INTRODUCTION TO INTERNATIONAL BUSINESS (REMIX)

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CHAPTER OVERVIEW

1: Globalization and International Business

1.1: What Is International Business?

LEARNING OBJECTIVES

1. Know the definition of international business.
2. Comprehend how strategic management is related to international business.
3. Understand how entrepreneurship is related to international business.

The Definition of International Business

As the opening case study on Google suggests, international business relates to any situation where the production or distribution of goods or services crosses country borders. **Globalization**—the shift toward a more interdependent and integrated global economy—creates greater opportunities for international business. Such globalization can take place in terms of markets, where trade barriers are falling and buyer preferences are changing. It can also be seen in terms of production, where a company can source goods and services easily from other countries. Some managers consider the definition of international business to relate purely to "business," as suggested in the Google case. However, a broader definition of international business may serve you better both personally and professionally in a world that has moved beyond simple industrial production. **International business** encompasses a full range of cross-border exchanges of goods, services, or resources between two or more nations. These exchanges can go beyond the exchange of money for physical goods to include international transfers of other resources, such as people, intellectual property (e.g., patents, copyrights, brand trademarks, and data), and contractual assets or liabilities (e.g., the right to use some foreign asset, provide some future service to foreign customers, or execute a complex financial instrument). The entities involved in international business range from large multinational firms with thousands of employees doing business in many countries around the world to a small one-person company acting as an importer or exporter. This broader definition of international business also encompasses for-profit border-crossing transactions as well as transactions motivated by nonfinancial gains (e.g., triple bottom line, corporate social responsibility, and political favor) that affect a business's future.

Strategic Management and Entrepreneurship

A knowledge of both strategic management and entrepreneurship will enhance your understanding of international business. **Strategic management** is the body of knowledge that answers questions about the development and implementation of good strategies and is mainly concerned with the determinants of firm performance. A **strategy**, in turn, is the central, integrated, and externally oriented concept of how an organization will achieve its performance objectives.Mason Carpenter and William G. Sanders, *Strategic Management: A Dynamic Perspective, Concepts and Cases* (Upper Saddle River, NJ: Pearson Education, 2007). One of the basic tools of strategy is a **SWOT (strengths, weaknesses, opportunities, threats)** assessment. The SWOT tool helps you take stock of an organization's internal characteristics—its strengths and weaknesses—to formulate an action plan that builds on what it does well while overcoming or working around weaknesses. Similarly, the external part of SWOT—the opportunities and threats—helps you assess those environmental conditions that favor or threaten the organization's strategy. Because strategic management is concerned with organizational performance—be that social, environmental, or economic—your understanding of a company's SWOT will help you better assess how international business factors should be accounted for in the firm's strategy.

Entrepreneurship, in contrast, is defined as the recognition of opportunities (i.e., needs, wants, problems, and challenges) and the use or creation of resources to implement innovative ideas for new, thoughtfully planned ventures. An **entrepreneur** is a person who engages in entrepreneurship. Entrepreneurship, like strategic management, will help you to think about the opportunities available when you connect new ideas with new markets. For instance, given Google's current global presence, it's difficult to imagine that the company started out slightly more than a decade ago as the entrepreneurial venture of two college students. Google was founded by Larry Page and Sergey Brin, students at Stanford University. It was first incorporated as a privately held company on September 4, 1998. Increasingly, as the Google case study demonstrates, international businesses have an opportunity to create positive social, environmental, and economic values across borders. An entrepreneurial perspective will serve you well in this regard.

Spotlight on International Strategy and Entrepreneurship

Hemali Thakkar and three of her fellow classmates at Harvard found a way to mesh the power of play with electrical power. The foursome invented "a soccer ball with the ability to generate electricity," Thakkar said."Harnessing the Power of Soccer," interview with Thakkar Hemali by Ike Sriskandarajah, October 20, 2010, accessed November 12, 2010, www.loe.org/shows/segments.htm?

programID=10-P13-00044&segmentID=5. Every kick of the ball creates a current that's captured for future use. Fifteen minutes of play lights a lamp for three hours.

Called the sOccket, the soccer ball can bring off-grid electricity to developing countries. Even better, the soccer ball can replace kerosene lamps. Burning kerosene is not only bad for the environment because of carbon dioxide emissions but it's also a health hazard: according to the World Bank, breathing kerosene fumes indoors has the same effects as smoking two packs of cigarettes per day.Ariel Schwartz, "The SOccket: A Soccer Ball to Replace Kerosene Lamps," *Fast Company*, January 26, 2010, accessed November 12, 2010, http://www.fastcompany.com/blog/ariel-schwartz/sustainability/soccket-soccer-ball-replace-kerosene-lamps.

How did the idea of sOccket emerge? All four students (Jessica Lin, Jessica Matthews, Julia Silverman, and Hemali Thakkar) had experience with developing countries, so they knew that kids love playing soccer (it's the world's most popular sport). They also knew that most of these kids lived in homes that had no reliable energy.Clark Boyd, "SOccket: Soccer Ball by Day, Light by Night," *Discovery News*, February 18, 2010, accessed November 12, 2010, news.discovery.com/tech/soccket-soccer-ball-by-day-light-by-night.html.

As of November 2010, the sOccket prototype cost $70 to manufacture, but the team hopes to bring the cost down to $10 when production is scaled up.Ike Sriskandarajah, "Soccer Ball Brings Off-Grid Electricity Onto the Field," *The Atlantic*, November 3, 2010, accessed November 12, 2010, http://www.theatlantic.com/technology/archive/2010/11/soccer-ball-brings-off-grid-electricity-onto-the-field/65977. One ingenious way to bring costs down is to set up facilities where developing-world entrepreneurs assemble and sell the balls themselves.

At this point it's also important to introduce you to the concepts of **intrapreneurship** and the **intrapreneur**. Intrapreneurship is a form of entrepreneurship that takes place inside a business that is already in existence. An intrapreneur, in turn, is a person within the established business who takes direct responsibility for turning an idea into a profitable finished product through assertive risk taking and innovation. An entrepreneur is starting a business, while an intrapreneur is developing a new product or service in an already existing business. Thus, the ideas of entrepreneurship can be applied not only in new ventures but also in the context of existing organizations—even government.

KEY TAKEAWAYS

- International business encompasses a full range of cross-border exchanges of goods, services, or resources between two or more nations. These exchanges can go beyond the exchange of money for physical goods to include international transfers of other resources, such as people, intellectual property (e.g., patents, copyrights, brand trademarks, and data), and contractual assets or liabilities (e.g., the right to use some foreign asset, provide some future service to foreign customers, or execute a complex financial instrument).
- Strategic management is the body of knowledge that answers questions about the development and implementation of good strategies and is mainly concerned with the determinants of firm performance. Because strategic management is concerned with organizational performance, your understanding of a company's SWOT (strengths, weaknesses, opportunities, threats) helps you better assess how international business factors should be accounted for in the firm's strategy.
- Entrepreneurship is the recognition of opportunities (i.e., needs, wants, problems, and challenges) and the use or creation of resources to implement innovative ideas. Entrepreneurship helps you think about the opportunities available when you connect new ideas with new markets.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What is international business?
2. Why is an understanding of strategy management important in the context of international business?
3. Why is an understanding of entrepreneurship important in the context of international business?

1.2: How Global Are We?

In 1983, Theodore Levitt, the late Harvard Business School professor and editor of the *Harvard Business Review*, wrote a controversial article entitled “The Globalization of Markets.” In it, he famously stated, “The globalization of markets is at hand. With that, the multinational commercial world nears its end, and so does the multinational corporation… The multinational operates in a number of countries, and adjust its products and processes in each, at high relative cost. The global corporation operates with resolute constancy… it sells the same things in the same way everywhere” (Levitt (1983, May–June)).

Levitt both overestimated and underestimated globalization. He did not anticipate that some markets would react against globalization, especially against Western globalization. He also underestimated the power of globalization to transform entire nations to actually embrace elements of global capitalism, as is happening in the former Soviet Union, China, and other parts of the world. He was right, however, about the importance of branding and its role in forging the convergence of consumer preferences on a global scale. Think of Coca-Cola, Starbucks, McDonald’s, or Google. (Ghemawat (2007a), p. 9).

More than 20 years later, in 2005, Thomas Friedman, author of *The World is Flat: A Brief History of the Twenty-First Century*, had much the same idea, this time focused on the globalization of production rather than of markets. Friedman argues that a number of important events, such as the birth of the Internet, coincided to “flatten” the competitive landscape worldwide by increasing globalization and reducing the power of states. Friedman’s list of “flatteners” includes the fall of the Berlin Wall; the rise of Netscape and the dot-com boom that led to a trillion-dollar investment in fiber-optic cable; the emergence of common software platforms and open source code enabling global collaboration; and the rise of outsourcing, offshoring, supply chaining, and in-sourcing. According to Friedman, these flatteners converged around the year 2000, creating “a flat world: a global, web-enabled platform for multiple forms of sharing knowledge and work, irrespective of time, distance, geography and increasingly, language.” (Friedman (2007), p. 50). And, he observed, at the very moment this platform emerged, three huge economies materialized—those of India, China, and the former Soviet Union, and “three billion people who were out of the game, walked onto the playing field.” (Friedman (2007), p. 205).

Taking a different perspective, Harvard Business School professor Pankaj Ghemawat disputes the idea of fully globalized, integrated, and homogenized future in his *Laws of Globalization and Business* (2017). He identifies two general patterns : *the law of semiglobalization* and *the law of distance.*

1. **Law of semiglobalization:** differences between countries and cultures are larger than is generally acknowledged and that “*semiglobalization*” is the real state of the world today and is likely to remain so for the foreseeable future.
2. **Law of distance:** borders and distance still matter and that it is important to take a broad view of the differences they demarcate, to identify those that matter the most in a particular industry, and to look at them not just as difficulties to be overcome but also as potential sources of value creation. Geography, administration, and culture are impacted by *economic distance* as well as physical distance.

Ghemawat cites the 2017 Brexit vote as a source of support for these general patterns, noting that while globalized industry and movement of people motivated the design and approval of Brexit by voters in the United Kingdom, in fact the U.K. economy is largely driven by regional trade within Europe. At the time Brexit was being developed and approved, exports made up approximately one-third of U.K. GDP. and 45% of its imports came from the European continent. In a fully globalized economy, 96% of the GDP would need to be considered international in production and distribution. (Ghemawat 2017).

Moore and Rugman also reject the idea of an emerging single world market for free trade and offer a regional perspective. They note that while companies source goods, technology, information, and capital from around the world, business activity tends to be centered in certain cities or regions around the world, and suggest that regions—rather than global opportunity—should be the focus of strategy analysis and organization. As examples, they cite decisions by DuPont and Procter & Gamble to roll their three separate country subsidiaries in the United States, Canada, and Mexico into one regional organization. (Moore and Rugman (2005a); see also Moore and Rugman (2005b)). Regional trade agreements such as USMCA in North America (formerly NAFTA) and ASEAN in Southeast Asia and the Asian continent follow trade patterns and formalize regional trade by incentivizing companies to work regionally.

The histories of Toyota, Wal-Mart, and Coca-Cola provide support for the diagnosis of a semiglobalized and regionally divided world. Toyota’s globalization has always had a distinct regional flavor. Its starting point was *not* a grand, long-term vision of a fully integrated world in which autos and auto parts can flow freely from anywhere to anywhere else. Rather, the company anticipated expanded free-trade agreements within the Americas, Europe, and East Asia but not across them. This reflects a vision of a semiglobalized world in which neither the bridges nor the barriers between countries can be ignored. The Toyota, Wal-Mart, and Coca-Cola examples are taken from Ghemawat (2007a), chap. 1.

The globalization of Wal-Mart illustrates the complex realities of a more nuanced global competitive landscape (see the Wal-Mart minicase). It has been successful in markets that are culturally, administratively, geographically, and economically closest to the United States: Canada, Mexico, and the United Kingdom. In other parts of the world, it has yet to meet its profitability targets. The point is not that Wal-Mart should not have ventured into more distant markets, but rather that such opportunities require a different competitive approach. For example, in India, which restricts foreign direct investment in retailing, Wal-Mart was forced to enter a joint venture in 2007 with an Indian partner, Bharti, that operated the stores, while Wal-Mart dealt with the back end of the business. Twenty superstores were built in major cities, and yet in 2013 the partnership was dissolved. Forbes reported on the story, citing Scott Price, President and CEO of Walmart, who indicated that their hope was to spark a liberalization of the Indian market which did not happen, and thus the relationship no longer served the Wal-Mart corporation. (*Wal-Mart: What Happened in India?* Walter Loeb, 2013: forbes.com/sites/walterloeb/2013/10/16/walmart-what-happened-in-india/?sh=263c4de07d1c, accessed 2021)

Consider the history of Coca-Cola, which, in the late 1990s under chief executive officer Roberto Goizueta, fully bought into Levitt's idea that the globalization of markets (rather than globalization of production) was imminent. Goizueta embarked on a strategy that involved focusing resources on Coke's megabrands, an unprecedented amount of standardization, and the official dissolution of the boundaries between Coke's U.S. and international organizations. Fifteen years later and under new leadership, Coke's strategy looks very different and is no longer always the same in different parts of the world. In big, emerging markets such as China and India, Coke has lowered price points, reduced costs by localizing inputs and modernizing bottling operations, and upgraded logistics and distribution, especially rurally. The boundaries between the United States and international organizations have been restored, recognizing the fact that Coke faces very different challenges in America than it does in most of the rest of the world. This is because per capita consumption is an order of magnitude that is higher in the United States than elsewhere.

COVID-19 Impact on Globalization of Business

The long-term impacts of COVID-19 on internationalized businesses are being studied and and discussed broadly by economists, corporate leaders, and politicians (as well as international business students!) During the first months and years of the global pandemic, it has been clear that supply chains have been impacted across the spectrum of production and distribution. Steven Altman of the Harvard Business Review pointed out that international flows respond to macroeconomic patterns - as economies grow, international flows grow faster and stronger, and as they shrink, the global indicators decline more rapidly and drastically (*Will COVID-19 Have a Lasting Impact on on Globalization? Steven Altman,* 2020: hbr.org/2020/05/will-covid-19-have-a-lasting-impact-on-globalization, accessed 2021). He points to five factors that will influence the rebound of international trade and cooperation:

1. Global Growth Patterns: the pandemic will need to subside for many international exchanges to resume, but the act of engaging internationally to develop strong health support services, medical supplies, and technology improves the likelihood that the pandemic will be controlled more thoroughly and completely at a faster rate.
2. Supply Chain Policies: companies will either turn to diversifying their trade partners to limit disruption to their supply chain, or will rely more on domestic supply chains.
3. Governmental Relationships: global superpowers have delicately-balanced relationships that impact international trade agreements, sourcing, and delivery or distribution lines. The global pandemic has increased nation-state power over policy (moving away from business-led policy) and thus the relationships between nation-states plays a greater factor in international business success than pre-pandemic.
4. Technology Developments: the pandemic has provided a great space for accelerated innovation and technological developments. The impacts of robotics, Artificial Intelligence (AI), and remote work platforms can influence businesses internally and externally. Developments may change the international labor market and impact cross-border recruitment or production decisions. The pace of production and distribution may be impacted by efficiencies introduced by technological advances.
5. Public Opinion: the global transfer of COVID-19 spiked fears about international travel and exchange, and also highlighted vulnerabilities in the international supply chain. Protectionist policies may gain popularity, and awareness of corporate actions around social issues has become core to consumer and labor views of businesses.

This pandemic is unlike any pandemic in recent history because of the unique state of globalized trade, travel, and technological advancement that inarguably creates a more closely connected world. While the final results aren't in yet, international businesses and policies will necessarily consider the impacts of COVID-19 in their decision-making processes.

Minicase: The Globalization of Wal-Mart

This mini case study was first published in de Kluyver and Pearce (2009), chap. 8.

In venturing outside the United States, Wal-Mart had the option of entering Europe, Asia, or other countries in the western hemisphere. It realized that it did not have the resources—financial, organizational, and managerial—to enter all of them simultaneously and instead opted for a carefully considered, learning-based approach to market entry. During the first 5 years of its globalization (1991 to 1995), Wal-Mart concentrated heavily on establishing a presence in the Americas: Mexico, Brazil, Argentina, and Canada. This choice was motivated by the fact that the European market was less attractive to Wal-Mart as a first point of entry. The European retail industry was already mature, which meant that a new entrant would have to take market share away from an existing player. There were well-entrenched competitors such as Carrefour in France and Metro AG in Germany that would likely retaliate vigorously. Moreover, European retailers had formats similar to Wal-Mart's, which would have the effect of reducing Wal-Mart's competitive advantage. Wal-Mart might have overcome these difficulties by entering Europe through an acquisition, but the higher growth rates of the Latin American and Asian markets would have made a delayed entry into those markets extremely costly in terms of lost opportunities. In contrast, the opportunity costs of delaying acquisition-based entries into European markets were relatively small. Asian markets also presented major opportunities, but they were geographically and culturally more distant. For these reasons, as its first global points of entry, Wal-Mart chose Mexico (1991), Brazil (1994), and Argentina (1995), the countries with the three largest populations in Latin America.

By 1996, Wal-Mart felt ready to take on the Asian challenge. It targeted China, with a population of more than 1.2 billion inhabitants in 640 cities, as its primary growth vehicle. This choice made sense in that the lower purchasing power of the Chinese consumer offered huge potential to a low-price retailer like Wal-Mart. Still, China's cultural, linguistic, and geographical distance from the United States presented relatively high entry barriers, so Wal-Mart established two beachheads as learning vehicles for establishing an Asian presence. From 1992 to 1993, Wal-Mart agreed to sell low-priced products to two Japanese retailers, Ito-Yokado and Yaohan, that would market these products in Japan, Singapore, Hong Kong, Malaysia, Thailand, Indonesia, and the Philippines. Then, in 1994, Wal-Mart formed a joint venture with the C. P. Pokphand Company, a Thailand-based conglomerate, to open three Value Club membership discount stores in Hong Kong.

Once Wal-Mart had chosen its target markets, it had to select a mode of entry. It entered Canada through an acquisition. This was rational because Canada was a mature market—adding new retail capacity was unattractive—and because the strong economic and cultural similarities between the U.S. and Canadian markets minimized the need for much learning.

For its entry into Mexico, Wal-Mart took a different route. Because there were significant income and cultural differences between the U.S. and Mexican markets about which the company needed to learn, and to which it needed to tailor its operations, a greenfield start-up would have been problematic. Instead, the company chose to form a 50-50 joint venture with Cifra, Mexico's largest retailer, counting on Cifra to provide operational expertise in the Mexican market.

In Latin America, Wal-Mart targeted the region's next two largest markets: Brazil and Argentina. The company entered Brazil through a joint venture, with Lojas Americana, a local retailer. Wal-Mart was able to leverage its learning from the Mexican experience and chose to establish a 60-40 joint venture in which it had the controlling stake. The successful entry into Brazil gave Wal-Mart even greater experience in Latin America, and it chose to enter Argentina through a wholly owned subsidiary. This decision was reinforced by the presence of only two major markets in Argentina.

1.3: Who Is Interested in International Business?

LEARNING OBJECTIVES

1. Know who has an interest in international business.
2. Understand what a stakeholder is and why stakeholder analysis might be important in the study of international business.
3. Recognize that an organization's stakeholders include more than its suppliers and customers.

The Stakeholders

As you now know, *international business* refers to a broad set of entities and activities. But who cares about international business in the first place? To answer this question, let's discuss stakeholders and stakeholder analysis. A **stakeholder** is an individual or organization whose interests may be affected as the result of what another individual or organization does.Mason Carpenter, Talya Bauer, and Berrin Erdogan, *Principles of Management* (Nyack, NY: Unnamed Publisher, 2009), accessed January 5, 2011, www.gone.2012books.lardbucket.org/printed-book/127834. **Stakeholder analysis** is a technique you use to identify and assess the importance of key people, groups of people, or institutions that may significantly influence the success of your activity, project, or business. In the context of what you are learning here, individuals or organizations will have an interest in international business if it affects them in some way—positively or negatively.Management Sciences for Health and the United Nations Children's Fund, "Stakeholder Analysis," *The Guide to Managing for Quality*, 1998, accessed November 21, 2010, erc.msh.org/quality/ittools/itstkan.cfm. That is, they have something important at stake as a result of some aspect of international business.

Obviously, Google and its managers need to understand international business because they do business in many countries outside their home country. A little more than half the company's revenues come from outside the United States. (Statista: Revenue distribution of Alphabet 2015 - 2020 by region, statista.com/statistics/266250/regional-distribution-of-googles-revenue/ accessed December 2021). Does this mean that international business wouldn't be relevant to Google if it only produced and sold its products in one country? Absolutely not! Factors of international business would still affect Google—through any supplies it buys from foreign suppliers, as well as the possible impact of foreign competitors that threaten to take business from Google in its home markets. Even if these factors were not present, Google could still be affected by price swings—for instance, in the international prices of computer parts, even if they bought those parts from US suppliers. After all, the prices of some of the commodities used to make those parts are determined globally, not locally. Beyond its involvement in web advertising, which requires massive investments in computer-server farms around the world, Google is increasingly active in other products and services—for example, cell phones and the operating systems they use.

A business and its managers should understand international business, regardless of whether their organization sells or produces products or services across borders. Who else might be an international business stakeholder beyond Google and its management? First, Google is likely to have to pay taxes, right? It probably pays sales taxes in markets where it sells its products, as well as property and payroll taxes in countries where it has production facilities. Each of these governmental stakeholders has an important economic interest in Google. Moreover, in many countries, the government is responsible for protecting the environment. Google's large computer-server farms consume energy and generate waste, and its products (e.g., cell phones) come in disposable packaging, thus impacting the environment in places where they are manufactured and sold.

Beyond the company and governments, other stakeholder groups might include industry associations, trade groups, suppliers, and labor. For instance, you've already learned that Google is an Internet search-engine company, so it could be a member of various computer-related industry associations. Labor is also a stakeholder. This can include not only the people immediately employed by a business like Google but also contract workers or workers who will lose or gain employment opportunities depending on where Google chooses to produce and sell its products and services.

Did You Know?

FAt about the same time Google was experiencing difficulty protecting individuals' privacy in China, its managers in Italy were being convicted of violating consumer-privacy laws. Google executives had been accused of breaking Italian law by allowing a video clip of four boys bullying another child to be posted online."Google Bosses Convicted in Italy," *BBC News*, February 24, 2010, accessed November 21, 2010, http://news.bbc.co.uk/2/hi/8533695.stm. The video had originally been posted by the boys themselves and Google removed the video when Italy's Interior Ministry requested its removal.J. R. Raphael, "Italy's Google Convictions Set a Dangerous Precedent," *PCWorld*, February 24, 2010, accessed November 21, 2010, http://www.pcworld.com/article/190191/italys_google_convictions_set_a_dangerous_precedent.html. The three Google executives were absolved of the defamation charges but convicted of privacy violations. Colleen Barry, "Three Google Employees Convicted in Italian Court of Privacy Violations," *Associated Press*, February 24, 2010, accessed November 21, 2010, www.cleveland.com/world/index.ssf/2010/02/three_google_employees_convict.html. Google said that the conviction of its top Italian managers "attacks the 'principles of freedom' of the Internet and poses a serious threat to the web."Paul McNamara, "Conviction of Google Execs in Italy Sheer Madness," *PCWorld*, February 24, 2010, accessed April 5, 2010, http://www.pcworld.com/article/190125/conviction_of_google_execs_in_italy_sheer_madness.html. Following the conviction, several privacy advocates stepped up to speak out in Google's defense—a position quite contrary to their typical stances in Google privacy stories.Jaikumar Vijayan, "Conviction of Google Execs Alarms Privacy Advocates," *PCWorld*, February 24, 2010, accessed April 5, 2010, http://www.pcworld.com/article/190175/conviction_of_google_execs_alarms_privacy_advocates.html.

KEY TAKEAWAYS

- Beyond yourself, as an international business student and future international business person, you can identify the people and organizations that might have an interest in international business if their interests are affected now or in the future by it. Such international business stakeholders include employees, managers, businesses, governments, and nongovernmental organizations.
- Stakeholder analysis is a technique used to identify and assess the importance of key people, groups of people, or institutions that may significantly influence the success of an activity, project, or business.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What is a stakeholder?
2. Why is stakeholder analysis important in international business?

1.4: Global Competition's Changing Center of Gravity

The rapid emergence of a number of emerging economies—notably the so-called BRIC countries (Brazil, Russia, India, China, and South Africa)—is the latest development shaping the global competitive environment. These economies are experiencing rates of growth in gross domestic product (GDP), trade, and disposable income that are unprecedented in the developed world. The sheer size of the consumer markets now opening up in emerging economies, especially in India and China, and their rapid growth rates will shift the balance of business activity far more than did the earlier rise of less populous economies such as Japan and South Korea and their handful of "new champions" that seemed to threaten the old order at the time. China is predicted to overtake the U.S. economy by the end of the 2020s, potentially followed by India in the mid-21st century (Statista (2021) https://www.statista.com/statistics/...ric-countries/).

> "Since the beginning of the 21st century, the BRICS countries have been considered the five foremost developing economies in the world. Originally, the term BRIC was used by economists when talking about the emerging economies of Brazil, Russia, India, and China, however these countries have held annual summits since 2009, and the group has expanded to include South Africa since 2010. China has the largest GDP of the BRICS country, at 16.86 trillion U.S. dollars in 2021, while the others are all below three trillion. Combined, the BRICS bloc has a GDP over 23.5 trillion U.S. dollars in 2021, which is slightly more than the United States."
>
> -Statista (2021): https://www.statista.com/statistics/...ric-countries/

This shift in the balance of business activity has redefined global opportunity. For the last 50 years, the globalization of business has primarily been interpreted as the expansion of trade from developed to emerging economies. Today's rapid rise of emerging economies means this view is no longer tenable—business now flows in both directions and increasingly from one developing economy to another. Or, as the authors of "Globality," consultants at the Boston Consulting Group (BCG), put it, business these days is all about "competing with everyone from everywhere for everything."Sirkin, Hemerling, and Bhattacharya (2008).

The evidence that this latest shift in the global competitive landscape will have seismic proportions is already formidable. Consider, for example, the growing number of companies from emerging markets that appear in the *Fortune* 500 rankings of the world's biggest firms. In 2011 there were 62, mostly from the BRIC economies, up from 31 in 2003, and in 2017 rose to 164, 137 of which are from BRIC countries (A general theory of springboard MNEs - Scientific Figure on ResearchGate. Available from: https://www.researchgate.net/figure/...fig1_320339877 [December 2021]).

Look also at the recent sharp increase in the number of emerging-market companies acquiring established rich-world businesses and brands, proof that "globalization" is no longer just another word for "Americanization." For instance, Budweiser, the maker of America's favorite beer, was bought by a Belgian-Brazilian conglomerate. And several of America's leading financial institutions avoided bankruptcy in 2008 only by being bailed out by the sovereign-wealth funds (state-owned investment funds) of various Arab kingdoms and the Chinese government.

Another prominent example of this seismic shift in global business is provided by Lenovo, the Chinese computer maker. It became a global brand in 2005, when it paid around $1.75 billion for the personal-computer business of one of America's best-known companies, IBM, including the ThinkPad laptop range. Lenovo had the right to use the IBM brand for 5 years, but dropped it 2 years ahead of schedule, such was its confidence in its own brand. It squeezed into 499th place in the *Fortune* 500 in 2011, and in 2021 sits at 159 with worldwide revenues of $60.7 billion in 2021 and growth prospects many Western companies envy.

The conclusion is that this new phase of "globality" is creating huge opportunities—as well as threats—for developed-world multinationals and new champions from developing countries alike.

1.5: What Forms Do International Businesses Take?

> **Learning Objectives**
>
> 1. Know the possible forms that international businesses can take.
> 2. Understand the differences between exporting, importing, and foreign direct investment.
> 3. See how governments and nongovernmental organizations can be international businesses.

The Forms of International Business

It probably doesn't surprise you that international businesses can take on a variety of forms. Recognizing that international business, based on our broad definition, spans business, government, and nongovernmental organizations (NGOs), let's start by looking at business.

A **business** can be a person or organization engaged in commerce with the aim of achieving a profit. Business profit is typically gauged in financial and economic terms. However, some level of sustained financial and economic profits are needed for a business to achieve other sustainable outcomes measured as social or environmental performance. For example, many companies that are for-profit businesses also have a social and environmental mission. Table 1.1 provides an example of a company with this kind of mission.

Table 1.1 Sample Three-Part Mission Statement

Social and Environmental Mission	Product Mission	Economic Mission
Part of being a responsible company is working hard to help solve the world's environmental problems and, importantly, also helping those who buy our products to make more responsible choices."Investing in People, Investing for the Planet," SC Johnson, accessed November 21, 2010, http://www.scjohnson.com/en/commitment/report/CEO-Letter.aspx.	To make, distribute, and sell the finest quality products with a continued commitment to promoting business practices that respect the Earth and the environment."Ben & Jerry's," Unilever, accessed November 21, 2010, www.unileverusa.com/brands/foodbrands/benandjerrys.	To create long-term value and capture the greatest opportunity for our stakeholders by delivering sustainable, profitable growth in sales, earnings, and cash flow in a global company built on pride, integrity, and respect."Our Business Purpose," Amtrak, accessed November 21, 2010, www.aramark.com/AboutARAMARK/BusinessPurpose.

On the one hand, while companies such as Ben & Jerry's (part of Unilever) and SC Johnson are very large, it's hard to imagine any business—small or large—that doesn't have international operating concerns. On the other hand, the *international* part of a firm's business can vary considerably, from importing to exporting to having significant operations outside its home country. An **importer** sells products and services that are sourced from other countries; an **exporter**, in contrast, sells products and services in foreign countries that are sourced from its home country. Beyond importing and exporting, some organizations maintain offices in other countries; this forms the basis for their level of **foreign direct investment**. Foreign direct investment means that a firm is investing assets directly into a foreign country's buildings, equipment, or organizations. In some cases, these foreign offices are carbon copies of the parent firm; that is, they have all the value creation and support activities, just in a different country. In other cases, the foreign operations are focused on a small subset of activities tailored to the local market, or those that the entity supplies for operations every place in which the firm operates.

When a firm makes choices about foreign operations that increase national and local responsiveness, the organization is more able to adapt to national and local market conditions. In contrast, the greater the level of standardization—both within and across markets—the greater the possible level of global efficiency. In many cases, the choice of foreign location generates unique advantages, referred to as **location advantages**. Location advantages include better access to raw materials, less costly labor, key suppliers, key customers, energy, and natural resources. For instance, Google locates its computer-server farms—the technological backbone of its massive Internet services—close to dams that produce hydroelectric power because it's one of the cheapest sources of electricity.Stephanie N. Mehta, "Behold the Server Farm! Glorious Temple of the Information Age!," *Fortune*, August 1, 2006, accessed April 27, 2010, http://money.cnn.com/magazines/fortune/fortune_archive/2006/08/07/8382587/index.htm. Ultimately, managerial choices regarding the trade-off between *global efficiency* and *local responsiveness* are a function of the firm's strategy and are likely to be significant determinant of firm performance.

International Forms of Government

Governmental bodies also take on different international forms. Among political scientists, **government** is generally considered to be the body of people that sets and administers public policy and exercises executive, political, and sovereign power through customs, institutions, and laws within a state, country, or other political unit. Or more simply, government is the organization, or agency, through which a political unit exercises its authority, controls and administers public policy, and directs and controls the actions of its members or subjects.

Most national governments, for instance, maintain embassies and consulates in foreign countries. National governments also participate in international treaties related to such issues as trade, the environment, or child labor. For example, the North American Free Trade Agreement (NAFTA) is an agreement signed by the governments of the United States, Canada, and Mexico to create a trade bloc in North America to reduce or eliminate tariffs among the member countries and thus facilitate trade. The Kyoto Protocol is an agreement aimed at combating global warming among participating countries. In some cases, such as with the European Community (EC), agreements span trade, the environment, labor, and many other subjects related to business, social, and environmental issues. The Atlanta Agreement, in turn, is an agreement between participating governments and companies to eliminate child labor in the production of soccer balls in Pakistan.“Atlanta Agreement,” Independent Monitoring Association for Child Labor, accessed November 12, 2010, http://www.imacpak.org/atlanta.htm. Finally, supraorganizations such as the United Nations (UN) or the World Trade Organization (WTO) are practically separate governments themselves, with certain powers over all member countries.United Nations website, accessed January 20, 2010, www.un.org; World Trade Organization website, accessed January 20, 2010, http://www.wto.org.

Nongovernmental Organizations

National **nongovernmental organizations (NGOs)** include any nonprofit, voluntary citizens’ groups that are organized on a local, national, or international level. International NGOs (NGOs whose operations cross borders) date back to at least 1839.Steve Charnovitz, “Two Centuries of Participation: NGOs and International Governance,” *Michigan Journal of International Law* 18, no. 183 (Winter 1997): 183–286. For example, Rotary International was founded in 1905. It has been estimated that, by 1914, there were 1,083 NGOs.Oliver P. Richmond and Henry F. Carey, eds., *Subcontracting Peace: The Challenges of NGO Peacebuilding* (Burlington, VT: Ashgate, 2005), 21; United Nations, “Chapter X: The Economic and Social Council,” *Charter of the United Nations*, accessed April 28, 2010, www.un.org/en/documents/charter/chapter10.shtml. International NGOs were important in the antislavery movement and the movement for women’s suffrage, but the phrase “nongovernmental organization” didn’t enter the common lexicon until 1945, when the UN was established along with the provisions in Article 71 of Chapter 10 of the UN charter,United Nations, “Chapter X: The Economic and Social Council,” *Charter of the United Nations*, accessed April 28, 2010, www.un.org/en/documents/charter/chapter10.shtml., which granted a consultative role to organizations that are neither governments nor member states.

During the twentieth century, globalization actually fostered the development of NGOs because many problems couldn’t be solved within a single nation. In addition, international treaties and organizations, such as the WTO, were perceived by human rights activists as being too centered on the interests of business. Some argued that in an attempt to counterbalance this trend, NGOs were formed to emphasize humanitarian issues, developmental aid, and sustainable development. A prominent example of this is the World Social Forum—a rival convention to the World Economic Forum held every January in Davos, Switzerland.

KEY TAKEAWAYS

- International businesses take on a variety of forms. Importers sell goods and services obtained from other countries, while exporters sell goods and services from their home country abroad.
- Firms can also make choices about the extent and structure of their foreign direct investments, from simply an array of satellite sales offices to integrated production, sales, and distribution centers in foreign countries.
- Government and nongovernmental organizations also comprise international business.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What is the difference between an exporter and an importer?
2. What is a location advantage?
3. How is government considered an international business?

1.6: Globalization Pressures on Companies

Gupta, Govindarajan, and Wang identify five "imperatives" that drive companies to become more global: *to pursue growth, efficiency, and knowledge; to better meet customer needs; and to preempt or counter competition*. (Gupta, Govindarajan, and Wang (2008), p. 28).

Growth

In many industries, markets in the developed countries are maturing at a rapid rate, limiting the rate of growth. Consider household appliances: in the developed part of the world, most households have, or have access to, appliances such as stoves, ovens, washing machines, dryers, and refrigerators. Industry growth is therefore largely determined by population growth and product replacement. In developing markets, in contrast, household penetration rates for major appliances are still low compared to Western standards, thereby offering significant growth opportunities for manufacturers.

Efficiency

A global presence automatically expands a company's scale of operations, giving it larger revenues and a larger asset base. A larger scale can help create a competitive advantage if a company undertakes the tough actions needed to convert scale into economies of scale by (a) spreading fixed costs, (b) reducing capital and operating costs, (c) pooling purchasing power, and (d) creating critical mass in a significant portion of the value chain. Whereas economies of scale primarily refer to efficiencies associated with supply-side changes, such as increasing or decreasing the scale of production, economies of scope refer to efficiencies typically associated with demand-side changes, such as increasing or decreasing the scope of marketing and distribution by entering new markets or regions or by increasing the range of products and services offered. The economic value of global scope can be substantial when serving global customers through providing coordinated services and the ability to leverage a company's expanded market power.

Knowledge

Foreign operations can be reservoirs of knowledge. Some locally created knowledge is relevant across multiple countries, and, if leveraged effectively, can yield significant strategic benefits to a global enterprise, such as (a) faster product and process innovation, (b) lower cost of innovation, and (c) reduced risk of competitive preemption. For example, Fiat developed Palio—its global car—in Brazil; Texas Instruments uses a collaborative process between Indian and U.S. engineers to design its most advanced chips; and Procter & Gamble's liquid Tide was developed as a joint effort by U.S. employees (who had the technology to suspend dirt in water), the Japanese subsidiary (who had the cleaning agents), and the Brussels operations (who had the agents that fight mineral salts found in hard water). Most companies tap only a fraction of the full potential in realizing the economic value inherent in transferring and leveraging knowledge across borders. Significant geographic, cultural, and linguistic distances often separate subsidiaries. The challenge is creating systematic and routine mechanisms that will uncover opportunities for knowledge transfer.

Customer Needs and Preferences

When customers start to globalize, a firm has little choice but to follow and adapt its business model to accommodate them. Multinationals such as Coca-Cola, GE, and DuPont increasingly insist that their suppliers—from raw material suppliers to advertising agencies to personnel recruitment companies—become more global in their approach and be prepared to serve them whenever and wherever required. Individuals are no different—global travelers insist on consistent worldwide service from airlines, hotel chains, credit card companies, television news, and others.

Competition

Just as the globalization of customers compels companies to consider globalizing their business model, so does the globalization of one or more major competitors. A competitor who globalizes early may have a first-mover advantage in emerging markets, greater opportunity to create economies of scale and scope, and an ability to cross-subsidize competitive battles, thereby posing a greater threat in the home market. The global beer market provides a good example of these forces at work. Over the past decade, the beer industry has witnessed significant consolidation, and this trend continued during 2008. On a pro forma basis, beer sales by the top 10 players now total approximately 65% of total global sales, compared to less than 40% at the start of the century. In recent major developments, the division of Scottish and Newcastle's business between Carlsberg and Heineken was completed during the first half of 2008, while InBev acquired Anheuser-Busch in November 2008. SABMiller and Molson Coors combined their operations in the United States and Puerto Rico on July 1, 2008, to form the new MillerCoors brewing joint venture.

Minicase: Chocolatiers Look to Asia for Growth (Fishbein (2008, January 17))

Humans first cultivated a taste for chocolate 3,000 years ago, but for India and China this is a more recent phenomenon. Compared to the sweet-toothed Swiss and Brits, both of whom devour about 24 lbs (11 kg) of chocolate per capita annually, Indians consume a paltry 5.8 oz and the Chinese, a mere 3.5 oz (165 g and 99 g, respectively).

Western chocolate makers hungry for growth markets are banking on this to change. According to market researcher Euromonitor International, in the past 5 years, the value of chocolate confectionery sales in China has nearly doubled, to $813.1 million, while sales in India have increased 64%, to $393.8 million. That is a pittance compared to the nearly $35-billion European chocolate market. But while European chocolate sales are growing a mere 1% to 2% annually, sales in the two Asian nations show no sign of slowing.

European chocolatiers are already making their mark in China. The most aggressive is Swiss food giant Nestlé, which has more than doubled its Chinese sales since 2001 to an estimated $91.5 million—still a relatively small amount. It is closing in on Mars, the longtime market leader, whose sales rose 40% during the same period to $96.7 million.

Green Tea Kisses

Nestlé’s Kit Kat bar and other wafer-type chocolates are a big hit with the Chinese, helping the Swiss company swipe market share from Mars. Italy’s Ferrero is another up-and-comer. It has boosted China sales nearly 79% since 2001, to $55.6 million, drawing younger consumers with its Kinder chocolate line, while targeting big spenders with the upscale Ferrero Rocher brand. Indeed, its products are so popular that they have spawned Chinese knockoffs, including a Ferrero Rocher look-alike made by a Chinese company that Ferrero has sued for alleged counterfeiting. Despite those problems, the privately owned Ferrero has steadily gained market share against third-ranked Cadbury Schweppes, whose China sales have risen a modest 26% since 2001, to $58.6 million.

Until now, U.S.-based Hershey has been a relatively small player in China. But the company has adopted ambitious expansion plans, including hooking up with a local partner to step up its distribution and introducing green-tea-flavored Hershey Kisses to appeal to Asian tastes.

Attractively Packaged

Underscoring China’s growing importance, Switzerland’s Barry Callebaut, a big chocolate producer that supplies many leading confectioners, opened a factory near Shanghai to alleviate pressure at a Singapore facility that had been operating at capacity. The company also inaugurated a nearby Chocolate Academy, just 1 month after opening a similar facility in Mumbai, to train local confectioners and pastry chefs in using chocolate.

Unlike China’s chocolate market, India’s is dominated by only two companies: Cadbury, which entered the country 60 years ago and has nearly 60% market share, and Nestlé, which has about 32% market share. The two have prospered by luring consumers with attractively packaged chocolate assortments to replace the traditional dried fruits and sugar confectioneries offered as gifts on Indian holidays, and by offering lower-priced chocolates, including bite-sized candies costing less than 3 cents.

The confectionary companies have been less successful, though, at developing new products adapted to the Indian sweet tooth. In 2005, Nestlé launched a coconut-flavored Munch bar, and Cadbury introduced a dessert called Kalakand Crème, based on a popular local sweet made of chopped nuts and cheese. Both sold poorly and were discontinued.

1.7: Corporations and their Social Responsibility

Understanding Corporations and CSR

C*orporate social responsibility* (CSR) is a broad term that refers generally to the ethical role of the corporation in society. Before we define CSR more precisely and before we explore in depth a number of case studies that illustrate aspects of the ethical role of corporations, we first need to understand exactly what corporations are, why they exist, and why they have become so powerful.

Today, the global role of corporations rivals that of national or local governments. In 2000, it was reported that, of the 100 largest economic organizations in the world, 51 were corporations and 49 were countries.[1] General Motors, Walmart, Exxon, and Daimler Chrysler all ranked higher than the nations of Poland, Norway, Finland and Thailand (in terms of economic size, comparing corporate revenues with national gross domestic product, or GDP). This trend has continued, and for the past decade, 68 - 79 of the world's 100 largest economic organizations have been corporations, with the rest being national economies; 157 of the top 200 have been corporate entities (globaljustice.org).

For corporate employees, as for citizens living in communities dominated by large corporations, the corporation is arguably the most important form of social organization. For people such as corporate executives and shareholders, whose lives depend directly on corporations, it is not surprising that company politics often are considered more relevant than national or local politics. Corporations are also a major part of the daily lives of the world's citizens and consumers. For devoted fans of iconic brands like Nike, Apple, Mercedes, or Louis Vuitton, the corporation can occupy a psychological niche very much like that of a member of the family. Indeed, if many teenagers today were forced to choose between an iPhone and a memorable night out celebrating their parents' anniversary, the parents would likely celebrate alone. Similarly, those parents might also be loath to part with their cherished products. Dad would not easily say goodbye to his Chevrolet Corvette or Bose stereo, and Mom might not be easily persuaded to part with her Yamaha piano or Rossignol skis.

At the opposite extreme, for citizens who have been harmed physically or financially by corporations—like the Louisiana or Alaska residents whose beaches were fouled by massive oil spills, or the thousands of small investors who found their life savings wiped out by the Ponzi schemes of Bernie Madoff's investment company—the corporation can seem as dangerous as an invading army, or as destructive as an earthquake.

Despite their vast social role, corporations remain poorly understood by the world's citizens. While school children everywhere are expected to study the structure and history of their nation's government, they are not similarly taught to appreciate the functions, motivations, and inner workings of corporations. Let us begin with a brief review of the nature of corporations.

BP oil rig explosion, photo by United States Coast Guard (2010, public domain). Figure 1.1 The 2010 explosion of a British Petroleum (BP) oil rig off the coast of Louisiana, the cause of the worst environmental disaster in U.S. history.

Why Do Corporations Exist?

There were no corporations in ancient Egypt, Greece, or Rome; or in imperial China or Japan; or among the precolonial kingdoms of the Zulu or Ashanti. The Aztecs and Incas had no corporations, nor did the Sioux, Cherokee, or Navajo. It is true that in some classical and traditional societies there were certain forms of communal and religious organizations that anticipated the organizational capacities of corporations, but strictly speaking, they were not corporations.

Corporations are a relatively modern social innovation, with the first great corporations dating from about 1600. Since then, the growth of corporations has been phenomenal. What explains it? Why has the corporate structure been so successful, profitable, and powerful? Here are a few of the distinguishing characteristics of corporations.

Corporations are Creatures of Law

The first point to make about corporations is that they are not informal organizations or assemblies. In order to exist at all, corporations must be authorized by state or national laws. In their daily operations, corporations are regulated by a specific set of laws. Every country has laws that stipulate how corporations can be created; how they must be managed; how they are taxed; how their ownership can be bought, sold, or transferred; and how they must treat their employees. Consequently, most large corporations have large legal and government affairs departments. Since the laws and rules that may constrain corporations are written and enforced by the government, most corporations consider it of vital importance to seek influence over governmental regulators and lawmakers. In most countries, the very largest corporations have privileged access to top decision makers. The extent and reach of corporate influence over governments is one of the most controversial aspects of corporate existence.

Corporations Raise Capital for Major Undertakings

The first great benefit of corporations is that they provide an organized vehicle for pooling cash and capital from a large number of investors so that they can undertake major enterprises. Thus, one great stimulus to the growth of corporations was the rapid growth of international trade between 1400 and 1700 CE. In that era, sending a large vessel across the oceans was a major financial and logistical undertaking, which was also extremely risky; ships were often lost in storms. These early commercial ventures required such large capital investments that, at first, funding them was only within the reach of royalty. American schoolchildren are taught that the legendary explorer Christopher Columbus needed the royal patronage of Queen Isabella of Spain to support the voyages that led to the “discovery” of the New World. However, as new ocean trading routes were established and the vast potential for profits from trading spices became known, the first modern corporations were formed: the English East India Company, chartered in 1600, and its archrival, the Dutch East India Company, chartered in 1602. These companies are considered the world’s first multinational corporations, and they possessed most of the hallmarks of corporate structure that we see today.

Corporations and Other Business Structures

Not all businesses or companies are public corporations. For example, in the US, it is legal to operate a business in your own name (this is called a *sole proprietorship*) or with partners (a *partnership*). Corporations also come in a bewildering array of forms. Thus, in the US, we have *C corporations*, *S corporations*, *benefit corporations* (also *B corporations*), and *limited liability companies* (LLCs). In the UK, the term *company* is preferred to corporation, and we will notice that the names of most large UK companies followed by the designation *plc* or *PLC* (public limited company), as in Rolls-Royce plc, while smaller companies often have the designation *Ltd* (private limited company). In France, large companies are usually designated *SA* (société anonyme), while smaller ones may be known as *SARL* (sociétéà responsabilité limité). In Germany, large companies are designated *AG* (Aktiengesellschaft), while smaller ones are known as *GmbH* (Gesellschaft mit beschränkter Haftung). In Japan, the corresponding terms are *KK* (kabushiki kaisha) and *YK* (yūgen kaisha).

All of these terms define two basic aspects of corporations: 1) their limited liability (which applies to all corporations), and 2) their status as a *public* or *private* company. Public companies are allowed to sell their shares on public stock markets and tend to be the larger type of company.

The Importance of Limited Liability

Why aren’t all businesses sole proprietorships or partnerships, instead of corporations? The answer is found in the concept of *liability*, which refers to the risk of loss for debts incurred by the business, or for damages caused by the business.

If you start a business as a sole proprietor or via a partnership, you (and/or your partners) are *personally liable* for any debts or damage that can be attributed to the particular business. Let us say that you have $1 million in assets and your good friend has $2 million in assets. Together, you agree to invest $250,000 each in a pizza delivery business (the business will start with $500,000 worth of capital). Unfortunately, in the first month of operation, one of your drivers negligently causes a car accident and severely injures a family driving in another car. The family sues you for their injuries and they obtain a court judgment ordering you to pay $3 million in compensation. Even though you had intended to invest only $250,000 in the business, now your entire fortune and that of your friend are likely to be wiped out in satisfying that court judgment. The same sort of result could arise if your business ran up $3 million in debt that it was unable to pay back. Thus, the founder of a sole proprietorship exposes his/her entire personal assets to the risk that the assets will be seized to satisfy liabilities incurred by the business.

The result can be quite different for a corporation. One of the principal advantages of a corporation, from an investor's point of view, is that the corporation provides a legal a "shield" from liability. A shareholder of a corporation only risks the stock that the shareholder owns. The shareholder's personal assets are not in jeopardy. When a corporation suffers an adverse legal judgment and does not have sufficient funds to satisfy the judgment, the corporation simply goes bankrupt. The party or parties who have been injured cannot sue the owners—the shareholders—of the corporation because the corporation acts as a shield from liability.

Why does society allow the shareholders of a corporation to retreat behind the corporate shield, while we do not allow the same for owners of a so-called mom-and-pop business in the form of a sole proprietorship? The main purpose of the liability-shield is to encourage investment in corporations. People are more willing to invest in a corporation (by acquiring stock) because they need not fear that their personal assets can be seized to satisfy the business's debts or liabilities. The underlying implication is that corporations and corporate investment provide important benefits for society, which explains why governments have been willing to adopt laws that protect and encourage corporate ownership. As many U.S. states learned in the nineteenth century, it can make sound economic sense to attract large corporations because they often become major employers and taxpayers. Corporations may enhance the ability of the local economy to compete with foreign economies that are supported by the productivity of their own corporations.

In many instances the ability of corporations to retreat behind the corporate shield has been controversial. For example, several major airlines (notably American Airlines) have been accused of choosing to declare bankruptcy over finding a way to pay high wages to their pilots and cabin personnel.[3] The airlines were attacked by labor unions as having used the bankruptcy as a tactic to avoid meeting the union's demands for fair wages. Such corporations are able to benefit from an option provided by US bankruptcy law, known as *Chapter 11 reorganization*, which allows them to enter bankruptcy temporarily. The courts appoint a trustee to run the corporation, and the trustee is empowered to take any actions necessary to reduce the corporation's debts, including revoking labor agreements with employees. Such corporations can later "emerge" from bankruptcy with fewer employees or with employees earning lower salaries.

Corporations Permit Wealth Creation and Speculation in Stocks

While all corporations possess limited liability, not all of them are permitted to raise money in the stock market or have their shares traded in stock markets. Here, we find the important distinction between *public corporations,* which may have their shares traded on stock markets, and *private corporations*, which may not have their shares traded on stock markets.

As a rule, large corporations and multinational corporations choose to do business as public corporations because big companies have such enormous capital needs that they may best raise funds by placing stock for sale in public stock markets. However, this is not always the case; there are some very large corporations that choose to remain private, which means that they raise money directly from investors rather than from making stock available on stock markets.

On the whole, ownership of a corporate interest in the form of stocks is more freely and easily transferable than ownership of an interest in a sole proprietorship or partnership. If you want to sell a mom-and-pop store, you generally have to sell the whole business; you cannot sell a small portion when you need to raise money.

If you are one of the members of a partnership and you want to sell your share, you will generally have to get prior approval from the other partners; needing to do so may discourage possible investors because they may not want to go to the trouble of seeking approval from your partners. However, if you inherit a thousand shares of stock in Apple from your wealthy aunt, and you find that you need extra money, you can sell one hundred shares. Such a transaction is easy because there are lots of investors eager to own Apple shares and you do not need anyone's approval. This ease of transferability also encourages people to invest in stock instead of in other businesses, because it is so easy to sell corporate stock as needed.

When a corporation grows and/or becomes more profitable, the shareholders benefit financially in two ways. First, the corporation will often distribute a portion of its profits to the shareholders in the form of *dividends,* a certain annual payment per share of stock. Second, if a corporation is growing rapidly and is expected to be very profitable in the future, more investors will want to own its stock and the price of that stock will increase. Thus, ownership of stock is an investment vehicle that provides many advantages over other types of investments. For one thing, you can own stock without having to personally take part in the management of the company. In addition, you can sell all or part of your ownership when you need the funds. Finally, if the corporation is very successful, it will not only pay a steady revenue stream—through dividends—but your shares will become more valuable over time.

The advantages of stock ownership as an investment vehicle explains the growth of the world's great stock exchanges, such as the New York Stock Exchange or the Hong Kong Stock Exchange. Stock exchanges are like enormous flea markets for stock, because you can either buy or sell stock there. Unlike the goods available in ordinary markets, though, the price of stocks fluctuates constantly, literally minute by minute. A stock that was worth $10 last year may now be worth as much as $1000 or as little as $0.10. Thus, stock markets are also somewhat like casinos or lotteries, because they allow investors to speculate on the future.

Speculation has its pros and cons. The potential for wealth creation through stock ownership has spawned an important industry that employs hundreds of thousands of people and generates vast profits: financial services. Stock brokerages, investment banks, and trading houses have arisen to provide expert guidance and services to investors.

American colleges and universities have developed a highly collaborative and perhaps even symbiotic relationship with the financial services industry. For one thing, since there are many jobs and professional occupations in financial services, virtually all universities offer courses and majors in finance or financial economics, and many also have graduate business schools that prepare students for careers in the financial services industry.

Perhaps equally importantly, most colleges and universities depend on private and charitable donations to help defray the cost of running the institution and, consequently, to keep tuition rates and fees lower (although many students will find it hard to imagine how tuition could be any higher). When wealthy individuals and corporations make donations or charitable contributions to colleges and universities, they often do so by giving corporate stock. Even when they make a cash donation, the university may find that it is most financially convenient to use that cash to acquire corporate stock. As a result, the largest universities have amassed vast holdings of corporate stock, among other investments. The financial resources of a university are often held in the form of a special trust known as an *endowment*. Universities prefer not to sell off parts of the endowment but rather seek to cover costs by using the interest and dividends generated by the endowment.

