KATHOLIEKE UNIVERSITEIT LEUVEN

Faculty of Economics and Business

International Business Strategy - D0M19B

Course notes

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Academic year: 2018 – 2019

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PART I: INTRODUCTION AND OVERVIEW

1. GLOBALIZATION

Globalization
It is the shift toward a more integrated and interdependent world economy. It is an integrated environment where there are no restrictions in trade (integration) and what happens in one country has repercussions in another one (interdependency).

Globalization of markets
It is the merging of historically distinct and separate national markets into one huge global marketspace. The most global of markets are markets for industrial goods and materials that serve universal needs (oil).
- falling trade barriers make it easier to sell globally
- consumers' tastes and preferences are converging on some global norm
- firms promote the trend by offering the same basic products worldwide
=> You compete with national and international competitors and the demand is the world demand

Globalization of production
It is the sourcing of goods and services from locations around the globe to take advantage of national differences in cost and quantity of production factors. Companies hope to lower their overall cost or improve the quality or functionality of their product offering.
=> You spread the activities to spread the advantages in for example the difference in resources, human capital (labor costs)

Why do we need global institutions?
- help manage, regulate, and police the global marketplace
- promote the establishment of multinational treaties to govern the global business system

- WTO (World Trade Organization): responsible for policing the world trading system, making sure nation-states adhere to the rules laid down in trade treaties and facilitating the establishment of additional multinational agreements.

- GATT (General Agreement on Tariffs and Trade): several rounds of negotiations worked to lower barriers to the free flow of goods and services.

- IMF (International Monetary Fund): established to maintain order in the international monetary system. Often seen as the lender of last resort.

- World Bank: set up to promote economic development. It has focused on making low-interest loans to cash-strapped governments in poor nations that which to undertake significant infrastructure investments.

- UN (United Nations): has 4 purposes:
    - ➢ maintain international peace and security
    - ➢ develop friendly relations among nations
    - ➢ cooperate in solving international problems and in promoting respect for human rights
    - ➢ harmonizing the actions of nations

- G20: originally established to formulate a coordinated policy response to financial crises in developing nations, in 2008 it became the forum through which major nations attempted to launch a coordinated policy response to the global financial crisis
=> They are essential to globalization

The global economy
There has been a drastic change in the demographics of the world economy in the last 30 years
Four trends are important:

<u>1. The Changing World Output and World Trade Picture</u>
- ➢ China and Japan are getting bigger, while the other parts of the world are losing market shares
- ➢ most important changes are between 1960 and 2000
- ➢ The US has lost his shares in terms of output
- ➢ The more advanced industrial economies are losing their place
- ➢ There has been more trade than ever before, and it's thanks to this trade that the countries have become so big
- ➢ China is as important as Europe and the US has more export than import
- ➢ You see that countries like Ireland are becoming very important (fiscal damage)

<u>2. The Changing Foreign Direct Investment Picture</u>
- ➢ The FDI inflows are increasing in developing economies, while it decreases in developed economies ad in general in the world it's slowly decreasing
- ➢ FDI is done by MNE (any business that has productive activities in two or more countries)
- ➢ Beginning in the 1970s, European and Japanese firms began to shift labor-intensive manufacturing operations from their home markets to developing nations where labor costs were lower

<u>3. The Changing Nature of the Multinational Enterprise</u>
- ➢ 2 notable trends: the rise of non-US multinationals and the growth of mini-multinationals

<u>4. The Changing World Order</u>
China may move from third-world to industrial superpower status even more rapidly than Japan did. The changes in China are creating both opportunities and threats for established international businesses. The attractiveness of Latin America increased, both for a market for exports and as a site for FDI, but there is no guarantee that these favorable trends will continue.

Is globalization unstoppable?

- ➢ globalization is not evitable
  - o there are signs of a retreat from liberal economic ideology
  - o Europe : Brexit, Le Pen, Wilders, etc.
  - o US: Trump and Sanders
- ➢ globalization brings risks
  - o a severe crisis in one country can affect the whole globe
  - o the financial crisis that swept through South East Asia in the late 1990s
  - o the subprime mortgage crisis (2008)
- ➢ The most globalized pillar is information

Globalization: two sides to the story

Supporters	Critics
o lower prices for goods and services o greater economic growth o higher consumer income, and more jobs	o job losses o downward pressure on the wages of unskilled labour o environmental degradation o the cultural imperialism of global media and MNEs

Anti-globalization protesters now regularly show up at most major meetings of global institutions

Globalization, jobs and income

There's a lot of dislocation: for the skilled there's a shortage and for the unskilled there's too much in Belgium

Supporters	Critics
benefits of this trend outweigh the costs ➢ countries will specialize in what they do most efficiently and trade for other goods - and all countries will benefit ➢ when countries get richer they can invest more in environment, everything goes down except for carbohydrate (because of traffic and stuff).	falling barriers to trade are destroying manufacturing jobs in advanced countries

North American Free Trade Agreement (NAFTA)
- Free trade agreement between United States, Mexico, and Canada (1994)
- Controversial because the first major trade deal with a poor country (Mexico)
- Involvement with Canada not controversial: already a free trade agreement with Canada (CUSFTA)
- Focus on impact of Mexico

<u>GDP</u>

- ➢ Most estimates: modest but positive impact on US GDP of less than 0.5 percent

<u>Unemployment</u>

- ➢ Growing trade between US-Mexico contributes to unemployment in the US market
- ➢ But trade is not the sole explanation
- ➢ 2009-2011: 13 million workers were dislocated (4 million annually) mainly because of technological and competitive forces within the US economy.

At most 5% of dislocated jobs can be traced to imports from Mexico.

- ➢ Two-way trade expands some industries and shrinks others: some Americans lose their jobs, while others gain new or better jobs! Export jobs generally pay wages 10-11% higher

! Nevertheless, general perception that job losses are associated with FTAs (55% of respondents)

<u>US manufacturing wages</u>

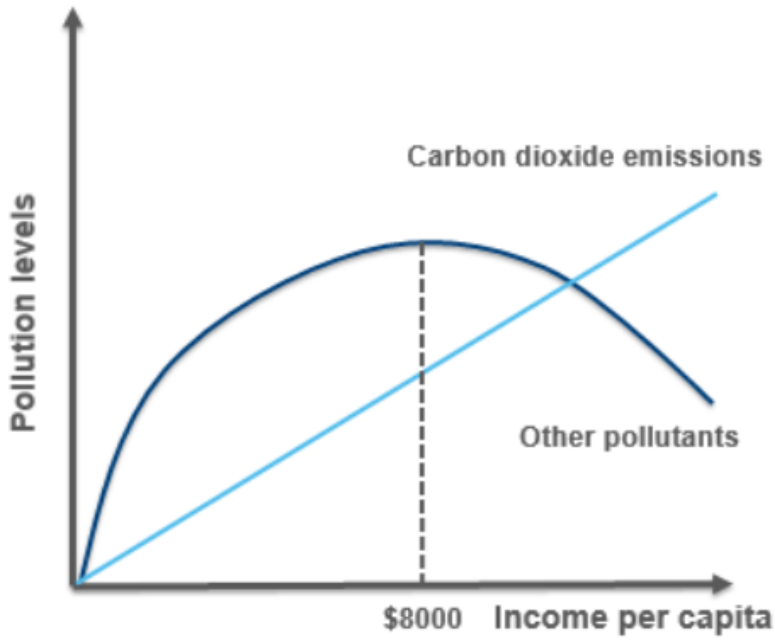
- ➢ Increased imports from Mexico and Central America did not have an impact on the US manufacturing wages
- ➢ Imports from China between 1992 and 2007 did: decrease of 3%

=> Increased imports of manufactures exert, at most, modest and highly localized downward pressure on wages

Globalization, labor policies and the environment

- ➢ Critics: firms avoid costly efforts to adhere to labor and environmental regulations by moving production to countries where such regulations do not exist, or are not enforced
- ➢ Supporters: as countries get richer, they enact tougher environmental and labor regulations.

→ Empirical support: this hump-shaped relationship seems to hold across a wide range of pollutants but not for carbon dioxide emissions.



Globalization and national sovereignty

Is shifting economic power away from national governments toward supranational organizations (as the WTO, the EU and the UN)?

- Critics : Unelected bureaucrats now impose policies on the democratically elected governments of nation-states, thereby undermining the sovereignty of those states and limiting the nation's ability to control its own destiny.

- Supporters : real power still resides with individual nation-states as those states will withdraw their support if these bodies fail to serve the collective interests of member states.

Globalization and the world's poor:

Is the gap between rich nations and poor nations getting bigger?

- Critics: despite the supposed benefits associated with free trade and investment, the gap between the rich and poor nations of the world has gotten wider

- Supporters: They claim that the best way for poor nations to improve their situation is to:
    - Reduce barriers to trade investment
    - Implement economic policies based on free market economies
    - Receive debt forgiveness for debts incurred under totalitarian regime

How does the global marketplace affect managers?

Managing an international business differs from managing a domestic business

- countries are different
- managers in an international business are confronted with a wider range of problems and more complex problems
- managers in an international business must deal with government restrictions on international trade and investment
- managers in an international business must develop policies for dealing with exchange rate movements

PART II. COUNTRY DIFFERENCES

What makes countries and regions different?
Culture, social systems, economic systems, political systems, legal systems

2. NATIONAL DIFFERENCES IN THE POLITICAL ECONOMY

2.1 Introduction

Political economy

The political, economic and legal systems of a country are interdependent: they interact and influence each other and in doing so, they affect the level of economic well-being.

2.2. Political systems

Political system

The system of government in a nation. Political systems can be assessed according two dimensions:
(1) the degree to which they emphasize collectivism as opposed to individualism
(2) the degree to which they are democratic or totalitarian.

2.3. Economic systems

Economic system

- Political ideology and economic systems are connected
- In countries where individual goals are emphasized free market economies are likely
- 3 types of economic systems:

Market economy: la loi de l'offre et la demande => theory that this leads to the maximum wealth

Command economies: should be organized by the states

Mixed economies: we do not find pure market and pure command economy, but something in between

2.4. Legal systems

Legal system
Refers to the rules, or laws, that regulate behavior along with the processes by which the laws are enforced and through which redress for grievances is obtained.
There are three main types of legal systems:

Different legal systems
Common law:
Based on tradition (a country's legal history), precedent (cases that have come before courts in the past) and custom (ways in which laws are applied in specific situations). Judges have the power to interpret the law.

Civil law:
Based on a detailed set of laws organized into codes. Judges have the power to apply the law.

Theocratic law:
Based on religious teachings. Islamic law is the most widely practiced.

2.5. Implications for managers

- raise important ethical issues that have implications for the practice of international businesses
- influence the attractiveness of that country.

3. POLITICAL ECONOMY AND ECONOMIC DEVELOPMENT

3.1. Differences in Economic Development

GNI
Gross National Income: a common measure of economic development. Measures the total annual income received by residents of a nation. To account for differences I the cost of living one can just adjust the GNI per capita by purchasing power.

PPP
Purchasing Power Parity: purchasing power. Allows for a more direct comparison of living standards in different countries.

Black Economy
Refers to the unrecorded cash transactions or barter agreements not included in official figures.

HDI
Human Development Index: Measures the quality of human life in different nations. It is based on 3 measures:
- Life expectancy at birth
- Educational attainment
- Whether average incomes based on PPP estimates are sufficient to meet the basic needs of life in a country

Broader conceptions of development
- Nobel Prize winning economist Amartya Sen: "development should be seen as a process of expanding the real freedoms that people experience"
- So, development requires the removal of major impediments to freedom like poverty, tyranny, and neglect of public facilities
- Sen emphasizes basic health care and basic education

- some countries are emphasizing the individual and some the collective
=> not the same political system
- Greeks: big debate on what's good and not
- Plato: the individual should not be the central element, the collective good was more emphasized than the individual (not as extreme as Marx)
- polis= community= the big value for him
- Aristotles= emphasizing individualism. If we go to the collective good, we will have no progress. people should strive for their own wellbeing
- The last 30 years: more democratic, but the last 10 years: U-turn, where more and more countries are totalitarian and collective ideas. It's not constant over time.

3.2. Political Economy and Economic Progress

Innovation & entrepreneurship are the engines of growth

- ➢ Innovation and entrepreneurship = engines of long-run economic growth
    - Require a market economy
    - Require strong property rights (free use and returns of a resource)

m.a.w.
In order to have a good economic system you need innovation and entrepreneurship.
To have innovation and entrepreneurship you need a market economy.
To have a market economy you need property rights.

Economic progress begets democracy

- ➢ It seems likely that democratic regimes are more conducive to long- term economic growth than a dictatorship, even one of the benevolent kind
- ➢ Subsequent economic growth leads to establishment of democratic regimes

Geography, education and economic development
- In addition to political and economic systems, geography and education are also important determinants of economic development
- Countries with favorable geography are more likely to engage in trade, and so, be more open to market-based economic systems, and the economic growth they promote
- Countries that invest in education have higher growth rates because the workforce is more productive

3.3. States in Transition

The spread of democracy
The political economy of many of the world's nation-states has changed radically since the late 1980's.

- ▪ A wave of democratic revolutions swept the world: totalitarian governments collapsed and were replaced by democratically elected governments that were typically more committed to free market capitalism
- ▪ There has been a strong move away from centrally planned and mixed economics, towards a freer market economic model

Three main reasons account for the spread of democracy:

- ▪ Many totalitarian regimes failed to deliver economic progress to the vast bulk of their populations
- ▪ New information and communication technologies have reduced a state's ability to control access to uncensored information → spread of democratic ideals and information from free societies
- ▪ Economic advances have led to the emergence of increasing prosperous middle and working classes that have pushed for democratic reforms

The new world and global terrorism

- Fukuyama: a more harmonious world dominated by universal civilization characterized by democratic regimes and free market capitalism
- Huntington: there is no 'universal' civilization based on widespread acceptance of Western liberal democratic ideals. Furthermore, global terrorism is a product of the tension between civilizations and the cash of value systems and ideology

The spread of market-based systems

The shift toward a market-based economic system often entails a number of steps.

Deregulation: involves removing legal restrictions to the free play of markets, the establishment of private enterprises and the manner in which private enterprises operate

Privatization: Transfers the ownership of state property into the hands of private individuals, frequently by the sale of state assets through and auction. For privatization to work, it must also be accomplished by a more general deregulation and opening of the economy

Creation of legal systems

3.4. Implications for managers

By identifying and investing early in a potential future economic star, international firms may build brand loyalty and gain experience in that country's business practices. Early entrants into potential future economic stars may be able to reap substantial first-mover advantages, while late entrants may fall victim to later-mover disadvantages.

- First mover advantages: the advantages that accrue to early entrants into a market.
- Late-mover advantages: the handicaps that late entrants might suffer.

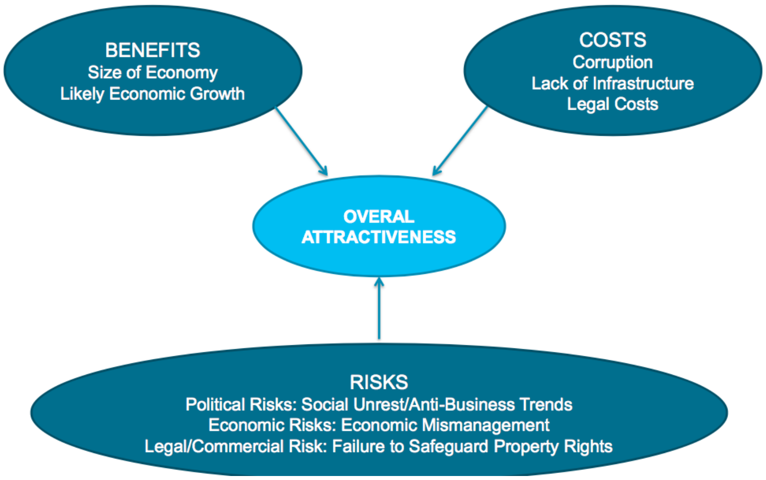
It may be more costly to do business in relatively primitive or undeveloped economies because of the lack of infrastructure and supporting businesses. McDonalds had to set up its own dairy farms, vegetable plots... in Russia.

As for legal factors, it can be more costly to do business in a country where local laws and regulations set strict standards or that lacks well-established laws for regulating business practice.

- Political risk = the likelihood that political forces will cause drastic changes in a country's business environment that adversely affect the profit and other goals of a business enterprise. Indicators: social unrest.
- Economic risk = the likelihood that economic mismanagement will cause drastic changes in a country's business environment that hurt the profit and other goals of a particular business enterprise. Indicators: inflation rate & the level of business and government debt.
- Legal risk = the likelihood that a trading partner will opportunistically break a contract or expropriate property rights.

Overall attractiveness

- ➢ The overall attractiveness of a country as a potential market and/or investment site for an international business depends on balancing the benefits, costs, and risks associated with doing business in that country
- ➢ Other things being equal, the benefit-cost-risk trade-off is likely to be most favorable in politically stable developed and developing nations that have free market systems and no dramatic upsurge in either inflation rates or private sector debt



Benefits, costs and risks

• Translate distance into benefits, costs and risks of doing business in a foreign country
• Manage the risk

4. DIFFERENCES IN CULTURE

4.1 Introduction

Cross-cultural literacy

It’s an understanding of how cultural differences across and within nations can affect the way business is practiced.

- It is critical to the success of international businesses
- Companies that are ill informed about the practices of another culture are unlikely to succeed in that culture
- Managers must also beware of ethnocentric behavior, or a belief in the superiority of one's own culture

Culture

A system of values and norms that are shaped among a group of people and that when taken together constitute a design for living. It’s something immaterial, intangible

- what determines culture? is shaped by the social structure, education, but culture also determines education and social structure. Through education you can change your culture, or your social culture has implication on norms and value
- religion is very important and has everything to do with good and bad
- It’s important for a society to understand how a society’s culture affects workplace values
- Management processes and practices must be adapted to culturally-determined work-related values

Values

Abstract ideas about what a group believes to be good, right and desirable.

Norms

The social rules and guidelines that prescribe appropriate behavior in particular situations. Norms can be subdivided further into two major categories: folkways and mores.

Mistakes that business people tend to make

- Stereotyping: assume that all people within one culture behave, believe, feel, and act the same
- Ethnocentrism: occurs when people from one culture believe that theirs are the only correct norms, values, and beliefs
- Managers are too egocentric

4.2. Cultural dimensions of Hofstede

Power distance

How a society deals with the fact that people are unequal in physical and intellectual capabilities. High power distance cultures have beliefs such as *inequality is good*, *age and seniority matter*.
Latin-America: there's more acceptance for authority, they respect differences, they believe that ppl in power are more able to do things

Uncertainty avoidance

To what extent are people looking to a stable environment? High uncertainty avoidance cultures have beliefs such as *conflict should be avoided*, *experts and authorities are usually correct*, *laws and rules are important*.
Belgium: we like stability a lot, everything should be predictable, we don't like change

Individualism versus collectivism

Focused on the relationship between the individual and his/her fellows. Individualistic cultures have beliefs such as *people are responsible for themselves*, *individual achievement is ideal* and *people need not be emotionally dependent on groups*.
In Asia: the group is the primary unit of the social organization. This may discourage job switching between firms, encourage lifetime employment systems, and lead to corporations in solving business problems. But it might also suppress individual creativity and initiative.
In US: individualism is a big thing and people respect and value the ones that have made it

Masculinity versus femininity

Looked at the relationship between gender and work roles. Masculine cultures have beliefs such as *gender roles should be clearly distinguished*, *men should be decisive, more materialistic*. Feminine cultures are more focused on wellbeing, family etc.

Long term orientation

Captures attitudes toward time, persistence, protection of face, respect for tradition. Long term orientation cultures have beliefs such as *strategic planning is important*, *you need to be willing to invest, accept slower results, persist to achieve goals, sensitivity to social relationships, pragmatic adaptation*.

