14.2: Globalization

What you'll learn to do: explain why nations and U.S. firms engage in global business

In this section you'll learn about the drivers of the global economy and how companies and countries evaluate whether or not to pursue global opportunities.

Learning Objectives

- Differentiate between comparative and absolute advantage
- Explain the roles of absolute and comparative advantage in global business

Globalization and Business

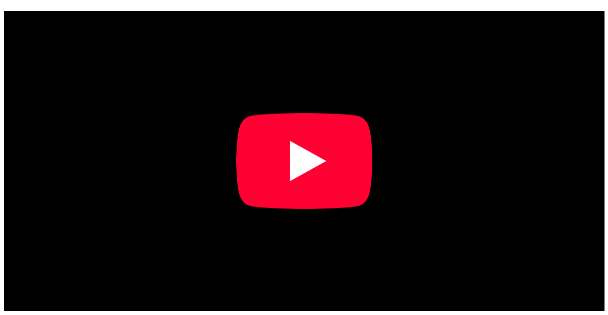
Globalization

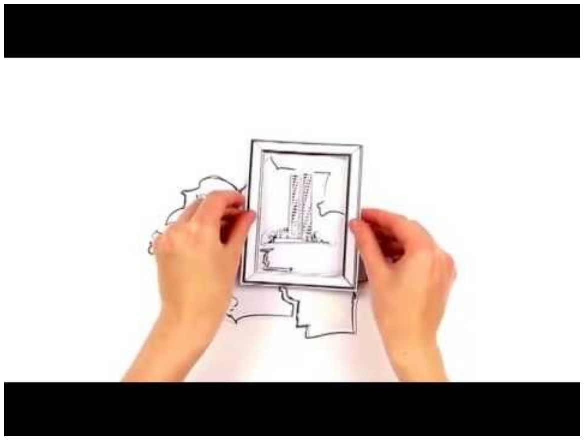
There was a time when consumers only had access to goods and services that were available locally. Their choices were limited by what they could access on foot, by horse, or by carriage. This is still the case for many people around the world, and in rural and remote parts of the U.S., it's still necessary for families to make weekly trips to town to stock up on food, household items and other necessities. However, with the rise of Internet-based business (think Amazon), there's been an explosion of international trade, and more and more consumers essentially have the world at their door. Of course international trade isn't just a twentieth-century phenomenon. Trade across borders and between cultures has been a feature of human civilization for centuries—there's evidence of this dating back as far as the nineteenth century BCE. The Silk Road, one of the best-known and most enduring "international" trade routes, began sometime around 200 BCE and for centuries was central to cultural interaction from China through regions of the Asian continent all the way to the Mediterranean Sea.

So, if cultures and nations have been trading with one other for four thousand years, what makes today's business landscape different? The answer lies in the distinction between *international business* and *globalization*.

International business refers to commerce in which goods, services, or resources cross the borders of two or more nations. This is what the Egyptians were doing when they sent goods across the Red Sea to Assyria. **Globalization** is broader than international business and describes a shift toward a more integrated world economy in which culture, ideas, and beliefs are exchanged in addition to goods, services, and resources. Globalization implies that the world is "getting smaller": As a result of new transportation and communication technologies, people around the world can more readily connect with one another—both virtually and geographically.

The following video provides a good introduction to the causes and consequences of globalization.





Impact of Globalization on Global Business

The video, above, provides a good bird's eye view of the affect of globalization on business—from opening up new markets to increasing the level of competition within markets and industries. Let's take a look at particular example, though, to think through the various implications of conducting business on a global scale. Consider McDonald's, which was started by two brothers in San Bernadino, California, sixty-eight years ago. As a result of globalization, nearly 69 *million* people in 118 different countries eat at McDonald's every day. The first McDonald's outside the U.S. and Canada was established in Costa Rica in 1970, and since the 1990s, most of the company's growth has taken place in foreign countries. The process of building a global presence, entering new markets, and capitalizing on growing international demand for American fast food has enabled McDonald's to expand from a single location to a global corporation with revenues in excess of U.S. $25.4 billion in 2015. [1] However, entering new markets—whether at home or abroad—means contending with increased competition in those markets, including competition with other globally minded companies. In 2010, Subway surpassed McDonald's to become the largest single-brand restaurant chain and the largest restaurant operator globally.

What is it like for companies that decide to take advantage of global opportunities as McDonald's and Subway have? Return to the discussion of "external forces" in module 1, but now consider them from a global business perspective. Globalization certainly means that businesses can reach consumers around the word more rapidly and efficiently—thanks to cell phones, airplanes, and the Internet, we are all so much more interconnected and "accessible" now. But globalization also means incredible complexity. The list below sketches out just a few of the complexities and challenges that an American fast-food company like McDonald's faces when it takes on the global business environment.