At times, the corporate holdings of universities have become quite controversial. For example, in the 1970s and 1980s, a growing student movement called on universities to *divest* (to sell all their stock) in any corporations that did business with the racist apartheid regime that controlled South Africa at that time. Many commentators believe that it was this pressure on corporations that led to the fall of the apartheid regime and the election of South Africa's first black president, Nelson Mandela.

Corporations Can Have Perpetual Existence

It is possible but rare for family-owned businesses to remain sole proprietorships for several generations; more commonly, they eventually become corporations, or they are sold or transferred to a new business operator. Very often, a small business is sold when the founder dies, because the founder's children or heirs either do not want to work in the family business or are not as gifted in that business as was the founder. Even in successful, family-owned businesses where a child or relative of the founder inherits the business, it still happens that after a generation or two, no further family members are qualified (or wish) to join the business, and the business must be sold.

However, corporations are structured from the outset to have a potentially perpetual existence, because corporations do business through their officers and executives rather than through their owners. Although it is possible for owners to have dual roles as shareholders and as executives, it is not necessary. One common scenario is for the founder of the corporation to act as its chief executive officer (CEO) until such time as the corporation becomes so large and successful that the shareholders prefer to transfer management responsibility to an executive with specific professional experience in running a large corporation.

Disadvantages of the Corporate Form

Separation of Ownership and Management Functions

One potential disadvantage of the corporate form (from the point of view of its founders) is that, as the corporation grows, the original founders may lose control and even be pushed out of the corporation by newcomers. This happened to Steve Jobs, the legendary cofounder of Apple, who was pushed out of his leadership role in 1985 by Apple's board of directors, only to return in the mid-1990s and retake his role as CEO. In 2013, George Zimmer, the founder of the apparel retailer Men's Wearhouse, was terminated as chairman of the board by his own board of directors. This situation can arise because, as a company grows, the founders may be tempted to part with some portion of their equity by selling stock to new investors. Corporations are ultimately controlled by the board of directors, who are voted into office by the shareholders. If a founder allows his or her share of corporate stock to drop beneath 50%, then the founder will no longer be able to elect a majority of the board of directors, and may become subject to termination as an officer by the board. The board of directors is thus a sort of committee that controls the fate of the corporation, and it does this principally by choosing a CEO and supervising the CEO's performance.

Dual Taxation

Although the tremendous growth in the number and size of corporations, and their ever-increasing social role, is due in part to their advantages as an investment vehicle, there are some financial disadvantages worth mentioning. One of the most important is so-called dual taxation, which refers to the practice in most countries of taxing corporate profits twice: once when the corporation declares a certain amount of profit, and again when the corporation distributes dividends to shareholders. The complexity of corporate tax regulations is such that even small corporations must frequently employ specialized accountants and attorneys to handle their tax returns.

Quarterly Financial Reporting for Publicly Traded Corporations

Another disadvantage applies only to publicly traded corporations. Although all corporations are subject to a number of government regulations, the highest degree of regulation applies to public corporations, which raise capital by selling stock in stock markets. Large corporations are often willing to submit to these burdensome regulations because there are strong benefits to being traded on a stock exchange, the most important of which is the ability to raise a great deal of initial funding when the stock is first made available for trade. This first public sale of stock is known in the US an *initial public offering* or *IPO*. In two famous recent examples, Google raised $1.67 billion with its IPO in 2004, and Facebook raised $18 billion with its IPO in 2012.

Source: Toms Shoes, photo by Vivianna Love (CC BY 2.0, 2009) Figure 1.2 A well-worn pair of Toms Shoes; Toms gives away free shoes to a poor child for every pair it sells.

Despite the allure of additional financing, a company that is traded on a stock market must make a great deal of financial information publicly available, usually on a quarterly basis, four times per year. This obligation can be quite onerous because it requires the corporation to employ a number of internal accountants as well as outside auditors. In addition, the information that is publicly revealed can be of strategic value to the corporation's competitors. Moreover, the need to make frequent quarterly reports on the company's ongoing profitability can have a negative impact on corporate strategy, because executives may become fixated on short-term goals while neglecting long-term goals. In light of these disadvantages, it is not surprising that some public corporations decide to take their shares off the stock markets in a process that is known as *going private*, which is the opposite of an IPO. Other corporations simply avoid going public in the first place. Thus, there are also some very large corporations, such as the multi–billion-dollar engineering firm Bechtel, which prefer to remain private even though they could raise investment capital with an IPO. Such companies prefer to raise capital by other means to avoid the requirements of quarterly earnings reports and therefore not revealing financial information to competitors.

Corporate Social Responsibility

It is important to realize that CSR is an evolving concept that can be analyzed from multiple perspectives. The term *CSR* may be used quite differently depending on whether a given speaker is looking at it from the point of view of a corporation, a government, a charity sponsored by the corporation, a citizen employed by the corporation, a citizen who has been harmed by the corporation, or an activist group protesting abuses of corporate power. Let us review key concepts and terms related to CSR, starting with CSR itself.

CSR: Definition

We define CSR simply and broadly as the ethical role of the corporation in society. Corporations themselves often use this term in a narrower, and less neutral, form. When corporations have a director of CSR or a committee in charge of CSR, or when they mention CSR prominently in their mission statements, they are invariably using the term to mean "corporate actions and policies that have a positive impact on society." Corporations refer most frequently to CSR when they speak of civic organizations they support, or to corporate environmental or social policies.

One related term here is corporate "compliance." Not only are large corporations subjected to a host of governmental regulations, many of which have social objectives (such as avoidance of discrimination, corruption, or environmental damage), but many corporations also have set up internal guidelines. In order to make sure that a corporation respects or complies with all these laws, regulations, and norms, both internal and external, corporations increasingly employ "compliance" officers or executives. For example, large fashion and apparel companies frequently place a specific executive in charge of "human rights compliance," to ensure that its clothing was manufactured in safe factories that respect labor laws and do not employ children.

Corporate Philanthropy

Corporate philanthropy refers to a corporation's gifts to charitable organizations. There is an implication that the corporation's donations have no strings attached, which is probably quite rare. At a minimum, most corporations expect that their donations will be publicly attributed to the corporation, thus generating positive public relations. When corporations make large cash gifts to universities or museums, they are usually rewarded with a plaque, or with a building or library named after the donor. Such attributions burnish the corporation's public image, and in such cases we are not dealing with true corporate philanthropy, strictly speaking, but something more in the nature of marketing or public relations.

Stakeholder Capitalism

Stakeholder capitalism refers to a conception of the corporation as a body that owes a duty not only to its *shareholders* (the predominant American view) but also to all of its *stakeholders*, defined as all those parties who have a stake in the performance and output of the corporation. Stakeholders include the company's employees, unions, suppliers, customers, local and national governments, and communities that may be affected by corporate activities such as construction, manufacturing, and pollution. Stakeholder capitalism is a concept that was largely developed in Europe and reflects the widespread European attitude toward corporate governance, which accepts a great degree of government and social oversight of the corporation. The American approach is often described, in contrast, as *laissez-faire* (meaning "leave alone"), in that corporations are granted more freedom of operation than in Europe. One example of a stakeholder approach is in the German practice known as *codetermination*, in which corporations are required to provide a seat on the corporation's board of directors for a union representative. This is intended to oblige the corporation to be more cognizant of worker needs and demands, and to ensure that corporate strategies are not concealed from workers.

Cause-Related Marketing

Cause-related marketing (CRM) refers to a corporation's associating the sales of its products to a program of donations or support for a charitable or civic organization. An example is provided by the famous Red campaign, in which corporations such as Gap pledged to contribute profits from the sale of certain red-colored products to a program for African development and alleviation of AIDS-related social problems. The basic idea of cause-related marketing is that the corporation markets its brand at the same time that it promotes awareness of the given social problem or civic organization that addresses the social problem. Another well-known example is the pink ribbon symbol that promotes breast-cancer awareness and is used prominently in the marketing of special lines of products by many corporations, such as Estée Lauder, Avon, New Balance and Self Magazine. In addition to marketing products with the pink-ribbon symbol, Estee Lauder has made support for breast cancer awareness one of the defining features of its corporate philanthropy. Thus, Estee Lauder also frequently refers to such charitable contributions, currently on the order of $150 million, in its corporate communications and public relations documents.[4]

Sponsorship

Sponsorship refers to a corporation's financial support for sports, art, entertainment, and educational endeavors in a way that prominently attributes the support to the particular corporation. Sponsorship can be considered a form of marketing communications because it seeks to raise awareness and appreciation of the corporation in a given target audience. Arguably, of course, sponsorship benefits society, because society appreciates sports, art, and entertainment. However, in the case of sponsorship, as opposed to philanthropy, the sponsors expect a clear return. Indeed, many corporations carefully analyze the benefits of their sponsorship activities in the same way they measure the impact of their marketing and advertising.

Many prominent global sponsors are companies that find it difficult to advertise through other channels. For example, Philip Morris, the world's largest tobacco company and owner of the Marlboro brand, which finds its global advertising restricted due to a number of bans and limits on tobacco advertising, has invested heavily in sponsorship. Philip Morris has long been the number one sponsor of Formula 1 race car competitions, and it is impossible for a spectator to watch one of these races without observing, consciously or otherwise, huge billboards and banners featuring the famous red-and-white Marlboro logo. Similarly, since alcohol advertising is also increasingly scrutinized, it is not surprising that Budweiser has followed a similar tactic and become the principal sponsor of NASCAR racing. Pharmaceuticals have also become an area subjected to tight advertising and marketing controls; therefore, Pfizer, the world's largest pharmaceutical company, engages in scores of sponsorship activities, notably in its support for the Paralympics, an Olympic-style competition for physically-handicapped athletes.

Sustainability

Sustainability has become such an important concept that it is frequently confused with CSR. Indeed, for some companies it seems that CSR is sustainability. This is perhaps not surprising, given the growing media attention on issues related to sustainability.

Sustainability is a concept derived from environmentalism; it originally referred to the ability of a society or company to continue to operate without compromising the planet's environmental condition in the future. In other words, a sustainable corporation is one that can sustain its current activities without adding to the world's environmental problems. Sustainability is therefore a very challenging goal, and many environmentalists maintain that no corporation today operates sustainably, since all use energy (leading to the gradual depletion of fossil fuels while emitting greenhouse gases) and all produce waste products like garbage and industrial chemicals. Whether or not true sustainability will be attainable anytime in the near future, the development and promotion of sustainability strategies has become virtually an obsession of most large corporations today, as their websites will attest in their inevitable reference to the corporation's sincere commitment to sustainability and responsible environmental practices. No corporation or corporate executive today will be heard to say that they do not really care about the environment. However, if we observe their actions rather than their words, we may have cause for doubt.

We will explore specific cases related to sustainability in later chapters. For now, let us just note that CSR, strictly speaking, is broader than environmental sustainability because it also refers to a corporation's ethical relationship to its employees, shareholders, suppliers, competitors, customers, and local and foreign governments.

More recently, many people have been using the term *sustainability* also to refer to social and political sustainability, which brings the concept closer to that of CSR.

Greenwashing

Greenwashing refers to corporations that exaggerate or misstate the impact of their environmental actions. By the early 1990s a great number of consumer products were being promoted as "environmentally friendly," "eco-friendly," or "green," when in fact there was little or nothing to justify the claims. In 1991, an American Marketing Association study revealed that 58% of environmental ads contained at least one deceptive claim. As a result, many advertising regulatory bodies around the world adopted specific advertising codes to regulate the honesty and accuracy of environmental claims in advertising. For example, in the UK, a producer of a recycling bin advertised that it helped buyers "save the rainforests" by encouraging recycling of plastic and paper products. The advertisement was found to be misleading because most paper products sold in the UK were not made from wood in tropical rainforests, but from wood harvested on northern European tree farms.

In Norway, car manufacturers and dealers are prohibited from claiming that their cars are green, eco-friendly, etc., because in the view of the Norwegian Consumer Ombudsman, it is impossible for cars to be beneficial for the environment; the best they can do is reduce the environmental damage they cause.[5]

Greenwashing is not only a corporate practice but a political one as well, as politicians everywhere promise to undertake actions to improve the environment. Thus, the administration of former US President George W. Bush was widely criticized for promoting legislation under the name of the "Clear Skies Initiative," when in fact the purpose of the legislation was to weaken antipollution measures.[6]

Social Entrepreneurship and Social Enterprise

Social entrepreneurship and social enterprise refer to the use of business organizations and techniques to attain laudable social goals. Blake Mycoskie decided to create TOMS Shoes largely as a reaction to his travels in Argentina, which had exposed him to terrible poverty that left many school-age children without shoes. An important part of the corporate mission of TOMS Shoes lies in its pledge to give away a free pair of shoes for every pair purchased by a customer. TOMS Shoes' model has been imitated by many others, including the popular online eyewear brand, Warby Parker.

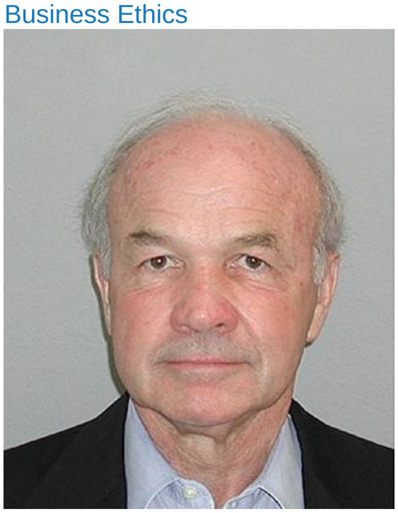
The difference between social entrepreneurship and CSR is that, with social entrepreneurship, the positive social impact is built into the mission of the company from its founding. Other examples of social entrepreneurship include The Body Shop, Ben & Jerry's ice cream, and Newman's Own. The Body Shop was founded by noted activist Anita Roddick who insisted that all products be derived from ingredients which were natural, organic, and responsibly sourced. Her employment policies famously allowed every employee to take off one day a month from work to engage in social or community projects. Similarly, Ben & Jerry's was founded to promote the use of organic, locally-produced food. The company's founders insisted on a policy that executives earn no more than seven times the salary of factory line-workers (although this policy was eventually relaxed when it became difficult to recruit a competent CEO at those wages). Ben & Jerry's engaged in a number of high-profile political activities in which they encouraged their employees to participate, such as protesting the building of the Seabrook nuclear power plant in Vermont. Newman's Own was founded by film actor Paul Newman and his friend A. E. Hotchner with the goal of selling wholesome products and giving away 100% of the profits to charitable ventures. To date, Newman's Own has given away over $550 million (https://www.newmansown.com/charity).

Social Marketing

Social marketing refers to the use of business marketing techniques in the pursuit of social goals. Often, governments and nonprofit organizations make use of social marketing to make their points more forcefully and effectively to a wide audience. Classic examples are the extremely powerful TV commercials warning of the dangers of unsafe driving or of failing to use seatbelts. Cinematic techniques are employed to portray dramatic, arresting images of crumpled cars and bodies, children and mothers crying. The source of social marketing advertisements is usually a local government or nonprofit organization.

Social marketing is usually used to try to convince citizens to drive more safely, eat better, report child and domestic abuse, and avoid various forms of criminality and drug use. As with ordinary advertising, social marketing can seem overdone or maudlin, and some social marketing ads have been mocked or considered silly. For example, former First Lady Nancy Reagan participated in a social marketing campaign that urged young people to "Just Say No" to drugs, an approach which was ridiculed as simplistic by many. Noted radical activist Abbie Hoffman said that telling drug users to "just say no" to drugs was like telling manic-depressives to "just cheer up." Despite that, drug use in America declined over the time period that the campaign was in progress, though there is no evidence that any part of this decline was due to the campaign.

Business Ethics



Source: United States Marshals Service, 2004, public domain
Figure 1.3 The mug shot of former Enron top executive Ken Lay. Lay was eventually convicted on 10 counts of fraud;

while awaiting sentencing of up to 100 years in prison he died of a heart attack in 2006.

Business ethics is an academic discipline closely related to CSR, but one that tends to use the tools of philosophy to formally analyze the ethical role of individuals and corporations. Although the terms are quite similar, there are differences of nuance. For example, although academics who study business ethics tend to focus on corporations, the term itself could also apply to the ethical dilemmas of sole proprietors or of individuals involved in commercial situations, such as a private party trying to sell a used car that he knows has a hidden mechanical flaw. While the term *CSR* tends to be used by corporations and social entrepreneurs in a way that assumes a positive connotation, *business ethics* is used in a more neutral and even critical fashion, as one might expect, given the perspective of writers who are not beholden to corporations. Indeed, when the media uses the term *business ethics*, it is often in a negative sense, to draw attention to instances of deception or fraud on the part of corporations or executives.[7]

White-Collar Crime

White-collar crime refers to fraudulent or financially-oriented criminal activities by high-status professionals or businesspeople. The term *white-collar crime* was coined by sociologist Edwin Sutherland, who defined it as a "crime committed by a person of respectability and high social status in the course of his occupation" in a 1939 speech entitled "The White Collar Criminal." Although the term applies to financial fraud committed by individuals who are not associated with corporations, there is a strong linkage to corporations in actual practice because corporate executives are often well-placed to commit crimes of fraud and corruption. However, a distinction should be drawn between white-collar crime and corporate crime, which refers to crimes for which the corporation itself is responsible. In many cases, such as in violations of US laws against bribing foreign government officials, it may be unclear whether the matter is better classified as white-collar crime or corporate crime. In the law, it may depend on whether the corporation's senior executives were aware of and supported the acts of criminality.

While there is a popular perception that punishments for wealthy white-collar criminals are less severe than for poor and middle-class criminals, the situation appears to have changed in light of the severe penalties for white-collar crime mandated by the 2002 Sarbanes–Oxley Act, which was adopted by the US Congress in the wake of the notorious Enron scandal. As a result, former Enron CEO Jeffrey Skilling, the architect of Enron's frauds, was sentenced to 24 years in prison. Bernie Ebbers, former CEO of WorldCom, was convicted of fraudulent misstating of billions of dollars of WorldCom earnings, resulting in a sentence of 25 years. Bernie Madoff, whose vast Ponzi scheme defrauded investors of up to $65 billion, was sentenced in 2009 to 150 years in prison for his crimes, effectively a life sentence without possibility of parole.

Readings

The readings below are meant only to stimulate your thinking about possible perspectives to take on corporations. Please supplement them with your own research.

1.1 The Corporation as a "Psychopathic" Creature

Bakan, Joel. "Business as Usual," in The Corporation: The Pathological Pursuit of Profit and Power, 28-59. New York: Simon and Schuster, 2004.

Bakan, Joel. "The Externalizing Machine," in The Corporation: The Pathological Pursuit of Profit and Power, 60-84. New York: Simon and Schuster, 2004.

Business leaders today say their companies care about more than profit or loss, that they feel responsible to society as a whole, not just to their shareholders. Corporate social responsibility is their new creed, a self-conscious corrective to earlier greed-inspired visions of the corporation. Despite this shift, the corporation itself has not changed. It remains, as it was at the time of its origins as a modern business institution in the middle of the nineteenth century, a legally designated "person" designed to valorize self-interest and invalidate moral concern. Most people would find its "personality" abhorrent, even psychopathic, in a human being, yet curiously we accept it in society's most powerful institution. The troubles on Wall Street today, beginning with Enron's spectacular crash, can be blamed in part on the corporation's flawed institutional character, but the company was not unique for having that character. Indeed, all publicly traded corporations have it, even the most respected and socially acceptable….

As a psychopathic creature, the corporation can neither recognize nor act upon moral reasons to refrain from harming others. Nothing in its legal makeup limits what it can do to others in pursuit of its selfish ends, and it is compelled to cause harm when the benefits of doing so outweigh the costs. Only pragmatic concern for its own interests and the laws of the land constrain the corporation's predatory instincts, and often that is not enough to stop it from destroying lives, damaging communities, and endangering the planet as a whole…. Far less exceptional in the world of the corporation are the routine and regular harms caused to others—workers, consumers, communities, the environment—by corporation's psychopathic tendencies. These tend to be viewed as inevitable and acceptable consequences of corporate activity—"externalities" in the coolly technical jargon of economics.

"An externality," says economist Milton Friedman, "is the effect of a transaction…on a third party who has not consented to or played any role in the carrying out of that transaction." All the bad things that happen to people and the environment as a result of corporations' relentless and legally compelled pursuit of self-interest are thus neatly categorized by economists as externalities—literally, other people's problems.

1.2 "EPA Costs US Economy $353 Billion per Year"

Young, Ryan. "EPA costs US economy $353 billion per year." The Daily Caller. Last modified December 27, 2012. http://dailycaller.com/2012/12/27/epa-costs-us-economy-353-billion-per-year/ .

Transparency is the lifeblood of democracy. Washington needs more of it, especially in the all-too-opaque world of regulation. The Environmental Protection Agency (EPA), for example, is the most expensive federal regulatory agency. Its annual budget is fairly modest in Beltway terms, at a little less than $11 billion, but that's not where the vast majority of its costs come from. Complying with EPA regulations costs the US economy $353 billion per year—more than 30 times its budget—according to the best available estimate. By way of comparison, that is more than the entire 2011 national GDPs of Denmark ($332 billion) and Thailand ($345 billion)…

In the last edition of the Unified Agenda, the fall 2011 edition, the EPA had 318 rules at various stages of the regulatory process. Nobody outside the agency knows how many rules it currently has in the pipeline. All in all, 4,995 EPA rules appeared in the Winter Unified Agenda from 1999–2011. Over the same period, 7,161 EPA final rules were published in the *Federal Register*. That means more than 2,000 final rules, which have the force of law, came into effect without first appearing in the Unified Agenda. This could indicate an important transparency problem.

That's just the EPA's *annual* flow of regulations. The agency has existed for more than 40 years. How many total rules does it currently have in effect? Again, the answer doesn't come from the agency. Earlier this year, the Mercatus Center's Omar Al-Ubaydli and Patrick A. McLaughlin ran text searches through the entire *Code of Federal Regulations* (CFR) for terms such as "shall," "must," "prohibited," and the like. The CFR Title covering environmental protection alone contains at least 88,852 specific regulatory restrictions. The number could be as high as 154,350….

Justice Louis Brandeis correctly believed that sunshine is the best disinfectant. With high regulatory costs contributing to a stagnant economic recovery, it is well past time to shine more light on regulatory agencies. Annual agency report cards would make a good start.

1.3 Press Release from the US Consumer Product Safety Commission

Consumer Product Safety Commission. "Port Surveillance News: CPSC Investigators Find, Stop Nearly 650,000 Unsafe Products at the Start of Fiscal Year 2012." News Release. April 5, 2012. https://www.cpsc.gov/en/Newsroom/News-Releases/2012/Port-Surveillance-News-CPSC-Investigators-Find-Stop-Nearly-650000-Unsafe-Products-at-the-Start-of-Fiscal-Year-2012/.

Investigators Stop Nearly 650,000 Unsafe Products

Investigators with the US Consumer Product Safety Commission (CPSC) prevented more than half a million violative and hazardous imported products from reaching the hands of consumers in the first quarter of fiscal year 2012.

Working with US Customs and Border Protection (CBP) agents, CPSC port investigators successfully identified consumer products that were in violation of US safety rules or found to be unsafe. CPSC and CBP teamed up to screen more than 2,900 imported shipments at ports of entry into the United States. As applicable, these screenings involved use and abuse testing or the use of an X-ray fluorescence (XRF) analyzer. Their efforts prevented more than 647,000 units of about 240 different non-complying products from reaching consumers, between October 1, 2011 and December 31, 2011.

Topping the list of products stopped were children's products containing levels of lead exceeding the federal limits, toys and other articles with small parts that present a choking hazard for children younger than 3 years old, and toys and child-care articles with banned phthalates.

In addition to violative toys and other children's products, items stopped at import included defective and dangerous hair dryers, lamps, and holiday lights.

"We mean business when it comes to enforcing some of the toughest requirements for children's products in the world. If an imported product fails to comply with our safety rules, then we work to stop it from coming into the United States," said Chairman Inez Tenenbaum. "Safer products at the ports means safer products in your home."

During fiscal year 2011, CPSC inspected more than 9,900 product shipments at the ports nationwide and stopped almost 4.5 million units of violative or hazardous consumer products from entering the stores and homes of US consumers.

CPSC has been screening products at ports since it began operating in 1973. In 2008, the agency intensified its efforts with the creation of an import surveillance division.

1.4 "Costs of Air Pollution in the U.S."

Taylor, Timothy. "Costs of Air Pollution in the U.S.," *Conversable Economist* (blog), November 7, 2011, http://conversableeconomist.blogspot.com/2011/11/costs-of-air-pollution-in-us.html.

What costs does air pollution impose on the U.S. economy? Nicholas Z. Muller, Robert Mendelsohn, and William Nordhaus tackle that question in the August 2011 issue of the *American Economic Review*. Total "gross external damages" the six "criterion" air pollutants in 2002—sulfur dioxide, nitrogen oxides, volatile organic compounds, ammonia, fine particulate matter, and coarse particulate matter—was $182 billion.

Since GDP was about $10.5 trillion in 2002, the cost of air pollution was a bit under 2% of the total. The effects included in the model calculations are adverse consequences for human health, decreased timber and agriculture yields, reduced visibility, accelerated depreciation of materials, and reductions in recreation services.

The sectors with the biggest air pollution costs measured in terms of "gross external damages" (GED) (counting the same six pollutants but again not counting carbon emissions) are utilities, agriculture/forestry, transportation, and manufacturing.

If one looks at the ratio of gross economic damages to value-added in the sector, agriculture/forestry and utilities lead the way by far with ratios above one-third. Manufacturing has fairly high gross external damages, but the GED/VA ratio for the sector as a whole is only 0.01.

To me, a lesson that emerges from these calculations is that the costs of air pollution and of burning fossil fuels are very high, both in absolute terms and compared to the value-added of certain industries, even without taking carbon emissions into account. Environmentalists who are discouraged by their inability to persuade more people of the risks of climate change might have more luck in reducing carbon emissions if they deemphasized that topic—and instead focused on the costs of these old-fashioned pollutants.

1.5 "Over-Regulated America"

"Over-regulated America: The home of laissez-faire is being suffocated by excessive and badly written regulation." The Economist. Last modified February 8, 2012. http://www.economist.com/node/21547789 .

Synthesis Questions

The most productive discussions and debates are those that open our eyes to different perspectives and different ways of thinking. While we may not change our initial opinions, we may emerge with an enhanced understanding of the perspectives of others, or of the complexity of a particular issue.

So we suggest that at the end of each chapter you answer a few questions in a way that allows you to "synthesize" your discussions and readings—by bringing together the strongest parts of each side of the argument—so as to arrive at a deeper, more nuanced understanding of the issues involved.

Clearly, the ethical role of corporations is a vast, complex topic and allows for a great diversity of opinions. Here are three initial synthesis questions for further reflection:

Synthesis Questions

1. Are corporations on the whole good for society?
2. Do you personally like or distrust corporations? Why?
3. How should society regulate corporations?

Endnotes

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2. Vincett Trivett, "25 US Mega Corporations: Where They Rank If They Were Countries," *Business Insider*, June 27, 2011, accessed December 6, 2014, http://www.businessinsider.com/25-corporations-bigger-tan-countries-2011-6?op=1.

3. Steven Pearlstein, "Two Can Play the Airline Bankruptcy Game," *Washington Post*, 28 April 2012, accessed November 28, 2014, www.washingtonpost.com/business/steven-pearlstein-two-can-play-the-airline-bankruptcy-game/2012/04/27/gIQAJ239nT_story.html.

4. "The Estee Lauder Companies Breast Cancer Awareness Campaign," accessed November 28, 2014, bcacampaign.com/.

5. "Norway Outlaws 'Green' Cars," *TerraPass*, September 11, 2007, accessed December 6, 2014, terrapass.com/politics/norway-outlaws/.

6. US Senator Patrick Leahy, "The Greenwashing of the Bush Anti-Environmental Record on the President's Earth Day Visits to Maine and Florida," (statement on the Senate floor, Washington, DC, April 26, 2004).

7. See Sebastian Bailey, "Business Leaders Beware: Ethical Drift Makes Standards Slip," *Forbes*, May 15, 2013, accessed December 6, 2014, http://www.forbes.com/sites/sebastianbailey/2013/05/15/business-leaders-beware-ethical-drift-makes-standards-slip/.

1.8: Debating CSR- Methods and Strategies

Source: U.S. Navy (CC-BY 2012) Figure 2.1 Deployed U.S. sailors watching the U.S. Presidential debate between candidates Barack Obama and Mitt Romney in 2012.

Why Debate CSR?

In this chapter, we help you prepare for productive debates on CSR. Our first question is: why debate CSR? Why not just study texts on CSR, and then write essays or take tests on the topic? Why do we need to debate?

The position of this textbook is that CSR is not only an important social phenomenon, but a complex and controversial one. As we will see in this book, there are often two sides to CSR issues. As future voters and future employees of corporations, schools, governments, and civil society organizations, you will get a chance to have a real impact on the future of CSR. But what should the future of CSR be? It is not the role of teachers or textbooks to tell you what to think when it comes to such a new and politically divisive topic. Like your fellow citizens, you are entitled to develop your own opinion, but we hope that it will be an informed and logical opinion, rather than one that emerges reflexively from political partisanship or cultural tradition.

In short, we want you to practice thinking for yourself about CSR, and we think the best way to practice is that is to debate crucial issues relating to CSR. At times you will be asked to come up with the strongest arguments in favor of a position that you do not initially support. As the saying goes, to understand another person you have to walk a mile in their shoes. If you want to understand why many of your fellow citizens take social and political positions that are different from yours, the best thing to do is to consider the strongest arguments on their side—and the best way to do that is to become their advocate, even if only for the length of a class session.

Questioning the Value of CSR Itself

As an example of the importance and complexity of CSR-related public debates, consider the following controversies related to CSR:

CSR: Sincere ethics or hypocritical public relations?

- **Facts:** CSR is a rapidly growing field of study in universities and business schools, and most large corporations have adopted CSR programs.
- **The controversial aspect:** Is CSR a good thing or is it just corporate window-dressing?
- **In favor of CSR:** CSR motivates corporations to address social problems, it energizes and rewards workers, it strengthens ties to the community, and it improves the image of the corporation.
- **Against CSR:** Surveys show that citizens are more concerned about corporations treating their workers well and obeying laws than about engaging in philanthropic activities, and CSR may allow corporations to distract consumers and legislators from the need to tightly regulate corporations.

Climate change and CSR

- **Facts:** There is a scientific consensus that global warming and climate change represent an enormous threat facing mankind.
- **The controversial aspect:** Can corporate CSR really have a significant impact on climate change, or is it just a public relations vehicle for companies and a distraction from the need for stronger government action, such as through a carbon tax?
- **In favor of global warming–related CSR:** Corporations can have a major impact in the battle against global warming by reducing their large carbon footprints, by encouraging other corporations to follow suit, and by helping discover and develop alternative sources of energy.
- **Against global warming–related CSR:** Companies spend a lot of advertising money to boast about small measures against global warming, but many of these companies are in industries—such as fossil fuels or automobiles—that produce the most greenhouse gases to begin with; self-serving claims of climate-change concern are often simply corporate public relations campaigns intended to distract us from the need for society to take more effective measures through taxation and regulation.

Corporate Lobbying and Government Influence

- **Facts:** Most large corporations spend money on lobbying and on seeking to influence legislators and regulators. In the *Citizens United* decision, the Supreme Court ruled that, as “corporate persons,” corporations enjoy the same freedom of speech protections as ordinary citizens and are entitled to relief from strict government control of their rights to political speech.

- **The controversial aspect:** Many citizens are outraged to find that the justice system accords multinational corporations the same rights as ordinary people on the grounds that corporations are "persons." However, others point out that The *New York Times* and CNN are also corporations, and that it could have a chilling effect on freedom of speech if all corporations were legally-constrained from speaking out freely.
- **In favor of corporate lobbying:** As major employers and technological innovators, corporations benefit society. They should be free to oppose inefficient and cumbersome government regulations and taxation that can limit the benefits they provide. In this way, freedom of political speech is so important that we should be cautious about limiting it in any way.
- **Against corporate lobbying:** Corporations are not "persons" in the same sense that humans are, and therefore, they should not enjoy the same freedom of speech protection. Since corporations can become vastly wealthier than ordinary citizens, allowing them to participate in politics will enable them to bend laws and regulations to their will.

In each of the debates outlined above, there are intelligent and well-informed people on both sides of the issue. However, if our society is going to progress in its handling of these issues, we will need to reach consensus on the best approach, or at least on the best compromise. It is therefore vital that citizens learn to discuss these issues in an informed, respectful and productive manner.

How to Debate CSR: Rules of Civility and Logic

Civility

This chapter introduces you to the techniques of logical debate. We hope to improve your ability to craft a forceful, persuasive argument and to detect faulty logic and weak evidence put forward by your adversaries. It is equally important, however, to practice engaging in social and political debates in a way that is respectful and tolerant of differing viewpoints.

Although we will base our approach to some extent on the rules and methods of formal debate, the reality of life is that most of our disagreements, and much public debate, are not carried out according to formal rules or any previously agreed structure. Indeed, the average political debate with our schoolmates, work colleagues, and family is often quite freewheeling and sometimes extremely illogical. It is an accepted truism of American life that political campaigns are filled with name-calling, mud-slinging, finger-pointing, and scurrilous attack ads. That is one reason that so many people say that you should never discuss politics or religion among friends or family—because doing so can compromise friendships and spoil family gatherings with angry and unproductive arguments.

In this course and in this textbook, we want to lean toward the other extreme. We believe that there are sincere, intelligent people on both sides of most social debates. As educated people, we should not engage in political discussion in order to flaunt our superior intelligence or backgrounds, or to browbeat or insult our interlocutors. Unfortunately, since people sometimes resort to bullying and offensive tactics when discussing sensitive topics, and since many of us are unable to control our wounded, emotional responses to such aggression, it can become difficult to discuss important social issues in a productive way.

We suggest certain ground rules to promote fair and respectful debate.

1. Do not try to "win" the debate.

In formal debate contests, each side is trying to defeat the other. Similarly, in political debates each candidate is trying to come out on top so as to win the election. However, in the classroom or in informal discussions around the dinner table or at the workplace, such tactics can be unproductive and can backfire.

Therefore, we recommend that (at least part of the time) instructors randomly assign students to each side of an argument. In this fashion, you will sometimes find that you are arguing on behalf of a position that you would not ordinarily support. This may seem paradoxical to you, so why do we insist on its value?

By obliging you to consider and advocate on behalf of the strongest points of each side of the argument, we want you to appreciate that there are valuable, sincere motivations on both sides of most social debates. We are not asking you to be insincere and pretend to believe in something that you do not support. Rather, we are simply asking you to look for the strongest arguments the other side could make.

So, in this course the goal is not to try to win the debate by making the other side look bad. The objective here is to obtain greater knowledge and greater depth of understanding. Everyone in the class should consider it a win anytime fellow students make a new or interesting point, express themselves eloquently, or show a willingness to listen and learn from the other side. The ultimate win in this course is to learn more about an important social topic, and to learn to engage in debates in a respectful way.

2. Admit discomfort or emotionality.

Discussions of important social or political topics often touch upon values that each of us holds dear. They may be values we have imbibed from the teachings of our parents, trusted elders, respected teachers, and admired thinkers. As a result, when someone strongly challenges those values, especially in a way that we find disrespectful, it is understandable that we feel negative emotions or anger. The challenge is to control those emotions without being tempted to retaliate.

So if you ever feel uncomfortable or embarrassed in a class debate, whether online or in person, do not hesitate to let your interlocutor, the class, and the instructor know of your feelings. You can simply say, for example, "I think that last remark was bit personal," or "I find that the tone you are using is somewhat aggressive." However, try to avoid responding in an equally offensive fashion because that usually leads to a breakdown in the conversation.

It is not only up to the instructor; it is up to each class member to monitor class discussions for inappropriate levels of aggression or condescension.

3. Listen respectfully and show that you have heard the other side.

It is very easy for debates to degenerate into emotional contests if neither side makes a sincere attempt to listen to the other side's arguments. Therefore, it is always a good strategy to show that you have heard the other side and have understood their point. For example, you can say, "So it seems that you feel the strongest argument in favor of freedom of corporate lobbying is that if we restrict such lobbying, then we will create a precedent that could eventually lead to restrictions on the freedom of speech of individuals. However, we would like to argue that…"

On political talk shows and at the dinner table, it is quite common for debaters to cut each other off, interrupt rudely, or talk over each other. In the classroom, however, we want to hold ourselves to a higher standard. Let people finish talking before you make your point. If you feel someone is going on too long, you can alert the instructor and request that you be given an equivalent amount of time for your rebuttal.

Logic: The Techniques of Persuasive Argumentation

The Structure of a Debate

Although this is not a course in logical debate, you will get more out of it if you proceed in a systematic manner. Although there are many systems and theories for debate, we present a simplified version here so that your class can have a common framework to follow. The elements of a logical debate are the topic, the argument, and the rebuttal or counter-argument.

The Topic

Sometimes also called the "proposition," "claim," or "thesis," this is the concise statement of what the argument will address. In formal debating, the topic is usually called a proposition and may be presented in the form of a motion that is going to be submitted to a body for a vote, for example:

Resolved, that American corporations should refrain from outsourcing to factories in countries where child labor under the age of 15 is permitted.

Thereafter, one side (sometimes an individual but often a team consisting of up to three people) takes the *affirmative* position (meaning that it supports the proposition), while the other takes the *negative* position (meaning that it opposes the proposition). The party taking the affirmative side then opens with a clear formulation of its position and begins the debate by presenting the "main line," or strongest point on its side. The negative side is allowed to question the manner in which the affirmative side has defined the proposition, and may choose to present an alternative formulation before presenting the main line of its argument. In team debating, the second and third members will then present the second and third lines of their team's argument. Opportunities for rebuttal may be provided after each speaker or at the end of each team's main presentation. When the debate is concluded, a vote may be taken (for example, by the audience or by a group of judges) to determine which team has been more persuasive.

In this course, we encourage a more informal approach in order to suit the preferences and prior experience of the instructor and students. You may prefer to present different topics for debate, or provide for a range of alternatives for action. Regardless of the approach you choose, each class and each student should have some freedom to frame the debate in the perspective that he or she finds the most relevant while ensuring that both sides are still engaging the same question. Consequently, it is always a good practice to begin a debate or discussion (or a written assignment) with a clear statement of your topic or proposition, even if it seems implied by the assignment.

The Argument

Once you have clearly stated the debate topic and your opening proposition, you must go on to provide logical support or evidence in support of your argument. In order to persuade an audience, you must support your main thesis with compelling reasoning and/or factual evidence. You may choose to focus on either logic or evidence, or you may use both. For example, if you wanted to base your argument on moral reasoning, you might say,

In the United States, we do not permit full-time factory work for children under the age of 15, so we should not participate in the exploitation of children abroad in a manner we would not accept at home.

Note that this argument, like many other arguments based on logic or reasoning, is itself based on further unstated assumptions, which we may call the logical basis or moral basis of the argument. Thus, the person making the above argument is assuming that

1. it is self-evident that we should not participate in behavior abroad that we do not accept at home (which may or may not be true depending on circumstances); and/or
2. behavior that is not legally accepted in the United States is necessarily exploitative when practiced abroad (which, again, may or may not be the case).

If you wanted to base your argument on factual evidence or statistics, you might say, for example:

Statistics show that countries that permit full-time employment for children have lower levels of literacy.
Or :
Studies show that underage female factory workers are subjected to high levels of sexual harassment and are at greater risk to become victims of rape or violence.

As with arguments based on reasoning, arguments based on evidence also depend on implicit assumptions about the evidence. For example the evidence must be

1. accurate and recent (thus, the statistics should not be derived from unreliably small samples, and they should not be obtained from studies conducted so long ago that they are no longer valid),
2. relevant and logically connected to the argument (thus, the statistics on literacy might show that children raised in the countryside have even lower rates of literacy than urban children who work in factories), and
3. available to be examined (it is very easy to say, "Studies show that . . ." but if you cannot produce any published report of the study, or the study itself, then your argument cannot be considered valid; you might even be misstating the results of the survey).

Rebuttal and Counter-argument

A good debate allows opportunities for each side to respond to the other side's arguments, and this may be called a rebuttal or a counter-argument.

To develop an effective rebuttal, you should listen carefully to the other side's argument and try to detect flaws or gaps in their claims, reasoning, or evidence. In classical rhetoric, debaters were trained to detect a number of logical fallacies, common types of arguments which on further examination are unconvincing. Here are some of the key fallacies, or flaws, you may encounter:

Arguing Off-topic

Failure to stick to the main argument is perhaps the most common of all logical fallacies encountered in everyday discussions. In informal discussions, this is sometimes acceptable, but in a serious intellectual discussion, it wastes time and energy because you cannot seriously argue about two different topics at the same time. For example, in the debate described above, one of the parties might say something like,

"Everyone knows that American corporations don't really care about people; all they care about is profits."

Not only is that point arguable in itself (though it might make for an interesting argument), it is not directly relevant to a discussion of child labor in overseas factories. In such a case, it is appropriate simply to say, "The point you are making is not relevant to the topic of this discussion."

Drawing Excessive or Illogical Conclusions from Evidence

In debates over the value of evidence, it is frequently said that "correlation does not prove causation." In other words, if statistics show a correlation between two sets of facts, they do not necessarily prove a causal connection between them. For example, in one nineteenth century study of tuberculosis in Paris, the researcher noted that tuberculosis most frequently struck people living on the fifth floor of apartment buildings (the highest floor in apartment buildings of the day). He concluded that there was a causal relation between tuberculosis and altitude, and theorized that it was unhealthy to live too high above the ground. In fact, the highest floor was reserved for the small, drafty attic chambers of the poor servants who served the bourgeois families on the lower floors, so the true correlation was between poverty and tuberculosis. Statistics must always be closely scrutinized for relevance. We must always ask whether the statistics apply to the same fact pattern that we are discussing. Also, be wary of statistics that are out of date or are drawn from samples that differ in some fundamental way from the population being discussed.

Ad Hominem Argument

This refers to a statement that attacks you personally (or personally attacks an authority upon whom you are relying), rather than addressing the argument that you are making. In everyday discussions, this is perhaps the most dangerous of rhetorical fallacies. Not only is it irrelevant, but it frequently arouses such negative emotions that the opponent retaliates in kind. Everyone, including the instructor and other classmates, should be attentive to ad hominem arguments, and the person making them should be gently but firmly admonished against this tactic.

The Problem of Cognitive Bias

One of the difficulties encountered in everyday discussions of social and political affairs is that people enter the discussion with their minds already made up. No matter how compelling the reasoning or convincing the evidence, they will refuse to consider the other side. If asked to research the facts, they will only look for facts that support the views they already had. Such people could be said to be wearing "intellectual blinders." In a classroom or college context, this attitude is unfortunate: It closes us off from learning and from growing intellectually. In order to detect it in others and avoid it ourselves, it pays to learn about this tendency toward stubborn consistency, which is sometimes referred to by psychologists as *cognitive bias*.

One of the great discoveries of modern psychology is that humans are, in fact, extremely susceptible to biased thinking. Much of our understanding of the powerful influence of cognitive bias is due to the work of two psychologists, Daniel Kahneman and Amos Tversky. (Kahneman won the Nobel Prize for his efforts in 2002.) Kahneman postulates that humans use two different kinds of thinking systems, fast and slow.[1] Fast thinking is instinctive, emotional, and reactive, and can be useful in contexts when you have to make a decision quickly (e.g., you see a bear coming toward you in the forest, so it is time to think quickly about climbing a tree). Slow thinking is logical, laborious, and difficult: the kind of thinking that we use when we solve a math problem or a logic puzzle.

Cognitive bias represents the tendency toward instinctive, reflexive modes of thought, or fast thinking, when we might be better off using our slower, more laborious mode of thinking. One might suppose that when it comes to politics and social issues, such as those involved in analyzing corporate social responsibility, people would always rely on slow, logical thinking. However, Kahneman's research (as well as that of many other cognitive psychologists) indicates the opposite.

Let us consider the power of some important cognitive biases that draw us astray.

Confirmation Bias

Confirmation bias is the human tendency to discredit or ignore information that contradicts our beliefs, while we uncritically adopt information that supports our beliefs. Studies have demonstrated that most people are only open to hearing new information if it confirms their previously-held beliefs.

Confirmation bias explains why information exchange tends to reinforce our beliefs. The more we learn about ethical, social, or political issues, the more biased we become. Confirmation bias is thus the motor of prejudice. Once we get a tiny bit biased one way or another, the confirmation bias pushes us farther and farther in that direction. Increased education and research, strangely, can end up making us all more deeply biased.

In one classic study, a group of pro–death penalty students and a group of anti–death penalty students evaluated two "opposing" studies on capital punishment. In fact, the studies were identical, except that they carried different titles and came to different conclusions. The students were asked to decide which of these studies was better and more convincing (despite their being *virtually identical*). Almost invariably, the students concluded that the study with the title that supported their pre-existing views was superior to the other study. Not only that, but when the students were asked why they preferred the study they felt was superior, they were able to present a number of highly-specific examples to support their evaluations. Since both studies were based on exactly the same information, the students' preference for one study over the other was derived purely from bias.

When we are exposed to mixed information, part of it supporting our views and part of it contradicting our views, we are more attentive to the part that supports our views, which we are likely to accept as accurate and true, while we ignore the part that contradicts our views. Indeed, sometimes these contrary arguments barely register in our consciousness.

Partisan Bias

Partisan bias is a form of prejudice and overconfidence that takes hold of people whenever they feel loyalty or affiliation with a group or a team. We witness partisan bias in the political sphere when presidential campaigns are under way, as Democrats are always quick to point out that their preferred candidate is vastly superior to the Republican candidate, while Republicans are equally certain of the contrary.

Partisan bias does not only rule the world of politics, but can occur in any sphere where people feel drawn to one group over another. We can relate this concept to CSR: If you begin to perceive that you are part of a group that is a big supporter of a certain kind of CSR activity, then you will probably be susceptible to the assumption that your group is always right in all aspects. As soon as we feel we belong to a group, we begin to view that group as superior to other groups. It is so easy to elicit group bias that psychologists have proposed the existence of *implicit partisanship*—a hard-wired human predisposition to take sides and then prefer that side.

One experiment relating to implicit partisanship showed that, if people are shown a list of names and asked to study it for as briefly as a few minutes, they develop a preference for the names on the list and consider them superior to other names.[2] In another experiment, a group of college students was assigned to one of two teams to watch a taped football game. The students displayed a clear preference for their assigned team and later argued that the referee had unfairly called fouls against their team.[3]

If a group of people are told that they will be assigned to either group A or group B according to a coin toss, they begin to prefer their group even *before* they are sure they are assigned to it. Those to whom it has been merely hinted that they *may* have been assigned to group B begin nonetheless to express a clear preference for the members of group B and a belief that group B is generally superior to group A.[4]

While the existence of the partisan bias has been confirmed by recent research, it has long been apparent to perceptive observers of political argument. In fact, Socrates noted the following in Plato's *Phaedo*:

> The partisan, when he is engaged in a dispute, cares nothing about the rights of the question, but is anxious only to convince his hearers of his own assertions.[5]

Availability Bias

Availability bias refers to the fact that, in an uncertain situation, people tend to use the most obvious fact or statistic in order to come to a conclusion—even if a moment's thought or the slightest bit of research would have demonstrated that the particular fact or statistic was unreliable. You can test your own susceptibility to the availability bias by trying to correctly answer the following question as quickly as possible:

Facts: A bat and a ball cost $1.10 in total. The bat costs $1 more than the ball.

Question: How much does the ball cost?

Most people answer 10 cents. However, this is clearly wrong, as you will probably realize if you think about it carefully for a few more seconds. The correct answer is that the ball costs 5 cents.

If you answered incorrectly, don't feel bad—more than half of a group of Princeton students got the answer wrong as well. How is it possible that even smart people can be so dumb when it comes to such a simple question? In Kahneman's words, "The respondents offered their responses without checking. People are not accustomed to thinking hard and are often content to trust a plausible judgment that comes quickly to mind."[6] Since $1.10 divides neatly into $1.00 and ten cents, respondents leaped to this seemingly obvious answer, though it was incorrect. Kahneman named this the *availability heuristic*, the tendency to rely on a mental shortcut to choose answers from the most obvious (available) options.

Kahneman amusingly illustrated a variant of the availability bias, which he called the *anchoring bias*. When asked to estimate anything numerically, we have a tendency to over-rely (or "anchor") on any number that has recently been suggested to us, regardless of its relevance. Kahneman asks an audience to think of the last four digits of their social security number, and then asks them to estimate the number of physicians living in New York City. To a remarkable and entirely illogical extent, people's subsequent estimates of the number of New York physicians correlated with the last four digits of their own social security number. (Amazingly, this held true even when the audience was composed of math teachers.) Numbers hold a mystical sway over the human brain and it appears we are frighteningly suggestible when it comes to arguments based on data, even when the data is irrelevant. Thus we acquire newfound respect for the prescience of Mark Twain's famous quip, "There are three kinds of lies: lies, damned lies, and statistics."

One example of availability bias that comes up in the context of CSR relates to the impact of global warming on polar bears. Global warming contrarian Bjorn Lomborg often uses this example to show that most people think they understand global warming better than they actually do. Thus, he opens his book *Cool It* with a long chapter that provides abundant statistics to show that, over the past 25 years, the global population of polar bears has been increasing.[7] This comes as such a profound shock to most citizens who are concerned about global warming that they can scarcely believe it. Is Bjorn Lomborg telling the truth, or is he pulling our leg? Some students even become angry when presented with the evidence.

Actually, Lomborg does not deny that in the long term global warming may have a highly negative impact on polar bear populations. The point he is trying to make is that people leap to assumptions without checking the facts. People are concerned about polar bears because so many groups that try to raise awareness about the dangers of global warming have used the endangered polar bear as their favored mascot. Consequently, many people have simply assumed polar bear populations were already being decimated by global warming. While, polar bear populations may become under severe strain from global warming in the 21st century, for the past several decades, as well as the current decade, the main danger to polar bears comes from legally licensed hunters.

This point is raised here not to advance any argument about global warming. We will devote an entire chapter to global warming issues, and you will have an opportunity to learn more there about the very real dangers associated with global warming. The point here is that people have a tendency to leap to the easiest assumption, and that is one tendency that we should try to resist when we engage in formal research and debate.

Debating CSR: What are the Key Issues?

As noted at the beginning of this chapter, some people are surprised to hear that there is anything to debate about CSR. After all, such people may ask, isn't CSR a matter of corporations doing good things? And what could possibly be wrong with corporations doing good things?

Actually, even corporations that fully support CSR do engage in debates about CSR, but these are usually about *how* to do CSR, not about whether CSR is in general a positive thing or not. Corporations, like individuals, sometimes have to make difficult choices about how to spend their money. It can be quite challenging for a corporation to choose among different options for CSR, and equally difficult to decide how much to spend on a particular CSR project in terms of cash and organizational resources. Several of the case studies in this book deal these types of strategic CSR questions.

However, it is worth noting at the outset that many CSR skeptics also believe that CSR merits greater ethical scrutiny, and thus there are some prominent voices who have expressed doubts about the perceived social benefits of CSR.

So that you can begin to develop your own informed opinion on this topic, let us begin with a review of the potential benefits and drawbacks to CSR.

CSR: Potential Benefits

Neglected Social Problems Are Addressed

It is undeniable that even governments in the wealthiest countries cannot effectively address all social problems. Every society is to some extent plagued by issues such as unemployment, criminality, homelessness, disease, discrimination, pollution, and natural disaster. Why not mobilize the vast economic and organizational resources of corporations to help alleviate the damage caused by such problems?

Corporate Employees Are Energized and Motivated

A large percentage of the workforce in most countries is employed in the corporate sector (38% of Americans are employed by large companies).[8] CSR allows corporate employees to feel an added level of meaning in their lives by enriching their jobs with an ethical dimension. Such employees may be more productive on the job and may be more willing to volunteer for community service and contribute to charitable organizations.

Links between Business, Nonprofits and the Government Are Enhanced

Today, a great deal of CSR involves partnerships between corporations, nonprofit organizations, and governmental bodies. For example, the Timberland footwear and apparel company developed a partnership with the Boston-based nonprofit organization City Year in 1989, beginning with a small contribution of 50 boots.[9] City Year engages young people from 17 to 24 in a 10-month program of community service. By 1994, Timberland had provided $5 million to help City Year expand into 6 cities, and by 1998, Timberland employees had contributed 20,000 hours to City Year efforts. President Bill Clinton was so impressed by the City Year story in 1992 that, in 1993, he enlisted its founders to help him establish the AmeriCorps program, a federally-funded means of supporting community service by young people. Since its founding, 575,000 AmeriCorps volunteers have contributed over 700 million hours of community service.

Corporate Image Is Improved

In a competitive global marketplace, corporations want to maintain a strong, positive image in the minds of consumers and legislators, and CSR helps them achieve this. For example, Estée Lauder has become closely associated with the pink ribbon symbol of its Estée Lauder Breast Cancer Awareness Campaign, a program that has raised over $35 million for breast cancer research and has spread to over 70 countries.

