MSc INTERNATIONAL BUSINESS, ESCI-UPF & BSM
INTERNATIONAL RISK ANALYSIS
Academic Year 2013-2014
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NOTE 1 - FIRMS IN INTERNATIONAL BUSINESS AND TRADE

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1 International trade

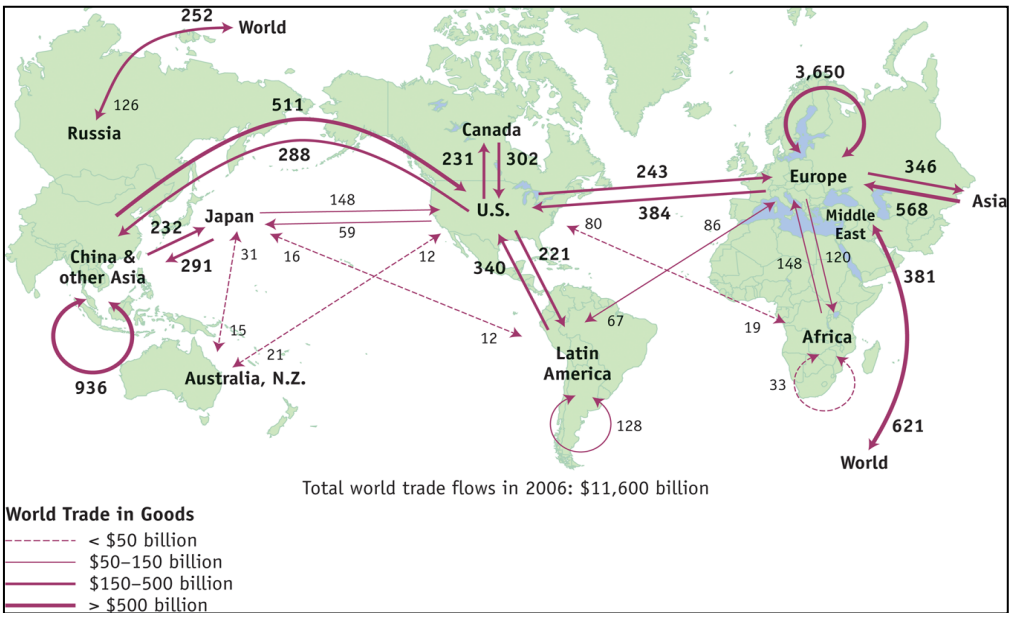
1.1 Map of world trade

Although it is easy to recognize Brazilian coffee beans shipped to the U. S. coffee market as an export, trade also occurs when services are performed on site. For example, one of the larger categories of service exports is travel and tourism. When a Canadian visits the Sydney Opera House, the money spent is a service export of Australia. Likewise, a Japanese tourist eating at one of the many restaurants along Waikiki contributes to the U. S. service exports.

The difference between a country's total value of exports and imports with the rest of the world is its trade balance, where it has a trade surplus if export exceeds import. By contrast, when export is lower than import, a country runs a trade deficit. From 2006 to 2009, the U. S. trade deficit with China was worth over $200 billion every year.

Figure 1 shows the world exports and imports flow of goods in 2006, where thicker lines indicate larger amounts of trade. In addition, trade flows within regions are noted by circles.

Figure 1. World exports and imports of goods, 2006 ($ billions)



Source. Feenstra and Taylor, 2009.

European and U.S. Trade

More than a quarter of world trade occurred within Europe in 2006 with $3. 7 trillion. Reasons for the large trade flows include proximity (many countries are located in the region) and the lack of (or low) import tariffs, which are taxes on international trade. With the continuing expansion of the European Union, trade within this region is expected to grow. If we include the internal trade among the European countries with the large trade flows between Europe and

the United States, we find that about 37% of the $11. 6 trillion in world-trade flows in 2006 can be accounted for by these industrially advanced trading partners.

Trade in the Americas

Total trade in goods between North, Central, and South America and the Caribbean accounts for 11% of the world-trade flows, with a large portion of the trade flows occurring between the North American Free Trade Area (NAFTA) partners, namely the United States, Mexico, and Canada.

