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THE GLOBAL ENVIRONMENT

Every company is looking to reduce its costs, raise its market share or generate more value for the money it spends. When contemplating a project, you can't afford to look only at your home market. Instead, you evaluate the whole world. You look at what countries offer in terms of infrastructure, tax structure, intellectual property protection, technical capabilities, and markets, and you evaluate the trade-offs.¹

Learning Objectives of the Chapter

Effective managers are constantly aware of the changes taking place at home and around the globe; they scan their environment on an ongoing basis, and when they detect opportunities and/or threats, they transform their organization to seize the opportunities and/or combat the threats.² This means that to make effective decisions, managers must gather information from their domestic (home country) environment, as well as from the international and foreign environments. After studying this chapter, you should be able to do the following:

1. Briefly discuss the nature of the firm's home country environment
2. Describe the international environment, such as groupings of nations—the European Union (EU), for example, and its impact on international management
3. Discuss the nature of countries' cultural, economic, legal and political, and competitive environments, as well as trade barriers, exchange rates, and labor relations, and their impact on international management
4. Point out some of the sources of this information.

The Domestic Environment

At the domestic (home country) level, international business enterprises are affected by numerous factors, including the political, competitive, economic, legal, and governmental climates.

Domestic Political Climate

International managers must remain informed about the political climate in their home country, and based on the information, they must ascertain whether the climate can now or in the future have an impact on their enterprises' business. For example, for economic and other reasons, interest groups sometimes persuade their government to attach tariffs (taxes) or place quotas (number limits) on certain imports. Tariffs and quotas (discussed later in the chapter) can have a direct, as well as an indirect, effect on businesses.

Embargos, where a country's government, for political reasons, prohibits its businesses to trade with another country—the U.S. embargos on Cuba and North Korea, for example—also have a direct impact on businesses. If a company needs to do business in a country on which its country's government has imposed an embargo, it will find a way to do it, thus increasing costs. For instance, if a company in the United States needs a certain resource available in Cuba, it can get it by Cuba selling it to a company in another country, which subsequently sells it to the company in the United States, thus increasing the costs. The company in the United States can itself set up a subsidiary in the foreign country (discussed more thoroughly in Chapters 4 and 5), again increasing costs in the sense that jobs are lost in the home country.

For illustration purposes, suppose that the managers of a corporation manufacturing tractors in Country X are considering exporting to Country Y, that companies in Country Y export wheat to Country X, and that wheat growers at home (Country X) are attempting to persuade their government to apply a quota or a tariff on wheat imports. It is possible that if a tariff or a quota is imposed, Country Y's wheat exporters, in retaliation, might persuade their government to attach a tariff or quota on tractor imports. (As discussed later in the chapter, history shows that one tariff usually begets another.) The tariff or quota would affect the tractor exporters' business.

International business managers thus need to be thoroughly familiar with nations' tariff and quota practices, as well as with the embargos. In the United States, an aid is The National Trade Estimate Report on Foreign Trade Barriers, generated by the Office of the U.S. Trade Representatives (USTR), which had a new purpose bestowed on it by the 1988 Trade Act. The Act requires the USTR to submit the report to Congress by the end of April and point out the trade barriers that cost the United States the most exports. A recalcitrant will be open to retaliatory tariffs or bans.³ The USTR (www.ustr.gov), a part of the Executive Office of the President, is involved in trade agreements, in trade and development, in trade sectors, and with World Trade Organization (WTO) (discussed later in the chapter) issues. (For illustration purposes, read Practical Perspective 3.1.)

September 11, 2001. *Of course, the September 11, 2001, attack on the United States has changed the U.S. political climate dramatically, as well as the global political climate. These*

PRACTICAL PERSPECTIVE 3-1

U.S. Hikes Tariffs on Imports

WASHINGTON—A bitter trade battle between the United States and Europe over bananas turned even nastier yesterday as the United States began notifying importers that they are now liable for hefty penalty tariffs on \$520 million worth of European goods. If allowed to stand, the tariffs of 100 percent on items such as German coffee makers and French handbags effectively would double their price, putting them out of reach for most U.S. consumers. The administration is seeking to penalize European producers by an amount equal to the damages U.S.-based banana companies say they are suffering in lost sales because of unfair European trade barriers.

The U.S. action, which caught European officials by surprise, was immediately denounced by the [then] 15-nation European Union. The move came only a day after the World Trade Organization asked for more information before ruling on the legality of the U.S. trade sanctions. The WTO had requested both sides to provide that information by March 15 [1999]. "The United States decided to defy the WTO system by introducing a form of sanctions that has no WTO authorization whatsoever," said Leon Brittan, EU's trade minister, in a statement issued in Brussels. "What the United States has done is therefore unacceptable and unlawful."

The United States said it would not collect any punitive tariffs until the WTO rules on the appropriate size of the sanctions. But starting yesterday, importers of those products must post bonds and assume liability for paying the higher tariffs if the WTO rules in the U.S.'s favor. The United States contends that American banana companies are losing \$520 million annually in lost sales to Europe because of illegal trade barriers that favor bananas imported from former European colonies in the Caribbean and Africa. Chiquita Brands, Inc. and Dole Food Company, Inc., the major American companies involved, grow their bananas on plantations in South America. While the United States won a WTO case on this issue, the EU argued that the matter needed further review because it has changed some banana import rules. The U.S. side says the changes do not satisfy American objections.

SOURCE: Excerpted from Martin Crutsinger, "U.S. Hikes Tariffs on Imports," *The Star Ledger* (March 4, 1999), p. 43. Reprinted with permission. Copyright by the Associated Press.

changes have affected business practices in the United States (e.g., the airline and security industries), as well as business practices throughout the globe. In July 2006, extremists were getting ready to carry out a clever plan to blow up numerous passenger airplanes scheduled to fly from London to various cities in the United States, but those extremists were caught by U.K. security authorities before they could execute their plan.

September 11, 2001, has created higher security costs in the airline industry, which in turn had negative economic consequences on many other industries—for instance, delaying executives at the United States' airport security checks is costly, and so are the additional security people and additional technologies needed to do the checking. Importing goods into the United States is now more costly because of the additional security requirements at the nation's ports. And the creation of the U.S. Homeland Security Agency, resulting from the 9/11 incident, is very costly, and so is the cost of insurance, other transport costs, the costs of investments and security, as well as the costs in the tourism industries. These are just a few of the many political consequences brought on the United States' and other nations' political atmosphere by the September 11, 2001, incident.

Domestic Competitive Climate

Managers also need information about domestic competitors' objectives. Domestic competitors may be developing similar strategies to penetrate the same foreign markets, and they may be introducing a newer product that would give them a competitive edge. Or they may be planning to manufacture their products in a foreign country where labor is cheaper, which would also give them a competitive edge. This would have an impact on the enterprise's promotional, product, pricing, and place (channels of distribution) strategies and may force it to internationalize its operations, to leave home and go produce in a foreign country (discussed more thoroughly in Chapters 4 and 5).

Domestic Economic Climate

Information is also needed about the domestic economic climate. If it is deteriorating, the government may place constraints on foreign investments to strengthen the domestic economy. On the other hand, if a firm's sales are declining because the local economy is in recession and there are no governmental constraints, entering prosperous foreign countries may be a viable survival strategy for the firm (discussed more thoroughly in Chapter 4).

Domestic Legal System and Government Policies

Managers must be thoroughly familiar with their home country's legal system and government policies. For political and security reasons, as well as other reasons, the U.S. government sometimes prohibits the export of certain technologies—for example, the United States' high-tech industries, such as machine tools, telecommunications, military-oriented technologies, and supercomputers. Executives in such industries have complained about contradictions in such U.S. government policies. They claim that while the government helped them develop technology for military reasons, it used the same national security concerns to impose export controls on high technology, hence keeping United States' most dynamic corporations from competing in global commercial markets. Nevertheless, the United States is the leading exporter of military goods in the world to developed countries, and Russia is the leading exporter of military goods in the world to less developed countries.

U.S. machine tool manufacturers, for instance, were once deterred from exporting advanced machines for producing soda cans to Hungary. U.S. West was prohibited from assisting the former U.S.S.R. in laying modern optical fiber cable. And Cray Research Corporation, a maker of supercomputers subsidized by the military, once had difficulty getting the U.S. government's clearance to sell products in India and Brazil.⁴ For sure, one would think, after the September 11, 2001, incident, that the U.S. government would very strongly prohibit U.S. weapons manufacturers from selling their products to the United States' enemies, those who say they want to kill Americans.

The International Environment

Managers must remain informed about the international environment, which consists of groupings of nations such as the EU; of worldwide bodies such as the World

Bank, the International Monetary Fund (IMF), the WTO; and of organizations of nations by industry agreements, such as the Organization of the Petroleum Exporting Countries (OPEC). For example, the 1970s' manipulation of oil prices by OPEC had a tremendous negative economic and business impact on many nations, and many nations are today (2007) still trying to recover from the setbacks. It seems as if the consolidation of nations into free-trade blocks is going to continue. (For illustration purposes, read Practical Perspective 3.2.) Such organizations have an impact on firms' international strategies, and effective international business managers must carefully and continuously monitor their policy and program changes, because changes present both threats and opportunities for businesses.

PRACTICAL PERSPECTIVE 3-2

The Road to Santiago

When in December 1994 Bill Clinton welcomed to Miami the leaders of 33 other countries in the Americas, their meeting was widely seen as the start of a new chapter in the often troubled relations between the United States and Latin America. With the Cold War over, with elected governments in power except (uninvited) Cuba, and with market reforms and freer trade supplanting protectionism, many old sources of tension seemed to have been replaced by shared ideas and new opportunities for cooperation.

Chief among these was the notion, mooted earlier by President George Bush in 1990, of a "free-trade area of the Americas" (FTAA), stretching from Alaska to Cape Horn. In Miami, Latin America's leaders embraced the idea with surprising enthusiasm. A target date of 2005 was set for its achievement, with "concrete progress" to be made by 2000. Alongside this, the 34 summiteers put their names to a long list of collective virtues, 150 "action items" concerned with topics ranging from health services through women's rights to the environment.

On April 18 and 19 [1998] in the Chilean capital, Santiago, the 34 countries' leaders [were scheduled to] meet again . . . [to] formally launch the FTAA negotiations. After three years of hard talking, at a final preparatory meeting in Costa Rica last month, their trade ministers agreed to a detailed agenda of what to negotiate, how, where, and when. Their ambitious dream might seem, at first glance, to be steadily becoming a reality.

True, the FTAA concept faces criticism. Some economists argue that regional preferences divert more trade than they create. Some Latin Americans fear that the cost of adjusting to free trade with the world's most powerful economy will far outweigh the benefits, especially in smaller and less developed countries.

SOURCE: Excerpted from "The Road to Santiago," *The Economist* (April 11, 1998), p. 25. Reprinted with permission.

The European Union⁵

The economic unification of the EU had a strong impact on international business. The unification, which officially took place on December 31, 1992, and the foundation on November 1, 1993, is the result of the Single European Act of July 1, 1987. The Act aimed to commit the then 12-member EU nations to an economically standardized/harmonized single market of about 320 million people—which was expected to be the industrialized world's largest single market.⁶ The 12 nations were Belgium, Denmark, France, Germany, Great Britain, Greece, Ireland, Italy,

Luxembourg, the Netherlands, Portugal, and Spain. In January 1995, Austria, Finland, and Sweden also became members. And on May 1, 2004, Cyprus (the Greek part), the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia also became EU members. Thus, the EU is now a union of 25 independent states based on the European Communities and founded to enhance political, economic, and social cooperation.

Oops! The world changes so fast! The EU now consists of 27 nations—Bulgaria and Romania became members on January 1, 2007. It used to be that residents traveling outside Europe would identify themselves as being from their specific country (I'm from France, or Germany, or Spain, and so on), but now people in the EU countries are starting to identify themselves as being from Europe (I'm European). This is similar to the United States, where people traveling within the U.S. states identify themselves as being from their state of residency (I'm from Kentucky, and so on), but when traveling in another country, they say they are from America (the United States), or Americans. So the EU is becoming very similar to the United States—of course, there is no European language yet, but many Europeans learn several European languages, including English. Hence, the EU's MNCs are likely to become even more powerful competitors than they already are in the global marketplace.

Opportunities Presented by the EU⁷

The original EU generated many opportunities and threats for external firms, (discussed more thoroughly in Chapter 4) both small and large firms. The harmonization aimed to replace the then existing patchwork of standards, which varied from country to country, region to region within countries, and even city to city within regions. This means that external firms can now realize greater profits because they will need to produce only one version of a product as opposed to their then practice of producing dozens. Furthermore, the EU intended to establish mutual recognition among member countries. Under the mutual recognition directive, goods and services legitimately produced in one member country can be marketed without hindrance anywhere in the EU.⁸ This helped firms attain greater economies of scale, as they no longer needed to make expensive modifications and prepare the 100 or so customs forms then required to meet different EU members' regulations.⁹

The EU also aimed to establish the means for capital, including cash and bank transfers, to move freely between member countries. On January 1, 2002, most of the member countries adopted a single currency unit—the euro. This, too, provided new opportunities to many external firms, as did the EU's deregulation of transportation. Previously, trucks entering one EU country could make only one stop in the nation. Now trucks are permitted to make several stops and are not required to stop for border checks.¹⁰ This decreased transportation costs and made transportation more efficient. For example, the United States' Federal Express benefited from this change, and it purchased companies in the EU that held national trucking licenses.¹¹

The EU also proposed a directive permitting cross-border transmission of television signals. This enables firms to advertise more efficiently. As a result, many new cable and satellite stations were started. 3M Corporation, for example, took a pan-European approach to advertising and expected to reach a vast audience at far less cost.¹² The EU is committed to fair competition. The cartels that monopolize certain EU industries were to be dismantled to provide competition and opportunities to new businesses.¹³ And it also created the European Research Corporation Agency, which provides financial assistance to EU-based firms in the fields of energy, IT, robotics, lasers, and biotechnology.