CSR: Potential Drawbacks

Bad Corporations Are Able to Buy a Positive Image

Some of the biggest contributors to CSR are companies in the oil, tobacco, and alcohol sectors, arguably those who have the most to gain from repairing negative associations with the harm caused by their products. Although the World Health Organization has declared that tobacco is the single greatest cause of preventable deaths worldwide, that fact has not stopped global tobacco companies, such as Philip Morris International (owner of the Marlboro brand) from spending huge sums to improve their image. Philip Morris not only contributes over $30 million per year to a variety of charitable causes in over 50 countries, it is also a leading sponsor of sporting events (notably Formula 1 racing).[10]

The Public Is Misled on the True Impact of Corporate Activities, e.g., "Greenwashing"

Greenwashing refers to the corporate practice of making misleading environmental claims. By the early 1990s, nearly a quarter of all consumer products were marketed with some sort of environmental claim, using terms such as "green" or "environmentally friendly."[11] So many of these claims were later found to be exaggerated or deceptive that a number of advertising regulatory bodies and consumer protection agencies around the world enacted strict controls on environmental claims in advertising.

Among the leaders in making environmental claims have been oil, chemical, and automobile companies, all of which are arguably linked to increasing levels of pollution. Thus, in Norway, for example, strict regulations prohibit car manufacturers from making virtually any environmental claims, because in the view of the Norwegian Consumers Ombudsman, "cars can't be environmentally beneficial."

As early as the mid-1990s, the Chevron oil company had become a leader in touting its commitment to environmentalism, but that did not prevent it from getting embroiled in a controversial lawsuit involving claims of massive amounts of pollution in the Ecuadorian Amazon, with Chevron suffering an adverse $19 billion legal judgment for the environmental damage it caused. Similarly, BP (British Petroleum), went so far as to revamp the corporate logo in its attempt to become recognized for environmentalism despite evidence that BP management was aware of the risks that led to the offshore oil platform explosion off the coast of Louisiana in 2010, considered the worst marine oil spill in the world and the greatest environmental disaster in the history of the United States. Evidence uncovered in a U.S. Congressional hearing suggested that BP management had overruled its own staff and consultants to undertake riskier procedures because these were perceived to save time and money.[12]

Nonprofits and Charities May Rely Too Heavily on Corporate Handouts

Many charities and nonprofits come to rely heavily on corporate contributions and often on contributions from a single corporation, which leaves them at the mercy of corporate goodwill, and at the risk of economic or management reversals which could lead to a cutoff of their funds. Thus, in the Timberland–City Year example discussed earlier, by 1997, City Year found that it was almost wholly dependent on Timberland for financial support, and it was only at that point that Timberland and City Year reached out for help from other corporations. Indeed, the City Year sponsorship had even caused a problem within Timberland when the company suffered a sharp decline in revenue in 1995 that led to layoffs. Employees were angry that management continued to spend millions on charitable contributions at the same time it was terminating jobs.

From a similar perspective, consider the cases of Enron and Lehman Brothers, enormous companies that disappeared virtually overnight due to fraud and mismanagement, respectively. Both companies maintained large CSR programs that had to be suddenly abandoned.[13] Indeed, Enron had become known as a leading “poster child” for CSR, with widely reported commitments to green energy, so that at the 1997 Kyoto Conference it received an award from the Climate Institute.

Topic for Debate: To CSR or Not to CSR?

You have a close friend, John Goodie, who is considering obtaining a graduate degree in business and is trying to decide between two programs. One program is part of the MBA (master of business administration degree) curriculum at University A, and it focuses on CSR. The other program is part of the MBA curriculum at University B, and it focuses on the management of nonprofits and charities. John has always considered himself a very ethical and responsible citizen and has spent most of his summers since his teenage years volunteering in a number of community service positions. Both schools have excellent reputations, but University B is slightly more prestigious.

John tells you that his ultimate goal is simply “to make the world a better place.” He asks for your advice. What do you tell him? Provide the strongest arguments in favor of either University A or University B, as follows:

Affirmative Position

John should attend **University A**, which has a strong program in CSR.

Possible Arguments:

- CSR is likely to be the most powerful and effective way of making the world a better place.
- CSR is a rapidly growing field with lots of jobs.
- John is already implicitly interested in CSR since he wants to make the world a better place.

Negative Position

John should attend **University B**, which is slightly more prestigious but does not have a well-developed CSR program.

Possible Arguments:

- There are problems with CSR, such as greenwashing.
- If John wants to make the world a better place, he will be better off developing his skills in the more prestigious institution.
- With a more prestigious degree, he will be able to get a job in a nonprofit or charitable organization if he wants.

Readings

2.1 CSR Isn’t Working

Morrell, Marcus. “Anita Roddick: Corporate Social Responsibility?” Transcript of video, 5:02. Filmed September 15, 2006. www.globalissues.org/video/733/anita-roddick-corporate-social-responsibility.

Corporate social responsibility, I don’t think it’s working. I think it’s been taken over by the big management houses, marketing houses, been taken over by the big groups like KPMG, like Arthur Anderson. It’s a huge money-building operation now. I think maybe it’s the word “corporate.”

When I was part of the architects of this responsibility business movement, that was so different; that was an alternative to the International Chamber of Commerce, it was a traders’ alliance, it had progressive thinkers, progressive academics, it had, you know, people who were philanthropists.

Things happened. We didn’t see the whole growth of corporate globalization; we didn’t see the immense power of businesses playing, especially in the political arena. We didn’t look at the language, the economic language which was about control, which was about everything had to be for the market economy. We were just flowering around on our own thinking and so we took our eyes off the ball and when we put it on the ball again we thought, “you know, it’s been hijacked, this social responsibility in business”; and it became *corporate*social responsibility.

And it was a huge money-earner, for these big management companies, like KPMG, like Arthur Anderson, like PriceWaterHouseCoopers, all of those. They were making shed-loads of money by actually doing a system of analysis about how you measure your behavior. But it was no good; it was like this obsession for measurement. It wasn’t showing you how you can put these ideas into practice and they never told you it meant a truth—truth that nobody wants to discuss, that if it gets in the way of profit, businesses aren’t going to do anything about it. So we still have rapacious businesses, you still have businesses in bed with government, you still have governments’ inability to measure their greatness by how they look after the weak and the frail. You still have government’s only true measurement of success as economic measurement. And you still have businesses that can legitimately kill, can legitimately have boardroom murder, can legitimately have a slave-labor economy, so that all of us in the West—primarily in the West, or all of us who are wealthy—are guaranteed a standard of living to which we are used to.

But for me, corporate social responsibility in my life, I don’t think it has worked. And that’s a shame. Because it’s controlled the language and it’s hijacked the language.

Morrell, Marcus. “Anita Roddick: Corporate Social Responsibility?” Transcript of video, 5:02. Filmed September 15, 2006. http://www.globalissues.org/video/73...responsibility.

2.2 Paul Newman reflects on founding Newman's Own

Newman, Paul and A.E. Hotchner. *In Pursuit of the Common Good*, 197-199. New York: Broadway Books, 2003. Find this book in a library.

I really cannot lay claim to some terribly philanthropic instinct in my base nature. It was just a combination of circumstances. If the business had stayed small and had just been in three local stores, it would never have gone charitable. It was just an abhorrence of combining tackiness, exploitation, and putting money in my pocket, which was excessive in every direction.

Now that I'm heavily into peddling food, I begin to understand the romance of the business—the allure of being the biggest fish in the pond and the juice you get from beating out your competitors. I would like to see the company reach $300 million in sales, and be able to support new philanthropic initiatives. We were a joke in 1982, but the joke has given away $250 million so far—so we are a very practical joke.

One thing that really bothers me is what I call “noisy philanthropy.” Philanthropy ought to be anonymous, but in order for this to be successful you have to be noisy. Because when a shopper walks up to the shelf and says, “Should I take this one or that one?” you've got to let her know that the money goes to a good purpose. But overcoming that dichotomy has provided us with the means of bringing thousands of unlucky children to the Hole in the Wall Gang Camps.

Since the Connecticut camp opened in 1988, a time when only 30 percent of the children who attended survived, medical progress has been phenomenal, especially in the field of bone marrow transplants; the result is that the percentages have been completely reversed—70 percent of those children who come to camp will now survive; but during the critical time of treatment and recovery we furnish them with much needed respite….

It is also thrilling to note that thirty-five of last summer's counselors were former campers who had overcome cancer and were now taking care of kids afflicted as they were. At the end of last summer's session, a counselor who had been a media major in college, on the basis of her experience at the camp changed her course of studies to pursue a medical career in pediatric oncology….

Another experience last summer, a marvelous African-American girl who told me, “Coming up here is what I live for, what I stay alive for during those miserable eleven months and two weeks is to come up here for the summer.”

2.3 “Corporate Conscience Survey Says Workers Should Come First”

Strom, Stephanie. “Corporate Conscience Survey Says Workers Should Come First.” The *New York Times* online. May 31, 2006. www.nytimes.com/2006/05/31/business/31charity.html?_r=0.

2.4 Corporate Watch Critiques CSR

“What's Wrong with Corporate Social Responsibility? The Arguments against CSR,” Corporate Watch, accessed November 30, 2014, www.corporatewatch.org/content/whats-wrong-corporate-social-responsibility-arguments-against-csr.

Like the iceberg, most CSR activity is invisible…It is often an active attempt to increase corporate domination rather than simply a defensive “image management” operation.

CSR is supposed to be win-win. The companies make profits and society benefits. But who really wins? If there is a benefit to society, which in many cases is doubtful, is this outweighed by losses to society in other areas of the company's operation and by gains the corporation is able to make as a result? CSR has ulterior motives. One study showed that over 80% of corporate CSR decision-makers were very confident in the ability of good CSR practice to deliver branding and employee benefits. To take the example of simple corporate philanthropy, when corporations make donations to charity they are giving away their shareholders' money, which they can only do if they see potential profit in it. This may be because they want to improve their image by associating themselves with a cause, to exploit a cheap vehicle for advertising, or to counter the claims of pressure groups, but there is always an underlying financial motive, so the company benefits more than the charity.

…CSR diverts attention from real issues, helping corporations to avoid regulation, gain legitimacy and access to markets and decision makers, and shift the ground towards privatization of public functions. CSR enables business to pose ineffective market-based solutions to social and environmental crises, deflecting blame or problems caused by corporate operations onto the consumer and protecting their interests while hampering efforts to find just and sustainable solutions.

CSR as Public Relations

CSR sells. By appealing to customers' consciences and desires CSR helps companies to build brand loyalty and develop a personal connection with their customers. Many corporate charity tie-ins gain companies access to target markets and the involvement of the charity gives the company's message much greater power. In our media-saturated culture, companies are looking for ever more innovative ways to get across their message, and CSR offers up many potential avenues, such as word of mouth or guerilla marketing, for subtly reaching consumers.

CSR also helps to greenwash the company's image, to cover up negative impacts by saturating the media with positive images of the company's CSR credentials….

A prominent case against Nike in the US Supreme Court illustrates this point. When, in 2002, the Californian Supreme Court ruled that Nike did not have the right to lie in defending itself against criticism, chaos ensued in the CSR movement. Activist Marc Kasky attempted to sue the company over a misleading public relations campaign. Nike defended itself using the First Amendment right to free speech. The court ruled that Nike was not protected by the First Amendment, on the grounds that the publications in question were commercial speech. The case proceeded to the US Supreme Court. Legal briefs were submitted to the Supreme Court by public relations and advertising trade associations, major media groups, and leading multinationals, arguing that if a company's claims on human rights, environmental and social issues are legally required to be true, then companies won't continue to make statements on these matters.

The submission from ExxonMobil, Monsanto, Microsoft, Bank of America, and Pfizer contended that "if a corporation's every press release, letter to an editor, customer mailing, and website posting may be the basis for civil and criminal actions, corporate speakers will find it difficult to address issues of public concern implicating their products, services, or business operations."

This case simply reinforces the criticism that CSR is nothing more than a PR exercise. Corporations would not be so concerned about potential legal actions if they valued truth, transparency, and accountability as much as they claim.

CSR is a strategy for avoiding regulation

CSR is a corporate reaction to public mistrust and calls for regulation. In an Echo research poll, most financial executives interviewed strongly resisted binding regulation of companies. Companies argue that setting minimum standards stops innovation; that you can't regulate for ethics, you either have them or you don't; and that unless they are able to gain competitive advantage from CSR, companies cannot justify the cost.

Companies are essentially holding the government to ransom on the issue of regulation, saying that regulation will threaten the positive work they are doing. CSR consultancy Business in the Community supports corporate lobbying against regulation, arguing that "regulation can only defend against bad practice—it can never promote best practice." These arguments, however, simply serve to expose the sham of CSR. Why would a "socially responsible company" take issue with government regulation to tackle bad corporate practice?

…The argument that regulation would hinder voluntary efforts on the part of the company to improve their behavior has been readily accepted by a government keen to avoid its regulatory duties when it comes to curbing corporate power. The UK Department for International Development (the department charged with tackling global poverty…) dismissed the idea of an international legally binding framework for multinational companies saying that it would "divert attention and energy away from encouraging corporate social responsibility and towards legal processes." As this quotation shows, without any evidence for its effectiveness, the government is choosing CSR over making corporate exploitation and abuse illegal.

2.5 "Leading Organizations Build Case for Green Infrastructure"

"Leading Organizations Build Case for Green Infrastructure," *The Nature Conservancy*, accessed June 11, 2013, www.nature.org/newsfeatures/pressreleases/leading-organizations-build-case-for-green-infrastructure.xml.

Research by experts from industry and an environmental organization finds that incorporating nature into man-made infrastructure can improve business resilience—and bring additional economic, environmental, and socio-political benefits.

Experts from The Dow Chemical Company, Shell, Swiss Re, and Unilever, working with The Nature Conservancy and a resiliency expert, evaluated a number of business Case Studies, and recommend in their newly published White Paper that green infrastructure solutions should become part of the standard toolkit for modern engineers.

Green infrastructure employs elements of natural systems, while traditional gray infrastructure is man-made. Examples of green infrastructure include creating oyster reefs for coastal protection, and reed beds that treat industrial wastewater.

"Instead of thinking about independent solutions, we must look at integrated systems," said Andrew Liveris, Chairman and Chief Executive Officer of Dow. "Natural systems not only serve multiple functions, but have multiple benefits—often requiring less capital and less maintenance while promoting biodiversity that we all enjoy."

"Green infrastructure can bring benefits for companies, for communities and for the environment," said Peter Voser, Chief Executive Officer of Royal Dutch Shell plc. "It can be cheaper, provide new opportunities for engagement with stakeholders, and create wildlife habitats. Green infrastructure should be part of mainstream business thinking."

"Protecting nature and the services it provides to people and business is one of the smartest investments we can make," said Mark R. Tercek, president and CEO of The Nature Conservancy.

"This is the case whether we are talking about the production of clean, abundant freshwater, protection from storms, or healthy and productive soils. Green infrastructure solutions also provide many co-benefits, such as wildlife habitat, and typically appreciate over time, rather than depreciate as happens with gray infrastructure."

Union Carbide Corporation (subsidiary of The Dow Chemical Company) uses constructed wetlands to treat wastewater near Seadrift in Texas.

This 110-acre (approximately 44.5-hectare) engineered wetland was designed to consistently meet regulatory requirements for water discharge from the manufacturing plant, and has operated successfully for over a decade.

Petroleum Development Oman LLC (PDO) uses constructed wetlands to treat produced water from oilfields in Oman.

The Nimr oilfields, in which The Shell Petroleum Company Ltd is a joint venture partner, not only produce oil, but also more than 330,000 m^3 of water per day. PDO built the world's largest commercial wetland, and it treats more than 30% (or 95,000 m^3 per day) of the total produced water. This volume would normally require extensive infrastructure to treat and inject the water into a subsurface disposal well. As gravity pulls the water downhill, reeds act as filters, removing oil from the water. The oil is eaten by microbes that naturally feed on hydrocarbons underground. Oil content in the produced water is consistently reduced from 400 mg/l to less than 0.5 mg/l when leaving the wetlands.

Power consumption and CO2 emissions are 98% lower than they would have been with the alternative man-made solution. Also, the wetlands are providing habitat for fish and hundreds of species of migratory birds.

The Nature Conservancy is a leading conservation organization working around the world to protect ecologically important lands and waters for nature and people. The Conservancy and its more than 1 million members have protected nearly 120 million acres worldwide.

Synthesis Questions

1. Are there companies you can name whose social responsibility actions you admire and trust? What do they do that inspires you?
2. Are there companies you can name whose social responsibility actions you would not trust, or even doubt? Which companies are they, and why do they fail to convince you?
3. Would you like to work in the field of CSR? Why or why not?

Endnotes

1. Daniel Kahneman, *Thinking, Fast and Slow* (New York: Farrar Straus and Giroux, 2011), 19-25.

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3. Albert H. Hastorf and Hadley Cantril, "They Saw a Game: A Case Study," *The Journal of Abnormal and Social Psychology* 49(1) (1954), 129-134.

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5. Plato, The Dialogues of Plato (Oxford: Clarenden Press, 1921), 439.

6. Michael Schrage, "The Thought Leader Interview: Daniel Kahneman," *Business + Strategy*, Winter 2003, accessed November 29, 2014, www.strategy-business.com/article/03409?pg=all.

7. Bjorn Lomborg, Cool It: The Skeptical Environmentalist's Guide to Global Warming (New York: Vintage, 2010).

8. Kristie Arslan, "Five Big Myths About American Small Business," Huffington Post, May 24, 2011, accessed November 29, 2014, http://www.huffingtonpost.com/kristie-arslan/five-big-myths-about-amer_b_866118.html.

9. "Integrated Partnership: City Year and Timberland," SR International, accessed November 29, 2014, srint.org/2010/11/01/integrated-partnership-cityyear-and-timberland/.

10. "Corporate Contributions," Philip Morris International Management, accessed June 19, 2015, http://www.pmi.com/eng/about_us/corporate_contributions.

11. Joshua Karliner, "A Brief History of Greenwash," *CorpWatch*, May 22, 2001, accessed on November 30, 2014, http://www.corpwatch.org/article.php?id=243.

12. "BP Engineer Called Doomed Rig a 'Nightmare Well'". CBSNews/CBS/Associated Press, last updated June 14, 2010, http://www.cbsnews.com/news/bp-engineer-called-doomed-rig-a-nightmare-well/.

13. Robert Murphy, "Enron, the CSR Poster Child," Townhall.com, last updated April 26, 2008, http://townhall.com/columnists/robertmurphy/2008/04/26/enron,_the_csr_poster_child/page/full

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SECTION OVERVIEW

1.9: Going Global - Yes or No?

1.10: Chapter Introduction

Center Rock Inc.

Source: Reprinted with permission from Center Rock, Inc.

Brandon Fisher, the founder of Center Rock Inc., is shown on the left side in the picture The man to his right is Richard Soppe, the senior drilling application engineer. The number 33 is the number of Chilean miners who were rescued in 2010. Brandon and his company, now at seventy-five employees, are true American heroes.

Center Rock manufactures and distributes a complete line of air drilling tools and products. At its state-of-the-art manufacturing facility in Pennsylvania, they build stock and made-to-order products that are used by leading drilling, oil and gas, foundation, construction, roadway, and mining contractors across North America, Europe, Asia, Russia, and Australia. Fisher entered the global market four years ago as a way to expand the business. He was able to finance the expansion internally, so financing was not an issue.

Center Rock Inc., founded in 1998 by then twenty-six-year-old Brandon Fisher, began as a drilling company. He designed and built his own horizontal drilling rig and, shortly thereafter, began focusing on making Center Rock an air and rock drilling supplier and manufacturer. He recognized the need for a manufacturing company that was reactive to customer needs, with innovative products and 24/7 customer service and support. Working with his high-tech engineering and design team, Fisher created a company different from its competitors with its unique products and service capabilities.

"I love what I do," says Fisher. "There is always a challenge in this industry to find new ways to drill into the earth, and the challenge feeds the excitement.""About Us," *Center Rock Inc.*, accessed February 7, 2012, www.centerrock.com/content/about-us; e-mail correspondence with Brandon Fisher, July 28, 2011.

1.11: US Small Business in the Global Environment

Learning Objectives

1. Understand and appreciate the role of small businesses in the global environment.
2. Learn about the global growth opportunities for small businesses.
3. Understand the advantages and the disadvantages of a small business going global.

Although small businesses make up a disproportionately large share of the number of companies that export and import, this represents only about 1 percent of the total number of small businesses. Thus many small businesses have yet to compete globally. The opportunities are there. "So much of what America makes is in great demand," said US Commerce Secretary Gary Locke in an interview, adding further that the growth potential for small companies is outside the United States. Dale Hayes, vice president of US marketing for UPS concurs, observing that the demand for high-quality American products is huge.Paul Davidson, "Small Businesses Look Across Borders to Add Markets," *USA Today*, April 12, 2011, accessed February 7, 2012, www.usatoday.com/money/economy/2011-04-06-small-businesses-go-international.htm; Rieva Lesonsky, "Increased Opportunities for Small-Business Exports," *Small Business Trends*, June 27, 2010, accessed February 7, 2012, smallbiztrends.com/2010/06/opportunities-small-business -exports.html. It may be that a small business is already competing globally because foreign-owned companies are competing in our own backyards."Breaking into the Trade Game: A Small Business Guide to Exporting," *US Small Business Administration*, 2005, accessed February 7, 2012, archive.sba.gov/idc/groups/public/documents/sba_homepage/serv_entire.pdf.

According to the U.S. Census Bureau in 2015, "Small- and medium-sized companies (those employing fewer than 500 workers, including number of employees unknown) comprised 97.6 percent of all identified exporters and 97.2 percent of all identified importers." (https://sbecouncil.org/about-us/facts-and-data/). Manufacturing and wholesalers represent a smaller portion of global trade revenue in the U.S. If a small business is considering entering the international marketplace, it must undertake careful analyses before jumping into the global arena.

The Small Business Global Presence

It may seem to many that the global market is the domain of the large corporations, but the statistics tell a very different story.

- Small businesses account for 96.4 percent of all manufacturing exporters, which is 17.2 percent of the sector's $562 billion in exports.
- Nearly 100 percent (99.2 percent) of exporting wholesalers were small businesses, which is 61.1 percent of the sector's $218 billion in exports.
- Of other companies with exports, 96.9 percent were small businesses. These companies include manufacturing companies of prepackaged software and books, freight forwarders and other transportation service firms, business services, engineering and management services, gas and oil extraction companies, coal mining companies, and communication services, to name a few.
- Small businesses account for 93.6 percent of all manufacturing importers, which is 12.9 percent of the sector's $602 billion in imports.
- Nearly 100 percent (99.2 percent) of wholesaler importers were small businesses, contributing 56.8 percent of the sector's $451 billion in imports.
- Small businesses accounted for 94.3 percent of the companies that both exported and imported, accounting for 29 percent of the export value and 27 percent of the import value.

This tells us that small businesses are very active in the global marketplace, and small business success in international markets is extremely important to the welfare of the United States."Breaking into the Trade Game: A Small Business Guide to Exporting," *US Small Business Administration*, 2005, accessed February 7, 2012, archive.sba.gov/idc/groups/public/documents/sba_homepage/serv_entire.pdf. Although it is true that small businesses are major users of imported goods, the focus of this chapter is on small business exporting because exporting can be an effective way to diversify the customer base, manage market fluctuations, grow, and become more competitive.US Department of Commerce, *A Basic Guide to Exporting*, 10th ed. (Washington, DC: International Trade Association, 2008), i.

Small businesses are limited in the products and the services that they export. Small business exports are concentrated in four main product categories: computers and electronic products, chemicals, machinery, and transportation equipment. However, the leading product categories in terms of market share were wood products, apparel and accessories, tobacco products, beverages, and leather products.“Small and Medium-Sized Enterprises: Overview of Participation in U.S. Exports,” *US International Trade Commission*, January 2010, accessed February 7, 2012, www.usitc.gov/publications/332/pub4125.pdf.

Although the United States is one of the world’s largest participants in global services trade, very little information exists with respect to services exports by small businesses. What is known is that it is increasingly common for most US services firms to establish a **foreign affiliate**—a branch or a subsidiary of the parent company established outside the national boundaries of the parent company’s home market—because most services are better supplied in close proximity to the principal or final customers.“Small and Medium-Sized Enterprises: Overview of Participation in U.S. Exports,” *US International Trade Commission*, January 2010, accessed February 7, 2012, www.usitc.gov/publications/332/pub4125.pdf. Additionally, in some business sectors, foreign regulations may restrict the delivery of some services to affiliates only. For example, to comply with domestic solvency requirements, some countries require that personal lines of insurance be carried out only by affiliates. Another example is the protection of intellectual property rights. This is often accomplished through the services of affiliates, thus intellectual property is kept in-house.“Small and Medium-Sized Enterprises: Overview of Participation in U.S. Exports,” *US International Trade Commission*, January 2010, accessed February 7, 2012, www.usitc.gov/publications/332/pub4125.pdf.

What is particularly interesting is that most of the service exporting occurs in businesses with 0–19 employees, with the least service exporting done by small businesses with 300–499 employees. This may be the exact opposite of what you would expect.

The Advantages of Going Global

The flexibility of a smaller company may make it possible to meet the demands of global markets and redefine a company’s programs more quickly than might occur in the larger **multinational corporation**.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 312. A multinational corporation is a company that operates on a worldwide scale without ties to any specific nation or region; it is organized under the laws of its own country.William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2007), 94. This flexibility of the smaller company is particularly true of the **micromultinationals**, a relatively new category of tiny companies that operate globally, having a presence and people in multiple countries.Anita Campbell, “The Trend of the Micro-Multinationals,” *Small Business Trends*, February 20, 2007, accessed February 7, 2012, smallbiztrends.com/2007/02/the-trend-of-the-micro-multinationals.html; Bernard Lunn, “Introducing the Tales of Micro-Nationals,” *Small Business Trends*, July 7, 2010, accessed February 7, 2012, smallbiztrends.com/2010/07/introducing-the-tales-of-micro-multinationals.html.

These micromultinationals outsource virtually everything to specialists all over the world and sell to people all over the world through the Internet.Bernard Lunn, “Introducing the Tales of Micro-Nationals,” *Small Business Trends*, July 7, 2010, accessed February 7, 2012, smallbiztrends.com/2010/07/introducing -the-tales-of-micro-multinationals.html. The Internet is inexpensive technology, and the services designed to help small businesses make it possible for the small company to operate across borders with the same effectiveness and efficiencies as large businesses.Anita Campbell, “Preparing Your Business to Go Global,” *Small Business Trends*, November 19, 2010, accessed February 7, 2012, smallbiztrends.com/2010/11/preparing-your-business-to-go-global.html.

Micromultinationals

Generation Alliance is a branding and design firm that provides services to clients all over the world. They have core employees in Australia and specialist contractors in New Zealand, the United Kingdom, Germany, Switzerland, Jamaica, Dubai, and Singapore. One of their more interesting projects was to rebrand the country of Botswana for the global market.Bernard Lunn, “Tales of Micro-Multinationals: Generation Alliance,” *Small Business Trends*, July 7, 2010, accessed February 7, 2012, smallbiztrends.com/2010/07/tales-of-micro-multinationals-generation-alliance.html.

Jadience sells a line of health and skincare products that has its roots in traditional oriental medicine. Their physical products are sent to customers, mostly spas, in the United States, Canada, and Mexico.Bernard Lunn, “Tales of Micro-Multinationals: Jadience,” *Small Business Trends*, July 15, 2010, accessed February 7, 2012, smallbiztrends.com/2010/07/tales -of-micro-multinationals-jadience.html.

Worketc operates in the large and competitive business software market. Their focus is small businesses, selling web-based customer relationship management (CRM), project management, billing, shared calendars, help desk, and document management software. The company is headquartered in Sydney, Australia, and it claims happy customers in sixteen countries. The United States accounts for 86 percent of its customers.Bernard Lunn, “Tales of Micro-Multinationals: Worketc,” *Small Business Trends*, July 21, 2010, accessed February 7, 2012, smallbiztrends.com/2010/07/micro -multinationals-worketc.html; "The Why of What We're About," *Worketc*, accessed February 7, 2012, www.worketc.com/about_us.

There are many reasons why small businesses should consider going global:"Benefits of Exporting," *Export.gov*, March 31, 2011, accessed February 7, 2012, export.gov/about/eg_main_016807.asp; Laurel Delaney, "A How-To on Expanding Your Business Globally," *The Global Small Business Blog*, January 11, 2011, accessed February 7, 2012, borderbuster.blogspot.com/2011/01/how-to-on-expanding -your-business.html; Steve Strauss, "Globalization Is Good for (Small) Business," *USA Today*, May 17, 2004, accessed February 7, 2012, www.usatoday.com/money/smallbusiness/columnist/strauss/2004-05-17-globalization_x.htm; "Breaking into the Trade Game: A Small Business Guide to Exporting," *US Small Business Administration*, 2005, accessed February 7, 2012, archive.sba.gov/idc/groups/public/documents/sba_homepage/serv_entire.pdf.

- A small business that thinks and sells only domestically may be reaching only a small share of its potential customers because 95 percent of the world's consumers live outside the United States.
- Exporting enables companies to diversify their portfolios and weather changes in the domestic economy. This stabilizes seasonal and cyclical market fluctuations.
- Exporting helps small businesses grow and become more competitive in all their markets, which reduces the dependence on existing markets.
- Exporting increases sales and profits, also extending the sales potential of existing products. Research has shown that exporting can expand total sales 0.6 percent to 1.3 percent faster than would otherwise be the case.
- Exporting companies are able to sell excess production capacity.
- Exporting companies are nearly 8.5 percent less likely to go out of business.
- There are higher worker earnings as well, which contributes to the betterment of the community.

According to the US Small Business Administration (SBA),"Breaking into the Trade Game: A Small Business Guide to Exporting," *US Small Business Administration*, 2005, accessed February 7, 2012, archive.sba.gov/idc/groups/public/documents/sba_homepage/serv_entire.pdf. US exporting businesses experience faster annual employment growth by 2 to 4 percentage points over their nonexporting counterparts. Workers employed in exporting companies have better paying jobs and better opportunities for advancement. Research has estimated that blue-collar worker earnings in firms that export are 13 percent higher than those in nonexporting plants, 23 percent higher when comparing large plants, and 9 percent higher when comparing small plants. White-collar employees also benefit from higher salaries, 18 percent more than their nonexporting counterparts. Less skilled workers also earn more at companies that export. Lastly, the benefits that all workers receive at exporting plants are 37 percent higher and include improved medical insurance and paid leave.

Video Link 15.1

Why Export?

Why small businesses should consider entering the global marketplace.

www.inc.com/exporting/whyexport.htm

The Disadvantages of Going Global

There is no question that the benefits of going global are considerable. However, disadvantages or barriers must also be considered. For example, a small business will incur additional costs, such as modifying its product or its packaging (perhaps even changing the name of its product so that it does not convey negative meanings outside the United States), developing new promotional materials, administrative costs (such as hiring staff to launch the export expansion and dedicating personnel for traveling), traveling to foreign locations (very important), and shipping.Laurel Delaney, "A How-To on Expanding Your Business Globally," *The Global Small Business Blog*, January 11, 2011, accessed February 7, 2012, borderbuster.blogspot.com/2011/01/how-to-on-expanding-your-business.html; Strategic Name Development, Inc., "Global Linguistic Analysis" (2011), accessed February 7, 2012, www.namedevelopment.com/global-linguistic-analysis.html. It may also be necessary for the owner to subordinate short-term profits to long-term gains, wait longer for payments, apply for additional financing, and obtain special export licenses."Breaking into the Trade Game: A Small Business Guide to Exporting," *US Small Business Administration*, 2005, accessed February 7, 2012, archive.sba.gov/idc/groups/public/documents/sba_homepage/serv_entire.pdf. There will be differences in consumer needs, wants, and usage patterns for products; differences in consumer response to the elements of the marketing mix and differences in the legal environment may conflict with those of the United States."Global Marketing," *SmallBusiness.com*, accessed February 7, 2012, smallbusiness.com/wiki/Global_marketing. Then, of course, there are cultural and language issues along with the all-too-familiar fear of the unknown.Rieva Lesonsky, “Increased Opportunities for Small-Business Exports,” *Small Business Trends*, June 27, 2010, accessed February 7, 2012, smallbiztrends.com/2010/06/opportunities-small-business-exports.html. A recent survey of exporting and nonexporting members of the National Small Business Association (NSBA) and the Small Business Exporters Association (SBEA) reported the following main barriers to small businesses selling their goods and/or services to foreign customers:“2010 Small Business Exporting Survey,” *NSBA and SBEA*, March 11, 2010, accessed February 7, 2012, www.nsba.biz/docs/2010_small_business_exporting_survey__001.pdf.

- I do not have goods and/or services that are exportable: 49 percent.
- I do not know much about it and am not sure where to start: 38 percent.
- I would worry too much about getting paid: 29 percent.
- It is too costly: 27 percent.
- It would take too much time away from my regular, domestic sales: 17 percent.
- I cannot obtain financing to offer products or services to foreign customers: 7 percent.

Three things were identified as the single largest challenge: worrying about getting paid (26 percent), feeling that exporting is confusing and difficult to do (24 percent), and having limited goods and/or services that are exportable (18 percent).

Richard Ginsburg in the SBA’s Office of International Trade commented that most US small businesses simply do not understand the value of taking their business global, further noting that “the number-one barrier to trade is the psychological acceptance that global business is necessary.”Kevin Morris, “Small Business Owner Takes His Green Energy Business Global,” *AllBusiness.com*, April 22, 2011, accessed February 7, 2012, www.allbusiness.com/small-green-energy-business/15572754-1.html.

Small businesses also face some resource constraints that reduce their ability to export. For example, small businesses are more likely than larger firms to face scarcities of financial and human resources that limit their ability to take advantage of global opportunities. Limited personnel, the inability to meet quality standards, the lack of financial backing, and insufficient knowledge of foreign markets are important constraints affecting the ability of small businesses to export.“Breaking into the Trade Game: A Small Business Guide to Exporting,” *US Small Business Administration*, 2005, accessed February 7, 2012, archive.sba.gov/idc/groups/public/documents/sba_homepage/serv_entire.pdf. Fortunately, being proactive, innovative, and willing to take risks have helped small businesses overcome export impediments and improve export performance.“Breaking into the Trade Game: A Small Business Guide to Exporting,” *US Small Business Administration*, 2005, accessed February 7, 2012, archive.sba.gov/idc/groups/public/documents/sba_homepage/serv_entire.pdf.

The disadvantages of going global may warrant a go-slow approach, but they should not be viewed as knockout factors. If a business’s financial situation is weak, the timing may not be right for becoming an exporter…but perhaps exporting makes sense in the future. In any case, very careful thinking should precede the decision to export.

KEY TAKEAWAYS

- Small businesses make up a disproportionately large share of the number of companies that export and import. However, this is only about 1 percent of the total number of small businesses.
- The growth potential for small companies outside the United States is huge because of the demand for high-quality American products.
- Small businesses account for close to 98 percent of US exporters and 33 percent of the value of US exports.
- Small business success in international trade is extremely important to the welfare of the United States.
- There are many advantages and disadvantages of a small business going global. These must be analyzed very carefully before deciding to enter the global marketplace.
- A recent survey of small business owners revealed that the number one barrier to exporting was the feeling that their businesses did not have exportable goods and/or services. The number one challenge was worrying about getting paid.

EXERCISE

1. Go to www.trade.gov/mas/ian/statereports. Select your state and prepare a profile of small business exporting. Review additional sites as well, for example, websites sponsored by your state’s commerce and/or economic development departments. When looking at government sites, you may see the term *small- and medium-sized businesses* or something similar. They are simply referring to businesses with fewer than five hundred employees. This is the small business group for your purposes.

1.12: What You Should Know Before Going Global

Learning Objectives

1. Learn about the different ways that a business can export.
2. Understand the importance of an industry analysis.
3. Understand that it is important to carefully assess a business.
4. Learn about the marketing decisions that must be made.
5. Learn about the kinds of legal and political issues that will affect the exporting activities of a business.
6. Understand why the currency exchange rate is important to determining price.
7. Learn about the different sources of financing.

Although expanding into global markets offers many important benefits, not the least of which is increased profits, it will also introduce new complexities into the operations of a small business. There are several key decisions (see Figure 15.1) that will need to be made, including the following:Adapted from David L. Kurtz, *Contemporary Business* (Hoboken, NJ: John Wiley & Sons, 2011), 121.

- Determine which foreign market(s) to enter.
- Analyze the expenditures required to enter a new market and determine the source(s) of financing.
- Determine the best way to organize the overseas operation in concert with the US organization.
- Determine the extent to which, if any, the marketing mix will need to be adapted to the needs of the foreign market(s).
- Figure out the best way for the business to get paid.

These decisions, and others, will be based on an assessment of the ways to export, an analysis of the industry and the business, marketing and cultural factors, legal and political conditions, currency exchange issues, and sources of financing.

Video Link 15.2

A Family Business Goes Global

A small business specializing in leather-care products gets a lesson in expanding beyond its old fashioned clientele.

money.cnn.com/video/fsb/2008/09/10/fsb.pecard.makeover.fsb

Figure 15.1 Factors Affecting the Decision to Go Global

Ways to Export

Small businesses can choose from two basic ways to export: directly or indirectly.Laurel Delaney, "A How-To on Expanding Your Business Globally," *The Global Small Business Blog*, January 11, 2011, accessed February 7, 2012, borderbuster.blogspot.com/2011/01/how-to-on-expanding-your-business.html. There are advantages and disadvantages of each that should be understood before making a choice.

Direct Exporting

In **direct exporting**, a small business exports directly to a customer who is interested in buying a particular product. The small business owner makes all the arrangements for shipping and distributing the product overseas, is responsible for the marketing research, and collects payment. This approach gives the owner greater control over the entire transaction and entitles him or her to higher profits—although these higher profits are accompanied by the need to invest significantly more resources and efforts (see Table 15.1). It also requires a significantly changed internal organizational structure, which entails more risk.Laurel Delaney, "A How-To on Expanding Your Business Globally," *The Global Small Business Blog*, January 11, 2011, accessed February 7, 2012, borderbuster.blogspot.com/2011/01/how-to-on-expanding-your-business.html; Laurel Delaney, "Direct Exporting: Advantages and Disadvantages to Direct Exporting," *About.com*, accessed February 7, 2012, importexport.about.com/od/DevelopingSalesAndDistribution/a/Direct-Exporting-Advantages-And -Disadvantages-To-Direct-Exporting.htm; "The Advantages of Direct Exporting," *vcShipping.com*, accessed February 7, 2012, www.vcshipping.com/export/the-advantages-of-direct-exporting.html.

Table 15.1 Advantages and Disadvantages of Direct Exporting

Advantages	Disadvantages
Potential profits are greater because intermediaries are eliminated.	It takes more time, energy, and money than an owner may be able to afford.
The owner has a greater degree of control over all aspects of the transaction.	It requires more "people power" to cultivate a customer base.
The owner knows customers, and the customers know the owner. Customers feel more secure in doing business directly with the owner.	Servicing the business will demand more responsibility from every level in the organization. The owner is held accountable for whatever happens. There is no buffer zone.
Business trips are much more efficient and effective because an owner can meet directly with the customer responsible for selling the product.	The owner may not be able to respond to customer communications as quickly as a local agent can.
The owner knows whom to contact if something is not working. The owner gets slightly better protection for trademarks, patents, and copyrights.	The owner must handle all the logistics of the transaction. If it is a technological product, the owner must be prepared to respond to technical questions and provide on-site start-up training and ongoing support services.
The owner is presented as fully committed and engaged in the export process and develops a better understanding of the marketplace. As a business develops in the foreign market, the owner has greater flexibility to improve or redirect marketing efforts.	

Source: Laurel Delaney, "Direct Exporting: Advantages and Disadvantages to Direct Exporting," *About.com*, accessed February 7, 2012, http://importexport.about.com/od/Dev...-Exporting.htm.

Indirect Exporting

Indirect exporting involves entering "into an agreement with an agent, distributor, or a traditional exporting house for the purpose of selling (or marketing and selling) the products in the target market."Team Canada Inc., "10 Steps to Successful Exporting," *About.com*, accessed February 7, 2012, sbinfocanada.about.com/od/canadaexport/a/10exportsteps.htm. Many small businesses choose this option, at least at the outset. It is the simplest approach, particularly when a business does not have the necessary human and financial resources to promote products in foreign markets in any other way (see Table 15.2).CBS Investment, “Advantages and Disadvantages of Direct and Indirect Exports,” *CBS Investment*, accessed February 7, 2012, www.cbsinvestment.com/advantages-and-disadvantages-of-direct-and-indirect-exports/; Laurel Delaney, “A How-To on Expanding Your Business Globally,” *The Global Small Business Blog*, January 11, 2011, accessed February 7, 2012, borderbuster.blogspot.com/2011/01/how-to-on-expanding-your-business.html. The easiest way to export indirectly is to sell to an intermediary in the United States because the business will normally not be responsible for collecting payment from the overseas customer or coordinating the shipping logistics.Laurel Delaney, *Start and Run a Profitable Exporting Business* (Vancouver, BC: Self-Counsel Press, 1998): chapter 8.

Table 15.2 Advantages and Disadvantages of Indirect Exporting

Advantages	Disadvantages
Does not require a lot of organizational effort or staff workers.	Not all types of goods lend themselves to indirect exporting (e.g., technically complex goods and services).
The producer of the goods is subject to only small dangers and risk (e.g., a short-term drop in the exchange rate).	The profits of a business will be lower, and control over foreign sales is lost.
It is an almost risk-free way to begin. It demands minimal involvement in the export process. It allows the owner to continue to concentrate on its domestic business.	A business very rarely knows who its customers are, thus losing the opportunity to tailor its offerings to their evolving needs.
The business has limited liability for product marketing problems. There is always someone else at which to point the finger.	When an owner visits, he or she is a step removed from the actual transaction and feels out of the loop.
The owner learns on the fly about international marketing. Depending on the type of intermediary with which the owner is dealing, the owner does not have to be concerned with shipment and other logistics.	The intermediary might be offering products similar to a particular business’s products, including directly competitive products, to the same customers instead of providing exclusive representation.
A business can field-test its products for export potential. In some instances, the local agent can field technical questions and provide necessary product support.	The long-term outlook and goals for an export program can change rapidly, and if a business has put its product in someone else’s hands, it is hard to redirect efforts accordingly.

Source: CBS Investment, “Advantages and Disadvantages of Direct and Indirect Exports,” *CBS Investment*, accessed February 7, 2012, http://www.cbsinvestment.com/advanta...irect-exports/; Laurel Delaney, *Start and Run a Profitable Exporting Business* (Vancouver, BC: Self-Counsel Press, 1998), chapter 8.

Industry Analysis

Before jumping into the global pond, it is a good idea to identify where an industry currently is and then look at the trends and directions that are predicted over the next three years. This will be true whether a business is only on the ground, only online, or both brick and click.

A business should try to determine how competitive an industry is in the global market.Laurel Delaney, “A How-To on Expanding Your Business Globally,” *The Global Small Business Blog*, January 11, 2011, accessed February 7, 2012, borderbuster.blogspot.com/2011/01/how-to-on-expanding-your-business.html. Try to get as good a picture of the market as possible because the better informed a business is, the better its chances of a successful global entry. Learn a product’s potential in a given market, where the best prospects for success seem to be, and common business practices.“6 Steps to Begin Exporting,” *US Small Business Administration*, accessed February 7, 2012, www.sba.gov/content/6-steps-begin-exporting.

A small business owner may be reticent about conducting market research before going global, particularly if domestic research efforts have been limited or nonexistent. However, the global market is a very different animal compared to the domestic market. It is even more important to conduct thorough market research to help identify possible risks in advance so that the appropriate steps can be taken to avoid mistakes. This ultimately portrays the business as forward-thinking, trustworthy, and credible.Tricia Phillips, “Biz Bureau Gives Top Tips on Going Global with Your Business,” *Mirror*, January 26, 2011, accessed February 7, 2012, www.mirror.co.uk/advice/money/2011/01/26/biz-bureau-gives-top-tips-on-going-global-with-your-business-115875 -22875517.

- Several resources should be consulted. However, the best guide to exporting for the small business comes from the US government.“A Small Business Guide to Exporting: Part 1—Getting Started,” *AllBusiness.com*, accessed February 7, 2012, www.allbusiness.com/economy-economic-indicators/money-currencies/11790828-1.html.
- The SBA is a great place to start to find information to help a business break into the global game. The information on exporting and importing is comprehensive and easily understood.
- The US government portal Export.gov provides online trade resources and one-on-one assistance for global businesses. Export.gov provides particularly helpful information on regulations, licenses, and trade data and analysis. Trade data can help a business identify the best countries to target for exports. A business can gauge the size of the market for a product or a service and develop a pricing strategy to become competitive.“Trade Data and Analysis,” *Export.gov*, March 3, 2011, accessed February 7, 2012, export.gov/tradedata/index.asp.
- The US International Trade Commission offers market information, trade leads, and overseas business contacts. Trade professionals are available to help a business every step of the way with information counseling that can reduce costs, risks, and the mystery of exporting.“Session 11: Global Expansion,” *My Own Business*, accessed February 7, 2012, www.myownbusiness.org/global_expansion/index.html.
- The US Department of Commerce provides trade opportunities for US business, export-related assistance, and market information.“Session 11: Global Expansion,” *My Own Business*, accessed February 7, 2012, www.myownbusiness.org/global_expansion/index.html.
- Information about protecting intellectual property abroad can be found at http://www.stopfakes.gov. This is important because counterfeiting and piracy cost the world economy approximately $650 billion per year.“Session 11: Global Expansion,” *My Own Business*, accessed February 7, 2012, www.myownbusiness.org/global_expansion/index.html.

Other sources to be consulted include people in the same business or industry, industry-specific magazines, trade fairs, seminars,Laurel Delaney, “A How-To on Expanding Your Business Globally,” *The Global Small Business Blog*, January 11, 2011, accessed February 7, 2012, borderbuster.blogspot.com/2011/01/how-to-on-expanding-your-business.html. and export training and technical assistance that is available to small businesses through the states and the federal government. The Federation of International Trade Associations is a global trade portal that provides trade leads, market research, links to eight thousand import/export websites, and even travel services. WorldBid.com describes itself as the largest network of international trade marketplaces in the world, providing trade leads and new business contacts.“Session 11: Global Expansion,” *My Own Business*, accessed February 7, 2012, www.myownbusiness.org/global_expansion/index.html.

The Internet makes it possible to gather and view tremendous amounts of information. If a business is thinking seriously about going global, there is no better time to take advantage of this quick-and-easy access than now.

Video Link 15.3

Knowing the Export Environment

Government experts identify challenges and debunk some myths.

www.inc.com/exporting/exportsuccess.htm

Business Assessment: Are You Ready?

It is important to honestly self-evaluate a business to determine whether it is really ready to go global or not…or at least not yet.“Is Your Small Business Ready to Go Global?,” *Small Business CEO*, February 7, 2011, accessed February 7, 2012, www.smbceo.com/2011/02/07/global-business-2. If a business is thinking about expanding globally, it is probably already doing something right to have reached this point. However, that does not preclude the importance of assessing its strengths and its weaknesses to determine the approach that should be taken in the global market.Laurel Delaney, “A How-To on Expanding Your Business Globally,” *The Global Small Business Blog*, January 11, 2011, accessed February 7, 2012, borderbuster.blogspot.com/2011/01/how-to-on-expanding-your-business.html. This will be true no matter what role e-commerce plays in a business. Even a micromultinational business should assess its strengths and its weaknesses, although its instantaneous presence as a global business means that the assessment must be done at start-up and then must continue as products and services move from country to country.

There are several issues that should be addressed. The following are some of the questions that should be asked:Laurel Delaney, “A How-To on Expanding Your Business Globally,” *The Global Small Business Blog*, January 11, 2011, accessed February 7, 2012, borderbuster.blogspot.com/2011/01/how-to-on-expanding-your-business.html; “Starting an Export Business,” *Gaebler.com*, May

19, 2011, accessed February 7, 2012, www.gaebler.com/Starting-an-Export-Business.htm; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 96; "Is Your Small Business Ready to Go Global?," *Small Business CEO*, February 7, 2011, accessed February 7, 2012, www.smbceo.com/2011/02/07/global-business-2.

- Why is a business successful in the domestic market? What is its growth rate? What are its strengths?
- What products have export potential? Do the products fill a niche that is exclusive to the US market? Are they packaged in a way that can be understood by non-English-speaking consumers? Do they violate any cultural taboos or contain ingredients that will prohibit their sale in a foreign market? Identify the key selling features of the products, identify the needs that they satisfy, and identify any selling constraints.
- What are the competitive advantages of a particular business's products over other domestic and international businesses?
- What competitive products are sold abroad and by whom?
- Does the product require complementary goods and technologies? If so, who will provide them?
- How will the business provide customer service?
- Can production handle a wider demographic? Can the business increase output without sacrificing quality?
- Does the business have the money to market globally?
- Is the entire business (including all staff) committed to a global effort?

If a product is an industrial good, a business will want to know things such as what firms will likely use it, whether its use or life might be affected by climate, and whether geography will present transportation problems that will affect purchase. In the case of a consumer good, a business will want to know who will consume it; how frequently it will be purchased; whether it will be restricted abroad; whether climate or geography will negatively impact accessibility for purchase; and—perhaps most importantly—whether it conflicts with traditions, taboos, habits, or the beliefs of customers abroad.Laurel Delaney, "A How-To on Expanding Your Business Globally," *The Global Small Business Blog*, January 11, 2011, accessed February 7, 2012, borderbuster.blogspot.com/2011/01/how-to-on-expanding-your-business.html.

A helpful tool to assess readiness is the export questionnaire available at www.export.gov/begin/assessment.asp. This questionnaire highlights characteristics common to successful exporters and identifies areas that need to be strengthened to improve export activities.

Video Link 15.4

Where Will Your Next Customer Come From?

Small businesses looking to grow should look beyond US borders to find new customers.

www.sba.gov/content/where-will-your-next-customer-come

Marketing

Just as it is necessary to offer a different marketing mix (see Figure 15.2) for different target markets, it will generally be necessary to adapt the marketing mix to the global market in general and different countries in particular. A business's unique **value proposition** (the set of benefits offered to customers to satisfy their needs and wants consisting of some combination of products, services, information, and experiences)Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 13. is what will differentiate one marketplace offering from the competition. Given the more diversified competition in the global marketplace, identifying the value proposition is even more critical—and most likely more difficult—than in the domestic market.Jennifer LeClaire, "How to Take Your Small Business Global," *E-Commerce Times*, June 20, 2006, accessed February 7, 2012, www.ecommercetimes.com/story/50910.html%20?wlc=1305842348.

Figure 15.2 The Marketing Mix

Product

The ideal situation is when a product developed for the US market can be sold in a foreign country without any changes. Although some kinds of products can be introduced with no changes (e.g., cameras, consumer electronics, and many machine tools),Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 611. most products usually have to be altered in some way to meet conditions in a foreign market.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 49. From a small business perspective, the owner will want to market products that do not require drastic changes to be accepted. Relatively minor packaging changes, such as size or the language on the package, can be made inexpensively, but more drastic changes should be avoided. If a product must be changed drastically to market it globally, conduct an in-depth cost analysis to determine whether the additional costs will outweigh the anticipated benefits.“All About Global Marketing,” *BusinessKnowledgeSource.com*, accessed February 7, 2012, www.businessknowledgesource.com/marketing/all_about_global_marketing__032164.html. If a product is a food or a beverage, for example, is the business prepared to make the changes necessary to appeal to widely varying tastes?Arundhati Parmar, “Dependent Variables: Sound Global Strategies Rely on Certain Factors,” *Marketing News*, September 2002, 2.

Products need to be adapted for many reasons, including the following:Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 341, 351, 353; “Global Linguistic Analysis,” *Strategic Name Development*, accessed February 7, 2012, www.namedevelopment.com/global-linguistic -analysis.html.

- Different physical or mandated requirements must be met (e.g., electrical goods will need to be rewired for different voltage systems).
- The legal, economic, political, technological, and climatic requirements of the local marketplace vary (e.g., varying laws will set specific packaging sizes and safety and quality standards).
- The product or the company name must translate flawlessly to the new target market so that it does not convey an unintended, perhaps very negative, meaning. One of the most well-known examples of a translation blunder is the Chevy Nova. In Spanish,

“nova” means “no go.”
- The package label may need to be changed. Imagine the horror of a well-known baby food producer that introduced small jars of baby food in Africa when it found out that the consumers inferred from the baby picture on the jars that the jars contained ground-up babies. This shows us that even big companies can make big mistakes.
- A change in flavor or fragrance may be necessary to bring a product in line with what is expected in a culture. The pine and hints of ammonia or chlorine scents that are popular in the United States were flops in Japan because many Japanese sleep on the floor on futons. With their heads so close to the floor, a citrus scent is more pleasing.

The less economically developed a market happens to be, the greater may be the need for product adaptation. Research has found that only one in ten products can be marketed in developing countries without some kind of product adaptation.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 341.

Cultural Differences

It is important to know that cultural and social differences are intertwined with the perceived value and importance that a market places on a product.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 343. “A product is more than a physical item: It is a bundle of satisfactions (or *utilities*) that the buyer receives. These include its form, taste, color, odor, and texture; how it functions in use; the package; the label; the warranty; the manufacturer’s and retailer’s servicing; the confidence or prestige enjoyed by the brand; the manufacturer’s reputation; the country of origin; and any other symbolic utility received from the possession or use of the goods. In short, the market relates to more than a product’s physical form and primary function.”C. K. Prahalad, *The Fortune at the Bottom of the Pyramid* (Philadelphia: Wharton School Publishing, 2005), as cited in Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 343.