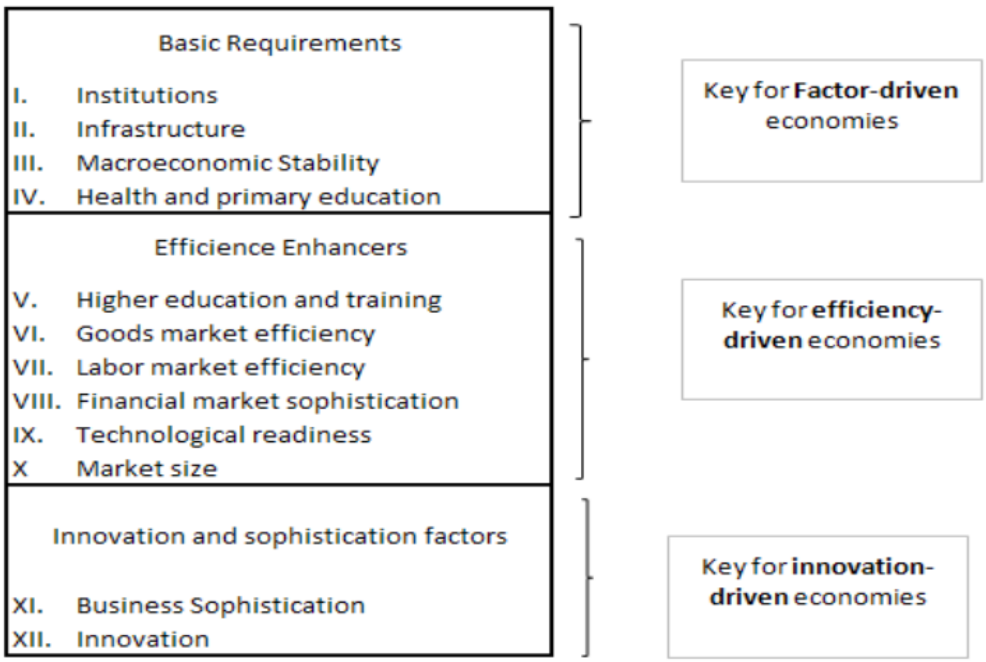
Indulgence versus retrainance

Do people enjoy being happy in their way of working? To what extent do they like to express themselves, to be open, time for fun? To what extent do you think that in your work/public appearances you should restrain yourself and be strict?

Global Competitiveness report

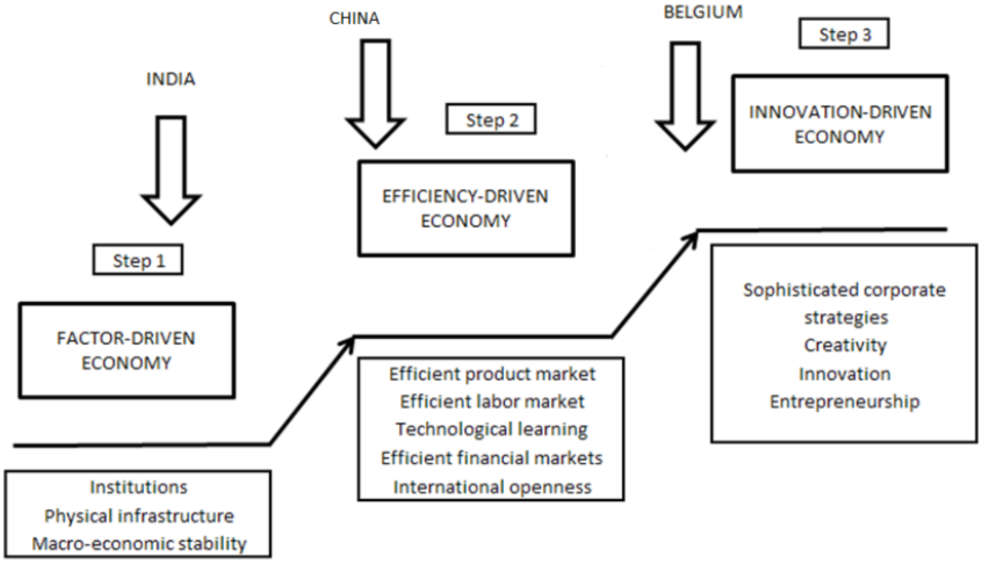
Competitive markets are attractive markets
The World Competitiveness Report defines competitiveness as the set of institutions, policies, and factors that determine the level of productivity of a country.

The index is composed of 12 pillars measuring different aspects of an economy's competitiveness



The world bank is now using it for measuring development
To what extent can people grasp opportunities? do they have the health to do so? do they have the training to do so?

Stages of development



CAGE

	Cultural Distance	Administrative Distance	Geographic Distance	Economic Distance
attributes creating distance	Different languages	Absence of colonial ties	Physical remoteness	Differences in consumer incomes
	Different ethnicities; lack of connective ethnic or social networkd	Absence of shared monetary or political associations	Lack of a common border	Difference in costs and quality of: natural, financial and human resources; infrastructure, intermediate inputs, information or knowledge
	different religions	Political hostility	Lack of sea or river access	
	different social norms	Government policies	Size of country	
		Institutional weakness	Weak transportation or communication links	
			Differences in climates	
industries or products affected by distance	products that have high linguistic content (TV)	government involvement is high in industries that are:	products have a low value-to weight or bulk ratio (cement)	nature of demand varies with income levels (cars)
	products affect cultural or national identity of consumers (foods)	producers of staple goods (electricity); producers of other "entitlements" (drugs);	products are fragile or perishable (glass, fruit)	economies of standardisation or scale are important (mobile phones)
	productfeatures vary in terms of: size (cars), standards (electrical appliances), packaging	large employers (farming); large suppliers to government (mass transportation); national champions (aerospace);	communications and connectivity are important (financial services)	labor and other factor cost differences are salient (garments)
	products carry country-specific quality associations (wine)	vital to national security (telecom); exploiters of natural resources (oil, mining); subject to sunk costs (infrastructure)	local supervision and operational requirements are high (many services)	distribution or business systems are different (insurance)
				companies need responsive and agile (home appliances)

PART III. THE GLOBAL TRADE AND INVESTMENT ENVIRONMENT

6. INTERNATIONAL TRADE THEORY

Free Trade
Situation where a government does not attempt to influence through quotas or duties what its citizens can buy from another country or what they can produce and sell to another country.

The benefits of trade
Smith, Ricardo and Heckscher-Ohlin show why it is beneficial for a country to engage in international trade even for products it is able to produce for itself

- International trade allows a country to:
    - specialize in the manufacture and export products that it can produce efficiently
    - importing products that can be produced more efficiently in other countries.

The patterns of international trade
- Some patterns of trade are fairly easy to explain - it is obvious why Saudi Arabia exports oil, Ghana exports cocoa, and Brazil exports coffee
- But, why does Switzerland export chemicals, pharmaceuticals, watches, and jewelry? Why does Japan export automobiles, consumer electronics, and machine tools?
David Ricardo's theory of comparative advantage offers an explanation in terms of international differences in labor productivity. The more sophisticated Heckscher-Ohlin theory emphasizes the interplay between the proportions in which the factors of production (such as land, labor, and capital) are available in different countries and the proportions in which they are needed for producing particular goods. This explanation rests on the assumption that countries have varying endowments of the various factors of production. Tests of this theory, however, suggest that it is a less powerful explanation of real-world trade patterns than once thought.

One early response to the failure of the Heckscher-Ohlin theory to explain the observed pattern of international trade was the product lifecycle theory. Proposed by Raymond Vernon, this theory suggests that early in their life cycle, most new products are produced in and exported from the country in which they were developed. As a new product becomes widely accepted internationally, however, production starts in other countries. As a result, the theory suggests, the product may ultimately be exported back to the country of its original innovation.

Trade theory and government policies

Mercantilism :
export > import => gold => good
The principle assertion of mercantilism was that gold and silver were the mainstays of national wealth and essential to vigorous commerce. The main tenet of mercantilism was that it was in a country's best interests to maintain a trade surplus, to export more than it imported. By doing so, a country would accumulate gold and silver and, consequently, increase its national wealth, prestige, and power. But that's not true, because if you do that, the inflation will go up and your prices will not be competitive anymore and you won't be able to export if you do this one-way trade.

- Smith, Ricardo, and Heckscher-Ohlin promote unrestricted free trade

- New trade theory and Porter's theory of national competitive advantage justify limited and selective government intervention to support the development of certain export-oriented industries

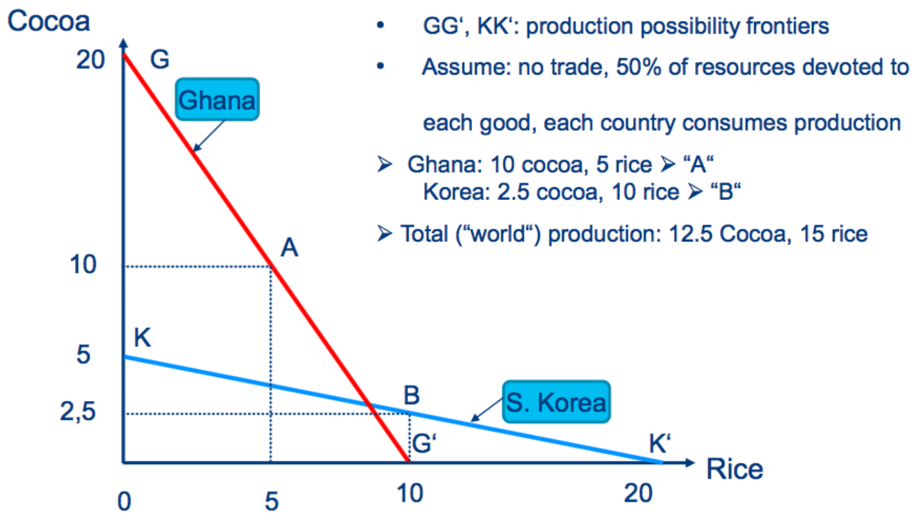
- **New trade theory** (Krugman): stresses that in some cases countries specialize in the production and export of particular products not because of underlying differences in factor endowments, but because in certain industries the world market can support only a limited number of firms. The observed pattern of trade between nations may be due in part to the ability of firms within a given nation to capture first-mover advantages.

- **Theory of national competitive advantage** (Porter): attempts to explain why particular nations achieve international success in particular industries.

Empirical analysis of free trade benefits

- Relationship of economic growth and "openness" for a sample of more than 100 countries from 1970 and 1990
- Developing countries:
  - open economies: average growth 4.5% per year
  - closed economies: 0.7% per year
- Developed countries:
  - open: average growth 2.3% per year
  - closed: 0.7% per year
- Another study looking at 1950 – 1998:
  - countries that liberalized trade, increase annual growth by 1.5% compared to pre-liberalization periods

Absolute advantage

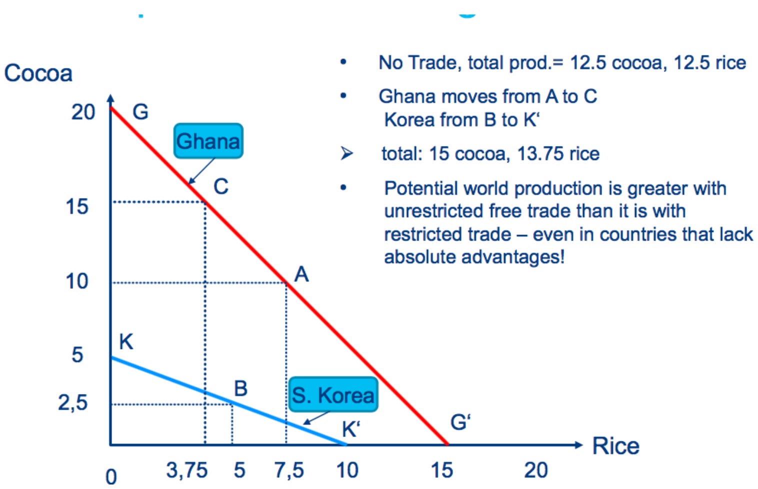


A country has an absolute advantage in the production of a product when it is more efficient than any other country in producing it.
→ Smith: countries should specialize in the production of goods for which they have an absolute advantage and then trade these goods for those produced by other countries.

Ghana can produce 4 times more cocoa than S-Korea, and S-Korea can produce 2 times more rice than Ghana. It’s not the absolute advantage that matters but the relative advantage.

PPF (Production Possibility Frontier): indicates the different combinations a country can produce. 200 units of resources available – it takes 10 resources to produce 1 ton of cocoa – it takes 20 resources to produce 1 ton of rice – the country ca produce 20 tons of cocoa and no rice or 10 tons of rice and no cocoa

Comparative advantage



It makes sense for a country to specialize in the production of those goods that it produces most efficiently and to buy the goods that it produces less efficiently from other countries, even if this means buying goods from other countries that it could produce more efficiently itself. If you respect your comparative advantage you will always gain from trade.

Imagine that Ghana exploits its comparative advantage in the production of cocoa to increase its output from 10 to 15 tons. This uses up 150 units of resources, leaving the remaining 50 to producing 3.75 tons of rice. (Point C)

→ To an even greater degree than the theory of absolute advantage, the theory of comparative advantage suggests that trade is a positive-sum game in which all countries that participate realize economic gains.

Our simple model includes many unrealistic assumptions:

- Only two countries and two goods
- no transportation costs
- no price differences in resources, no exchange rates
- resources can move freely from the production of one good to another
- constant returns to scale
- a fixed stock of resources, no change in the efficiency with which a country uses its resources
- no effects of trade on income distribution

Hekscher (1919)-Ohlin (1933) Theory

How come some countries are more efficient?

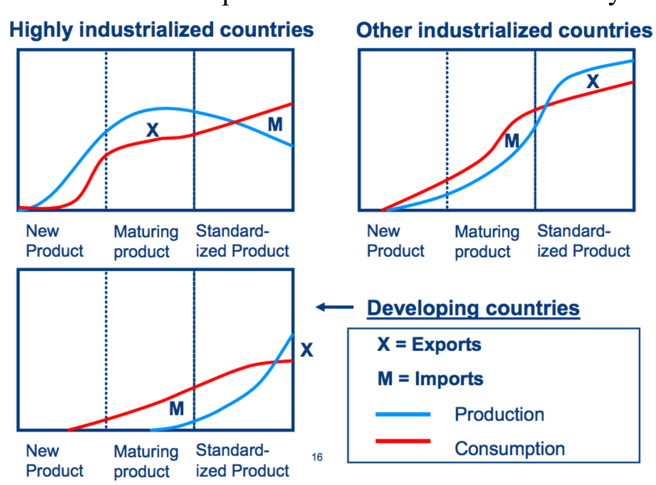
1st response: they have technology, but this is not a good answer, but endowments = right answer

- Rather than differences in productivities, differences in factor endowments matter
  - US exports agricultural goods reflecting its high endowment with land
  - China exports goods in labor-intensive manufacturing industries, e.g. textiles and footwear, reflecting its endowment with low-cost labor
  - US that lacks low-cost labor is importer of such goods
  - Note: Relative, not absolute, endowments are important.
- Leontief Paradox:
  - US: abundant of Capital
  - Hypothesis: Exports more capital intensive than its imports
  - Empirical support: US exports less capital intensive than imports

Product Life Cycle Theory by Vernon (1966)

In 1960s, very large proportions of the world's new products were developed in US and sold first on US market =>Wealth and size of US market gave incentives to develop new products

- Demand for new products is mainly based on non-price factors
  →production is kept domestically, as high prices may be charged
- Demand grows rapidly domestically and demand in other countries is limited to high income groups
  - Limited demand in other countries does not require to produce elsewhere, but stimulates exports
- Demand in other developed countries grows
  → they start producing themselves, or firms set up production there
  - Exports from initial inventor country become limited



- ➢ As market in inventor country and other highly developed countries matures
    - ○ product becomes more standardized, and price becomes main competitive weapon
    - ○ Cost considerations play a major role
- ➢ Countries where labor is cheap may be able to start exporting to countries where labor is more expensive
    - ○ Developing countries (cheapest labor) acquire production
- ➢ Product life cycle theory explains patterns of trade accurately
    - ○ Example: Xerox (photocopiers)
        - invented in the US and initially sold in the US
        - exports to Japan and Western Europe
        - joint ventures to produce: Fuji-Xerox in Japan, Rank-Xerox in Great Britain
        - patents expired: foreign competitors enter the market, e.g. Canon in Japan, Olivetti in Italy
        - US exports declined; US buys photocopiers from Japan (lower cost)
        - Japanese and European firms outsource manufacturing to Singapore and Thailand
        - Other advanced countries become importers of photocopiers

New Trade Theory

Suggests that the ability of firms to gain economies of scale (unit cost reductions associated with a large scale of output) can have important implications for international trade

→ Makes two important points:

(1) Through its impact on economies of scale, trade can increase the variety of goods available to consumers and decrease the average cost of those goods;

(2) when the output required to attain economies of scale represents a significant proportion of total world demand, the global market may be able to support only a small number of enterprises: world trade in certain products may be dominated by countries whose firms were first movers.

Implications of New Trade Theory

- ▪ Nations may benefit from trade even when they do not differ in resource endowments or technology
- ▪ A country may dominate in the export of a good simply because it was lucky enough to have one or more firms among the first to produce that good
- ▪ An extension of the theory is the implication that governments should consider strategic trade policies that nurture and protect firms and industries where first mover advantages and economies of scale are important

Basically, Trump says that they have to protect the US economy by giving subsidies etc. When you look at it, he's not really wrong, because China and Germany have made a lot of subsidies in order to dynamize their markets. The best would be that nobody gives subsidies and that we let everything go and do its thing, but here once a country starts to subsidize, all the others also have to do it to stay competitive.

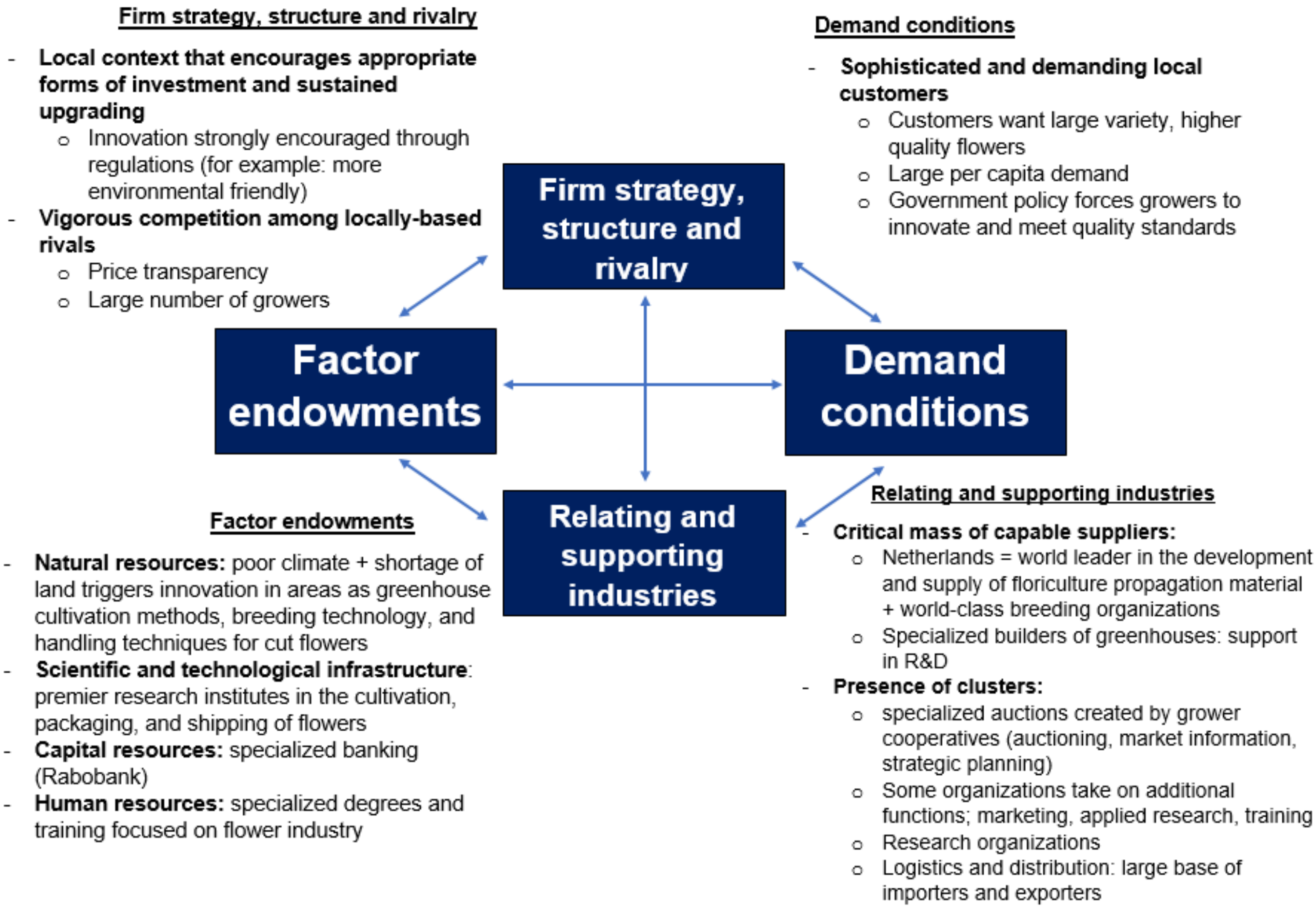
National Competitive Advantage: Porter's Diamond

Michael Porter tried to explain why a nation achieves international success in a particular industry. These questions cannot be answered easily by the Heckscher-Ohlin theory, and the theory of comparative advantage offers only a partial explanation.