Threats Presented by the EU

The objective of the EU was to make its members' firms more competitive in the global marketplace, not to offer external enterprises a large market to exploit. This threatened many external firms. For example, some external firms that had planned to start operating in the EU feared that they would not have direct contact with the EU's standard-setting body. To combat this, some U.S. companies already in the EU tried to secure fair treatment in tenders for public contracts and to avert being handicapped when the EU sets product and safety standards. In order to have input, IBM joined JESSI, a government-backed European research project on semiconductors.¹⁴

External companies also feared that a "Fortress Europe," which allows protectionism and preferential treatment, may evolve. For example, the EU indicated that it may continue imposing quantitative restrictions on some imported products—such as automobiles—to enable EU companies to adjust to their internal market. Its directive on telecommunications proposed that bids must be rejected unless 50% or more of their value is derived from EU sources and that EU companies be preferred even when the 50% is met. Furthermore, the harmonization of the EU was expected to lead to the fall of prices across Europe.¹⁵ This was likely to provide a threat to many external firms that depended on the prices they were then charging in the EU but may have had to lower them to compete with EU enterprises. Well, that's what competition is for, isn't it?

North American Free Trade Agreement (NAFTA)

It should be noted that the North American Free Trade Agreement (NAFTA), a union consisting of Canada, Mexico, and the United States, was started in January 1994 to combat the EU's threats. But NAFTA is relatively new, and its mission is quite different from the EU's mission. As of 2007, NAFTA's three members are not quite as cooperative as are the EU's members—although, it has generated a number of economic developments, such as the reduction of tariffs, removal of restriction on certain products, and more investment opportunities. But reports indicate that NAFTA has failed so far.¹⁶ Will the United States build the 700-mile-long fence on Mexico's border? Will the United States build an even longer one? It's very difficult getting through the U.S./Canada border customs. There are no border customs among the EU's countries.

The notion of a unified Europe actually started about 1,000 years ago, and it still has a long way to go. On the other hand, NAFTA and other similar unions existing throughout the globe are in their early starting stages, but they can accelerate development if they can learn from the EU's experience. Some U.S. opinion leaders have proposed that NAFTA should reorganize itself along the EU model.

The World Bank

The World Bank (<http://web.worldbank.org>) describes itself as a vital source of financial and technical assistance to developing countries around the world but not a bank in the common sense. It is made up of two unique development institutions owned by 184 member countries—the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). Each institution plays different but supportive roles in the Bank's mission of global poverty reduction and improvement of living standards. The IBRD focuses on middle-income and creditworthy poor countries, and the IDA focuses on the poorest countries in the

world. Together, they provide low-interest loans, interest-free credit, and grants to developing countries for education, health, infrastructure, communications, and many other purposes. Thus, the programs the World Bank funds provide many opportunities for international businesses.

International Monetary Fund (IMF)

The IMF is an international organization that oversees the global financial system by monitoring exchange rates and balance of payments, as well as offering technical and financial assistance when asked. Its headquarters is in Washington, D.C. The IMF describes itself as an organization of 184 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty.

The World Trade Organization (WTO)

The WTO, located in Geneva, established on January 1, 1995, and created by the Uruguay Round negotiations between 1986 and 1994, is the only international organization dealing with the rules of trade between nations. At its heart are two agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments. The goal is to help producers of goods and services, exporters, and importers conduct their business, including providing intellectual property protection and subsidies. As of December 11, 2005, its membership consisted of 149 countries. Vietnam became a member on January 1, 2007, increasing the membership to 150 countries.

Organization of the Petroleum Exporting Countries (OPEC)

As January 1, 2008, OPEC is made up of 13 developing nations whose economies rely on oil export revenues. The nations are Algeria, Angola, Ecuador, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates, and Venezuela. It was created at the Baghdad Conference, September 10–14, 1960. One of OPEC's primary missions is to achieve stable oil prices that are fair and reasonable for producers and consumers. OPEC member countries coordinate their oil production to help stabilize the oil market and help achieve a reasonable rate of return on their investments. This policy is also designed to ensure that oil consumers continue to receive stable supplies of oil.

Just as blood sustains our physical being, oil sustains the economic, political, and social being of nations and organizations within them. In the 1970s, OPEC's policies created global instability and devastation in many nations, Brazil, for example, on track to becoming a super economic power, became paralyzed. Currently (2008), OPEC, by increasing the cost of oil (in March 2008, a barrel of oil rose to U.S.\$105), is creating problems for many nations. The inflation of oil costs has hurt many corporations throughout the globe. For example, in 2006, Wal-Mart's profits fell by 26%, its first drop in 10 years. They attribute this to the rise in the cost of gasoline, leaving consumers with less money to spend at retail stores.¹⁷

In the 1970s, the United States combated the problem created by OPEC by implementing many austerity programs to conserve oil usage, such as importing small, fuel-efficient automobiles; imposing the 55-miles-per-hour speed limit, which was

found to be the most fuel-efficient highway speed; encouraging people to walk more and use cars less; and many other programs.

Currently, Americans drive large, gas-guzzling automobiles. George Bush, the current (2007) president of the United States, has informed the American public that “we have become foreign oil addicted.” Heroin drug addicts become dependent on their suppliers and would steal/and or even kill to get the money they need to purchase the heroin their body craves the cost of heroin goes up when the supply becomes scarcer, and the supply becomes scarcer because of the producers and/or governments’ actions or because of the greater number of customers.

New entrants into the industrialized world—for example, China, with its 1.3 billion people—are likely to make the costs of oil go higher and higher and, like the United States, are likely to become foreign oil addicted. On the other hand, Brazil, in the 1970s, took a different route; it invented ethanol, which is made out of sugarcane, as an alternative to oil fuel. Thus, currently, Brazil is almost totally independent of foreign oil—it is not addicted to foreign oil. But it did take Brazil many years to develop and implement its ethanol program. Visit Japan, and you will see hundreds of thousands of people getting around via a bicycle. Visit Taiwan, and you will see hundreds of thousands of people getting around via a scooter or a bicycle.

The Foreign Environment

Foreign (individual nations) environmental factors can have a dramatic impact on international business and management. The factors include the cultural environment, the economic environment, the legal and political environment, as well as the competition, trade barriers, fluctuating monetary exchange rates, labor relations, and geography. These factors differ in many respects from country to country, and in some cases from region to region within each nation. To develop an effective strategic plan for doing business in a foreign country, enterprises’ managers must first become thoroughly familiar with the foreign factors and how they differ from their home country factors.¹⁸ And they must make the necessary adaptations—otherwise, failure is almost inevitable. The ensuing sections briefly explain the above factors.

Culture

Culture, as discussed in Chapter 1, is the total of humankind’s knowledge, beliefs, arts, morals, laws, customs, and other capabilities and habits adopted by individuals as members of society.¹⁹ As pointed out in Chapter 1, societies around the globe develop differing cultures. To develop an effective international business strategy, the critical aspects of culture must be identified. (As an illustration of how culture affects international strategies, read Practical Perspective 3.3.)

Practical Perspective 3.4 suggests that Japanese international business managers tend to make greater efforts to study foreign cultures than do U.S. international managers.

The cultural environment, as demonstrated in Chapter 1, affects the international management process in many ways. For example, for many managers of U.S. organizations, the highest priority is profit maximization. However, for many managers of Japanese organizations, the highest priority has always been, and remains, increasing the market share and keeping people employed.²⁰ Therefore, American

PRACTICAL PERSPECTIVE 3-3

The Case of the Sacred Ground

A civil engineer in a U.S. construction firm was given the responsibility of selecting a site for, designing, and constructing a fish-processing plant in a West African nation. The engineer identified viable sites on the basis of availability of reliable power, closeness to transportation means and to the river which accesses fishing boats from the Atlantic Ocean, nearness to major markets, and the availability of housing and human resources. Following the analysis of the viable sites, the optimum site was selected. Just before obtaining bids from contractors for site preparation, the engineer happened to learn that the site was located on ground considered by local people to be sacred—where their gods resided. The local people on whom the engineer was counting to “man” the operation would thus not work there. The engineer therefore chose another site.

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PRACTICAL PERSPECTIVE 3-4

The Impatient North Americans

Numerous North American government officials and businesspeople were sent on a trade mission to Brazil. They returned two weeks later after having toured several Brazilian cities. Upon their return, one of the business-people commented that the trip had been a flop since no orders had been obtained during the entire trip. In contrast, a Japanese firm sent a business manager to Rio de Janeiro with instructions to “Get to know the people and learn Portuguese during your first year there, and then concern yourself with conducting business.”

SOURCE: Excerpted from H. W. Lane and J. J. DiStefano, *International Management Behavior*, 2nd ed. (Boston: PWS-Kent, 1992), p. 27. Reproduced with permission of South-Western College Publishing, a division of Thomson Learning. Fax 800-730-2215.

managers’ practices would not fit well in Japanese organizations. The cultural environment also dictates what a product or service should look like or be able to do, what people will consume, as well as promotional strategies (these are discussed in Chapter 5).

For example, the British like dry cakes with their tea, but Americans tend to favor fancy, iced cakes, and Brazilians eat pizza and other foods with a knife and fork, but Americans eat pizza and many other foods with their hands. Not knowing these things, America’s General Mills²¹ and KFC²² failed miserably when they entered these markets because they did not make the necessary adaptations required by their cultures.²³ And Wal-Mart, like many other entrants into foreign markets, is learning through “the school-of-hard-knocks.”²⁴ Similar issues were at stake when United

Airlines entered the Pacific market. During the inauguration of its concierge services for first-class passengers from Hong Kong, each concierge proudly wore a white carnation. This was not well received by the Chinese, for whom the white carnation is a symbol of death.²⁵ Many Hong Kong Chinese businesspeople believe that their business office must have a view of the water for it to prosper otherwise the business will do poorly. Buildings in Hong Kong tend to have a view of the bay. As a matter of fact, several years ago, a huge convention center was built by Hong Kong's bay, blocking the water view of several offices in the building across the street from it. The companies that occupied those offices then moved out, leaving the offices vacant for quite some time—certainly presenting an opportunity for a Western company to rent an office there at a cheap cost.

Culture also affects how business and negotiations are conducted. For instance, in Mexico and most of South America as well as in many other cultures, personal relationships must be established before business negotiations can begin. Furthermore, culture affects a country's human resources management practices. For example, in China, employees expect their enterprises to watch out for their welfare, ranging from the provision of pay and bonuses to housing, health care, child education, meal services, and recreation. Chinese managers are expected to become involved in their employees' personal family matters. And although divorce is rare in China, when a couple divorces, the enterprise is often expected to provide housing for the departing spouse. However, as China heads toward a market-like economy, these practices are likely to become less and less common.

As was also pointed out in Chapter 1, closely related to culture is religion. The religious aspects of culture are of great importance in consumption patterns. For example, Judaism and Islam prohibit the consumption of pork. In essence, religion influences people's habits, the products they buy, and their perception of life. Sex in advertising, for example, which is widely used in the United States and Brazil, may not be acceptable in some cultures—Honduras, for instance—as a result of religious beliefs; it may be viewed as immoral or demeaning. And some religions have a negative view of profits earned by investors who do not work for the business (Practical Perspective 3.5 presents an illustration of how religion affects the banking system in the Muslim world).

PRACTICAL PERSPECTIVE 3-5

Turning the Prophet's Profits

According to Islamic tradition, overturned wine jars stained the streets of Medina red when Allah revealed to the prophet Muhammad that Muslims should be forbidden alcohol. He banned interest payments too, but bankers have had better luck than vintners. Most banks across the Muslim world still earn their money in the time-honored way, rewarding savers with some interest and charging borrowers a little more. Some, however, claim to offer a truly "Islamic" alternative. These are proving popular as well as pious. But in order to keep growing, they are having to explore more adventurous ways to invest their depositors' cash.

There are now more than 100 specialized institutions that invest money according to strict Islamic principles, ranging from mass-market savings banks in Jordan to *pukka* private banks in Geneva. Even some western banks are embracing the concept: the U.S.'s Citibank opened the first western-owned Islamic bank. Based in Bahrain, Citi Islamic Investment Bank has a start-up capital of \$20 million.

Islamic banks are [1996] still puny by international standards. Taken together, their assets of somewhere between \$25 billion and \$100 billion (depending on whom you believe) are equal only to those of a middling American or European bank. But they are growing fast. Some of the biggest, such as Kuwait Finance House and Pakistan's Muslim Commercial Bank, are growing their assets by about 10 percent a year. The potential market—one billion or so Muslims—is huge.

Islam's religious revival is the industry's motor. True believers obey *sharia*, Islam's holy law. This places several demands on Muslim savers. They must not finance activities prohibited by the Koran, such as gambling and the consumption of alcohol. Nor are they allowed to receive interest. ("Those who benefit from interest," warns the Koran, "shall be raised like those driven mad by the touch of the devil.")

To abide by these strictures, Islamic banks have developed alternative financial contracts. The most common of these is *murabaha*, a form of so-called "cost-plus" financing. This works as follows: Say a company wants to purchase \$100 million of equipment. Instead of lending it the money for three months at 2 percent interest, an Islamic bank will buy the equipment itself. It will then sell it to the firm for \$102 million, with payment deferred for three months. The bank can then claim that it is charging a profit mark-up rather than an interest rate.

SOURCE: Excerpted from "Turning the Prophet's Profits," *The Economist* (September 9, 1996), p. 32. Reprinted with permission.