The values, customs, rituals, language, and taboos within a culture will determine the acceptability of a product or a service. Cultural sensitivity is particularly important in cyberspace. Website visitors may come from anywhere in the world. Icons and gestures that seem friendly to US visitors may shock people from other cultures. For example, a high-five hand gesture would be insulting to a visitor from Greece.David L. Kurtz, *Contemporary Business* (Hoboken, NJ: John Wiley & Sons, 2011), 109. Knives and scissors should not be given as gifts in South America because they symbolize the severing of a friendship.David L. Kurtz, *Contemporary Business* (Hoboken, NJ: John Wiley & Sons, 2011), 109.

The **psychological attributes** of a product (features that have little to do with the primary function of the product but add value to customer satisfaction, e.g., color, size, design, brand name, and price)Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 343. can also vary across cultures, and the meaning and the value assigned to those attributes can be positive or negative. It may be necessary to adapt the nonphysical features of the product to maximize the positive meanings and eliminate the negative ones.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 343. When Coca-Cola, the number one global brand, introduced Diet Coke to Japan, it found that Japanese women do not like to admit to dieting. Further, the idea of diet was associated with medicine and sickness. Coca-Cola ended up changing the name to Coke Light.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 343. This happened in Europe as well, so if a product is associated with weight loss, a business must be very careful with its marketing.

The Package

The package for a product includes its design, colors, labeling, trademarks, brand name, size, product information, and the actual packaging materials. There are many reasons why a package may have to be adapted for a particular country. There may be laws that stipulate a specific type of bottle or can, package sizes, measurement units, extraheavy packaging, and the use of particular words on the label.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 352. In some cases, the expense of package adaptation may be cost prohibitive for entering a market. Consider the following examples:Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 352–53.

- In Japan, a poorly packaged product is seen as an indicator of product quality.
- Prices are required to be printed on the labels in Venezuela, but putting prices on labels or in any way suggesting the retail price in Chile is illegal.
- A soft-drink company from the United States incorporated six-point stars as decoration on its package labels. But it had inadvertently offended some of its Arab customers who interpreted the stars as symbolizing pro-Israeli sentiment.
- Soft drinks are sold in smaller sizes in Japan to accommodate the smaller Japanese hand.
- Descriptive words such as giant or jumbo on a package or a label may be illegal in some countries.

The message here is clear. Before going global with a product, examine the packaging so that each element is in compliance with appropriate laws and regulations so that nothing will offend prospective customers.

Global Packaging

Canada's oldest candymaker, Ganong Brothers, is located about one mile from Maine. The company chairman, David Ganong, can see the US border from his office window. You would think it would be easy for Ganong Brothers to sell to the US market. Not so. In Canada, nutritional labels read *5 mg*, with a space between the number and the unit of measurement. Ganong's jellybeans cannot get into America unless the label reads *5mg*, without the space. This difference, as well as differences in Canada's nutritional guidelines, means that Ganong must produce and package its US products separately, which reduces its efficiency. Small differences can and do have a significant effect on cross-border trade. This may be the reason why there is not as much trade between the United States and Canada as you would think.Ryan Underwood, "Creating a Smart Export Strategy," *Inc.*, May 3, 2011, accessed February 7, 2012, www.inc.com/magazine/20110501/author-pankaj-ghemawat -on-global-expansion-for-small-exporters.html. This notwithstanding, however, Canada remains the number one exporting destination for US small businesses."Small and Medium-Sized Enterprises: Overview of Participation in U.S. Exports," *US International Trade Commission*, January 2010, accessed February 7, 2012, www.usitc.gov/publications/332/pub4125.pdf.

The Business Website

As part of product preparations, a business will need to make its website ready for international business. Remember that the website is a very cost-effective way to sell a product or a service across borders. Here are four ways to ready the website:Anita Campbell, "How to Make Your Website Ready for International Business," *Small Business Trends*, October 29, 2010, accessed February 7, 2012, smallbiztrends.com/2010/10/website-ready-international-business.html.

1. **Internationalize website content.** A business must account for language differences, and cultural differences may require different graphics and different colors. One way to deal with the additional costs is to translate text or provide country-specific sites only for the country or countries where the most products are sold. One organization that provides resources to help businesses localize their products and resources is the Globalization and Localization Association.
2. **Calculate the buyer's costs and estimate shipping.** Shipping internationally will take longer, is more complicated, and will be more expensive than shipping domestically. Fortunately, there are shipping management software packages available that will automatically figure the costs and delivery times for overseas orders, giving a close estimate. Large shipping carriers, such as UPS and FedEx, offer such software; other companies include E4X Inc., eCustoms, and Kewill Systems Plc.Paul Demery, "Anchors Aweigh," *Internet Retailer*, January 31, 2008, accessed February 7, 2012, www.internetretailer.com/2008/01/31/anchors-aweigh.
3. **Optimize site and search marketing for international web visitors.** With the increase in cross-border selling, websites can be optimized for visitors from specific countries, and techniques can be used to attract international visitors through search engines and search ads. This is a growing specialty among search marketers. A business should definitely check out the cost of hiring such a marketer as a consultant. It would be well worth the investment.
4. **Comply with government export regulations.** A business does not need government approval to sell most goods and services across international borders. There are, of course, notable exceptions. For example, the US government restricts defense or military goods, and agricultural, plant, and food items may have restrictions or special labeling requirements. Such restrictions should be addressed on the website. It may be necessary to restrict the sale of certain products to certain countries only.

Video Link 15.5

Finding Your First Customer

To find the first customer, visit the selected country.

www.inc.com/exporting/findingfirst.htm

Translation Blunders in Global Marketing

We often hear it said that something was lost in the translation. Here are some global marketing examples of translation blunders. Something important to note is that most of these blunders were committed by the "big guys," companies that are extremely marketing-savvy—proof positive that no one is immune from this kind of error.

- When Coca-Cola was first translated phonetically into Chinese, the result was a phrase that meant "bite the wax tadpole." When Coca-Cola discovered the error, the company was able to find a close phonetic equivalent that could be loosely translated as

"happiness in the mouth.""Translation Problems in Global Marketing," *My Opera*, November 14, 2006, accessed February 7, 2012, my.opera.com/kitkreuger/blog/2006/11/14/translation -problems-in-global-marketing.
- When Pope John Paul II visited Miami in 1987, an ambitious entrepreneur wanted to sell t-shirts with the logo, "I saw the Pope" in Spanish. The entrepreneur forgot that the definite article in Spanish has two genders. Instead of printing "El Papa" ("the Pope"), he printed "La Papa" ("the potato"). Needless to say, there was no market for t-shirts that read "I saw the potato.""Translation Problems in Global Marketing," *My Opera*, November 14, 2006, accessed February 7, 2012, my.opera.com/kitkreuger/blog/2006/11/14/translation -problems-in-global-marketing.
- Sunbeam got into trouble when it did not change the name of its Mist-Stick curling iron when marketing it in Germany. As it turned out, "mist" is German slang for manure. Not surprisingly, German women did not want to use a manure stick in their hair.Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 613.
- A proposed new soap called "Dainty" in English came out as "aloof" in Flemish (Belgium), "dimwitted" in Farsi (Iran), and "crazy person" in Korean. The product was dropped. The company either did not have the resources to research a new name or did not want to take the time and incur the costs to do so.
- Kellogg's Bran Buds sounded like "burned farmer" in Swedish.John Freivalds, "What's in a Name?," *Business Library*, April 1996, accessed February 7, 2012, findarticles.com/p/articles/mi_m4422/is_n4_v13/ai_18512264.

Given that misunderstanding foreign languages can destroy a brand, it is worth the investment to hire someone who is proficient in the native language in the intended market—including the use of slang. This will help a small business avoid a fatal mistake because it does not have the resources of the big companies to fix the mistakes.Jeffrey Gangemi, "Avoiding Faux Pas When Exporting," *Bloomberg BusinessWeek*, June 27, 2007, accessed February 7, 2012, www.BusinessWeek.com/smallbiz/content/jun2007/sb20070627_897013.htm?campaign_id=rss_smlbz. This concern must be extended to the web presence as well because the website is an integral part of the product.

Price

Pricing for the global market is not an easy thing to do. Many factors must be taken into account, the first of which are traditional price considerations: fixed and variable costs, competition, company objectives, proposed positioning strategies, the target group, and willingness to pay."The International Marketing Mix," *Learn Marketing*, accessed February 7, 2012, www.learnmarketing.net/internationalmarketingmix.htm. Add to these factors things such as the additional costs that are incurred due to taxes, tariffs, transportation, retailer margin, and currency fluctuation risks;John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 40; Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 616. the nature of the product or industry, the location of production facility, and the distribution system;Eric Mitchell, "The Pricing Advisor," *The Pricing Advisor Newsletter*, accessed February 7, 2012, members.pricingsociety.com/articles/Pricing-for-Global-Markets.pdf. the psychological effects of price; the rest of the marketing mix; and the price transparency created by the Internet"The International Marketing Mix," *Learn Marketing*, accessed February 7, 2012, www.learnmarketing.net/internationalmarketingmix.htm. and a business can begin to appreciate the challenges of global price setting. About the only thing that can be seen as a certainty is that a small business should expect the price of its product or service to be different, usually higher, in a foreign market.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 50. The specifics of that difference need to be worked out carefully, with thorough analysis.

Setting the right price for a product or a service is critical to success. It will be a challenge to navigate the pricing waters of each different country—to learn why, for example, a product sells for $16 in the United States but $23 in Britain.

Place

As challenging as distribution may be for a small business in the domestic market, it is even more so for the global market. No matter the product, it has to go through a **distribution process**—the physical handling and distribution of goods, the passage of ownership or title, and the buying and selling negotiations between producers and middlemen and middlemen and customers.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 396. It would make sense to be able to take advantage of existing transportation systems, retailers, and suppliers to sell goods and provide services. Unfortunately, adequate distribution systems do not exist in all countries, so a business will need to develop ways to get products to customers in as cost-effective a manner as possible.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 50.

Video Link 15.6

Getting Your Product from Here to There

Small businesses rely on freight forwarding and shipping experts to move products around the world.

www.inc.com/exporting/heretothere.htm

Before deciding on a channel or channels of distribution, a business needs information. The following are some basic questions as a starting point:

- Is the selected market dominated by major retailers or is the retail sector made up of small independent retailers?“The International Marketing Mix,” *Learn Marketing*, accessed February 7, 2012, www.learnmarketing.net/internationalmarketingmix.htm.
- How many intermediaries will be involved? In Japan, for example, a product must go through approximately five different types of wholesalers before it reaches the final consumer.“The International Marketing Mix,” *Learn Marketing*, accessed February 7, 2012, www.learnmarketing.net/internationalmarketingmix.htm.
- Can we use the manufacturer, wholesaler, retailer, or consumer channel or can we export directly to a retailer?
- Should we work with a foreign partner? Unless a business plans to establish a retail operation on foreign soil, it will need to establish business-to-business (B2B) sales relationships. Then products can be sold directly to foreign retailers or foreign distributors who will sell to those retailers. A foreign partner can provide valuable insights about local import regulations, product marketability, and local customs. The US Department of Commerce website contains directories of foreign buyers.Ryan Underwood, “Creating a Smart Export Strategy,” *Inc.*, May 3, 2011, accessed February 7, 2012, www.inc.com/magazine/20110501/author-pankaj-ghemawat -on-global-expansion-for-small-exporters.html. Small businesses excel at forming strategic partnerships.Laurel Delaney, “Global Guru: Shaking Things Up. Making Things Happen,” *Change This*, October 2004, accessed February 7, 2012, changethis.com/manifesto/6.03.GlobalGuru/pdf/6.03.GlobalGuru.pdf.
- Where can we attend a trade show or a trade mission? Going to these events can help a business find distribution channels.
- Is the Internet commonly used to distribute my product?

Video Link 15.7

Understanding Partnerships and Distributors

Partnerships help many thriving US businesses overseas.

www.inc.com/exporting/partnerships.htm

Video Link 15.8

Identifying Marketing Channels/Activities

How research and planning inform business growth.

www.inc.com/exporting/marketingchannels.htm

In the final analysis, the behavior of distribution channel members will be the result of the interaction between cultural, economic, political, legal, and marketing environments. A small business that is looking to go global—or is already there—will encounter channel structures that range from a minimally developed marketing infrastructure, such as in emerging markets, to highly complex, multilayered systems, such as in Japan.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 396.

When deciding to enter the global marketplace, a determination must be made as to whether the current channel structure in the selected country (or countries) will meet the business’s needs or whether some additional arrangements will be needed. The means of distribution will necessarily be a country-by-country decision. No matter the arrangement, however, figure on the costs being greater than in the United States.

Promotion

It is understandable that a small business owner may want to use the same integrated marketing communications (IMC) programs used in the home market to inform customers in foreign markets and persuade them to buy. This “one voice” approach offers the advantage of enabling a business or a product to gain broader recognition in the global marketplace; it also helps reduce costs, minimize redundancies in personnel, and maximize the speed of implementation.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 50; "Global Marketing," *SmallBusiness.com*, accessed February 7, 2012, smallbusiness.com/wiki/Global_marketing. However, things are not that easy. Cultural, social, language, and legal differences from country to country will usually make it necessary to modify IMC messages to not offend current or prospective customers. Modification is more of a challenge for the small business because the resources needed to make the changes are more limited.

A business communicates with its customers through some combination of its website, advertising, publicity, public relations, sales promotion, sales personnel, e-mail, and social media. The actual mix will be a function of the selected country or countries. For example, in some less-developed countries, the major portion of the promotional effort in rural and less-accessible parts of the market is sales promotion; in other markets, product sampling works especially well when the product concept is new or has a very small market share.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 468. In Saudi Arabia, there is an appreciation for fancy packaging, and point-of-sale advertising elicits the best reaction.Marian Katz, "No Women, No Alcohol; Learn Saudi Taboos before Placing Ads," *Abstracts, Business International*, 1986, accessed June 1, 2012, www.faqs.org/abstracts_/Business-international/No-women-no-alcohol-learn-Saudi-taboos-before-placing-ads.html. However, the appropriateness of IMC activities for a small business will depend on the product being marketed, the industry in which it is competing, and the country in which it hopes to sell the product.

Of all the four Ps, decisions involving advertising are thought to be those most often affected by cultural differences in foreign markets. Consumers respond in terms of their culture, style, feelings, value systems, attitudes, beliefs, and perceptions. Because advertising's function is to interpret or translate the qualities of products and services in terms of consumer needs, wants, desires, and aspirations, emotional appeals, symbols, persuasive approaches, and other characteristics in an advertisement must coincide with cultural norms if the ad is to be effective.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 473.

Examples abound of international advertising mistakes that have offended different cultures. Three are presented here. Although they are linked to large corporations, there are lessons to be learned by small businesses. No business is immune from making mistakes from time to time.

- Burger King ran in-store ads for three restaurants in Spain that depicted the Hindu goddess Lakshami on top of a ham sandwich. The caption read, "a snack that is sacred." Many Hindus are vegetarian and were offended by the ad. Burger King pulled it.Emily Bryson York, "Burger King's MO: Offend, Earn Media, Apologize, Repeat," *Ad Age Global*, July 8, 2009, accessed February 7, 2012, adage.com/article/global-news/advertising-burger-king-draws-ire-hindus-ad/137801.
- Burger King ran a campaign in Europe for the Texican Whopper that featured a lanky American cowboy; a short, round Mexican draped in a cape resembling Mexico's flag; and the caption, "the taste of Texas with a little spicy Mexican." There was an immediate uproar, with the Mexican ambassador to Spain objecting publicly.Shaun Rein, "Learn from Burger King's Advertising Fiasco," *Forbes*, April 20, 2009, accessed February 7, 2012, www.forbes.com/2009/04/20/advertising-global-mistakes -leadership-managing-marketing.html.
- During a time when Fiat was trying to take advantage of auto sales growth in China, it released an ad in Italy in which actor Richard Gere drove a Lancia Delta from Hollywood to Tibet. The ad did not air in China, but it caused an online uproar nonetheless. Richard Gere is hated in China because he is an outspoken supporter of the Dalai Lama. His selection as the Fiat spokesperson was a major faux pas by Fiat.Shaun Rein, "Learn from Burger King's Advertising Fiasco," *Forbes*, April 20, 2009, accessed February 7, 2012, www.forbes.com/2009/04/20/advertising-global-mistakes -leadership-managing-marketing.html.

The reality of international advertising is that its cost and the effort required to prepare and place the ads correctly may be prohibitive for most small businesses, therefore pushing the emphasis on other elements of the IMC mix. However, a business will not know that for sure until it does the proper research before making a decision. Consider the characteristics of the target market, how the market uses media in that country, and which media are actually available. Some countries do not have commercial television, and some do not have advertising in newspapers. There will be newspaper and magazine circulation differences from country to country; in countries with a low literacy rate, radio and television advertising (if available) will be more effective than print media.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 50.

Fortunately, small businesses that want to go global can look to social media for assistance. The social web is a low-cost way to catapult a small business brand into the global arena.Susan Gunelius, "Building Your Brand with Social Media," *Reuters*, January 4, 2011, accessed February 7, 2012, www.reuters.com/article/2011/01/05/idUS16245956220110105. Facebook, the most popular social networking site in the world, has developed a self-serve advertising tool that has created the greatest interest among small businesses that might not have had the means to launch a global advertising campaign before. This would be a good place to start—along with a map of the world's most popular media applications country by country and culture by culture, which is available at www.appappeal.com/the-most-popular-app-per-country/social-networking.

No matter the mix of the IMC program, and no matter whether a business is business-to-consumer (B2C) or B2B, the way a business communicates internationally will be a major determinant of success. Each IMC component is a communication channel in its own right. A business must consider the appropriateness of each message in each channel. For example, is the message adequate? Does it contain correct cultural interpretations? Are the colors and graphics right? In the case of advertising, have the media been chosen that match the behavior of the intended audience? Have you correctly assessed the needs and wants or the thinking processes of the target market?Adapted from Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 479.

Careful consideration of these and other communication issues will not guarantee success, but it should help reduce the chances of making a major marketing blunder.

Legal and Political Issues

It is impossible for any small business to know all the laws that pertain to exporting from the United States. Thus it is important to consult an attorney who is knowledgeable about the legal implications of globalization: international trade laws, tax laws, local regulations,"Small Business Globalization: Should You Pursue Global Markets?," *more-for-small business.com*, accessed February 7, 2012, www.more-for-small-business.com/small-business-globalization-should-you-pursue-global-markets.html. international border restrictions, customs rules, and duties and taxes.Paul Demery, "Anchors Aweigh," *Internet Retailer*, January 31, 2008, accessed February 7, 2012, www.internetretailer.com/2008/01/31/anchors-aweigh.

To varying degrees, each small business must be concerned with the following. However, this list is not exhaustive; it is a sampling only.

- The Foreign Corrupt Practices Act makes it illegal for companies to pay bribes to foreign officials, candidates, or political parties. The challenge for all US businesses is that bribery is a common business practice in many countries, even though it is illegal.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 203. Interestingly, private business bribes are tax deductible in Germany as long as the German businessperson discloses both his or her identity and the recipient of the bribe(s). Although it is supposedly rarely used, it is available.Joshua Ritchie, "The 5 Most Bizarre Tax Deductions around the World," *Mint Software Inc.*, December 15, 2009, accessed June 1, 2012, http://www.mint.com/blog/trends/the-...und-the-world/.
- Specific licenses and permits are required or additional paperwork must be completed if the following specific products are exported or imported: agricultural products, automobiles (not a likely product for a small business), chemicals, defense products, food and beverage products, industrial goods, and pharmaceutical and biotechnology products."Exporting/Importing Specific Products," *US Small Business Administration*, accessed February 7, 2012, www.sba.gov/content/exportingimporting-specific-products.
- There is heightened sensitivity since September 11, 2011, about exporting products that could even remotely be used in a military or a terrorist capacity."For Entrepreneurs: Starting an Export Business," *Gaebler.com*, May 19, 2011, accessed February 7, 2012, www.gaebler.com/Starting-an-Export-Business.htm.
- Brand names, trademarks, products, processes, designs, and formulas are among the more valuable assets a small business can possess. These need to be protected—domestically and internationally. US officials estimate that $300 billion of intellectual property assets are ripped off every year.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 193.
- There are commercial laws within countries related to marketing, environmental issues, and antitrust.

Video Link 15.9

Understanding Legal Considerations

Important legal considerations for small businesses that want to go global.

www.inc.com/exporting/legal.htm

In addition to legal considerations, no small business can conduct global business without understanding the influence of the political environments in which it will be operating.Philip R. Cateora and John L. Graham, *International Marketing* (New York:

McGraw-Hill Irwin, 2007), 158. Every nation has the sovereign right to grant or withhold permission to do business within its political boundaries and control where its citizens do business, so the political environment of countries is necessarily a critical concern to any small business.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 158. Political issues include the stability of government policies (a stable and friendly government being the ideal), the forms of government (with some being more open to foreign commerce than others), political parties and their influence on economic policy, the degree of nationalism (the greater the nationalism, the greater the bias against foreign business and investments may be), fear and/or animosity that is targeted toward a specific country, and trade disputes.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 159-165. One or all these things create political risk that must be assessed. The most severe political risk is confiscation, the seizing of a company's assets without payment.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 166.

Currency Exchange Issues

The **exchange rate** is the rate at which one country's currency can be exchanged for the currency of another country.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 39. For example, assume that on a particular day, $1 exchanged for 0.75643 euros and 49.795 Indian rupees."Euro," *X-rates.com*, accessed March 5, 2012, www.x-rates.com/d/EUR/table.html;%20X-rates.com; "Indian Rupee," *X-Rates*, accessed March 5, 2012, www.x-rates.com/d/INR/table.html. These exchange rates then changed the next day, when $1 exchanged for 0.6891 euros and 49.845 Indian rupees, meaning that the value of the US dollar *increased* in value with respect to the euro and *decreased* in value against the Indian rupee. Currency exchange rates change daily, and they are important because currency fluctuations can present additional problems for the small business looking to go global. The appreciation and depreciation of a currency will have an effect on the prices of goods and services. For example, as the dollar declines in value against the euro, the price of goods and services from the European Union for US customers will increase, likely reducing their purchases.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 39. The following are other implications of exchange rate fluctuations:Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 537; David L. Kurtz, *Contemporary Business* (Hoboken, NJ: John Wiley & Sons, 2011), 113.

- Inattention to exchange rates in long-term contracts could result in large unintended discounts.
- Rapid and unexpected currency fluctuations can make pricing in local currencies very difficult.
- Shifts in exchange rates can influence the attractiveness of various business decisions, not the least of which is whether doing business in a particular country is worthwhile.

Different strategies may be needed when the dollar is weak versus when it is strong. For example, when the US dollar is weak, a business should stress price benefits. When the dollar is strong, a business can engage in nonprice competition by improving quality, delivery, and after-sale services.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 538. To navigate these challenging currency exchange waters, it will be necessary to tap into accounting and finance expertise.

Sources of Financing

How a business finances an export project is often a critical factor in its success. Financing decisions extend to working capital and export transactions. Working capital is needed to finance operations before and after a sale, and money is needed to sustain a business until it is paid for the goods and services that have been provided (export transactions). The International Trade Association in the US Department of Commerce identifies the following factors as important to consider when making financing decisions.US Department of Commerce, *A Basic Guide to Exporting*, 10th ed. (Washington, DC: International Trade Association, 2008), 193–94.

- **The need for financing to make the sale.** Offering favorable payment terms can make a product more competitive.
- **The length of time the product is being financed.** The term of the loan required determines how long a business will have to wait before the buyer pays for the product, which will influence the choice of how to finance the transaction.
- **The cost of different methods of financing.** Interest rates and fees will vary, and a business should probably expect to assume some of the financing costs. Before providing an invoice to the buyer, a business must understand how these costs will affect price and profit.
- **The risks associated with financing the transaction.** The riskier the transaction, the more difficult and costly it will be for a business to finance it because there will likely be a higher chance for default. The level of risk will be influenced by several

things, not the least of which is the political and economic stability of the buyer's country. In risky situations, the financing provider may require the most secure method of payment—a letter of credit or export credit insurance.

- **The need for preshipment financing and postshipment working capital.** Working capital could experience unexpected and severe strains with the production of an unusually large order or a surge of orders. Inadequate working capital can limit exporting growth—even during normal periods.

Where to Go

Small businesses have reported that problems with access to financing for their exporting operations are a major barrier to exporting. The difficulties they experience in obtaining both trade finance and working capital often prevent small businesses from financing purchases by foreign buyers. This encourages foreign buyers to choose suppliers that are able to extend credit. Small businesses must also face the perception of lending institutions that they are a higher risk than larger companies coupled with a lack of familiarity with exporting by community banks."Small and Medium-Sized Enterprises: Overview of Participation in U.S. Exports," *US International Trade Commission*, January 2010, accessed February 7, 2012, www.usitc.gov/publications/332/pub4125.pdf.

Despite any anticipated difficulties, small businesses need to find export financing. They can look for financing in several places. The first place to look is internally. Does it already have the funds to finance global efforts? If the answer is yes, then all is well. This was the case for Center Rock, the small business featured at the beginning of this chapter. If the answer is no, which will most likely be the case, it will be necessary to look for external financing. A range of options is available for small businesses to consider (see Table 15.3). As you will see, most financing sources are available from the government. A small business must become familiar with the financing, insurance, and grant programs that are available to help it finance transactions and carry out export operations."6 Steps to Begin Exporting," *US Small Business Administration*, accessed February 7, 2012, www.sba.gov/content/6-steps-begin-exporting.

Table 15.3 Sources of Export Financing for the Small Business

Source	Information
Extending credit to foreign buyers working with commercial banks	Liberal financing can enhance export competitiveness, but extending credit must be weighed carefully. Some commercial bank services used to finance domestic business, including revolving lines of credit for working capital, are often needed to finance export sales until payment is received. However, commercial banks prefer to establish an ongoing business relationship instead of financing solely on the basis of an individual order. Most US banks do not lend against export orders, export receivables, or letters of credit.
Export Express 7(a) Loan Programs	Offered by the SBA, this streamlined program helps small businesses develop or expand their export markets. A business may be able to obtain SBA-backed financing for loans and lines of credit up to $500,000.
Export Working Capital Program (EWCP) 7(a) Loan Programs	This SBA loan program targets small businesses that are able to generate export sales but need additional working capital to support these sales. The SBA provides lenders guarantees of up to 90 percent on export loans to ensure that qualified exporters do not lose viable export sales due to a lack of working capital.
International Trade Loan Program 7(a) Loan Programs	Loans are available for businesses that plan to start or continue exporting or have been adversely affected by competition from imports. The loan proceeds must enable the borrower to be in a better position to compete. The program offers borrowers a maximum SBA-guaranteed portion of $1.75 million.

Source	Information
Export-Import Bank	An independent federal agency that provides working capital loan guarantees, export-credit insurance, and other forms of financing for US exporters of all sizes. The funds are aimed at offsetting the added risks of doing business abroad, from complex trade rules to unpaid bills.
Using export intermediaries	Many export intermediaries, for example, trading companies and export management companies, can help finance export sales. The intermediaries may provide short-term financing or may purchase the goods to be exported directly from the manufacturer, thus eliminating any risks to the manufacturer that are associated with the export transaction as well as the need for financing.

Source: "Export Financing," *US Small Business Administration*, accessed February 7, 2012, www.sba.gov/content/export-financing-0; US Department of Commerce, *A Basic Guide to Exporting*, 10th ed. (Washington, DC: International Trade Association, 2008), 194, 197; "More Small Businesses Seek Export Financing," *Wall Street Journal*, May 20, 2011, accessed February 7, 2012, http://blogs.wsj.com/in-charge/2011/...port-financing.

Video Link 15.10

Financing

Some of the ways small businesses can finance their exporting projects.

www.inc.com/exporting/financing.htm

KEY TAKEAWAYS

- Expanding into global markets introduces new complexities into small business operations.
- The decision to go global should be based on an assessment of the ways to export, an analysis of the industry and a particular company, marketing and cultural factors, legal and political conditions, currency exchange rates, and sources of financing.
- There are two basic ways to export: direct or indirect. In direct exporting, a small business exports directly to a customer who is interested in buying the product. Indirect exporting involves using a middleman for marketing and selling the product in the target market.
- Industry analysis involves looking at where an industry currently is and the trends and directions predicted over the next three years so that a business can try to determine how competitive an industry is in the global market.
- It is important to honestly self-evaluate a business to determine whether it is ready to go global or not.
- It will generally be necessary to adapt the marketing mix to the global market in general and different countries in particular.
- Legal issues include international trade laws, tax laws, and local regulations.
- No small business can conduct global business without understanding the influence of the political environments in which it will be operating.
- Currency exchange rates are important because currency fluctuations can present additional problems for a small business that is looking to go global. In particular, the appreciation and depreciation of a currency will have an effect on the prices of goods and services.
- How a business finances an export project is often a critical factor in its success.
- Working capital is needed before and after the sale, and money is needed until the goods and services that have been provided have been paid for.
- Many—perhaps most—of the sources for small business exporting activity are governmental.

EXERCISES

1. Comment on the following: a small business owner firmly believes that because a product is successful in Chicago, Illinois, it will be successful in Tokyo or Berlin.Adapted from Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 367. Be as specific as you can in your comments.
2. There has been tremendous growth in online business, which has introduced new elements to the legal climate of global business. Patents, brand names, copyrights, and trademarks are difficult to monitor because there are no boundaries with the

Internet. What steps could a small business take to protect its trademarks and brands in this environment? Prepare at least five suggestions.David L. Kurtz, *Contemporary Business* (Hoboken, NJ: John Wiley & Sons, 2011), 133.
3. Find a local small business that exports its products. Talk to the owner about his or her experiences. Ask questions such as the following: What convinced you to export? How did you decide on the product(s) to export? Did you have to adapt your product(s) in any way? What were the greatest barriers you had to face?

1.13: Key Management Decisions and Considerations

Learning Objectives

1. Understand the organizational support that will be needed for exporting activities.
2. Understand the need to select the best market to entry.
3. Identify and describe each possible market entry strategy.
4. Learn about the different approaches to getting paid.
5. Appreciate the importance of business etiquette when traveling to visit customers.
6. Understand the importance of an export plan.

After a business decides to jump into the global pond, several key management decisions must be made (Figure 15.3). Among them are organization for the global project, selecting the best market to enter, the level of involvement desired, and how to get paid. There should also be consideration of global etiquette and travel.

Figure 15.3 Management Decisions

Several important questions about the global venture should be answered before making any management decisions or considerations.“Management Issues Involved in the Export Decision,” *Export.gov*, March 31, 2011, accessed February 7, 2012, export.gov/exportbasics/eg_main_017455.asp. Less than satisfactory answers to these questions may put the global venture in jeopardy.

1. Do the company’s reasons for pursuing export markets include solid objectives, such as increasing sales volume or developing a broader, more stable customer base, or are the reasons frivolous, such as the owner wants an excuse to travel?
2. How committed is top management to the export effort? Is it viewed as a quick fix for a slump in domestic sales? Will the company neglect its export customers if domestic sales pick up?
3. What are management’s expectations for the export effort? Will they expect export operations to become self-sustaining quickly? If so, how quickly?
4. What level of return on investment is expected from the export project?

Organization for the Global Project

It will be important to have some kind of structure or team within the business to handle the global side of the business. It does not have to be large, but it should be dedicated to ensuring that export sales are adequately serviced, and there should be a clear indication of who will be responsible for the organization and staffing.“Management Issues Involved in the Export Decision,” *Export.gov*, March 31, 2011, accessed February 7, 2012, export.gov/exportbasics/eg_main_017455.asp. Having the right resources for the global effort is critical, so a business should make the most of skills already held by staff members, for example, languages or familiarity with a range of foreign currencies. If these and other needed skills are not already available on staff, a small business should seek assistance from external experts.Tricia Phillips, "Biz Bureau Gives Top Tips on Going Global with Your Business," *Mirror*, January 26, 2011, accessed February 7, 2012, www.mirror.co.uk/advice/money/2011/01/26/biz-bureau-gives-top-tips-on-going-global-with-your-business-115875 -22875517.

Other organizational issues that small businesses must address before going abroad include the following:Denise O'Berry, "Is Now the Time to Expand to Global Markets?," *AllBusiness.com*, April 14, 2008, accessed February 7, 2012, www.allbusiness.com/company-activities-management/company-strategy/8518731-1.html; Anita Campbell, "Smaller and Younger Companies Get Overseas Presence," *Small Business Trends*, December 7, 2007, accessed February 7, 2012, smallbiztrends.com/2007/12/smaller-and-younger-companies-get-overseas-presence.html; "Management Issues Involved in the Export Decision," *Export.gov*, March 31, 2011, accessed February 7, 2012, export.gov/exportbasics/eg_main_017455.asp.

- **Getting internal buy-in.** Because going overseas to do business is a larger undertaking than many businesses realize, make sure that senior management and the people who are responsible for implementing and supporting the overseas effort know what the goals are and what is expected of them with respect to oversight and management. Knowing how much senior management time should be and could be allocated is an important part of getting internal buy-in. Look for support from people in all functions of the business.
- **Making sure that the full costs of overseas hiring are understood.** If people from overseas will be hired, employment regulations and practices are very different. For example, outside the United States, employment benefits often represent a larger percentage of an employee's salary than in the United States; in the European Union, for example, a full-blown employment contract is needed, not just an offer letter. This tilts the balance of power to the employee at the expense of the company, making termination very difficult. Understanding the full ramifications of hiring people outside the United States has significant implications for a company's financial success.
- **Thinking about how the business will manage overseas employees' expectations.** Different time zones and countries wreak havoc with keeping employees on the same page. Employees hired locally may have very different ideas about what is considered acceptable than a US employee does. Unless expectations and responsibilities are clearly conveyed at the beginning, problems will undoubtedly arise. They may anyway, but perhaps they will not be as serious.

Market Selection

A business must select the best market(s) to enter. The three largest markets for US products are Canada, Japan, and Mexico, but these countries may not be the largest or best markets for a particular product.Laurel Delaney, "A How-To on Expanding Your Business Globally," *The Global Small Business Blog*, January 11, 2011, accessed February 7, 2012, borderbuster.blogspot.com/2011/01/how-to-on-expanding-your-business.html. If a business is not sure where the best place for doing global business is, one good approach is to find out where domestic competitors have been expanding internationally. Although moving into the same market(s) may make good sense, a good strategy might also be to go somewhere else. Three key US government databases that can identify the countries that represent significant export potential for a product are as follows:Laurel Delaney, "A How-To on Expanding Your Business Globally," *The Global Small Business Blog*, January 11, 2011, accessed February 7, 2012, borderbuster.blogspot.com/2011/01/how-to-on-expanding-your-business.html.

1. The SBA's Automated Trade Locator Assistance System
2. Foreign Trade Report FT925
3. The US Department of Commerce's National Trade Data Bank

After identifying the country or countries that may offer the best market potential for a product, serious market research should be conducted. A business should look at all the following factors: demographic, geographic, political, economic, social, cultural, market access, distribution, production, and the existence or absence of **tariffs** and nontariff trade barriers. Tariffs are taxes imposed on imported goods so that the price of imported goods increases to the level of domestic goods. Tariffs can be particularly critical in selecting a particular country because the tariff may make it impossible for a US small business to profitably sell its products in a particular country.

Nontariff trade barriers are laws or regulations enacted by a country to protect its domestic industries against foreign competition.Laurel Delaney, "A How-To on Expanding Your Business Globally," *The Global Small Business Blog*, January 11, 2011, accessed February 7, 2012, borderbuster.blogspot.com/2011/01/how-to-on-expanding-your-business.html. These barriers include such things as import licensing requirements; fees; government procurement policies; border taxes; and packaging, labeling, and marking standards.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 40.

Market Entry Strategies

A small business must decide how it wants to enter the selected foreign market(s). Several choices might look attractive for a business (see Figure 15.4). Direct and indirect exporting, strategic alliances, joint ventures, and direct foreign investment are discussed in this section. The benefits and risks associated with each strategy depend on many factors. Among them are the type of product or service being produced; the need for product or service support; and the foreign economic, political, business, and cultural environment to be penetrated. A firm's level of resources and commitment and the degree of risk it is willing to incur will help determine the strategy that the business thinks will work best.“Exporting Basics,” *SmallBusiness.com*, February 6, 2010, accessed February 7, 2012, smallbusiness.com/wiki/Exporting_basics.

Figure 15.4 Examples of Export Market Entry Strategies

Direct exporting and indirect exporting are discussed in Section 15.2.

- A **joint venture (JV)** is a partnership with a foreign firm formed to achieve a specific goal or operate for a specific period of time. A legal entity is created, with the partners agreeing to share in the management of the JV, and each partner holds an equity position. Each company retains its separate identity. Among the benefits are immediate market knowledge and access, reduced risk, and control over product attributes. On the negative side, JV agreements across national borders can be extremely complex, which requires a very high level of commitment by all parties.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 329; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 93; “Joint Ventures and Strategic Alliances,” *Fukuda Law Firm*, accessed February 7, 2012. Because some countries have restrictions on the foreign ownership of corporations, a JV may be the only way a small business can purchase facilities in another country.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 47.
- A **strategic alliance** is very similar to a JV in that it is a partnership formed to create competitive advantage on a worldwide basis.William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 93). An agreement is signed between two corporations, but a separate business entity is not created.“Joint Ventures and Strategic Alliances,” *Fukuda Law Firm*, accessed February 7, 2012. The business relationship is based on cooperation out of mutual need, and there is shared risk in achieving a common objective. Growing at a rate of about 20 percent per year, strategic alliances are created

for many reasons (e.g., opportunities for rapid expansion into new markets, reduced marketing costs, and strategic competitive moves).Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 327. “Small businesses excel at forming strategic partnerships and alliances which make them look bigger than they are and offer their customers a global reach.”Laurel Delaney, “Global Guru: Shaking Things Up. Making Things Happen,” *Change This*, October 19, 2004, accessed February 7, 2012, changethis.com/manifesto/6.03.GlobalGuru/pdf/6.03.GlobalGuru.pdf.
- **Direct foreign investment** is exactly what it sounds like: investment in a foreign country. If a business is interested in manufacturing locally to take advantage of low-cost labor, gain access to raw materials, reduce the high costs of transportation to market, or gain market entry, direct foreign investment is something to be considered. However, the complicated mix of considerations and risks—for example, the growing complexity and contingencies of contracts and degree of product differentiation—makes decisions about foreign investments increasingly difficult.Philip R. Cateora and John L. Graham, *International Marketing* (New York: McGraw-Hill Irwin, 2007), 332.

Getting Paid

Being paid in full and on time is of obvious importance to a business, so the level of risk that it is willing to assume in extending credit to customers is a major consideration.US Department of Commerce, *A Basic Guide to Exporting*, 10th ed. (Washington, DC: International Trade Association, 2008), 177. The credit of a buyer will always be a concern, but potentially more worrisome is the lessened recourse a business will have when it comes to collecting unpaid international debts. Extra caution must be exercised. Both the business owner and the buyer must agree on the terms of the sale in advance.Laurel Delaney, “A How-To on Expanding Your Business Globally,” *The Global Small Business Blog*, January 11, 2011, accessed February 7, 2012, borderbuster.blogspot.com/2011/01/how-to-on-expanding-your-business.html.

The primary methods of payment for international transactions are payment in advance (the most secure), letters of credit, documentary collection (drafts), consignment, and open account (the least secure), which are described as follows:Laurel Delaney, “A How-To on Expanding Your Business Globally,” *The Global Small Business Blog*, January 11, 2011, accessed February 7, 2012, borderbuster.blogspot.com/2011/01/how-to-on-expanding-your-business.html; US Department of Commerce, *A Basic Guide to Exporting*, 10th ed. (Washington, DC: International Trade Association, 2008), 178–80, 182–83.

- **Cash in advance.** This is the ideal method of payment because a company is relieved of collection problems and has immediate use of the money. Unfortunately, it tends to be an option only when the manufacturing process is specialized, lengthy, or capital intensive and requires partial or progress payments. Wire transfers are commonly used, and many exporters accept credit cards.
- **Documentary letter of credit.** This is an internationally recognized instrument issued by a bank on behalf of its client, the purchaser. A letter of credit represents the bank’s guarantee to pay the seller, provided that the conditions specified in the letter are fulfilled.
- **Documentary collection or draft.** This involves the use of a draft, drawn by the seller on the buyer. It requires the buyer to pay the face amount either on sight (sight draft) or on a specified date in the future (time draft). The draft is an unconditional order to make payment in accordance with its terms, which specify the documents needed before title to the goods will be passed. All terms of payment should be clearly specified so that confusion and delay are avoided.
- **Open account.** With an open account, the exporter bills the customer, who is then expected to pay under agreed-on terms at a future date after the goods are manufactured and delivered (usually with fifteen, thirty, or sixty days). This payment method works well if the buyer is well established, has a long and favorable payment record, or has been thoroughly checked for being creditworthy. This approach is considered risky in international business because a business has limited recourse if debts are unpaid. Small businesses considering this option must examine the political, economic, and commercial risks very thoroughly.
- **Consignment sales.** Goods are shipped to a foreign distributor, which sells them on behalf of the exporter. Title to the goods remains with the exporter until they are sold, at which point payment is sent to the exporter. The exporter has the greatest risk and least control over the goods with this method, and payment may take a while. Risk insurance should be seriously considered with consignment sales.

When buyers default on their payments, it can be time-consuming, difficult, and expensive to obtain payments. A business should contact the buyer and try to negotiate payment. If negotiation fails and the amount of the debt is large enough to make a difference in that business, obtain the assistance and advice of the business’s bank, legal counsel, and the US Commercial Service, an organization that can resolve payment problems informally. If arbitration becomes necessary, the International Chamber of Commerce is the place to go. It handles most international arbitrations and is usually acceptable to foreign companies because it is not affiliated with any single country.US Department of Commerce, *A Basic Guide to Exporting*, 10th ed. (Washington, DC: International Trade Association, 2008), 184.

Business Etiquette and Travel

Having a successful global business requires getting to know the history, the culture, and the customs of the country or countries in which a business hopes to expand. Each country is different from another and the United States in some ways. Some of these differences have been discussed earlier in this chapter. Among the cultural differences to be faced are business styles, attitudes toward business relationships and punctuality, negotiating styles, gift-giving customers, greetings, the significance of gestures, the meanings of colors and numbers, and customs regarding titles. For example, engaging in small talk before conducting business is standard practice in Saudi Arabia, and gift giving is an important part of doing business in Japan.US Department of Commerce, *A Basic Guide to Exporting*, 10th ed. (Washington, DC: International Trade Association, 2008), 211.

Before traveling to the chosen country or countries, knowing any and all cultural differences is critical. It is also important to educate stateside employees who will be working with international customers.

Being successful in global operations will depend on the relationships that are built. The best way to build them is by traveling to the selected country. Travel there…but do so with the cultural knowledge and understanding that will allow the conduct of business without inadvertently offending a potential customer.

Video Link 15.11

Meet Your Customers: Traveling There

Building relationships for success in exporting businesses.

www.inc.com/exporting/travelingthere.htm

The Export Plan

After deciding to sell products or services abroad, a carefully researched export plan is a source of direction. An export plan helps a business act on—rather than react to—the challenges and risks encountered in global business. The plan will also help a business obtain financial assistance and find investors, strategic partners, and JV partners that may be needed for success.“10 Steps to Successful Exporting,” *About.com*, accessed February 7, 2012, sbinfocanada.about.com/od/canadaexport/a/10exportsteps.htm.

There are many elements of an export plan, including a description of the company; its market and industry; its objectives; information on its products or services; an analysis of the target market and industry, including trends and forecasts; an examination of competitors and their strengths and weaknesses; international marketing strategies, including customer profiling and the development of sales and distribution channels; employment and training issues; after-sales and customer service, and financial requirements and forecasts.“10 Steps to Successful Exporting,” *About.com*, accessed February 7, 2012, sbinfocanada.about.com/od/canadaexport/a/10exportsteps.htm. “Many companies launch their export activities haphazardly and are unsuccessful in their early efforts because of poor or no planning, which often leads them to abandon exporting altogether.”US Department of Commerce, *A Basic Guide to Exporting*, 10th ed. (Washington, DC: International Trade Association, 2008), 18.

Video Link 15.12

Providing Good Customer Service

Small business owners talk about what they have learned by serving international customers.

www.inc.com/exporting/customerservice.htm

A business’s first export plan should be simple, only a few pages because important market data and planning elements may not be easily available or completely unavailable. The plan should be written and seen as a flexible management document, not a static document that sits on a shelf somewhere gathering dust. Objectives need to be compared against actual results, just as a business would do with its marketing plan and its overall business plan. A business should be open to revising the plan as necessary as new information becomes available and experience is gained.US Department of Commerce, *A Basic Guide to Exporting*, 10th ed. (Washington, DC: International Trade Association, 2008), 18.

Video Link 15.13

Creating an Export Business Plan

Small business owners agree that developing a strategic plan is the first step toward exporting success.

www.inc.com/exporting/businessplan.htm

KEY TAKEAWAYS

- Before taking a business global, desire to pursue export markets for good rather than frivolous reasons.
- Management commitment must be present for successful global operations.
- A business must decide on some kind of structure to handle its global side. It should be dedicated to ensuring that export sales are adequately serviced.
- Getting internal buy-in is critical.
- A business will need to select the best market(s) to enter. Although Canada, Japan, and Mexico are the largest markets for US products, these countries may not be the best markets for specific products or services.
- Tariffs and nontariff trade barriers can pose serious constraints.
- A business must decide how to enter a foreign market. For example, it can choose direct and indirect exporting, strategic alliances, JVs, and direct foreign investment.
- Being paid in full and on time is of obvious importance, especially considering the difficulties a business will encounter in collecting an unpaid international debt. The most secure method of payment is cash in advance. The least secure is an open account.
- Learning and understanding the business etiquette of the country or countries to which a business is exporting is a very important part of building business relationships.
- A carefully researched export plan is a source of direction, and it will help a business act on—rather than react to—the challenges and risks it will encounter in global business.

EXERCISE

1. Go to the Coca-Cola website (www.coca-cola.com/en/index.html) and select one website from each of the following geographic areas: Latin America, Europe, Eurasia, Africa, and Asia Pacific. Compare the home pages of these sites to the US home page—even though you will not understand the language (unless you are bilingual). Look at the graphics, layout, and uses of color. What are the similarities? What are the differences? To what would you attribute the differences? How would these similarities and differences inform the design of a small business website for conducting global business?

1.14: The Three Threads

Learning Objectives

1. Understand how to contribute to customer value in exporting activities.
2. Explain how exporting can impact cash flow.
3. Explain how technology and the e-environment impact exporting.

Customer Value Implications

Always remember that customers make the decision about whether the appropriate value is present, and that value will always be as they perceive it. Carefully adapting a product to the targeted country for an exporting venture is an important first step in providing customer value. This means knowing about the sources of value in a product or a service and then acting on them. It can mean a minor product adaptation—for example, serving beer in McDonald's in Germany or wine in McDonald's in France and Italy—or a new twist on distribution—for example, Procter & Gamble selling shampoo in single-use tubes in newsstands in India. Although these are large-company examples, the experiences can be easily translated into small business exporting practice.

Another important source of customer value is the company website. Whether the website is the only selling platform of a business or is part of a brick-and-click exporting business, foreign buyers are much more likely to buy if a business's website is in their language. Although translation and country-specific sites can be a costly proposition, the text, graphics, and colors of the website can either enhance or detract from an exporting business. A small business owner should find out what organizational services and website designers can provide assistance. It may be possible to link the website to the Google translation tool to get a rough translation in seconds.Anita Campbell, "How to Make Your Website Ready for International Business," *Small Business Trends*, October 29, 2010, accessed February 7, 2012, smallbiztrends.com/2010/10/website-ready-international-business.html.

Once a sale is made, do not make the mistake of thinking that it is the end of the relationship between the business and an overseas customer. Providing after-sale service must be an integral part of a company's export strategy from the very beginning.US Department of Commerce, *A Basic Guide to Exporting*, 10th ed. (Washington, DC: International Trade Association, 2008), 219. This service should include regular thank-yous for their business; a plan for regular communication; and offering customers 24/7 availability via some combination of fax, Twitter, e-mail alerts, a wiki, a Skype account, and telephone voicemail services where messages can be retrieved around the clock. This level of access will be of great value to foreign customers because it lets them know that you are reliable, dependable, ready to serve, and willing to minimize risk. It is this proper care and feeding of customers that will keep them coming back because the business provides value that makes it worth their while.Laurel Delaney, "Building Global Bonds One Customer at a Time," *Small Business Trends*, June 27, 2008, accessed February 7, 2012, smallbiztrends.com/2008/06/global-customer-bonds.html.

There is something else to consider as well. Research has shown that global online shoppers demand live customer service, with this service being more important than price."Webinar: Online Retail and the ROI of Live Help—Why Global Online Shoppers Demand Live Customer Service," accessed February 7, 2012, www.retailcustomerexperience.com/whitepapers/2508/Webinar-Online-Retail-and -the-ROI-of-Live-Help-Why-Global-Online-Shoppers-Demand-Live-Customer-Service. This has implications not only for how customer service is designed for the targeted country for exports but for buyers from other countries as well.

Cash-Flow Implications

A small business exporter will face the same cash-flow challenges that affect any small business, but being an exporter presents additional cash-flow challenges that are unique to selling products overseas. One of these challenges comes from the value-added tax (VAT) in Europe. Having the proper VAT registration can be key because all non–European Union businesses must collect and remit the VAT on applicable transactions. A business is required to charge the VAT, and compliance requires periodic VAT filings, which means keeping VAT records on file and available for inspection by local tax authorities and anyone else who has reason and authority to inspect them. A failure to comply can result in significant penalties and cash-flow problems.Denise O'Berry, "Is Now the Time to Expand to Global Markets?," *AllBusiness.com*, April 14, 2008, accessed February 7, 2012, www.allbusiness.com/company-activities-managements/company-strategy/8518731-1.html.

Shipping costs pose another threat to cash flow. Shipping products overseas is very expensive, with the fees sometimes being as high as the cost of shipping the merchandise itself. Add to that the differences in currencies and taxes, and a business is faced with the possibility of having to pay all or most of the shipping costs up front. While waiting for customers to pay, paying these costs will have a negative impact on cash flow.Anita Campbell, “How to Make Your Website Ready for International Business,” *Small Business Trends*, October 29, 2010, accessed February 7, 2012, smallbiztrends.com/2010/10/website-ready-international-business.html. Fortunately, there are cost-cutting approaches available. For example, Michael Katz, a small business owner who ships portfolio and art cases overseas, was able to reduce the extra expenses by negotiating a discount with UPS, cutting his shipping costs to 50 percent of the list rate.Elise Craig, “How to Get Your Small Business into the Export Game,” *CBS Money Watch*, March 3, 2011, accessed February 7, 2012, www.cbsnews.com/8301-505143_162-46540438/how-to-get-your-small-business-into-the-export-game.

Implications of Technology and the E-Environment

Inexpensive technology and the Internet have made it possible for small businesses to operate internationally with some of the same efficiencies as larger companies.Anita Campbell, “Preparing Your Business to Go Global,” *Small Business Trends*, November 19, 2010, accessed February 7, 2012, smallbiztrends.com/2010/11/preparing-your-business-to-go-global.html. The global reach of the Internet makes it cost-effective for small businesses to sell products and services overseas. Small businesses can broaden their presence internationally by adopting e-commerce and e-business practices that are user-friendly for non-English-speaking countries.US Department of Commerce, *A Basic Guide to Exporting*, 10th ed. (Washington, DC: International Trade Association, 2008), 219.

The small business owner can also look to several other sources of assistance for global endeavors. Consider the following three examples:

1. The self-service advertising product developed by Facebook gives small businesses an opportunity to reach a global audience.“Small Business News: The Global View,” *Small Business Trends*, January 18, 2011, accessed February 7, 2012, smallbiztrends.com/2011/01/small-business-news-the -global-view.html.
2. Shipping management software packages will automatically figure the costs and the delivery times for overseas orders, giving a close estimate. They also convert the currency for the buyer. Integrating this software into the website of a small business will provide a seamless experience for the customer, making an important contribution to customer value.Anita Campbell, “How to Make Your Website Ready for International Business,” *Small Business Trends*, October 29, 2010, accessed February 7, 2012, smallbiztrends.com/2010/10/website-ready-international-business.html.
3. The Internet and mobile devices lower information and communication costs, providing new channels of distribution and permitting 24/7 global reach through Twitter, wikis, e-mail alerts, and Skype.

KEY TAKEAWAYS

- A small business can offer customer value in its global activities by carefully adapting its products to the targeted country, having a website that caters to the language and culture of the buyers, and providing excellent after-sale service.
- The small business faces potential cash-flow problems from the VAT and shipping costs.
- Inexpensive technology and the Internet have made it possible for small businesses to operate internationally with some of the same efficiencies as larger companies.

EXERCISES

1. How can mobile devices be used to help the exporting operations of a small business?
2. How does the advertising product developed by Facebook work? How can it help increase the global reach of a small business? What are the costs for a small business?

Disaster Watch

Michael has been very successful with his exporting business. Instead of choosing Canada, Japan, or Mexico, the top three countries for small business exporting, he decided on Babalacala, a small country in the Middle East that has a history of political stability even though it has been ruled by one man for more than thirty-five years. The risk has been worth it so far. Michael identified the demand for his product, and he was right on target with his marketing research.

