FDI: **ownership-specific advantages, location-specific advantages, and internalization advantages.**

Ownership-specific advantages

Refer to firm-specific *competitive* advantages, e.g. knowledge, skills, capabilities, key relationships, proprietary technology, unique managerial talent, trademarks/brand names, economies of scale, access to substantial financial resources, and other assets.

The more valuable the firm's ownership-specific advantages, the more likely it is to internationalize via FDI.

Example -

The **Aluminum Corporation of America** (Alcoa) has over 70,000 employees in roughly **35 countries**.

The firm's integrated operations include bauxite mining and aluminum refining. Its products include primary aluminum (which it refines from bauxite), automotive components, and sheet aluminum for beverage cans and Reynolds Wrap®.

Over time, Alcoa has acquired several **ownership-specific advantages**: Proprietary technology from R&D activities; special managerial and marketing skills from the production/marketing of refined aluminum; economies of scale from its size and the ability to finance expensive projects - all of which serve to maximize profits from international operations.

Location-specific advantages

Refer to host country *comparative* advantages, e.g., natural resources, skilled labor, low-cost labor, and inexpensive capital.

Two conditions must be met for FDI to succeed:

The advantage must actually exist in the given country (that is, the country must possess low-cost labor, inexpensive capital, or some other advantage).

The advantage must lead to facilitating profitable operations for the MNE.

In terms of **location-specific advantages**,

Alcoa located refineries in Brazil because of that country's huge deposits of bauxite, a mineral that is found in relatively few other locations worldwide.

Amazon and other major rivers in Brazil generate huge amounts of hydroelectric power, a critical ingredient in electricity-intensive aluminum refining.

Alcoa also benefits from Brazil's low-cost, relatively well-educated laborers, who work in the firm's refineries.

Internalization advantages

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Refer to the *competitive* advantages that the firm derives from internalizing foreign-based manufacturing, distribution, or other stages in its value chain.

When profitable, the firm will transfer its ownership-specific advantages across national borders *within* its own organization rather than dissipating them to independent, foreign entities.

FDI Decision: Which is best - internalization via FDI versus externalization using external partners (licensees, distributors, or suppliers)?

Internalization **advantages**:

control how the firm's products are produced or marketed;
control dissemination of the firm's proprietary knowledge; and
reduce buyer uncertainty about product value.

Alcoa has internalized many of its operations because:

(1) Alcoa wants to minimize knowledge dissemination regarding its aluminum refining operations knowledge the firm acquired at great expense.

(2) Internalization provides the best net return to Alcoa, allowing it to minimize the costs of operations.

(3) Alcoa needs to control sales of its aluminum products to avoid depressing world aluminum prices through oversupply.

(4) Alcoa wants to be able to apply a differential pricing strategy – charge different prices to different customers, thus distribution control is key.

(5) Aluminum refining is a complex business and Alcoa wants to control it for quality purposes.

Non-FDI Based Explanations

FDI became a popular entry mode with the rise of the MNE in the 1960s and the 1970s.

Since the 1980s, firms began to recognize the importance of collaborative ventures and other flexible non-FDI entry strategies.

International Collaborative Ventures

A collaborative venture is a form of **cooperation** between two or more firms.

Interfirm collaborations may be **horizontal** - that is, between partners at the same level of the value chain or **vertical** - between partners at different levels of the value chain.

Two types:

Equity-based joint ventures that result in the formation of a new legal entity; and

Non-equity-based ***strategic alliances*** in which firms partner temporarily to work on projects related to R&D, design, manufacturing, or any other value-adding activity.

In both cases, collaborating firms pool resources and capabilities, generate synergy, and share risks to carry out activities that each might be unable to perform on its own.

Through collaborative ventures, firms gain access to resources and capabilities, foreign partners' know-how, capital, distribution channels, marketing assets, and transcend government-imposed barriers.

Examples illustrating international success through collaborative ventures:

Starbucks boasts of over 700 coffee shops in Japan thanks to its joint venture with its local partner, Sazaby League, Ltd.

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Sony's collaborative ventures include: joint venture with Sweden's Ericsson, through which it sells mobile phones; a partnership with pop star Michael Jackson, since deceased, which led to the formation of Sony/ATV Music Publishing; a joint venture with automaker Toyota, to produce liquid crystal displays; and a 50 percent stake in the German media giant Bertelsmann AG, called Sony BMG Music Entertainment.

Networks and Relational Assets

Networks and relational assets represent the stock of the firm's economically beneficial long-term *relationships* with other business entities, such as manufacturers, distributors, suppliers, retailers, consultants, banks, transportation suppliers, governments, and any other organization that can provide needed capabilities.

Japanese *keiretsu* are the predecessors of the networks and alliances now emerging in the Western world. Keiretsu are complex groupings of firms with interlinked ownership and trading relationships that foster inter-firm organizational learning.

Like the keiretsu, networks are neither formal organizations with clearly defined hierarchical structures nor impersonal, decentralized markets.

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