Economic Environment

Economics is the way people manage their material wealth and the results of their management. The economic environment includes the production of goods and services, their distribution and consumption, the means of exchange, and the income derived from them. In the search for new markets, international business managers will find that nations differ in their stage of economic development. A nation's stage of economic development will have a great impact on the types of products and services it needs, the price, the promotional strategies, and the distribution system. It will also have an enormous impact on the type of financial concessions a foreign government is willing to make to attract technologies that will aid the country in its economic development efforts. Nations in earlier stages of development tend to subsidize foreign investments more than countries in a later stage of development. (For illustration purposes, read Practical Perspective 3.6.)

PRACTICAL PERSPECTIVE 3-6

Singer's Internationalization Strategy

The Singer Company developed itself into an international enterprise, conducting business in more than 30 countries, including the U.S., soon after it was founded in Europe in the late 1800s by Sir Isaac Singer. The firm primarily produced sewing machines. Early in the twentieth century, Singer applied techniques for assessing entry into foreign markets that are widely applied by many corporations today. It analyzed foreign country variables, such as geography, labor costs, economic environment, financial stability, market support for the product, export potential, and the country's repatriation of profits policies. Singer considered foreign government subsidies, such as tax breaks and land and factories

PRACTICAL PERSPECTIVE 3-6 (Continued)

provided for free or at reduced rates, as important factors in deciding whether or not to start operations in a foreign nation. Foreign governments were willing to make many concessions to Singer because they needed the technology for economic development and other reasons. Singer thus became a pioneer in entering markets in less-developed countries and developed excellent skills in negotiating foreign government subsidies.

SOURCE: Excerpted from an unpublished term paper by William Werner, M.B.A. student, for the course Issues in International Management, Montclair State University (Spring 1992).

Nations' Technological Needs as They Develop

Walt W. Rostow, formerly a professor in the United States, developed a theory that can aid managers in assessing a foreign country's technological needs.²⁶ The theory concludes that societies pass through five stages of economic development, described in Box 3.1.

Box 3.1 The Stages of Economic Development of Nations

Stage One In the first stage, agriculture usually comprises the largest part of the country's resources. The society operates on past societal precepts, technology is essentially static, occupations are passed down from one generation to the next, and the social and economic systems remain essentially closed to change.

Stage Two In the second stage, government and entrepreneurs establish the preconditions for take-off. The government must be dedicated to modernization and must be willing to spend public monies on education and infrastructure to service industry (roads, communication, electricity, etc.). A leading sector, such as agriculture, mining, petroleum, etc., is essential.

Stage Three In Stage three, takeoff begins. Investment rises; manufacturing becomes a leading growth sector; political, social, and institutional structures are transformed to help maintain a steady rate of growth. This period lasts 20 to 30 years.

Stage Four Stage four is the drive to maturity. The most advanced technology available is used. This period lasts about 60 years.

Stage Five In Stage five, high mass consumption occurs. Emphasis is given to consumer durables and services that allow the majority of a country's population to attain a relatively high standard of living.

SOURCE: Excerpted from Walt W. Rostow, *The Stages of Economic Development* (New York: Cambridge University Press, 1971).

In general, the goods and services required by a country in an earlier stage of economic development are different from the goods and services required in a later stage. For example, residents in a country where electricity is scarce would have little use for electric refrigerators. A less developed country may need to import industrial machinery and equipment to exploit its raw materials and to produce agricultural products, as well as specialized construction equipment to develop a transportation system.²⁷ It may need management consulting, accounting systems, and training and development services. These services are needed because nations seldom possess the systems and skilled personnel required to manage the new technologies (e.g., refer to this author's experience with an American Indian tribe, described in Chapter 1).

When a country begins to process its raw materials and resources for export, the demand may be for other kinds of machinery and industrialized goods—for example, British and American companies, such as Halliburton, provided for these demands in the Middle East, in Africa, as well as in other parts of the world.

When entering the stage in which investment and manufacturing become the leading growth sector, a country may need products necessary to operate entire manufacturing facilities. When the country becomes fairly well industrialized, producing capital and consumer goods such as machinery, automobiles, and refrigerators, it may need more specialized and heavy capital equipment not yet manufactured there. For example, a country producing automobiles may need more modern equipment, such as wheel alignment indicators. In the fifth stage, a country reaches complete industrialization and usually assumes world leadership in the production of a variety of goods. Even though a country may be totally industrialized, a demand for goods from another country still exists, because highly industrialized countries tend to specialize in the production of certain goods. For example, U.S. enterprises are highly skilled in producing communications and sophisticated computer technologies, and Japanese enterprises are highly skilled in producing process technologies.²⁸

It should be noted that there have been several objections to Rostow's theory. First, in practice, the stages are not clearly distinguishable from each other. Second, they do not display characteristics that can be tested empirically. Third, the characteristics that tend to cause movement from one stage to another are not identifiable. Fourth, the time periods Rostow suggests do not apply to all industrialized nations—for instance, China is currently industrializing at a very rapid pace. And fifth, the model is more applicable to some nations than others.²⁹ Nevertheless, the theory can be useful as a concept or framework for strategic analysis. For example, the theory tells the international manager that people in countries in an earlier stage of development may possess a different perspective from those in countries in a later stage with respect to the aesthetic values of a product/service and preference for managerial styles. For instance, people in less developed countries may place relatively little value on electric toothbrushes, and they may not value participative management as much as do people in the more developed nations. As demonstrated in Chapter 1, most of the less developed countries tend to be governed by the large power distance cultural dimension, thus people in these cultures expect a more directive approach to leadership.

Legal and Political Systems

A nation's legal and political systems have an enormous impact on international business management. As Joseph Conner, former chairman of Price Waterhouse World

Firm, indicated, “Multinational corporations start by looking at the stability of government, the legal structure regarding expropriation and how strongly private property is protected, and they look at how easy it is to move capital in and out of the country.”³⁰ (Practical Perspective 3.7 discusses the instability in Mexico.) And, of course, the September 11, 2001, incident has helped create enormous instabilities that currently exist throughout the globe.

PRACTICAL PERSPECTIVE 3-7

Troubles in Mexico

In Mexico, the path to progress has some enormous obstacles along its way. True, the economic reforms of the 1980s and 1990s were impressive, even if the government badly mismanaged its currency devaluation at the end of 1994. By 1997 the country appeared to be on the road to recovery from the peso crisis: forecasters estimated growth in the range of 4 to 5 percent for 1997, and the nation’s export economy was flourishing. But the current-account deficit started rising again. Mexico’s external debt had grown from 35 percent of GDP in 1992 to more than 60 percent in 1996. High interest rates and taxes were strangling the middle class. The banking system bordered on insolvency. In the recession of the past two years, 5 million Mexicans had been added to the 22 million citizens (one-fourth of the population) who already lived in extreme poverty. And the government estimated that an annual growth rate of 6 percent was necessary to absorb the 1 million new entrants into the labor force each year—a rate that did not appear to be attainable anytime soon.

Mexico’s ability to deal with those daunting problems depended on an effective government. The country had been ruled by the iron fist of the Institutional Revolutionary Party for more than 60 years, but the party had become arthritic and corrupt. It was incapable of acting as a safety valve for the wellspring of popular discontent in Mexico, let alone as a vehicle for implementing critical new policies necessary for a rapidly changing economy. The party was in fact resisting change, having recently overturned President Ernesto Zedillo’s far-reaching proposal to open and modernize Mexico’s political process.

Nevertheless, political change will come—if not peacefully then violently. Already, crime, kidnapping, assassinations, and guerilla activity were [and in 2007, still are] on the rise, signaling both a mounting level of dissatisfaction and the inability of the public sector to maintain order. But even if a more open and representative government emerges, it will lack the experience and the underlying institutions—such as honest courts—to govern effectively in the short run. Initially, that government may be besieged by the accumulated demands of tens of millions of Mexican citizens who have felt disenfranchised. It also will have its hands full cleaning up the old system—getting a grip on widespread criminality and creating a rule of law that all segments of the population can respect.

In light of those pressures, future governments may put off liberalizing the economy and instead concentrate on the immediate welfare of ordinary citizens. A democratic administration could become more nationalistic and more protectionist than the existing oligarchy. It could take many years before Mexico restores its current trajectory, at least in the eyes of foreign companies and governments.

SOURCE: Excerpted from Jeffrey E. Garten, “Troubles Ahead in Emerging Markets,” *Harvard Business Review* (May–June 1997), pp. 39–40. Reprinted with permission.

Legal Systems

Laws vary widely in the world’s societies. The following are some common issues of the legal environment that must be given special attention when planning to transact business in a foreign country:

- Rules of competition on (a) collusion, (b) discrimination against certain buyers, (c) promotional methods, (d) variable pricing, and (e) exclusive territory agreements
- Retail price maintenance laws
- Cancellation of distributor or wholesaler agreements
- Product quality regulations and controls
- Packaging laws
- Warranty and after-sales exposure
- Price controls, limitations on markups or markdowns
- Patents, trademarks, and copyright laws and practices³¹

Labor laws, foreign investment, contract enforcement, and other issues must also be given special attention. For example, foreign moviemakers are not allowed to distribute movies in mainland China or even own copyrights. They can, however, share in the profits by setting up coproductions with Chinese companies, provided they give the government the final cut.³² Besides imposing steep taxes on cars, the Thai government unofficially controls their price. Car manufacturers must file the prices of new cars three weeks before they go on sale. In 1996, government officials decreed that the \$15,000 Honda City was overpriced by 16,000 baht (\$625) because of too much corporate overhead. In addition to lowering prices, Honda was required to pay rebates to 150 customers.³³ Wal-Mart, which is pulling its operations out of Germany, was frustrated by the legal charges for the way it does business. In November 2002, Germany's highest court ruled that Wal-Mart and other retailers could not sell milk and butter below the wholesale prices, because doing so was damaging competition.³⁴

Labor Laws. *Wages may be low in a nation, but its legal authority may require that high fringe benefits, such as profit sharing, health and dental, and retirement benefits be given to workers. Labor laws in many countries provide extensive security for workers and make it extremely expensive to terminate an employee. For instance, Germany fiercely holds on to its "cradle-to-grave" benefits and job projections at the expense of job creation and vigorous growth, and its slow economic growth combined with its generous social welfare benefits has created a problem for the country.³⁵ China had a 100% employment policy. Some companies in China were therefore overstaffed. Furthermore, the laws in many countries mandate long vacations—for example, there was a six-week mandatory vacation in Germany, and firing an employee in France is almost impossible (see Chapter 8). Wal-Mart also had cultural issues with workers in Germany. Wal-Mart has historically operated union-free, but about 2,000 workers from several dozen of its stores went on strike in a bid to pressure Wal-Mart to join the employers association.³⁶ Wal-Mart has encountered similar problems in Canada as well.*

Foreign Investment. *Many countries' laws often dictate that foreign investments in their nation must be in the form of a joint venture with local partners and that the local partners must be majority owners. For example, in the past, IBM's policy was that its foreign subsidiaries had to be wholly owned (100% ownership). IBM became confronted with a problem when many countries' governments began to mandate joint ventures with local partners. For instance, IBM was operating in India on a wholly owned basis. The Indian government subsequently issued a mandate requiring that foreign investments in India be on a joint-venture basis, with the local partners owning 70%. Not wanting to take on partners, IBM elected to pull its operations out of India. India has since substantially reduced the 70% local ownership requirement. China once mandated more than 50% local ownership (see Case 3.1 at the end of the chapter). China now allows fully owned operations,*

but it's different from fully owned foreign operations in other countries, as the Chinese communist government still maintains substantial control through land ownership and ownership in companies' stock.

Also, the legal systems in some countries mandate that top management of foreign-owned enterprises must consist of locals. This can lead to problems when capable managers are not available in the foreign country. For example, when Russia began to shift from a communist to a market-like economy in the mid-1980s and began to draw foreign investments, its laws required that top management of foreign-owned enterprises be Russian. However, since Russians lacked experience in managing market-like enterprises, they were not very effective. By the late 1980s, the Russian government repealed the law, allowing foreigners to manage foreign-owned operations.

Contract Enforcement. *Contract enforcement can sometimes be a problem. For example, if there is a default in a contract entered into by firms from different nations, which nation's law is applied? Usually, the contract stipulates whose law is applied in the event of default. However, some countries' legal systems mandate that the laws of the nation where the contract was signed shall be applied. Other legal systems mandate that the laws of the country where the contract was executed shall be applied. In some parts of the world, enforcing contracts is difficult. For example, what happens if Iraq defaults on its contract with Halliburton or Halliburton defaults on its contract with Iraq? How would the dispute be settled?*

Other Issues. *These include the issues of sovereignty and sovereign immunity, international jurisdiction, doctrine of comity, and act of state of doctrine, as well as "bureaucratization" and "privatization" facing MNCs (discussed in Chapters 4 and 5).*

Political Systems

Awareness of the foreign country's political thinking and activities is absolutely essential. Before investing in a foreign country, a manager must learn about the country's type of government and what effect it could have on business operations. A manager must learn if the political system is primarily a democracy, a dictatorship, a monarchy, or a socialist or communist system, or if it seems to be moving in any of these directions. The political environment, if it is extreme or headed toward extremes, would greatly influence an investment decision. If a country's radical party is likely to be dominant, investment may be too risky. International companies have had their foreign subsidiaries confiscated when a radical political party in the country suddenly assumed power. Extreme social and economic turbulence are sometimes omens that foreshadow the emergence of extremist parties.