Porter theorizes that four broad attributes of a nation shape the environment in which local firms compete, and these attributes promote or impede the creation of competitive advantage

- Factor endowments - *a nation's position in factors of production such as skilled labor or the infrastructure necessary to compete in a given industry.*
- Demand conditions - *the nature of home demand for the industry's product or service.*
- Relating and supporting industries - *the presence or absence of supplier industries and related industries that are internationally competitive.*
- Firm strategy, structure, and rivalry - *the conditions governing how companies are created, organized, and managed and the nature of domestic rivalry.*

Porter speaks of these four attributes as constituting the diamond. Firms are most likely to succeed in industries or industry segments where the diamond is most favorable. He also argues that the diamond is a mutually reinforcing system, they're complementing each other and in combination creating the conditions appropriate for competitive advantage. The effect of one attribute is contingent on the state of others. For example, Porter argues favorable demand conditions will not result in competitive advantage unless the state of rivalry is sufficient to cause firms to respond to them.



Global Value Chains

- Value chain: Full range of activities involved in design, production, marketing, distribution and support to the final consumer
- Rise of global value chains (GVCs)
  - Value chains **no longer** in just one country
  - Goods and services are 'made in the world': assembled from intermediate goods and services sourced from many countries
- Trade in intermediate goods and services represents >2⁄3 global trade
  > 50% of world's manufactured imports are themselves inputs
  > 70% of world services imports are intermediate services.

7. THE POLITICAL ECONOMY OF INTERNATIONAL TRADE

7.1. How Do Governments Intervene in Markets?

Governments use various methods to intervene in markets including

Tariffs

Taxes levied on imports that effectively raise the cost of imported products relative to domestic products. In most cases, tariffs are placed on imports to protect domestic producers from foreign competition by raising the price of imported goods. However, tariffs also produce revenue for the government.

- ➢ specific tariffs: levied as a fixed charge for each unit of a good imported (for example, $3 per barrel of oil)
- ➢ ad valorem tariffs: levied as a proportion of the value of the imported good.

Subsidies

Government payments to domestic producers. By lowering production costs, subsidies help domestic producers in two ways: (1) competing against reign imports and (2) gaining export markets

Import Quotas

Restrict the quantity of some good that may be imported into a country. The restriction is usually enforced by issuing import licenses to a group of individuals or firms.

Tariff Rate Quota

A common hybrid of a quota and a tariff. A lower tariff rate is applied to imports within the quota than those over the quota. Tariff rate quotas are common in agriculture, where their goal is to limit imports over quota.

Voluntary Export Restraints (VER)

Quotas on trade imposed by the exporting country, typically at the request of the importing country's government

Local Content Requirements

Demand that some specific fraction of a good be produced domestically. The requirement can be expressed in physical terms (75% of the parts of the product) or in value terms (75% of the value of the product). Local content regulations have been widely used by developing countries to shift their manufacturing base from the simple assembly of products whose parts are manufactured elsewhere into the local manufacture of component parts.

Administrative Policies

Bureaucratic rules designed to make it difficult for imports to enter a country. Ex.: Japan

Antidumping Policies
Dumping is viewed as a method by which firms unload excess production in foreign markets. It is selling goods in a foreign market at below their costs of production or as selling goods in a foreign market at below their "fair" market value. Antidumping policies are designed to punish foreign firms that engage in dumping and protect domestic producers from "unfair" foreign competition.

Antidumping duties
Countervailing duties = special tariffs on offending foreign imports

As with tariffs and subsidies, both import quotas and VERs benefit domestic producers by limiting import competition. As with all restrictions on trade, quotas do not benefit consumers. An import quota or VER always raises the domestic price of an imported good. When imports are limited to a low percentage of the market by a quota or VER, the price is bid up for that limited foreign supply.

7.2. Arguments for government intervention

There are two main arguments for government intervention in the market

- ➢ Political arguments: concerned with protecting the interests of certain groups within a nation (normally producers), often at the expense of other groups (normally consumers)
- ➢ Economic arguments: concerned with boosting the overall wealth of a nation – benefits both producers and consumers

Political arguments for government intervention

- Protecting jobs and industries : the most common political argument for government intervention from unfair foreign competition
- National security : industries like aerospace or electronics are often protected because they are deemed important for national security
- Retaliation : governments should use the threat to intervene in trade policy as a bargaining tool to help open foreign markets and force trading partners to "play by the rules of the game."
- Protecting consumers : limit "unsafe" products. Ex.: beef that might be tainted by mad cow disease
- Furthering foreign policy objectives : preferential trade terms can be granted to countries that a government wants to build strong relations. Trade policy has also been used several times to pressure or punish "rogue states" that do not abide by international law or norms.
- Protecting human rights : Governments sometimes use trade policy to try to improve the human rights policies of trading partners. Others contend that limiting trade with such countries would make matters worse, not better. They argue that the best way to change the internal human rights stance of a country is to engage it through international trade. At its core, the argument is simple: Growing bilateral trade raises the income levels of both countries, and as a state becomes richer, its people begin to demand, and generally receive, better treatment with regard to their human rights.
- Protecting the environment

Economic arguments for government intervention

Infant industry agreement

An industry should be protected until it can develop and be viable and competitive internationally

- ➢ Accepted as a justification for temporary trade restrictions under the WTO
- ➢ Question: When is an industry “grown up”?
    - ○ Critics argue that if a country has the potential to develop a viable competitive position its firms should be capable of raising necessary funds without additional support from the government

Strategic trade policy

In cases where there may be important first mover advantages, governments can help firms from their countries attain these advantages

=> Governments can help firms overcome barriers to entry into industries where foreign firms have an initial advantage

=> Criticism:Krugman

- Beggar-thy-neighbor policies that boost national income at the expense of other countries

- Countries that attempt to use such policies will probably provoke retaliation

- Since special interest groups can influence governments, strategic trade policy is almost certain to be captured by such groups who will distort it to their own ends

7.3. Development of the world trading system

- Until the great depression (1930): protectionism
- After World War II (1947): GATT (General Agreement on Trade and tariffs)
- 1980: protectionist trends emerged
    - Japan's perceived protectionist policies created intense political pressures in other countries
    - The world trade system was strained by the persistent trade deficit in the US
    - Many countries found ways to get around GATT regulations (VERs)
- 1986: Uruguay Round which focused on:
    - Extending GATT rules to cover trade in services
    - Writing rules governing the protection of intellectual property
    - Reducing agricultural subsidies
    - Strengthening the GATT's monitoring and enforcement mechanisms.
- WTO (World Trade Organization): encompasses 3 bodies:
    - GATT
    - GATS (General Agreement on Trade in Services): to extending free trade agreements to services
    - TRIPS (Agreement on Trade-Related Aspects of Intellectual Property Rights): attempt to narrow the gaps in the way intellectual property rights are protected around the world and bring them under common international rules.

The WTO has something the GATT never had: teeth → if offenders fail to comply, trading partners have the right to compensation or to impose trade sanctions.

- Future of the WTO: four issues at the forefront of the current agenda:
    - Antidumping policies → the vague definition of dumping has proved to be a loophole
    - The high level of protectionism in agriculture
    - The lack of strong protection of intellectual property rights in many nations
    - Continued high tariff rates on non-agricultural goods and services in many nations
- 2001: Doha Round which focuses on (talks are currently ongoing):
    - Cutting tariffs on industrial goods and services
    - Phasing out subsidies to agricultural producers
    - Reducing barriers to cross-border investment
    - Limiting the use of anti-dumping laws

Implications for managers

The impact of trade barriers on a firm's strategy:

- ➢ Tariff barriers raise the costs of exporting products to a country
- ➢ quotas may limit a firm's ability to serve a country from locations outside of that country
- ➢ To conform to local content regulations, a firm may have to locate more production activities in a given market than it would otherwise
- ➢ The threat of antidumping action limits the ability of a firm to use aggressive pricing to gain market share in a country
- ➢ The role that business firms can play in promoting free trade or trade barriers

8. FOREIGN DIRECT INVESTMENTS

8.1 Introduction

FDI (Foreign Direct Investment)

Foreign direct investment (FDI) occurs when a firm invests directly in facilities to produce or market a product in a foreign country. According to the U.S. Department of Commerce, FDI occurs whenever a U.S. citizen, organization, or affiliated group takes an interest of 10 percent or more in a foreign business entity. Once a firm undertakes FDI, it becomes a multinational enterprise.

FDI takes on two main forms:

- greenfield investment = the establishment of a new operation in a foreign country
- acquiring or merging with an existing firm in a foreign country. (Ex.: Walmart in Japan was through acquisition)

8.2 Foreign Direct Investment in the World Economy

Flow of FDI refers to the amount of FDI undertaken over a given time period (normally a year)
Stock of FDI refers to the total accumulated value of foreign-owned assets at a given time
Outflows of FDI, the flow of FDI out of a country
Inflows of FDI, the flow of FDI into a country

Trends in FDI

FDI has grown more rapidly than world trade and world output for several reasons:

- Executives see FDI as a way of circumventing future trade barriers
- The general shift toward democratic political institutions and free market economies has encouraged FDI
- The globalization of the world economy is also having a positive effect on the volume of FDI.

Firms prefer to acquire existing assets because:

- M&As are quicker to execute than greenfield investments
- Foreign firms have valuable strategic assets, such as brand loyalty, customer relationships or trademarks
- Firms believe they can increase the efficiency of the acquired unit by transferring capital, technology or management skills

The source of FDI

Since World War II, the United States has been the largest source country for FDI, a position it retained during the late 1990s and early 2000s. Other important source countries include the United Kingdom, France, Germany, the Netherlands, and Japan. Collectively, these six countries accounted for 60 percent of all FDI outflows for 1998-2010. As might be expected, these countries also predominate in rankings of the world's largest multinationals. These nations dominate the market because they were the most developed nations with the largest economies during much of the post-war period and therefore home to many of the largest and best-capitalized enterprises. Many of these countries also had a long history as trading nations and naturally looked to foreign markets to fuel their economic expansion.

The Form of FDI: Acquisition vs. Greenfield Investments

The majority of cross-border investment is in the form of mergers and acquisitions rather than greenfield investments. Why?

- M&A are quicker than greenfield investments. It’s an important consideration in the modern business world where markets evolve very rapidly.
- Local firms are acquired because they have valuable strategic assets, such as brand loyalty, customer relationships, trademarks or patents, distribution systems, production systems, etc.
- They believe they can increase the efficiency of the acquired unit by transferring capital, technology, or management skills.

8.3. Theories of FDI

Why FDI?

- Exporting= producing goods at home and then shipping them to receiving country for sale.

- Licensing= granting a foreign entity (the licensee) the right to produce and sell the firm's product in return for a royalty fee on every unit sold.

Limitations of exporting

- Transportation costs → particularly true of products that have a low value-to-weight ratio and can be produced in almost any location (*cement*)
- Trade barriers such as import tariffs or quotas → important to understand that trade barriers do not have to be physically in place for FDI to be favored over exporting.

Limitations of licensing

Internationalization theory = market imperfections approach = theory that seeks to explain why firms often prefer FDI over licensing as a strategy for entering foreign markets:

- Licensing may result in a firm's giving away valuable technological know-how to a potential foreign competitor;
- Licensing does not give a firm the tight control over manufacturing, marketing and strategy in a foreign country that may be required to maximize its profitability;
- Management, marketing and manufacturing capabilities are often not amenable to licensing: this may be a problem when the firm's competitive advantage is based on such capabilities.

Advantages of FDI

- A firm will favor FDI over export when the transportation costs and trade barriers make exporting unattractive.
- It will also favor FDI for licensing (or franchising) when it wishes to maintain control over its technological know-how, or over its operations and business strategy

The pattern of FDI
Firms in the same industry undertake FDI at about the same time and tend to direct their FDI to certain locations.

<u>Strategic Behavior</u>

- Knickerbocker's theory: There's this idea that FDI flows are a reflection of strategic rivalry between firms in the global marketplace. Therefore, the imitative behavior of firms in an oligopoly also characterizes FDI. Knickerbocker's theory can be extended to embrace the concept of multipoint competition.
- Multipoint competition: arises when two or more enterprises encounter each other in different regional markets, national markets or industries.
- Shortcomings:
  - ➢ Knickerbocker's theory does not explain why the first firm in an oligopoly decides to undertake FDI
  - ➢ The theory also does not address the issue of whether FDI is more efficient than exporting or licensing

Basically: firms in oligopoly → imitative behavior → FDI to stay competitive

<u>The product life cycle</u>

Vernon argues that often the same firms that pioneer a product in their home markets undertake FDI to produce a product for consumption in foreign markets. They invest in other countries when the demand there gets large enough to support local production. They subsequently shift production to developing countries when product standardization and market saturation give rise to price competition and cost pressures.
Ex.: Xerox introduced the photocopier in the United States, and it was Xerox that set up production facilities in Japan (Fuji-Xerox) and Great-Britain (Rank-Xerox) to serve those markets.
However, Vernon's theory fails to explain why these companies have to undertake FDI at such times rather than continuing exporting. Just because demand in a foreign country is large enough to support local production doesn't mean that it's the most profitable option. Could be that it's easier to license, but the product-life cycle theory doesn't go that far. The only thing that we know is that of the foreign market is able to support local production, FDI will happen.

Basically: Pioneer in the product + foreign market is able to support local production → FDI

The electric paradigm
Dunning argues that in addition to the various factors discussed above, location-specific advantages are also of considerable importance in explaining both the rationale for and the direction of FDI.

Location-specific advantages = the advantages that arise from utilizing resource endowments or assets that are tied to a particular foreign location and that a firm finds valuable to combine with its own unique assets (such as the firm's technological, marketing or management capabilities).

He argues that combining location-specific assets or resource endowments with the firm's own unique abilities often requires FDI. Explains the FDI undertaken by many oil companies, which have to invest where oil is located in order to combine their technological and managerial capabilities with this valuable location-specific resource.

Careful, we do not only talk about minerals and labor in location-specific resources, but also about knowledge. Ex.: Silicon Valley and knowledge spillovers (positive externalities).

Basically: location-specific assets + firm's own unique abilities → FDI

8.4. Political ideology and FDI

Radical view
FDI of advanced capitalist nations keeps the less developed countries relatively backward and dependent on advanced capitalist nations for investment, jobs and technology.
→ By the early 1990s the radical view was in retreat almost everywhere, there seem to be three reasons:
- The collapse of communism in eastern Europe
- The general poor economic performance of those countries that embraced the radical view and a growing belief by these countries that FDI can be an important source of technology and jobs and can stimulate economic growth
- The strong economic performance of those developing countries that embraced capitalism rather the radical view

Free market view
FDI increases the overall efficiency of the world economy. FDI is a benefit to both the source and the host country.

Pragmatic Nationalism
FDI has both benefits and costs:

- ➢ FDI can benefit a host country by bringing capital, skills, technology and jobs;
- ➢ When a foreign company rather than a domestic company produces products, the profits from that investment go abroad and a foreign owned manufacturing plant may import many components from its home country, which has negative implications for the home country's balance-of-payments position

→ FDI should be allowed so long as the benefits outweigh the costs.

Shifting ideology - p 265 book (flemme)

8.5. Benefits and costs of FDI

Host-country effects

Host-country benefits of FDI	**Host-country costs of FDI**
Resource-transfer effects: A study by the OECD found that foreign investors invested significant amounts of capital in R&D in the countries in which they had invested, suggesting that not only were they transferring technology to those countries, but they may also have been upgrading existing technology	Effects on competition Because an acquisition does not result in a net increase in the number of players in a market, the effect on completion may be neutral or when a foreign investor acquires two or more firms and subsequently merges them, the effect may be to reduce competition and create monopoly power, reduce consumer choice and raise prices;
Employment effects Direct (a foreign MNE employs host-country citizens) and indirect (jobs are created in local suppliers as a result of the investment)	
Balance-of-payments effect Two ways in which FDI can help to run a current account surplus: (1) FDI is a substitute for imports: Japanese FDI in the US approves the current account of the US (2) a foreign subsidiary may contribute to the host-country's exports	Balance-of-payments effects (1) outflow of earnings from the foreign subsidiary to its parent company (2) import of inputs from abroad by the foreign subsidiary.

<u>Effects on competition and economic growth</u> FDI in the form of greenfield investments should increase competition and this may lead to increased productivity growth, product and process innovations, greater economic growth and lower prices.	<u>National sovereignty and autonomy</u> key decisions that can affect the host country's economy will be made by a foreign parent that has no real commitment to the host country and over which the host country's government has no real control.

Home-country effects

Home-country benefits	Home-country costs
<u>Balance-of-payments effects</u> The balance benefits from the inward flow of foreign earnings	<u>Balance of payments effects</u> (1) the balance suffers from the initial capital outflow required to finance FDI (2) the current amount suffers if the purpose of the foreign investment is to serve the home market from a low-cost production location; (3) the current amount suffers if the FDI is a substitute for direct exports.
<u>Employment effects</u> Positive employment effects arise when the foreign subsidiary creates demand for home-country exports	<u>Employment effects</u> The most serious concerns arise when FDI is seen as a substitute for domestic production.
<u>Reverse resource-transfer effect</u> The home-country MNE learns valuable skills from its exposure to foreign markets that can be transferred back to the home country	

Offshore production: FDI undertaken to serve the home market. Such FDI may actually stimulate economic growth and hence employment in the home country by freeing home-country resources to concentrate on activities where the home country has a comparative advantage.

8.6. Government Policy Instruments

Home-country policies to encourage outward FDI	**Host-country policies to encourage inward FDI**
Foreign risk insurance: to cover major types of foreign investment risk and encourage firms to undertake investments in politically unstable countries	Incentives: offer incentives to foreign firms to invest in their countries (*low-interest loans*)
Capital assistance: special funds or banks that make government loans to firms wishing to invest in developing countries	Incentives are motivated by a desire to gain from the resource-transfer and employment effects of FDI, and to capture FDI away from other potential host countries
Tax incentives: many countries have eliminated double taxation of foreign income	
Political pressure: a number of investor countries have used their political influence to persuade host countries to relax their restrictions on inbound FDI.	**Host - country policies Restrict inward FDI**
Home-country policies to restrict outward FDI	Performance requirements: controls over the behaviour of the MNE's local subsidiary (*technology transfer*).
- limit capital outflows; - manipulate tax rules to try to encourage their	Ownership restraints: foreign companies are excluded from specific fields or foreign ownership may be permitted, although a significant proportion of the equity of the subsidiary must be

firms to invest at home - prohibit national firms from investing in certain countries for political reasons.	owned by local investors → why? (1) on the grounds of national security or competition (2) based on the belief that local owners can help maximize the resource-transfer and employment benefits of FDI for the host country

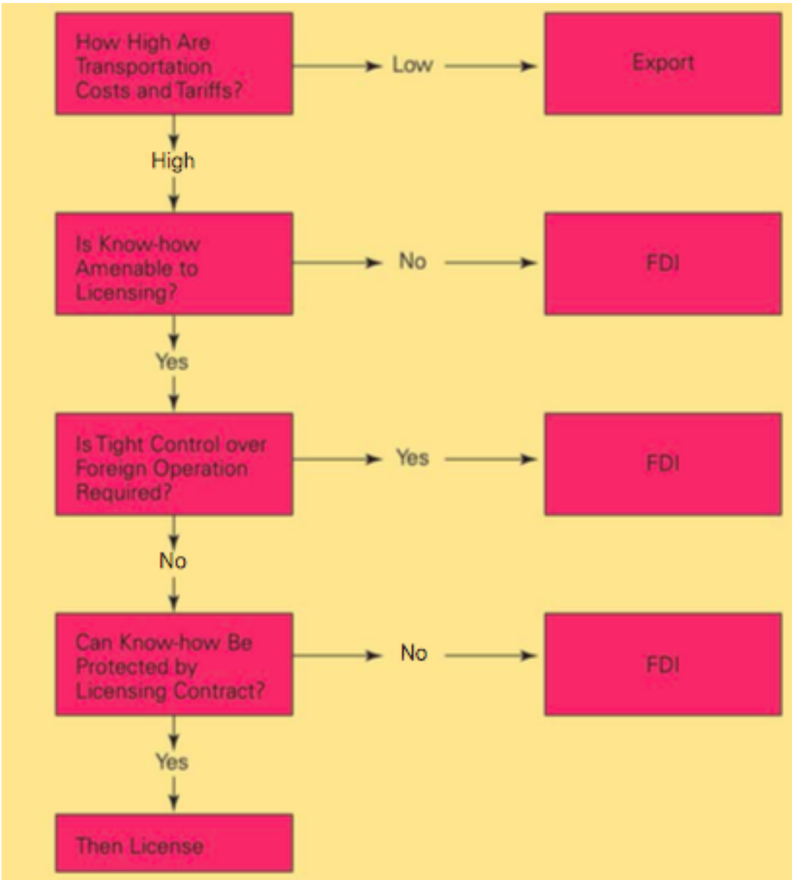
8.7 Implications

For managers

Implications of the theory

- ➢ The location-specific advantages argument helps explain the direction of FDI, however it does not explain why firms prefer FDI to licensing or exporting.
- ➢ The most useful theories focusing on why firms prefer FDI to licensing or exporting are those that focus on the limitations of the two, that is internationalization theories.
    - These theories suggest that exporting is preferable when to licensing and FDI so long as transportation costs are minor and trade barriers are trivial.
    - If transportation costs ↗ and trade barriers ↗=> X costs unprofitable => FDI or licensing? => licensing > FDI
    - Licensing is not attractive when:
        - The firm has valuable know-how that can't be protected by a licensing contract
        - The firm needs tight control over a foreign entity to maximize its market share and earnings in that country
        - A firm's skills and capabilities are not amenable for licensing
- ➢ Firms for which licensing is not a good option:
    - High-technology industries in which protecting firm-specific expertise is of paramount importance and licensing is hazardous
    - Global oligopolies: competitive interdependence requires that multinational firms maintain tight control over foreign operations so that they have the ability to launch coordinated attacks against their global competitors
    - Industries in which intense competition requires that they have a tight control over foreign operations
    - When the competitive advantage is marketing or managerial knowledge that is embedded in the routines of the firm or the skills of the managers
- ➢ Firms for which licensing is a good option:
    - Fragmented, low technology industries in which globally dispersed manufacturing is not an option. Ex.: The Fast Food industry
- ➢ Product life-cycle and Knickerbocker's theory of FDI tend to be less useful from a business perspective: they do a good job describing the evolution of FDI, but they do a relatively poor job identifying the factors that influence the relative profitability of FDI, licensing and exporting.