Michael has a small manufacturing plant that employs 150 locals and 5 people from the United States. He has successfully adapted his product to the local cultural, legal, and economic environments. His prices and promotion strategy are good fits, and his distribution structure—with some minor tweaking—is proving to be very efficient and effective. Needless to say, Michael and his investors are very happy campers.

But not for much longer.

Michael awakened one morning to a large-scale revolt against the current governor of Babalacala. The streets of the capital city were filled with protestors. Things were peaceful at first, but violence erupted in the afternoon. Many of Michael's local workers left the factory to protest or because they were afraid. Telecommunications were out, transportation was spotty, and there was only intermittent power. Most of the local stores closed. The word on the street was that the protestors were in for the long haul. They planned to keep protesting until the current governor resigned or left the country.

What should Michael do? He has a lot of money, time, and passion invested in his exporting business, and there are investors to think about. He does not want to leave Babalacala, but this is a serious situation.

1.15: Points to Remember

1. Although we often speak of global markets and a "flat" world, in reality, the world's competitive structure is best described as semiglobal. Bilateral and regional trade and investment patterns continue to dominate global ones.
2. The center of gravity of global competition is shifting to the East, with China and India taking center stage. Russia and Brazil, the other two BRIC countries, are not far behind.
3. Global competition is rapidly becoming a two-way street, with new competitors from developing countries taking on traditional companies from developed nations everywhere in every industry.
4. Companies have several major reasons to consider going global: to pursue growth, efficiency, and knowledge; to better meet customer needs; and to preempt or counter competition.
5. Global companies are those that have a global market presence, supply-chain infrastructure, capital base, and corporate mind-set.
6. Although we live in a "global" world, distance still very much matters, and companies must explicitly and thoroughly account for it when they make decisions about global expansion.
7. Distance between countries or regions is usefully analyzed in terms of four dimensions: *cultural, administrative, geographic,* and *economic,* each of which influences business in different ways.
8. Even with the best planning, globalization carries substantial risks. Globalization risks can be of a *political, legal, financial-economic,* or *sociocultural nature.*

CHAPTER OVERVIEW

2: National Differences

2.1: What Is Culture, Anyhow? Values, Customs, and Language

Learning Objectives

1. Understand what is meant by *culture*.
2. Know that there are different kinds of culture.
3. Identify several different kinds of culture.

As the opening case about Dunkin' Brands illustrates, local preferences, habits, values, and culture impact all aspects of doing business in a country. But what exactly do we mean by culture? Culture is different from personality. For our purposes here, let's define *personality* as a person's identity and unique physical, mental, emotional, and social characteristics.*Dictionary.com*, s.v. "personality," accessed February 22, 2011, http://dictionary.reference.com/browse/personality. No doubt one of the highest hurdles to cross-cultural understanding and effective relationships is our frequent inability to decipher the influence of culture from that of personality. Once we become culturally literate, we can more easily read individual personalities and their effect on our relationships.

So, What Is Culture, Anyway?

Culture in today's context is different from the traditional, more singular definition, used particularly in Western languages, where the word often implies refinement. Culture is the beliefs, values, mind-sets, and practices of a group of people. It includes the behavior pattern and norms of that group—the rules, the assumptions, the perceptions, and the logic and reasoning that are specific to a group. In essence, each of us is raised in a belief system that influences our individual perspectives to such a large degree that we can't always account for, or even comprehend, its influence. We're like other members of our culture—we've come to share a common idea of what's appropriate and inappropriate.

Culture is really the collective programming of our minds from birth. It's this collective programming that distinguishes one group of people from another. Much of the problem in any cross-cultural interaction stems from our expectations. The challenge is that whenever we deal with people from another culture—whether in our own country or globally—we expect people to behave as we do and for the same reasons. Culture awareness most commonly refers to having an understanding of another culture's values and perspective. This does not mean automatic acceptance; it simply means understanding another culture's mind-set and how its history, economy, and society have impacted what people think. Understanding so you can properly interpret someone's words and actions means you can effectively interact with them.

When talking about culture, it's important to understand that there really are no rights or wrongs. People's value systems and reasoning are based on the teachings and experiences of their culture. Rights and wrongs then really become perceptions. **Cross-cultural understanding** requires that we reorient our mind-set and, most importantly, our expectations, in order to interpret the gestures, attitudes, and statements of the people we encounter. We reorient our mind-set, but we don't necessarily change it.

There are a number of factors that constitute a culture—manners, mind-set, rituals, laws, ideas, and language, to name a few. To truly understand culture, you need to go beyond the lists of dos and don'ts, although those are important too. You need to understand what makes people tick and how, as a group, they have been influenced over time by historical, political, and social issues. Understanding the "why" behind culture is essential.

When trying to understand how cultures evolve, we look at the factors that help determine cultures and their values. In general, a **value** is defined as something that we prefer over something else—whether it's a behavior or a tangible item. Values are usually acquired early in life and are often nonrational—although we may believe that ours are actually quite rational. Our values are the key building blocks of our cultural orientation.

Odds are that each of us has been raised with a considerably different set of values from those of our colleagues and counterparts around the world. Exposure to a new culture *may* take all you've ever learned about what's good and bad, just and unjust, and beautiful and ugly and stand it on its head.

Human nature is such that we see the world through our own cultural shades. Tucked in between the lines of our cultural laws is an unconscious bias that inhibits us from viewing other cultures objectively. Our judgments of people from other cultures will always be colored by the frame of reference we've been taught. As we look at our own habits and perceptions, we need to think about the experiences that have blended together to impact our cultural frame of reference.

In coming to terms with cultural differences, we tend to employ generalizations. This isn't necessarily bad. Generalizations can save us from sinking into what may be abstruse, esoteric aspects of a culture. However, recognize that cultures and values are not static entities. They're constantly evolving—merging, interacting, drawing apart, and reforming. Around the world, values and cultures are evolving from generation to generation as people are influenced by things outside their culture. In modern times, media and technology have probably single-handedly impacted cultures the most in the shortest time period—giving people around the world instant glimpses into other cultures, for better or for worse. Recognizing this fluidity will help you avoid getting caught in outdated generalizations. It will also enable you to interpret local cues and customs and to better understand local cultures.

Understanding what we mean by culture and what the components of culture are will help us better interpret the impact on business at both the macro and micro levels. Confucius had this to say about cultural crossings: "Human beings draw close to one another by their common nature, but habits and customs keep them apart."

What Kinds of Culture Are There?

Political, economic, and social philosophies all impact the way people's values are shaped. Our cultural base of reference—formed by our education, religion, or social structure—also impacts business interactions in critical ways. As we study cultures, it is very important to remember that all cultures are constantly evolving. When we say "cultural," we don't always just mean people from different countries. Every group of people has its own unique culture—that is, its own way of thinking, values, beliefs, and mind-sets. For our purposes in this chapter, we'll focus on national and ethnic cultures, although there are subcultures within a country or ethnic group.

Precisely where a culture begins and ends can be murky. Some cultures fall within geographic boundaries; others, of course, overlap. Cultures within one border can turn up within other geographic boundaries looking dramatically different or pretty much the same. For example, Indians in India or Americans in the United States may communicate and interact differently from their countrymen who have been living outside their respective home countries for a few years.

The countries of the Indian subcontinent, for example, have close similarities. And cultures within one political border can turn up within other political boundaries looking pretty much the same, such as the Chinese culture in China and the overseas Chinese culture in countries around the world. We often think that cultures are defined by the country or nation, but that can be misleading because there are different cultural groups (as depicted in the preceding figure). These groups include nationalities; subcultures (gender, ethnicities, religions, generations, and even socioeconomic class); and organizations, including the workplace.

Nationalities

A national culture is—as it sounds—defined by its geographic and political boundaries and includes even regional cultures within a nation as well as among several neighboring countries. What is important about nations is that boundaries have changed throughout history. These changes in what territory makes up a country and what the country is named impact the culture of each country.

In the past century alone, we have seen many changes as new nations emerged from the gradual dismantling of the British and Dutch empires at the turn of the 1900s. For example, today the physical territories that constitute the countries of India and Indonesia are far different than they were a hundred years ago. While it's easy to forget that the British ran India for two hundred years and that the Dutch ran Indonesia for more than one hundred and fifty years, what is clearer is the impact of the British and the Dutch on the respective bureaucracies and business environments. The British and the Dutch were well known for establishing large government bureaucracies in the countries they controlled. Unlike the British colonial rulers in India, the Dutch did little to develop Indonesia's infrastructure, civil service, or educational system. The British, on the other hand, tended to hire locals for administrative positions, thereby establishing a strong and well-educated Indian bureaucracy. Even though many businesspeople today complain that this Indian bureaucracy is too slow and focused on rules and regulations, the government infrastructure and English-language education system laid out by the British helped position India for its emergence as a strong high-tech economy.

Even within a national culture, there are often distinct regional cultures—the United States is a great example of diverse and distinct cultures all living within the same physical borders. In the United States, there's a national culture embodied in the symbolic concept of "all-American" values and traits, but there are also other cultures based on geographically different regions—the South, Southwest, West Coast, East Coast, Northeast, Mid-Atlantic, and Midwest.

Subcultures

Many groups are defined by ethnicity, gender, generation, religion, or other characteristics with cultures that are unique to them. For example, the ethnic Chinese business community has a distinctive culture even though it may include Chinese businesspeople in several countries. This is particularly evident throughout Asia, as many people often refer to Chinese businesses as making up a single business community. The overseas Chinese business community tends to support one another and forge business bonds whether they are from Indonesia, Malaysia, Singapore, or other ASEAN (Association of Southeast Asian Nations) countries. This group is perceived differently than Chinese from mainland China or Taiwan. Their common experience being a minority ethnic community with strong business interests has led to a shared understanding of how to quietly operate large businesses in countries. Just as in mainland China, *guanxi*, or "connections," are essential to admission into this overseas Chinese business network. But once in the network, the Chinese tend to prefer doing business with one another and offer preferential pricing and other business services.

Organizations

Every organization has its own workplace culture, referred to as the **organizational culture**. This defines simple aspects such as how people dress (casual or formal), how they perceive and value employees, or how they make decisions (as a group or by the manager alone). When we talk about an entrepreneurial culture in a company, it might imply that the company encourages people to think creatively and respond to new ideas fairly quickly without a long internal approval process. One of the issues managers often have to consider when operating with colleagues, employees, or customers in other countries is how the local country's culture will blend or contrast with the company's culture.

For example, Apple, Google, and Microsoft all have distinct business cultures that are influenced both by their industries and by the types of technology-savvy employees that they hire, as well as by the personalities of their founders. When these firms operate in a country, they have to assess how new employees will fit their respective corporate cultures, which usually emphasize creativity, innovation, teamwork balanced with individual accomplishment, and a keen sense of privacy. Their global employees may appear relaxed in casual work clothes, but underneath there is often a fierce competitiveness. So how do these companies effectively hire in countries like Japan, where teamwork and following rules are more important than seeking new ways of doing things? This is an ongoing challenge that human resources (HR) departments continually seek to address.

KEY TAKEAWAYS

- Culture is the beliefs, values, mind-sets, and practices of a specific group of people. It includes the behavior pattern and norms of a specific group—the rules, the assumptions, the perceptions, and the logic and reasoning that are specific to a group. Culture is really the collective programming of our minds from birth. It's this collective programming that distinguishes one group of people from another. Cultural awareness most commonly refers to having an understanding of another culture's values and perspective.
- When trying to understand how cultures evolve, we look at the factors that help determine cultures and their values. In general, a *value* is defined as something that we prefer over something else—whether it's a behavior or a tangible item. Values are usually acquired early in life and are usually nonrational. Our values are the key building blocks of our cultural orientation.
- When we say cultural, we don't always just mean people from different countries. Cultures exist in all types of groups. There are even subcultures within a country or target ethnic group. Each person belongs to several kinds of cultures: national, subcultural (regional, gender, ethnic, religious, generational, and socioeconomic), and group or workplace (corporate culture).

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What is culture?
2. What are the different levels or types of cultures?
3. Identify your national culture and describe the subcultures within it.

2.2: Culture Today

With the world in flux from globalization and technological advances, people are developing **multiple identities** apparent in their local and global linkages. Cultural identity is becoming increasingly contextual in the postmodern world where people transform and adapt depending on time and place (Kottak and Kozaitis 2012). Social and cultural changes now adapt in response to single events or issues. The instant response and connections to others beyond time and place immediately impacts our lives, and we have the technology to react quickly with our thoughts and actions.

According to Pew Research, in 2021 85% of American adults are online connecting with others, working, studying, or learning on a daily basis (https://www.pewresearch.org/fact-tan...tantly-online/ accessed December 2021). The increasing use of the Internet makes virtual worlds and cybersocial interactions powerful in constructing new social realities. Having a networked society allows anyone to be a cultural creator and develop an audience by sharing their thoughts, ideas, and work online. Amateurs are now **cultural creators** and have the ability to control dissemination of their creations (Griswold 2013). Individuals now have the freedom to restrict or share cultural meaning and systems.

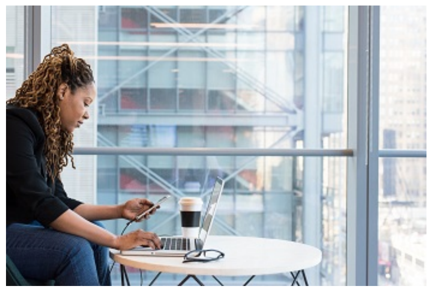


Figure 2.2.2: Woman Wearing Black Long Sleeved Shirt Using Laptop. (CC BY 4.0; Christina Morillo).

Postmodern culture and the new borderless world fragments traditional social connections into new cultural elements beyond place, time, and diversity without norms. People can now live within **global electronic cultural communities** and reject cultural meta-narratives (Griswold 2013). Postmodern culture also blurs history by rearranging and juxtaposing unconnected signs to produce new meanings. We find references to actual events in fictional culture and fictional events in non-fictional culture (Barker and Jane 2016). Many U.S. television dramas refer to 9/11 in episodes focusing on terrorists or terrorist activities. Additionally, U.S. social activities and fundraising events will highlight historical figures or icons. The blurring of non-fiction and fiction creates a new narrative or historical reality people begin to associate with and recognize as actual or fact.

CULTURAL TRANSFORMATION

1. How has globalization and technology changed culture and cultural tastes?
2. How have people harnessed these changes into cultural objects or real culture?
3. How do you envision the growth or transformation of receivers or the audience as participants in cultural production?
4. What cultural objects are threatened in the age of postmodern culture?

2.3: What Are the Key Methods Used to Describe Cultures?

Learning Objectives

1. Know several methods to describe cultures.
2. Define and apply Hofstede's and Hall's categories for cultural identification.
3. Identify and discuss additional determinants of culture.

The study of cross-cultural analysis incorporates the fields of anthropology, sociology, psychology, and communication. The combination of cross-cultural analysis and business is a new and evolving field; it's not a static understanding but changes as the world changes. Within cross-cultural analysis, two names dominate our understanding of culture—Geert Hofstede and Edward T. Hall. Although new ideas are continually presented, Hofstede remains the leading thinker on how we see cultures.

This section will review both the thinkers and the main components of how they define culture and the impact on communications and business. At first glance, it may seem irrelevant to daily business management to learn about these approaches. In reality, despite the evolution of cultures, these methods provide a comprehensive and enduring understanding of the key factors that shape a culture, which in turn impact every aspect of doing business globally. Additionally, these methods enable us to compare and contrast cultures more objectively. By understanding the key researchers, you'll be able to formulate your own analysis of the different cultures and the impact on international business.

Hofstede and Values

Geert Hofstede, sometimes called the father of modern cross-cultural science and thinking, is a social psychologist who focused on a comparison of nations using a statistical analysis of two unique databases. The first and largest database composed of answers that matched employee samples from forty different countries to the same survey questions focused on attitudes and beliefs. The second consisted of answers to some of the same questions by Hofstede's executive students who came from fifteen countries and from a variety of companies and industries. He developed a framework for understanding the systematic differences between nations in these two databases. This framework focused on **value dimensions**. Values, in this case, are *broad preferences for one state of affairs over others*, and they are mostly unconscious.

Most of us understand that values are our own culture's or society's ideas about what is good, bad, acceptable, or unacceptable. Hofstede developed a framework for understanding how these values underlie organizational behavior. Through his database research, he identified five key value dimensions that analyze and interpret the behaviors, values, and attitudes of a national culture:"Dimensions of National Cultures," Geert Hofstede, accessed February 22, 2011, www.geerthofstede.nl/culture/dimensions-of-national-cultures.aspx.

1. Power distance
2. Individualism
3. Masculinity
4. Uncertainty avoidance (UA)
5. Long-term orientation

Power distance refers to how openly a society or culture accepts or does not accept differences between people, as in hierarchies in the workplace, in politics, and so on. For example, *high power distance* cultures openly accept that a boss is "higher" and as such deserves a more formal respect and authority. Examples of these cultures include Japan, Mexico, and the Philippines. In Japan or Mexico, the senior person is almost a father figure and is automatically given respect and usually loyalty without questions.

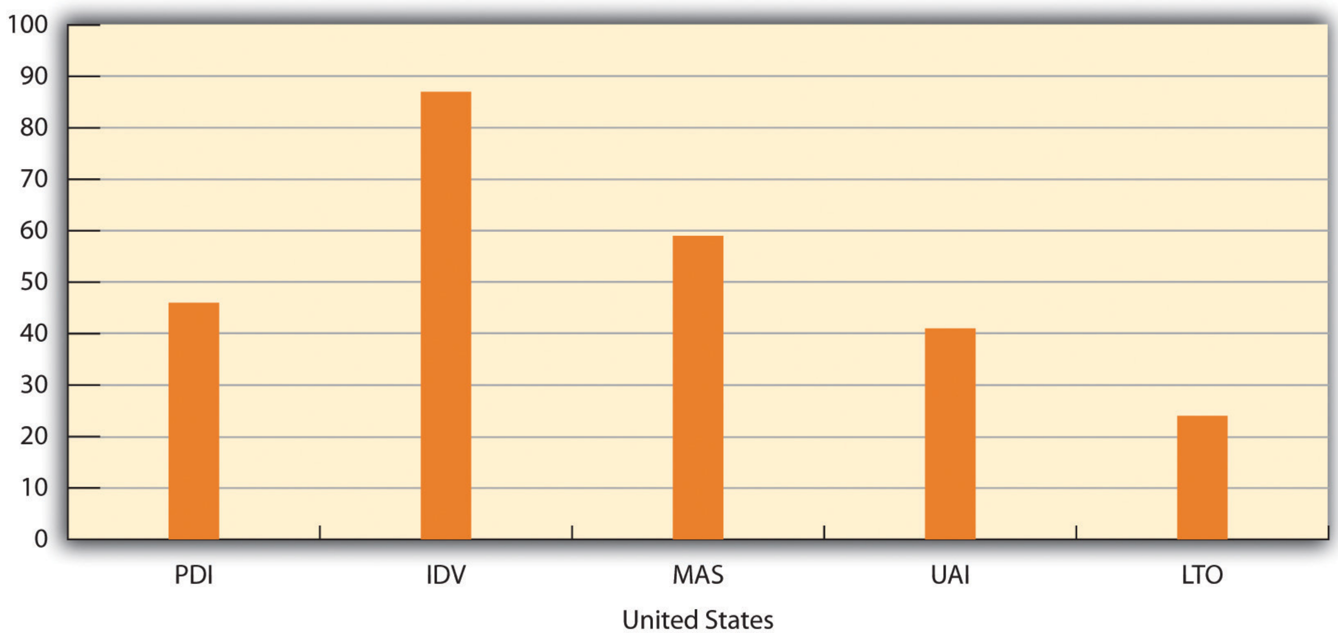
In Southern Europe, Latin America, and much of Asia, power is an integral part of the social equation. People tend to accept relationships of servitude. An individual's status, age, and seniority command respect—they're what make it all right for the lower-ranked person to take orders. Subordinates expect to be told what to do and won't take initiative or speak their minds unless a manager explicitly asks for their opinion.

At the other end of the spectrum are *low power distance* cultures, in which superiors and subordinates are more likely to see each other as equal in power. Countries found at this end of the spectrum include Austria and Denmark. To be sure, not all cultures view power in the same ways. In Sweden, Norway, and Israel, for example, respect for equality is a warranty of freedom. Subordinates and managers alike often have carte blanche to speak their minds.

Interestingly enough, research indicates that the United States tilts toward low power distance but is more in the middle of the scale than Germany and the United Kingdom.

Let's look at the culture of the United States in relation to these five dimensions. The United States actually ranks somewhat lower in power distance—under forty as noted in Figure 3.1. The United States has a culture of promoting participation at the office while maintaining control in the hands of the manager. People in this type of culture tend to be relatively laid-back about status and social standing—but there's a firm understanding of who has the power. What's surprising for many people is that countries such as the United Kingdom and Australia actually rank lower on the power distance spectrum than the United States.

Figure 3.1 The United States' Five Value Dimensions



Source: "Geert Hofstede™ Cultural Dimensions," Itim International, accessed June 3, 2011, www.geert-hofstede.com/hofstede_united_states.shtml.

Individualism, noted as IDV in Figure 3.1, is just what it sounds like. It refers to people's tendency to take care of themselves and their immediate circle of family and friends, perhaps at the expense of the overall society. In individualistic cultures, what counts most is self-realization. Initiating alone, sweating alone, achieving alone—not necessarily collective efforts—are what win applause. In individualistic cultures, competition is the fuel of success.

The United States and Northern European societies are often labeled as individualistic. In the United States, individualism is valued and promoted—from its political structure (individual rights and democracy) to entrepreneurial zeal (capitalism). Other examples of high-individualism cultures include Australia and the United Kingdom.

On the other hand, in collectivist societies, group goals take precedence over individuals' goals. Basically, individual members render loyalty to the group, and the group takes care of its individual members. Rather than giving priority to "me," the "us" identity predominates. Of paramount importance is pursuing the common goals, beliefs, and values of the group as a whole—so much so, in some cases, that it's nearly impossible for outsiders to enter the group. Cultures that prize collectivism and the group over the individual include Singapore, Korea, Mexico, and Arab nations. The protections offered by traditional Japanese companies come to mind as a distinctively group-oriented value.

The next dimension is **masculinity**, which may sound like an odd way to define a culture. When we talk about masculine or feminine cultures, we're not talking about diversity issues. It's about how a society views traits that are considered masculine or feminine.

This value dimension refers to how a culture ranks on traditionally perceived "masculine" values: assertiveness, materialism, and less concern for others. In masculine-oriented cultures, gender roles are usually crisply defined. Men tend to be more focused on performance, ambition, and material success. They cut tough and independent personas, while women cultivate modesty and quality of life. Cultures in Japan and Latin American are examples of masculine-oriented cultures.

In contrast, feminine cultures are thought to emphasize “feminine” values: concern for all, an emphasis on the quality of life, and an emphasis on relationships. In feminine-oriented cultures, both genders swap roles, with the focus on quality of life, service, and independence. The Scandinavian cultures rank as feminine cultures, as do cultures in Switzerland and New Zealand. The United States is actually more moderate, and its score is ranked in the middle between masculine and feminine classifications. For all these factors, it’s important to remember that cultures don’t necessarily fall neatly into one camp or the other.

The next dimension is **uncertainty avoidance (UA)**. This refers to how much uncertainty a society or culture is willing to accept. It can also be considered an indication of the risk propensity of people from a specific culture.

People who have high uncertainty avoidance generally prefer to steer clear of conflict and competition. They tend to appreciate very clear instructions. At the office, sharply defined rules and rituals are used to get tasks completed. Stability and what is known are preferred to instability and the unknown. Company cultures in these countries may show a preference for low-risk decisions, and employees in these companies are less willing to exhibit aggressiveness. Japan and France are often considered clear examples of such societies.

In countries with low uncertainty avoidance, people are more willing to take on risks, companies may appear less formal and structured, and “thinking outside the box” is valued. Examples of these cultures are Denmark, Singapore, Australia, and to a slightly lesser extent, the United States. Members of these cultures usually require less formal rules to interact.

The fifth dimension is **long-term orientation**, which refers to whether a culture has a long-term or short-term orientation. This dimension was added by Hofstede after the original four you just read about. It resulted in the effort to understand the difference in thinking between the East and the West. Certain values are associated with each orientation. The long-term orientation values persistence, perseverance, thriftiness, and having a sense of shame. These are evident in traditional Eastern cultures. Based on these values, it’s easy to see why a Japanese CEO is likely to apologize or take the blame for a faulty product or process.

The short-term orientation values tradition only to the extent of fulfilling social obligations or providing gifts or favors. These cultures are more likely to be focused on the immediate or short-term impact of an issue. Not surprisingly, the United Kingdom and the United States rank low on the long-term orientation.

Long- and short-term orientation and the other value dimensions in the business arena are all evolving as many people earn business degrees and gain experience outside their home cultures and countries, thereby diluting the significance of a single cultural perspective. As a result, in practice, these five dimensions do not occur as single values but are really woven together and interdependent, creating very complex cultural interactions. Even though these five values are constantly shifting and not static, they help us begin to understand how and why people from different cultures may think and act as they do. Hofstede’s study demonstrates that there are national and regional cultural groupings that affect the behavior of societies and organizations and that these are persistent over time.

Edward T. Hall

Edward T. Hall was a respected anthropologist who applied his field to the understanding of cultures and intercultural communications. Hall is best noted for three principal categories that analyze and interpret how communications and interactions between cultures differ: context, space, and time.

Context: High-Context versus Low-Context Cultures

High and low context refers to how a message is communicated. In high-context cultures, such as those found in Latin America, Asia, and Africa, the physical context of the message carries a great deal of importance. People tend to be more indirect and to expect the person they are communicating with to decode the implicit part of their message. While the person sending the message takes painstaking care in crafting the message, the person receiving the message is expected to read it within context. The message may lack the verbal directness you would expect in a low-context culture. In high-context cultures, body language is as important and sometimes more important than the actual words spoken.

In contrast, in low-context cultures such as the United States and most Northern European countries, people tend to be explicit and direct in their communications. Satisfying individual needs is important. You’re probably familiar with some well-known low-context mottos: “Say what you mean” and “Don’t beat around the bush.” The guiding principle is to minimize the margins of misunderstanding or doubt. Low-context communication aspires to get straight to the point.

Communication between people from high-context and low-context cultures can be confusing. In business interactions, people from low-context cultures tend to listen only to the words spoken; they tend not to be cognizant of body language. As a result, people often miss important clues that could tell them more about the specific issue.

Space

Space refers to the study of physical space and people. Hall called this the study of **proxemics**, which focuses on space and distance between people as they interact. *Space* refers to everything from how close people stand to one another to how people might mark their territory or boundaries in the workplace and in other settings. Stand too close to someone from the United States, which prefers a "safe" physical distance, and you are apt to make them uncomfortable. How close is too close depends on where you are from. Whether consciously or unconsciously, we all establish a comfort zone when interacting with others. Standing distances shrink and expand across cultures. Latins, Spaniards, and Filipinos (whose culture has been influenced by three centuries of Spanish colonization) stand rather close even in business encounters. In cultures that have a low need for territory, people not only tend to stand closer together but also are more willing to share their space—whether it be a workplace, an office, a seat on a train, or even ownership of a business project.

Attitudes toward Time: Polychronic versus Monochronic Cultures

Hall identified that time is another important concept greatly influenced by culture. In **polychronic cultures**—*polychronic* literally means "many times"—people can do several things at the same time. In **monochronic cultures**, or "one-time" cultures, people tend to do one task at a time.

This isn't to suggest that people in polychronic cultures are better at multitasking. Rather, people in monochronic cultures, such as Northern Europe and North America, tend to schedule one event at a time. For them, an appointment that starts at 8 a.m. is an appointment that starts at 8 a.m.—or 8:05 at the latest. People are expected to arrive on time, whether for a board meeting or a family picnic. Time is a means of imposing order. Often the meeting has a firm end time as well, and even if the agenda is not finished, it's not unusual to end the meeting and finish the agenda at another scheduled meeting.

In polychronic cultures, by contrast, time is nice, but people and relationships matter more. Finishing a task may also matter more. If you've ever been to Latin America, the Mediterranean, or the Middle East, you know all about living with relaxed timetables. People might attend to three things at once and think nothing of it. Or they may cluster informally, rather than arrange themselves in a queue. In polychronic cultures, it's not considered an insult to walk into a meeting or a party well past the appointed hour.

In polychronic cultures, people regard work as part of a larger interaction with a community. If an agenda is not complete, people in polychronic cultures are less likely to simply end the meeting and are more likely to continue to finish the business at hand.

Those who prefer monochronic order may find polychronic order frustrating and hard to manage effectively. Those raised with a polychronic sensibility, on the other hand, might resent the "tyranny of the clock" and prefer to be focused on completing the tasks at hand.

What Else Determines a Culture?

The methods presented in the previous sections note how we look at the structures of cultures, values, and communications. They also provide a framework for a comparative analysis between cultures, which is particularly important for businesses trying to operate effectively in multiple countries and cultural environments.

Additionally, there are other external factors that also constitute a culture—manners, mind-sets, values, rituals, religious beliefs, laws, arts, ideas, customs, beliefs, ceremonies, social institutions, myths and legends, language, individual identity, and behaviors, to name a few. While these factors are less structured and do not provide a comparative framework, they are helpful in completing our understanding of what impacts a culture. When we look at these additional factors, we are seeking to understand how each culture views and incorporates each of them. For example, are there specific ceremonies or customs that impact the culture and for our purposes its business culture? For example, in some Chinese businesses, feng shui—an ancient Chinese physical art and science—is implemented in the hopes of enhancing the physical business environment and success potential of the firm.

Of these additional factors, the single most important one is communication.

Communication

Verbal Language

Language is one of the more conspicuous expressions of culture. As Hall showed, understanding the context of how language is used is essential to accurately interpret the meaning. Aside from the obvious differences, vocabularies are actually often built on the cultural experiences of the users. For example, in the opening case with Dunkin' Donuts, we saw how the local culture complicated the company's ability to list its name in Chinese characters.

Similarly, it's interesting to note that Arabic speakers have only one word for ice, *telg*, which applies to ice, snow, hail, and so on. In contrast, Eskimo languages have different words for each type of snow—even specific descriptive words to indicate the amounts of snow.

Another example of how language impacts business is in written or e-mail communications, where you don't have the benefit of seeing someone's physical gestures or posture. For example, India is officially an English-speaking country, though its citizens speak the Queen's English. Yet many businesspeople experience miscommunications related to misunderstandings in the language, ranging from the comical to the frustrating. Take something as simple as multiplication and division. Indians will commonly say "6 into 12" and arrive at 72, whereas their American counterparts will divide to get an answer of 2. You'd certainly want to be very clear if math were an essential part of your communication, as it would be if you were creating a budget for a project.

Another example of nuances between Indian and American language communications is the use of the word *revert*. The word means "to go back to a previously existing condition." To Indians, though, the common and accepted use of the word is much more simplistic and means "to get back to someone."

To see how language impacts communications, look at a situation in which an American manager, in negotiating the terms of a project, began to get frustrated by the e-mails that said that the Indian company was going to "revert back." He took that to mean that they had not made any progress on some issues, and that the Indians were going back to the original terms. Actually, the Indians simply meant that they were going to get back to him on the outstanding issues—again, a different connotation for the word because of cultural differences.

The all-encompassing "yes" is one of the hardest verbal cues to decipher. What does it really mean? Well, it depends on where you are. In a low-context country—the United States or Scandinavian countries, for example—"yes" is what it is: yes. In a high-context culture—Japan or the Philippines, for example—it can mean "yes," "maybe," "OK," or "I understand you,"—but it may not always signify agreement. The meaning is in the physical context, not the verbal.

Language or words become a code, and you need to understand the word and the context.

Did You Know?

English Required in Japan

It's commonly accepted around the world that English is the primary global business language. In Japan, some companies have incorporated this reality into daily business practice. By 2012, employees at Rakuten, Japan's biggest online retailer by sales, will be "required to speak and correspond with one another in English, and executives have been told they will be fired if they aren't proficient in the language by then. Rakuten, which has made recent acquisitions in the U.S. and Europe, says the English-only policy is crucial to its goal of becoming a global company. It says it needed a common language to communicate with its new operations, and English, as the chief language of international business, was the obvious choice. It expects the change, among other things, to help it hire and retain talented non-Japanese workers."Daisuke Wakabayashi, "English Gets the Last Word in Japan," *Wall Street Journal*, August 6, 2010, accessed February 22, 2011, http://online.wsj.com/article/SB10001424052748703954804575382011407926080.html.

Rakuten is only one of many large and small Japanese companies pursuing English as part of its ongoing global strategy. English is key to the business culture and language at Sony, Nissan Motor, and Mitsubishi, to name a few Japanese businesses. English remains the leading global business language for most international companies seeking a standard common language with its employees, partners, and customers.

Body Language

How you gesture, twitch, or scrunch up your face represents a veritable legend to your emotions. Being able to suitably read—and broadcast—body language can significantly increase your chances of understanding and being understood. In many high-context cultures, it is essential to understand body language in order to accurately interpret a situation, comment, or gesture.

People may not understand your words, but they will certainly interpret your body language according to *their* accepted norms. Notice the word *their*. It is *their* perceptions that will count when you are trying to do business with them, and it's important to understand that those perceptions will be based on the teachings and experiences of their culture—not yours.

Another example of the “yes, I understand you” confusion in South Asia is the infamous head wobble. Indians will roll their head from side to side to signify an understanding or acknowledgement of a statement—but not necessarily an acceptance. Some have even expressed that they mistakenly thought the head wobble meant “no.” If you didn’t understand the context, then you are likely to misinterpret the gesture and the possible verbal cues as well.

Did You Know?

OK or Not OK?

Various motions and postures can mean altogether divergent things in different cultures. Hand gestures are a classic example. The American sign for OK means “zero” in Tunisia and southern France, which far from signaling approval, is considered a threat. The same gesture, by the way, delivers an obscenity in Brazil, Germany, Greece, and Russia. If you want to tell your British colleagues that victory on a new deal is close at hand by making the V sign with your fingers, be sure your palm is facing outward; otherwise you’ll be telling them where to stick it, and it’s unlikely to win you any new friends.

Eye contact is also an important bit of unspoken vocabulary. People in Western cultures are taught to look into the eyes of their listeners. Likewise, it’s a way the listener reciprocates interest. In contrast, in the East, looking into someone’s eyes may come off as disrespectful, since focusing directly on someone who is senior to you implies disrespect. So when you’re interacting with people from other cultures, be careful not to assume that a lack of eye contact means anything negative. There may be a cultural basis to their behavior.

Amusing Anecdote

Kiss, Shake, Hug, or Bow

Additionally, touching is a tacit means of communication. In some cultures, shaking hands when greeting someone is a must. Where folks are big on contact, grown men might embrace each other in a giant bear hug, such as in Mexico or Russia.

Japan, by contrast, has traditionally favored bowing, thus ensuring a hands-off approach. When men and women interact for business, this interaction can be further complicated. If you’re female interacting with a male, a kiss on the cheek may work in Latin America, but in an Arab country, you may not even get a handshake. It can be hard not to take it personally, but you shouldn’t. These interactions reflect centuries-old traditional cultural norms that will take time to evolve.

Ethnocentrism

A discussion of culture would not be complete without at least mentioning the concept of ethnocentrism. **Ethnocentrism** is the view that a person’s own culture is central and other cultures are measured in relation to it. It’s akin to a person thinking that their culture is the “sun” around which all other cultures revolve. In its worst form, it can create a false sense of superiority of one culture over others.

Human nature is such that we see the world through our own cultural shades. Tucked in between the lines of our cultural laws is an unconscious bias that inhibits us from viewing other cultures objectively. Our judgments of people from other cultures will always be colored by the frame of reference in which we have been raised.

The challenge occurs when we feel that our cultural habits, values, and perceptions are superior to other people’s values. This can have a dramatic impact on our business relations. Your best defense against ethnocentric behavior is to make a point of seeing things from the perspective of the other person. Use what you have learned in this chapter to extend your understanding of the person’s culture. As much as possible, leave your own frame of reference at home. Sort out what makes you and the other person different—*and* what makes you similar.

KEY TAKEAWAYS

- There are two key methods used to describe and analyze cultures. The first was developed by Geert Hofstede and focuses on five key dimensions that interpret behaviors, values, and attitudes: power distance, individualism, masculinity, uncertainty avoidance, and long-term orientation. The second method was developed by Edward T. Hall and focuses on three main categories for how communications and interactions between cultures differ: high-context versus low-context communications, space, and attitudes toward time.
- In addition to the main analytical methods for comparing and contrasting cultures, there are a number of other determinants of culture. These determinants include manners, mind-sets, values, rituals, religious beliefs, laws, arts, ideas, customs, beliefs,

ceremonies, social institutions, myths and legends, language, individual identity, and behaviors. Language includes both verbal and physical languages.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Define Hofstede's five value dimensions that analyze and interpret behaviors, values, and attitudes.
2. Identify Hall's three key factors on how communications and interactions between cultures differ.
3. What are the two components of communications?
4. Describe two ways that verbal language may differ between countries.
5. Describe two ways that body language may differ between cultures.
6. What is ethnocentrism?

2.4: Building Cultural Intellegence

2.5: Why Nations Trade

2. Why do nations trade?

One might argue that the best way to protect workers and the domestic economy is to stop trade with other nations. Then the whole circular flow of inputs and outputs would stay within our borders. But if we decided to do that, how would we get resources like cobalt and coffee beans? The United States simply can't produce some things, and it can't manufacture some products, such as steel and most clothing, at the low costs we're used to. The fact is that nations—like people—are good at producing different things: you may be better at balancing a ledger than repairing a car. In that case you benefit by "exporting" your bookkeeping services and "importing" the car repairs you need from a good mechanic. Economists refer to specialization like this as *advantage.*

Absolute Advantage

A country has an **absolute advantage** when it can produce and sell a product at a lower cost than any other country or when it is the only country that can provide a product. The United States, for example, has an absolute advantage in reusable spacecraft and other high-tech items.

Suppose that the United States has an absolute advantage in air traffic control systems for busy airports and that Brazil has an absolute advantage in coffee. The United States does not have the proper climate for growing coffee, and Brazil lacks the technology to develop air traffic control systems. Both countries would gain by exchanging air traffic control systems for coffee.

Comparative Advantage

Even if the United States had an absolute advantage in both coffee and air traffic control systems, it should still specialize and engage in trade. Why? The reason is the **principle of comparative advantage**, which says that each country should specialize in the products that it can produce most readily and cheaply and trade those products for goods that foreign countries can produce most readily and cheaply. This specialization ensures greater product availability and lower prices.

For example, India and Vietnam have a comparative advantage in producing clothing because of lower labor costs. Japan has long held a comparative advantage in consumer electronics because of technological expertise. The United States has an advantage in computer software, airplanes, some agricultural products, heavy machinery, and jet engines.

Thus, comparative advantage acts as a stimulus to trade. When nations allow their citizens to trade whatever goods and services they choose without government regulation, free trade exists. **Free trade** is the policy of permitting the people and businesses of a country to buy and sell where they please without restrictions. The opposite of free trade is **protectionism**, in which a nation protects its home industries from outside competition by establishing artificial barriers such as tariffs and quotas. In the next section, we'll look at the various barriers, some natural and some created by governments, that restrict free trade.

The Fear of Trade and Globalization

The continued protests during meetings of the World Trade Organization and the protests during the convocations of the World Bank and the International Monetary Fund (the three organizations are discussed later in the chapter) show that many people fear world trade and globalization. What do they fear? The negatives of global trade are as follows:

- Millions of Americans have lost jobs due to imports or production shifting abroad. Most find new jobs, but often those jobs pay less.
- Millions of others fear losing their jobs, especially at those companies operating under competitive pressure.
- Employers often threaten to export jobs if workers do not accept pay cuts.
- Service and white-collar jobs are increasingly vulnerable to operations moving offshore.

Sending domestic jobs to another country is called **outsourcing**, a topic you can explore in more depth. Many U.S. companies, such as Dell, IBM, and AT&T, have set up call service centers in India, the Philippines, and other countries. Now even engineering and research and development jobs are being outsourced. Outsourcing and "American jobs" were a big part of the 2016 presidential election with Carrier's plan to close a plant in Indianapolis and open a new plant in Mexico. While intervention by President Trump did lead to 800 jobs remaining in Indianapolis, Carrier informed the state of Indiana that it will cut 632 workers from its Indianapolis factory. The manufacturing jobs will move to Monterrey, Mexico, where the minimum wage is $3.90 per day.[15]

Exhibit 3.3: Anti-globalization groups oppose America's free-trade stance, arguing that corporate interests are hurting the U.S. economy and usurping the power of the American people. The recent protests at the G20 meetings in Hamburg, Germany, expressed anti-free-trade sentiment, supporting the idea that multinational corporations wield too much power. *Are fears expressed by anti-globalization activists and nationalists justified?*(Credit: fiction of reality/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

So is outsourcing good or bad? If you happen to lose your job, it's obviously bad for you. However, some economists say it leads to cheaper goods and services for U.S. consumers because costs are lower. Also, it should stimulate exports to fast-growing countries. No one knows how many jobs will be lost to outsourcing in coming years. According to estimates, almost 2.4 million U.S. jobs were outsourced in 2015.[16]

Benefits of Globalization

A closer look reveals that globalization has been the engine that creates jobs and wealth. Benefits of global trade include the following:

- Productivity grows more quickly when countries produce goods and services in which they have a comparative advantage. Living standards can increase faster. One problem is that big **G20** countries have added more than 1,200 restrictive export and import measures since 2008.
- Global competition and cheap imports keep prices down, so inflation is less likely to stop economic growth. However, in some cases this is not working because countries manipulate their currency to get a price advantage.
- An open economy spurs innovation with fresh ideas from abroad.
- Through infusion of foreign capital and technology, global trade provides poor countries with the chance to develop economically by spreading prosperity.
- More information is shared between two trading partners that may not have much in common initially, including insight into local cultures and customs, which may help the two nations expand their collective knowledge and learn ways to compete globally.[17]

CONCEPT CHECK

1. Describe the policy of free trade and its relationship to comparative advantage.
2. Why do people fear globalization?
3. What are the benefits of globalization?

2.6: International Economic Communities

What are international economic communities?

Nations that frequently trade with each other may decide to formalize their relationship. The governments meet and work out agreements for a common economic policy. The result is an economic community or, in other cases, a bilateral trade agreement (an agreement between two countries to lower trade barriers). For example, two nations may agree upon a **preferential tariff**, which gives advantages to one nation (or several nations) over others. When members of the British Commonwealth (countries that are former British territories) trade with Great Britain, they pay lower tariffs than do other nations. For example, Canada and Australia are former British territories but still members of the British Commonwealth. You will note that Queen Elizabeth still appears on Canadian currency and the Union Jack is still incorporated into the Australian flag. In other cases, nations may form free-trade associations. In a **free-trade zone**, few duties or rules restrict trade among the partners, but nations outside the zone must pay the tariffs set by the individual members.

North American Free Trade Agreement (NAFTA) and U.S.-Mexico-Canada Agreement (USMCA)

The **North American Free Trade Agreement (NAFTA)** created the world's largest free-trade zone. The agreement was ratified by the U.S. Congress in 1993. It includes Canada, the United States, and Mexico, with a combined population of 450 million and an economy of over $20.8 trillion.[24] In July 2020, NAFTA was transformed into the U.S. Mexico Canada Agreement to update the free trade agreement for 21st century business concerns, practices, and environment (ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement).

Canada, one of the largest U.S. trading partners, entered a free-trade agreement with the United States in 1988. Thus, most of the new long-run opportunities opened for U.S. business under NAFTA are in Mexico, America's third-largest trading partner. Before NAFTA, tariffs on Mexican exports to the United States averaged just 4 percent, and most goods entered the United States duty-free, so NAFTA's primary impact was to open the Mexican market to U.S. companies. When the treaty went into effect, tariffs on about half the items traded across the Rio Grande disappeared. Since NAFTA came into effect, U.S.-Mexican trade has increased from $80 billion to $515 billion annually. The pact removed a web of Mexican licensing requirements, quotas, and tariffs that limited transactions in U.S. goods and services. For instance, the pact allows U.S. and Canadian financial-services companies to own subsidiaries in Mexico for the first time in 50 years.

Exhibit 3.5: The softwood lumber dispute between the United States and Canada that has resulted in the U.S. imposing tariffs on Canadian softwood lumber imports is one of the longest trade disputes between the two nations. The dispute is the result of disagreements about Canadian lumber production and imports between the two nations. The main contention in the softwood lumber dispute is the U.S. claim that the Canadian government is unfairly subsidizing Canadian lumber production by providing access to public land while U.S. producers harvest softwood lumber on their own property. *Why do anti-free-trade groups support these tariffs when the result will be higher prices for softwood lumber?* (Credit: Jesse Wagstaff/ Flickr/ Attribution-NoDerivs 2.0 Generic (CC BY 2.0))

The real test of NAFTA was the delivery of rising prosperity on both sides of the Rio Grande. For Mexicans, NAFTA provided rising wages, better benefits, and an expanding middle class with enough purchasing power to keep buying goods from the United States and Canada. At the Delphi Corp. auto parts plant in Ciudad Juárez, just across the border from El Paso, Texas, the assembly line is a cross section of working-class Mexico. In the years since NAFTA lowered trade and investment barriers, Delphi has significantly expanded its presence in the country. Today it employs 70,000 Mexicans, who every day receive up to 70 million U.S.-made components to assemble into parts. The wages are modest by U.S. standards—an assembly-line worker with two years' experience earns about $2.30 an hour. But that's triple Mexico's minimum wage, and Delphi jobs are among the most coveted in Juárez.

USMCA renegotiated the terms of NAFTA to bring the free trade agreement into the 21st century by incorporating chapters on Digital Trade, Anticorruption, and Good Regulatory Practices, including specific updates to benefit small- and medium-sized businesses. U.S. Ambassador Katherine Tai spoke on the spirit of the renegotiated agreement on the North American continent: "[The USMCA's] most important feature is that it provides us a framework for pursuing a positive economic agenda that lifts up workers and communities across our three countries." (https://ustr.gov/usmca). Major positive impacts for agriculture were negotiated, purportedly set to increase agricultural exports from the U.S. by $2 billion. Labor markets will see boost in pay in factory jobs, with a negotiated minimum pay rate set for auto factories. Digital platforms received additional protection from lawsuits against user-posted content, and efforts were made to enact agreements that may lead to lower pharmaceutical costs for consumers by allowing earlier competitive development of drugs and medications. (pbs.org/newshour/economy/making-sense/these-4-changes-helped-trump-and-democrats-agree-to-the-usmca-trade-deal, accessed December 2021)

Central America Free Trade Agreement

The Central America Free Trade Agreement (CAFTA) passed in 2005. Besides the United States, the agreement includes Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua. The United States is already the principal exporter to these nations, so economists don't think that it will result in a major increase in U.S. exports. It will, however, reduce tariffs on exports to CAFTA countries. Already, some 80 percent of the goods imported into the United States from CAFTA nations are tariff-free. CAFTA countries may benefit from the new permanent trade deal if U.S. multinational firms deepen their investment in the region.

The European Union

In 1993, the member countries of the European Community (EC) ratified the Maastricht Treaty, which proposed to take the EC further toward economic, monetary, and political union. Although the heart of the treaty deals with developing a unified European Market, Maastricht was also intended to increase integration among **European Union (EU)** members.

The EU has helped increase this integration by creating a borderless economy for the 28 European nations, shown on the map in **Exhibit 3.6**.[26]

EU28 Member States:	Candidate Countries:

EU28 Member States:	Candidate Countries:
• Austria • Belgium • Bulgaria • Croatia • Cyprus • Czech Republic • Denmark • Estonia • Finland • France • Germany • Greece • Hungary • Ireland • Italy • Latvia • Lithuania • Luxembourg • Malta • The Netherlands • Poland • Portugal • Romania • Slovakia • Slovenia • Spain • Sweden • United Kingdom	• Albania • Former Yugoslav Republic of Macedonia • Montenegro • Serbia • Turkey

European Union member states have set up common institutions to which they delegate some of their sovereignty so that decisions on specific matters of joint interest can be made democratically at the European level. This pooling of sovereignty is also called **European integration**. In 2016, citizens of the United Kingdom voted to leave the European Union, a plan known as Brexit, which could take several years to occur.[27]

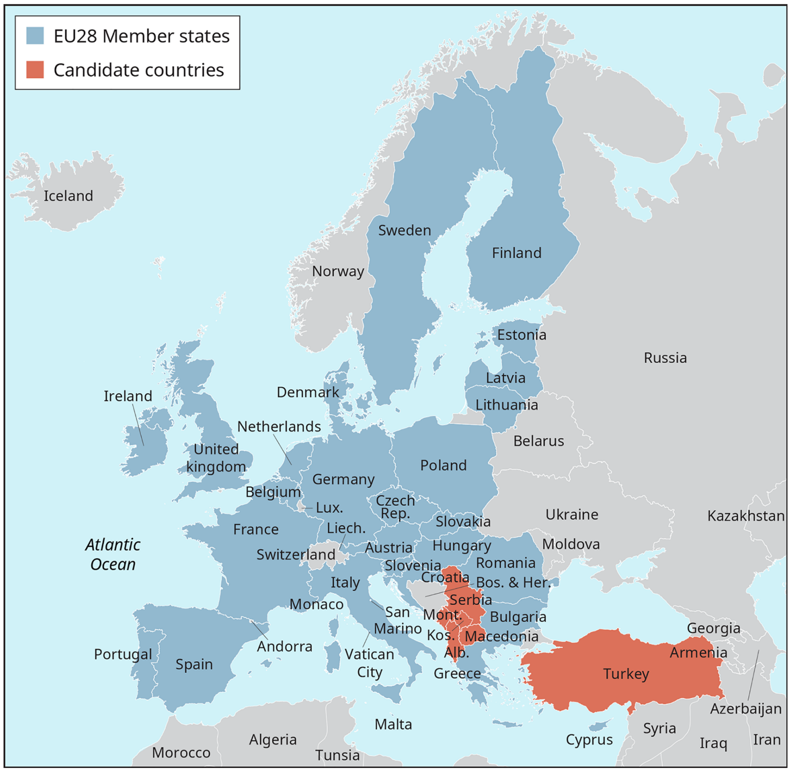


Exhibit 3.6: The European Union Source: Adapted from https://europa.eu/european-union/abo...r-countries_en.

One of the principal objectives of the European Union is to promote economic progress of all member countries. The EU has stimulated economic progress by eliminating trade barriers, differences in tax laws, and differences in product standards, and by establishing a common currency. A new European Community Bank was created, along with a common currency called the euro. The European Union's single market has created 2.5 million new jobs since it was founded and generated more than $1 trillion in new wealth.[28] The opening of national EU markets has brought down the price of national telephone calls by 50 percent since 1998. Under pressure of competition, the prices of airfares in Europe have fallen significantly. The removal of national restrictions has enabled more than 15 million Europeans to go to another EU country to work or spend their retirement.

The EU is a very tough antitrust enforcer; some would say it is tougher than the United States. The EU, for example, fined Google $2.7 billion for favoring some of its own services in its search results.[29]Unlike in the United States, the EU can seal off corporate offices for unspecified periods to prevent destruction of evidence and enter the homes, cars, yachts, and other personal property of executives suspected of abusing their companies' market power or conspiring to fix prices.

Microsoft has been fighting the European Court since 2002, with no quick end in sight. The Court fined Microsoft for monopolizing internet access by offering Internet Explorer with its Windows software. The company is also appealing a Court decision requiring it to share code with "open source" companies. Another big U.S. company, Coca-Cola, settled a six-year antitrust dispute with the European Court by agreeing to strict limits on its sales tactics. Coke can't sign exclusive agreements with retailers that would ban competing soft drinks or give retailers rebates based on sales volume. Furthermore, it must give rivals, like Pepsi, 20 percent of the space in Coke coolers so Pepsi can stock its own brands. If Coke violates the terms of the agreement, it will be fined 10 percent of its worldwide revenue (over $2 billion).[30]

An entirely different type of problem facing global businesses is the possibility of a protectionist movement by the EU against outsiders. For example, European automakers have proposed holding Japanese imports at roughly their current 10 percent market share. The Irish, Danes, and Dutch don't make cars and have unrestricted home markets; they are unhappy at the prospect of limited imports of Toyotas and Hondas. Meanwhile, France has a strict quota on Japanese cars to protect its own Renault and Peugeot. These local automakers could be hurt if the quota is raised at all.

Interestingly, a number of big U.S. companies are already considered more "European" than many European companies. Coke and Kellogg's are considered classic European brand names. Ford and General Motors compete for the largest share of auto sales on the continent. Apple, IBM, and Dell dominate their markets. General Electric, AT&T, and Westinghouse are already strong all over Europe and have invested heavily in new manufacturing facilities there.

The European Union proposed a constitution that would centralize powers at the Union level and decrease the powers of individual member countries. It also would create a single voice in world affairs by creating a post of foreign minister. The constitution also gave the EU control over political asylum, immigration, guaranteed freedom of speech, and collective labor bargaining. In order to become law, each EU country had to ratify the constitution. The two most powerful countries in the EU, France and Germany, voted "no" in the summer of 2005. Citizens of both countries were afraid that the constitution would draw jobs away from Western Europe and to the Eastern European EU countries. These new members of the EU have lower wage rates and fewer regulations. Voters were also worried that the constitution would result in free-market reforms along American or British lines over France and Germany's traditional social protections. Concerns over immigration also sparked the referendum vote that led to the United Kingdom leaving the European Union. The "Brexit" transition process was finalized in December 2020 and the U.K. will go through national processes to update immigration and trade policy over the next decade. In the first year after the end of the transition, import and exports were stalled and mass departure of E.U. citizens led to a labor shortage amplified by the impacts of COVID-19. (euronews.com/2021/06/23/brexit-draft-deal-first-of-many-hurdles-to-a-smooth-exit accessed December 2021)

CONCEPT CHECK

1. Explain the pros and cons of NAFTA.
2. What is the European Union? Will it ever be a United States of Europe?

2.7: Global Trade Forces

What you'll learn to do: identify and describe forces that affect global trade

In this section you'll learn about the range of forces that affect global trade. These forces include everything from culture and politics to the natural environment.