Types of Political Systems. *Some nations, such as the United States and the United Kingdom, function with a two-party system. Change from one party to another does not cause great changes in the business realm. Other nations, such as Germany and France, are not dominated by any one party; theirs is a multiparty system, and the government may be controlled by a coalition of parties. Still other nations, such as Mexico, for many decades had a multiparty system, but only the candidates of one party had a real chance of being elected and controlling the government. This one-party control provided some degree of stability in Mexico's governmental policies. The most extreme type is the one-party political system, such as in China, Cuba, and the former USSR, where opposition is repressed. The one-party system can, however, also provide stability.*

Regardless of the political system, firms can generally do business in any nation and with any party as long as there is stability in policy. For example, some U.S. firms, such

as Pepsi Cola, conducted business effectively in the former USSR, and many foreign firms are currently conducting business effectively in Communist China. If policies change gradually, as they do in most nations, the firm has time to adjust its business strategies accordingly. The danger occurs when a country's dominant party makes radical changes in its policy. In this case, the firm would not have sufficient time to adapt, thus placing it in a difficult situation.

Government Policies. *Extreme social and economic conditions may some times force a political party into radical policy changes. Generally, however, government policies change gradually; governments implement new policies to attract the foreign investments needed by the nation to attain its economic development objectives. William Stoever, a professor of international business at Seton Hall University, developed a schema linking the stages of a country's economic development described in Rostow's theory to the country's policy changes toward foreign investment.³⁷ This model can be helpful to international managers in predicting and understanding a nation's policy changes.*

According to Stoever, countries at Stage 1 of economic development are usually unattractive to foreign investment, though government subsidies may attract some "show" factories. Stage 2 countries tend to attract low-technology investments; they attract labor-intensive technology for assembling or producing for the local market or for assembling for export. In moving to Stage 3, Stoever proposed, policymakers begin to be more selective in the type of investments they import, and their policies aim to take over part or full ownership of foreign-owned facilities. To move to Stage 4, the country's economy must strengthen and diversify to the point where it can rely more on market mechanisms. The country's policies are therefore those that guide the nation to a "free market" system. The more productive capabilities now existing in these countries make it an attractive investment for MNCs, and firms are usually more willing to supply their advanced technologies to these countries.

The Government's Attitude Toward the Product. *International business managers also need to learn about the foreign government's attitude toward investment and products. Some investments and products are more politically vulnerable than others. Some receive favorable consideration by a nation, such as lower tariffs and higher quotas, while others receive unfavorable impositions. Product vulnerability is influenced by political philosophies, economic variations, and cultural differences. For example, China, as of 2005, allowed only 20 foreign films to be shown in the country.³⁸*

By obtaining accurate answers to the questions in Box 3.2, an international manager may discover whether a product will face a favorable or a hostile environment. Generally, a firm may expect to receive favorable consideration if its product/service contributes to the achievement of the import nation's goals, and it will receive unfavorable attention if, in view of the nation's current needs, the product/service is nonessential. Box 3.3 presents a framework that helps international firms improve the political considerations they will receive in a foreign country.

As a case illustration, Honda Motor Company of Japan applies a strategy of localizing profits and production.³⁹ Honda reinvests as much of its profits as possible in the local market. It regards itself as a local company and aims to prosper together with the host nation. For example, in 1959, Honda established a wholly owned marketing subsidiary, American Honda, in California with a capital investment of \$250,000. By 1999, this sum had grown to \$200 million through reinvestment of American Honda's profits. Honda has invested in the construction and expansion of motorcycle, automobile, and engine manufacturing plants in Ohio and Canada.

Box 3.2 A Process for Assessing the Political Vulnerability of a Product

1. Is the availability of the product ever going to be subject to political debate? (Sugar, salt, gasoline, public utilities, medicines, foodstuffs)
2. Do other industries depend on the production of the product? (Cement, power machine tools, construction machinery, steel)
3. Is the product considered socially or economically essential? (Key drugs, laboratory equipment, medicines)
4. Is the product essential to agricultural industries? (Farm tools and machinery, crops, fertilizers, seed)
5. Does the product affect national defense capabilities?
6. Does the product require important resources that are available from local sources? (Labor, skills, materials)
7. Is there local competition or potential local competition from manufacturers in the near future? (Small, low-investment manufacturing)
8. Does the product relate to channels of mass communication media? (Newsprint, radio equipment)
9. Is the product primarily a service?
10. Does the use of this product or its design depend on legal requirements?
11. Is the product potentially dangerous to the user? (Explosives, drugs)
12. Does the product induce a net drain on scarce foreign exchange?

SOURCE: Adapted from Richard D. Robinson, "The Challenge of the Underdeveloped National Market," *The Journal of Marketing* (October 1961), pp. 24–25. Used with permission of publisher. © 1961 American Marketing Association, Chicago, IL. All rights reserved.

Box 3.3. How to Make Friends in Foreign Countries

Remember that

1. the company is a guest in the country and its managers should act accordingly;
2. the profits of an enterprise do not belong solely to the company—the local "national" employees and the economy of the purchasing country should also benefit;
3. it is not wise to try to win over new customers by trying to completely "Americanize" them;
4. although English is an accepted language overseas, fluency in the language of the international customer goes further in making sales and cementing good public relations;
5. the international company should try to contribute to the host country's economy and culture with worthwhile public projects;
6. it should train its executives, and their families, to act appropriately overseas; and
7. it is best not to conduct business from headquarters but to staff foreign offices with competent foreign nationals and supervise the operation from headquarters.

SOURCE: Adapted from "Making Friends and Customers in Foreign Lands," *Printer's Ink* (June 3, 1960), p. 59. Reprinted with permission.

Relative to localization of production, Honda does not merely make profits by exporting completed products to a foreign market; it produces where major markets exist, therefore contributing to the development of the host country and achieving mutual prosperity. For example, in 1990 Honda produced about 470,000 automobiles in its North American plants, in 1994 it produced about 520,000, and it planned to produce 610,000 in 1995—an indication that Honda continues to invest locally. As of October 1999, Honda's investment was \$2.562 billion in the United States, \$800 million in Canada, and \$92 million in Mexico.⁴⁰ Practical Perspective 3.8 represents a time line of some of Honda's expansion activities in the United States through 2007.

PRACTICAL PERSPECTIVE 3-8

American Honda: Time Line

- 1959 American Honda Motor Co. was established with a small motorcycle store in Los Angeles.
- 1970 Honda introduced its first car, the N600 Sedan, to the United States
- 1979 Production began at the Honda Motorcycle Plant in Marysville, Ohio.
- 1982 A new auto plant began producing the Accord, making Honda the first Japanese automobile company to manufacture in the United States.
- 1985 Honda began production at an engine plant in Anna, Ohio, to manufacture both motorcycle and automobile engines.
- 1988 The first American-made Accord was exported to Japan.
- 1989 Honda began production of the Civic Sedan and Coupe at its new plant in East Liberty, Ohio.
- 1991 Honda began exporting the Accord Wagon to Europe and Japan. It was designed, engineered, and produced exclusively in the United States.
- 1994 Honda sold its 10 millionth car in the United States.
- 1999 In September, Honda sold 91,054 units, and for the nine-month period, it sold 1,067,468 units in the United States.
- 2001 Honda Accord is the best-selling car in America.
Honda introduces the redesigned 2002 CR-V.
- 2006 Honda Aircraft Company was established. It produces and markets HondaJet in the United States.
 - Honda is to build a new automobile manufacturing plant in Indiana, scheduled to begin production in 2008, employing 2,000 people.
 - Honda America directly employs more than 25,000 Americans. And it employs more than 100,000 workers at authorized Honda automobile, motorcycle, and power equipment dealerships in the United States. Tens of thousands of additional Americans are employed by more than 600 U.S. suppliers, from which it purchases its parts and equipment,
- 2007 Honda Aircraft Company announces that it will establish its world headquarters in Greensboro, North Carolina. HondaJet is to be produced at new plant for delivery to customers in 2010.

SOURCE: www.honda.com

Scarce Foreign Exchange. *International managers must understand the dynamics of hard versus soft currencies. Hard currencies are those readily accepted as payment in international business transactions. The currencies of most of the industrialized nations, such as Japan, the United States, and the EU, are hard currencies. The currencies of most less developed countries and of countries with government-controlled economies (e.g., Cuba and China), are generally classified as soft currencies. These are normally not accepted as payment in international business transactions.*

The governments of countries whose money is classified as soft currency usually accumulate hard currencies. These countries' governments use the hard currencies to pay for foreign goods and services, which in their view are needed to accomplish national goals. If the product or service is viewed as needed, the government may authorize payment in hard currency; if not, the government usually will not authorize such payment. (Box 3.2 aids the international manager in assessing the situation.) Payment in hard currency usually must be negotiated with authorized government officials. If the officials do not authorize payment in hard currency, international managers who have decided to do business in the country must seek alternative ways, such as barter trade (discussed in Chapter 5); payment is made in goods or services that can be sold for a profit in another market. For example, in the former USSR, the United States' Pepsi Cola sold its product to Russia for vodka, which it then sold in other markets for money. A current (2007) practice is the Middle East trading oil for food and the buying high technology for oil.

Political Risk Insurance. *Many industrial nations offer some form of political risk insurance when investments are made in foreign countries. The United States, for example, provides coverage through the Overseas Private Investment Corporation (OPIC). OPIC insures new investments in qualified projects, in less developed but friendly countries, against losses owing to certain political risks. OPIC is authorized to provide insurance against three specific types of risks:*

1. Inability to convert into dollars currencies received by the investor as profits of earnings or return on the original investment
2. Loss of investments resulting from expropriation, nationalization, or confiscation by the action of a foreign government
3. Loss due to war, revolution, civil strife, or insurrection (civil strife, coverage for which is optional, would encompass damage resulting from politically motivated violent acts, including terrorism and sabotage)⁴¹

The Multilateral Investment Guarantee Agency, an affiliate of the World Bank, offers similar insurance.⁴²

Expropriation, Nationalization, Confiscation

Expropriation is the seizure by a government of foreign-owned assets. This does not violate international law if it is followed by prompt, adequate, and effective compensation.

Nationalization occurs when a government takes over private property. Reasonable compensation is usually paid by the government. For example, in May 2007, Hugo Chavez, Venezuela's president, announced that his government will nationalize the country's energy and telecommunications industries where there is substantial foreign ownership.

Confiscation occurs when a government seizes foreign-owned assets and does not make prompt, effective, and adequate compensation.

Competition

Throughout the 20th century, most nations tried to avoid competition; competition was viewed as a wasteful practice. The major exception has been the United States, where its citizens are taught to be competitive, as opposed to harmonious, at an early age. However, as the world heads toward a single marketplace, a more aggressive international competitive environment seems to be evolving. Japanese culture considers competition a wasteful practice, but Japanese MNCs behave very competitively in the global market arena. Numerous factors restrict international competition, including cartels, bribery, economic conditions, government-owned enterprises, and a short-range versus long-range managerial orientation.

Cartels

Cartels consist of groups of private businesses that agree to set prices, share markets, and control production. (OPEC is a prime example.) Cartels restrict competition. In Japan, *keiretsu* links⁴³ (giant industrial groups linked by cross-ownership, such as Mitsubishi or Sumitomo), bidding cartels, and old-boy networks present external firms with formidable obstacles that Japanese corporations do not face in some markets, such as the U.S. market.⁴⁴

Bribery

Bribery as a means of obtaining a competitive edge is an accepted business practice in many nations. As pointed out in Chapter 2, the U.S. Foreign Corrupt Practices Act of 1977 makes it illegal for U.S. businesspeople to engage in bribery in any country, even if it is an accepted practice there. Many U.S. businesspeople have complained that this law has made their firms less competitive, because competitors from other nations are not bound by such laws. Numerous U.S. businesspeople, however, have said that the law has not impeded their competitive position, and what really make many U.S. firms less competitive in the international arena is the high-cost, low-quality products they are trying to market.

Economic Conditions

Competition can also be weakened by a nation's economic conditions.⁴⁵ During difficult economic times, many governments apply protectionist policies, such as tariffs and quotas, to restrict or diminish foreign competition. And many governments manipulate their currency exchange rates up or down to deter foreign competition during difficult economic times.

Government-Owned Enterprises

Competition is further weakened by government-owned enterprises competing with private firms. Governments do not necessarily have to realize profits and therefore can afford to cut prices. These government-owned enterprises can also get cheaper financing, can easily win government contracts, and, with government assistance, can even hold down wages in their country. Government-owned firms thus have a competitive advantage over private enterprises. The Japanese, for example, through the

Ministry of International Trade and Industry, target certain industries, help them reduce the risk of developing new technologies, and assist them in achieving large-scale production to reduce costs. These practices enable Japanese firms to compete more effectively in international markets.⁴⁶ By conducting research, which is made available to businesses for commercialization, the U.S. government also aids firms in reducing risk and obtaining a competitive edge. The NASA program, for example, has generated many ideas that were subsequently commercialized by business entrepreneurs. Furthermore, the U.S. government awards grants to less developed nations to aid them in their development objectives. Some of these grants stipulate that certain goods and services necessary to carry out the program must be procured from U.S.-based enterprises. Such practices also restrict competition.

Long-Range Versus Short-Range Orientation

Firms holding a short-range managerial orientation (e.g., many U.S. firms) often find it difficult to compete with firms holding a long-range managerial orientation (e.g., Japanese firms tend to hold a long-range orientation). For instance, one of Japan's top computer manufacturers won a contract over a U.S. firm to design a computer system in Hiroshima by bidding \$1. Its strategy was to give away the design job in order to gain the inside advantage for the city's equipment purchase. This exemplifies a common Japanese strategy of forgoing short-range profits for long-term profits. Japanese firms project that once they have established a business relationship, they will obtain lifetime orders. Firms that cannot wait for possible profits down the road, such as many U.S. firms, which are usually evaluated on the basis of quarterly profits, will therefore encounter difficulties in competing with Japanese companies.