Trade with Asia

The amount of trade that occurs between Europe and Asia and the United States and Asia is also considerable. In 2006, exports from Asia to the United States were $659 billion. China was the largest exporter to the U.S. in 2006 (selling $288 billion) followed by Japan ($148 billion) and South Korea ($46 billion). In addition, if we include trade in services we will find more exports from Asia to the United States (and Europe), given the increased use of outsourcing by American and European firms in countries such as India.

Other Regions

The oil exported by countries in the Middle East, along with Russia's export of oil and natural gas, contribute 9% to world trade. By contrast, the African countries add only 3% to world trade.

Table 1. Ratio of trade to a country's gross domestic product (GDP), 2008.

Country	Trade/GDP (%)	GDP ($ billion)
Hong Kong, China	207	215
Malaysia	116	222
Hungary	81	155
Thailand	75	272
Switzerland	65	492
Austria	56	414
Denmark	54	341
Sweden	50	479
Germany	44	3,649
Norway	38	452
South Africa	37	276
Canada	33	1,501
China	33	4,327
United Kingdom	30	2,674
Indonesia	29	511
Italy	29	2,303
Mexico	29	1,088
Spain	29	1,604
Greece	28	356
France	28	2,857
Turkey	26	735
Russian Federation	26	1,679
Venezuela	25	314
India	25	1,159
Argentina	23	328
Pakistan	18	165
Japan	16	4,911
United States	15	14,093
Brazil	14	1,575

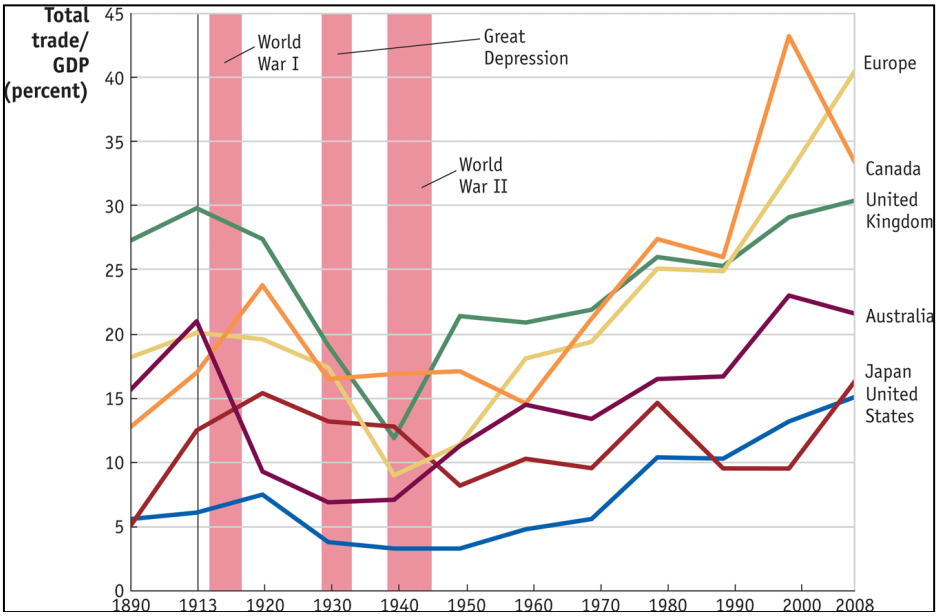
Source. Feenstra and Taylor, 2009.

Relative to its economic size, trade is a smaller portion of GDP for the United States (15% in 2008) than for countries such as Hong Kong (207% in 2008). The high trade-to-GDP ratio for Hong Kong is because of the citystate's role as the middleman for firms in developing countries that outsource the assembly part of the production process to low-wage countries such as China. In contrast, large countries such as the United States tend to have more trade within border (i. e., among states) than across borders. Countries in the middle of the list are those that are large and located close to other major trading partners. Examples include European countries such as Germany, the United Kingdom, and France.

Another reason why the trade/GDP ratio differs across countries is because there are factors that influence the amount of goods and services that are traded internationally. These include trade barriers such as import tariffs, transportation costs, customs, laws, events such as wars, and so forth. Figure 2 shows the trade in goods and services relative to GDP for selected countries over time. The countries are Australia, Canada, Japan, the United Kingdom, the United States, and Europe, which is an average of Denmark, France, Germany, Italy, Norway, and Sweden.