Learning Objectives

- Describe the impact of political and economic forces on global trade
- Describe the impact of physical and environmental forces on global trade
- Describe the impact of tariff and nontariff restrictions on global trade

Sociocultural Differences

Culture refers to the influence of religious, family, educational, and social systems on people, how they live their lives, and the choices they make. Business always exists in an environment shaped by culture. Organizations that intend to sell products and services in different countries must be sensitive to the cultural factors at work in their target markets. Even cultural differences between different countries—or between different regions in the same country—can seem small, but businesses that ignore them risk failure in their ventures.

Culture is complex, and fully appreciating its influence takes significant time, effort, and expertise. Certain features of a culture can create an illusion of similarity, but businesses need to delve deeply to make sure they truly understand the people and environments in which they work. Even a common language does not guarantee similarity of interpretation. For example, in the U.S. we purchase "cans" of various grocery products, but the British purchase "tins." In India, where English is one of a number of officially recognized languages, "matrimonial" is used as a noun in casual conversation, referring to personal ads in newspapers seeking marriage partners.

Several dimensions of culture that require particular attention from global businesses are listed below.

Language

The importance of language differences can't be overemphasized, and there are nearly three thousand languages in the world. Language differences can be a challenge for businesses designing international marketing campaigns, product labels, brand and product names, tag lines, and so on. Finding a single brand name that works universally in terms of pronunciation, meaning, and "ownability" is a monumental challenge. Of course, correct and grammatical use of language in business communication is essential for a product, brand, or company to be viewed as credible, trustworthy, and of high quality.

The language issue becomes more complicated when a country has more than one officially recognized language. To illustrate, in Canada, national law requires that labels include both English and French. In India and China, more than two hundred different dialects are spoken. India has more than twenty officially recognized languages. Mainland China's official spoken language is Standard Chinese, and several autonomous regions have designated other additional official languages. Meanwhile in Hong Kong and Macau, Cantonese Chinese, English, and Portuguese are the official languages. Clearly language can quickly become a very challenging issue for businesses!

Finally, businesses should be attuned to what they communicate when they choose which languages to use—or not use. In Eastern Europe, for example, the long history of Soviet occupation during the Cold War has left many inhabitants with a negative perception of the Russian language. Products that carry Russian labeling may suffer accordingly.

Customs and Taboos

All cultures have their own unique sets of customs and taboos. It's important for businesses to learn about these customs and taboos so they'll know what is acceptable and unacceptable for their foreign operations. For example, in Japan, the number four is considered unlucky, and products packages containing four items are avoided by many consumers. In Middle Eastern countries where Islamic law is strictly observed, images displaying the uncovered arms or legs of the female body are considered offensive. Meanwhile in Egypt, where many women wear the headscarf or hijab in public, an increasing number of younger women are in work and educational settings where gender segregation does not exist. Businesses struggle with whether to portray women with or without the hijab, knowing that they risk offending some of their target audience with either choice. Businesses should seek guidance from native experts familiar with local culture and customers.

Values

The role of values in society is to dictate what is acceptable or unacceptable. Values are part of the societal fabric of a culture, and they can also be expressed individually, arising from the influence of family, education, moral, and religious beliefs. Values are also learned through experiences. As a result, values can influence consumer perceptions and purchasing behavior. For example, consumers in some countries, such as the United States, tend to be individualistic and make many purchasing decisions based on their own personal preferences. In other countries, such as Japan, the well-being of the group is more highly valued, and buying decisions are more influenced by the well-being of the group, such as the family. Based on these differences in values, it is not surprising that ads featuring individuals tend to do better in countries where individualism is an important value, and ads featuring groups do better in countries where the group's well-being is a higher value.

Time and Punctuality

Different cultures have different sensitivities around time and punctuality. In some countries, being slightly late to a meeting is acceptable, whereas in other countries it's very insulting. For cultures that highly value punctuality, being on time is a sign of good planning, organization, and respect. In cultures where precise punctuality is less important, there is often a greater emphasis on relationships. The fact that a meeting happens is more important than when it happens.

While there are cultural stereotypes about time management (such as the laid-back "island time" many residents of island nations refer to), the best rule of thumb in business is to be punctual and meet deadlines as promised. You will not insult people by following this rule. Also, it's wise not to apply popular stereotypes to individual people for whom the cultural stereotype may or may not be true. You should let a person's behavior speak for itself, and always treat others with the same level of courtesy you would expect from them.

Business Norms

Business norms vary from one country to the next and may present challenges to foreigners not used to operating according to the particular norms of the host country. In business meetings in Japan, for example, it's expected that the most senior person representing an organization will lead the discussion, and more junior-level colleagues may not speak at all. The role of alcohol in business meetings varies widely by culture: In Middle Eastern cultures where alcohol is forbidden, it may be insulting to serve or even offer an alcoholic beverage. In China, many rounds of toasts are customary as part of formal dinner meetings.

Likewise, business norms around greetings and physical contact also vary. American-style handshakes have become accepted as a business norm in many cultures, but this custom is not universal. In Japan and some other Asian cultures, a respectful bow is the traditional business greeting, although the handshake is becoming more common. In Islamic cultures, contact between men and women is a sensitive issue, even in business settings. In those regions and cultures, it's best to shake hands with a woman only if she extends her hand first. Similarly, Western women may avoid causing embarrassment by shaking hands only if a hand is extended to her. In India, the namaste (a slight bow with hands brought together on the chest) remains a respectful, if traditional, business greeting particularly when interacting with women and older people.

Always seek guidance from a trusted colleague or friend who has experience in the local customs and can offer coaching on proper etiquette.

Religious Beliefs and Celebrations

As discussed earlier in this module, religious beliefs and practice can strongly influence what consumers buy (or don't buy), when and where they shop, and how they conduct business. It's important for companies to understand the influence of religion on consumer culture in the markets where they operate, so that their business activities can be appropriately sensitive. Failing to respect religious beliefs or cultures can seriously undermine the reputation of a company or brand. At the same time, businesses that are attuned to the impact of religion on culture can more easily integrate their operations and employees into the local culture.

For example, all the major world religions observe holidays that include feasting and gift giving. These festival seasons tend to be prime shopping seasons as well. Holidays originating from the prominent religion of a country or region create sensitivities about certain products: in the Hindu religion, cows are considered sacred and people refrain from eating beef. Observant Jews and Muslims consider pork unclean, and they consume only kosher or halal meats, respectively. Many religions eschew alcohol: for example, devout Sikhs, Muslims, Mormons, Buddhists, and conservative Southern Baptists all refrain from drinking.

Religious beliefs may cause sensitivities around revealing images or sexually suggestive material. Religious beliefs associated with the symbolism of different colors may create either preferences for or rejection of certain products. The link between religious practice and gender roles may affect which members of the family influence which types of buying decisions. It is important, however, for businesses not to oversimplify how decision making happens in these settings. Even if a woman, for example, is not the primary buyer, she may exercise strong influence of many consumer decisions. Here, as in other areas of cultural impact, is it crucial for businesses to educate themselves about the people and cultures they are targeting for business in order to use cultural knowledge to their advantage.

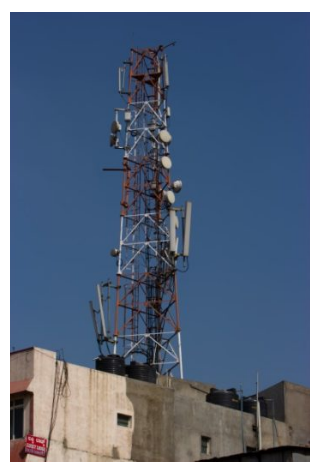
Political and Economic Differences

The **political economy** of a country refers to its political and economic systems, together. The political system includes the set of formal and informal legal institutions and structures that comprise the government or state and its sovereignty over a territory or people. As you know, political systems can differ in the way they view the role of government and the rights of citizens (compare, for example, the democratic political system of Canada with the communist system of North Korea). As you'll recall, the economic system refers to the way in which a country organizes its economy: most are command, market, or mixed economies.

The nature of a country's political economy plays a big role in whether it is attractive to foreign business and entrepreneurship. Historically, there has been a direct relationship between the degree of economic freedom in a country and its economic growth—the more freedom, the more growth, and vice versa. For decades, the Chinese government maintained an ironclad grip on all business enterprise, which effectively prevented foreign businesses from fully engaging with the Chinese market. That climate has tempered, however, and now the political economy of China is much more open to foreign investment, though it is still not as open as Europe or the U.S.

Businesses seeking global opportunities must consider other economic factors beyond a country's political economy. For one thing, they will want to target the markets and countries where people have the highest incomes and the most disposable income. The world map below shows just how much variation there is in the gross national income (GNI) per person among the nations of the world.

However, often those markets are not where *new* opportunity exists, so businesses have to pursue what economists refer to as "emerging markets." The four largest emerging and developing economies are the BRIC countries (Brazil, Russia, India, and China). One means of measuring a country's level of economic development is by its purchasing power parity (PPP), which enables economists to compare countries with very different standards of living. The PPP for a given country is determined by adjusting up or down as compared to the cost of living in the United States.



India has the world's second-largest mobile-phone user base: 996.66 million users as of September 2015. Shown here is a rooftop mobile phone tower in Bangalore.

However, there is often more to a country's economic story than its PPP or GNI. Consider India: As an emerging market, India is attracting significant attention from businesses all around the globe. It has the second-fastest-growing automotive industry in the world. According to a 2011 report, India's GDP at purchasing power parity could overtake that of the United States by 2045. During the next four decades, Indian GDP is expected to grow at an annualized average of 8 percent, making it potentially the world's fastest-growing major economy until 2050. The report highlights key growth factors: a young and rapidly growing working-age population; growth in the manufacturing sector because of rising education and engineering skill levels; and sustained growth of the consumer market driven by a rapidly growing middle class.

At the same time, surveys continue to emphasize the chasm between two contrasting pictures of India—on one side, an urban India, which boasts of large-scale space and nuclear programs, billionaires, and information technology expertise, and a rural India on the other, in which 92 million households (51 percent) earn their living by manual labor. In 2014, a report by the Indian Government Planning Commission estimated that 363 million Indians, or 29.5 percent of the total population, were living below the poverty line.

Another aspect of a country's political economy is the stability of its current government. Business activity tends to grow and thrive when a country is politically stable. When a country is politically unstable, multinational firms can still conduct business profitably, but there are higher risks and often higher costs associated with business operations. Political instability makes a country less attractive from a business investment perspective, so foreign and domestic companies doing business there must often pay higher insurance rates, higher interest rates on business loans, and higher costs to protect the security of their employees and operations. Alternatively, in countries with stable political environments, the market and consumer behavior are more predictable, and organizations can rely on governments to enforce the rule of law.

As you can see, the desirability of a country as a potential market or investment site depends on a host of complex, interrelated factors. To further complicate matters, once a business arrives in a foreign market, it must also contend with the uncertainty of exchange rates. An **exchange rate** is the value of one country's currency relative to the value of another country's currency. For example, an exchange rate of 119 Japanese yen (JPY, ¥) to the United States dollar (US$) means that ¥119 will be exchanged for each US$1, or US$1 will be exchanged for ¥119.

Each country, using various mechanisms, manages the value of its currency. A market-based exchange rate will change whenever the value of either of the two component currencies change. A currency will tend to become more valuable whenever demand for it is greater than the available supply. It will become less valuable whenever demand is less than the available supply (this does not mean that people no longer want money, only that they prefer to hang on to their wealth in some other form, possibly another currency).

The video below will provide a complete picture of exchange rates and how they impact trade:

Clearly, exchanges rates are an important consideration for companies wanting to take their business global, since they will likely have to buy and sell even the most mundane commodities once they arrive in the foreign market. Local labor wants to be paid in its nation's currency, and if the exchange rate of that currency changes in a way that makes it more valuable, then the business's costs rise unexpectedly. Although businesses try to anticipate and plan for fluctuations in exchange rates, currency values are determined by supply and demand, and businesses are at the mercy of market forces beyond their control.

Legal Differences

Governments around the world maintain laws that regulate business practices. In some countries, these laws are more heavy-handed, and in others, the business climate is less regulated and structured. Some laws and regulations, such ones governing property rights and contracts, are designed to create a stable environment for business (both domestic and international)—by establishing the establishment and enforcement of property rights and contracts, for example. Others are designed to protect consumers and the environment, requiring businesses to adhere to responsible, safe, and ethical practices. Still other laws and regulations privilege domestic businesses and protect or partially shield them from foreign competition. There are even laws and regulations that affect what marketers are allowed to include in marketing communications, although these are more strict in some countries than in others. And of course, some laws and regulations deal with taxation and other costs of conducting business.

Businesses must understand and conform to the legal and regulatory environments of the countries and regions in which they operate. The following is a short list of common regulatory areas that affect businesses globally:

- **Contract law** governing agreements about the supply and delivery of goods and services
- **Trademark** registration and enforcement for brand names, logos, tag lines, and so forth
- **Labeling** requirements for consumer safety, protection, and transparency
- **Patents** to enforce intellectual property rights and business rights associated with unique inventions and "ownable" business ideas
- **Decency, censorship, and freedom-of-expression** laws to which marketing communications are subject
- **Price floors, ceilings, and other regulations** regarding the prices organizations can charge for certain types of goods and services
- **Product safety**, testing, and quality-control
- **Environmental protection** and conservation regulations and permits governing acceptable and responsible business practices
- **Privacy**, including laws governing data collection, storage, use, and permissions associated with consumers and their digital identities
- **Financial reporting** and disclosure to ensure that organizations provide transparency around sound business and financial practices

In some cases, international laws and regulations designed to simplify these issues among regional allies and economic partners may also apply.

Physical and Environmental Differences

Physical and environmental factors can have a significant impact on a company's ability to do business in a foreign country. Some developing countries lack the infrastructure such as roads, railways, and port systems needed to transport goods, or they may not have adequate storage facilities. You can imagine that this would be a major barrier for businesses trying to sell fresh food or perishable goods. Add to that the limited access to electricity, clean water, and sanitation in many parts of the world, and you begin to understand some of the practical and logistical challenges of doing business globally.

A country's natural environment and the surrounding regulations aimed at protecting it may pose additional challenges. Many governments require foreign companies to undergo a complex permitting process if any of their planned activities will adversely affect the environment. Even in developing countries, minimum standards for air emissions, waste disposal, and hazardous-material handling are becoming the norm, and in places where such regulations are weak or lacking, companies often face considerable pressure from local residents and consumer groups to clean up their act or leave. While all of these challenges can make companies think twice about setting up shop in a foreign country, the growing trend of corporate social responsibility shows that more companies are devising creative, collaborative solutions to doing global business more sustainably.

Tariff and Nontariff Trade Restrictions

Although many people find it hard to imagine, not every nation welcomes the expansion of businesses into their country. When a nation seeks to restrict the flow of incoming foreign goods and services, economists refer to this as trade protectionism. Protectionism is the economic policy of restraining trade between countries through methods such as tariffs on imported goods, restrictive quotas, and a variety of other government regulations designed to foster fair competition between imports and domestically produced goods and services.

According to proponents, protectionist policies protect the businesses and workers within a country by restricting or regulating trade with foreign nations. The doctrine of protectionism contrasts with the doctrine of free trade, according to which governments reduce the barriers to trade as much as possible. There is a broad consensus among economists that the impact of protectionism on economic growth and prosperity is largely negative.

Let's take a closer look at several of the most common tools used by nations hoping to protect local industry through trade restrictions.

Import Tariffs

Import tariffs are are simply a type of tax that is levied on goods and services coming into a country. They increase the price of imported goods and services, since the businesses pass the cost of the tariff on to consumers. Tariffs benefit local producers of goods and services while generating revenue for the government. They are one of the oldest form of trade protectionism, one of the easiest to implement, and the most common subject in trade-agreement negotiations.

Nontariff Restrictions

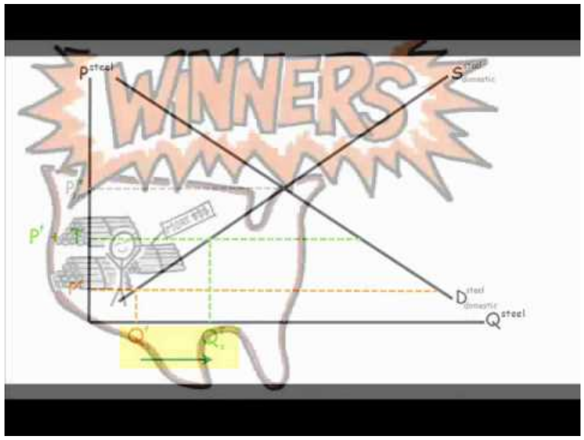
Import quotas are another means of restricting the flow of foreign goods into a local economy. An import quota is exactly what its name implies: a limit on the amount or quantity of a particular good or service that can be imported into a country. Although not as common today as they have been historically, import quotas seek to protect local businesses from a flood of cheap foreign imports. Many countries have passed "antidumping" laws aimed at foreign imports that they believe are priced below fair market value. Dumping is when a company exports a product at a price lower than the price it normally charges in its own home market. The economic impact of an import quota is similar to that of a tariff, except that the tax revenue generated by a tariff is instead paid to those who possess import licenses.

When a country is reluctant to impose quotas and tariffs, another way it can protect domestic markets is with local content requirements. **Local content requirements** are set by the government and require foreign businesses to use a certain quantity of local labor, resources, and/or suppliers in their operations. This kind of trade restriction has been a point of contention in recent trade negotiations between the United States and India. India's government has been aggressive about using local content requirements to its "Made in India" program, which it hopes will establish India as an international manufacturing hub. The United States and other countries argue that India's policies are detrimental to foreign competition. The situation is currently under review by the World Trade Organization, and given the size of the Indian economy, the rest of the world is watching.

The most extreme form of trade restriction is the **embargo**. An embargo is an official ban on trade or other commercial activity with a particular country. The reasons for a country to place an embargo on another country range from human rights violations to ideological differences to national security interests. Embargoes are considered strong diplomatic measures imposed in an effort, by the imposing country, to elicit a given national-interest result from the country on which it is imposed. Although trade and commercial activities are barred under an embargo, medical and humanitarian supplies are usually exempt. The most enduring of all trade embargoes is the United States' embargo against Cuba, which, after fifty-five years, appears to be coming to an end.

As you can see, global trade restrictions can be as narrow as a tariff on a particular imported good or as broad as an embargo, which stops the flow of goods and services between countries altogether. Since these types of restrictions are imposed by governments, businesses have no choice but to follow their rules—even when it means walking away from a lucrative opportunity.

The following video discusses the effects of different kinds of trade restrictions.


WINNERS

2.8: Global Trade Agreements and Organizations

What you'll learn to do: describe global trade agreements and economic organizations that regulate and promote global trade

In this section, you'll learn about the organizations that oversee global economic cooperation and help facilitate global trade agreements.

Learning Objectives

- Describe the role of the World Bank in promoting global economic development
- Describe the role of trade agreements in global business

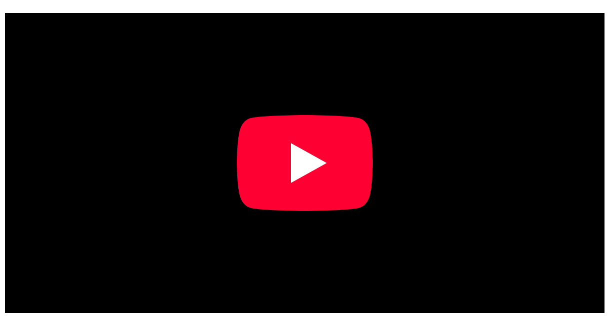
The World Trade Organization (WTO)

In the post–World War II environment, countries came to realize that a major component of achieving any degree of global peace was global cooperation—politically, economically, and socially. The intent was to level the trade playing field and reduce economic areas of disagreement, since inequality in these areas could lead to more serious conflicts. Nations agreed to work together to promote free trade and, with the help of key international organizations like the World Trade Organizations, they entered into bilateral and multilateral agreements.

GATT: How the World Trade Organization Got Its Start

Before you begin your reading on the World Trade Organization (WTO), take a few minutes to watch the following video that will give you some background on **General Agreement on Tariffs and Trade (GATT)** and explain how it grew into the WTO we know today. Remember, the world is much smaller today than when your parents and grandparents were growing up, and international trade hasn't always been the norm. After watching the video, consider how impossible world trade would be without some type of agreement among nations.

Enjoy!



As you saw in the video, what began with one agreement (GATT) eventually evolved into the WTO. In fact, GATT was the only multilateral instrument governing global trade from 1946 until 1995. Given the difficulty of trying to regulate trade among more than one hundred nations according to a single document, it's easy to see why the WTO came into existence. It became clear to the participating nations that GATT was incapable of adapting to an increasingly globalized world economy. Moreover, when the Uruguay Round of GATT negotiations was launched in September 1986, it marked the largest global effort to structure trade in history. Today, GATT still exists as the WTO's umbrella treaty for trade in goods, but it's no longer the only legally binding global-trade agreement.

What does the WTO actually do? Among its various functions, the most important are the following:

- Oversees the implementation and administration of the agreements between nations that fall under the WTO's scope of authority
- Provides a forum for negotiations and settling disputes among nations.

In recent years, the WTO has also made it a priority to assist developing nations as they come under WTO regulation. Many developing countries and emerging markets lack the experience and technical expertise needed to deal with large and very comprehensive trade agreements. The WTO provides them with critical training and support, thereby ensuring that the WTO is inclusive and equitable toward both the wealthiest and the poorest nations in the world.

Part of the nondiscrimination mandate of the WTO is most-favored-nation (MFN) status. Most-favored-nation status requires that a WTO member must apply the same terms and conditions to trade with any and all other WTO members. In other words if a country grants another country (even a non-WTO member) a special favor, then every other WTO member must get the same treatment. You probably experienced a version of most-favored-nation status as a child, when an adult told you that if you were going to take gum or candy to class, you had to bring enough for everyone. In other words you couldn't just give gum or candy to your best friends, and if you didn't have enough for everyone in the class, then nobody got any. That, in effect, is how most-favored-nation status works.

One of the other key elements to the success of the WTO is its transparency requirement. WTO members are required to publish their trade regulations and follow a system that allows external parties to review and evaluate any administrative decisions and their impact on trade regulations. When a WTO nation changes its trade policies, those changes must be reported to the WTO.

Overall, the WTO's mission is to improve the stability and predictability of global trade. As a result, it tends to support free-trade, as opposed to protectionist, policies, and strongly discourages the use of quotas and other such restrictions on imports.

Whether or not the WTO is doing its duty and accomplishing its mission is a matter of ongoing debate. Nonetheless, the WTO currently has 104 members and twenty observer governments. WTO member states account for almost 97 percent of global trade and 98 percent of global GDP. Once the twenty observer governments become members, it is possible that the WTO will oversee the entire world economy. What began in 1947 in Geneva, with twenty-three nations focused solely on tariff reduction, has grown into a truly global organization that deals with agriculture, labor standards, environmental issues, competition, and intellectual property rights.

The World Bank

World Bank Group president Jim Yong Kim visits an integrated child development services and skills center in Delhi, India.

Created in 1944 at the Bretton Woods Conference in New Hampshire, the **World Bank** is an international financial institution that provides loans for capital programs to developing countries. It comprises two institutions: the International Bank for Reconstruction and Development (IBRD), and the International Development Association (IDA). Originally, the IBRD was tasked with supporting post-war reconstruction, but it has evolved to include the present-day mandate to alleviate poverty worldwide. The World Bank is a component of the World Bank Group, which is part of the United Nations system. The World Bank is comprised of 189 member countries represented by a board of governors. Although headquartered in Washington DC, the World Bank has a presence in almost every nation in the world.

The World Bank has set two goals to achieve by 2030:

1. End extreme poverty by decreasing the percentage of the world's population that live on less than US$1.90 per day to no more than 3 percent
2. Promote shared prosperity by fostering the income growth of the bottom 40 percent in every country

The World Bank's primary function is providing low-interest loans and grants to developing countries. It tends to fund projects focused on education, infrastructure, natural-resource management, and public health. In many instances, the World Bank provides technical assistance as well as research and policy advice to developing nations. One of the projects currently underway is the Education Sector Support Project for the Republic of the Congo. The primary objective of this project is to improve education outcomes for primary- and secondary-school children by providing quality education in an appropriate teaching and learning environment. Other World Bank projects are aimed at improving basic infrastructure, such as building and maintaining safe water supplies and sanitary sewer systems in Africa and parts of Asia. For developing nations, many of these improvements would be impossible without the World Bank's help. Although the World Bank has come under fire in the past for budget overruns and poor project oversight, its role in promoting economic development has been undeniable.

The following video shows how a World Bank project works:

The International Monetary Fund (IMF)

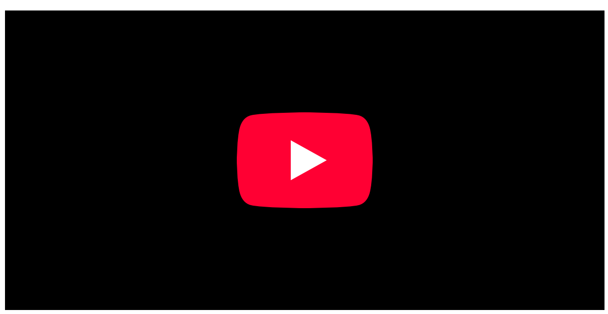
The **International Monetary Fund (IMF)** is an international organization headquartered in Washington, D.C., comprised of 189 member countries. The IMF works to foster global growth and economic stability by providing policy, advice, and financing to its members. It also works with developing nations to help them reduce poverty and achieve macroeconomic stability. Formed in 1944 at the Bretton Woods Conference in New Hampshire, it came into formal existence in 1945 with twenty-nine member countries and the goal of reconstructing the international payment system. It now plays a central role in the management of balance-of-payments difficulties and international financial crises.

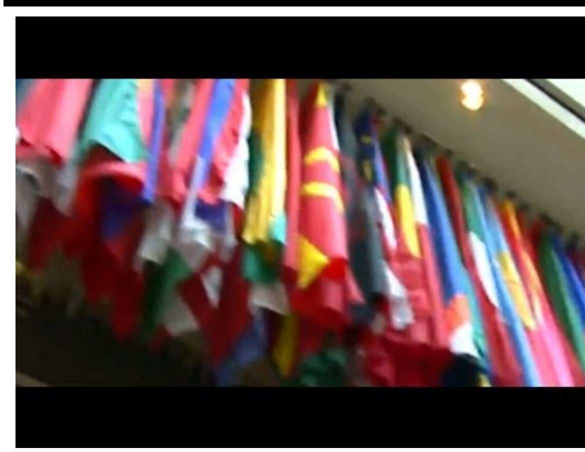
IMF member countries contribute funds to a pool, from which they can borrow if they are experiencing balance-of-payments problems. The rationale for this arrangement is that private international capital markets function imperfectly, and many countries have limited access to financial markets. Without access to IMF financing, many countries can only correct large external payment imbalances through drastic measures that can have adverse effects on their own economies and the world's. The IMF provides alternate sources of financing to countries in need that would not otherwise be available to them.

When the IMF was founded, its primary functions were to provide short-term capital to aid the balance of payments and to oversee fixed-exchange-rate arrangements between countries, thus helping national governments manage their exchange rates and prioritize economic growth. This assistance was meant to prevent the spread of international economic crises. The IMF was also formed to help put the pieces of the international economy back together after the Great Depression and World War II. In addition, it also sought to provide capital investments for economic growth and infrastructure projects.

The IMF's role was fundamentally altered by floating exchange rates post-1971. At that point the organization began examining the economic policies of its loan recipients to determine whether a shortage of capital was due to economic fluctuations or economic policy. The IMF also researched what types of government policy would ensure economic recovery. The current challenge is to help countries implement economic policies that reduce the frequency of crises among the emerging-market countries, especially the middle-income countries that are vulnerable to massive capital outflows. In order to meet this challenge, the IMF's activities have expanded beyond the oversight of exchange rates to surveillance of the overall macroeconomic performance of its member countries. Today it plays an active role in shaping and managing economic policy around the world.

The following video gives a good overview of the IMF and its role in promoting global trade.





Trade Agreements

So far you have seen how international organizations such as the WTO, IMF, and World Bank support global trade, but this is only part of the story. Where global trade really gets a boost is from trade agreements (also called trade blocs). This where the term "global economic integration" gets its legs— from the process of modifying barriers among and between nations to create a more fully integrated global economy. Trade agreements vary in the amount of free trade they allow among members and with nonmembers; each has a unique level of economic integration. We will look at four: regional trade agreement (RTA) (also called a "free trade area"), customs unions, common markets, and economic unions.

Regional trade agreements are reciprocal trade agreements between two or more partners (nations). Almost all countries are part of at least one RTA. Under an RTA, countries "huddle together," forming an international community that facilitates the movement of goods and services between them. For example, the North American Free Trade Agreement (NAFTA) enacted between Canada, the U.S., and Mexico facilitates trade among these countries through tariff reductions and elimination. The Association of Southeast Asian Nations (ASEAN), shown below, provides for the free exchange of trade, service, labor, and capital across ten independent member nations to provide a balance of power to China and Japan. The Central American Free Trade Agreement (CAFTA) (Costa Rica, Dominican Republic, Guatemala, Honduras, Nicaragua, and El Salvador) eliminated tariffs on more than 80 percent of U.S. exports and opened U.S. trade restrictions for Central American sugar, textiles, and apparel imports, thereby reducing costs on these products for American consumers[1].

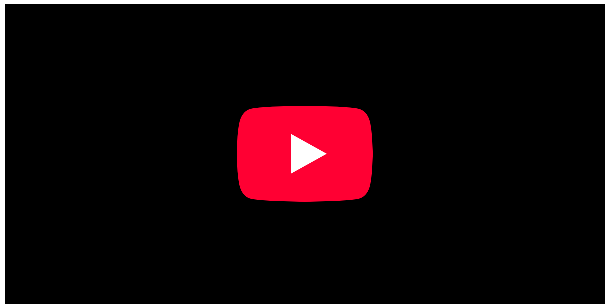
The Association of Southeast Asian Nations (ASEAN) as of 2015.

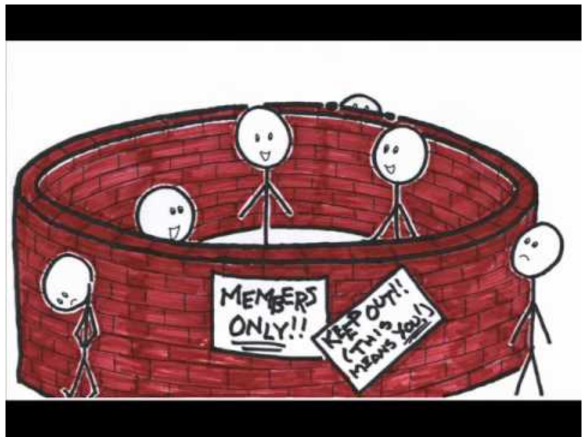
Customs unions are arrangements among countries whereby the parties agree to allow free trade on products *within* the customs union, and they agree to a *common external tariff* (CET) on imports from the rest of the world. It is this CET that distinguishes a customs union from a regional trade agreement. It is important to note that although *trade* is unrestricted within the union, customs unions do not allow free movement of capital and labor among member countries. An example is the customs union of Russia, Belarus, and Kazakhstan, which was formed in 2010. These countries eliminated trade barriers among themselves but have also agreed to some common policies for dealing with nonmember countries.

Common markets are similar to customs unions in that they eliminate internal barriers between members and adopt common external barriers against nonmembers. This difference is that common markets also allow free movement of resources (e.g., labor) among member countries. An example of a common market is the Economic Community of West African States (ECOWAS), comprised of Benin, Burkina Faso, Cape Verde, Gambia, Ghana, Guinea, guinea-Bissau, Ivory Coast, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, and Togo.

An even more economically integrated arrangement is the **economic union**. Economic unions eliminate internal barriers, adopt common external barriers, permit free movement of resources (e.g., labor), AND adopt a common set of economic policies. The best-known example of an economic union is the European Union (EU). EU members all use the same currency, follow one monetary policy, and trade with one another without paying tariffs.

The following video further explains and compares the different types of trade agreements:





1. USTR, CAFTA-DR Dominican Republic-Central America FTA ↵

2.9: Corruption in International Business

Source: Stockmonkeys.com, (CC-BY 2.0, 2012) Figure 10.1 A common practice worldwide is for government favors to be sought in exchange for surreptitious payments in cash. Corruption is not merely a problem in developing countries. In recent years, American, German and Italian companies have been implicated in corruption scandals, both domestic and international.

The Problem of Corruption

When a large corporation decides to enter a foreign market, it must usually secure a number of licenses, permits, registrations, or other government approvals. Certain types of business may be even be impossible or illegal unless the corporation is first able to obtain a change or adjustment to the nation's laws or regulations. Since the power to authorize the foreign corporation's activities is vested in the hands of local politicians and officials, and since corporations have access to large financial resources, it should not be surprising that some corporate executives resort to financial incentives to influence foreign officials. While certain financial incentives, such as promises to invest in local infrastructure, may be legitimate, any form of direct payment to the foreign official that is intended to influence that official's public decisions will cross the line into illegal *subornation*, also commonly referred to as *bribery*.

Bribery is one of the archetypal examples of a corporation engaged in unethical behavior. A number of problems can be attributed to business bribery. First, it is obviously illegal—all countries have laws that prohibit the bribery of government officials—so the foreign company engaging in bribery exposes its directors, executives, and employees to grave legal risks. Second, the rules and regulations that are circumvented by bribery often have a legitimate public purpose, so the corporation may be subverting local social interests and/or harming local competitors. Third, the giving of bribes may foment a culture of corruption in the foreign country, which can prove difficult to eradicate. Fourth, in light of laws such as the US Foreign Corrupt Practices Act (FCPA) and the Organization of Economic Cooperation and Development (OECD) Convention on Anti-Bribery (discussed in greater detail below), bribery is illegal not only in the target country, but also in the corporation's home country. Fifth, a corporation that is formally accused or convicted of illicit behavior may suffer a serious public relations backlash.

Despite these considerable disincentives, experts report that worldwide business corruption shows little signs of abating. Transparency International (TI), a leading anticorruption organization based in Berlin, estimates that one in four people worldwide paid a bribe in 2009. It appears that the total number of bribes continues to increase annually. The World Economic Forum calculated the cost of corruption in 2011 at more than five percent of global GDP (US$2.6 trillion) with over $1 trillion paid in bribes each year.[1]

Governments and intergovernmental organizations have redoubled their efforts to combat the perceived increase in international business corruption. Globalization, which accelerated in the final decades of the twentieth century, is often cited by specialists as contributing to the spread of corruption. Corporations and businesses in every nation have become increasingly dependent on global networks of suppliers, partners, customers, and governments. The increased interaction between parties in different countries has multiplied the opportunities for parties to seek advantage from illicit incentives and payoffs. Although outright bribery is clearly unethical and illegal, there is great deal of behavior that falls into a gray zone that can be difficult to analyze according to a single global standard. When does a business gift become a bribe? What level of business entertainment is "right" or "wrong"? Over the past two decades, governments and regulators have sought to clearly define the types of behavior that are considered unethical and illegal.

Another factor that has heightened the sense of urgency among regulators is the magnitude of recent cases of corruption (several of which are described in greater detail below). The cost to shareholders as well as stakeholders and society has proven enormous. Governments and international organizations have ramped up their enforcement of anticorruption laws and sought increasingly severe penalties, sometimes imposing fines amounting to hundreds of millions of dollars. Largely as a result of these efforts, most multinational corporations have developed internal policies to ensure compliance with anticorruption legislation. However, as we will see in the case study featured in this chapter, such compliance also raises complex ethical dilemmas for corporations. It remains difficult to regulate ethical behavior when social and cultural norms vary significantly from country to country. Acts that are considered unethical in one country may represent a traditional way of doing business in another. One legal scholar explains the difference as follows:

> A common misconception, held in both Western and developing countries, and even among many researchers on corruption, is to confuse what is corrupt with what is legal. Laws are defined by values, as are ethical norms, but the two are not equivalent.[2]

In this chapter, we will explore the impact, reasonableness, and the effectiveness of anticorruption laws and corporate compliance rules. Finally, we will discuss a case in which the line between corruption and traditional business practices remains difficult to ascertain.

The Scope of the Problem

Recent cases of corruption in international business have attracted considerable media attention. Paying a traffic officer to ignore a minor traffic violation is unremarkable; paying a senior government official a secret bribe of millions of dollars to get a large contract signed is a different matter.

While virtually all multinational companies have adopted anticorruption policies, it is not clear how often these policies are fully implemented and internalized as part of the corporate culture. The emphasis on anticorruption policies is relatively recent and, even in the most responsible organizations, such policies are still works in progress. However, there is some evidence that the implementation is not always as effective as might be hoped.

For example, a study by Control Risks and the *Economist* magazine's Intelligence Unit showed that while most companies acknowledge the need to combat bribery and corruption, many are complacent and unprepared to deal with scandals inside their own organizations.[3] The review of global attitudes on corruption surveyed more than 300 senior lawyers and compliance heads in April 2013. It painted a disturbing picture. The authors concluded that "too many companies still fall short of best practices in their anticorruption compliance programs." Despite ranking anticorruption high on most corporate agendas, the report noted a "danger of complacency" among companies, and as a result, "the risk of a company finding itself in the middle of a corruption-based investigation remains real."[4]

Transparency International's Corruption Perceptions Index (CPI) ranks countries and territories according to their perceived levels of public sector corruption. It is an aggregate indicator that combines different sources of information about corruption, making it possible to compare countries. Perceptions are used because corruption is generally a hidden activity that is difficult to measure. The CPI confirms that corruption remains a problem worldwide and takes place even in the wealthiest countries.[5] Research in 2012 by the Austrian economist Friedrich Schneider placed the annual loss to the German economy alone at €250 billion.[6]

The Dow Jones State of Anti-Corruption Survey in 2011, which surveyed more than 300 companies worldwide, found that more than 55 percent of companies have found cause to reconsider working with certain global business partners due to concerns about possible violation of anticorruption regulations. Additionally, the biannual survey indicated than more than 40 percent of companies believe they have lost business to competitors who won contracts unethically, an increase from only 10 percent in the 2009 study. "Strict liability provisions in legislation like the UK Bribery Act make businesses responsible for the activities of their agents and partners overseas, and this is having a direct impact on the occurrence of new business partnerships between firms," said Rupert de Ruig, managing director of Risk and Compliance, Dow Jones.[7]

Global social costs from corruption include the reluctance of investors to commit to projects in developing economies, inhibited growth of businesses due to syphoning off of revenues for bribes, and diversion of funds from food, medical, and educational aid programs. In addition, it seems likely that corruption hampers the development of executive talent in developing nations, given that frustrated local executives may seek to emigrate to countries where corruption is less prevalent. Consider for example, the long term impact of the necessity of paying a bribe to get running water in a household in rural India.[8] This type of corruption can effectively exclude the poor from access to vital public services. Economist Daniel Kaufmann of the Harvard Institute of International Development cites public sector corruption as the most severe obstacle to development in developing and post-communist countries.[9]

Notable Examples of Corruption

The number and magnitude of recent corruption cases prosecuted by government authorities is disconcerting. Moreover, these widely-publicized cases may represent only the tip of the iceberg: Regulatory bodies focus principally on the bribery of public officials so that other forms of business corruption are under-reported. To date, the ten largest cases successfully tried pursuant to the FCPA are listed below (in order of magnitude of fines):

1. Siemens (Germany): $800 million in 2008
2. KBR/Halliburton (USA): $579 million in 2009
3. BAE (UK): $400 million in 2010
4. Total SA (France): $398 million in 2013
5. Snamprogetti Netherlands BV/ENI SpA (Holland/Italy): $365 million in 2010
6. Technip SA (France): $338 million in 2010
7. JGC Corporation (Japan) $218.8 million in 2011
8. Daimler AG (Germany): $185 million in 2010

9. Alcatel-Lucent (France): $137 million in 2010
10. Magyar Telekom/Deutsche Telekom (Hungary/Germany): $95 million in 2011

There are other recent examples of large-scale corruption in international business.

Walmart in Mexico

According to a report issued by the Mexican Employers Association in 2011, companies operating in Mexico spend more than 10 percent of their revenue on corrupt acts. One of the most well-known cases was the Walmart scandal that was brought to light in September 2005 and resulted in the company's stock value dropping by as much as $4.5 billion. Evidence unearthed by internal and external investigations revealed a widespread use of bribes, alleged to total over $24 million. The bribes were paid to facilitate the construction of Walmart stores throughout Mexico. The country is a huge market for Walmart—one in every five Walmart stores is in Mexico. As of October 2014, the investigation continued, having implicated Walmart management at the most senior levels of complicity or awareness.

GlaxoSmithKline in China

In September 2013, China's Xinhua news agency reported that a police investigation into bribes paid by drug manufacturer GlaxoSmithKline (GSK) indicated that the bribes were organized and paid by GSK China and not by individuals operating on their own prerogative as had been reported by the company initially. Police also alleged that the corporate parent merely went through the motions of an internal audit process, indicating a knowledge and acceptance of the bribery. This very recent case suggests that the Chinese government's widely publicized arrests and convictions for bribery have not yet served as a sufficient deterrent to corrupt practices by foreign corporations.

Alcatel in Costa Rica

In January 2010 Alcatel agreed to pay Costa Rica US $10 million in reparations for social damage caused by Alcatel's payment of US$2.5 million in bribes to get a contract to provide mobile phone services in that country. This case is notable for its application of the concept of *social damage* and the resulting order of compensation to the citizens of Costa Rica.

Anticorruption Laws and Regulations

The first major international anticorruption law was the United States' Foreign Corrupt Practices Act (FCPA), adopted in 1977.[11] The FCPA criminalized bribery of foreign public officials by American business enterprises. Initially, the FCPA was not well received. Few other countries followed suit and US companies complained that the FCPA shut them out of the competition for billions of dollars' worth of overseas business contracts. Slowly, however, the push for concerted anticorruption measures gathered momentum, and intergovernmental institutions such as the OECD, the African Union, and the United Nations eventually adopted anticorruption conventions. Further support for a global anticorruption agenda was provided by the lending institutions such as the World Bank, by NGOs such as Transparency International, and by the rapidly evolving CSR movement. Notable among these efforts was the Communist Party of China's promulgation of a code of ethics to fight the widespread corruption within the Communist Party of China.[12]

The FCPA applies only to bribes paid (or offered) to foreign government officials to obtain or retain business or to develop an unfair competitive advantage. The concepts of *bribe* and *foreign government official* can be interpreted broadly. While companies and executives charged with FCPA violations have often sought to characterize their payments as business "gifts," this has not shielded them from liability when there was evidence that the payments were intended as a means of obtaining illicit objectives. However, where payments have been characterized as "facilitation" or "lubrication" payments, meaning that they merely created an incentive for an official to promptly execute legal actions, such as mandatory customs inspections, the payments have been allowed. In numerous countries, the state owns all or part of commercial enterprises so that a great number of business executives could be classified as foreign government officials.

In 1997, the OECD established legally binding standards for defining bribery in international business transactions. Similar to the FCPA, the OECD Anti-Bribery Convention focuses on the bribery of public officials. Like the FCPA, the OECD also potentially creates the opportunity for companies to circumvent the regulations by hiring consultants or agents (this topic will be the focus of this chapter's case study discussion). Notably excluded from the scope of the OECD Convention is a prohibition against bribing private parties. Despite such loopholes, the OECD Convention was an important step in the right direction. By 2012, forty-three countries had ratified the agreement and begun its implementation.

Corruption and Culture

Prior to the expansion of international trade in the nineteenth and twentieth centuries, most commerce was local and followed traditional norms and ethical standards. With the expansion of international trade, however, businesses began to operate across cultural and linguistic boundaries. Misunderstandings and transgressions, both intended and unintended, became commonplace. To some extent, perceptions of corruption may derive from cultural differences, because behavior that is considered corrupt in one society may represent a normal business practice in another.

One example can be found in the Chinese concept of *guanxi*, which refers to the reciprocal obligations and benefits expected from a network of personal connections. A person with a powerful level of *guanxi* is considered a preferred business partner because such a person can utilize connections to obtain business or government approvals. *Guanxi* can derive from extended family, school friends and alumni, work colleagues, members of common clubs or organizations, and business associates. Chinese businesspeople seek to cultivate an intricate and extensive web of lifelong *guanxi* relationships. The key expectation in *guanxi* networks is reciprocity in the granting of favors; the failure to reciprocate is considered a breach of trust. The greater the favor asked or granted, the greater the favor owed. *Guanxi* thus generates a cycle of favors over time. Among the questionable practices facilitated by *guanxi* are certain types of corrupt favoritism—such as nepotism (favoring family members) and cronyism (favoring friends). In fact, relatively high levels of nepotism or cronyism are accepted and tolerated in many non-Western cultures, not only in China. As applied to business transactions, *guanxi* opens doors and creates opportunities for business relationships and dealings. In itself, *guanxi* is not corrupt. However, strong *guanxi* connections and obligations can serve as an incentive to corruption.

Many traditional business practices around the world are rooted in concepts analogous to *guanxi*, as in the practice of using business gifts or personal connections to speed up transactions both large and small. Russians use the term *blat* to refer to the ability to get things done through personal networks or contacts with people of influence. The Japanese have adapted the English word *connections* to coin a term of their own, *konne*. In Pakistan, the use of personal *sifarish* ("recommendation") refers to the ability to make contact with the right official on the most favorable terms. The French expression for bribe is *pot de vin* ("jug of wine"), which implies friendly relations. In Urdu and Hindi, petty bribes are known as *chai pani* ("tea water"). In West Africa the term is *dash*. The English colloquial term *grease* and the German *schmiergeld* ("grease money") imply a lubrication or easing of resistance to the transaction. In Mozambique, one term for corruption is *cabritismo* or "goatism," which is derived from the saying "a goat eats where it is tethered."

The universality of such terms suggests that various forms of business bribery and graft are prevalent worldwide. However, specific business activities that are considered acceptable in some societies may be considered taboo in others. Thus, the American practice of lobbying legislators and governmental agencies would be considered an illegal form of buying influence in many other countries. In some societies, gift giving to chiefs, elders, or religious leaders is considered not only acceptable and appropriate, but even a mandatory traditional expression of respect and obligation.

A survey conducted by KPMG in the United Kingdom found that while 80 percent of respondents agreed that the UK Anti-Corruption Act was an admirable attempt to address the problem of corruption, 58 percent believed that the Act was impractical and ignored the reality that bribery is an accepted way of doing business in many countries. Other similar studies have revealed widespread international criticism of US anticorruption law as hypocritical in light of the American business practice of offering gifts to potential customers or clients (e.g., trips to conferences, golf outings, tickets to entertainment and sporting events, use of luxury facilities such as spas, condos, and country clubs, etc.).

Case Study: The Chinese Agent

The fictional case subject for this chapter is based on the difficult issue of determining the ethics of employing a well-connected agent. In our case, an American for-profit educational institution, which we will call Cleveland College, is opening a Shanghai campus to offer United States–style college programs in China. There is a ready market in China for "prestigious" US baccalaureate degrees. However, Cleveland College needs to satisfy a lot of red tape to be accredited in China and obtain the necessary licenses for an educational institution in the Shanghai area.

On an exploratory trip to Shanghai, the President of Cleveland College, Mark Rollins, is approached by a prominent businessman, Wang Li, a former member of the Shanghai city government who is familiar with the educational bureaucracy. Wang offers to assist as a public relations agent, but his fee is so hefty ($200,000 per year) that Rollins fears that Wang is going to use much of it to grease palms. Research with local authorities indicates that Wang is well respected and has a high level of *guanxi* with local educational officials. Wang promises to get Cleveland College all the necessary certifications in much faster time than it usually takes, and also promises to prevent bothersome audits and bureaucratic problems. Should Cleveland College sign him on? What FCPA danger would this entail?

Corruption in China

Over the past decade, the Chinese government has joined the global community in decrying corruption and initiating regulations and laws, and publically stating a strong intent to clamp down on corruption. Thus, in a widely publicized 2011 statement by China's Premier, Wen Jiabao, anticorruption actions were emphasized as a "primary task in 2011."[13] This was interpreted as an indication that increased enforcement of anticorruption laws will be a top government priority and that these prohibitions must be taken seriously by foreign corporations operating in China.

A number of recent high-profile cases have illustrated the extent of the Chinese crackdown on corruption. One notorious case was that of the former anticorruption official Huang Songyou, who was sentenced to death for accepting 7.71 billion yuan in bribes. In another case, Wang Huayuan and eight other senior officials of the provincial governments in Guangdong and Zhejiang provinces were convicted of corrupt actions that took place between 1998 and 2009. The former president of the Supreme Court and the former vice president of the state-owned China Development Bank were charged with taking bribes and then convicted to life in prison. In 2011, China sought the repatriation of Lai Changxing from Canada after twelve years there. As former chairman of Yuanhua International Corporation, Changxing was accused of absconding with $7.7 billion dollars. His defense against the repatriation was that he would face torture and execution.

Some observers have questioned the resolve of the Chinese government and have suggested that the small number of corruption prosecutions concluding with extreme punishments may have less to do with ending corruption than with sending a message to those who engage in corruption beyond an acceptable level. Others have suggested that anticorruption prosecutions may be an alternative means of conducting political purges. A more positive but still skeptical interpretation is to view the anticorruption cases as an expression of support for global anticorruption, an encouragement to foreign investors who fear corruption, and a way of appeasing the Chinese citizenry. According to Yan Sun, Associate Professor of Political Science at the City University of New York, it was corruption, rather than democracy as such, that lay at the root of the social dissatisfaction that led to the Tiananmen protest movement of 1989.

Foreign Educational Institutions in China

Accompanying China's meteoric economic development over the last three decades has been a corresponding growth in sophisticated higher education. The number of institutions of higher education in China has doubled in the last ten years. The Chinese government has determined that it must not only increase the number of college graduates, but also make China an education destination for non-Chinese students. Accomplishing these goals will necessitate increased cooperation with Western institutions of higher education

In an interview with University World News in 2013, Michael Gaebel, head of the higher education policy unit at the European University Association (EUA) reported that, just a few years ago, "it was very difficult to convince European vice-chancellors that Asia was not just a provider of fee-paying students. Now no one in Europe can ignore that China has become important globally for research and will continue growing in importance."[14] In 2013, China's vice minister for education announced that China would take efforts to attract more foreign students. By 2020, China had hoped to attract some 500,000 international students, making the country the largest Asian destination for international students.

With 37 million students studying in over 2,400 universities and colleges, China has the largest system of higher education in the world. The rapid growth of demand for colleges and universities in recent years has resulted in a number of problems, including rushed and poor quality construction, high student–lecturer ratio, shortages of qualified faculty, and questionable academic quality, not to mention allegations of corruption.

Corruption in higher education in China has been widely reported, including allegations of widespread plagiarism, selling of degrees, favoritism in admissions, and bribery for grades. A study by Wuhan University Professor Shen Yan showed that ghostwriting academic theses was a one billion–yuan business in 2009, and that 70 percent of the published theses were plagiarized. John Bray, author of "Facing up to Corruption, a Practical Guide,"[15] reports that parents in China often have to pay for a spot in a university for their child.

Compounding these problems is the growing level of unemployment among recent graduates. The *Epoch Times* reported a 7.7 percent employment rate among the seven million graduates in 2014.[16] The decline in the perceived value of Chinese higher education has created an opportunity for foreign universities. There is a perception that a degree from a Western university is more credible and that its graduates are more employable than graduates of Chinese institutions. Carl Fey, Dean of Nottingham University Business School China, discusses the growing number of foreign campuses opening in China. At his school, they spend the first year teaching students English, so they learn to work, study, and speak in English before diving into subject matter. "Your diploma looks exactly the same whether you graduated from Nottingham, UK, or Nottingham, China," Fey said. "That's because the education's actually the same."[17]

The number of foreign universities operating in China is changing rapidly as institutions from Europe, the United States, and other Western countries enter the fray. This course is not without operational hurtles, as was noted when Harvard University pulled out of a high profile and widely published and joint venture with its Chinese counterpart, the prestigious Beijing University. Harvard cited several reasons for ending the relationship, including low enrollment, high operating expenses, and issues within the Chinese language program.

One of the problems faced by Western universities operating in China is that the potential for government censorship places severe limitations on academic freedom. While this is the most notable issue, there are many other challenges, mostly related to cultural differences. The red tape involved in getting the appropriate licenses, accreditations, and building permits from the various governmental agencies involved in local, regional, and centralized government is a daunting task for a foreigner. Most foreign institutions find it more expedient to partner with established Chinese universities than to attempt to open a new university, but even then, there are all the usual issues related to operation of a partnership or joint venture, all complicated by the cultural differences.

Readings

10.1 "Corruption from a Cross-Cultural Perspective"

Hooker, John. "Corruption from a Cross-Cultural Perspective." Pittsburgh, PA: Carnegie Mellon University. October 2008. ba.gsia.cmu.edu/jnh/corruption08s.pdf.