In this respect, it should be noted that some Japanese MNCs have been accused of "dumping," which under the 124-nation General Agreement on Tariffs and Trade (GATT) is illegal. (GATT will be discussed further in the section Trade Barriers.) Dumping is practiced when an MNC sells a product in a foreign market at a price lower than the one it sells the product for in its own market and/or at below production cost. For example, it was reported in 1998 that the U.S. Department of Commerce had issued a preliminary finding that the South Korean chip makers Hyundai Electronics Company and LG Semicon Company (now merged and known as Hyundai Electronics Industries Company, Ltd.) dumped memory chips, or sold them below costs, in the U.S. market from May 1, 1996, to April 30, 1997.⁴⁷

The intent of dumping is to sell the product at a price much lower than the competitors' price, thus putting the competition out of business. Once the competition is out of the way, the MNC raises the price. These accusations are debatable, and Japanese managers refute them. Many international business managers and scholars view managers of Japanese MNCs not as "dumpers" but as effective customer- and quality-oriented strategists.

A Theory That Aids in Predicting Foreign Competition

Raymond Vernon and Louis T. Wells Jr., professors at Harvard Business School, developed a theory labeled *the international product life cycle* (IPLC), which can be used to assess which products are in danger of international competition.⁴⁸ According to this theory, many products pass through four phases.

Phase 1. *As a result of competition, large market size, strong market expertise, and the society's openness to innovation, firms in economically advanced countries, such as the United States, through research and development (R&D), create new products. In this phase, many firms eventually start selling the product in foreign markets. In the 20th century, U.S. firms were the leaders in this phase—about 80% of the world's innovations were first commercialized in the U.S. market.*

Phase 2. *Demand in some of these foreign markets grows large enough to justify local production, and many firms make direct investment in manufacturing facilities in those markets. Eventually, local firms in some of the overseas markets learn the manufacturing process and gain control of domestic production. Subsequently, the original manufacturers' sales in those countries, because of competition from the locals, begin to decline.*

Phase 3. *Eventually, some of the early foreign producers become highly experienced in marketing and manufacturing the product, and their costs lessen. As their markets become saturated, they look for customers in foreign markets. At this point, according to the IPLC theory, foreign producers are competing in the original producers' foreign markets. The original producers' sales continue to decline.*

For example, in the 1960s, Japan and West Germany (now Germany) began competing with U.S. firms in many industries, including the automobile industry. Japan, for instance, had only one industrial corporation in the top 50 of the world's largest industrial corporations in 1970; by 1980, it had six.⁴⁹ As of 1993, Japan had 128 companies on Fortune's Global 500 list; the United States, 161; Great Britain, 40; Germany, 32; and France, 30. U.S. firms held 10 of the 15 major industries in 1960; the number was reduced to 9 in 1970 and 3 in 1980.⁵⁰ Of the top 50 corporations listed on the 1999 Fortune 500 list (www.fortune.com), 16 were U.S. based, 16 Japanese based, and 7 German based. The German car manufacturer Daimler-Benz acquired the U.S. car manufacturer Chrysler several years ago—the headquarters is in Germany. And as indicated in Practical Perspective 3.10, Honda, a Japanese car manufacturer, now builds cars in the United States, sells them locally, and exports them to Europe and Japan as well. And in 2006, Toyota's U.S. sales edged past Ford's (being second only to General Motors [GM]), and it was expected that Toyota would become No. 1 by the end of the year.⁵¹

Phase 4. *Production to meet the wants of both domestic and foreign consumers may be large enough to allow the foreign manufacturers to reach economies of scale similar to those of the original producers. Since foreign producers started later, they possess newer plants, which results in a cost advantage over the original producers. At this point, the original manufacturers' exports dwindle, and sales in their domestic market by the foreign producers accelerate. Such competition may become so severe that the original manufacturers close production completely.*

For example, in the late 1960s, there were as many as 18 American television set manufacturers; by the 1990s, just about all brands (e.g., RCA, General Electric, Magnavox) were made by foreign companies.⁵² German steel and Japanese radios and automobiles compete with U.S. industries in the domestic market. By the 1980s, a great many of the automobiles sold in the U.S. market were imported from Japan. In 2005, GM, the world's largest auto producer, announced that it will cut 30,000 jobs in North America and close all or some of a dozen plants over a three-year

period. This action was triggered by Toyota's and Honda's as well as other auto producers' lower costs and reputation for building more reliable cars.⁵³ In 2006, Toyota became the world's number two automaker after GM, bypassing Ford. In 2007, Toyota became the world's No. 1 automaker. By 1979, the Japanese, unchallenged, were flooding the U.S. market with videocassette recorders.⁵⁴ (For a case illustration of the automobile industry, read Practical Perspective 3.10.)

The U.S. television, steel, and automobile industries are cases that help substantiate the IPLC theory. These industries seem to be in Phase 4, and to remain "alive," they, in the early 1980s, tried to push the U.S. government to take protective measures;⁵⁵ that is, through tariffs and quotas (discussed in the next section), the government keeps out or limits foreign competition. It should be noted that it is not a necessary condition that the original producers go out of business. They often, as will be discussed in Chapter 4, make direct investment in foreign markets to enjoy the same advantages foreign producers enjoy. The large increases in U.S. direct foreign investment and the huge U.S. trade deficits in recent decades indicate that many U.S. firms are doing this. Many U.S. firms are producing goods in foreign markets and shipping them back to the U.S. domestic market. However, many foreign firms, such as the automobile manufacturers Honda and Toyota, have found it more profitable to establish assembling plants in the United States. Currently, with the advent of the Web, even many of the United States' service jobs are being sent to foreign countries.

Trade Barriers

In an effort to limit or restrict competition, nations often take protective measures by imposing trade barriers. (As an illustration, read Practical Perspective 3.9.) Some of the reasons for protectionist activities are as follows:

- Protection of an infant industry
- Protection of the home market
- The need to keep money at home
- Encouragement of capital accumulation
- Maintenance of the standard of living and real wages
- Conservation of natural resources
- Industrialization of a low-wage nation
- Maintenance of employment and reduction of unemployment
- National defense
- Increase of business size
- Retaliation and bargaining⁵⁶

In the 2000s, there have been a great many complaints reported in the media about U.S. companies outsourcing American jobs to foreign countries, and many media reporters, such as CNN's Lou Dobbs, have been crusading against such outsourcing. And the U.S. government is now (in 2008) taking extensive action to keep out illegal immigrants to preserve Americans' jobs—but this action may not be wise in the sense that these immigrants are needed to do the jobs Americans won't do or are unwilling to do for low pay.

PRACTICAL PERSPECTIVE 3-9

WTO's Kodak Ruling Heightens Trade Tensions

The World Trade Organization's [1997] resounding rejection of U.S. claims of Japanese protectionism in photographic film promised to heighten trade tensions and increase competitive pressures on Eastman Kodak Company. The WTO's verdict brought calls by Kodak for consideration of new tariffs or other unilateral sanctions against Japan. Set against the backdrop of a widening trade deficit with Japan and a strong dollar that was fettering U.S. exports and making imports from Japan cheaper, it also stands to set back efforts by the Clinton administration to convince congressional skeptics and voters that the international trade system is fair and open.

The WTO ruling "raises serious questions about the credibility of this international body and of the U.S. trade representatives' capacity to secure and defend free-trade agreements," said Sen. John Ashcroft, a Missouri Republican, in a statement. While the U.S. does have the right to challenge the decision, it could be awkward. The U.S. doesn't want to be seen as undercutting an organization it worked hard to create. Also, it doesn't want to turn up the heat too high on Japan while Tokyo is trying to deal with its economic problems. But the U.S. believes Japan can only deal with economic stagnation if it opens up its economy—exactly what it was calling for in its complaint.

SOURCE: Excerpted from K. S. Greenberger, L. Johannes, and R. Kerber, "WTO's Kodak Ruling Heightens Trade Tensions," *The Wall Street Journal* (December 8, 1997), pp. A3, A14. Permission conveyed through Copyright Clearance Center.

Tariffs and Quotas

Tariffs and quotas are often employed by governments to restrict trade. Tariffs are a form of tax imposed on incoming products. Quotas specify the number of foreign units allowed to enter the country. The tax added to the incoming products will increase prices on imported goods, thus reducing competition for domestic manufacturers. Quotas also tend to reduce competition and increase the price domestic manufacturers charge their home-country customers.

For example, for a period of three years in the early 1980s, Japanese car manufacturers could export only an established number of cars to the United States per year. The quota was established by the Japanese government—which was encouraged by the U.S. government. This measure was taken so that U.S. car manufacturers could earn higher profits, which they would then use to invest in retooling strategies. GM, for instance, diversified into other manufacturing fields, such as robotics, space travel, and artificial intelligence. Toyota, the Japanese car manufacturer, reacted to the embargo by attacking the high-end U.S. car market, and it moved its plant to assemble cars for the low-end U.S. market to U.S. soil. (As an illustration, refer to Practical Perspective 3.10.)

Tariffs tend to

- *increase* inflationary pressures, special interests' privileges, government control and political considerations in economic matters, and the number of tariffs—because tariffs beget other tariffs (as an illustration, refer again to Practical Perspective 3.1);

PRACTICAL PERSPECTIVE 3-10

United States Steel Tariff 2002

The Section 201 steel tariff is a political issue in the United States regarding a tariff that President George W. Bush placed on imported steel on March 5, 2002 (which took effect from March 20). The tariffs were lifted by Bush on December 4, 2003. The temporary tariffs of 8% to 30% were originally scheduled to remain in effect until 2005. They were imposed to give U.S. steel makers protection from what a U.S. probe determined was a detrimental surge in steel imports. More than 30 steel makers had declared bankruptcy in recent years. Steel industries had originally sought up to a 40% tariff. Canada and Mexico were exempt from the tariff because of the penalties the U.S. would face under the free-trade agreement. Additionally, developing countries such as Argentina, Thailand, and Turkey were also exempt. . . . For some of the President's conservative allies, imposing the tariff was a step away from Bush's commitment to free trade. Critics also contended that the tariffs would harm consumers and U.S. businesses that relied on steel imports and would cut more jobs than it would save in the steel industry. . . .

The tariffs ignited international controversy as well. Immediately after they were filed, the European Union announced that it would impose retaliatory tariffs on the United States, thus risking the start of a major trade war. To decide whether or not the steel tariffs were fair, a case was filed at the Dispute Settlement Body of the World Trade Organization (WTO). In late autumn of 2003, the WTO came out against the steel tariffs. After receiving the verdict, Bush declared that he would preserve the tariffs; in retaliation and under WTO rules, the European Union threatened to counter with tariffs of its own on products ranging from Florida oranges to cars produced in Michigan. . . . Faced with this threat, the United States backed down and withdrew the tariffs early.

SOURCE: Adapted from http://en.wikipedia.org/wiki/United_States_steel_tariff_2002 (February 27, 2007).

- *weaken* balance-of-payment positions, supply and demand patterns, and international understanding—they can start trade wars; and
- *restrict* manufacturers' supply sources, the choices available to consumers, and competition.⁵⁷

GATT/WTO

The imposition of tariffs has in the past been governed (although not very effectively) by GATT. GATT provided the conditions under which a nation could impose tariffs—for example, a nation could impose a tariff to protect its infant industry. GATT also prohibited a nation from imposing tariffs on selected countries; that is, if the tariff was legally imposed, it had to be applicable to all nations.

There is a current movement among nations to make GATT a more forceful regulatory organization. To accomplish this, a new organization (discussed earlier in the chapter), the WTO, was established to replace the old GATT organization. The three main goals of the WTO are to aid in the free flow of trade, to help negotiate further opening of the markets, and to settle trade disputes between its members. In 1999, the WTO recognized 133 member nations and 35 observer members, of which 31 have

applied for membership—as pointed out earlier, the WTO, as of December 11, 2005, consists of 149 country members. The new organization intends to slash tariffs by an average of 38% worldwide, and for some products, such as beer, tariffs are eliminated altogether. The WTO, based in Geneva, Switzerland, also settles trade disputes. (Refer again to Practical Perspectives 3.1 and 3.8.)

Monetary Barriers

Monetary barriers are another form of protection imposed by governments. Using this approach, the government creates a trade barrier by imposing exchange restrictions. Three methods used are blocked currency, differential exchange rate, and governmental approval requirements.

Blocked currency is a method used for cutting off all importing above a certain level. In using this approach, a government refuses to redeem national currencies in the world financial marketplace for specified imports or above specified amounts on certain imports.

With differential exchange rates, a government encourages the importation of certain goods and discourages the importation of others. The government accomplishes this by requiring the importer to pay a higher amount of domestic currency for the foreign currency needed to pay for the imported product being discouraged and a lower amount for the foreign currency needed to pay for the imported product being encouraged.

Using governmental approval requirements for securing foreign exchange, a government can create a barrier by not approving the acquisition of foreign exchange needed by importers for the purchase of specific foreign products.

Nontariff Protection

Nontariff barriers are used by many governments. Using this approach, a government can discourage imports by creating administrative barriers, such as by making importing a complex, frustrating, and expensive process. Japan offers a prime example. Because of administrative barriers, many foreign firms have in the past refused to export to Japan. There are also cultural barriers. For example, Americans with an individualistic cultural perspective (discussed in Chapter 1) often do not transact business well in Japan's collectivistic culture. In other words, Americans' "spirit of competitiveness" culture does not integrate well into the Japanese "spirit of cooperation" culture, and many Americans thus have difficulty when attempting to penetrate Japan's market.

Consequences of Trade Barriers

The added costs that result from trade barriers have an impact on a product's price as well as on the channels of distribution. The higher the tariffs or the smaller the quotas, the higher the costs and, therefore, the higher the prices to the final consumer.