Decision framework



For government policy

A host government's attitude toward FDI should be an important variable in decisions about where to locate foreign production facilities and where to make a FDI.

9. REGIONAL ECONOMIC INTEGRATION

9.1. Regional economic integration

Agreements between countries in a geographic region to reduce tariff and non-tariff barriers to the free flow of goods, services and production factors. While the move toward regional economic integration is generally seen as a good thing, some worry that it will lead to a world in which regional trade blocs compete against each other.

9.2. Levels of regional economic integration

From the least integrated to the most integrated:

Free Trade Area

All the barriers to the trade of goods and services among member countries are removed. No discriminatory tariffs, quotas, subsidies or administrative impediments are allowed to distort trade between members. Each country is allowed to determine its own trade policies with regard to non-members. The most enduring free trade area in the world is the European Free Trade Association (EFTA)

Customs Union

Eliminates trade barriers between member countries and adopts a common external trade policy.
Most countries that enter into a customs union desire even greater economic integration down the road. The EU began as a customs union but has now moved beyond this stage.
Ex.: Andean Community (formerly known as the Andean Pact) between Bolivia, Colombia, Ecuador, Peru, and Venezuela. The Andean Community established free trade between member countries and imposes a common tariff of 5 to 20%, on products imported from outside

Common Market

No barriers to trade between member countries, includes a common external trade policy, and allows factors of production to move freely between members. Labor and capital are free to move because there are no restrictions on immigration, emigration, or cross-border flows of capital between member countries. It demands a significant degree of harmony and cooperation on fiscal, monetary, and employment policies.

Economic Union

Like the common market, it involves the free flow of products and factors of production between member countries and the adoption of a common external trade policy, but it also requires a common currency, harmonization of member's tax rates, and a common monetary and fiscal policy. The EU is an economic union, although not a perfect one because not all countries have adopted the same currency.

Political Union

The move toward economic union raises the issue of how to make a coordinating bureaucracy accountable to the citizens of member nations. The answer is through political union in which a central political apparatus coordinates the economic, social, and reign policy of the member states.

	Free Trade Area	Customs Union	Common Market	Economic Union	Political Union
No trade barriers between member states	✓	✓	✓	✓	✓
Common external trade policy		✓	✓	✓	✓
Factors of production can move freely between members			✓	✓	✓
Labor and capital can move freely			✓	✓	✓
Common currency, harmonization of members tax rates, common monetary and fiscal policy				✓	✓
Central economic apparatus that coordinates the economic, social and reign policy of the member state					✓

9.3. Economic integration in the Americas

Central American Trade Agreement (CAFTA)
=> to lower trade barriers between the US and member states
CARICOM
=> to establish a customs union in the Americas
=> in 2006 six members formed the Caribbean Single Market and Economy (CSME) to lower trade barriers and harmonize macro-economic and monetary policy between members

Both of these pacts didn't achieve their goals yet

9.4. Economic integration in Asia

Various efforts at integration have been attempted in Asia, but most exist in name only
- Association of Southeast Asian Nations (ASEAN)
- Asia-Pacific Economic Cooperation (APEC)

9.5. Economic integration in Africa

Many countries are members of more than one of the nine blocs in the region
But, since many countries support the use of trade barriers to protect their economies from foreign competition, meaningful progress is slow
- East African Community (EAC)
  - was re-launched in 2001
  - 2005: implementation of customs union
  - 2010: established a common market

Why should countries integrate their economies?

- ➢ All countries gain from free trade and investment - regional economic integration is an attempt to exploit the gains from free trade and investment
- ➢ Linking countries together, making them more dependent on each other
  - o creates incentives for political cooperation and reduces the likelihood of violent conflict
  - o gives countries greater political clout when dealing with other nations

What limits efforts at integration?

- ➢ Economic integration can be difficult because
  - ○ while a nation as a whole may benefit from a regional free trade agreement, certain groups may lose
  - ○ it implies a loss of national sovereignty
- ➢ Regional economic integration is only beneficial if the amount of trade it creates exceeds the amount it diverts
  - ○ trade creation
    - when low cost producers within the FTA replace high cost domestic producers
    - when low cost producers within the FTA replace high cost external producers
  - ○ trade diversion
    - occurs when higher cost producers within FTA replace lower cost external producers
    - trade you divert from the rest of the world with the only reason: discrimination because the ones on the outside have to pay tax

=> role of WTO: if you create more trade creation than trade diversion then it's acceptable, if it's the contrary then it's rejected.

What does economic integration mean for managers?

- ➢ Regional economic integration
  - opens new markets
  - allows firms to realize cost economies by centralizing production in those locations where the mix of factor costs and skills is optimal
- ➢ BUT
  - within each grouping, the business environment becomes competitive
  - there is a risk of being shut out of the single market by the creation of a "trade fortress"

9.6. The European Union

Languages

- 24 official languages
- 3 alphabets
- More than 60 minority and regional languages in EU
- German is the most widely spoken mother tongue in the EU
- English spoken by 38% of EU citizens as first foreign language
- In the EU about 50% of all children in primary education learn a foreign language

EU Economy

- With about 321 million people, the U.S. economy is the largest national economy in the world, with an estimated 2015 gross domestic product (GDP) of US $17.95 trillion (16% of nominal global GDP)
- With about 510 million citizens, the EU combined generated a GDP of US $16.23 trillion in 2015

=> The US produces more more GDP with less people than the EU (GDP/cap > in the US)

- the crisis has seriously affected the EU
  - o We have some important issues in terms of growth & productivity
  - o Unemployment rate is higher in the EU
  - o Industrial production: -20% since the crisis

Structural challenges

- ➢ Ageing is accelerating
  - EU working age population will be reduced by about 2 million by 2020
  - Number of 60+ is increasing twice as fast as before 2007
- ➢ Productivity levels are lagging behind
  - Two-thirds of EU income gap with the US is due to lower productivity

Factors explaining the US lead

- ➢ Better/larger science base
- ➢ Better in linking science & industry on a global scale
- ➢ Entrepreneurship
- ➢ Venture Capital
- ➢ Flexible labour markets

- ➢ Better incentives

=> But the main problem is lagging productivity in services

- 70% of the EU economy is in services
- The US make 30% more hours than the EU

There's a strong variation in income across and within the member states

Each country has some distinguished sectors in which it excels

<u>Bulgaria</u> ➢ light industrial products ➢ foods and wines	<u>Sweden</u> ➢ machinery ➢ motor vehicles ➢ paper products ➢ pulp and wood ➢ iron and steel products ➢ chemicals
<u>Italy</u> ➢ engineering products ➢ textiles and clothing ➢ production machinery ➢ motor vehicles ➢ transport equipment ➢ chemicals ➢ food, beverages and tobacco ➢ minerals and nonferrous metals	<u>France</u> ➢ machinery and transportation equipment ➢ aircraft ➢ plastics ➢ chemicals ➢ pharmaceutical products ➢ iron and steel ➢ beverages

Strategic consequences- how do EU firms react to integration?

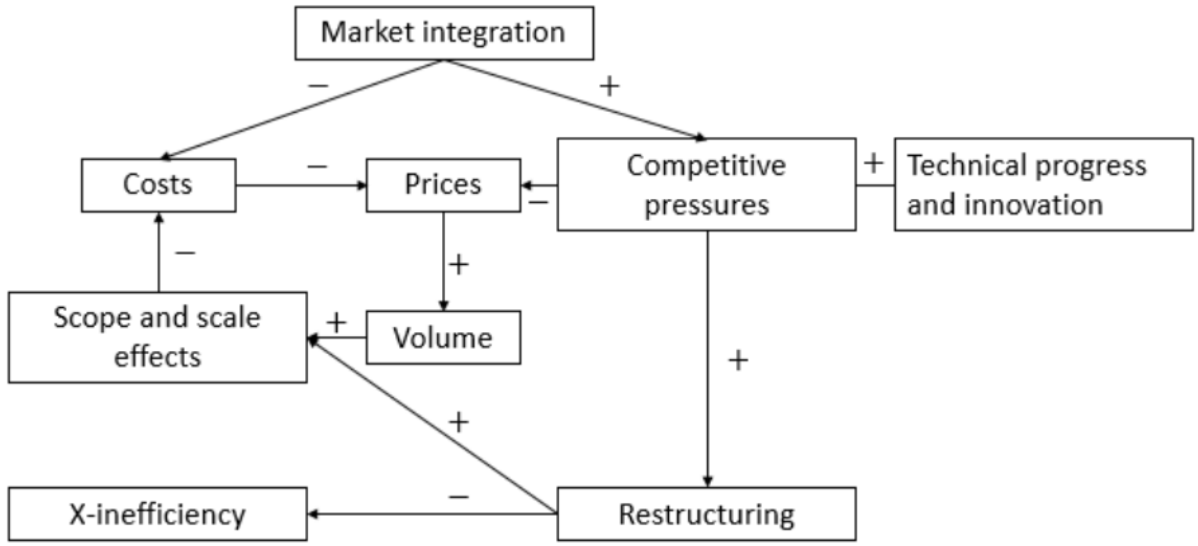
- New interplay of forces:

o closed economies → open economies

o regional producers as driving forces of prosperity → regional activities …

o « national » and protected producers → A-national world-wide competing companies

The effects of EU market integration



Market integration has a direct impact of the cost position of the companies (you don't have less administrative burdens, you can introduce it to everyone you like, because when one product is legal in one state, then it's legally accepted in every state, except health). means less costs, so lower prices, so they benefit from economies of scale, and these economies of scale translate in lower costs.
It puts more competition, so p goes down, and restructuring (weak companies are driven out), these restrictions give more economies of scale.
X-efficiency: when you're not using the resources in the best way (wrong use of resources), because of this pressure, it will disappear

Process of global/European restructuring

• As a result of integration:

  o Corporate diversification decreased
  o EU market share
  o Geographical concentration of activities

Old vs New EU organization
From national markets to Euro-Networks

Ex.: Unilever's soap manufacturing location in the EU:
From 13 locations to only 2 locations (1973-2002)

Why did Unilever keep one factory in the south of England and one in the south of Germany?

In the old Europe: the more you were selling, the bigger the shipping cost. see graph. they go where they can have the best economies of scale and close to the markets that are denser. So, you want to be close to customers that are there so that transportation costs are not too high.
In Europe you have the blue banana = a lot of activity is in that area (now we see some movements towards the South and east of Europe)
That's why we like the EU in Belgium, because we benefit a lot, and Greece and stuff don't benefit that much (peripheral regions). They will benefit from it but in terms of income difference, the ones in the center are much richer. For that reason, the EU gives a lot of assistance in these peripheral regions so that they also can have access to what happens to this integrated world.

Wider impact on value chain

Component of value-added	Possible nature of the impact
R&D	▯ growth in the number of joint projects ▯ more homogeneous environment at the EU level
Supply	▯ wider range of suppliers ▯ lower prices
Logistics	▯ lower transportation costs ▯ relocation of storage facilities
Production	▯ increased production at each plant ▯ creation of new plants in markets to be targeted or reduction in the number of production plants
Marketing & Distribution	▯ centralization of product management at EU level ▯ community-wide marketing campaigns
Consumers	▯ availability of wider range of products ▯ increased demand (growth effect)

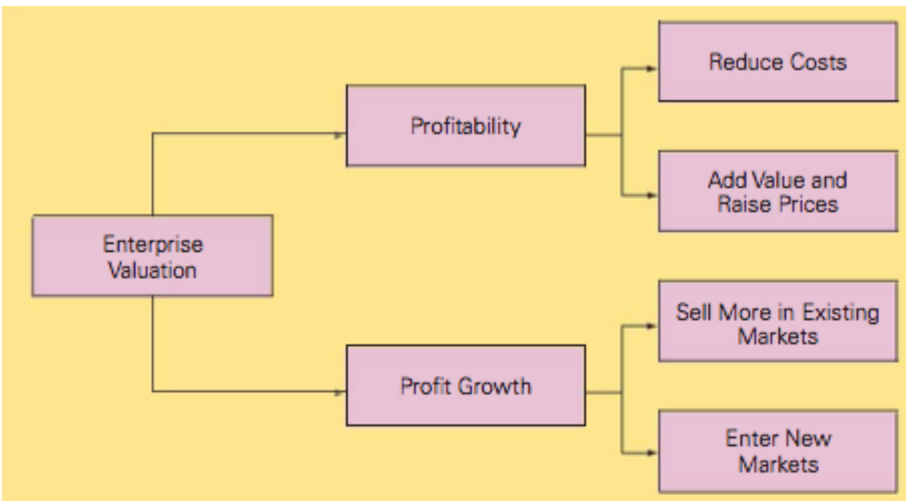
PART V. THE STRATEGY AND STRUCTURE OF INTERNATIONAL BUSINESS

13. THE STRATEGY OF INTERNATIONAL BUSINESS

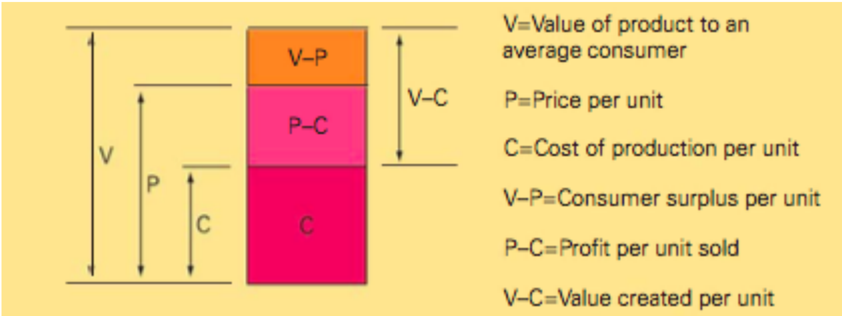
Learning objectives:
Discuss how firms should handle the complex international environment. Identify the benefits and costs from international strategies. Analyze the business model in the context of international markets

13.1. Strategy and the Firm

Firm strategy = actions that managers take to attain the goals of the firm (maximize the value of the firm).
To maximize the value of a firm, managers must pursue strategies that increase profitability and the rate of profit growth over time.
Profitability= ROIC (rate of return on invested capital) = net profits / total invested capital.
Profit growth= percentage increase in net profits over time.



Value creation
Definition: the difference between costs of production and the value that the consumers perceive in its products. V-C
In general, the more value the consumer place on a firm's products, the higher the price the firm can charge for those products. However, the price charged for the product is less than the value placed on that good by the consumer, that's what we call consumer surplus.
Low cost strategy: Strategy that focuses primarily on lowering the costs
Differentiation Strategy: strategy that focuses primarily on increasing the attractiveness of a product.
Note: superior value creation relative to rivals does not necessarily require a firm to have the lowest cost-structure or to create the most valuable, it does require the gap between V and C to be the greatest.



Strategic positioning

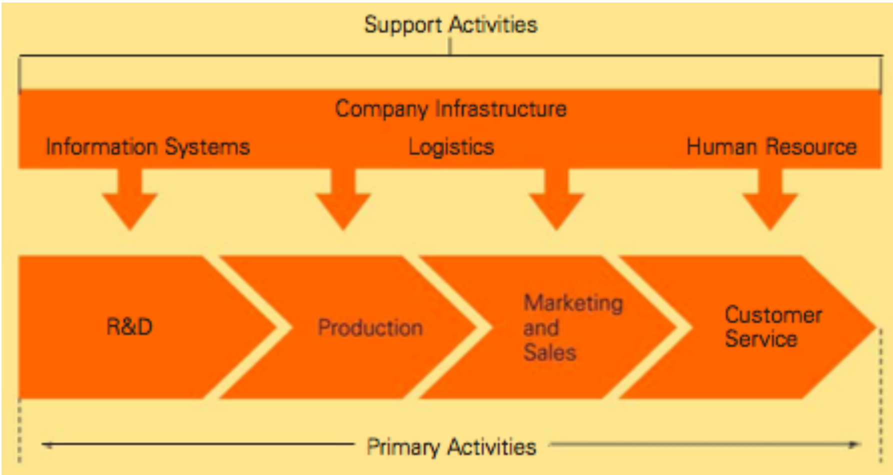
Efficiency Frontier: shows all of the different positions that a firm can adopt with regard to V and C assuming that its internal operations are configured efficiently to support a particular position. The frontier is convex because of diminishing returns.

Diminishing returns: when a firm already has significant value built into its product offering, increasing value by a relatively small amount requires significant additional costs or when a firm already has a low-cost structure, it has to give up a lot of value to get additional cost reductions.

To maximize its profitability, a firm must do three things:

(1) pick a position on the frontier where there is enough demand to support the choice
(2) configure its internal operations so that they support that position
(3) make sure that the firm has the right organization structure in place to execute its strategy

Operations: the value chain



Note: support activities can be as important or even more important as primary activities.

13.2. Global expansion, profitability and profit growth

Expanding globally allows firms to increase their profitability and rate of profit growth in ways not available to purely domestic enterprises. Firms that operate internationally are able to:

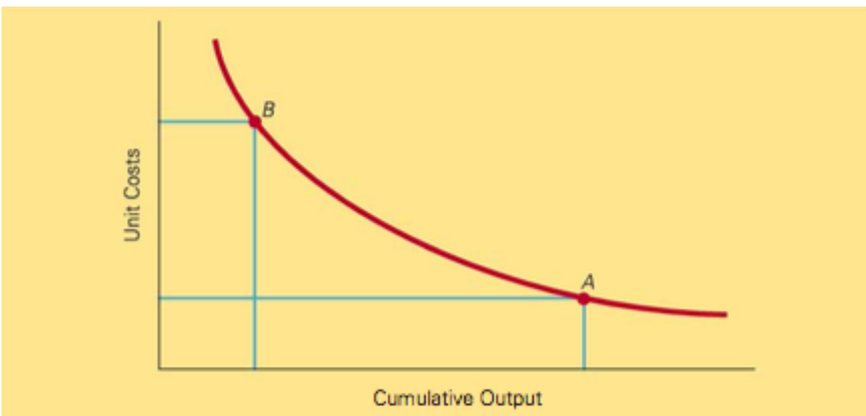
1. Expand the market for their domestic product offerings by selling those products in international markets
2. Realize location economies by dispersing individual value creation activities to those locations around the globe where they can be performed most efficiently and effectively.
3. Realize greater cost economies om experience effects by serving an expanded global market from a central location, thereby reducing the costs of value creation.
4. Earn a greater return by leveraging any valuable skills developed in foreign operations and transferring them to other entities within the firm's global network of operations.

<u>Core competence:</u> Skills within the firm that competitors cannot easily match or imitate.
<u>Location economies</u>: The economies that arise from performing a value creation activity in the optimal location for that activity, wherever in the world that might be.
<u>Global web of value creation activities:</u> the different stages of the value chain are being dispersed to those locations around the globe where perceived value is maximized or where the costs of value creation are minimized.

Experience effects

Experience curve: refers to systematic reductions in production costs that have been observed to occur over the life of a product. Two things explain this:

1. Learning effects: cost savings that come from learning by doing. Production costs decline due to increasing labor productivity and management efficiency which increases the firm's profitability. Important in the start-up period.
2. Economies of scale: reductions in unit cost achieved by producing a large volume of a product. Economies of scale have a number of sources:
   - The ability to spread fixed costs over a large volume;
   - The ability to attain an efficient scale of production → less switching costs
   - The increase in bargaining power which may allow it to attain economies of scale in purchasing, bargaining down the cost of key inputs and boosting profitability.



Moving down the experience curve allows firm to reduce its cost of creating value and increase its profitability. Firm A has a clear cost advantage over firm B.