1.2 Trade in historical perspective

Figure 2. Total trade in goods and services divided by GDP, 1890 - 2008



Source. Feenstra and Taylor, 2009.

First "Golden Age" of Trade

The "golden age" of international trade refers to the years 1890 to 1913, during which there were significant improvements in transportation because of steamship and railroad expansion.

Because of World War I and its aftermath, the trade to GDP ratio decreased between 1913 and 1920 for countries in Europe, as well as Australia. It continued to decline with the Great Depression in 1929 and World War II in 1939. To protect its farmers during this period, the United States passed the Smoot-Hawley Tariff Act in 1930, which raised tariffs on many goods imported from abroad. In retaliation, European countries, such as France, Italy, and Britain, as well as Canada, imposed their own tariffs and import quotas against American products. These trade barriers were eventually imposed against other countries in addition to the United States, leading to a dramatic decline in world trade. Concern about the high costs due to the loss in world trade is one of the reasons for the formation of international agreements such as the

General Agreement on Tariffs and Trade, which is now the World Trade Organization.

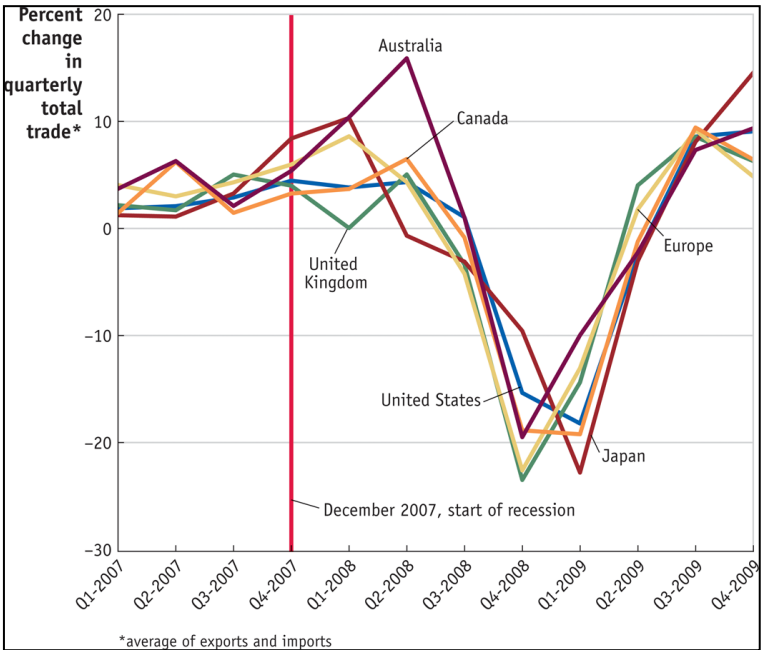
Second "Golden Age" of Trade

With the end of World War II in 1945, countries such as the United Kingdom, Europe, and Australia regained their trade. In general, world trade improved after 1950 for some countries and by 1960 for others. Adding to the trade growth was the reduction in transportation costs that occurred with the invention of the shipping container in 1956. The world as a whole is enjoying a second "golden age" of international trade as the ratio of trade to GDP continues to increase. In 2005, ratio of trade relative to GDP was nearly 30%. But, at the end of the decade, in 2008 many countries trade to GDP ratios began to fall. This was a result of the financial crisis.

The Financial Crisis

The fall of 2008 saw the financial crisis, which started in the U. S. and spread quickly throughout the global economy. The crisis began with mortgage defaults and then spread to the whole financial system. Even though the cause of the crisis was unrelated to international trade, the impact on trade was substantial because it sent many countries into recession, leading to a fall in both exports and imports. This dramatic decrease in trade can be seen in Figure 3, which graphs the quarterly change in average trade flows. Figure 1-5 demonstrates a large and synchronized drop in trade of nearly 20% for all countries shown.

Figure 3. Quarterly change in trade flows.



Source. Feenstra and Taylor, 2009.

Despite disagreements about how to implement trade and investment agreements, countries continue to enter into bilateral and multilateral contracts to liberalize trade and investment. The most inclusive of such agreements is the WTO, established in 1995. Today, the WTO is the umbrella organization that governs the international trading system for most countries of the world. When member countries have a dispute they turn to the WTO's dispute-settlement mechanism to help resolve it. For example, the United States and the European Union have brought cases against each other in such matters as banana imports, beef hormones, steel and foreign sales corporations. The WTO can enforce its decisions. Countries that refuse to comply can find themselves suffering severe consequences in the form of trade retaliation.