To avoid tariffs, instead of exporting, a firm may decide to manufacture or at least assemble the product in the foreign market. Many countries have a much higher tariff rate on products brought in assembled than on products brought in unassembled because assembling the products locally helps create jobs, which in turn helps the

nation's economy—for example, Toyota and Honda establishing car assembling plants on U.S. soil. On the other hand, the exporting country will encounter loss of jobs. Furthermore, tariffs keep out competition, and the lack of competition leads to higher prices being charged to consumers; for instance, when the U.S. car quota was imposed in the early 1980s, prices rose quickly. As another example, in 1989, Japan's virtual ban on rice imports was costing Japanese consumers an estimated \$28 billion a year. The U.S. Rice Millers' Association claimed that "if even 10 percent of the Japanese market were opened to imports, the resulting lower prices would have saved the Japanese \$6 billion annually."⁵⁸

Fluctuating Exchange Rates

Countries' currency exchange rates, just like the selling value of a company's stock, can and do fluctuate on a daily basis. For example, U.S.\$1 can equal 100 Japanese yen today and change to 95 yen or to 105 yen tomorrow. Fluctuations can be "dirty" or "clean."

Dirty fluctuations are the result of a government, for economic and/or other reasons, adjusting the exchange rate up or down.

Clean fluctuations are the result of supply and demand, just like a company's stock. If there is an abundance of a nation's currency for sale in international financial markets, its sale value is likely to decline, and if it is scarce and there is a demand for it, it is likely to appreciate. Nations tend to apply the "dirty" approach. One of the United States' current objectives (in 2007) is to convince China to increase currency flexibility, to let the yuan's value be set more freely by market forces.⁵⁹

The fluctuation can have an enormous impact on international business transactions. And the impact can be positive or negative depending on the direction of the fluctuation. International business managers must thus be skilled, or employ skilled people, in this area.

The case of Laker Airways serves as a good example of what can happen to an international enterprise when exchange rates fluctuate and its managers have not taken that possibility into account. Laker Airways, a British firm, was gravely affected by fluctuating exchange and interest rates and by fixed prices.⁶⁰ In 1980, Laker borrowed \$240 million from banks in the United States to finance its growing fleet of airplanes. At the time it seemed like a wise transaction because British interest rates were far above the U.S. levels. Laker sold advance tickets to British travelers with fares fixed in British pounds. Subsequently, U.S. interest rates rose and the value of the U.S. dollar also began rising rapidly. The fares had been fixed late in 1980, when £1 equaled U.S.\$2.40. Laker's U.S. bank loans had to be repaid in dollars in August 1981, when £1 equaled U.S.\$1.93.

When Laker borrowed the \$240 million, it was the equivalent of £100 million (\$240 million divided by \$2.40). When the loans were to be paid, however, Laker had to pay back approximately £124 million (\$240 million divided by \$1.93). In other words, to purchase the \$240 million it had to pay the U.S. banks, Laker Airways now had to spend £124 million, which is far more than the £100 million it would have spent had the exchange rate remained stable. Since Laker had sold tickets at a fixed rate, it could not adjust its prices to compensate for the change in the exchange rates. As a result of this, and the refusal of the banks to postpone payment or grant more loans, Laker went bankrupt in early 1982. Another illustration is the case of Coca-Cola. In 1998, Coca-Cola reported a 13.2% drop in its first-quarter earnings, sending its stock down. The company attributed the decline to devalued currencies in many countries where it was doing business.⁶¹

Of course, if the fluctuation had gone the other way, the firms would have realized unexpected profits. There are businesses that realize profits solely by buying and selling foreign currencies. At more than \$1 trillion in trading volume, the foreign exchange market is by far the largest capital market in the world—its volume is several times over the New York Stock Exchange. The market participants include governments, banks, nonbank financial institutions, and corporations.⁶² But Laker Airways, like most companies, are in the business of realizing profits from sales of goods and/or services—not from buying and selling foreign currencies.⁶³ As a result, such businesses often attempt to protect against negative fluctuations by contracting for a fixed exchange rate; by contracting for payment with a nation's currency that has a history of being relatively stable—for example, the U.S. dollar; or by contracting for a choice of payment by one of several nations' currencies—for instance, EU euros, U.S. dollars, or Japanese yens (whichever is the most advantageous at the time of payment is selected).

At the national level, in the 1990s, a financial collapse took place in Japan. Exchange rates were partially responsible for the collapse. Around 1980, U.S.\$1 cost about 300 Japanese yen. The U.S. dollar gradually became cheaper during the 1980s, to the point where the U.S.\$1 cost only 89 Japanese yen (the term used is *weak dollar* or *weakening of the U.S. dollar*). As the U.S. dollar gradually weakened in the 1980s, many Japanese businesses began to invest in the United States—"Japan's buying America," as it was then said. But the value of the investments in the United States did not inflate at the rate the U.S. dollar cheapened; the value of the Japanese investments in the United States, when translated into yen, declined dramatically. Of course, the value of the investments U.S. businesses had made in Japan also declined dramatically when the yen was translated into the dollar. The dollar has remained relatively weak, but the dramatic inflation of many properties in the United States in the 2000s has helped Japan stabilize its financial status. It should be noted that the weakening of the dollar did help increase exports to Japan—instead of producing certain products in Japan, it became cheaper to buy them from the United States. And the weak dollar made it very expensive for Americans to go on vacation to Japan, but it made it cheaper for the Japanese to go on vacation to the United States, thus helping the U.S. economy. Currently (2008), it costs U.S.\$1.50 to purchase 1 euro, whereas in 2002 it cost 98 U.S. cents to purchase 1 euro, which has created the same dynamic as the weakening of the dollar against the yen. (The Appendix describes trade theory and the impact of fluctuating exchange rates on international trade.)

Labor Relations

Labor relations, also referred to as industrial relations, have been defined as the "totality of the interactions between an organization's management and organized labor."⁶⁴ The term *international labor relations* can be misleading when applied within the context of the MNC. Webster's New Collegiate Dictionary defines *international* as "1. of, relating to, or constituting a group or association having members in two or more nations. 2. affecting or involving two or more nations. 3. of or relating to one whose activities extend across national boundaries." Even though some labor unions contain the word *international* in their title, they are not really international. This is because their domain does not really cut across multiple nations. International labor relations, in the context of the MNC, thus means management interacting with organized labor units in each country.

Unions in some nations, such as in the United States, are very hostile toward management—for this reason (and other reasons, such as cheaper labor), when Toyota established its car-assembling plants in the United States, it did so in the rural parts of the United States, where, in comparison with Detroit, labor unions tend to be less hostile (and land and labor tend to be cheaper).

It should be noted, however, that in the early 1980s, some U.S. unions began seeking transnational bargaining and standardization of labor conditions among MNC operations.⁶⁵ Andy Stern, who leads the largest and fastest-growing union in the United States, in 2005, was providing leadership in forming a global union.⁶⁶

Furthermore, it is difficult to compare labor (or industrial) relations systems and behavior across nations. For example, collective bargaining in the United States means negotiations between the firm's management and the labor union local, but in Germany and Sweden it means negotiations between an employer's organization and a trade union at the industry level. Also, the objective of collective bargaining is viewed differently across nations. For instance, in the United States it is viewed mostly in economic terms, but in Europe it is viewed as a form of "class struggle." And workers' actions also differ across countries. For instance, dissatisfied workers in U.S. unionized firms may totally disrupt output as a way of protesting against management's actions, but in Japan, dissatisfied workers protest during their work breaks, thus not disrupting output.

Differences in Labor Relations Across Nations

Labor relations across nations have their roots in two fundamental ideological themes: the pluralist/systems approach and the class approach.⁶⁷ The pluralist/systems approach, which is the prevalent ideology in the United States and the United Kingdom, tends to focus on procedural and institutional methods in labor relations problem solving. The class (Marxist) approach places greater emphasis on politics, political action, and the tensions between employers and employees than it does on procedures and practices related to labor relations. This type of system is dominant in Italy. Japan melds the two approaches. Different societies have thus developed their labor relations systems differently. It should be noted that governments also play an increasingly significant role in collective bargaining. In "varying ways, countries have developed income policies, or wage and price guidelines, for the purpose of controlling the outcomes of the collective bargaining process."⁶⁸

Labor Unions' Impact on MNCs' Strategies

Labor unions affect MNCs' strategies in three ways: (1) by influencing wage levels, (2) by limiting MNCs' employment-level variation, and (3) by hindering global integration.⁶⁹

Influencing Wage Levels. *Unions can influence wages to a cost level that puts companies at a disadvantage, making them less competitive in the global economy. This has forced many U.S. companies to flee overseas—for example, the U.S. bicycle manufacturer, Schwinn Bicycle Company (discussed in Chapter 4), was having problems with its union workers, so it transferred manufacturing to Asia.*

Limiting Employment-Level Variation. *Redundancy legislation in many nations often specifies that enterprises must compensate involuntarily terminated employees on the basis of a specified formula, such as one week's pay for each year of service, and in some countries*

it may even be more. For example, if an employer in Mexico decides to terminate an employee who has been with the company for six months, the employee could create a back pay issue of as much as an additional six weeks, plus prorated vacation and bonuses.⁷⁰ Labor unions influence this process by lobbying for such legislation. In France, it is almost impossible to dismiss an employee. And, as discussed earlier, Wal-Mart has learned its lesson about unions in Germany, from where it is pulling out its operations, and it is having its problems in Canada, where it has 260 stores and where unionization is strong. Wal-Mart closed its store in Quebec after it was certified by the Quebec government as the only unionized Wal-Mart store in North America.⁷¹

Hindering Global Integration. *As discussed in Chapter 5, many MNCs rationalize production and pricing across a number of nations to optimize their investments. Powerful unions, however, can force MNCs not to undertake such activities or force them to make suboptimal investments in their nation. As mentioned above, Japanese car makers, who do import car parts from many parts of the world and outsource many functions, stay away from Detroit, where unions are powerful, and locate where unions are traditionally less powerful, such as in the United States' rural South.*

Geography

There is not much businesses can do about geography. Bananas do not grow in Alaska, or in Russia or Europe, thus they must be imported from South and Central America, where they do grow. Coffee does not grow in the United States and in many parts of the world, so it must be imported from where it does grow, such as Brazil, Colombia, and some Central American countries. Rubber plants needed to build tires for automobiles, as well as other products, do not grow on the soil of many countries, such as the United States, and must be obtained from where it does grow, such as in Southeast Asia—Malaysia, for example.

In the early 1900s, Henry Ford, the efficient car manufacturer, attempted to bring his source of rubber closer to home by contracting with the Brazilian government to be allowed to grow rubber trees in the Amazons. It was a huge failure. First, the diseases workers encountered were overwhelming, and second, Ford's managers, against the Brazilian engineers' strong advice, planted the trees too close together for efficiency reasons. The trees rotted, and the soil was spoiled. It seems as if the "American way is O.K. everywhere" mentality was present then and is still present today.⁷²

Oil is not available in many countries, thus it must be purchased from countries where it is available, such as the Middle East. And historically, nations have conquered and gone to war with other nations to obtain vital resources needed at home or to obtain resources to make a profit at home or elsewhere.

Mother Nature

There is nothing very much businesses can do about natural disasters, such as hurricanes (e.g., Hurricane Katrina), tornados, psunamis, earthquakes, and so on. However, like wars, natural disasters provide businesses both threats and opportunities (discussed in Chapter 4).

Sources of Information

The above discussion of the global environment suggests that effective international business managers require an abundance of information. How is the information obtained? Information can be obtained through primary research and/or secondary research. Primary research is carried out to obtain first-hand information about the environment. Generally, only larger, wealthier corporations can afford to gather primary information, and only a few can afford to establish information sources around the globe. General Electric Corporation, for example, a huge multinational corporation, has established its own global scanning system.

Less wealthy enterprises usually depend on information obtained through secondary research, which is less costly. Basically, secondary research means obtaining information that was gathered through primary research by other organizations. There are many sources of secondary data, including the following:

Corporations: Some large multinational enterprises, such as GE, and banks, such as Citicorp, gather primary information. These corporations make much of the information available to other organizations.

Governments: Many governments have established agencies to gather and compile information to aid managers in making international business decisions. For instance, the U.S. Department of Commerce has established agencies that gather information relative to worldwide economic, social, political, and technological developments. This information is available at a nominal cost.

The United Nations: The UN also gathers and disseminates an abundance of information about global economic, political, social, and technological developments.

International organizations: Organizations such as the Organization for Economic Cooperation and Development, the EU, the Pan American Union, the World Bank, and the IMF gather and compile information that is useful in international business decisions.

Chambers of commerce and trade organizations: National and international chambers of commerce and foreign trade associations also gather and disseminate useful information.

Research universities: Many professors at universities conduct empirical research relevant to global economic, social, political, and technological developments. Their findings are made available in published practical (and academic) journals, books, and professional conference papers.

Business periodicals: There is an abundance of business periodicals. In the United States, to mention just a few, there are *The Wall Street Journal*, *Business Week*, *Fortune*, *Forbes*, *The Financial Times*, *Business International*, and *Business America*.

Cable television: Many television channels, such as CNN, Fox, and NBC, provide information 24 hours a day, 7 days a week, and 12 months a year.

Certain religious institutions: The Mormon religion, for expansionary reasons, studies and documents the culture of many countries throughout the world. This information is available to business managers who want to learn about a certain country's culture.

The Internet: Of course, the Internet, discussed below, is now a valuable source of information.

The Internet as a Source of Information

The Internet is generating rapid changes in homes, businesses, and organizations of all kinds. Using the Internet on a laptop computer, it is possible, while sipping coffee in bed, to order products from anywhere in the world. Technologies of this nature have within the past decade generated rising expectations in consumers and business for value, choice, and innovation. These expectations have encouraged governments, regulatory agencies, and industry-leading companies to provide more diversity, openness, and competition in the marketplace.⁷³ (Practical Perspective 3.11 presents the views of C. Michael Armstrong, AT&T's Chairman and CEO, on the new technology.)