13.3. Cost pressures and pressure for local responsiveness

Firms typically face two types of competitive pressure:

- pressures for cost reductions;
- pressures to be locally responsive, differentiate.
  → because differentiation across countries can involve significant duplication and a lack of product standardization, it may raise costs

Pressures for cost reduction

Pressures for cost reductions are intense in:
- industries serving universal needs where price is the main competitive weapon;
- industries where major competitors are based in low-cost locations where there is persistent excess capacity and consumers are powerful and face low switching costs.

Universal needs: the tastes and preferences of consumers in different nations are similar if not identical.

Pressures for local responsiveness

Pressures for local responsiveness arise from:
- national differences in customer tastes and preferences;
- differences in infrastructure and traditional business practices;
- differences in distribution channels → soft sell versus hard sell;
- host-government demands → informal rules with regard to local content favor people who use local workers.

13.4. Choosing a strategy

Strategy is about making choices. The choice of a competitive positioning (based on cost, differentiation, focus) and fitting activity system. Your strategy is about designing the right activity system (that is difficult to imitate) and doing so will create this unique competitive positioning and will help you create a competitive advantage. You have to think in terms what strategic direction is more important and define a clear competitive positioning.

What is international business strategy?
An international business strategy consists of extending and adapting the business model to create extra value from being present in several countries. In search for a better fit, strategies include: **A**ggregation, **A**rbitrage, **A**daptation of activities across countries.

Choosing a strategy

The combination of the triple A strategies results in four generic international strategies yielding different degrees of global integration and local responsiveness benefits:
- Global Standardization: arbitrate and aggregate
- Localization: adaptation
- Transnational
- International extension: arbitrage

<u>International strategy</u>

Taking products first produced for the domestic market and then selling them internationally with only minimal local customization. The international extension strategy makes sense when:

➢ There are low cost pressures
➢ Low pressures for local responsiveness

There are very few international strategies and if you find them, they don't last very long.

<u>Localization strategy</u>

The localization strategy focuses on increasing profitability by customizing the firm's goods or services so that they provide a good match to tastes and preferences in different national markets. The localization strategy makes sense when:

➢ There are substantial differences across nations with regard to consumer tastes and preferences, an environment that's not too national
➢ Where cost pressures are not too intense

Ex.: construction industry (different partners, different customers, very localized business in consultancy)

<u>Global standardization strategy</u>

The global standardization strategy focuses on increasing profitability and profit growth by reaping the cost reductions that come from economies of scale, learning effects, and location economies. The strategic goal is to pursue a low-cost strategy on a global scale. The global standardization strategy makes sense when:

➢ There are strong pressures for cost reductions
➢ Demands for local responsiveness are minimal

Global strategy levers:

- ➢ Major market participation
- ➢ Product standardization
- ➢ Activity concentration
- ➢ Uniform marketing
- ➢ Integrated competitive modes

<u>Transnational strategy</u>

The transnational strategy tries to simultaneously:

- ➢ achieve low costs through location economies, economies of scale, and learning effects
- ➢ differentiate the product offering across geographic markets to account for local differences
- ➢ foster a multi directional flow of skills between different subsidiaries in the firm's global network of operations

- ➢ You combine everything, and you want to localize: you want to aggregate where it's possible and arbitrate to have the best costs, it's a very difficult strategy

The transnational strategy makes sense when:

- ➢ cost pressures are intense
- ➢ pressures for local responsiveness are intense

It's very hard to organize.

The choice of strategy

The choice of an appropriate strategy depends on the industry pressures for integration (global industries) versus local responsiveness (local industries).

How to check if it's a local business:

- ➢ Who are my relevant competitors? if they are in other countries then it means you're in a global industry.

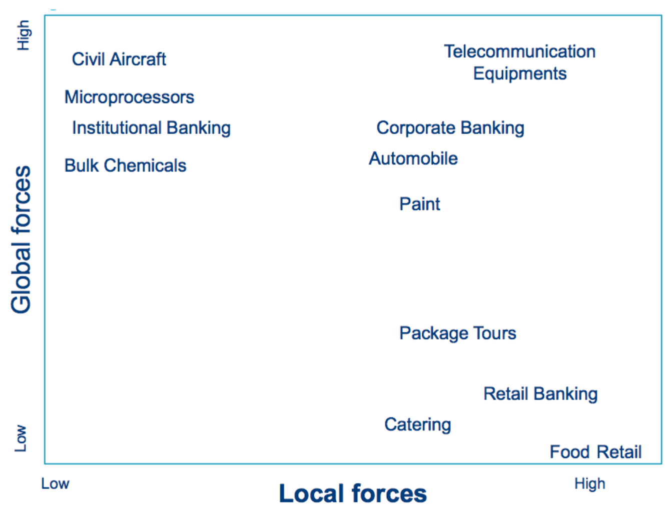
Local vs. Global industries

LOCAL INDUSTRIES	GLOBAL INDUSTRIES
Local industries are industries in which firms can sustain competitive within the boundaries of countries. they are either: - domestic firms within each country - subsidiaries of multinational companies operating independently of each others in the respective countries	Global industries are industries in which firms can sustain competitive advantages only if: - they are present in key countries of the world - they integrate and coordinate their activities across the world on a centralized manner.

Industries: global or local?

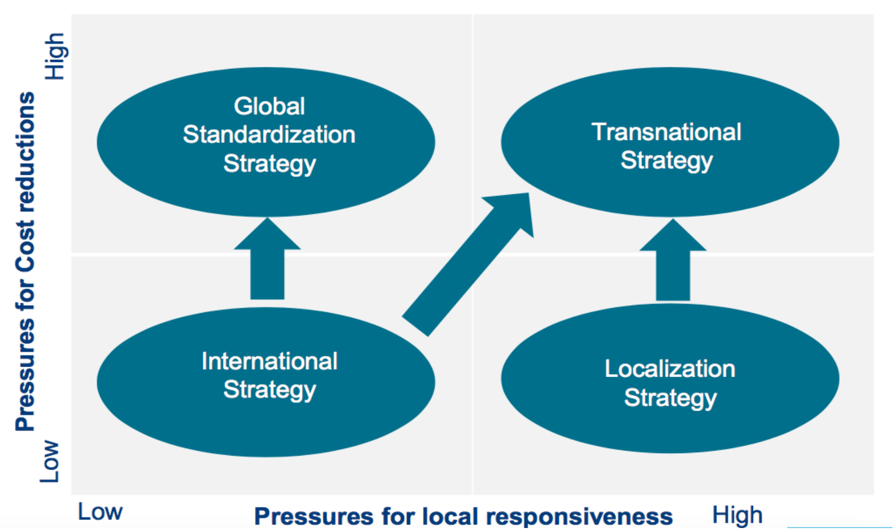
Factors pushing for globalization	**Factors against globalization**
- low entry barriers - High Scale Technology - Convergence of consumption - Transport	- Cultural differences - Customer proximity - Transport costs - Legal requirements
Characteristics of global industries	**Characteristics of local industries**
- Similar needs & customers behavior - Standardized products - beyond country economies of scale - Speed of innovation - Transferability of experience - “Global” customers - “Global” pricing - “Global” competitors	- Different needs & customers behavior - Customized products/services - Low economies of scale - Complex distribution - Transferability of experience - “Local” customers - High transport costs

Industry context



The evolution of strategy

- ➢ An international strategy may not be viable in the long term
- ➢ As competitors emerge, localization and international strategies tend to become less viable and managers need to direct their companies toward either globalization or transnational strategies.
- ➢ Similarly, localization may give a firm a competitive edge, but if the firm is simultaneously facing aggressive competitors, the company will also have to reduce its cost structures, and the only way to do that may be to shift toward a transnational strategy



En gros quand la pression est grosse en localization alors tu vas dans transnational. Quand la pression est forte en international strategy alors tu vas soit en global standardization strategy ou transnational strategy. Mais le prof dit qu'en gros tout le monde a tendance à aller vers le global standardization strategy.

Leveraging subsidiary skills
to what extent are firms still based in a country?

It's important for managers to:

- ➢ Recognize that valuable skills that could be applied elsewhere in the firm can arise anywhere within the firm's global network (not just at the corporate center)
- ➢ Establish an incentive system that encourages local employees to acquire new skills
- ➢ Have a process for identifying when valuable new skills have been created in a subsidiary

Ex.: Philips: would you still call it a Dutch company? All their R&D is in Germany…

13.5. The adding framework

Given the competitive strategy: HOW does internationalization help to create extra strategic value?

Adding volume or growth	- look at the true economic profitability of incremental volume - Probe the level at which additional volume yields economies of scale: globally, nationally, at the plant or customer level - calibrate the strength of scale effects (slope, percentage of costs, etc.) - look at labor costs-to-sale-ratios for your industry - assess the other effects of volume
Decreasing costs	- unbundle cost effects and price effects - unbundle costs into subcategories - consider cost increases (e.g. due to complexity, adaptation) as well as decreases, and net them out - look at cost drivers other than scale and scope - look at labor costs-to-sales ratios for your industry (or company) - analyze how the value chain can be spread across countries
Differentiation	- try to make your product different => ex: Stella Artois, was considered a lousy beer, but by internationalization in the UK it created a global brand and helped to increase the willingness to pay from the customer for the beer
Improving industry attractiveness/ bargaining power	- what is the relevant market? - how are competitors organized across countries? - how are suppliers organized? - how are distributors organized?

	=> if you are a small company, your bargaining power is small, but of you're big, then it become stronger.
Normalizing Risk	- understand key sources of risk in your business - assess cross border operations on overall corporate risk => You can diversify into different parts of the world, if it goes wrong in one part, then you can maybe focus on another Various risks to be managed: - political risk - economic risk - legal/contractual risk - operational/ exchange risk
Generating knowledge	- generate and diffuse knowledge/cross borders- network advantages - acquire enhanced resources or capabilities => You can learn from what happens in different markets and transfer knowledge in your sector if it's better somewhere else

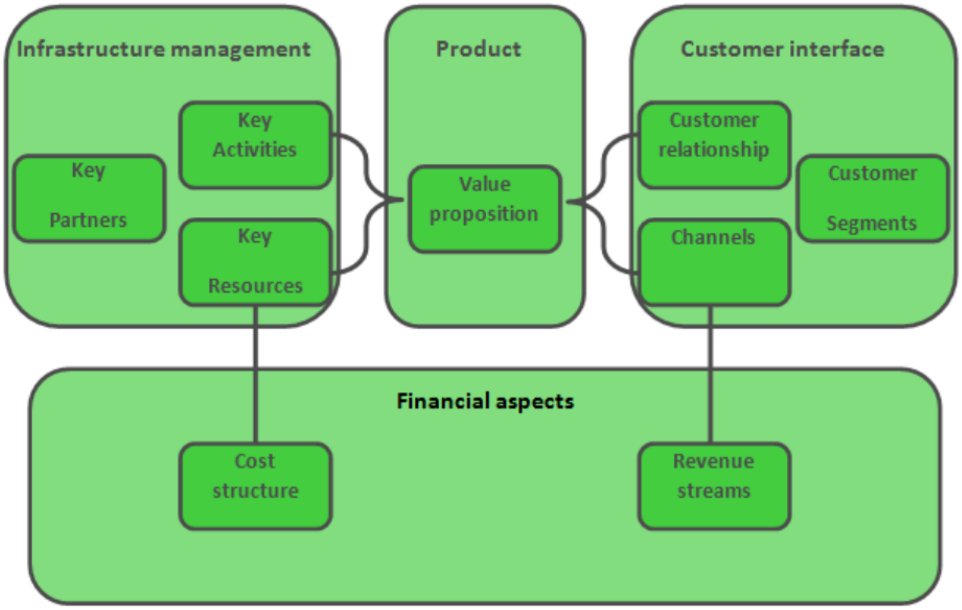
Be careful: when you do internationalization then you have the adding method, but you have to adapt it on your own ways in order to create value!

Value curve

<u>Ikea:</u>

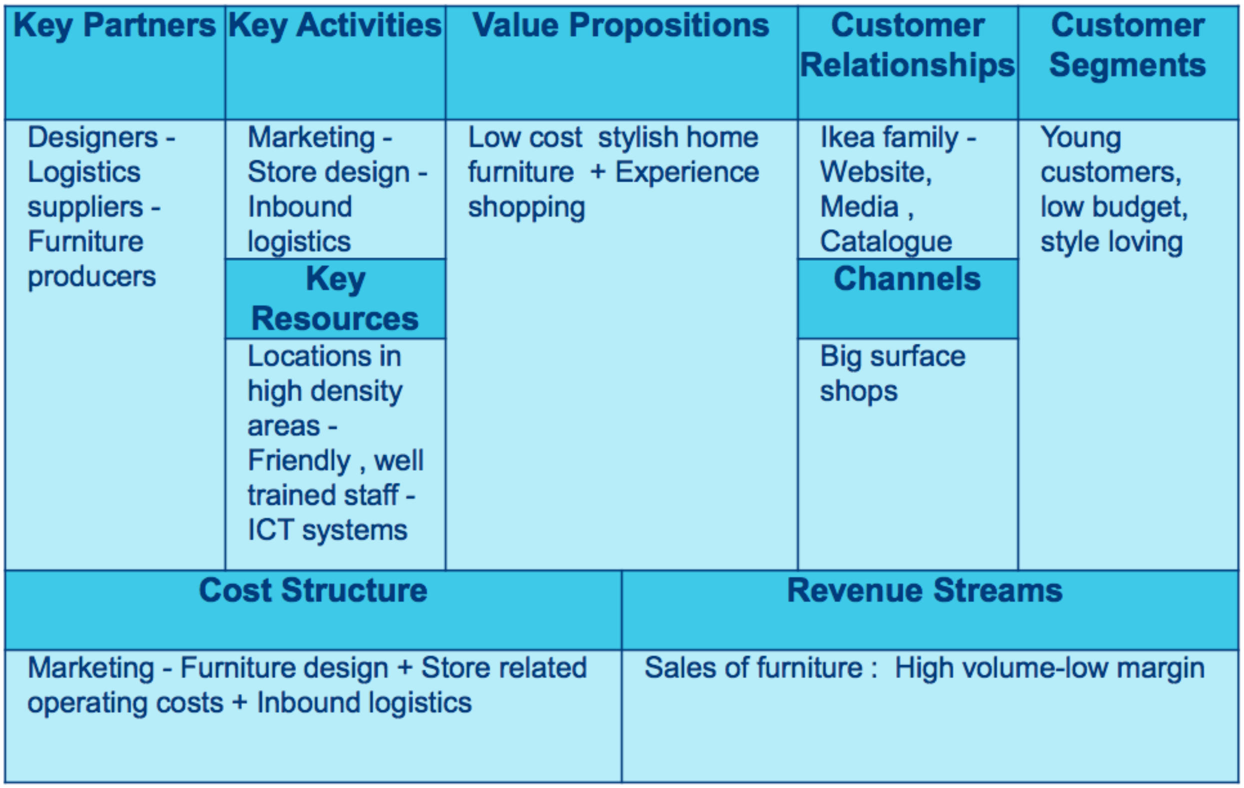
- not product resembled
- no proximity w/ customer
- the highest variety in products
- good product quality
- price is not the most important to them (they are not differentiating with the price)

The Business Model Canvas



• left: activities
• right: customer
=> it all is about the value proposition

Ex.: the BMC from IKEA



	Business Model	Target country
Value proposition	How are products, core services and complementary services packaged and offered to fulfil customer needs?	- How should the special characteristics of the foreign market be taken into account when designing the value proposition? - What kinds of value propositions exist currently in the foreign market?
Target customers	How does the company segment the target customers in the foreign market?	How do the international customers differ from the domestic customers?
Distribution channels	- How are the distribution channels which allow the company to deliver value to foreign customers organised within the company? - Presence of geographic and industry experience in the company regarding the distribution channels in the foreign market?	- What tools are there for distribution in the foreign market? - Are there common channels in the domestic and foreign markets? - How does the legal environment of the foreign markets affect the channels?
Customer relationships	- How does the company build and keep up the relationships with customers? - How can the different relationships in the foreign market be organised in the company? - Are there significant geographic and industry experience in the company regarding typical customer relationships in the foreign market?	- To which kind of relationships are the foreign customers used to? - How do these differ from those with domestic customers? - Does the company have a reputation for superior product, process or management technology (in the foreign market)?
Key activities	- Are there differences between the domestic and foreign market's typical value configurations? - Does the company have capabilities to adapt to the possibly different value configurations suitable in the foreign market?	- Are there regulatory or normative restrictions in the ways value configurations can be constructed in the foreign markets? - What is the currently typical value configuration in the foreign market? - To what kinds of value configurations are the customers used to in the foreign market?

	Business model	Target country
Key resources	- Is there proprietary technology or knowhow related to the service in the company? - Does the company have a specialised asset that is required in competitive production of the service in the foreign market? - Does the company have a culture that provides a competitive advantage in the foreign market?	- What kinds of assets and resources are available to the company in the foreign market? - Does the firm require complementary resources in order to operate successfully in the foreign market? - Is the company large relative to its competitors in the foreign market?
Partnership	- Which parts of the activity configuration and which resources are distributed among the company's partners? - Are the company's current partners available and capable to operate in the foreign market? - Do the company's current partners have experience in the foreign market?	- Does the foreign market provide potential partners for the company? - Are partners for joint ventures, licensing or franchising available in the foreign market?
Cost structure	What kind of costs are there for the company in order to create, market and deliver value to customers?	Is the cost structure of the foreign market substantially different from the domestic market?
Revenue streams	How is the value the firm offers translated into monetary terms and incoming revenue streams?	- Are the typical revenue streams of the foreign market different from the domestic market? - Are the currency risks related to the foreign market?

Profitable international growth

Profitable international growth should avoid:

- ➢ Risk to move too far from the core business
- ➢ Risk to jeopardize the company business model (Porter 1996, Ghemawat 2007)
- ➢ Risk of "liability of foreignness", which puts the firm at a competitive disadvantage vis-à-vis local firms (Zaheer, 1995)
- ➢ Internationalization should not jeopardize but reinforce your business model
  → adaptations for foreign countries should not undermine the global competitive positioning of the firm

Profitable international growth from expanding to a foreign country:

- ➢ Attractiveness factors: potential gains - ADDING factors in relation to country conditions
- ➢ Compatibility factors: Business model elements in relation to country conditions

14. THE ORGANIZATION OF INTERNATIONAL BUSINESS

The organization used in order for a firm to manage its global operations.

Superior enterprise profitability requires three conditions to be fulfilled:
(1) the different elements of a firm's organizational architecture must be internally consistent;
(2) the organizational architecture must match the strategy of the firm;
(3) the architecture and strategy must not only be consistent with each other but make sense given the competitive conditions prevailing in the firm's market.

14.1. Organizational architecture

The totality of a firm's organization including:

1. Formal organizational structure

- ➢ The formal division of the organization into subunits
- ➢ The location of decision-making responsibilities within that structure - centralized versus decentralized
- ➢ The establishment of integrating mechanisms to coordinate the activities of subunits including cross-functional teams or pan-regional committees

2. Control systems and incentives

- ➢ Control systems - the metrics used to measure performance of subunits
- ➢ Incentives - the devices used to reward managerial behavior but also your worker
- ➢ How are you going to make sure that the people are going to work for the general views?

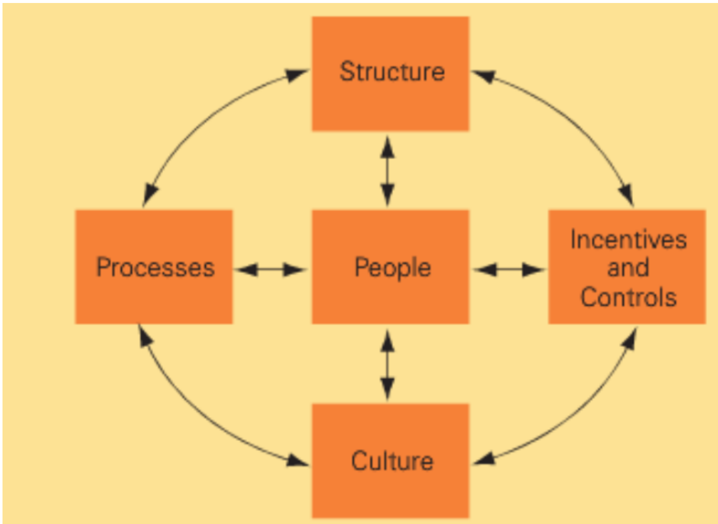
3. Processes, organizational culture and people

- ➢ Processes - the manner in which decisions are made and work is performed within the organization/ How the activities are linked = the backbone of the business model. these activities have to be linked so that they help to implement the strategy
- ➢ Organizational culture - the norms and value systems that are shared among the employees of an organization and make people work together
- ➢ People - the employees and the strategy used to recruit, compensate, and retain those individuals and the type of people they are in terms of their skills, values, and orientation

To be the most profitable

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

=> Mr. Miller had to think how to make all of this works. he had to make sure it works for the AUS market but also worldwide. A strategy had was not accepted in the industry.