The Global Economic Environment

McDonald's is a corporation based in the United States, where all business transactions are conducted using the U.S. dollar, but there are 167 official national currencies in the world, each with a different value and purchasing power. Imagine trying to balance the corporate checkbook at McDonald's when your deposits have been made in more than a hundred different currencies.

The Global Legal Environment

In Greece, there is a $650 fine for eating ice cream at certain historic, artistic, and culturally important sites. If you are the operator of a McDonald's near the Parthenon, should you remove the ice cream cones and McFlurries from your menu to protect your customers against being fined, or not?

The Global Competitive Environment

McKebab, a fast-food restaurant in Slovakia whose name and golden "M" bear a striking resemblance to McDonald's.

How does McDonald's recapture the number-one position it lost to Subway in 2010? The company may need to make substantial changes to its operations, menu offerings, and/or marketing tactics. This is a steep, uphill climb in the United States alone, but consider trying to accomplish it in 118 different countries in 188 different markets—where you are competing not only with other global U.S. fast-food companies like Subway and KFC but with local ones, like "McKebab," as well!

The Global Technological Environment

What does technology have to do with fast food or McDonald's? Consider the company's presence in China, where there are nearly 1.3 billion mobile users, and say hello to "McDonald's Next," a "modern and progressive" version of the restaurant that first opened in Hong Kong, featuring mobile-phone-charging platforms, free Wi-Fi, and self-ordering kiosks. This next generation of McDonald's is a response to increased expectations around speed, service, economy, and availability across established and developing economies, mostly fueled by consumers' growing access to affordable technology. As global businesses respond to demands created *by* technology, they must also leverage technology to move products, people, and supplies around the globe in a cost-effective and efficient manner.

The Global Social Environment

McDonald's Maharaja Mac

McDonald's has had to adapt in countless ways to meet the demands of its customers around the world. While it prides itself on offering a consistent, internationally recognizable menu and brand, the company has also had to cater to local dining preferences and customs. In 1995, for example, the first kosher McDonald's opened in a Jerusalem suburb. In Arab countries, the restaurant chain offers "halal" menus, which comply with Islamic laws governing the preparation of meat. In 1996, McDonald's entered India for the first time, where it offered a Big Mac made with lamb called the Maharaja Mac.[2]

McDonald's is not a complex business—after all, it sells inexpensive burgers and fries, not automobiles or airplanes or pharmaceuticals—but clearly the global environment presents challenges even for them. You may be wondering why nations and businesses decide to take on such challenges, given the ongoing difficulty, risk, and uncertainty. We'll investigate this question throughout the remainder of this module.

Absolute and Comparative Advantage

Consider the humble banana. Even if you're not a big fan of this yellow fruit, you've surely seen them in the grocery store or in a market somewhere. If you walked through a US city with a banana and asked people to identify it, it's unlikely you would encounter anyone who had no idea what it was. What if you did the same thing with a picture of a *banana tree*? How many people could identify it? Maybe some, but not all. Why is that? In the United States, bananas are grown in Hawaii, and not everyone has been to Hawaii. In fact, most of the bananas in the world are grown in Ecuador. If we Americans love bananas and don't live in Hawaii and can't get to Ecuador regularly, without global trade, we're out of luck: no bananas for cereal in the morning or as snacks during the day and, worse, no banana splits at the local ice cream parlor. Why do Ecuador and Hawaii trade away their bananas instead of keeping them all to themselves? Probably because, although bananas are delicious and nutritious, it's hard to build houses out of them. Instead, the state of Hawaii and nation of Ecuador choose to trade their bananas for things they lack, while considering the cost and profitability of exporting their product.

Ecuador and Hawaii offer an example of comparative advantage. Because bananas are not grown or readily available everywhere in the world, Ecuador and Hawaii can profitably export theirs to banana-less places like Iowa and Canada. At the same time, Ecuador may need computer systems to keep track of all of those bananas they are selling, but Ecuador is not a technologically advanced economy like the United States. The United States has a comparative advantage in computers, so we sell our computers to Ecuador and let them concentrate on selling us bananas.

The Concept of Advantage

In order to understand why businesses are willing to operate in a complex global environment, we must first understand two fundamental concepts that drive almost all business decisions: absolute and comparative advantage. Countries and companies are willing to assume the risk of engaging in global trade because they believe that they have an advantage over the competition that they can turn into profits. Not all countries have the same natural resources, infrastructure, labor force, or technology. These differences create advantages that can be exploited in global trade, to a country's (or company's) benefit.