The world is shrinking, but its cultures remain worlds apart, as do its ethical norms. Bribery, kickbacks, cronyism, and nepotism seem to be more prevalent in some parts of the world, and one wants to know why. Is it because some peoples are less ethical than others? Or is it because they have different ethical systems and regard these behaviors as acceptable?

…The phenomenon of corruption provides a good illustration of these realities. Corruption is best understood as behavior that corrupts: it undermines the cultural system in which it occurs. Because cultures can operate in very different ways, very different kinds of behavior can corrupt. Practices that Westerners consider questionable, such as cronyism and nepotism, may be functional in other cultures. Practices that are routine and acceptable in the West, such as bringing a lawsuit for breach of contract, may be corrupting in a wide range of cultures, Western and non-Western, but for very different reasons.

The West tends to be universalist in its outlook: every society works, or should work, essentially the same way. Its business practices, for example, should be based on a market system that is characterized by transparency and regulated by laws that apply to everyone. A country that fails to conform to this model is seen as underdeveloped or dysfunctional. It follows from this view that that corruption is basically the same in Sweden as in Sudan.

The reality, however, is that different cultures use radically different systems to get things done. Whereas Western cultures are primarily rule-based, most of the world's cultures are relationship-based. Westerners tend to trust the system, while people …cemented by personal honor, filial duty, friendship, or long-term mutual obligation. Loyalty to cronies is suspect behavior in the West but represents high moral character in much of the world.

…What is corrupt in the West may be acceptable elsewhere. The classic example of the purchasing agent illustrates this point. The Western purchasing agent is expected to award contracts based on the quality of bids and transparently available financial information about the bidders. An agent who favors personal friends is viewed as corrupt, because cronyism subverts this transparency-based system. It creates a conflict of interest: A choice that is good for the agent and his or her cronies may not be good for the company.

In much of the world, however, cronyism is a foundation for trust. A purchasing agent does business with friends because friends can be trusted. He or she may not even ask to see the company financials, since this could insult the other's honor. It is assumed that cronies will follow through on the deal, not because they fear a lawsuit, but because they do not wish to sacrifice a valuable relationship in an economy where relationships are the key to business. In such a system it is in the company's interest for the agent to do business with friends, and cronyism may therefore present no conflict of interest.

What is acceptable in the West may be corrupt elsewhere …Even so basic a practice as negotiation, which is routine in the West, can disrupt harmony in Confucian cultures. Westerners tend to organize their affairs around agreements, deals, or contracts, relying on a concept of covenant that traces back to the ancient Middle East. These agreements are hammered out in negotiation, as for example when labor and management sit across the table from each other. This practice is functional and constructive, so long as it proceeds according to rules of fair play and good faith.

Confucian cultures …are based primarily on loyalty and obligation to friends, family or superiors rather than on a system of rules.

10.2 "Facing up to Corruption: A Practical Business Guide"

Bray, John. "Facing up to Corruption: A Practical Business Guide." London: Control Risks. 2007. www.giaccentre.org/documents/CONTROLRISKS.CORRUPTIONGUIDE.pdf

Direct and Indirect Bribery

Indirect bribery is one of the most sensitive policy issues facing international companies. A typical example would be a case where a company employs a commercial agent to help it win a government contract. The agent is paid by commission based on a percentage of the contract fee; part of that commission is passed on to a government official. The agent's employers do not know—and do not wish to know—what happened…

The OECD Anti-Bribery Convention explicitly covers payments made "directly or through intermediaries" to secure a business advantage. US and other international legal practice already includes several cases where companies have been prosecuted for paying bribes via agents. Ignorance—wilful or otherwise—is not a defence.

…A broad understanding of corruption includes certain kinds of influence, although the boundary between acceptable and unacceptable forms of influence is often hard to define. A series of cases in the US and other countries have drawn attention to the ethical issues surrounding political lobbying. In principle, political lobbying is legitimate. One of the main roles of industry associations is to lobby government on their members' behalf. Individual companies, like ordinary citizens, are entitled to seek assistance from their political and diplomatic representatives. Problems arise when such contacts appear secretive, when there is a suspicion of favouritism or when a company's influence appears to be both disproportionate and against the wider public interest.

In many societies it is common to speed up both larger and smaller transactions through personal connections… The use of personal contacts is both commonplace and useful. However, as with political lobbying, it becomes problematic when the connections lack transparency and when officials break rules on behalf of their business friends, or seek illicit favours in return.

In cases of doubt, the so-called "newspaper test" provides a useful indicator: would a proposed transaction cause you or your company embarrassment when reported in the press? If it would, do not do it.

10.3 "The Cost of Corruption: A Discussion Paper on Corruption, Development and the Poor"

Evans, Bryan R. "The Cost of Corruption: A Discussion Paper on Corruption, Development and the Poor," (Middlesex, UK: Tearfund, 1999), accessed December 3, 2014, www.tearfund.org/webdocs/Website/Campaigning/Policy%20and%20research/The%20cost%20of%20corruption.pdf.

Far from being a "victimless crime," corruption infringes the fundamental human right to fair treatment. All persons are entitled to be treated equally, and when one person bribes a public official he acquires a privileged status in relation to others. He becomes an 'insider' while others are made "outsiders" (and the more "outside" they are—the very poor, the landless, women, ethnic minorities—the more they will be hurt). Clare Short, the UK Secretary of State for International Development, notes a report in the Indian magazine Outlook to the effect that the bribe for a new water connection was R1,000. This effectively excluded the poor from access to running water, with all the health and time-loss implications that this entails. Corruption is thus profoundly inegalitarian in its effects—it has a "Robin Hood-in-reverse" character. Hugh Bayley

MP, introducing a bill to create offences of international bribery and corruption, went so far as to say that "bribery is a direct transfer of money from the poor to the rich."

…The ramifications spread yet further. Productive foreign investment may be lost. Before the Asian crisis of 1997/98 there were some who argued that corruption was not harmful, it merely greased the wheels of commerce. It was pointed out that some countries which ranked high in surveys of the level of corruption, also excelled in economic growth. The World Development Report notes that the question of predictability (the amount to be paid, the certainty of outcome) throws some light on this apparent paradox. "For a given level of corruption, countries with more predictable corruption have higher investment rates…"

However, the Report went on to state that even in these countries corruption had an adverse impact on economic performance, because the higher transaction costs and increased uncertainty put off potential investors. Time magazine quotes research by Professor Shang-Jin Wei of Harvard School of Government to the effect that the high level of corruption in Mexico compared with Singapore was the equivalent of a 24 per cent increase in the marginal rate of taxation.

A conservationist, Lansen Olsen, in a letter to the Transparency International Newsletter notes that "political corruption is a major feature of the political habitat in which wildlife conservation efforts sink or swim." When corruption breaches regulations designed to protect the environment, everyone suffers in the long term, as the loss of primary forest leads to soil erosion, local climate change, etc., but it is the poor who have the smallest resources with which to weather environmental degradation.

Corruption can also have ugly and unpredictable consequences for the (Western) briber. As soon as he pays he begins to lose control. If he does not get what he paid for he is in no position to complain. Having broken the law he is vulnerable to blackmail. If he tries to break the corrupt relationship he may face a variety of threats, including the threat of violence.

Synthesis Questions

1. Consider the following hypothetical example: An American college seeks to obtain a good image among Chinese educational regulators and accreditors by inviting a number of them, all expenses paid, to a week-long conference in Hawaii. Is this morally acceptable? Does it constitute a form of bribery? Why or why not?
2. In the past two decades, a number of very large corporations have paid large fines for corrupt behavior. Presumably, the executives who authorized the payments were highly-educated, experienced, professional people. Why do you think they failed to speak up against the corruption?
3. This chapter explores the concept of guanxi. Do you think guanxi is morally wrong, or rather, is an acceptable form of traditional practice that must be allowed to continue? What are the prospects for guanxi in the future?

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CHAPTER OVERVIEW

3: Global Trade Environment

3.1: Chapter Introductions

World Economies

WHAT'S IN IT FOR ME?

1. How are economies classified?
2. What is the developed world?
3. What is the developing world?
4. Which are the emerging markets?

From the title of this chapter, you may be wondering—is this chapter going to cover the world? And, in a sense, the answer is yes. When global managers explore how to expand, they start by looking at the world. Knowing the major markets and the stage of development for each allows managers to determine how best to enter and expand. The manager's goal is to hone in on a new country—hopefully, before their competitors and usually before the popular media does. China and India were expanding rapidly for several years before the financial press, such as the *Wall Street Journal*, elevated them to their current hot status.

It's common to find people interested in doing business with a country simply because they've read that it's the new "hot" economy. They may know little or nothing about the market or country—its history, evolution of thought, people, or how interactions are generally managed in a business or social context. Historically, many companies have only looked at new global markets once potential customers or partners have approached them. However, trade barriers are falling, and new opportunities are fast emerging in markets of the Middle East and Africa—further flattening the world for global firms. Companies are increasingly identifying these and other global markets for their products and services and incorporating them into their long-term growth strategies.

Savvy global managers realize that to be effective in a country, they need to know its recent political, economic, and social history. This helps them evaluate not only the current business opportunity but also the risk of political, economic, and social changes that can impact their business. First, Section 4.1 outlines how businesses and economists evaluate world economies. Then, the remaining sections review what developed and developing worlds are and how they differ, as well as explain how to evaluate the expanding set of emerging-market countries, which started with the BRIC countries (i.e., Brazil, Russia, India, and China) and has now expanded to include twenty-eight countries. Effective global managers need to be able to identify the markets that offer the best opportunities for their products and services. Additionally, managers need to monitor these emerging markets for new local companies that take advantage of business conditions to become global competitors.

Opening Case: China versus India: Who Will Win??

India and China are among the world's fastest-growing economies, contributing nearly 30 percent to global economic growth. Both China and India are not emerging economies—they're actually "re-emerging," having spent centuries at the center of trade throughout history: "These two Asian giants, which until 1800 used to make up half the world economy, are not, like Japan and Germany, mere nation states. In terms of size and population, each is a continent—and for all the glittering growth rates, a poor one."“Contest of the Century,” *Economist*, August 19, 2010, accessed January 3, 2011, http://www.economist.com/node/16846256.

Both India and China are in fierce competition with each other as well as in their quest to catch up with the major economies in the developed world. Each have particular strengths and competitive advantages that have allowed each of them to weather the recent global financial crisis better than most countries. China's growth has been mainly investment and export driven, focusing on low-cost manufacturing, with domestic consumption as low as 36 percent of gross domestic product (GDP). On the other hand, India's growth has been derived mostly from a strong services sector and buoyant domestic consumption. India is also much less dependent on trade than China, relying on external trade for about 20 percent of its GDP versus 56 percent for China. The Chinese economy has doubled every eight years for the last three decades—the fastest rate for a major economy in recorded history. By 2011, China is the world's second largest economy in the world behind the United States.Gopal Ethiraj, "China Edges Out Japan to Become World's No. 2 Economy," *Asian Tribune*, August 18, 2010, accessed January 7, 2011, www.asiantribune.com/news/2010/08/18/china-edges-out-japan-become-world%E2%80%99s-no-2-economy. A recent report by PricewaterhouseCoopers forecasts that China could overtake the US economy as early as 2020.Suzanne Rosselet, "Strengths of China and India to Take Them into League of Developing Countries," *Economic Times*, May 7, 2010, accessed January 3, 2011, http://economictimes.indiatimes.com/features/corporate-dossier/Strengths-of-China-and-India-to-take-them-into-league-of-developing-countries/articleshow/5900893.cms.

China is also the first country in the world to have met the poverty-reduction target set in the UN Millennium Development Goals and has had remarkable success in lifting more than 400 million people out of poverty. This contrasts sharply with India, where 456 million people (i.e., 42 percent of the population) still live below the poverty line, as defined by the World Bank at $1.25 a day.Suzanne Rosselet, "Strengths of China and India to Take Them into League of Developing Countries," *Economic Times*, May 7, 2010, accessed January 3, 2011, http://economictimes.indiatimes.com/features/corporate-dossier/Strengths-of-China-and-India-to-take-them-into-league-of-developing-countries/articleshow/5900893.cms. Section 4.1 will review in more detail how we classify countries. China has made greater strides in improving the conditions for its people, as measured by the HDI. All of this contributes to the local business conditions by both developing the skill sets of the workforce as well as expanding the number of middle-class consumers and their disposable incomes.

India has emerged as the fourth-largest market in the world when its GDP is measured on the scale of purchasing power parity. Both economies are increasing their share of world GDP, attracting high levels of foreign investment, and are recovering faster from the global crisis than developed countries. "Each country has achieved this with distinctly different approaches—India with a 'grow first, build later' approach versus a 'top-down, supply driven' strategy in China."Suzanne Rosselet, "Strengths of China and India to Take Them into League of Developing Countries," *Economic Times*, May 7, 2010, accessed January 3, 2011, http://economictimes.indiatimes.com/features/corporate-dossier/Strengths-of-China-and-India-to-take-them-into-league-of-developing-countries/articleshow/5900893.cms.

The Chinese economy historically outpaces India's by just about every measure. China's fast-acting government implements new policies with blinding speed, making India's fractured political system appear sluggish and chaotic. Beijing's shiny new airport and wide freeways are models of modern development, contrasting sharply with the sagging infrastructure of New Delhi and Mumbai. And as the global economy emerges from the Great Recession, India once again seems to be playing second fiddle. Pundits around the world laud China's leadership for its well-devised economic policies during the crisis, which were so effective in restarting economic growth that they helped lift the entire Asian region out of the downturn.Michael Schuman, "India vs. China: Whose Economy Is Better?," *Time*, January 28, 2010, accessed January 3, 2011, www.time.com/time/world/article/0,8599,1957281,00.html.

As recently as the early 1990s, India was as rich, in terms of national income per head. China then hurtled so far ahead that it seemed India could never catch up. But India's long-term prospects now look stronger. While China is about to see its working-age population shrink, India is enjoying the sort of bulge in manpower which brought sustained booms elsewhere in Asia. It is no longer inconceivable that its growth could outpace China's for a considerable time. It has the advantage of democracy—at least as a pressure valve for discontent. And India's army is, in numbers, second only to China's and America's…And because India does not threaten the West, it has powerful friends both on its own merits and as a counterweight to China."Contest of the Century," *Economist*, August 19, 2010, accessed January 3, 2011, http://www.economist.com/node/16846256.

India's domestic economy provides greater cushion from external shocks than China's. Private domestic consumption accounts for 57 percent of GDP in India compared with only 35 percent in China. India's confident consumer didn't let the economy down. Passenger car sales in India in December jumped 40 percent from a year earlier.Michael Schuman, "India vs. China: Whose Economy Is Better?," *Time*, January 28, 2010, accessed January 3, 2011, www.time.com/time/world/article/0,8599,1957281,00.html.

Since 1978, China's economic growth and reform have dramatically improved the lives of hundreds of millions of Chinese, increased social mobility. The Chinese leadership has reduced the role of ideology in economic policy by adopting a more pragmatic perspective on many political and socioeconomic problems. China's ongoing economic transformation has had a profound impact not only on China but on the world. The market-oriented reforms China has implemented over the past two decades have unleashed individual initiative and entrepreneurship. The result has been the largest reduction of poverty and one of the fastest increases in income levels ever seen.

China used to be the third-largest economy in the world but has overtaken Japan to become the second-largest in August 2010. It has sustained average economic growth of over 9.5 percent for the past 26 years. In 2009 its $4.814 trillion economy was about one-third the size of the United States economy."Background Note: China," Bureau of East Asian and Pacific Affairs, US Department of State, August 5, 2010, accessed January 3, 2011, http://www.state.gov/r/pa/ei/bgn/18902.htm. China leapfrogged over Japan and became the world's number two economy in the second quarter of 2010, as receding global growth sapped momentum and stunted a shaky recovery.

India's economic liberalization in 1991 opened gates to businesses worldwide. In the mid- to late 1980s, Rajiv Gandhi's government eased restrictions on capacity expansion, removed price controls, and reduced corporate taxes. While his government viewed liberalizing the economy as a positive step, political pressures slowed the implementation of policies. The early reforms increased the rate of growth but also led to high fiscal deficits and a worsening current account. India's major trading partner then, the Soviet Union, collapsed. In addition, the first Gulf War in 1991 caused oil prices to increase, which in turn led to a major balance-of-payments crisis for India. To be able to cope with these problems, the newly elected Prime Minister Narasimha Rao along with Finance Minister Manmohan Singh initiated a widespread economic liberalization in 1991 that is widely credited with what has led to the Indian economic engine of today. Focusing on the barriers for private sector investment and growth, the reforms enabled faster approvals and began to dismantle the *License Raj*, a term dating back to India's colonial historical administrative legacy from the British and referring to a complex system of regulations governing Indian businesses."Economic History of India," History of India, accessed January 7, 2011, http://www.indohistory.com/economic_history_of_india.html.

Since 1990, India has been emerging as one of the wealthiest economies in the developing world. Its economic progress has been accompanied by increases in life expectancy, literacy rates, and food security. Goldman Sachs predicts that India's GDP in current prices will overtake France and Italy by 2020; Germany, the United Kingdom, and Russia by 2025; and Japan by 2035 to become the third-largest economy of the world after the United States and China. India was cruising at 9.4 percent growth rate until the financial crisis of 2008–9, which affected countries the world over.Mamta Badkar, "Race of the Century: Is India or China the Next Economic Superpower?," *Business Insider*, February 5, 2011, accessed May 18, 2011, http://www.businessinsider.com/are-you-betting-on-china-or-india-2011-1?op=1.

Both India and China have several strengths and weaknesses that contribute to the competitive battleground between them.

China's Strengths

1. **Strong government control.** China's leadership has a development-oriented ideology, the ability to promote capable individuals, and a system of collaborative policy review. The strong central government control has enabled the country to experience consistent and managed economic success. The government directs economic policy and its implementation and is less susceptible than democratic India to sudden changes resulting from political pressures.
2. **WTO and FDI.** China's entry into the World Trade Organization (WTO) and its foreign direct investment (FDI) in other global markets has been an important factor in the country's successful growth. Global businesses also find the consistency and predictability of the Chinese government a plus when evaluating direct investment.
3. **Cheap, abundant labor.** China's huge population offers large pools of skilled and unskilled workers, with fewer labor regulations than in India.
4. **Infrastructure.** The government has prioritized the development of the country's infrastructure including roads and highways, ports, airports, telecommunications networks, education, public health, law and order, mass transportation, and water and sewer treatment facilities.
5. **Effectiveness of two-pronged financial system.** "The first prong is a well-run directed-credit system that channels funds from bank and postal deposits to policy-determined public uses; the second is a profit-oriented and competitive system, albeit in early and inefficient stages of development. Both prongs continue to undergo rapid government-sponsored reforms to make them more effective."Albert Keidel, "E-Notes: Assessing China's Economic Rise: Strengths, Weaknesses and Implications," Foreign Policy Research Institute, July 2007, accessed January 3, 2011, www.fpri.org/enotes/200707.keidel.assessingchina.html.

India's Strengths

Infosys is one of India's new wave of world-class IT companies.

Image courtesy of Infosys.

1. **Quality manpower.** India has a technologically competent, English-speaking workforce. As a major exporter of technical workers, India has prioritized the development of its technology and outsourcing sectors. India is the global leader in the business process outsourcing (BPO) and call-center services industries.
2. **Open democracy.** India's democratic traditions are ingrained in its social and cultural fabric. While the political process can at times be tumultuous, it is less likely than China to experience big uncertainties or sudden revolutionary changes as those recently witnessed in the Middle East in late 2010 and early 2011.
3. **Entrepreneurship.** India entrepreneurial culture has led to global leaders, such as the Infosys cofounder, Narayana Murthy. Utilizing the global network of Indians in business and Indian business school graduates, India has an additional advantage over China in terms of entrepreneurship-oriented bodies, such as the TiE network (The Indus Entrepreneurs) or the Wadhwani Foundation, which seek to promote entrepreneurship by, among other things, facilitating investments.“Entrepreneurship: Riding Growth in India and China,” INSEAD, accessed January 3, 2011, knowledge.insead.edu/contents/Turner.cfm.
4. **Reverse brain drain.** Historically many emerging and developing markets experienced what is known as brain drain—where its best young people, once educated, moved to developed countries to access better jobs, incomes, and prospects for career advancement. In the past decade, economists have observed that the fast-growing economies of China and India are experiencing the reverse. Young graduates are remaining in India and China to pursue dynamic domestic opportunities. In fact, older professionals are returning from developed countries to seek their fortunes and career advancements in the promising local economies—hence the term *reverse brain drain*. The average age of the Indian returnees is thirty years old, and these adults are well educated—66 percent hold a master's degree, while 12 percent hold PhDs. The majority of these degrees are in management, technology, and science. Indians returning home are encouraged by the increasing transparency in business and government as well as the political freedoms and the prospects for economic growth.Vivek Wadhwa, “Beware the Reverse Brain Drain to India and China,” *TechCrunch*, October 17, 2009, accessed January 7, 2011, http://techcrunch.com/2009/10/17/beware-the-reverse-brain-drain-to-india-and-china.
5. **Indian domestic-market growth.** According to the *Trade and Development Report 2010*, for sustainable growth, policies “should be based on establishing a balanced mix of domestic and overseas demand.”Pioneer Edit Desk, “Expand Domestic Market,” *The Pioneer*, September 20, 2010, accessed January 7, 2011, http://dailypioneer.com/284197/Expand-domestic-market.html. India has a good mix of both international and domestic markets.

Each country has embraced the trend toward urbanization differently. Global businesses are impacted in the way cities are run:

China is in much better shape than India is. While India has barely paid attention to its urban transformation, China has developed a set of internally consistent practices across every element of the urbanization operating model: funding, governance, planning, sectorial policies, and shape. India has underinvested in its cities; China has invested ahead of demand and given its cities the freedom to raise substantial investment resources by monetizing land assets and retaining a 25 percent share of value-added taxes. While India spends $17 per capita in capital investments in urban infrastructure annually, China spends $116. Indian cities have devolved little real power and accountability to its cities; but China's major cities enjoy the same status as provinces and have powerful and empowered political appointees as mayors. While India's urban planning system has failed to address competing demands for space, China has a mature urban planning regime that emphasizes the systematic development of run-down areas consistent with long-range plans for land use, housing, and transportation.Richard Dobbs and Shirish Sankhe, “Opinion: China vs. India,” *Financial Times*, May 18, 2010, reprinted on McKinsey Global Institute website, accessed January 3, 2011, www.mckinsey.com/mgi/mginews/opinion_china_vs_india.asp.

Despite the urbanization challenges, India is likely to benefit in the future from its younger demographics: “By 2025, nearly 28 percent of China's population will be aged 55 or older compared with only 16 percent in India.”Richard Dobbs and Shirish Sankhe, “Opinion: China vs. India,” *Financial Times*, May 18, 2010, reprinted on McKinsey Global Institute website, accessed January 3, 2011, www.mckinsey.com/mgi/mginews/opinion_china_vs_india.asp. The trend toward urbanization is evident in both countries. By 2025, 64 percent of China's population will be living in urban areas, and 37 percent of India's people will be living in cities.Richard Dobbs and Shirish Sankhe, “Opinion: China vs. India,” *Financial Times*, May 18, 2010, reprinted on McKinsey Global Institute website, accessed January 3, 2011, www.mckinsey.com/mgi/mginews/opinion_china_vs_india.asp. This historically unique trend offers global businesses exciting markets.

So what markets are likely to benefit the most from these trends? In India, by 2025, the largest markets will be transportation and communication, food, and health care followed by housing and utilities, recreation, and education. Even India's slower-growing spending categories will represent significant opportunities for businesses because these markets will still be growing rapidly in comparison with their counterparts in other parts of the world. In China's cities today, the fastest-growing categories are likely to be transportation and communication, housing and utilities, personal products, health care, and recreation and education. In addition, in both China and India, urban infrastructure markets will be massive.Richard Dobbs and Shirish Sankhe, "Opinion: China vs. India," *Financial Times*, May 18, 2010, reprinted on McKinsey Global Institute website, accessed January 3, 2011, www.mckinsey.com/mgi/mginews/opinion_china_vs_india.asp.

While both India and China have unique strengths as well as many similarities, it's clear that both countries will continue to grow in the coming decades offering global businesses exciting new domestic markets.See also "India's Surprising Economic Miracle," *Economist*, September 30, 2010, accessed January 3, 2011, http://www.economist.com/node/17147648; "A Bumpier but Freer Road," *Economist*, September 3, 2010, accessed January 3, 2011, http://www.economist.com/node/17145035; Chris Monasterski, "Education: India vs. China," *Private Sector Development Blog*, World Bank, April 25, 2007, accessed January 7, 2011, psdblog.worldbank.org/psdblog/2007/04/education_india.html; Shreyasi Singh, "India vs. China," *The Diplomat*, August 27, 2010, accessed January 7, 2011, http://the-diplomat.com/indian-decade/2010/08/27/india-vs-china; "The India vs. China Debate: One Up for India?," *Benzinga*, January 29, 2010, accessed January 7, 2011, http://www.benzinga.com/global/104829/the-india-vs-china-debate-one-up-for-india; Steve Hamm, "India's Advantages over China," *Bloomberg Business*, March 6, 2007, accessed January 7, 2011, http://www.businessweek.com/globalbiz/blog/globespotting/archives/2007/03/indias_advantag.html.

Opening Case Exercise

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. Pick an industry and company that interests you. As a global manager of the firm you've selected, you're asked to review China and India and determine which market to enter first. How would you evaluate each market and its potential customers? Use your understanding of the stage of development for each country from the case study as well as online resources. Which country would you recommend entering first? Based on your understanding of these markets, would you recommend a strategy for only one country or both?

3.2: Classifying World Economies

Learning Objectives

1. Understand how economies are classified.
2. Evaluate the statistics used in classifications: GNP, GDP, PPP as well as HDI, HPI, GDI, and GEM.

Classification of Economies

Experts debate exactly how to define the level of economic development of a country—which criteria to use and, therefore, which countries are truly developed. This debate crosses political, economic, and social arguments.

When evaluating a country, a manager is assessing the country's income and the purchasing power of its people; the legal, regulatory, and commercial infrastructure, including communication, transportation, and energy; and the overall sophistication of the business environment.

Why does a country's stage of development matter? Well, if you're selling high-end luxury items, for example, you'll want to focus on the per capita income of the local citizens. Can they afford a $1,000 designer handbag, a luxury car, or cutting-edge, high-tech gadgets? If so, how *many* people can afford these expensive items (i.e., how large is the domestic market)? For example, in January 2011, the *Financial Times* quotes Jim O'Neill, a leading business economist, who states, "South Africa currently accounts for 0.6 percent of world GDP. South Africa can be successful, but it won't be big."Jennifer Hughes, "'Bric' Creator Adds Newcomers to List," *Financial Times*, January 16, 2010, accessed January 7, 2011, http://www.ft.com/cms/s/0/f717c8e8-21be-11e0-9e3b-00144feab49a.html#ixzz1MKbbO8ET. Section 4.4 discusses the debate around the term *emerging markets* and which countries should be labeled as such. But clearly the size of the local market is an important key factor for businesspeople.

Even in developing countries, there are always wealthy people who want and can afford luxury items. But these consumers are just as likely to head to the developed world to make their purchase and have little concern about any duties or taxes they may have to pay when bringing the items back into their home country. This is one reason why companies pay special attention to understanding their global consumers as well as where and how these consumers purchase goods. Global managers also focus on understanding if a country's target market is growing and by what rate. Countries like China and India caught the attention of global companies, because they had large populations that were eager for foreign goods and services but couldn't afford them. As more people in each country acquired wealth, their buying appetites increased. The challenge is how to identify which consumers in which countries are likely to become new customers. Managers focus on globally standard statistics as one set of criteria to understand the stage of development of any country that they're exploring for business."Global Economies," *CultureQuest Global Business Multimedia Series* (New York: Atma Global, 2010).

Let's look more closely at some of these globally standard statistics and classifications that are commonly used to define the stage of a country's development.

Statistics Used in Classifications

Gross Domestic Product

Gross domestic product (GDP) is the value of all the goods and services produced by a country in a single year. Usually quoted in US dollars, the number is an official accounting of the country's output of goods and services. For example, if a country has a large black, or underground, market for transactions, it will not be included in the official GDP. Emerging-market countries, such as India and Russia, historically have had large black-market transactions for varying reasons, which often meant their GDP was underestimated.

Figure 4.1

Rank	Country	GDP (purchasing power parity)
1	European Union	$14,430,000,000,000
2	United States	$14,140,000,000,000
3	China	$8,748,000,000,000
4	Japan	$4,150,000,000,000
5	India	$3,570,000,000,000
6	Germany	$2,810,000,000,000
7	United Kingdom	$2,128,000,000,000
8	Russia	$2,110,000,000,000
9	France	$2,097,000,000,000
10	Brazil	$2,013,000,000,000
11	Italy	$1,739,000,000,000
12	Mexico	$1,465,000,000,000
13	South Korea	$1,364,000,000,000
14	Spain	$1,362,000,000,000
15	Canada	$1,269,000,000,000
16	Indonesia	$962,500,000,000
17	Turkey	$874,500,000,000
18	Australia	$851,100,000,000
19	Iran	$827,100,000,000
20	Taiwan	$735,400,000,000

Source: US Central Intelligence Agency, "Country Comparison: GDP (PPP)," World Factbook, accessed June 3, 2011, www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html.

Figure 4.1 shows the total size of the economy, but a company will want to know the income per person, which may be a better indicator of the strength of the local economy and the market opportunity for a new consumer product. GDP is often quoted on a per person basis. **Per capita GDP** is simply the GDP divided by the population of the country.

The per capita GDP can be misleading because actual costs in each country differ. As a result, more managers rely on the **GDP per person** adjusted for purchasing power to understand how much income local residents have. This number helps professionals evaluate what consumers in the local market can afford.

Companies selling expensive goods and services may be less interested in economies with low per capita GDP. Figure 4.2 shows the income (GDP) on a per person basis. For space, the chart has been condensed by removing lower profile countries, but the ranks are valid. Surprisingly, some of the hottest emerging-market countries—China, India, Turkey, Brazil, South Africa, and Mexico—rank very low on the income per person charts. So, why are these markets so exciting? One reason might be that companies selling cheaper, daily-use items, such as soap, shampoos, and low-end cosmetics, have found success entering developing, but promising, markets.

Figure 4.2 Per Capita GDP on a Purchasing Power Parity Basis

Rank	Country	GDP Per Capita (PPP) 2007 Estimates
1	Liechtenstein	$122,100
2	Qatar	$119,500
3	Luxembourg	$79,600
4	Bermuda	$69,900
5	Norway	$57,400
6	Jersey	$57,000
7	Kuwait	$52,800
8	Singapore	$52,200
9	Brunei	$51,200
10	Faroe Islands	$48,200
11	United States	$46,000
15	Hong Kong	$42,800
17	Switzerland	$41,400
18	Ireland	$41,000
19	Australia	$40,000
20	Iceland	$39,600
21	Netherlands	$39,500
22	Austria	$39,200
23	United Arab Emirates	$38,900
24	Bahrain	$38,800
27	Canada	$38,200
29	Belgium	$36,800
30	Sweden	$36,600
31	Denmark	$36,000
32	Greenland	$35,900
35	United Kingdom	$34,800
36	Finland	$34,100
37	Germany	$34,100
38	Spain	$33,600
40	Japan	$32,700
41	France	$32,600
42	European Union	$32,500

Rank	Country	GDP Per Capita (PPP) 2007 Estimates
43	Taiwan	$32,000
44	Greece	$31,000
46	Italy	$29,900
48	Israel	$28,400
49	South Korea	$28,100
50	Slovenia	$27,700
51	New Zealand	$27,400
53	Czech Republic	$24,900
56	Portugal	$21,700
58	Slovakia	$21,100
59	Cyprus	$21,000
61	Saudi Arabia	$20,600
62	Hungary	$18,800
63	Estonia	$18,500
65	Poland	$17,900
68	Croatia	$17,500
69	Puerto Rico	$17,100
72	Russia	$15,100
74	Malaysia	$14,900
76	Chile	$14,600
80	Argentina	$13,400
83	Mexico	$13,200
85	Venezuela	$13,000
97	Turkey	$11,400
101	World Average	$10,400
104	South Africa	$10,300
107	Brazil	$10,100
119	Thailand	$8,200
128	China	$6,600
136	Egypt	$6,000
163	India	$3,100

Source: US Central Intelligence Agency, "Country Comparison: GDP—Per Capita (PPP)," World Factbook, accessed June 3, 2011, www.cia.gov/library/publications/the-world-factbook/rankorder/2004rank.html.

Purchasing Power Parity

To compare production and income across countries, we need to look at more than just GDP. Economists seek to adjust this number to reflect the different costs of living in specific countries. **Purchasing power parity (PPP)** is, in essence, an economic theory that adjusts the exchange rate between countries to ensure that a good is purchased for the same price in the same currency. For example, a basic cup of coffee should cost the same in London as in New York.

A nation's GDP at purchasing power parity (PPP) exchange rates is the sum value of all goods and services produced in the country valued at prices prevailing in the United States. This is the measure most economists prefer when looking at per-capita welfare and when comparing living conditions or use of resources across countries. The measure is difficult to compute, as a US dollar value has to be assigned to all goods and services in the country regardless of whether these goods and services have a direct equivalent in the United States (for example, the value of an ox-cart or non-US military equipment); as a result, PPP estimates for some countries are based on a small and sometimes different set of goods and services. In addition, many countries do not formally participate in the World Bank's PPP project to calculate these measures, so the resulting GDP estimates for these countries may lack precision. For many developing countries, PPP-based GDP measures are multiples of the official exchange rate (OER) measure. The differences between the OER- and PPP-denominated GDP values for most of the wealthy industrialized countries are generally much smaller.US Central Intelligence Agency, "Country Comparison:GDP (PPP)," *World Factbook*, accessed January 3, 2011, www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html.

In some countries, like Germany, the United Kingdom, or Japan, the cost of living is quite high and the per capita GDP (nominal) is higher than the GDP adjusted for purchasing power. Conversely, in countries like Mexico, Brazil, China, and India, the per capita GDP adjusted for purchasing power is higher than the nominal per capita GDP, implying that local consumers in each country can afford more with their incomes.

Figure 4.3 Per Capita GDP (Nominal) versus Per Capita GDP (PPP) of Select Countries (2010)

Country	Per Capita GDP (Nominal)	Per Capita GDP (PPP)
United States	47,100	47,400
Germany	40,500	35,900
United Kingdom	36,200	35,100
Japan	42,500	34,200
Mexico	8,900	13,800
Brazil	10,100	10,900
China	4,300	7,400
India	1,200	3,400

Sources: "List of Countries by GDP (Nominal) Per Capita," Wikipedia, http://en.Wikipedia.org/wiki/List_of_countries_by_GDP_(nominal)_per_capita. "Country Comparison: GDP—Per Capita (PPP)," US Central Intelligence Agency, www.cia.gov/library/publications/the-world-factbook/rankorder/2004rank.html.

Human Development Index (HDI)

GDP and purchasing power provide indications of a country's level of economic development by using an income-focused statistic. However, in recent years, economists and business analysts have focused on indicators that measure whether people's needs are satisfied and whether the needs are equally met across the local population. One such indication is the **human development index (HDI)**, which measures people's satisfaction in three key areas—long and healthy life in terms of life expectancy; access to quality education equally; and a decent, livable standard of living in the form of income.

Since 1990, the United Nations Development Program (UNDP) has produced an annual report listing the HDI for countries. The HDI is a summary composite index that measures a country's average achievements in three basic aspects of human development: health, knowledge, and a decent standard of living. Health is measured by *life expectancy* at birth; knowledge is measured by a combination of the adult *literacy* rate and the combined primary, secondary, and tertiary gross enrollment ratio; and standard of living by (*income as measured by*) GDP per capita (PPP US$).UNDP, "Frequently Asked Questions (FAQs) about the Human Development Index (HDI): What Is the HDI?," *Human Development Reports*, accessed May 15, 2011, http://hdr.undp.org/en/statistics/hdi.

While the HDI is not a complete indicator of a country's level of development, it does help provide a more comprehensive picture than just looking at the GDP. The HDI, for example, does not reflect political participation or gender inequalities. The HDI and the other composite indices can only offer a broad proxy on some of the key the issues of human development, gender disparity, and human poverty.UNDP, "Is the HDI Enough to Measure a Country's Level of Development?," *Human Development Reports*, accessed May 15, 2011, http://hdr.undp.org/en/statistics/hdi. Table 4.1 shows the rankings of the world's countries for the HDI for 2010 rankings. Measures such as the HDI and its components allow global managers to more accurately gauge the local market.

Table 4.1 Human Development Index (HDI)—2010 Rankings

Very High Human Development	High Human Development	Medium Human Development	Low Human Development
1. Norway	43. Bahamas	86. Fiji	128. Kenya
2. Australia	44. Lithuania	87. Turkmenistan	129. Bangladesh
3. New Zealand	45. Chile	88. Dominican Republic	130. Ghana
4. United States	46. Argentina	89. China	131. Cameroon
5. Ireland	47. Kuwait	90. El Salvador	132. Myanmar
6. Liechtenstein	48. Latvia	91. Sri Lanka	133. Yemen
7. Netherlands	49. Montenegro	92. Thailand	134. Benin
8. Canada	50. Romania	93. Gabon	135. Madagascar
9. Sweden	51. Croatia	94. Suriname	136. Mauritania
10. Germany	52. Uruguay	95. Bolivia (Plurinational State of)	137. Papua New Guinea
11. Japan	53. Libyan Arab Jamahiriya	96. Paraguay	138. Nepal
12. Korea (Republic of)	54. Panama	97. The Philippines	139. Togo
13. Switzerland	55. Saudi Arabia	98. Botswana	140. Comoros
14. France	56. Mexico	99. Moldova (Republic of)	141. Lesotho
15. Israel	57. Malaysia	100. Mongolia	142. Nigeria
16. Finland	58. Bulgaria	101. Egypt	143. Uganda
17. Iceland	59. Trinidad and Tobago	102. Uzbekistan	144. Senegal
18. Belgium	60. Serbia	103. Micronesia (Federated States of)	145. Haiti
19. Denmark	61. Belarus	104. Guyana	146. Angola
20. Spain	62. Costa Rica	105. Namibia	147. Djibouti
21. Hong Kong, China (SAR)	63. Peru	106. Honduras	148. Tanzania (United Republic of)
22. Greece	64. Albania	107. Maldives	149. Côte d'Ivoire

Very High Human Development	High Human Development	Medium Human Development	Low Human Development
23. Italy	65. Russian Federation	108. Indonesia	150. Zambia
24. Luxembourg	66. Kazakhstan	109. Kyrgyzstan	151. Gambia
25. Austria	67. Azerbaijan	110. South Africa	152. Rwanda
26. United Kingdom	68. Bosnia and Herzegovina	111. Syrian Arab Republic	153. Malawi
27. Singapore	69. Ukraine	112. Tajikistan	154. Sudan
28. Czech Republic	70. Iran (Islamic Republic of)	113. Vietnam	155. Afghanistan
29. Slovenia	71. The former Yugoslav Republic of Macedonia	114. Morocco	156. Guinea
30. Andorra	72. Mauritius	115. Nicaragua	157. Ethiopia
31. Slovakia	73. Brazil	116. Guatemala	158. Sierra Leone
32. United Arab Emirates	74. Georgia	117. Equatorial Guinea	159. Central African Republic
33. Malta	75. Venezuela (Bolivarian Republic of)	118. Cape Verde	160. Mali
34. Estonia	76. Armenia	119. India	161. Burkina Faso
35. Cyprus	77. Ecuador	120. Timor-Leste	162. Liberia
36. Hungary	78. Belize	121. Swaziland	163. Chad
37. Brunei Darussalam	79. Colombia	122. Lao People's Democratic Republic	164. Guinea-Bissau
38. Qatar	80. Jamaica	123. Solomon Islands	165. Mozambique
39. Bahrain	81. Tunisia	124. Cambodia	166. Burundi
40. Portugal	82. Jordan	125. Pakistan	167. Niger
41. Poland	83. Turkey	126. Congo	168. Congo (Democratic Republic of the)
42. Barbados	84. Algeria 85. Tonga	127. São Tomé and Príncipe	169. Zimbabwe

Source: UNDP, "Human Development Index (HDI)—2010 Rankings," *Human Development Reports*, accessed January 6, 2011, http://hdr.undp.org/en/statistics.

In 1995, the UNDP introduced two new measures of human development that highlight the status of women in each society.

The first, *gender-related development index (GDI)*, measures achievement in the same basic capabilities as the HDI does, but takes note of inequality in achievement between women and men. The methodology used imposes a penalty for inequality, such that the GDI falls when the achievement levels of both women and men in a country go down or when the disparity between their achievements increases. The greater the gender disparity in basic capabilities, the lower a country's GDI compared with its HDI. The GDI is simply the HDI discounted, or adjusted downwards, for gender inequality.

The second measure, *gender empowerment measure (GEM)*, is a measure of agency. It evaluates progress in advancing women's standing in political and economic forums. It examines the extent to which women and men are able to actively participate in economic and political life and take part in decision making. While the GDI focuses on expansion of capabilities, the GEM is concerned with the use of those capabilities to take advantage of the opportunities of life.UNDP, "Measuring Inequality: Gender-related Development Index (GDI) and Gender Empowerment Measure (GEM)," *Human Development Reports*, accessed January 3, 2011, hdr.undp.org/en/statistics/indices/gdi_gem.

In 1997, UNDP added a further measure—the **human poverty index (HPI)**.

If human development is about enlarging choices, poverty means that opportunities and choices most basic to human development are denied. Thus a person is not free to lead a long, healthy, and creative life and is denied access to a decent standard of living, freedom, dignity, self-respect and the respect of others. From a human development perspective, poverty means more than the lack of what is necessary for material well-being.

For policy-makers, the poverty of choices and opportunities is often more relevant than the poverty of income. The poverty of choices focuses on the causes of poverty and leads directly to strategies of empowerment and other actions to enhance opportunities for everyone. Recognizing the poverty of choices and opportunities implies that poverty must be addressed in all its dimensions, not income alone.UNDP, "The Human Poverty Index (HPI)," *Human Development Reports*, accessed January 3, 2011, hdr.undp.org/en/statistics/indices/hpi.

Rather than measure poverty by income, the HPI is a composite index that uses indicators of the most basic dimensions of deprivation: a short life (longevity), a lack of basic education (knowledge), and a lack of access to public and private resources (decent standard of living). There are two different HPIs—one for developing countries (HPI-1) and another for a group of select high-income OECD (Organization for Economic and Development) countries (HPI-2), which better reflects the socioeconomic differences between the two groups. HPI-2 also includes a fourth indicator that measures social exclusion as represented by the rate of long-term unemployment.UNDP, "The Human Poverty Index (HPI)," *Human Development Reports*, accessed January 3, 2011, hdr.undp.org/en/statistics/indices/hpi.

Why Does All This Matter to Global Business?

So, the richest countries—like Liechtenstein, Qatar, and Luxembourg—may *not* always have big local markets or, in contrast, the poorest countries may *have* the largest local market as determined by the size of the local population. Savvy business managers need to compare and contrast a number of different classifications, statistics, and indicators before they can interpret the strength, depth, and extent of a local market opportunity for their particular industry and company.

The goal of this chapter is to review a sampling of countries in the developed, developing, and emerging markets to understand how economists and businesspeople perceive market opportunities. Of course, one chapter can't do justice to all of these markets, but through select examples, you'll see how countries have evolved in the post–World War II global economic, political, and social environments. Remember that the goal of any successful businessperson is to monitor the changing markets and spot opportunities and trends ahead of his or her peers.

Advice to Students

The major classifications used by analysts are evolving. The primary criteria for determining the stage of development may change within a decade as demonstrated with the addition of the gender and poverty indices. In addition, with every global crisis or event, there's a tendency to add more acronyms and statistics into the mix. Savvy global managers have to sort through these to determine what's relevant to their industry and their business objectives in one or more countries. For example, in the fall of 2010, after two years of global financial crisis, global investors started using a new acronym to describe the changing economic fortunes among countries: HIICs, or heavily indebted industrialized countries. These countries include the United States, the United Kingdom, and Japan. "'Developed markets are basically behaving like emerging markets,' says HSBC's Richard Yetsenga. 'And emerging markets are quickly becoming more developed.'"Kelly Evans, "'HIIC' Nations Are Acting Like Backwaters," *Wall Street Journal*, October 1, 2010, accessed January 3, 2011, http://online.wsj.com/article/SB10001424052748704789404575524402059410506.html. Investors are pulling money from the developed countries and into the BRIC countries (i.e., Brazil, Russia, India, and China), which are "'where the population growth is, where the raw materials are, and where the economic growth is,' says Michael Penn, global equity strategist at Bank of America Merrill Lynch."Kelly Evans, "'HIIC' Nations Are Acting Like Backwaters," *Wall Street Journal*, October 1, 2010, accessed January 3, 2011, http://online.wsj.com/article/SB10001424052748704789404575524402059410506.html. *The key here is to understand that classifications—just like countries and international business—are constantly evolving.*

Rather than being overwhelmed by the evolving data, it's critical to understand *why* the changes are occurring, *what* attitudes and perceptions are shifting, and *if* they are supported by real, verifiable data. In the above example of HIICs, investors from the major economies are likely motivated by quick gains on stock prices and the prevailing perception that emerging markets offer companies the best growth prospects. But as a businessperson, the timeline for your company would be in years, not months; so it's important to evaluate information based on your company's goals rather than relying on the media, investment markets, or other singularly focused industry professionals.

To truly monitor the global business arena and select prospective countries, you need to follow the news, trends, and available information for a period of time. Over time, savvy global managers develop a geographic, industrial, or product expertise—or some combination. Those who become experts on a specific country spend a great deal of time in the country, sometimes learn the language, and almost always develop an understanding of the country's political, economic, and social history as well as its culture and evolution. They gain a deeper knowledge of more than just the country's current business environment. In the business world, these folks are affectionately called "old hands"—as in he is an "old China hand" or an "old Indonesia hand." This is a reflection of how seasoned or experienced a person is with a country.

KEY TAKEAWAYS

- There are some classifications that are commonly used to define a stage of a country's development. The GDP is the value of all the goods and services produced by a country in a single year. The income per person, a better indicator of the strength of the local economy and the market opportunity for a new consumer product, is the nominal per capita GDP—the GDP divided by the population of the country. Finally, to compare production and income across countries, economists adjust this number to reflect the different costs of living in specific countries. PPP adjusts the exchange rate between countries to ensure that a good is purchased for the same price in the same currency.
- The HDI measures people's satisfaction in three key areas: (1) long and healthy life in terms of life expectancy; (2) access to quality education equally; and (3) a decent standard of living in the form of income. Health is measured by *life expectancy* at birth; knowledge is measured by a combination of the adult *literacy* rate and the combined primary, secondary, and tertiary gross enrollment ratio; and standard of living by *(income as measured by)* per capita GDP.
- Standards are constantly evolving to meet changing global scenarios; for instance, in 1997, the UNDP added the HPI to factor in the denial of basic opportunities and choices to those who live in poverty. It's critical to understand *why* the changes are occurring, *what* attitudes and perceptions are shifting, and *if* they are supported by real, verifiable data.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Describe the main criteria used to classify economies.
2. Select two countries on Figure 4.1 identifying GDP per person and research the local economy. Are your findings consistent with what you would expect based on the country rankings? What is the human development ranking for each country? In your opinion, are these rankings consistent with the GDP rankings?

3.3: Understanding the Developed World

Learning Objectives

1. Understand what the developed world is.
2. Identify the major developed economies.

The Developed World

Many people are quick to focus on the developing economies and emerging markets as offering the brightest growth prospects. And indeed, this is often the case. However, you shouldn't overlook the developed economies; they too can offer growth opportunities, depending on the specific product or service. The key is to understand what developed economies are and to determine their suitability for a company's strategy.

In essence, **developed economies**, also known as advanced economies, are characterized as postindustrial countries—typically with a high per capita income, competitive industries, transparent legal and regulatory environments, and well-developed commercial infrastructure. Developed countries also tend to have high human development index (HDI) rankings—long life expectancies, high-quality health care, equal access to education, and high incomes. In addition, these countries often have democratically elected governments.

In general, the developed world encompasses Canada, the United States, Western Europe, Japan, South Korea, Australia, and New Zealand. While these economies have moved from a manufacturing focus to a service orientation, they still have a solid manufacturing base. However, just because an economy is developed doesn't mean that it's among the largest economies. And, conversely, some of the world's largest economies—while growing rapidly—don't have competitive industries or transparent legal and regulatory environments. The infrastructure in these countries, while improving, isn't yet consistent or substantial enough to handle the full base of business and consumer demand. Countries like Brazil, Russia, India, and China—also known as BRIC—are hot emerging markets but are not yet considered developed by most widely accepted definitions. Section 4.4 covers the BRIC countries and other emerging markets.

The following sections contain a sampling of the largest developed countries that focuses on the business culture, economic environment, and economic structure of each country.The sections that follow are excerpted in part from two resources owned by author Sanjyot P. Dunung's firm, Atma Global: *CultureQuest Business Multimedia Series* and *bWise: Business Wisdom Worldwide*. The excerpts are reprinted with permission and attributed to the country-specific product when appropriate.

The United States

Geographically, the United States is the fourth-largest country in the world—after Russia, China, and Canada. It sits in the middle of North America, bordered to the north by Canada and to the south by Mexico. With a history steeped in democratic and capitalist institutions, values and entrepreneurship, the United States has been the driver of the global economy since World War II.

The US economy accounts for nearly 25 percent of the global gross domestic product (GDP). Recently, the severe economic crisis and recession have led to double-digit unemployment and record deficits. Nevertheless, the United States remains a global economic engine, with an economy that is about twice as large as that of the next single country, China. With an annual GDP of more than $14 trillion, only the entire European Union can match the US economy in size. An economist's proverb notes that when the US economy sneezes, the rest of the world catches a cold. Despite its massive wealth, 12 percent of the population lives below the poverty line.US Central Intelligence Agency, "North America: United States: Economy," *World Factbook*, accessed January 7, 2011, www.cia.gov/library/publications/the-world-factbook/geos/us.html.

Throughout the cycles of growth and contractions, the US economy has a history of bouncing back relatively quickly. In recessions, the government and the business community tend to respond swiftly with measures to reduce costs and encourage growth. Americans often speak in terms of bull and bear markets. A **bull market** is one in which prices rise for a prolonged period of time, while a **bear market** is one in which prices steadily drop in a downward cycle.

The strength of the US economy is due in large part to its diversity. Today, the United States has a service-based economy. In 2009, industry accounted for 21.9 percent of the GDP; services (including finance, insurance, and real estate) for 76.9 percent; and agriculture for 1.2 percent.US Central Intelligence Agency, "North America: United States: Economy," *World Factbook,* accessed January 7, 2011, www.cia.gov/library/publications/the-world-factbook/geos/us.html. Manufacturing is a smaller component of the economy; however, the United States remains a major global manufacturer. The largest manufacturing sectors are highly diversified and technologically advanced—petroleum, steel, motor vehicles, aerospace, telecommunications, chemicals, electronics, food processing, consumer goods, lumber, and mining.

The sectors that have grown the most in the past decades are financial services, car manufacturing, and, most important, information technology (IT), which has more than doubled its output in the past decade. It now accounts for nearly 10 percent of the country's GDP. As impressive as that figure is, it hardly takes into account the many ways in which IT has transformed the US economy. After all, improvements in information technology and telecommunications have increased the productivity of nearly every sector of the economy.

The United States is so big that its abundant natural resources account for only 4.3 percent of its GDP. Even so, it has the largest agricultural base in the world and is among the world's leading producers of petroleum and timber products. US farms produce about half the world's corn—though most of it is grown to feed beef and dairy cattle. The US imports about 30 percent of its oil, despite its own massive reserves. That's because Americans consume roughly a quarter of the world's total energy and more than half its oil, making them dependent on other oil-producing nations in some fairly troublesome ways.

The US retail and entertainment industries are very valuable to the economy. The country's media products, including movies and music, are the country's most visible exports. When it comes to business, the United States might well be called the "king of the jungle." Emboldened by a strong free-market economy, legions of US companies have achieved unparalleled success. One by-product of this competitive spirit is an abundance of secure, well-managed business partnerships at home and abroad. And although the majority of US companies aren't multinational giants, an emphasis on hard work and a sense of fair play pervade the business culture.

In a culture where entrepreneurialism is practically a national religion, the business landscape is broad and diverse. At one end are enduring multinationals, like Coca-Cola and General Electric, which were founded by visionary entrepreneurs and are now run by boards of directors and appointed managers who answer to shareholders. At the other end of the spectrum are small businesses—millions of them—many owned and operated by a single person.

Today, more companies than ever are "going global," fueled by an increased demand for varied products and services around the world. Expanding into new markets overseas—often through joint ventures and partnerships—is becoming a requirement for success in business.

Another trend that has gained much media attention is outsourcing—subcontracting work, sometimes to foreign companies. It's now quite common for companies of all sizes to pay outside firms to do their payroll, provide telecommunications support, and perform a range of operational services. This has led to a growth in small contractors, often operating out of their homes, who offer a variety of services, including advertising, public relations, and graphic design.*CultureQuest Business Multimedia Series: USA* (New York: Atma Global, 2010); *bWise: Business Wisdom Worldwide: USA* (New York: Atma Global, 2011).