14.2. Organizational structure

Organizational structure has three dimensions:

1. Vertical differentiation - the location of decision-making responsibilities within a structure
2. Horizontal differentiation - the formal division of the organization into sub-units
3. Integrating mechanisms - the mechanisms for coordinating sub-units

Vertical differentiation: centralization and decentralization

Vertical differentiation determines where decision-making power is concentrated.

Arguments for centralization	Arguments for decentralization
- Facilitates coordination. Ex.: assemble everything in the same country - Ensures decisions are consistent with organization's objectives. Ex.: low-level managers might not take the same decisions as top management - Gives managers the means to bring about the major organizational changes - Avoids duplication of activities	- Relieves the burden of centralized decision-making. Because managers can be overburdened and thus make lousy decisions. It enables them to focus on what's essential - Has been shown to motivate individuals, because they have more individual power - Permits greater flexibility: more rapid response to environmental changes - Can result in better decisions, because decisions are made by people that are closer to the spot than manager at several levels up - Can increase control: subunits that have responsibilities

BRLH: was decentralized and became centralized

Horizontal differentiation: the design of structure

Horizontal differentiation refers to how the firm divides into sub-units

→ Usually based on function, type of business, or geographical area

➢ Functional structure: Most firms begin with no formal structure, but as they grow, the organization is split into functions reflecting the firm's value creation activities
o functions are coordinated and controlled by top management
o decision-making is centralized
o product line diversification requires further horizontal differentiation

➢ Product divisional structure: Firms may switch to a product divisional structure where each division is responsible for a distinct product line

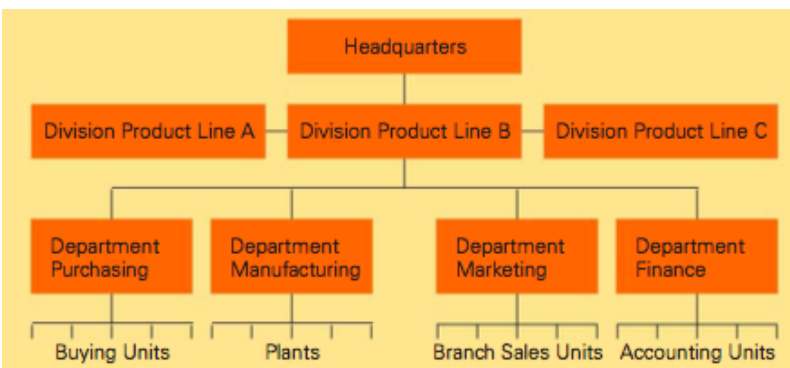
➢ International divisional structure: When firms expand internationally, they often group all of their international activities into an international division
→ Over time, manufacturing may shift to foreign markets
o firms with a functional structure at home would replicate the functional structure in the foreign market
o firms with a divisional structure would replicate the divisional structure in the foreign market
In either case, there is the potential for conflict and coordination problems between domestic and foreign operations. Ex.: BRLH: they put Davis on top the international division
Problems with this structure:
o the heads of foreign subsidiaries are not given as much voice in the organization as the heads of domestic functions or divisions;
o domestic and foreign operations are isolated from each other in separate parts of the structural hierarchy: this can inhibit the worldwide introduction of new products and the consolidation of global production at key locations so as to realize location and experience curve economies.
→ Firms that continue to expand will move to (1) **worldwide product divisions** (tends to be adopted by diversified firms that have domestic product divisions) and (2) a **worldwide area structure** (tends to be adopted by undiversified firms whose domestic structures are based on functions).

➢ Worldwide product divisional structure - adopted by firms that are reasonably diversified
o allows for worldwide coordination of value creation activities of each product division
o helps realize location and experience curve economies
o facilitates the transfer of core competencies
o does not allow for local responsiveness

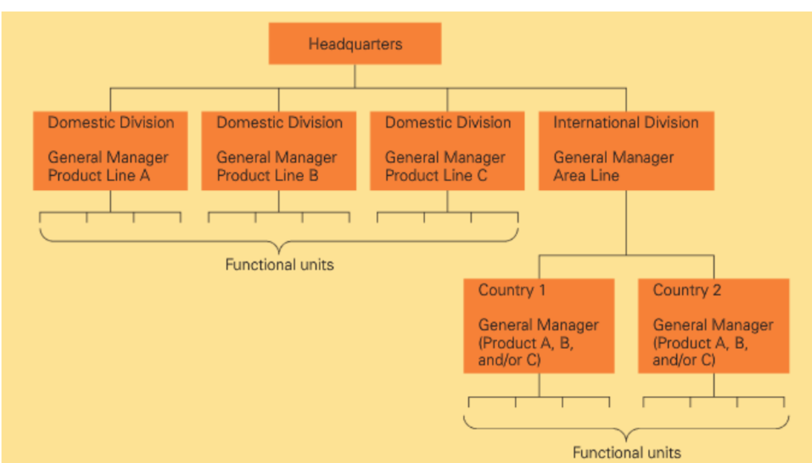
➢ Worldwide area structure - favored by firms with low degree of diversification and a domestic structure based on function
o divides the world into autonomous geographic area so decentralizes operational authority
o facilitates local responsiveness
o can result in a fragmentation of the organization
o is consistent with a localization strategy

Global matrix structure: horizontal differentiation proceeds along two dimensions: (1) product division and (2) geographic area.
Dual decision-making responsibility can enable a firm to simultaneously achieve its particular objectives. An individual manager thus belongs to two hierarchies (a division and an area) and has two bosses (a divisional boss and an area boss). In practice the matrix is often clumsy and bureaucratic: when all critical decisions are the product of negotiation between divisions and areas, one side can always blame the other when things go wrong.
For a complex matrix structure to succeed, the firm must (1) try to establish an informal knowledge network and (2) build a common culture that promotes teamwork and cooperation.

Functional structure



Product Divisional structure

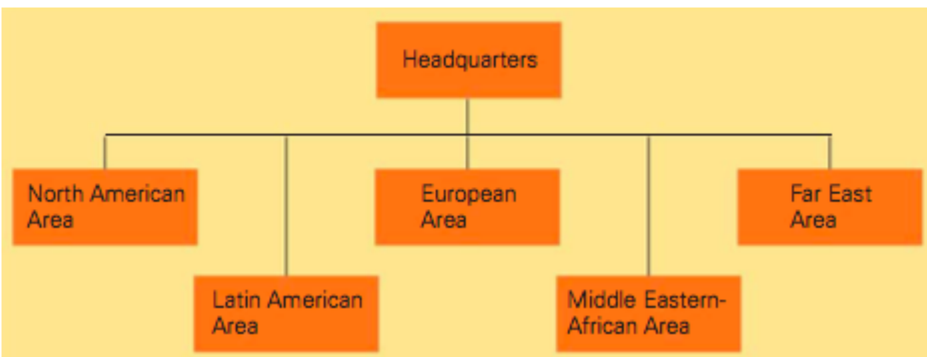


International Divisional Structure

International Structural Changes model

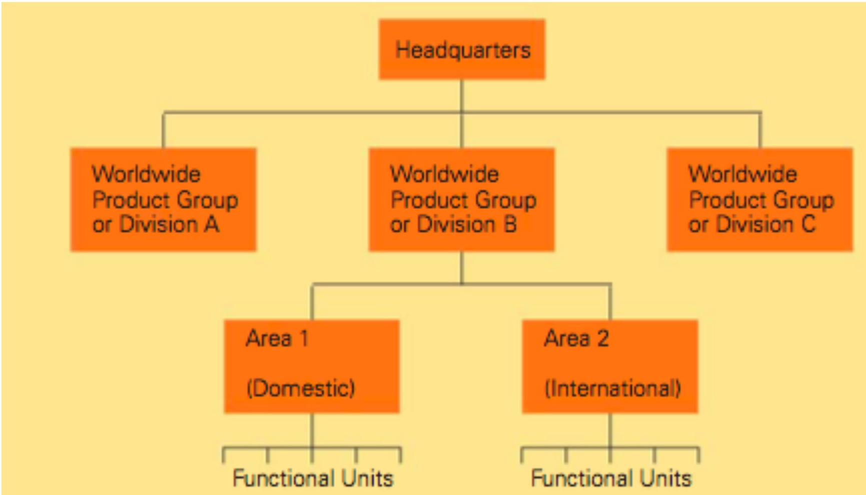
When firms grow bigger you see what happens:

- When you have a very diversified company w/ many product lines: international division - worldwide product division- global matrix
- When you don't have a lot of products: international division - area division - global matrix



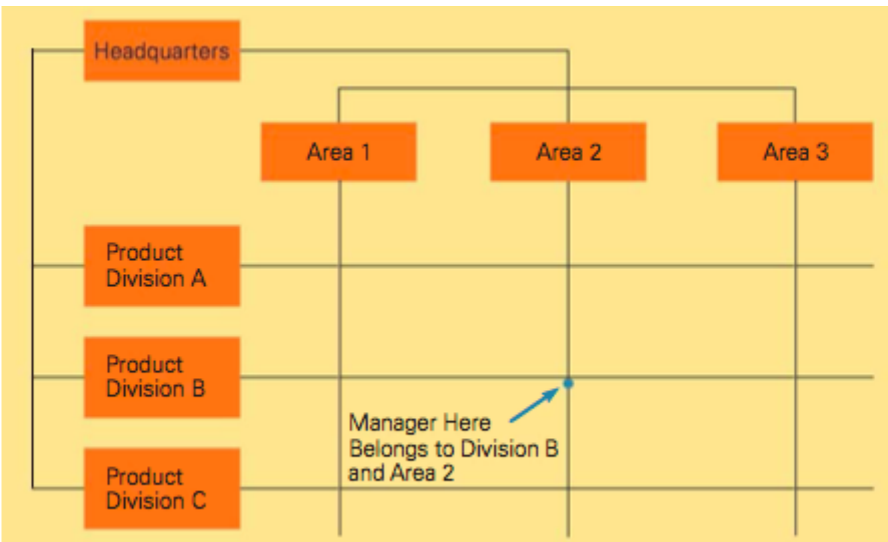
Worldwide Area Structure

Ex.: The automotive industry



Worldwide Product divisional structure

Ex.: Philips



Global Matrix Structure

14.3. Integrating Mechanisms

Strategy and Coordination in the International Business

Regardless of the type of structure, firms need a mechanism to integrate subunits

o The need for coordination is lowest in firms with a localization strategy and highest in transnational firms

o Coordination can be complicated by differences in subunit orientation and goals

o Simplest formal integrating mechanism is direct contact between subunit managers, followed by liaisons

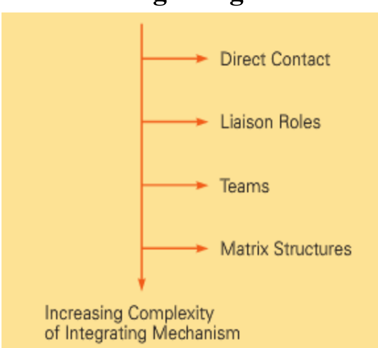
o Temporary or permanent teams composed of individuals from each subunit is the next level of formal integration

o The matrix structure allows for all roles to be integrating roles

Impediments to coordination

Managers of the various subunits have different orientations, partly because they have different tasks.
=> these differences can inhibit communication between managers
Differences in subunits' orientation also arise from their differing goals.
=> these different goals can lead to conflicts
Such impediments are not unusual, but they can be particularly problematic in the multinational enterprise with its profusion of subunits at home and abroad. Differences in subunit orientation are often reinforced in multinationals by the separations of time zones, distance and nationality between managers of the subunits.

Formal Integrating Mechanisms



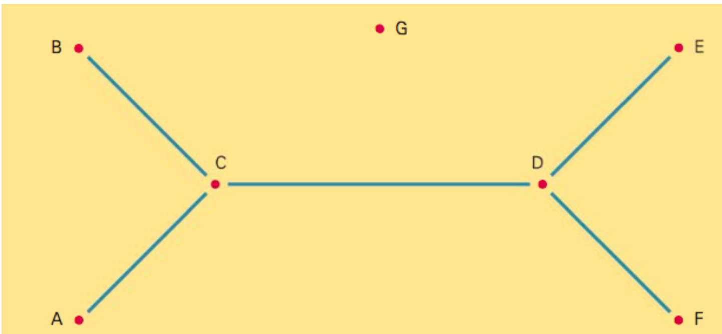
<u>Direct contact</u>: managers of the various subunits simply contact each other whenever they have a common concern. Direct contact may not be effective if the managers have differing orientations that act to impede coordination.
<u>Liaison:</u> giving a person in each subunit responsibility for coordinating with another subunit on a regular basis. Through these roles, the people involved establish a permanent relationship. This helps attenuate the impediments to coordination.
<u>Teams:</u> use temporary or permanent teams composed of individuals from the subunits that need to achieve coordination. They typically coordinate product development and introduction.
<u>Matrix Structures:</u> All roles are viewed as integrating roles. Designed to facilitate maximum integration among subunits. The most common matrix in multinational firms is based on geographic areas and worldwide production divisions. The firm can pay close attention to both local responsiveness and the pursuit of location and experience curve economies.

Informal Integrating Mechanism: Knowledge networks

Knowledge Network: a network for transmitting information within an organization that is based not on formal organization structure, but on informal contacts between managers within an enterprise and on distributed information systems

o a non-bureaucratic conduit for knowledge flows

o must embrace as many managers as possible and managers must adhere to a common set of norms and values that override differing subunit orientations



Managers A, B and C all know each other personally, as do managers D, E and F. Although manager B does not know manager F personally, there are linked through manager C and D. Manager G is not part of the network.

Two techniques used to establish networks:

- Information systems;
- Management development policies → development programs that bring managers of subunits together in a single location, so they can become acquainted.

14.4. Control Systems and incentives

Control systems: the metrics used to measure the performance of subunits and make judgments about how well managers are running those subunits.

Types of control systems

Personal control: control by personal contact with subordinates. Most widely used in small firms

Bureaucratic control: control through a system of rules and procedures that directs the actions of subunits. The most important bureaucratic controls in subunits are budgets and capital spending rules.
o *Budgets:* a set of rules for allocating a firm's financial resources. Budgets allow headquarters to specify the amount a subunit can spend in a given year.
o *Capital spending rules*: any capital expenditure by a subunit that exceeds a certain amount needs to be approved. Capital spending rules give headquarters additional control over how the money is spent.

Output controls: Involve setting goals for subunits to achieve and expressing those goals in terms of relatively objective performance metrics such as profitability, productivity, growth, market share and quality. The performance of subunit managers is then judged by their ability to achieve the goals.

Cultural controls: exist when employees 'buy into' the norms and value systems of the firm. Employees tend to control their own behavior, which reduces the need for direct supervision. Strong culture implies less need for other forms of control.

Incentive systems
Incentives: The devices used to reward behavior
o usually closely tied to performance metrics used for output controls
o should vary depending on the employee and the nature of the work being performed → you should make sure the incentive scheme for an individual employee is linked to an output target that he/she can influence
o should promote cooperation between managers in subunits
o should reflect national differences in institutions and culture
o can have unintended consequences

Control systems, Incentives and Strategy in the International Business

Performance ambiguity: exists when the causes of a subunit's poor performance are not clear
- o is common when a subunit's performance is dependent on the performance of other subunits
- o is lowest in firms with a localization strategy
- o is higher in international firms
- o is still higher in firms with a global standardization strategy
- o is highest in transnational firms

The key to understanding the relation between international strategy, control systems and incentive systems is the concept of performance ambiguity:

Strategy	Interdependence	Performance Ambiguity	Costs of Control
Localization	Low	Low	Low
International	Moderate	Moderate	Moderate
Global	High	High	High
Transnational	Very High	Very High	Very High

<u>Strategy:</u> the higher profitability associated with a transnational strategy could be cancelled out by the higher costs of control.
<u>Control:</u> in firms pursuing global or transnational strategies, the usefulness of output controls is limited by performance ambiguity, these firms should place greater emphasis on cultural control.
<u>Incentives:</u> when ambiguity makes it difficult to judge the performance of subunits as stand-alone entities, linking the incentive pay of senior managers to the entity to which both subunits belong can reduce the resulting problems.

Processes

<u>Processes:</u> The manner in which decisions are made and work is performed
- o many processes cut across national boundaries as well as organizational boundaries
- o processes can be developed anywhere within a firm's global operations network
- o formal and informal integrating mechanisms can help firms leverage processes

<u>Flow chart:</u> illustrates the various steps and decision points involved in performing work

Organizational culture

<u>Organizational culture</u>: The norms and value systems that are shared among the employees of an organization. Culture is maintained by a variety of mechanisms:
- Hiring and promotional practices of the organization
- Reward strategies
- Socialization processes (training programs or friendly advice from peers)
- Communication strategy

➢ Companies with adaptive cultures have the highest performance.
➢ Managers in companies with a "strong" culture share a relatively consistent set of values and norms that have a clear impact on the way work is performed
➢ A "strong" culture
o is not always good
=> you become blind of new developments because you are so egocentric in what you're doing and you are not promoting the most adaptive organization ('dynamic capabilities': the power to change easily, also because you don't have a strong culture)
o may not lead to high performance
o could be beneficial at one point, but not at another
➢ Companies with adaptive cultures have the highest performance

The link between strategy and architecture:

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

Firms pursuing a **localization strategy** focus on local responsiveness

- ➢ they do not have a high need for integrating mechanisms
- ➢ performance ambiguity and the cost of control tend to be low
- ➢ the worldwide area structure is common

Firms pursuing an **international strategy** create value by transferring core competencies from home to foreign subsidiaries

- ➢ the need for control is moderate
- ➢ the need for integrating mechanisms is moderate
- ➢ performance ambiguity is relatively low and so is the cost of control
- ➢ the worldwide product division structure is common

Firms pursuing a **global standardization strategy** focus on the realization of location and experience curve economies

- ➢ headquarters maintains control over most decisions
- ➢ the need for integrating mechanisms is high
- ➢ strong organizational cultures are encouraged
- ➢ the worldwide product division is common

Firms pursuing a **transnational strategy** focus on simultaneously attaining location and experience curve economies, local responsiveness, and global learning

- ➢ some decisions are centralized, and others are decentralized
- ➢ the need for coordination and cost of control is high
- ➢ an array of formal and informal integrating mechanism is used
- ➢ a strong culture is encouraged
- ➢ matrix structures are common

For a firm to succeed, two conditions must be fulfilled:

(1) the firm's strategy must be consistent with the environment in which the firm operates
(2) the firm's organizational architecture must be consistent with its strategy

Comments regarding the sources of organizational change and the strategies for implementing organizational change: Sources of inertia (= no change):

- The existing distribution of power and influence within an organization
- The existing culture, as expressed in norms and value systems
- Senior managers 'preconceptions about the appropriate business model → when a model has worked well in the past, managers might have trouble accepting it is no longer appropriate
- Institutional constraints

Implementing change:

- Unfreeze the organization through shock therapy
- Move the organization to a new state through proactive change in the architecture
- Refreeze the organization in its new state

15. ENTRY STRATEGIES AND STRATEGIC ALLIANCES

15. A Implementing Strategy: entering foreign markets

15.1. Introduction

Firms expanding internationally must decide:

- Which markets to enter
- When to enter them and on what scale
- Which entry mode to use

15.2. Basic Entry decisions

Which Foreign markets?

Politically stable developed and developing nations that have free market systems and where there is not a dramatic upsurge of either inflation rates or private-sector debt.

Timing of Entry

First-mover advantages

- ➢ the ability to pre-empt rivals and capture demand by establishing a strong brand name
- ➢ the ability to build sales volume and ride down the experience curve ahead of rivals
- ➢ the ability to create switching costs that tie customers into their products or services

First-mover disadvantages

Pioneering costs: these costs arise when the business system in a foreign country (liability of foreignness) is so different from that in a firm's home country that the enterprise has to devote considerable effort, time and expense to learning the rules of the game, in many cases there are sunk costs:

- ➢ costs of business failure if the firm makes major mistakes
- ➢ costs of promoting and establishing a product offering, including the costs of educating customers;
- ➢ regulation changes that invalid prior assumptions about the best business model

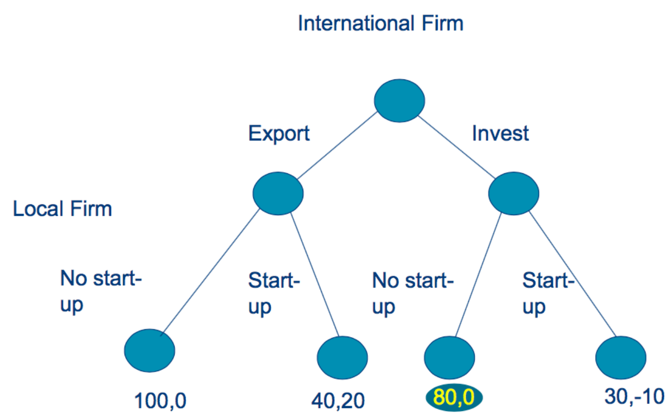
Nash Equilibrium : The best response given the response of the other

Local firm

International firm	No start-up	Start-up
Export	100,0	40,20
Invest	80,0	30,-10

Ex. First mover advantage:

We take the international firm moving first and then the local firm react to it.