Such changes are likely to force governments and international organizations to change their policies toward international trade, investment, intellectual property, and financial transactions. They will have to find ways to deal with the new issues of privacy, consumer protection, taxation, and the like. For example, a company publishing a magazine in Country A exports it to Country B and pays a tax for crossing the border. What if the publisher decides to transmit the magazine via electronic means to Country B for production and sale there? For example, the American magazine *Business Week*, which paid a high tariff to sell its magazine in Canada several years ago, started transmitting the information via the Internet to its subsidiary in Canada, and the magazine was produced there. *Business Week* claimed that it did not have to pay tariffs to Canada. Canada disputed this and tried to collect the tariffs. Such issues are being dealt with by the World Trade Organization.

PRACTICAL PERSPECTIVE 3-11

It's All Coming Together

Now technology and competition will redefine communications between countries. They will slip the constraints of national borders to make the very concept of "place" irrelevant. That, in essence, is what multinational businesses have long wanted: seamless communications services that operate the same way in New York, New Delhi, and New Zealand. Multimedia capabilities that make it possible to hold virtual meetings wherever an executive finds herself. Toll-free calling that crosses borders... Use of global communications by the world's largest companies is growing, and use by small and medium-sized companies is growing even faster. And consumer demand for international voice and data services is increasing. In fact, traffic between countries is increasing almost twice as fast as traffic within the countries themselves...

Communications companies are racing to make the Internet a reliable business tool. They are using wireless technology to extend advanced services to less-developed nations. They are increasing networking intelligence to give their customers greater control over communications, making them reachable whenever and wherever they want, on their own terms... data have overtaken voice traffic on the majority of the world's communication networks. In fact, global communications traffic is rapidly becoming global data transfer. Technology's ability to digitalize and transmit every form of information, combined with the ubiquity of the Internet, is redefining what the industry delivers to customers... These [giant mergers] reflect the fact that technology could remove the boundaries between markets: wired and wireless services, local and long distance, cable television and telephone, information and entertainment. Technology could bring these services together and so the market is bringing together companies that want to make customers an expanded offer.

SOURCE: Excerpted from C. Michael Armstrong, Chairman and CEO, AT&T, "It's All Coming Together," in *The World in 1999* (London: The Economist Publications), p. 90. Reprinted with permission.

Therefore, to be effective, international managers must continuously scan their environment for changes taking place around the globe. The Internet, a global web of many thousands of computer networks,⁷⁴ such as Google, now provides a quick and inexpensive means of global communication and access to information about the external environment.⁷⁵

Most organizations around the globe now offer information about their activities on the Web—for example, Nike (www.nike.com), Reebok (www.reebok.com), Adidas (www.adidas.com), Toyota (www.toyota.co.jp), and Sony (www.sony.com).

Caveat

Caveat About the Sources of Information. *Before managers use information, they first must analyze carefully its sources and its age. They must obtain answers to the following questions:*

- Who collected the information? Would there be any reason for deliberately misrepresenting the facts? (National pride and politics sometimes persuade the gatherers of information to inflate or deflate the data. For example, around election time, politicians like to create optimism or establish a positive image of their past performance; they sometimes do this by manipulating economic data.)
- For what purpose were the data collected?
- How were they collected (methodology)?
- Are the data internally consistent and logical in light of known data sources or market factors?⁷⁶

The age of the data must also be considered. Information about nations now changes very rapidly. For example, not too long ago, the idea of McDonald's in Paris was absurd, but today they are popular there. Also, many countries are rapidly growing economically. The national totals of income and income distribution are therefore quickly invalidated. And while primary and secondary data are of vital importance to international managers for decision-making purposes, it is also very important that they make on-site visits to intuitively assess the situation before they make their final decisions. And, of course, managers must be very careful about the way they interpret statistics because statistics can lie, and liars can use statistics.

Caveat on the Anecdotal Examples, Practical Perspectives, and Cases Appearing in This Textbook. *In the above context, it should be emphasized that the anecdotal examples, practical perspectives, and cases appearing in this textbook are not provided with the intention that they be used as information for managers in making actual business decisions. The intent is simply to exemplify in an interesting way the academic ideas presented in the textbook. It is the reader's responsibility to keep abreast of global activities currently taking place by using the sources outlined above as well as other sources that may be available.*

Summary

The major thrust of this chapter was that managers of effective international businesses must be aware of the changes taking place in their home country and throughout the globe. At home, they should remain informed about changes that can affect their organization, including legal, political, economic, and competitive changes. They must also remain informed about changes taking place in international organizations, such as the EU, and in individual foreign nations. When the changes present opportunities and/or threats, managers must

develop strategies to seize the opportunities and/or combat the threats (discussed in Chapter 4). They should also recognize that different countries present different cultural, economic, legal, political, and competitive environments, as well as trade barriers, monetary exchanges, and labor relations. When they develop international strategies, these managers should consider the differing factors and make the necessary adaptations. Therefore, effective international business managers do their “homework”; they gather the information needed to make effective decisions.

KEY TERMS AND CONCEPTS

1. Domestic environment
2. International environment
3. Foreign environment
4. Cultural environment
5. Economic, legal, and political environments
6. The five stages of economic development
7. A less developed country
8. Labor laws; foreign investment; contract enforcement
9. Political systems; government policies
10. Government’s attitudes toward products/services
11. Hard and soft currencies
12. Expropriation, nationalization, and confiscation
13. Competitive environment
14. Cartels, keiretsu
15. Dumping
16. The international product life cycle (IPLC)
17. Trade barriers; tariffs and quotas
18. GATT/WTO
19. Monetary barriers
20. Nontariff barriers
21. Currency exchange rates
22. International labor relations
23. Primary and secondary research
24. The Internet as a source of information

DISCUSSION QUESTIONS

1. Discuss how the domestic environment affects international business strategies.
2. What is meant by the term *international environment*? How does the international environment affect international business strategies?
3. What is meant by the term *foreign environment*?
4. How does culture affect international business?
5. How does a nation's economic environment affect international business?
6. The theory of the stages of economic development has been criticized. What are the criticisms? Notwithstanding the criticisms, how is the theory useful to international business managers?
7. How do labor laws, foreign investment laws, and contract enforcement laws affect international business management?
8. Political systems differ from country to country. Should a nation's political system be a factor in an international corporation's decision on whether or not to do business there? Why or why not?
9. How can an international firm reduce its political vulnerability?
10. In what ways do cartels, bribery practices, a nation's economic condition, government-owned enterprises, and long-range versus short-range managerial orientations affect competition?
11. Discuss the IPLC theory. How is it useful to international business managers?
13. Discuss the reasons for a nation's protectionist activities (tariffs and quotas).
14. What is nontariff protection?
15. What are the negative aspects of tariffs?
16. What is the role of GATT/WTO in international business?
17. What are monetary barriers?
18. How do fluctuating monetary exchange rates affect international business?
19. What are "clean" and "dirty" exchange fluctuations?
20. Discuss how labor relations differ across nations.
21. How do labor relations affect international business strategies?
22. Discuss the major sources of information available to international managers.
23. What are the major concerns about information?

EXERCISES

1. You are an international business consultant who has been employed by a domestic company involved in selling beef and pork products. The firm wants to expand its business activities into foreign markets. What would be the primary advice you would give your client?
2. You are an international business consultant employed by a domestic firm seeking to conduct business in a less developed country. The chapter discusses hard and soft currencies. In this context, what advice would you give your client?
3. You are an international consultant employed by a firm seeking to establish a subsidiary in China. What would you tell your client to expect?
4. You are an international business consultant who has been employed by a domestic company that wants to expand its business into a foreign market and wants to remain there for the long term. What would be the primary advice you would give your client?
5. You are an international business consultant who has been employed by a domestic company that wants to move its manufacturing activities into a foreign country because it has discovered that labor there is much cheaper than at home. What would be the primary advice you would give your client?

ASSIGNMENT

Interview a student or an acquaintance who is from another country. Ask him or her to describe how some of the factors discussed in this chapter differ between his or her country and your country.

CASE 3-1

Protecting the Pepsi Taste

When PepsiCo, Inc. was obliged to begin producing concentrate within China for its Chinese bottling plants, the company decided a wholly owned venture would be the only viable option. Only a WFOE [wholly foreign-owned enterprise] could adequately protect patented soft-drink formulas—but Chinese central government officials drove a hard bargain before approving the project.

While PepsiCo chose the WFOE option to protect formulas, there was another compelling reason for opening a new plant—pressure from the Chinese government to reduce imports of soft-drink concentrates. The company currently imports concentrates and sells them in hard currency to four joint-venture bottling plants—producing Pepsi Cola, 7 Up, and Mirinda Orange—in which it has equity stakes of up to 15–20 percent. PepsiCo balances foreign exchange through various countertrade and production ventures, such as its joint venture with McCormick & Co. Inc. in Shanghai, which processes spices sourced in China and sells them to the United States. Even though PepsiCo was not a net user of foreign exchange, China expressed dissatisfaction with the use of scarce hard currency to buy soft-drink concentrate. China views soda as a luxury item and refuses to let PepsiCo open any new bottling facilities before localizing concentrate production. Thus, PepsiCo agreed it would produce concentrate within China, selling in renminbi (RMB) to domestic factories and exporting part of the production—expected to average 20–50 percent—to bottling plants in Asia to balance foreign exchange. “This puts the monkey on our back to balance our foreign-exchange requirements,” says Peter M.R. Kendall, regional vice president for PepsiCo/North Asia. PepsiCo hopes eventually to source most of the citrus extracts, essential oils, caramel, and other ingredients within China, but finding suppliers that meet international standards is expected to be a problem. Negotiations for the 20-year, \$10 million venture began in 1988, and construction was to be completed in June 1990.

“What’s in It for China?”

PepsiCo chose the WFOE site in the Huangpu Economic and Technological Development Zone (ETDZ), about 20 miles from the center of Guangzhou. Near Hong Kong, the site offers proximity to shipping lines and convenience for expatriate staff. Perhaps more important, PepsiCo had developed good working relationships with local Guangzhou and Guangdong authorities through its bottling plants in Guangzhou and Shenzhen, and that local support proved important in selling the project in Beijing. As “very visible signs of foreign presence,” soft drink production ventures must receive central approval regardless of the size of investment, says Kendall. Huangpu ETDZ authorities acted, in effect, as consultants to PepsiCo in shepherding the project through the approval process involving the central Ministry of Light Industry (MLI), the Ministry of Foreign Economic Relations and Trade (MOFERT), and the State Planning Commission.

MLI proved to be the toughest sell. “The ministry was saying, ‘What’s in it for China?’” Kendall says. “They put pressure on PepsiCo to give a better deal,” in part by initially refusing permission for a WFOE that would sell its products domestically on grounds that WFOEs must produce exclusively for export.

In order to win WFOE approval and demonstrate their long-term commitment to China, PepsiCo agreed to build a neighboring joint-venture plant in partnership with the Chinese soda giant Asia Soft Drinks, which will produce concentrate for new, local soft-drink brands and a product-development lab and training facility to help China develop high-quality soft drinks. The two facilities, which will together employ around 40 people (the same number as planned to staff

the WFOE), will also provide training in water treatment, packaging, and the development of new flavors.

Government authorities stipulated that the joint-venture plant use the most modern equipment and made specific demands about staffing, management, expatriate compensation, and training. At the WFOE, however, PepsiCo will have a free hand in staffing and compensation. In the later stages of negotiation, government authorities concerned themselves only with holding PepsiCo to a capital-commitment schedule and negotiating foreign-exchange arrangements. Authorities have promised PepsiCo the WFOE plant will receive “high-technology enterprise” status, providing lower land-use fees and possibly some reduction in taxes. Under Chinese law, PepsiCo would not receive notification of its legal status until the plant’s opening in fall 1990.

Soda Market Going Flat

Construction was already under way at the WFOE plant in June 1989, when political upheaval devastated China’s tourist trade. Not only were tourists avoiding China, but the domestic austerity campaign had reduced spending power and helped discourage official banquets, which formerly provided much business to companies selling international-name beverages. In addition, tightening restrictions on the import and production of aluminum cans had severe impact on PepsiCo’s domestic can business, which accounted for 20 percent of total volume. With plastic-bottle (PET) sales also reduced by austerity, the plants saw a rising volume of returnable-bottle sales, necessitating a bigger truck fleet and glass investment by PepsiCo and associated bottlers. And while before austerity PepsiCo’s joint venture plants made some of their sales in foreign-exchange certificates (FEC), sales became almost exclusively in RMB.

Since its initial feasibility study for the WFOE, PepsiCo has lowered sales projections by about 20 percent and is keeping a cautious eye on China’s political situation. However, in China’s enormous market, PepsiCo believes that even severe constrictions in the short term leave ample room for sales. One sign of encouragement may be the strong support PepsiCo has continued to receive from local Guangzhou officials, despite attempts by Beijing to curtail Guangdong’s authority over foreign investment. PepsiCo is confident China will continue to support its sales, Kendall says. “A bottle of Pepsi produced in the PRC is almost entirely a Chinese product. It contributes to the country’s economic development.”

Questions

1. Based on what you have learned in this chapter, do you believe that PepsiCo’s managers effectively analyzed China’s environment? Why?
2. Based on what you have learned in the chapter, discuss the problems China’s systems present for foreign companies planning to invest in China.
3. What did PepsiCo do to establish a more positive relationship with the Chinese government?
4. What draws foreign investors to China?
5. This case is from 1990. The third edition of this textbook was written in 2006–2007. Thus, for discussion in class, using your Internet, obtain information about PepsiCo’s current position in China.

SOURCE: Excerpted from Anne Stevenson-Yany, “Protecting the Pepsi Taste,” *The China Business Review* (January–February 1990), pp. 32–33. Reprinted with the permission of The U.S.-China Business Council, Washington, DC.

