11.1: Why Do Firms Establish International Operations?

Business and finance are no longer national activities. Instead, they are global activities. Regardless of whether you are looking at retailers like Wal-Mart, technology firms like Apple, restaurants like McDonalds, money-center banks like Citigroup, or investment companies like Goldman Sachs, today's firms have a global footprint. In 2018, the S&P 500 saw 42.9% of their sales come from outside the US. There is also a combination of US firms with international production facilities and foreign firms with US-based production facilities. Why is global such an essential part of business? Here are a few reasons.

To get access to additional customers

While the US is one of the biggest consumer markets in the world, it still represents only a fraction of the total consumer market worldwide. Remember from Chapter One that we estimated that more than 95% of the population and more than 75% of global GDP is based outside the US. If firms operate solely in the US, they are giving up a large amount of potential sales. Expanding to new markets worldwide is especially important for firms that have saturated the US markets (Coca-Cola, Pepsi, Wal-Mart, etc.) or firms that see a decline in their US market (tobacco firms).

To acquire raw materials

Raw materials necessary to produce many products are found throughout the world. We can think of many different materials (oil, coffee, cocoa, diamonds, etc.) that are primarily found outside the US. For firms that use a significant amount of non-US-based resources, it makes sense to open production facilities in countries where these resources are more prominent.

To lower costs

Firms can increase profitability in two ways: (1) increase revenues and/or (2) lower costs. In many situations, firms can lower costs by producing outside the US. This cost savings may come from direct wages, benefits (such as health care), or less restrictive regulatory environments. Typically, these costs have been high in the US compared to some developing economies (although this article, The Rising Cost of Manufacturing, shows that this international cost advantage is lessening). There are also markets where production costs are higher than the US. This is one of the most controversial aspects of international operations. Are firms taking necessary steps to stay competitive (and creating economic growth in areas that need it), or are they exploiting foreign laborers and at the same time depriving the US labor force of jobs in exchange for higher profits for shareholders and upper level management? There are legitimate arguments on both sides and we do not plan to solve the debate here. However, consider the article linked above showing manufacturing costs of 25 major exporting nations. Note that many have seen their costs rise relative to the US over the 10-year period between 2004 and 2014. This happens as the capital flowing to cheaper manufacturing areas tends to push up the relative cost.

To diversify

Given that national economies tend to move in different business cycles, firms can diversify some of their business risk by operating internationally. Interest rates, inflation, and recessions occur at different times in different countries. By having operations across the globe, firms can offset down years in one country with strong years in markets in other countries. While there are significant "world economy" impacts (such as the Global Financial Crisis of 2008) that cannot be diversified away, there are still some benefits in diversifying country-specific risk.

To reduce currency risk

One of the issues we will encounter in this chapter is the impact of currency risk associated with international operations (or international competitors). When firms market their products outside their home country, they open themselves up to currency risk. A US firm that earns revenues in euros must convert those euros back to dollars. If the dollar increases in value relative to the euro, each euro received in revenue is now worth less than previously anticipated. By moving production costs into the same currency as their revenues, the firm will have less currency risk.