Scale of entry and strategic commitments

- Entering a foreign market on a significant scale is a major strategic commitment that changes the competitive playing field
  → decision has a long term impact and is difficult to reverse, and is likely to provoke reactions from its competitors
- Small-scale entry has the advantage of allowing a firm to learn about a foreign market while simultaneously limiting the firm's exposure to that market
- After choosing which market to enter and the timing of entry, firms need to decide on the scale of market entry
- The larger the market you enter, the larger you will commit

15.3. Entry modes

- ➢ Managers need to consider the advantages and disadvantages of each entry mode in relation to the chosen strategy and business model
- ➢ First choosing for go-it alone (exporting, WOS) or partnership (alliance, JV)

Exporting

attractive	unattractive
- avoids the often substantial costs of establishing manufacturing operations in the host country - may help a firm achieve experience curve and location economies.	- may not be appropriate if lower-cost locations for manufacturing can be found abroad - may be uneconomical due to high transport costs and tariff barriers - may lead a firm to delegate its marketing, sales and service to a local agent, but these often carry the products of competing firms and so have divided loyalties

Turnkey Projects
The contractor agrees to handle every detail of the project for a foreign client, including the training of operating personnel. At completion of the contract, the foreign client is handed the "key" to a plant that is ready for full operations. turnkey projects are most common in the chemical, pharmaceutical, petroleum-refining, and metal-refining industries, all of which use complex, expensive production technologies.

advantages	disadvantages
- are useful where FDI is limited by host-government regulations, for example: the governments of many oil-rich countries have set out to build their own petroleum-refining industries, so they restrict FDI in their oil-refining sectors, but because many of these countries lack technology, they gain it by entering into turnkey projects with foreign firms that have the technology - can be less risky than conventional FDI	- are short-term projects: a firm that enters into a turnkey deal will have no long-term interest - may inadvertently create an efficient competitor - may cause a firm selling his competitive advantage to potential or actual competitors

Licensing

➢ A licensing agreement is an arrangement whereby a licensor grants the rights to intangible property to another entity (the licensee) for a specified time period, and in return, the licensor receives a royalty fee from the licensee

➢ Intangible property includes patents, inventions, formulas, processes, designs, copyrights, and trademarks

Advantages	Disadvantages
- firm does not have to bear development costs and risks associated with opening a foreign market - firm avoids barriers to investment - firms with intangible property that might have business applications can capitalize on market opportunities without developing those applications itself - is attractive for firms lacking the capital to develop operations overseas	- does not give the firm the tight control over manufacturing, marketing, and strategy required for realizing experience curve and location economies - limits firm's ability to coordinate strategic moves across countries by using profits earned in one country to support competitive attacks in another - proprietary (or intangible) assets could be lost = losing competitive advantage Two ways of reducing this risk.

The 2 ways of reducing the risk of losing the competitive advantage:

(1) entering in a cross-licensing agreement (= a firm might license some valuable intangible property to a foreign partner, but, in addition to a royalty payment, the firm might also request the foreign partner to license some of its valuable know-how to the firm)

(2) establishing a joint venture in which both companies have an important stake

Franchising

It's a specialized form of licensing in which the franchiser not only sells intangible property to the franchisee but also insists that the franchisee agree to abide by strict rules as to how it does business.

Advantages	Disadvantages
- Allows a firm to build a global presence quickly and at a relatively low cost and risk.	- may inhibit the firm's ability to take profits out of one country to support competitive attacks in another; - can make poor quality difficult to detect.

Joint Venture or merging

A Joint Venture entails establishing a firm that is jointly owned by two or more otherwise independent firms.

Advantages	Disadvantages
- provides the marketing expertise and the local knowledge necessary for competing in the country - lowers the costs and risks by sharing these with the local partner - Can be the only feasible entry mode due to political considerations	- may cause a firm giving away its competitive advantage → two options to minimize that risk: (1) hold majority ownership in the venture and (2) wall off from a partner technology that is central to the core competence of the firm, while sharing other technology - does not give a firm tight control over subsidiaries that it might need to realize experience curve, location economies or engaging in coordinated global attacks against its rivals - can lead to conflicts and battles for control between the investing firms if their goals and objectives change or if they take different views as to what the strategy should be.

Wholly owned subsidiaries
In a wholly owned subsidiary, the firm owns 100 percent of the stock
Firms can establish a wholly owned subsidiary in a foreign market:

- ➢ Setting up a new operation in the host country
- ➢ Acquiring an established firm in the host country

Attractive	Unattractive
- reduce the risk of losing control over core competencies - give a firm a tight control over operations in different countries that is necessary for engaging in global strategic coordination - may be required in order to realize location and experience curve economies	- the firm bears the full cost and risk of setting up overseas operations

15.4. Selecting an entry mode

Trade-off

Entry Mode	Advantages	Disadvantages
Exporting	Ability to realize location and experience curve economies	High transport costs Trade barriers Problems with local marketing agents
Turnkey contracts	Ability to earn returns from process technology skills in countries where FDI is restricted	Creating efficient competitors Lack of long-term market presence
Licensing	Low development costs and risks	Lack of control over technology Inability to realize location and experience curve economies Inability to engage in global strategic coordination
Franchising	Low development costs and risks	Lack of control over quality Inability to engage in global strategic coordination
Joint ventures	Access to local partner's knowledge Sharing development costs and risks Politically acceptable	Lack of control over technology Inability to engage in global strategic coordination Inability to realize location and experience economies
Wholly owned subsidiaries	Protection of technology Ability to engage in global strategic coordination Ability to realize location and experience economies	High costs and risks

Core competencies and entry mode

The optimal entry mode for the firms depends to some degree on the nature of their core competencies. A distinction can be drawn between firms whose core competency is technological know-how and those whose core is management know-how.

Technological know-how

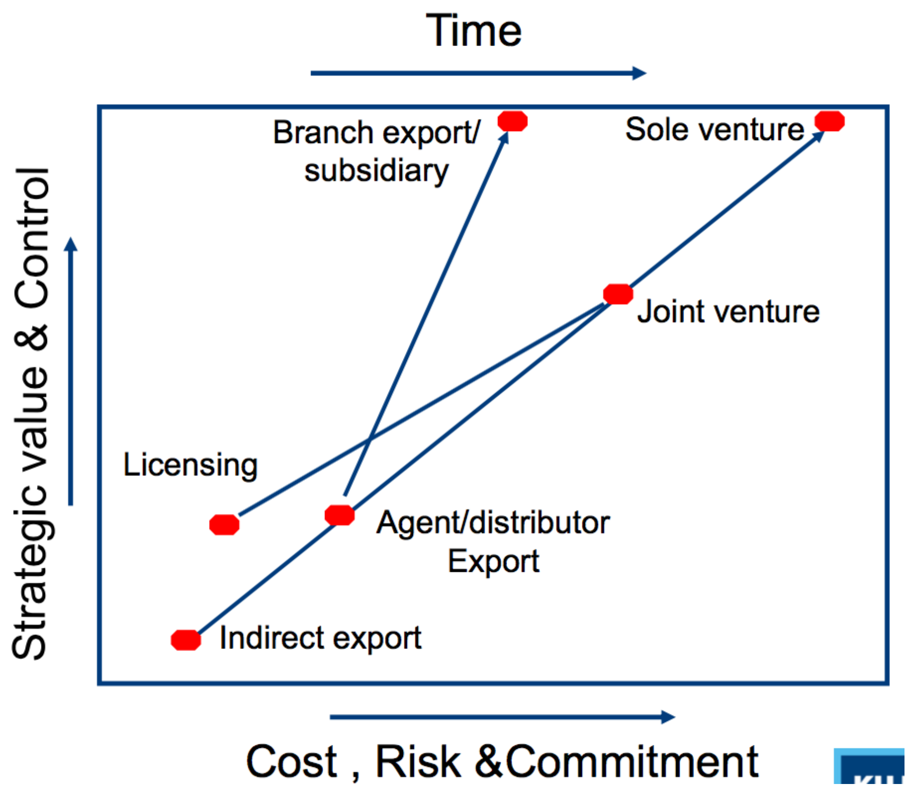
Wholly owned subsidiary or licensing when a firm wants to license its technology as rapidly as possible to foreign firms to gain global acceptance before the imitation occurs: by licensing the firm may deter them from developing their own technology and establish its technology as the dominant design

Management know-how

Combination of franchising and (wholly owned or joint venture) master subsidiaries to control the franchises within particular countries or regions

Selecting an entry mode

- all entry modes have both advantages and disadvantages
- the optimal choice of entry mode should be based on the chosen competitive strategy and a careful consideration of the risk-return trade-off



Three groups of variables are believed to influence the entry mode decision:

<u>Global strategic variables</u>

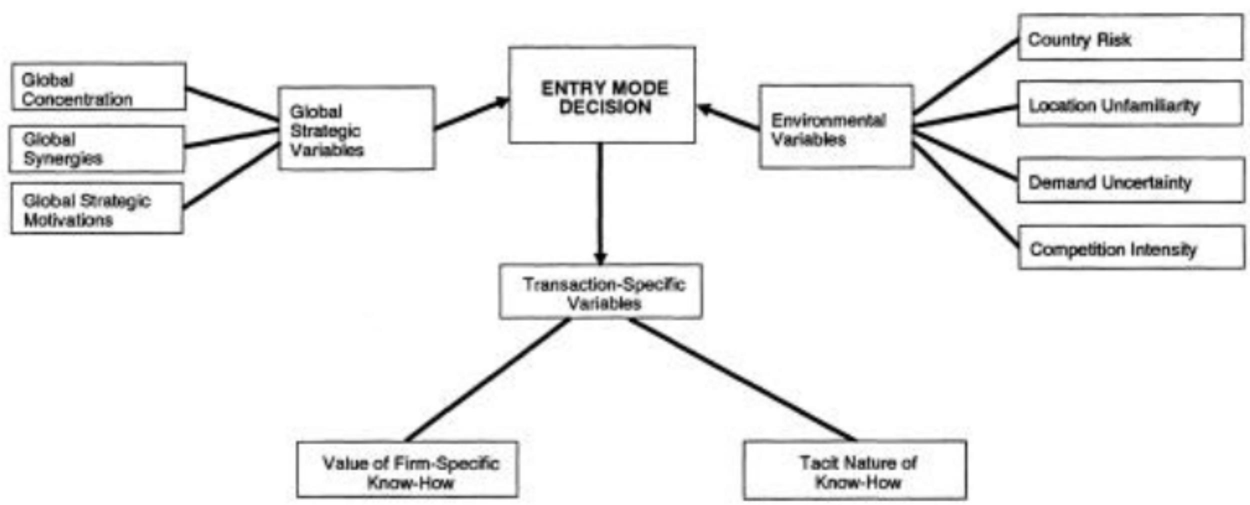
- ➢ global concentration → when the global industry is highly concentrated, MNEs will favor high control entry modes
- ➢ global synergies → when the extent of potential global synergies is great, MNEs will demand a high level of control
- ➢ global strategic motivations → MNEs exercising global strategic motivations will favor high control entry modes

<u>Environmental variables</u>

- ➢ country risk → when country risk is high, MNEs will favor entry modes that involve relatively low resource commitments
- ➢ location unfamiliarity → when the perceived distance between the home and host country is great, MNEs will favor entry modes that involve relatively low resource commitments
- ➢ demand uncertainty → when demand uncertainty is high, MNEs will favor entry modes that involve low resource commitments
- ➢ competition intensity → when the intensity of competition is high, MNEs will favor entry modes that involve low resource commitments.

Transaction-specific variables

- ➢ value of firm-specific know-how → the greater the rent stream generated by an MNEs proprietary know-how, the greater the probability that the MNE will favor an entry mode with high control
- ➢ tacit nature of know-how → the greater the tacit nature of know-how, the more an MNE will favor high control entry modes
- ➢ product factors:
    - ○ differentiation
    - ○ pre-and post purchase services
    - ○ services
    - ○ local marketing adaptation



The more abundant the resources + the more prepared to commit => the more entry mode options

The process of entry

Stage Theory

A slow and progressive process of internationalization

o stage 1: Indirect/ad hoc exporting
o stage 2: Active exporting and/or licensing
o stage 3: Active exporting, licensing and equity investment in foreign manufacture
o stage 4: Full-scale multinational marketing and production

Uppsala stage theory of internationalization

- ➢ Successive stages represent higher degrees of international involvement and commitment
- ➢ They explain in terms of learning: the more you learn, the more you are successful, the more you will be committed to that market
- ➢ Enter new markets with successively greater psychic distance
- ➢ Dynamic sequential model: the outcome of one stage constitutes the input to the next

Innovation related

- ➢ The internationalization decision is considered as an innovation for the firm
  - ○ learning sequence
  - ○ adoption process
- ➢ incentives to move to the next stage is affected by pull and push forces
  - ○ push: an external change which initiates the export decision
  - ○ pull: an internal change which explains the shift from one step to another

	Push	**Pull**
Stage 1	The completely uninterested firm	Export awareness: opportunity recognition
Stage 2	The partially interested firm	Export intention: motivation, attitude, beliefs and expectancy
Stage 3	The exploring firm	Export trial: personal experience from limited exporting
Stage 4	The experimental firm	Export acceptance: adoption/ rejection
Stage 6	The experienced large exporter	

Strategic Interaction

- ➢ Oligopolistic rivalry
- ➢ Strategic trade policy
- ➢ Dynamic models
    - *Sprinkler:* sprinkler: water spray system that goes in different countries at the same time. where do you find that? spinoffs in Heverlee (high tech), they have to go to many markets directly from the start
    - *Waterfall:* slow-moving cascade from successful domestic launch, selected advanced countries, more traditional industry. The following market conditions favour waterfall strategies:

→ long product life cycle
→ Less favorable conditions in foreign market
o small foreign market
o slow growth in foreign market
o low innovativeness in foreign market
o high fixed cost of entry into foreign market
→ weak competitiveness of foreign market
o weak competitors
o cooperative competitors
o monopoly position in foreign market

15.5. Greenfield venture or Acquisition?

Pros and cons of acquisitions

Pros	Cons
- acquisitions are quick to execute - in many cases firms make acquisitions to preempt their competitors - managers may believe acquisitions to be less risky than greenfield ventures: the revenue and profit stream that a greenfield venture might generate is uncertain because it does not yet exist	Acquisitions often produce disappointing results… Study made by KPMG: 30% of acquisitions created value for the acquiring company, 31% destroyed value, the remainder had little impact

Why do acquisitions fail?

- ➢ the management of the acquiring firm is often too optimistic about the value that can be created via an acquisition → hubris hypothesis = postulates that top managers typically overestimate their ability to create value from an acquisition, primarily because rising to the top of a corporation has given them an exaggerated sense of their own capabilities
- ➢ many acquisitions fail because there is a clash between the cultures of the acquiring and acquired firms
- ➢ many acquisitions fail because attempts to realize gains by integrating the operations of the acquired
- ➢ acquiring entities often run into roadblocks and take much longer than forecast
- ➢ many acquisitions fail due to inadequate pre-acquisition screening.

Reducing risks of failure

- ➢ screen the foreign enterprise, this can help make sure the firm (1) does not pay too much, (2) does not uncover any nasty surprises after acquisition, (3) acquires a firm whose organisation culture is not antagonistic to that of the acquiring enterprise
- ➢ move rapidly to put an integration plan in place and to act on that plan.

Pros and cons of greenfield ventures

Pros	Cons
- gives the firm a greater ability to build the kind of subsidiary company that it wants	- slower to establish - costly and risky

Greenfield investment or acquisition?

The choice between a greenfield investment and an acquisition depends on the situation confronting the firm

o Acquisition may be better when the market already has well-established competitors or when global competitors are interested in building a market presence

o Greenfield venture may be better when the firm needs to transfer organizationally embedded competencies, skills, routines, and culture

15. B. Strategic Alliances & Cross-Border M&A

15.6. International strategic alliances

Benefits

- ➢ Economies of scale
- ➢ Technology development
- ➢ Risk reduction
- ➢ Shaping competition
- ➢ New market opportunities
- ➢ Neo-protectionism

Costs & Risks

Costs	Risks
- mutual dependency - uncertainty re-outcomes - division of authority and decision-making power - top-management time & effort	- imbalance in benefits - imbalance in commitment & motivation - difficulties in achieving an agreement - communication problems - conflict between partners - retaliation from government & competition

15.7. Strategic alliances

Strategic alliances = cooperative agreements between potential or actual competitors, for example: joint ventures

Advantages & disadvantages of strategic alliances

Advantages	Disadvantages
- facilitate entry into a foreign market - allow firms to share the fixed costs and risks of developing new products or processes - bring together complementary skills and assets that neither company could easily develop on its own - establish technological standards for the	- give competitors a low-cost route to new technology and markets

industry that will benefit the firm	

Different sorts of strategic alliances

<u>Coalition</u>

Partners group together to gain global access or to establish a common standard.
Example: Airlines, or what's happening in the electronic industry

<u>Cospecialization</u>

Partners join together and specialize in what they're doing best and join their respective unique capabilities that complement each other:

- To create a business
- to develop new products or technology
- or to reinforce their competitiveness through
- Example: Renault-Nissan

<u>Learning</u>

Partners join together to accommodate mutual learning from each other and to co- develop new knowledge.

Example: Nummi, especially in R&D

Making alliances work

Partner selection

- a good partner has three characteristics:
  - helps the firm achieve its strategic goals, he must have capabilities that the firm lacks and that it values
  - shares the firm's vision for the purpose of the alliance: expectations fit between the partners
  - is unlikely to try to opportunistically exploit the alliance for its own ends: that it, to expropriate the firm's technological know-how while giving away little return
- to increase the probability of selecting a good partner, the firm should:
  - collect as much pertinent, publicly available information
  - gather data from informed third parties
  - get to know the potential partner as well as possible before committing to an alliance
- Criteria for choosing strategic alliance partners
  - Partners should have complementary or balanced resources in order that no one partner dominates
  - Partners must possess the desired source of competitive advantage (scale, technology, market access or other contribution) that the coalition seeks
  - Partners' international strategy should be compatible
  - There should be a low risk of partners dissolving the coalition and competing independently

Alliance structure

- the alliance should be structured so that the firm's risks of giving too much away are reduced:
  - alliances can be designed to make it difficult to transfer technology not meant to be transferred
  - contractual safeguards can be written into an alliance agreement to guard against the risk of opportunism (= theft) by a partner
  - both parties can agree in advance to swap skills and technologies, thereby ensuring a chance for equitable gain
  - to minimize the risk of opportunism by an alliance partner

Managing the alliance

- allow cultural differences
- build interpersonal relationships.

  Note: a major determinant of how much knowledge a company gains from an alliance is its ability to learn from its partner.

A strategic alliance planning model

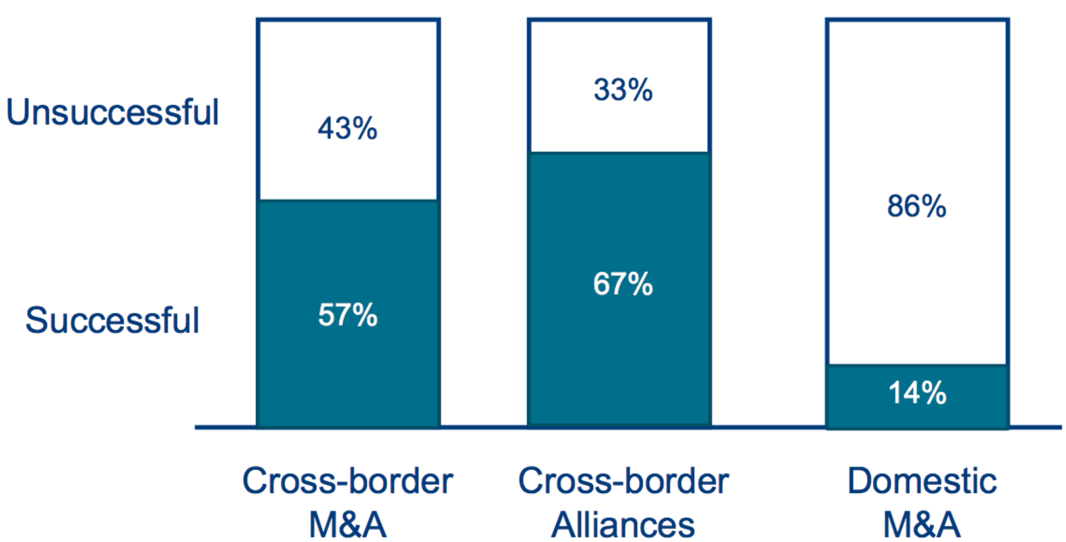
- Corporate self-evaluation
- Strategic objective
- The role of alliances
- Alliance criteria
- Partner selection
- Alliance structure and organisation
- Negotiate and conclude the agreement
- Alliance management
- Alliance audit

Probability of opportunism is reduced by:

- Walling off Critical technology
- Establishing Contractual Safeguards
- Swap Valuable Skills and Technologies
- Mutual learning
- Credible Commitments

15.8. Mergers motives & objectives

Success M&A vs. Alliances



Mergers motives & objectives

Shareholder wealth Perspective	Managerial Perspective
- neoclassical view of the firm - maximizing the wealth of the shareholder - discounted cash-flow from the decision should have a positive NPV	- empire-building motive: to pursue growth since remuneration, status and power are a function of firm size - self-fulfillment motive: to deploy currently underused managerial talent - job security motive: to avoid being taken over - to diversify risk

Special risks of M&A

- ➢ In most cases high transaction costs, especially in case of public companies
- ➢ Under-estimation of associated costs, over-estimation of benefits/synergies from the merger
- ➢ Unrecognized risks, liabilities or responsibilities during due diligence
- ➢ Liquidity risks, especially in case of leveraged buy-outs
- ➢ Risk of unintended employee turnover
- ➢ Negative reaction on merger by customers
- ➢ Problematic integration of different corporate cultures
- ➢ Differences in national cultures and regulatory systems
- ➢ Badly managed post-merger integration process

The business logic of an M&A process

Value of the future earnings of the acquired company + Value of the synergies
- Merger cost (consultants, new IT systems, corporate design...)
= Value of the acquisition

Due diligence review

It is the process by which research is carried out on a business entity to assist in the decision-making on a transaction both prior and after the transaction has been completed.