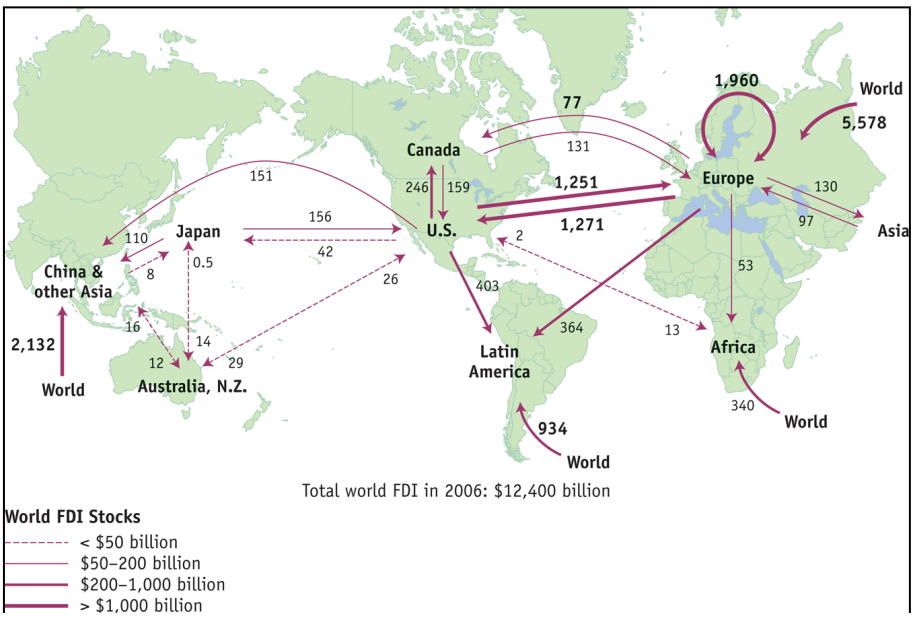
Appendix WTO: General Information about WTO and WTO Accession (Princeton Encyclopedia of the World Economy, pages 1185 - 1196.

2 Foreign Direct Investment

2.1 Map of Foreign Direct Investment

Similar to trade in merchandise goods, most of the stock of foreign direct investment (FDI) is within the OECD countries (i. e., $11. 4 of the $12. 4 trillion, or 93%). These flows are traced out in Figure 4, in which the width of the arrow corresponds to the amount of the FDI going into or out of the OECD countries. In addition, the inflow of FDI to Africa, Asia, and Latin America from unknown sources is denoted by arrows from the world.

Figure 4. Stock of Foreign Direct Investment, 2006 ($billions)



Source. Feenstra and Taylor, 2009.

European and U.S. FDI

Nearly one-half, or $5. 6 trillion, of the total world stock of FDI was in Europe in 2006. Examples of European direct investments in the United States include the merger of Daimler-Benz and Chrysler corporations in 1998, which became DaimlerChrysler. Chrysler was then owned by an American financial company, Cerberus Capital Management, from 2007 until 2009, when it was once again a source of European direct investment when it was sold to Italian automaker Fiat. An example of an American direct investment in Europe is the acquisition of Jaguar and Volvo by Ford Motor Company in 1989 and 1999, respectively.

FDI in the Americas

There are also substantial stocks of FDI in the United States, Canada, and Latin America. Although high, they are substantially lower than the amount between Europe and the United States. Direct investment from the United States in Canada totaled $246 billion in 2006, while from Canada to the United States FDI was $159 billion. In addition, most of the $403 billion in FDI from the United States in Latin America is in Mexico. Another large recipient of FDI in Latin America is Brazil. FDI to Mexico and Brazil are examples of vertical FDI, in which firms in the United States, Japan, and Europe relocate the production process to the low-wage countries to reduce costs.

FDI with Asia

The stock of direct investment to Asia has been increasing, with the bulk of it going to China. The United States and Europe have a direct investment stock of $151 and $130 billion, respectively, in the rest of Asia (which excludes Japan). These stocks are an example of vertical FDI.