Absolute Advantage

An entity (country, region, company, or individual) is considered to have an **absolute advantage** if either of the following conditions exists:

1. It is the only source of a particular product, good, or service. This kind of absolute advantage is very rare and usually depends on a particular natural resource being available only within a certain region or country. An example might be the coveted edible red bird's nests found only in the caves of Thailand (and prized in Chinese cooking as the main ingredient in bird's nest soup). Similarly, if Ecuador were the only place in the world where bananas could be grown, it would have an absolute advantage. However, suppose some sneaky banana spy goes to Ecuador and pilfers some banana tree seedlings and takes them back to her home country and begins growing and exporting bananas. At that point Ecuador no longer has an absolute advantage on the basis of the "only-source" condition.
2. An entity is also considered to have an absolute advantage if it is able to produce *more* of something than another entity while using the same amount of resources (factors of production). When the sneaky banana spy started growing bananas in her home country, she didn't actually take away Ecuador's absolute advantage, because Ecuador can produce *more* bananas using the same amount of resources (labor, land, water, equipment, etc.). Put another way, Ecuador's direct cost of producing bananas is lower than the banana spy's. Assuming that the bananas can be grown in the new country, it will take that country a very long time to match Ecuador's skill, efficiency, and output level, and until it does, Ecuador will retain its absolute advantage.

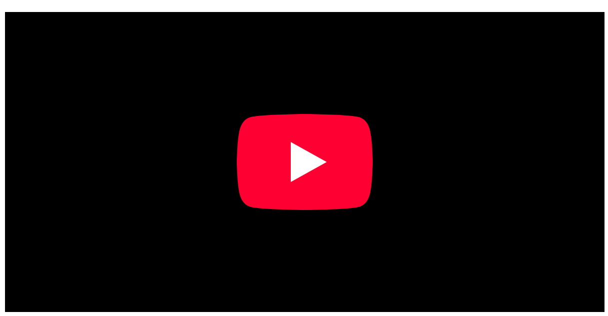
Comparative Advantage

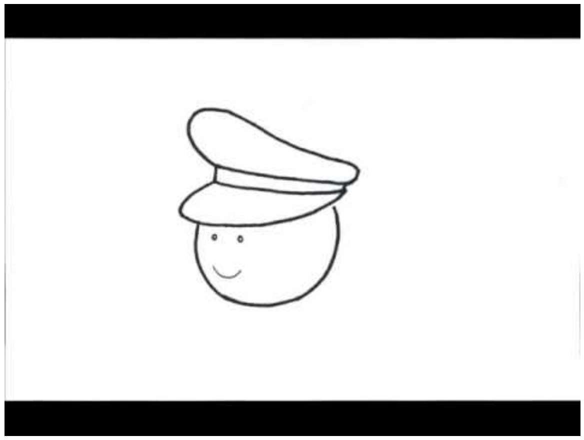
An entity (country, region, company, or individual) is considered to have a **comparative advantage** over another in producing a particular good or service if it can produce the good or service at a lower relative opportunity cost.

You'll recall from the economic environment module that opportunity cost is the value of the *next best alternative*. (The video, below, also includes a refresher on this concept.) Since countries and businesses have limited resources, they are forced to make choices about how they allocate those resources. As a student, you understand opportunity cost better than you think. You have a limited amount of time, and you must choose between reading this module and going out with your friends, because you can't do both. If you choose to go out with your friends, then the opportunity cost might be failure on your next exam because you did not use the time to prepare.

Ecuador has a comparative advantage in bananas over a long list of countries, including the United States. This comparative advantage is even better understood when you consider that their *next best alternative* product is oil. The Middle Eastern countries have been pumping oil from the ground for as long as Ecuador has been growing bananas. It makes as much sense for Kuwait to attempt to export bananas as it does for Ecuador to export oil. It's the reality of comparative advantage that encourages countries and businesses to do what they do best—leaving the production of other goods and services to other countries or companies—and in so doing, focusing on producing goods and services where they have advantage, thus maximizing their opportunities in a global environment.

The following video provides an excellent illustration of comparative and absolute advantage and explains why they are such important considerations in how countries decide to specialize and trade.





practice question 14.2.1

Consider an economy that has an absolute advantage in producing a given product, then it ________ have a comparative advantage in producing that same product.

a. must
b. might or might not
c. definitely

Answer

b. Absolute advantage means the economy can produce a given product with a lower resource cost and comparative advantage means the economy can product a given product with a lower opportunity cost. Absolute advantage meaning being better at something relative to something else. Specialization allows for everyone benefiting from producing under comparative advantage and then trading.

practice question 14.2.2

If Kate can make more tacos in an hour than Bill, but Bill can make more tacos at a lower opportunity cost then Bill has a(n) ________.

a. absolute advantage in making tacos.
b. both an absolute and comparative advantage in making tacos.
c. comparative advantage in making tacos.

Answer

c. Kate has an absolute advantage because she can make more tacos and Bill has a comparative advantage because he can make more tacos at a lower opportunity cost.