Types of integration approach

The approach a company should take towards integration should be understood by considering two criteria:

- the need for strategic interdependence
- the need for organizational autonomy

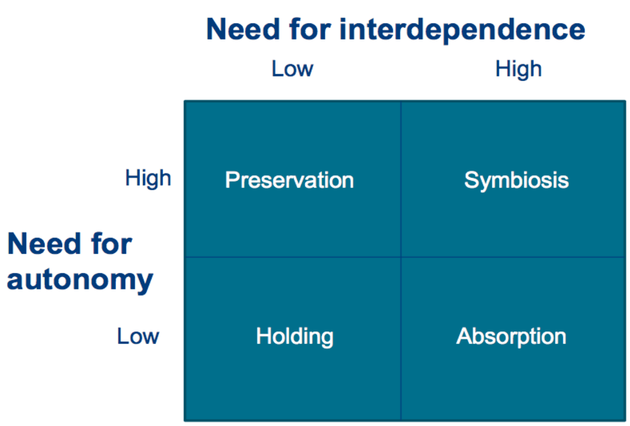
Strategic interdependence needs
o Synergy arguments
o Transfer capabilities (resource sharing, functional skill transfer, and general management skills)
o Functional skills transfer requires transfer of personnel
o Difficulty in transferring resources horizontally (violates integrity of units)

Organizational autonomy

Autonomy may be necessary to allow boundary protection such that the unit can use its capabilities
→ Particularly important when organizational culture contains the key capabilities necessary to create value

Depending on the score on these two factors, the preferred acquisition integration approaches are:

Absorption= management needs courage to ensure that its vision for the acquisition is carried out
Preservation = management focus is to keep the source of the acquired benefits intact
Symbiosis= management must ensure simultaneous boundary preservation and boundary permeability
Holding= non-intention of integrating and value is created only by financial transfers, risk-sharing or general management capability



Merger control regulation

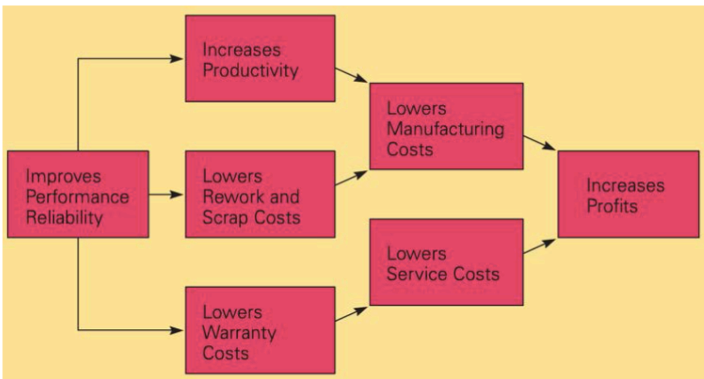
- aim: preserve and develop effective competition;
- factors taken into account:
    market position
    alternatives to suppliers and users
    barriers to entry
    supply and demand trends
    technical and economic progress to the consumer's advantage

17. GLOBAL PRODUCTION, OUTSOURCING AND LOGISTICS

17.1. Introduction

17.2. Strategy, Production and Logistics

Production and logistics functions have two important objectives:
(1) lower costs
(2) increase product quality



Link: improved quality control reduces costs by:

- increasing productivity because time is not wasted producing poor-quality
- lowering rework and scrap costs associated with defective products
- reducing the warranty costs and time associated with fixing defective products

The principal tool that most managers now use to increase the reliability of their product offering is the Six Sigma quality improvement methodology. It's a direct descendent of the **total quality management** (TQM) philosophy. It's a statistically based philosophy that aims to reduce defects, boost productivity, eliminate waste and cut costs throughout a company.
The growth of international standards has also focused greater attention on the importance of product quality. The EU requires that the quality of a firm's manufacturing processes and products be certified under a quality standard known as **ISO 9000** before the firms is allowed access to the EU marketplace.

17.3. Where to produce

Country Factors

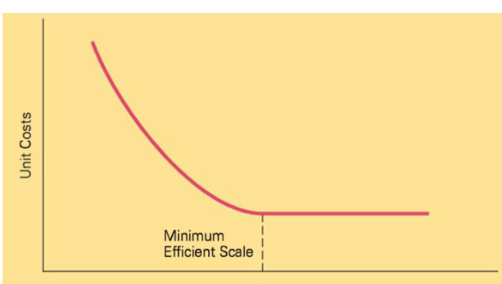
- differences in factor costs
- differences in political economy and national culture
- presence of global concentrations of activities at certain locations → externalities include the presence of an appropriately skilled labor pool and supporting industries
- formal and informal trade barriers
- transportation costs
- rules and regulations regarding FDI
- exchange rates → the low value of the yen helped strengthen Japan's position as low-cost location

Technological Factors

The type of technology a firm uses to perform specific manufacturing activities can be pivotal in location decisions. For example, because of technological constrains, in some cases it is necessary to perform certain manufacturing activities in only one location and serve the world market from there. In other cases, the technology may make it feasible to perform an activity in multiple locations. Three characteristics of manufacturing technology are of interest here: the level of fixed costs, the minimum efficient scale, and the flexibility of the technology.

<u>Fixed Costs</u> The fixed costs of setting up a production plant can be so high that a firm must serve the world market from a single location

<u>Minimum Efficient scale</u> The level of output at which most plant-level scale economies are exhausted → the larger the minimum efficient scale relative to global demand, the greater the argument for centralizing production in a single location



Flexible manufacturing

The view of production efficiency has been challenged by the rise of flexible manufacturing technologies. The term flexible manufacturing technology or lean production covers a range of manufacturing technologies designed to:

- reduce setup times
- increase the utilization of individual machines through better scheduling
- improve quality control at all stages of the manufacturing process → when flexible manufacturing technologies are available, a firm can manufacture products customized to various national markets, without absorbing a significant cost penalty

Ex.: **Flexible Machine Cells:** It's a grouping of various types of machinery, a common materials handler, and a centralized cell controller (computer). Each cell normally contains four to six machines capable of performing a variety of operations. The typical cell is dedicated to the production of a family of parts of products. The settings on machines are computer controlled, which allows each cell to switch quickly between the production of different parts or products.

Mass Customization

The term Mass Customization has been coined to describe the ability of companies to use flexible manufacturing technology, to reconcile two goals that were once thought to be incompatible – low cost and product customization.

Product Factors

Two product features affect location decisions:

1) value-to-weight ratio → products with a low value-to-weight ratio should be made in multiple locations close to major markets to reduce transportation costs;

(2) whether the product serves universal needs → if there are few national differences in consumer taste, production should be concentrated at one optimal location.

Locating Production Facilities

Two basic strategies for locating production facilities: (1) concentrate them or (2) decentralize them → the appropriate choice is determined by various factors:

	Concentrated Production Favored	Decentralized Production Favored
Country Factors		
Differences in political economy	Substantial	Few
Differences in culture	Substantial	Few
Differences in factor costs	Substantial	Few
Trade barriers	Few	Substantial
Location externalities	Important in industry	Not important in industry
Exchange rates	Stable	Volatile
Technological Factors		
Fixed costs	High	Low
Minimum efficient scale	High	Low
Flexible manufacturing technology	Available	Not available
Product Factors		
Value-to-weight ratio	High	Low
Serves universal needs	Yes	No

The Hidden costs of foreign locations
It is important to look beyond pay rates and make judgments about employee productivity before deciding whether to outsource activities to foreign locations.
Ex.: Microsoft in India: low wage, highly skilled labor, high concentration of IT companies, Indian employees of the US wanted to return home. After locating in India, there was a very high turnover rate among employees. That’s bad because it has a negative impact on productivity.

17.4. The strategic role of a foreign production site

When reviewing the location of production facilities, the international manager must consider the valuable skills that may have been accumulated at various locations and the impact of those skills on factors such as productivity and product design.

We see that the strategic role evolves over time.
- Initial role: low-cost production facilities
- Transition: for 2 reasons: (1) there's pressure from the center to improve a site's cost/structure and/or customize a product to the demands of consumers in a particular nation that leads to the development of additional capabilities at that factory (2) increasing abundance of advanced factors of production in the nation in which the factory is located
- New role: Globally dispersed centers of excellence

The development of such dispersed centers of excellence is consistent with the concept of transnational strategy. A major belief of transnational strategy is a belief in **global learning** – the idea that valuable knowledge does not reside just in a firm's domestic operations; it may also be found in its foreign subsidiaries. Foreign factories that upgrade their capabilities over-time are creating valuable knowledge that might benefit the whole corporation.

17.5. Outsourcing Production: Make-or-Buy decisions

Make-or-Buy decisions are decisions about whether they should perform a certain value creation activity themselves or outsource it to another entity.

The advantage of Make

- lower costs → the firm may be more efficient at producing than any other firms
- facilitate investments in highly specialized assets → when substantial investments in specialized assets are required to manufacture a component, the firm will prefer to make the component internally, to avoid mutual dependency
- protect proprietary product technology → the firm would not want competitors to get his technology
- enable the firm to accumulate valuable skills and capabilities → firms learn through experience
- ease the scheduling of adjacent processes

Specialized asset: Ford developed a new, high-performance, high-quality and uniquely designed fuel injection system and had to decide whether to make or buy. Manufacturing these injection systems requires investment in equipment that can only be used for this purpose. Investment in this equipment constitutes an investment in specialized assets.
Dynamic capabilities: skills that become more valuable over time through learning.

The advantages of Buy

- greater flexibility → the flexibility to switch sourcing
- drive down the cost structure → making all parts in-house increases an organization's scope and the resulting increase in organizational complexity can raise a firm's cost structure
    - the greater the number of subunits, the more problems coordinating and controlling these units
    - internal suppliers may lack an incentive to reduce costs because they have a captive customer
    - internal suppliers have the ability to manipulate transfer prices to their advantage, passing cost increases downstream rather than looking for ways to reduce costs
- offsets: help firms capture orders form international customers, Ex.: Aerospace

Trade-Offs

Clearly, make-or-buy decisions involve trade-offs. The benefits of making all or part of a product in-house seem to be greatest when highly specialized assets are involved, when in-house production is necessary for protecting proprietary technology, when the firm may build valuable capabilities over time if it continues to perform an activity in-house, or when the firm is simply more efficient than external suppliers at performing a particular activity. When these conditions are not present, the risk of strategic inflexibility and organizational problems suggest it may be better to contract out some or all production to independent suppliers. Because issues of strategic flexibility and organizational control loom even larger for international businesses than purely domestic ones, an international business should be particularly wary of vertical integration into component part manufacture. In addition, some outsourcing in the form of offsets may help a firm gain larger orders in the future.

Strategic alliances with suppliers

Strategic alliances build trust between the firm and its suppliers, these may encourage suppliers to undertake specialized investments but limit a firm's strategic flexibility.

17.6. Managing a global supply chain

The twin objectives of logistics are:
- to manage a firm's global supply chain at the lowest possible cost and in a way that best serves customer needs
- to lower the costs of value creation and help the firm establish a competitive advantage through superior customer service.

JIT systems

The basic philosophy is to economize on inventory holding costs by having materials arrive at a manufacturing plant just in time to enter the production process and not before.

Advantages

- cost savings: the major cost savings come from speeding up inventory turnover which reduces inventory holding costs, such as warehousing and storage costs
- improved product quality: parts enter the manufacturing system immediately, which allows defective inputs to be spotted right away.

Disadvantages

- no buffer stock of inventory: buffer stock helps a firm respond quickly to increases in demand and tides a firm over shortages brought about by disruption among suppliers.

The role of IT and the internet

- track component parts as they make their way across the globe toward an assembly plant and hereby enabling a firm to optimize its production scheduling according to when components are expected to arrive
- locate components parts in supply chain precisely and hereby allowing the firm to accelerate production when needed by pulling key components out of the regular supply chain and having them flown to the plant

Two consequences of EDI (Electronic Data Interchange) systems:

- suppliers, shippers and the purchasing firm can communicate with each other with no time delay, which increases the flexibility and responsiveness of the global supply system
- much of the paperwork between suppliers, shippers and the purchasing firm is eliminated.

PART VI: INTERVENANTS

First intervenant

Deloitte I: FDI (chapter)

Deloitte II: Cross-border arbitrage and outsourcing

Key concepts and definitions

Off-shoring
The moving of various operations of a company to another country for reasons such as lower labor costs or more favorable economic conditions in that other country

Outsourcing
The deliberate contracting of any task, operation, job or process that could be performed by employees within an organization to a third party
Offshoring
It first started after American Civil War (1861-1865)

Key levers

- cost arbitrage
- administrative arbitrage
- cultural arbitrage
- geographic arbitrage

The options

	Wage savings	**Nature of the business**	**Search area**
On-shoring	10-20%	Complex, highly customized, non-repetitive, high value regulatory imposed	In your own country
Near-shoring	20-60%	Highly interactive, language sensitive, time zone sensitive, high/medium value add	Outside home country, but not so far
Far-shoring	60-90%	Mainly transactional, moderate/minor English language requirements	Ove a considerable distance/ to another country, continent

Where would you locate what?

Where would you locate what?		Onshore	Nearshore	Farshore
Production		(x)	x	x
R&D		x	x	(x)
Marketing & Sales		x	x	(x)
Customer Service	Hands ?	x		x
Internal IT support services			x	x
Internal Finance support services		x		
Logistics		x	x	x

Locating production facilities

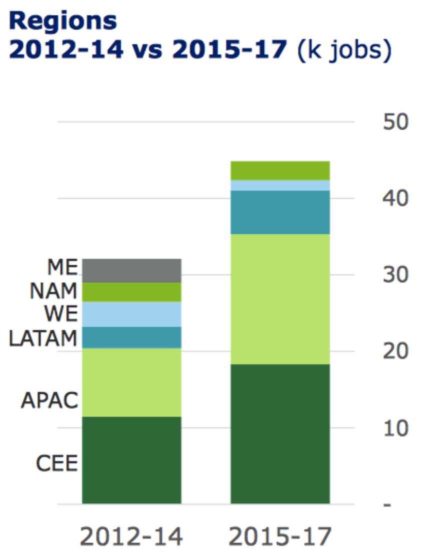
There are two basic strategies for locating manufacturing facilities:

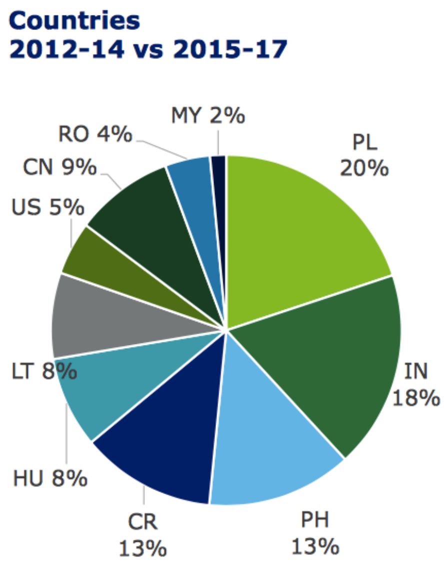
- Concentrating them in the optimal location and serving the world market from there
- Decentralizing them in various regional or national locations that are close to major markets

If the below conditions apply, which location strategy would you select for manufacturing operations?

Conditions	Decentralized	Centralized
Differences in political economy are high		
Differences in culture between markets served are high		
Differences in factor costs are high		
Trade barriers are high		
Exchange rates are volatile		
Level of fixed production costs is high		
The minimum production volume for efficient scale is low		
The flexibility of manufacturing technology is high		
The products' value-to-weight ratio is high		
Extent to which product services universal needs		

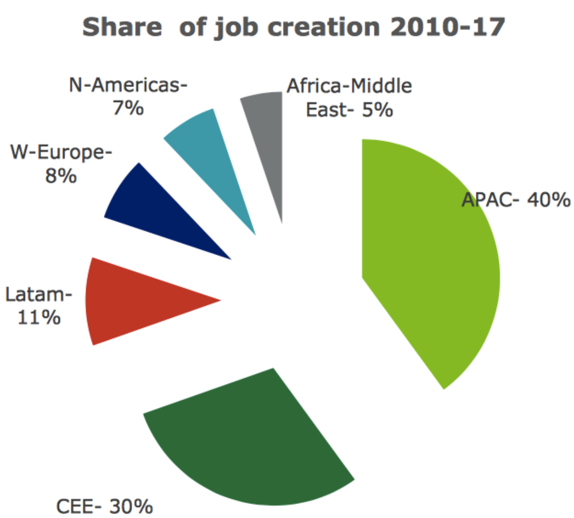
Where's hot and where's not?

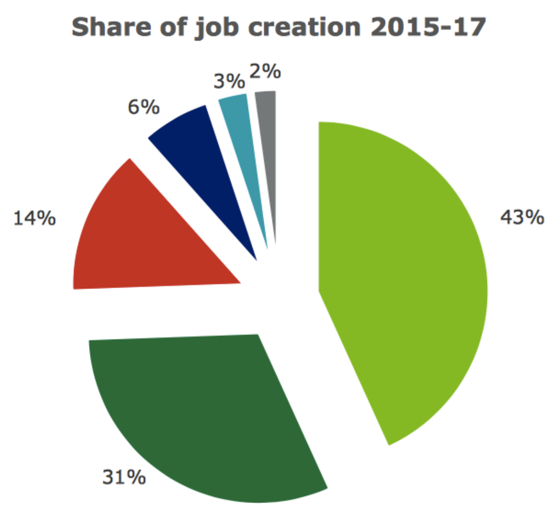




Cities 2017-18

- Warsaw
- Vilnius
- Krakow
- Kaunas
- Lodz
- Bratislava
- Miskolc
- Dublin
- Manila
- Mumbai
- Rzeszow
- Budapest
- San Jose
- Gdansk
- Sofiya
- Wroclaw





Outsourcing

The deliberate contracting of any task, operation, job or process that could be performed by employees within an organization, to a third party.

→Make-or-buy decisions are important factors in many firms' manufacturing strategies
→Today, service firms also face make-or-buy decisions as they choose which activities to outsource and which to keep in-house → Make-or-buy decisions involving international markets are more complex than those involving domestic markets

Challenges to parties involved

Outsourcers

- **Why** – Speed, flexibility, lack of critical mass, lower cost basis, …
- **What** – Strategic importance, technological specialization,
- **When** – timing versus PLC
- **Who** – Supplier evaluation criteria
- **Whether** – Company readiness

Outsourcing service providers

- Mitigation of client **cost/margin reductions**
- **Standardization**
- Creation of embedded **flexibility**
- Development of adequate **strategy**
- **Economic arbitrage**
- **Administrative arbitrage**
- **Cultural arbitrage**
- **Geographical arbitrage**

Make vs. Buy

	Make	Buy
Benefits	• Lower costs • Highly specialized assets investments • Protection proprietary technology • Scheduling of adjacent processes	• Greater flexibility • Lowering of cost structures • Orders from suppliers' countries

Outsourcing and CSR

Increased consumer awareness and Corporate Social Responsibility push outsources to become more vigilant about their provider's workers' rights compliance

Outsourcing vs. Offshoring

	Offshoring	Outsourcing
Core drivers	• Cost reduction • Resources • Markets	• Cost reduction • ROI • Quality improvements

Key aspects	• One company
	• Focus on cost reduction / resource availability
	• Key KPIs:
	  • Productivity
	• Mid/long terms investments
		• Outsourcer and provider(s)
		• Focus on core competencies
		• Key KPIs:
		  • Productivity
		  • SLAs
		  • Quality
		• Short/mid term contracts

PART VII: ARTICLES