2.2 Types of Foreign Direct Investment

Horizontal FDI or market-seeking

When a firm in one industrialized country invests in another industrialized country by purchasing a foreign company and staying at the same value chain stage, this form of investment is considered horizontal FDI.

Examples include the purchase of the Rockefeller Center in New York in 1989 and Pebble Beach golf course in California in 1990 by Japanese investors. One of the reasons why companies choose to acquire firms located in industrialized countries is to avoid trade barriers such as tariffs and import quotas. To circumvent the limits on the number of Japanese cars allowed to enter the United States, Japanese car manufacturers built plants in the United States. A second reason for horizontal FDI is that owning a foreign subsidiary allows companies to gain better access to the local economy. A third reason is that companies may draw on technical expertise available in the area by locating near other established firms.

Vertical FDI or resource seeking

Vertical FDI occurs when a firm in an industrial country builds or purchases a plant or a company in a developing country and moves upstream or downstream in the value chain. One of the advantages of establishing a plant in a developing country is to lower production costs by hiring low-wage workers. An example of vertical FDI constitutes the outsourcing activities of several U.S. and European clothes and apparel companies to Asia.

In addition to receiving direct investments, there has also been a growing trend of FDI outflow from Asia to the United States and Europe. This reverse-vertical FDI is motivated by firms in developing countries such as China purchasing established companies based in industrial countries as ways to acquire management and technological knowledge.

Platform FDI

Export-platform FDI is an investment and production in a host country, done by a source country, where the output is largely sold in third markets. It is not clear how to view these investments as separate from horizontal and vertical, because platform has elements of both.

3 International Business

3.1 Brief overview of world business

International business is the study of transactions taking place across national borders for the purpose of satisfying the needs of individuals and organizations. These economic transactions consist of trade, as in the case of exporting, importing and direct investment of funds in overseas operations.

Over half of all world trade and approximately 80 percent of all foreign direct investment are made by the 500 largest firms in the world. The vast majority of these are multinational enterprises, i.e. firms that are headquartered in one country but have operations in one or more other countries. The headquarters of the world's largest firms are the world's three largest economies, the United States, Japan, and the European Union (EU).

3.2 Today's international environment

Over the last few decades, an increasing number of countries have embraced trade and investment liberalization. Despite disagreements about how to implement trade and investment agreements, countries continue to enter into bilateral and multilateral contracts to liberalize trade and investment. The most inclusive of such agreements is the WTO, established in 1995. Today, the WTO is the umbrella organization that governs the international trading system for most countries of the world. When member countries have a dispute they turn to the WTO's dispute-settlement mechanism to help resolve it. For example, the United States and the European Union have brought cases against each other in such matters as banana imports, beef hormones, steel and foreign sales corporations. The WTO can enforce its decisions. Countries

that refuse to comply can find themselves suffering severe consequences in the form of trade retaliation.

Technology is having a major impact on the way multinational enterprises do business. Over the last few years, communication technology has allowed all businesses to use computers and mobile phones and to rely on the World Wide Web to access and send information. New technological developments have also been applied to the production of goods and services. Companies can now implement quality programs and improve manufacturing flexibility, among other things.

International business is not limited to giant multinational enterprises. Many small and medium-sized businesses are also involved in this arena. Most of these companies have annual sales of less than $5 million, but thanks to innovation, technology, and a well-trained workforce that is focused to their particular needs, they are able to compete effectively and to perform functions that multinationals cannot do as efficiently.

3.3 Globalization and strategic management

A common misconception about international business is that multinational enterprises (MNE) have far-flung operations and earn most of their revenues overseas. In fact, most MNEs earn the bulk of their revenues either within their home country or by selling in nearby locales. Of the largest 500 MNEs, 203 are headquartered in North America (the United States, Canada and Mexico), 153 are in the European Union and 123 are in Japan/Asia. Multinational enterprises (MNEs) do not develop homogeneous products for the world market but must adapt their product to local markets. For example, there is no global car but regional-based auto factories that are supported by regional/local suppliers and design cars to meet the preferences of local/regional customers.

Why can some firms innovate consistently while others cannot? According to Porter, the answer rests in four broad attributes that individually and interactively determine national competitive advantage: factor conditions, demand conditions, related supporting industries and firm strategy, structure and rivalry.