Game: Absolute and Comparative Advantage

It's one thing to talk and read about global business and another to actually engage in global trade. The following interactive provides a brief introduction to doing just that, with a focus on just how countries behave to create a more productive global economy.

learn more

Now that you've learned about specialization, you can try playing this trade game to explore trade in a fictional world: Play the Trade Ruler Game. Note that this game is Flash-based, so you'll need to enable Flash in your browser in order to see it.

Global Markets

Global Markets and Business Opportunity

Increasingly nations and business use their comparative or absolute advantages to enter global markets driven by the same factor: the immense *size* of these markets.

Let's return to the banana for a moment. In 2015, Ecuador exported 6.55 *million metric tons* of bananas. Without a large global demand for bananas, every man, woman, and child in Ecuador would have to eat 834 pounds of them per year to consume all of the production. Of course that wouldn't happen: Instead, the country would simply cut back on the production of bananas—but, in so doing, it would lose an export that now accounts for more than 10 percent of its gross domestic product (GDP). Ecuador needs a large and vibrant global market to keep up with its tremendous supply of bananas, and it relies on the revenue from those bananas to purchase the other things it needs (in the same way that you traded cell phones for blue jeans in the island trader simulation).

Later in this module we'll discuss how nations like Ecuador enter foreign markets, but for now let's look more closely at the size of the world's largest markets. The following table shows population and GDP data for the top five economies in the world as of 2015.[3] You'll recall from the economic environment module that GDP, or gross domestic product, is a monetary measure of the market value of all final goods and services produced in a period, and the GDP growth rate is the increase or decrease in GDP over a period of time, expressed as a percentage.

Country	GDP	Population	GDP Growth Rate
China	$19,390,000,000,000	1,367,485,388	6.90%
European Union	$19,180,000,000,000	513,949,445	2.20%
United States	$17,950,000,000,000	321,368,864	2.40%
India	$7,965,000,000,000	1,251,695,584	7.30%
Japan	$4,830,000,000,000	126,919,659	0.50%

Looking at the figures in this table, it isn't hard to imagine that a country or company would like to have a foothold in one or all of these markets. Taken together, these five economies represent a lot of people, a lot of purchasing power, and a lot of economic growth. However, the immensity of the global market offers more than just new target customers. Consider some of the following benefits nations and firms realize by entering foreign markets.

Access to Factors of Production

You will recall that the factors of production required for a successful business venture are natural resources, capital, human capital, and entrepreneurship. Access to global markets enables countries and companies to acquire these factors of production when they are nonexistent, scarce, or just too costly at home. For example, India is one of the largest providers of telephone-based customer service (labor) worldwide, which makes sense given that its population is second only to China and almost four times that of the United States. In addition, labor costs in India are significantly lower than in the U.S.

Innovation and Ideas

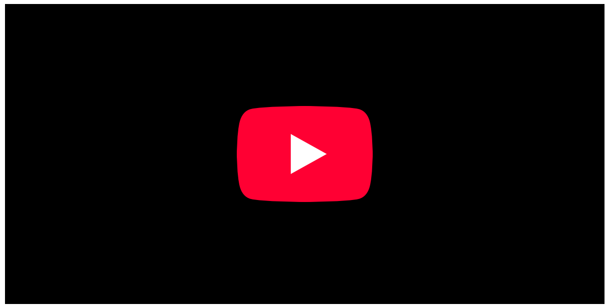
Many companies enter global markets and, once there, discover unmet needs or unique products and services. They are then able to use their discoveries to expand an existing product line or introduce new products in other markets or at home. For example, many people credit the United Kingdom with inspiring the development of the craft beer industry in the United States.

Risk Reduction

Given the complexity of operating a business globally, it may seem like a contradiction that risk reduction is one of the benefits of a large global market, but it's actually true. If a country or a company trades or does business with multiple foreign partners, they are less dependent on the success of any single partnership. Likewise, if a nation or business has *multiple* global sources for factors of production, then if one source "dries up," they will still have access to what they need. For example, in 2010 China halted its export of rare earth minerals to Japan after the two countries were unable to resolve a territory dispute. Japan used these minerals in the production of everything from cars to computer chips, and to say that the Japanese were in a state of distress is an understatement. As a result of this albeit brief reduction in Chinese supply, Japan established a trade agreement with India for the import of the needed materials. They will no longer be totally dependent upon the Chinese for these important resources.

In summary, globalization makes business on a global scale possible, and the size of the global market makes it attractive. By using their absolute and comparative advantages, countries and companies can leverage their resources to produce and trade the things that benefit them the most.

The following video provides a recap of the main reasons why countries and businesses engage in global trade.



1. https://en.Wikipedia.org/wiki/McDonald%27s ↵
2. en.Wikipedia.org/wiki/History_of_McDonald ↵
3. CIA World FactBook https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html#ch ↵