APPENDIX

An Explanation of the Theory of Comparative Advantage and Currency Exchange Rates

The term *international business* is defined as

business whose activities involve the crossing of national borders. This definition includes not only international trade and foreign manufacturing but also encompasses the growing service industry in areas such as transportation, tourism, banking, advertising, construction, retailing, wholesaling, and mass communications.⁷⁷

International business/trade has taken place for many centuries. Effective international business managers possess a thorough command of the impact of international trade theory and fluctuating currency exchange rates on their organization. The classical theory of comparative advantage attempts to explain why international business/trade occurs. It should be noted, however, that the theory is useful only as framework for analysis. Other factors, such as a company being able to earn more profits by penetrating a foreign market, provide practical explanations for why firms internationalize their operations. (The other factors are explained in Chapter 4.)

The Theory of Comparative Advantage

When countries such as the United States, the world's largest economy, run a (trade) deficit year after year that is chronically at very high levels with little hope of rapid reduction, there is a serious problem (Table A3.1 presents the U.S. trade deficit from 1970 to 1989, 1997, 2002, 2003, and 2007). Among the consequences are excessively high interest rates and a reduction in the funds available to other borrowers. The impact is felt by borrowers as diverse as home buyers, manufacturing corporations, and third-world debtors, all of whom pay higher interest rates because of the enormous borrowing demand. Other adverse consequences include a weak currency that encourages exports but is inflationary for the nation and causes major disruptions in many industries and communities. For example, construction in the United States was once adversely affected by high interest rates, and both automobiles and textiles are industries where domestic employment fell significantly in the face of foreign competition.⁷⁸

Classical trade theory proposes that trade among nations exists because of their factor endowment: land, labor, and capital. If each nation concentrates on producing the goods that require a large amount of its relative abundant factor, those goods will have lower production costs and can therefore be sold for less in the international market. One nation may have superiority over another in producing two or more products. However, according to David Ricardo's classical theory of comparative advantage, that nation may still find it advantageous to concentrate on production of a product that it can produce more efficiently than another country and trade it for other products it needs. As an illustration, assume that the following quantities can be produced per man-day in the United States and Mexico:

Commodity	Output per man-day	
	United States	Mexico
Capital-intensive units	2	1
Labor-intensive units	4	3

TABLE A3.1 The U.S. balance of trade: 1970–1989, 1997, 2002–2003, and 2007 (\$ billion)

Year	Exports	Imports	Balance of Trade
1970	42.7	40.0	2.7
1972	49.2	55.6	-6.4
1974	98.1	102.6	-4.5
1976	115.2	123.5	-8.3
1978	143.7	174.8	-31.1
1980	220.6	244.8	-24.2
1982	212.3	244.1	-31.8
1984	217.9	325.7	-107.9
1986	217.3	370.0	-152.7
1988	322.4	441.0	-118.5
1989	349.7	473.0	-123.3
1997	688.7	899.0	-210.3
2002			-418.0
2003			-489.4
2007	1.62 trillion	2.33 trillion	-711.61

SOURCES: 1970–1989: *Statistical Abstract of the United States: 1989*, p. 786; 1997: Michael M. Weinstein, "Limits of Economic Diplomacy," *The New York Times* (April 8, 1999), p. C1; 2002, 2003: www.cbsnews.com/2004/02/13/national/main600034.shtml; 2007: Alan Tonelson (February 20, 2008), www.americaneconomicalert.org/view_art.asp?prod_ID=2945

Production of capital-intensive units requires more advanced machinery and less labor, while production of labor-intensive units requires more labor and less advanced machinery. Note that the United States has superiority in producing both capital-intensive and labor-intensive units. In the United States, one individual can produce 2 capital-intensive or 4 labor-intensive units, while in Mexico an individual can produce only 1 capital-intensive or 3 labor-intensive units. Prior to the development of the theory of comparative advantage, it was believed that because of its superiority in producing both commodities, there would be no need for the United States to trade with Mexico. Based on the theory of comparative advantage, however, it would be advantageous for the United States to concentrate on the production of capital-intensive goods and trade with Mexico for the labor-intensive units; Mexico would benefit by concentrating on the production of labor-intensive goods and trading with the United States for the capital-intensive goods.

The theory is based on the concept that if the United States and Mexico did not trade—that is, if they both produced the capital- and the labor-intensive units, individuals in the United States would have to spend the equivalent of 1 capital-intensive unit to purchase 2 labor-intensive units (4:2), and individuals in Mexico would have to spend the equivalent of 3 labor-intensive units to purchase 1 capital-intensive unit (3:1). If the United States and Mexico concentrated production (and all other factors, such as transportation costs, were equal), the two nations would benefit if they arranged a trade agreement of approximately 2½ labor-intensive units for 1 capital intensive unit. The United

States would get the equivalent of $2\frac{1}{2}$ labor-intensive units for 1 capital-intensive unit, which is greater than the 2 units it would get if no trade existed, and Mexico would only have to spend the equivalent of $2\frac{1}{2}$ labor-intensive units for 1 capital intensive unit, as opposed to 3 units if no trade existed.

We have explained the theory in terms of units of production. However, money and the fluctuating monetary exchange rates existing among nations must be considered in describing the theory. Monetary exchange rates shift rapidly. For example, on February 3, 1984, U.S.\$1 equaled 234 Japanese yen (Japan's dollar-equivalent unit). By March 30, 1986, the exchange rate was U.S.\$1 to 180 Japanese yen, and as of March 3, 1991, the exchange rate was U.S.\$1 to 135 Japanese yen. At one point, U.S.\$1 equaled 89 yen. As of April 27, 2007, U.S.\$1 was equal to 119.3 Japanese yen and 0.82 euros. As of March 20, 2008, U.S.\$1 equals 99.0 Japanese yen and 0.65 euros—a dramatic drop in its value. When the euro was adopted on January 1, 2002, the U.S. dollar and the euro were just about 1:1 (nearly at par). Fluctuating exchange changes, as will be shown shortly, have a dramatic impact on international business transactions.

To illustrate the impact of fluctuating exchange rates on international business transactions, assume that in the United States it costs \$40 to produce the 2 capital-intensive units or the 4 labor-intensive units, and that in Mexico it costs 600 Mexican pesos (MP), Mexico's dollar-equivalent unit, to produce the 1 capital-intensive unit or the 3 labor-intensive units. The cost per unit would therefore be as follows:

<i>Commodity</i>	<i>Output per man-day</i>	
	<i>United States</i>	<i>Mexico</i>
Capital-intensive units	\$20 per unit (40/2)	600 MP per unit (600/1)
Labor-intensive units	\$10 per unit (40/4)	200 MP per unit (600/3)

Suppose that the monetary exchange rate between the two countries is U.S.\$1 to 25 MP. The price per unit translated into U.S. dollars is therefore as follows:

<i>Commodity</i>	<i>Output per man-day</i>	
	<i>United States</i>	<i>Mexico</i>
Capital-intensive units	\$20	\$24 (600 MP/\$25)
Labor-intensive units	\$10	\$8 (200 MP/\$25)

Note that if there were no trade between the two nations, the United States would pay \$10 per labor-intensive unit as opposed to (other factors, such as transportation, being equal) \$8 if it purchased the unit from Mexico, and Mexico would pay \$24 per capital-intensive unit, as opposed to \$20 if it purchased the unit from the United States. The concentration of production and the trade between these two countries is therefore ideal, in the sense that both benefit.

Suppose, however, that for political, economic, market, or other reasons, the exchange rate between the two nations fluctuated to U.S.\$1 equals 30 MP. The impact on trade would therefore be as follows:

<i>Commodity</i>	Output per man-day	
	<i>United States</i>	<i>Mexico</i>
Capital-intensive units	\$20	\$20 (600 MP/\$30)
Labor-intensive units	\$10	\$6.7 (200 MP/\$30)

In this situation, the cost of capital-intensive goods would be the same in both countries. Therefore, both nations would produce capital-intensive units. But it would be advantageous cost-wise for the United States not to produce the labor-intensive units and instead import them from Mexico, where the cost is only \$6.7, as opposed to \$10 in the United States. The result of this trade scenario between the two countries is that Mexico would eventually attain a surplus trade balance and the United States a deficit. The United States is currently confronted with a huge overall trade deficit, which worries many U.S. politicians and economists. As of 2007, the United States has a huge trade deficit with China, and U.S. politicians have in recent years been trying to reduce the deficit by trying to persuade the Chinese government to strengthen its currency (the yuan) against the U.S. dollar (similar to what they did to Japan in the 1980s).

Suppose that the exchange rate between the two nations fluctuates to U.S.\$1 equals 20 MP. Again, assuming all other factors, such as inflation and deflation, being equal, the price per unit would be as follows:

<i>Commodity</i>	Output per man-day	
	<i>United States</i>	<i>Mexico</i>
Capital-intensive units	\$20	\$30 (600 MP/\$20)
Labor-intensive units	\$10	\$10 (200 MP/\$20)

In this situation, the cost of the labor-intensive units is the same in both countries, and the cost of the capital-intensive units is less in the United States. In this scenario, it would benefit the United States if it produced both the capital-intensive and the labor-intensive units. On the other hand, cost-wise it would benefit Mexico to produce the labor-intensive units and to import the capital-intensive units from the United States, where the cost is \$10 less. In this scenario, the United States would eventually attain a trade surplus and Mexico a trade deficit. It should be pointed out that the U.S. dollar has been weak for several years, but, as shown in Table A3.1, the U.S. trade deficit has kept steadily increasing since 1970.

Limitations of the Trade Theory

It should be pointed out that there are limitations to this trade theory.⁷⁹ The theory is based on several incorrect assumptions:

- It assumes that factors of production, land, labor, and capital cannot be moved between nations. But labor and capital can be moved. For example, throughout its industrial era, the United States manipulated its immigration policies, importing relatively inexpensive labor from less developed countries to “man” its industries when a shortage of labor existed. And in

early 2007, the media reported that there were about 15 million “cheap” labor immigrants in the United States.

- It assumes that complete information about international trade opportunities exists. With the recent vast advancements in the communications technologies, the world is only now beginning to head in that direction, and nations’ political forces that control information flow are still very much dominant.
- It assumes that trading firms in different countries are independent entities. The fact is that multinational corporations establish subsidiaries in many nations.
- It assumes that there is perfect competition. In reality, governments interfere in commerce, and there are monopolies, oligopolies, and cartels. which curb competition.
- It does not recognize technology, know-how, and management and marketing skills as significant factors of production.
- It does not recognize the social aspects of consumers. For example, many U.S. consumers pay \$75 for an ounce of imported French perfume rather than \$10 an ounce for the same perfume produced locally, simply because of the cachet of French perfume.
- It assumes that goods/commodities are globally standardized. This, of course, is not true; not all goods/commodities are transferable.

Nevertheless, the theory does help one understand the impact of fluctuating exchange rates on nations’ trade deficits and surpluses and the risks imposed on enterprises conducting international transactions. Table A3.2 illustrates national concerns.

TABLE A3.2**Impact of Fluctuating Exchange Rates on National Economies**

The dollar’s ascent 1983 to 1985	Investors funnel funds into the United States attracted by strong growth and high interest rates. As the dollar increases in value, U.S. products become more expensive overseas. Exports plunge. The Reagan administration does nothing.
Plaza Agreement 1985	The United States decides that the dollar is too strong, and the other major economic powers agree. The central banks intervene, helping push the dollar down rapidly and bring the yen and German mark up (currently the euro).
Yen shock Late 1985 to early 1987	The strong yen makes Japanese products more costly in foreign markets, including sales abroad. To soften the impact on its economy, Tokyo eases monetary policy. But the easy-money situation means that more funds are chasing assets at home, starting the sharp run-up in the Japanese stock market and in property taxes.
Tokyo’s spending spree Late 1980s	The more muscular yen makes foreign investment cheaper for Japanese companies and investors. In the United States, the Japanese buy everything, from U.S. Treasury bonds to the Pebble Beach golf course. Japanese corporations buy several companies and build dozens of factories in the United States.
Resurgence of American manufacturing Late 1980s ^a	With the weaker dollar, U.S. manufacturers that survived the tough times begin to find that they are competitive again in export markets. The growth in exports helps cushion the economic shock waves from the 1987 stock market crash.
1990s to 2007	The huge U.S. trade deficit has increased steadily over the years (see Table A3.1), especially with China. Due to efforts to reduce the U.S. trade deficit, the U.S. dollar has weakened. U.S. politicians have been prodding the Chinese government to strengthen its yuan in an effort to reduce the huge trade deficit with China. And the U.S. dollar has for a couple decades remained weak against the Japanese yen.

SOURCE: a. “The Week in Review,” *The New York Times*, sec. 4 (Sunday, April 26, 1992), p. 1; current media reports.

Relative to the impact of fluctuating exchange rates on international business transactions, the case of Laker Airways (cited in the chapter) serves as an example.

Exercise

- a. Suppose that the “per-man-day” cost of producing four pairs of shoes or eight razor blades is 60 yen (y) in Japan and in Portugal it costs 360 escudos (e) to produce two pairs of shoes or six razor blades. (Note: *Portugal’s currency is as of January 1, 2002, the euro.*) Suppose that the monetary exchange rate is 1 y equals 8 e: (1) Will production be concentrated in any of the two countries, and will trade take place between the two countries? (2) If production is concentrated, what would be the general impact on the two nations’ balance of trade if free trade existed and all other factors remained equal? (You must explain your answer and show the computations.)
- b. If you find in (a) that there is no concentration of production in both countries, determine the nearest exchange rate required to generate concentration of production in both countries. (You must explain your answer and show the computations.)

The answers are contained in the *Instructor’s Manual*.

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