- Factor conditions include land, labor, and capital that are used to develop international market niches and tap world markets.
- Demand conditions require a sophisticated local demand that helps businesses, fashion and shape the goods and services that will later be offered on the world market.
- Related and supporting industries help MNEs remain abreast of low-cost inputs and knowledge regarding what is happening in their industry.
- Firm strategy, structure, and rivalry help organizations create, organize and manage their operations in the face of competitiveness.

Each of the four determinants in Porter's model often depends on the others. For example, if a country has sophisticated buyers that can provide a company with feedback regarding how to modify or improve its product (demand conditions), this information will not be useful if the firm lacks personnel with the skills to carry out these functions (factor conditions). Similarly, even though, suppliers can and are willing to provide the company with low-cost inputs and fresh ideas for innovation (related and supporting industries), but if the firm clearly and easily dominates the industry (firm strategy, structure and rivalry) and does not feel the need to upgrade the quality of its products and services, it will eventually lose this competitive advantage.

Porter notes that government and chance influence the four determinants of competitive advantage. Government policies, for example, can have serious consequences for international trade, since government intervention for the purpose of protecting home industries usually results in less competitive national companies. There is often strong domestic pressure to provide such protection. Yet research shows that a government's major role in international business may well be that of a world trade negotiator.

4 The multinational Enterprise

4.1 The nature of multinational enterprises

A multinational enterprise (MNE) is a firm headquartered in one country with operations in other countries. Sometimes it is difficult to know if a firm is an MNE, because multinationals often downplay the fact that they are foreign-held.

Multinational enterprises (MNEs) have a number of characteristics including the following:

a) responsiveness to environmental forces such as competitors, customers, suppliers, financial institutions and government;
b) drawing on a common pool of resources, including assets, patents, trademarks, information and human resources; and
c) affiliates that are linked by a common strategic vision.

Under the premise that foreign markets are risky, companies expand their operations abroad incrementally and cautiously. Setting up a wholly owned subsidiary is usually the last stage of doing business abroad.

A typical internationalization process for a firm producing a standardized product might begin with a licensing agreement: a contractual arrangement in which one firm provides access to some of its patents, trademarks, or technology to another firm in exchange for a fee or royalty. Apart from a licensing agreement, a firm might export via an agent or distributor. This might be followed by the direct hiring of a domestic representative or the establishment of a foreign sales subsidiary. The next step might be the establishment of local packaging and/or assembly operations. This is typically followed by FDI.

Firms become multinationals for a number of reasons. Some of these include the following:

a) a desire to protect themselves from the risks and uncertainties of the domestic business cycle;
b) a growing world market for their goods or services;
c) a response to increased foreign competition;
d) a desire to reduce costs;
e) a desire to overcome tariff barriers; and
f) a desire to take advantage of technological expertise by manufacturing goods directly rather than allowing others to do it under a license agreement.

Multinational enterprises have a strategic philosophy that is different from that of home country businesses. In particular, MNEs do not see their company as an extension of its domestic roots. They hire the personnel, fire and transfer them to meet global needs, even if this means laying off home country employees.
Most MNEs are not giant corporations, but the giants are almost all MNEs. Some of the exceptions are major utilities, banks and retailers that restrict their operations to the home country. Multinational enterprises (MNEs) range from extremely large to fairly small in terms of both sales, employment and they can also be found in a variety of different industries.

4.2 Strategic management of multinational enterprises

The strategic management process involves four major functions: strategy formulation, strategy implementation, evaluation and the control of operations. Strategic planning typically begins with a review of the company's basic mission. This is determined by answering the questions:

- What is the firm's business?
- What is its reason for existence?

After determining its mission, the MNE will evaluate the external and internal environments. The goal of external environmental analysis is to identify opportunities and threats that will need to be addressed. The purpose of internal environmental analysis is to evaluate the company's financial and personnel strengths and weaknesses.

Internal and external analysis helps the MNE identify both long-range goals (typically two to five years) and short-range goals (less than two years). The plan is then broken down into major parts, and each affiliate and department will be assigned goals and responsibilities. This begins the implementation process. Progress is then periodically evaluated and changes are made in the plan.

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