European Union

Today, the European Union (EU) represents the monetary union of twenty-seven European countries. (Chapter 5, Section 5.2 reviews the history of the EU and the factors impacting its outlook.) One of the primary purposes of the EU was to create a single market for business and workers accompanied by a single currency, the euro. Internally, the EU has made strides toward abolishing trade barriers, has adopted a common currency, and is striving toward convergence of living standards. Internationally, the EU aims to bolster Europe's trade position and its political and economic power. Because of the great differences in per capita income among member states (i.e., from \$7,000 to \$79,000) and historic national animosities, the EU faces difficulties in devising and enforcing common policies. The EU's strengths also come from the formidable strengths of some of its economic powerhouse members. Germany is the leading economy in the EU.

Spotlight on Germany

Germany has the fifth-largest economy in the world, after the United States, China, Japan, and India. With a heavily export-oriented economy, the country is a leading exporter of machinery, vehicles, chemicals, and household equipment and benefits from a highly skilled labor force. It remains the largest and strongest economy in Europe and the second most-populous country after Russia in Europe.

The country has a socially responsible market economy that encourages competition and free initiative for the individual and for business. The *Grundgesetz* (Basic Law) guarantees private enterprise and private property, but stipulates that these rights must be exercised in the welfare and interest of the public.

Germany's economic development has been shaped, in large part, by its lack of natural resources, making it highly dependent on other countries. This may explain why the country has repeatedly sought to expand its power, particularly on its eastern flank.

Since the end of World War II, successive governments have sought to retain the basic elements of Germany's complex economic system (the *Soziale Marktwirtschaft*). Notably, relationships between employer and employee and between private industry and government have remained stable. Over the years, the country has had few industrial disputes. Furthermore, active participation by all groups in the economic decision making process has ensured a level of cooperation unknown in many other Western countries. Nevertheless, high unemployment and high fiscal deficits are key issues.

Overall, living standards are high, and Germany is a prosperous nation. The majority of Germans live in comfortable housing with modern amenities. The choice of available food is broad and includes cuisine from around the world. Germans enjoy luxury cars, and technology and fashion are big industries. Under federal law, workers are guaranteed minimum income, vacation time, and other benefits. Recently, the government has focused on economic reforms, particularly in the labor market, and tax reduction.

Germany is home to some of the world's most important businesses and industries. Daimler, Volkswagen, and BMW are global forces in the automotive field. Germany remains the fourth-largest auto manufacturer behind China, Japan, and the United States. German BASF, Hoechst, and Bayer are giants in the chemical industry. Siemens, a world leader in electronics, is the country's largest employer, while Bertelsmann is the largest publishing group in the world. In the banking industry, Deutsche Bank is one of the world's largest. In addition to these international giants, Germany has many small- and medium-sized, highly specialized firms. These businesses make up a disproportionately large part of Germany's exports.

Services drive the economy, representing 72.3 percent (in 2009) of the total GDP. Industry accounts for 26.8 percent of the economy, and agriculture represents 0.9 percent. Despite the strong services sector, manufacturing remains one of the most important components of the Germany economy. Key German manufacturing industries are among the world's largest and most technologically advanced producers of iron, steel, coal, cement, chemicals, machinery, vehicles, machine tools, electronics, food and beverages, shipbuilding, and textiles. Manufacturing provides not only significant sources of revenue but also the know-how that Germany exports around the world.*CultureQuest Business Multimedia Series: Germany* (New York: Atma Global, 2010); *bWise: Business Wisdom Worldwide: Germany* (New York: Atma Global, 2011).

Japan

Located off the east coast of Asia, the Japanese archipelago consists of four large islands—Honshu, Hokkaido, Kyushu, and Shikoku—and about four thousand small islands, which when combined are equal to the size of California.

The American occupation of Japan following World War II laid the foundation for today's modern economic and political society. The occupation was intended to demilitarize Japan, to fully democratize the government, and to reform Japanese society and the economy. The Americans revised the then-existing constitution along the lines of the British parliamentary model. The Japanese adopted the new constitution in 1946 as an amendment to their original 1889 constitution. On the whole, American reforms rebuilt Japanese industry and were welcomed by the Japanese. The American occupation ended in 1952, when Japan was declared an independent state.

As Japan became an industrial superpower in the 1950s and 1960s, other countries in Asia and the global superpowers began to expect Japan to participate in international aid and defense programs and in regional industrial-development programs. By the late 1960s, Japan had the third-largest economy in the world. However, Japan was no longer free from foreign influences. In one century, the country had gone from being relatively isolated to being dependent on the rest of the world for its resources with an economy reliant on trade.

In the post–World War II period, Japanese politics have not been characterized by sharp divisions between liberal and conservative elements, which in turn have provided enormous support for big business. The Liberal Democratic Party (LDP), created in 1955 as the result of a merger of two of the country's biggest political parties, has been in power for most of the postwar period. The LDP, a major proponent of big business, generally supports the conservative viewpoint. The "Iron Triangle," as it is often called, refers to the tight relationship among Japanese politicians, bureaucrats, and big business leaders.

Until recently, the overwhelming success of the economy overshadowed other policy issues. This is particularly evident with the once powerful Ministry of International Trade and Industry (MITI). For much of Japan's modern history, MITI has been responsible for establishing, coordinating, and regulating specific industry policies and targets, as well as having control over foreign trade interests. In 2001, its role was assumed by the newly created METI, the Ministry of Economy, Trade and Industry.

Japan’s post–World War II success has been the result of a well-crafted economic policy that is closely administered by the government in alliance with large businesses. Prior to World War II, giant corporate holding companies called *zaibatsu* worked in cooperation with the government to promote specific industries. At one time, the four largest zaibatsu organizations were Mitsui, Mitsubishi, Sumitomo, and Yasuda. Each of the four had significant holdings in the fields of banking, manufacturing, mining, shipping, and foreign marketing. Policies encouraged lifetime employment, employer paternalism, long-term relationships with suppliers, and minimal competition. Lifetime employment continues today, although it’s coming under pressure in the ongoing recession. This policy is often credited as being one of the stabilizing forces enabling Japanese companies to become global powerhouses.Sanjyot P. Dunung, *Doing Business in Asia: The Complete Guide*, 2nd ed. (New York: Jossey-Bass, 1998).

The zaibatsus were dismantled after World War II, but some of them reemerged as modern-day *keiretsu*, and many of their policies continue to have an effect on Japan. Keiretsu refers to the intricate web of financial and nonfinancial relationships between companies that virtually links together in a pattern of formal and informal cross-ownership and mutual obligation. The keiretsu nature of Japanese business has made it difficult for foreign companies to penetrate the commercial sector. In response to recent global economic challenges, the government and private businesses have recognized the need to restructure and deregulate parts of the economy, particularly in the financial sector. However, they have been slow to take action, further aggravating a weakened economy.

Japan has very few mineral and energy resources and relies heavily on imports to bring in almost all of its oil, iron ore, lead, wool, and cotton. It’s the world’s largest importer of numerous raw materials including coal, copper, zinc, and lumber. Despite a shortage of arable land, Japan has gone to great lengths to minimize its dependency on imported agricultural products and foodstuffs, such as grains and beef. Agriculture represents 1.6 percent of the economy. The country’s chief crops include rice and other grains, vegetables, and fruits. Japanese political and economic protectionist policies have ensured that the Japanese remain fully self-sufficient in rice production, which is their main staple.

As with other developed nations, services lead the economy, representing 76.5 percent of the national GDP.US Central Intelligence Agency, “East & Southeast Asia: Japan: Economy,” *World Factbook*, accessed January 4, 2011, www.cia.gov/library/publications/the-world-factbook/geos/ja.html. Industry accounts for 21.9 percent of the country’s output. Japan benefits from its highly skilled workforce. However, the high cost of labor combined with the cost of importing raw materials has significantly affected the global competitiveness of its industries. Japan excels in high-tech industries, particularly electronics and computers. Other key industries include automobiles, machinery, and chemicals. The service industry is beginning to expand and provide high-quality computer-related services, advertising, financial services, and other advanced business services.*CultureQuest Business Multimedia Series: Japan* (New York: Atma Global, 2010); *bWise: Business Wisdom Worldwide: Japan* (New York: Atma Global, 2011).

KEY TAKEAWAYS

- The developed economies, also known as advanced economies, are characterized as postindustrial countries—typically with a high per capita income, competitive industries, transparent legal and regulatory environments, and well-developed commercial infrastructure. Developed countries also tend to have high human development index (HDI) rankings (i.e., long life expectancies, high-quality health care, equal access to education, and high incomes). In addition, these countries often have democratically elected governments.
- The major developed economies include Canada, the United States, Western Europe, Japan, South Korea, Australia, and New Zealand.
- The United States is the fourth-largest country in the world—after Russia, China, and Canada. However, the United States is the world’s largest single-country economy and accounts for nearly 25 percent of the global gross domestic product (GDP). The strength of the US economy is due in large part to its diversity. Today, the United States has a service-based economy. In 2009, industry accounted for 21.9 percent of the GDP; services (including finance, insurance, and real estate) for 76.9 percent; and agriculture for 1.2 percent.
- Germany, a member of the EU (European Union), has the fifth-largest economy in the world. The country is a leading exporter of machinery, vehicles, chemicals, and household equipment and benefits from a highly skilled labor force. It is the largest and strongest economy in Europe. Services drive the economy, representing 72.3 percent (in 2009) of the total GDP. Industry accounts for 26.8 percent of the economy, and agriculture represents 0.9 percent.
- Japan’s post–World War II success has been the result of a well-crafted economic policy closely administered by the government in alliance with large businesses. It also benefits from its highly skilled workforce. Japan has very few mineral and energy resources and relies heavily on imports to bring in almost all of its oil, iron ore, lead, wool, and cotton. It is the world’s

largest importer of numerous raw materials including coal, copper, zinc, and lumber. As with other developed nations, services lead the economy, representing 76.5 percent of the national GDP, while industry accounts for 21.9 percent of the country's output.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Describe the main characteristics of developed economies.
2. Select one developed country. Utilize a combination of the *World Factbook* at www.cia.gov/library/publications/the-world-factbook/geos/xx.html and the HDI at http://hdr.undp.org/en/statistics/, and formulate an opinion of why you think the country is a developed country. Identify the country's per capita GDP and HDI ranking to assess its level of development.

3.4: Developing World

Learning Objectives

1. Understand what the developing world is.
2. Identify the major developing economies and regions.

The Developing World

The **developing world** refers to countries that rank lower on the various classifications from Section 4.1. The residents of these economies tend to have lower discretionary income to spend on nonessential goods (i.e., goods beyond food, housing, clothing, and other necessities). Many people, particularly those in developing countries, often find the classifications limiting or judgmental. The intent here is to focus on understanding the information that a global business professional will need to determine whether a country, including a developing country, offers an interesting local market. Some countries may perceive the classification as a slight; others view it as a benefit. For example, in global trade, being a developing country sometimes provides preferences and extra time to meet any requirements dismantling trade barriers.

[In the World Trade Organization (WTO), t]here are no WTO definitions of “developed” and “developing” countries. Members announce for themselves whether they are “developed” or “developing” countries. However, other members can challenge the decision of a member to make use of provisions available to developing countries.

Developing country status in the WTO brings certain rights. There are for example provisions in some WTO Agreements which provide developing countries with longer transition periods before they are required to fully implement the agreement and developing countries can receive technical assistance.

That a WTO member announces itself as a developing country does not automatically mean that it will benefit from the unilateral preference schemes of some of the developed country members such as the Generalized System of Preferences (GSP). In practice, it is the preference giving country which decides the list of developing countries that will benefit from the preferences.“Who Are the Developing Countries in the WTO?,” World Trade Organization, accessed January 5, 2011, http://www.wto.org/english/tratop_e/devel_e/d1who_e.htm.

Developing countries sometimes find that their economies improve and gradually they become emerging markets. (Section 4.4 discusses emerging markets.) Many developing economies represent old cultures and rich histories. Focusing only on today’s political, economic, and social conditions distorts the picture of what these countries have been and what they might become again. This category hosts the greatest number of countries around the world.

Did You Know?

It’s important to understand that the term *developing countries* is different from Third-World countries, which was a traditional classification for countries along political and economic lines. It helps to understand how this terminology has evolved.

When people talk about the poorest countries of the world, they often refer to them with the general term Third World, and they think everybody knows what they are talking about. But when you ask them if there is a Third World, what about a Second or a First World, you almost always get an evasive answer…

The use of the terms First, the Second, and the Third World is a rough, and it’s safe to say, outdated model of the geopolitical world from the time of the cold war.

There is no official definition of the first, second, and the third world. Below is OWNO’s [One World—Nations Online] explanation of the terms…

After World War II the world split into two large geopolitical blocs and spheres of influence with contrary views on government and the politically correct society:

1. The bloc of democratic-industrial countries within the American influence sphere, the “First World.”

2. The Eastern bloc of the communist-socialist states, the “Second World.”

3. The remaining three-quarters of the world’s population, states not aligned with either bloc were regarded as the “Third World.”

4. The term “Fourth World,” coined in the early 1970s by Shuswap Chief George Manuel, refers to widely unknown nations (cultural entities) of indigenous peoples, “First Nations” living within or across national state boundaries…

The term “First World” refers to so-called developed, *capitalist*, industrial countries, roughly, a bloc of countries aligned with the United States after World War II, with more or less common political and economic interests: North America, Western Europe, Japan and Australia.“Worlds within the World?,” One World—Nations Online, accessed January 5, 2011, www.nationsonline.org/oneworld/third_world_countries.htm.

Developing economies typically have poor, inadequate, or unequal access to infrastructure. The low personal incomes result in a high degree of poverty, as measured by the human poverty index (HPI) from Section 4.1. These countries, unlike the developed economies, don’t have mature and competitive industries. Rather, the economies usually rely heavily on one or more key industries—often related to commodities, like oil, minerals mining, or agriculture. Many of the developing countries today are in Africa, parts of Asia, the Middle East, parts of Latin America, and parts of Eastern Europe.

Developing countries can seem like an oxymoron in terms of technology. In daily life, high-tech capabilities in manufacturing coexist alongside antiquated methodologies. Technology has caused an evolution of change in just a decade or two. For example, twenty years ago, a passerby looking at the metal shanties on the sides of the streets of Mumbai, India, or Jakarta, Indonesia, would see abject poverty in terms of the living conditions; today, that same passerby peering inside the small huts would see the flicker of a computer screen and almost all the urban dwellers—in and around the shanties—sporting cell phones. Installing traditional telephone infrastructure was more costly and time-consuming for governments, and consumers opted for the faster and relatively cheaper option of cell phones.

Did You Know?

Gillette’s Innovative Razor Sales

Companies find innovative ways to sell to developing world markets. Procter & Gamble (P&G)’s latest innovation is a Gillette-brand eleven-cent blade. “Gillette commands about 70 percent of the world’s razor and blade sales, but it lags behind rivals in India and other developing markets, mainly because those consumers can’t afford to buy its flagship products.”Ellen Byron, “Gillette’s Latest Innovation in Razors: The 11-Cent Blade,” *Wall Street Journal*, October 1, 2010, accessed January 5, 2011, http://online.wsj.com/article/SB10001424052748704789404575524273890970954.html. The company has designed a basic blade, called the Gillette Guard, that isn’t available in the United States or other richer economies. The blade is designed for the developing world, with the goal of bringing “‘more consumers into Gillette,’ says Alberto Carvalho, P&G’s vice president of male grooming in emerging markets…Winning over low-income consumers in developing markets is crucial to the growth strategy….The need to grow in emerging markets is pushing P&G to change its product development strategy. In the past, P&G would sell basically the same premium Pampers diapers, Crest toothpaste, or Olay moisturizers in developing countries, where only the wealthiest consumers could afford them.”Ellen Byron, “Gillette’s Latest Innovation in Razors: The 11-Cent Blade,” *Wall Street Journal*, October 1, 2010, accessed January 5, 2011, http://online.wsj.com/article/SB10001424052748704789404575524273890970954.html. The company’s approach now is to determine what the consumers can afford in each country and adjust the product features to meet the target price.

Global companies also recognize that in many developing countries, the local government is the buyer—particularly for higher value-added products and services, such as high-tech items, equipment, and infrastructure development. In addition, companies assess the political and economic environment in order to evaluate the risks and opportunities for business in managing key government relationships. (For more information on international trade, see Chapter 2, Section 2.1 and Chapter 2, Section 2.2.) In much of Africa and the Middle East, where the economies rely on one or two key industries, the governments remain heavily involved in sourcing and awarding key contracts. The lack of competitive domestic industry and local transparency has also made these economies ripe for graft.The sections that follow are excerpted in part from two resources owned by author Sanjyot P. Dunung’s firm, Atma Global: *CultureQuest Business Multimedia Series* and *bWise: Business Wisdom Worldwide*. The excerpts are reprinted with permission and attributed to the country-specific product when appropriate.

Ethics in Action

Studies have shown that developing countries that are known to be rich in hydrocarbons [mainly oil] are plagued with corruption and environmental pollution. Paradoxically, most extractive resource-rich developing countries are found in the bottom third of the World Bank’s composite governance indicator rankings. Again, on the Transparency International Corruption Perception Index (CPI), 2007—most of the countries found at the bottom of the table are rich in mineral resources. This is indicative of high prevalence of corruption in these countries.Gilbert Sam, “Ghana’s Oil Find: Benefits and Nightmares,” *Daily Guide*, April 30, 2009, reprinted on Modern Ghana website, accessed January 5, 2011, www.modernghana.com/news/213863/1/ghanas-oil-find-benefits-and-nightmares.html.

Major Developing Economies and Regions

The Middle East

The Middle East presents an interesting challenge and opportunity for global businesses. Thanks in large part to the oil-dependent economies, some of these countries are quite wealthy. Figure 4.2 in Section 4.1 shows the per capita gross domestic product (GDP) adjusted for purchasing power parity (PPP) for select countries. Interestingly enough Qatar, Kuwait, United Arab Emirates (UAE), and Bahrain all rank in the top twenty-five. Only Saudi Arabia ranks much lower, due mainly to its larger population; however, it still has a per capita GDP (PPP) twice as high as the global average.

While the income level suggests a strong opportunity for global businesses, the inequality of access to goods and services, along with an inadequate and uncompetitive local economy, present both concerns and opportunities. Many of these countries are making efforts to shift from being an oil-dependent economy to a more service-based economy. Dubai, one of the seven emirates in the UAE, has sought to be the premier financial center for the Middle East. The financial crisis of 2008 has temporarily hampered, but not destroyed, these ambitions.

Spotlight on the UAE

Tucked into the southeastern edge of the Arabian Peninsula, the UAE borders Oman, Qatar, and Saudi Arabia. The UAE is a federation of seven states, called emirates because they are ruled by a local emir. The seven emirates are Abu Dhabi (capital), Dubai, Al-Shāriqah (or Sharjah), Ajmān, Umm al-Qaywayn, Ras'al-Khaymah, and Al-Fujayrah (or Fujairah). Dubai and Abu Dhabi have received the most global attention as commercial, financial, and cultural centers.

Amusing Anecdote

Dubai, the Las Vegas of the Middle East

Dubai is sometimes called the Vegas of the Middle East in reference to its glitzy malls, buildings, and consumerism culture. Luxury brands and excessive wealth dominate the culture as oil wealth is displayed brashly. Among other things, Dubai is home to Mall of the Emirates and its indoor alpine ski resort."About Mall of the Emirates," Mall of the Emirates, accessed January 5, 2011, www.malloftheemirates.com/MOE/En/MainMenu/AboutMOE/tabid/64/Default.aspx. Dubai also features aggressive architectural projects, including the spire-topped Burj Khalifa, which is the tallest skyscraper in the world, and the Palm Islands, which are man-made, palm-shaped, phased land-reclamation developments. Visionary proposals include the world's first underwater hotel, the Hydropolis. Dubai's tourism attracts visitors from its more religiously conservative neighbors such as Saudi Arabia as well as from countries in South Asia, primarily for its extensive shopping options. Dubai as well as other parts of the UAE hope to become major global-tourist destinations and have been building hotels, airports, attractions, shops, and infrastructure in order to facilitate this economic diversification goal.

The seven emirates merged in the early 1970s after more than a century of British control of their defense and military affairs. Thanks to its abundant oil reserves, the UAE has grown from an impoverished group of desert states to a wealthy regional commercial and financial center in just thirty years. Its oil reserves are ranked as the world's seventh-largest and the UAE possesses one of the most-developed economies in West Asia.US Central Intelligence Agency, "Country Comparison: Oil—Proved Reserves," *World Factbook*, accessed January 5, 2011, www.cia.gov/library/publications/the-world-factbook/rankorder/2178rank.html. It is the twenty-second-largest economy at market exchange rates and has a high per capita gross domestic product, with a nominal per capita GDP of US$49,995 as per the International Monetary Fund (IMF)."IMF Data Mapper," International Monetary Fund, accessed January 5, 2011, http://www.imf.org/external/datamapper/index.php. It is the second-largest in purchasing power per capita and has a relatively high human development index (HDI) for the Asian continent, ranking thirty-second globally.UNDP, "Human Development Index (HDI)—2010 Rankings," *Human Development Report 2010: The Real Wealth of Nations and Pathways to Human Development*, November 4, 2010, accessed January 5, 2011, http://hdr.undp.org/en/statistics. The UAE is classified as a high-income developing economy by the IMF.*Wikipedia*, s.v. "United Arab Emirates," last modified February 15, 2011, accessed February 16, 2011, http://en.Wikipedia.org/wiki/United_Arab_Emirates.

For more than three decades, oil and global finance drove the UAE's economy; however, in 2008–9, the confluence of falling oil prices, collapsing real estate prices, and the international banking crisis hit the UAE especially hard.US Central Intelligence

Agency, “Middle East: United Arab Emirates,” *World Factbook*, accessed January 5, 2011, www.cia.gov/library/publications/the-world-factbook/geos/ae.html.

Today, the country’s main industries are petroleum and petrochemicals (which account for a sizeable 25 percent of total GDP), fishing, aluminum, cement, fertilizers, commercial ship repair, construction materials, some boat building, handicrafts, and textiles. With the UAE’s intense investment in infrastructure and greening projects, the coastlines have been enhanced with large parks and gardens. Furthermore, the UAE has transformed offshore islands into agricultural projects that produce food.

A key issue for the UAE is the composition of its residents and workforce. The UAE is perhaps one of the few countries in the world where expatriates outnumber the local citizens, or nationals. In fact, of the total population of almost 5 million people, only 20 percent are citizens, and the workforce is composed of individuals from 202 different countries. As a result, the UAE is an incredible melting pot of cultural, linguistic, and religious groups. Migrant workers come mainly from the Indian subcontinent: India, Pakistan, Bangladesh, and Sri Lanka as well as from Indonesia, Malaysia, the Philippines, and other Arab nations. A much smaller number of skilled managers come from Europe, Australia, and North America. While technically the diverse population results in a higher level of religious diversity than neighboring Arab countries, the UAE is an Islamic country.

The UAE actively encourages foreign companies to open branches in the country, so it is quite common and easy for foreign corporations to do so. Free-trade zones allow for 100 percent foreign ownership and no taxes. Nevertheless, it’s common and in some industries required for many companies outside the free-trade zone to have an Emirati sponsor or partner.

While the UAE is generally open for global business, recently Research in Motion (RIM) found itself at odds with the UAE government, which wanted to block Blackberry access in the country. RIM uses a proprietary encryption technology to protect data and sends it to offshore servers in North America. For some countries, such as the UAE, this data encryption is perceived as a national security threat. Some governments want to be able to access the communications of people they consider high security threats. The UAE government and RIM were able to resolve this issue, and Blackberry service was not suspended.

Human rights concerns have forced the UAE government to address the rights of children, women, minorities, and guest workers with legal consistency, a process that is continuing to evolve. Today, the UAE is focused on reducing its dependence on oil and its reliance on foreign workers by diversifying its economy and creating more opportunities for nationals through improved education and increased private sector employment.*bWise: Business Wisdom Worldwide: U.A.E.* (New York: Atma Global, 2011).

Africa

For the past fifty years, Africa has been ignored in large part by most global businesses. Initial efforts that focused on access to minerals, commodities, and markets have given way to extensive local corruption, wars, and high political and economic risk.

When the emerging markets came into focus in the late 1980s, global business turned its attention to Asia. However, that’s changing as companies look for the next growth opportunity. “A growing number of companies from the U.S., China, Japan, and Britain are eager to tap the potential growth of a continent with 1 billion people—especially given the weak outlook in many developed nations….Meanwhile, African governments are luring investments from Chinese companies seeking to tap the world’s biggest deposits of platinum, chrome, and diamonds.”Renee Bonorchis, “Africa Is Looking Like a Dealmaker’s Paradise,” *BusinessWeek*, September 30, 2010, accessed January 5, 2011, http://www.businessweek.com/magazine/content/10_41/b4198020648051.htm.

Within the continent, local companies are starting to and expanding to compete with global companies. These homegrown firms have a sense of African solidarity.

Big obstacles for businesses remain. Weak infrastructure means higher energy costs and trouble moving goods between countries. Cumbersome trade tariffs deter investment in new African markets. And the majority of the people in African countries live well below the poverty line, limiting their spending power.

Yet many African companies are finding ways around these barriers. Nigerian fertilizer company, Notore Chemicals Ltd., for example, has gone straight to governments to pitch the benefits of improved regional trade, and recently established a distribution chain that the company hopes will stretch across the 20 nations of Francophone Africa.Will Connors and Sarah Childress, “Africa’s Local Champions Begin to Spread Out,” *Wall Street Journal*, May 26, 2010, accessed January 5, 2011, http://online.wsj.com/article/SB10001424052748704912004575252593400609032.html.

While the focus remains on South Africa, it’s only a matter of time until businesses shift their attention to other African nations. Political unrest, poverty, and corruption remain persistent challenges for the entire continent. A key factor in the continent’s success will be its ability to achieve political stability and calm the social unrest that has fueled regional civil conflicts.

Google in Africa

Africa has some of the lowest Internet access in the world, and yet Google has been attracted to the continent by its growth potential. Africa with its one billion people is an exciting growth market for many companies.

"The Internet is not an integral part of everyday life for people in Africa," said Joe Mucheru of Google's Kenya office…

[Yet] Google executives say Africa represents one of the fastest growth rates for Internet use in the world. Nigeria already has about 24 million users and South Africa and Kenya aren't far behind, according to World Bank and research sites like Internet World Stats…

Other technology companies have also set their sights on the continent. Microsoft Corp., International Business Machines Corp. [IBM], Cisco Systems Inc., and Hewlett-Packard Co. have sales offices throughout Africa, selling laptops, printers and software to fast-growing companies and an emerging middle class.Will Connors, "In Africa, Google Sows the Seeds for Future Growth," *Wall Street Journal*, May 15, 2010, accessed January 5, 2011, http://online.wsj.com/article/SB10001424052748704866204575223863572630700.html.

Infrastructure, oil, gas and technology firms are not the only businesses looking to Africa; the world of advertising has now set its sights on the continent, following their largest global corporate clients.

Advertising growth in Africa is soaring, driven by telecom companies, financial services firms and makers of consumer products…

"All of our major clients, as they are looking for geographical expansion opportunities, have Africa and the Middle East high up on their priority list, if not at the top," said Martin Sorrell, chief executive of WPP, the world's largest advertising company by revenue…

Nigeria, Angola, Kenya and Ghana have some of the highest growth potential, ad executives say….

And with so many languages and big cultural differences, crafting ads can be labor-intensive, marketing executives say. Ads in Nigeria, for example, need to be in five different languages to reach a large audience.

Africa and the Middle East together represent only about 2.9 percent, or around $14 billion, of the total $482.6 billion global ad market, according to market research firm, eMarketer.Ruth Bender and Suzanne Vranica, "Global Ad Agencies Flocking to Africa," *Wall Street Journal*, October 22, 2010, accessed January 5, 2011, http://online.wsj.com/article/SB10001424052702304741404575564193783950352.html.

This small percentage indicates the potential for significant advertising growth and a huge opportunity for global advertising and marketing firms.

Spotlight on Nigeria

Located in West Africa, Nigeria shares borders with the Republic of Benin, Chad, Cameroon, and Niger. Its southern coast lies on the Atlantic Ocean. Nigeria is Africa's most populous country and its second largest economy. Goldman Sachs included Nigeria in its listing of the "Next Eleven" emerging economies after the BRIC countries (Brazil, Russia, India and China).Jim O'Neill and Anna Stupnytska, "Global Economics Paper No. 192: The Long-Term Outlook for the BRICs and N-11 Post Crisis," accessed February 16, 2011, http://www2.goldmansachs.com/ideas/brics/long-term-outlook-doc.pdf.

Since its independence from the United Kingdom in 1960, Nigeria has seen civil war, ethnic tensions and violence, and military rule. Although recent elections have been marred by violence and accusations of voter fraud, Nigeria is technically experiencing its longest period of civilian government since its independence. However, Nigeria remains a fractious nation, divided along ethnic and religious lines.

As noted in the Ethics in Action sidebar in this section, developing country economies that are primarily dependent on oil have widespread government corruption. The Nigerian government continues to face the challenge of reforming a petroleum-based economy, whose revenues have been squandered through corruption and mismanagement, and institutionalizing the early efforts at democracy. "Oil-rich Nigeria, long hobbled by political instability, corruption, inadequate infrastructure, and poor macroeconomic management, has undertaken several reforms over the past decade. Nigeria's former military rulers failed to diversify the economy away from its overdependence on the capital-intensive oil sector, which provides 95 percent of foreign exchange earnings and about 80 percent of budgetary revenues."US Central Intelligence Agency, "Africa: Nigeria," *World Factbook*, accessed January 5, 2011, www.cia.gov/library/publications/the-world-factbook/geos/ni.html.

The economy of Nigeria is one of the largest in the world, with GDP (PPP) at $341 billion. However on a per capita basis, the country ranks at a dismal 183rd in the world, with a per capita GDP (PPP) at just $2,300. Seventy percent of its population remains below the poverty line, and the country ranks at 142nd on the human development index (HDI) rankings for 2010. Despite the low quality of life rankings for the country, Nigeria's population of more than 152 million make it an interesting long-term prospect for global businesses, particularly as economic conditions enable more Nigerians to achieve middle-income status.US Central Intelligence Agency, "Africa: Nigeria," *World Factbook*, accessed January 5, 2011, www.cia.gov/library/publications/the-world-factbook/geos/ni.html; UNDP, "Nigeria," *International Human Development Indicators 2010*, accessed January 5, 2011, hdrstats.undp.org/en/countries/profiles/NGA.html.

Nigeria's economy is about evenly split between agriculture (which accounts for 32.5 percent), industry at 33.8 percent, and services at 33.7 percent. The country's main industries are crude oil, coal, tin, columbite, rubber products, wood, hides and skins, textiles, cement and other construction materials, food products, footwear, chemicals, fertilizer, printing, ceramics, and steel.US Central Intelligence Agency, "Africa: Nigeria," *World Factbook*, accessed January 5, 2011, www.cia.gov/library/publications/the-world-factbook/geos/ni.html.

Nigeria received IMF funding in 2000 but pulled out of the program in 2002, when it failed to meet the economic reform requirements, specifically failing to meet spending and exchange rate targets. In recent years, the Nigerian government has begun showing the political will to implement the market-oriented reforms urged by the IMF, such as to modernize the banking system, to curb inflation by blocking excessive wage demands, and to resolve regional disputes over the distribution of earnings from the oil industry. The country's main issues remain government corruption, poverty, inadequate infrastructure, and ethnic violence, mainly over the oil producing Niger Delta region. Nevertheless, with continued economic and political reforms, the expanding economy and large potential domestic market will continue to attract global business attention to Nigeria.US Central Intelligence Agency, "Africa: Nigeria," *World Factbook*, accessed January 5, 2011, www.cia.gov/library/publications/the-world-factbook/geos/ni.html.

How Do Developing Countries Become Emerging Markets?

Section 4.4 focuses more closely on emerging markets. However, it's important to remember that all of the emerging-market countries were once considered developing nations. What resulted in the transition? Are today's developing countries turning into tomorrow's emerging markets? These are the questions that not only global economists and development experts ask, but—more relevantly—global businesses as well.

Typically, the factors that result in the classification of many countries as developing economies are the same ones that—once addressed and corrected—enable these countries to become emerging markets. As Chapter 2, Section 2.2 explains, countries that seek to implement transparency in the government as well as in the political and economic institutions help inspire business confidence in their countries. Developing the local commercial infrastructure and reducing trade barriers attract foreign businesses. Educating the population equally and creating a healthy domestic workforce that is both skilled and relatively cheap is another incentive for global business investment.

Unlike emerging markets, developing and underdeveloped countries still need special attention from international aid agencies to prevent starvation, mass disease and political instability. Developing countries need to improve their education systems and create a strategy to begin their transition to the global emerging market. Companies from developed and emerging markets should play an important role in this process. Companies from emerging markets are especially crucial, as they have a great deal of experience operating in conditions of non-developed economies.Vladimir Kvint, "Define Emerging Markets Now," *Forbes*, January 28, 2008, accessed January 5, 3011, http://www.forbes.com/2008/01/28/kvint-developing-countries-oped-cx_kv_0129kvint.html.

While developing countries comprise the largest category, it's important to remember that there are wide differences between the nations in this classification. If a company wants to stay ahead of the competition, it must be able to identify those countries ripe for development. Early entrance into these markets helps create **first-mover advantage** in terms of brand recognition, forging essential relationships with the government and the private sector, and harnessing any early-stage cost advantages. First-mover advantage refers the benefits that a company gains by entering into a market first or introducing a new product or service before its competitors.

Did You Know?

Mongolia Is Becoming Hot!

For most people, the country of Mongolia conjures images of a remote place near China—a movie location. It hasn't been at the forefront of anyone's attention for almost two decades, and yet the "IMF says that Mongolia will be one of the fastest-growing economies over the next decade."Charlie Rose, "Charlie Rose Talks to Mongolia's Prime Minister," *BusinessWeek*, September 30, 2010, accessed January 5, 2011, http://www.businessweek.com/magazine/content/10_41/b4198014855514.htm. This is a remarkable turnaround for a country that lost its Soviet assistance—one-third of its economy—in 1990 with the fall of the Soviet Union. Traditionally an agriculture-based economy, Mongolia is landlocked by its borders with China and Russia and is the approximately the size of Western Europe, with a relatively small population. However, its tremendous untapped mineral resources, which include coal, copper, molybdenum, fluorspar, tin, tungsten, gold, and oil, are attracting foreign investment. The country is a major exporter to China—its large, relatively rich neighbor. The country is exploring new resources as well; according to Prime Minister Sukhbaatar Batbold, "Wind power could be a major opportunity for Mongolia and for export to China."Charlie Rose, "Charlie Rose Talks to Mongolia's Prime Minister," *BusinessWeek*, September 30, 2010, accessed January 5, 2011, http://www.businessweek.com/magazine/content/10_41/b4198014855514.htm.

KEY TAKEAWAYS

- The developing world refers to countries that rank lower on the various classifications from Section 4.1. The residents of these economies tend to have lower discretionary income to spend on nonessential goods.
- The poorest countries of the world are often referred to as the Third World. However, the Third World is not synonymous with the developing world, instead it is part of an outdated model of the geopolitical world from the time of the Cold War. It encompasses three-quarters of the world's population and consists of the states that were not aligned with either the democratic-industrial bloc or the eastern, communist-socialist bloc.
- A developing country, in order to evolve into an emerging market, must (1) seek to implement transparency in its government as well as in its political and economic institutions to help inspire business confidence in its country, (2) develop the local commercial infrastructure and reduce trade barriers to attract foreign businesses, and (3) educate the population equally and create a healthy domestic workforce that's both skilled and relatively cheap.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Describe the main characteristics of developing economies.
2. Select one developing country. Utilize a combination of the *World Factbook* at www.cia.gov/library/publications/the-world-factbook/geos/xx.html and the HDI at http://hdr.undp.org/en/statistics/, and formulate an opinion of why you think the country is a developing country. Identify its per capita GDP and HDI ranking to assess its level of development.

3.5: Emerging Markets

Learning Objectives

1. Understand what the emerging markets and BRIC countries are.
2. Identify key emerging markets.

What Exactly Is an Emerging Market?

On September 18, 2008, the *Economist* argued that the term *emerging market* is dated.

Is it time to retire the phrase "emerging markets"? Many of the people interviewed for this special report think so. Surely South Korea, with sophisticated companies such as Samsung, has fully emerged by now. And China already has the world's fourth-largest economy. [*Note:* As of summer 2010, China has the world's second-largest economy.]

The term "emerging markets" dates back to 1981, recalls the man who invented it, Antoine van Agtmael. He was trying to start a "Third-World Equity Fund" to invest in developing-country shares, but his efforts to attract money were constantly rebuffed. "Racking my brain, at last I came up with a term that sounded more positive and invigorating: emerging markets. 'Third world' suggested stagnation; 'emerging markets' suggested progress, uplift and dynamism.""Ins and Outs: Acronyms BRIC Out All Over," *Economist*, September 18, 2008, accessed January 6, 2011, http://www.economist.com/node/12080703.

The 2008 article clearly articulates the challenge for global businesses, as well as analysts, who are trying to both define and understand the group of countries typically termed the emerging market. In a 2008 *Forbes* article, Vladimir Kvint, president of the International Academy of Emerging Markets, noted the following:

During the last 20 years, the global business world has gone through drastic, but mostly positive changes. In the 1980s, international business was essentially an exclusive club of the 20 richest countries. This changed as dictatorships and command economies collapsed throughout the world. Countries that once prohibited foreign investment from operating on their soil and were isolated from international cooperation are now part of the global marketplace.

I remember well when, in 1987, the first $80 million of foreign origin was allowed to be invested in the former Soviet Union. So-called "patriots" accused Mikhail Gorbachev of selling their motherland. Twenty years later, in 2007, Russia received about $43 billion of foreign direct investment, and emerging-market countries received about 40 percent of the $1.5 trillion FDI [foreign direct investment] worldwide.Vladimir Kvint, "Define Emerging Markets Now," *Forbes*, January 28, 2008, accessed January 5, 3011, http://www.forbes.com/2008/01/28/kvint-developing-countries-oped-cx_kv_0129kvint.html.

The definition of an **emerging market** is complex and inconsistent. As discussed in Section 4.1, there is a plethora of statistics and data available. The application and interpretation of this information varies depending on who is doing the analysis—a private sector business, the World Bank, the International Monetary Fund (IMF), the World Trade Organization (WTO), the United Nations (UN), or any number of global economic, political, and trade organizations. The varying statistics, in turn, produce a changing number of countries that "qualify" as emerging markets. For many businesspeople, the definition of an emerging market has been simply a country that was once a developing country but has achieved rapid economic growth, modernization, and industrialization. However, this approach can be limiting.

Knowing that there are wide inconsistencies, how do we define emerging markets consistently from the perspective of global businesses? First, understand that there are some common characteristics in terms of local population size, growth opportunities with changes in the local commercial infrastructure, regulatory and trade policies, efficiency improvements, and an overall investment in the education and well-being of the local population, which in turn is expected to increase local incomes and purchasing capabilities.

As a leading economic and strategic thinker in the area of emerging markets, Kvint concludes from his research that there are several major characteristics of emerging markets, which create "a comfortable and attractive environment for global business, foreign investment and international trade. Based on my study, an emerging market country can be defined as a society transitioning from a dictatorship to a free market-oriented economy, with increasing economic freedom, gradual integration within the global marketplace, an expanding middle class, improving standards of living and social stability and tolerance, as well as an increase in cooperation with multilateral institutions."Vladimir Kvint, "Define Emerging Markets Now," *Forbes*, January 28, 2008, accessed January 5, 3011, http://www.forbes.com/2008/01/28/kvint-developing-countries-oped-cx_kv_0129kvint.html.

In April 2010, the chief of HSBC, the largest bank in Europe, forecasted a change for the next ten years in which six new countries (the CIVETS: Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa) will replace the BRIC countries (Brazil, Russia, India and China) of the last decade:

"Each has a very bright future," HSBC CEO Michael Geoghegan said of the CIVETS, named after the cat-like animals found in some of the countries. "Each has large, young, growing population. Each has a diverse and dynamic economy. And each, in relative terms is politically stable."…

"Within three years, for the first time, the economic firepower of emerging markets will overtake the developed world, measured by purchasing power parity. It's a defining moment."

The size of the emerging market middle class will swell to 1.2 billion people by 2030, from 250 million in 2000, he said.

That bodes well for financial services, as households tend to open bank accounts and ask for other products when income reaches about $10,000, Geoghegan said.

"Many Chinese households are about to hit this level. They number about 33 million now. But they will quadruple to 155 million by 2014. In India, the change will also be dramatic," he said.Steven Slater, "After BRICs, Look to CIVETS for Growth—HSBC CEO," *Reuters*, April 27, 2010, accessed January 6, 2011, http://www.reuters.com/article/idUSLDE63Q26Q20100427.

In addition, to illustrate how experts debate the next group of emerging-market countries, the Goldman Sachs economist who created the term *BRIC* in 2001 in a report for the investment bank has added a new group, *MITSK*. A January article in the British *Financial Times* newspaper notes, "Jim O'Neill, who coined the term 'Bric', is about to redefine further emerging markets. The chairman of Goldman Sachs Asset Management (until end of 2010) plans to add Mexico, South Korea, Turkey and Indonesia into a new grouping with the Brics—Brazil, Russia, India and China—that he dubs 'growth markets. It's just pathetic to call these four "emerging markets."Jennifer Hughes, "'Bric' Creator Adds Newcomers to List," *Financial Times*, January 16, 2010, accessed January 5, 3011, http://www.ft.com/cms/s/0/f717c8e8-21be-11e0-9e3b-00144feab49a.html#ixzz1MKbbO8ET.

The *Financial Times* continues to note how the

Brics have frequently been dismissed as a marketing ploy. However, the nine-year-old term has spawned government summits, investment funds, business strategies and a host of countries keen to join. Adding that Mr O'Neill himself stated that the term "emerging markets" was no longer helpful because it encompassed countries with too great a range of economic prospects. Mexico and South Korea account for 1.6 per cent each of global GDP in nominal terms. Turkey and Indonesia are worth 1.2 and 1.1 per cent respectively. China is the world's second-largest economy, at 9.3 per cent of global GDP (the US is worth 23.6 per cent), while Brazil, India and Russia combined provide a further 8 per cent. O'Neill offers a new approach that will involve looking at fresh ways to measure exposure to equity markets beyond market capitalisation—for example, looking at gross domestic product, corporate revenue growth and the volatility of asset returns.Jennifer Hughes, "'Bric' Creator Adds Newcomers to List," *Financial Times*, January 16, 2010, accessed January 5, 3011, http://www.ft.com/cms/s/0/f717c8e8-21be-11e0-9e3b-00144feab49a.html#ixzz1MKbbO8ET.

These opinions and analyses by different economists are highlighted in this chapter to illustrate that the category of emerging markets is complex, evolving, and subject to wide interpretation. So how then do savvy global professionals sort through all of this information? Managers focus on the criteria for emerging markets in an effort to take advantage of newly emerging ones. While there are differing opinions on which countries are emerging, it's clear that global businesses are focused on the groups of countries offering strong domestic markets. Many of these emerging-market countries are also home to companies that are taking advantage of the improved business conditions there. These companies are becoming world-class global competitors in their industries. Regardless of which definition or classification is used, the largest emerging markets remain lucrative and promising.The sections that follow are excerpted in part from two resources owned by author Sanjyot P. Dunung's firm, Atma Global: *CultureQuest Business Multimedia Series* and *bWise: Business Wisdom Worldwide*. The excerpts are reprinted with permission and attributed to the country-specific product when appropriate. The discussion about Asia also draws heavily from the author's book *Doing Business in Asia: The Complete Guide*, 2nd ed. (New York: Jossey-Bass, 1998).

Key Emerging Markets

Asia

Spotlight on China

Located below Russia on the western seaboard of the Pacific Ocean, China is about as large as the continent of Europe and slightly larger than the United States. It is the third-largest country in the world after Russia and Canada.

For more than fifty years, China has had a centrally planned economy in which the state controlled most of the commercial activity. Under Mao Zedong's over forty-year leadership, the Chinese government kept a firm grip on the country's economic activity. That grip has been loosening since the 1980s as a result of Deng Xiaoping's reforms, which introduced some strong capitalist characteristics into China's centrally planned economy. Since the early 1980s, the Chinese economy has been in transition away from central planning and toward a market-driven economy. In today's model, market forces work in conjunction with state ownership and intervention. This system is commonly referred to as "a socialist market economy with Chinese characteristics." The government now realizes that it can't provide all the resources needed to fuel the economy by itself and that the private sector has a major role to play in providing investment—and jobs. Today, China's economy is caught between two opposing forces—a burgeoning market sector that is outgrowing government control and the inability of that market to function efficiently due to continued influence by the state on production and prices.

In 1979, China instituted economic reforms, established "special economic zones," and opened its economy to foreign investments and companies. This change in attitude brought remarkable changes to the socialist market economy, resulting in improved living standards and new social attitudes. As local provinces have benefited from foreign investment, particularly in the south, central economic control has weakened. Since 1978, industrial output has increased more than sixfold, in large part due to foreign manufacturers and investors who have established operations in China (usually as joint ventures with corporations owned or influenced by the Chinese government but also with some private-sector companies).

In many areas, China remains a predominantly agricultural society. Major crops include rice, barley, millet, tobacco, sweet potatoes, wheat, soybeans, cotton, tea, raw silk, rapeseed, corn, peanuts, watermelon, and sesame seed. Under the 1979 regulations, peasants were permitted to lease land for private farming and were allowed to sell for profit any surplus produce above the quota demanded by the state in the open market. There are still more collectives than family farms, but this is changing. Besides agriculture, the leading industries include textiles, machinery, cement, chemicals, communications and transportation equipment, building materials, and electronic machinery and equipment.

The results of these reforms have been spectacular—China's economy has grown an average of 9 percent per year over the last fifteen years and is now the second largest in the world. If it continues at this rate of expansion, some pundits predict China could eventually replace the United States in first place.

One of the most interesting facets of China's economic transition has been the rise of the middle class. Prior to the 1980s, there was only a small middle class, with most people occupying the lower echelons of the economic ladder. Now it's estimated that some 300 million Chinese have entered the middle-class cohort, fueling a huge increase in consumer spending.

In the 1990s, the seven-day workweek was progressively lowered to five days. With increased time off and longer national holidays, the average Chinese person now has more leisure time—and more time to spend money on consumer goods.

Take a look at some of China's major cities—particularly those along the eastern coast—and you'll see soaring skyscrapers, glitzy boutiques, luxury hotels, and expensive cars. There's a feeling of economic prosperity and high-powered consumerism. Apartment buildings aimed at the prosperous middle-class market are sprouting up all over China's major cities.

Travel just a few hundred miles from the cities, though, and you'll encounter farming scenes reminiscent of the early days of the twentieth century. The economic disparity between the urban rich and the rural poor and all its accompanying problems are likely to continue for the foreseeable future.

With a burgeoning market sector that's outgrowing government control, China is now at the crossroads of reform. Yet despite the high growth rates, enormous challenges remain, including marked regional inequality, an entrenched and at times inflexible bureaucracy, high unemployment, a large floating population, and environmental degradation. Most commentators agree that the country has recognized the complex issues facing its economic future and is now ready to address them.

The growth of China's telecommunications industry is outstripping expectations. The number of mobile-phone subscribers, for example, has grown from 1 million in 1994 to around 700 million in 2009.Wang Xing, "Battle Begins over 3G Market," *China Daily*, October 19, 2009, accessed May 17, 2011, http://www.chinadaily.com.cn/business/2009-10/19/content_8808873.htm. But the industry's expansion hasn't automatically led to large profits. The growth has been fueled by an increase in competition, putting downward pressure on prices. In fact, a 2009 *China Daily* article claims that China's telecom market the biggest battlefield in the world.Wang Xing, "Battle Begins over 3G Market," *China Daily*, October 19, 2009, accessed May 17, 2011, http://www.chinadaily.com.cn/business/2009-10/19/content_8808873.htm.

Internet use is also expanding rapidly, although its spread is hindered by the government's attempts to regulate the sector and control access as evidenced in the case between the government and Google in the spring of 2010, as discussed in the case study in Chapter 1. Keeping up with the newest technology in the areas of delivery networks, broadband access, payment procedures, and security has created enormous opportunities. The government has made extensive efforts to invest in infrastructure and emerging technologies.

In 2009, agriculture accounted for an estimated 10.6 percent of China's gross domestic product (GDP), industry represented 46.8 percent, and services totaled 42.6 percent. Apart from agriculture, China's leading industries include "mining and ore processing of iron, steel, aluminum, and other metals, coal; machine building; armaments; textiles and apparel; petroleum; cement; chemicals; fertilizers; consumer products, including footwear, toys, and electronics; food processing; transportation equipment, including automobiles, rail cars and locomotives, ships, and aircraft; telecommunications equipment; commercial space launch vehicles; and satellites."US Central Intelligence Agency, "East & Southeast Asia: China," *World Factbook*, accessed January 6, 2011, www.cia.gov/library/publications/the-world-factbook/geos/ch.html. The production of consumer goods is now one of the fastest-growing sectors in the economy. Once a source of cheap consumer electronics for the West, China is now producing those items for its own rapidly expanding internal market.

Chinese economic statistics must still be regarded with a degree of skepticism. Often it's unclear where the numbers have originated or how they have been derived. Still, there's no doubt that phenomenal growth is taking place, and there are pressures for a more transparent economic reporting system.

In the past, China didn't see the environment as an issue in its race to industrialize. Now, there is an increasing sense of environmental awareness. "China is changing from the factory of the world to the clean-tech laboratory of the world. It has the unique ability to pit low-cost capital with large-scale experiments to find models that work."Thomas L. Friedman, "World, Not U.S., Takes Lead with Green Technology," *Post-Bulletin*, September 21, 2010, accessed January 6, 2011, www.postbulletin.com/newsmanager/templates/localnews_story.asp?z=12&a=470550.

Government attention and foreign investment have been focused on further developing the country's inadequate infrastructure, including roads, railways, seaports, communications systems, and power generation. Industrial capability, in both light and heavy industries, has also improved. China is a vast country rich in natural resources, including coal, oil, gas, various metals, ores, and minerals.

The largest Chinese companies are those that have capitalized on China's natural strengths and have state backing or are state-run. For example, PetroChina is the country's largest oil and gas producer and distributor. PetroChina is the listed arm of state-owned China National Petroleum Corporation (CNPC). It is one of the world's largest oil producers and is the world's most valuable company by market value as of 2010, exceeding a trillion-dollar market capitalization. China's largest companies have benefited from this combination of government support through access to capital and markets along with private-sector efficiencies. For more on Chinese companies in Africa, see the case study in Chapter 2.

China joined the WTO in December 2001, and it will likely be drawn even more into the global economy as companies continue to vie for access to its 1.3 billion consumers and cheap and productive labor pool. Most companies expect that dealing with China will now become more straightforward, if not easier. Whatever the future brings, the Chinese economy continues to be a powerhouse of growth and opportunity. *CultureQuest Business Multimedia Series: China* (New York: Atma Global, 2010); *bWise: Business Wisdom Worldwide: China* (New York: Atma Global, 2011).

Spotlight on India

India is officially called the Republic of India and is also known as Hindustan or Bharat. As the seventh-largest country in the world, India spans 1.267 million square miles; it's about one-third the size of the United States. India shares borders in the northwest with Pakistan; in the north with China, Bhutan, and Nepal; and in the east with Bangladesh and Myanmar (Burma). The Indian territory also extends to the Andaman and Nicobar Islands in the Bay of Bengal as well as to Lakshadweep in the Arabian Sea.

Prior to the mid-1980s, the country pursued a policy of socialism with the state planning and controlling many sectors of the economy. Foreign investment had been discouraged except in the area of technology transfers. Since the early 1990s, India has embarked on an economic liberalization scheme that has proven beneficial to the country.

In 1991, India was on the brink of defaulting on its foreign debt. The government responded with a series of successful measures to initiate widespread economic reforms, including reducing export and import barriers, dismantling some of its swollen bureaucracy, making the currency partially convertible, and eliminating the black market for foreign currency and gold. Efforts were also made to privatize or increase the efficiencies of unprofitable state companies. Finance Minister Manmohan Singh (who later became prime minister) was successful in beginning to dismantle the "License Raj," an intricate system of government economic control through permits and quotas. Various policies initiated by the government provided a larger role for the private sector and encouraged foreign investment. As a result, investment increased, though at much lower levels than in other Asian countries.

Since the 1990s, central government intervention, licensing, and regulation have decreased, as have bureaucratic inefficiencies. India boasts an established free-market system; a sophisticated industrial and manufacturing base; and a huge pool of skilled, low-to-moderate-cost workers, including professional managers. Economic gains, particularly as a result of further integration into the global economy, have provided improved the standard of living for all communities. The country's 2.1 percent annual population growth ensures that its population will surpass China's within the next decade and remains a significant problem for the government, as limited resources threaten the distribution of economic reform benefits.

The country is rich in natural resources, such as rubber, timber, chromium, coal, iron, manganese, copper ore, petroleum, bauxite, titanium, mica salt, limestone, and gypsum. The country is one of the world's leading producers of iron ore, and coal accounts for nearly 40 percent of all mined minerals. India also has reserves of natural gas and oil, but it remains a net importer of crude oil because its domestic generation is insufficient to meet demand. In addition, India has deposits of precious stones, including diamonds, emeralds, gold, and silver. Cut diamonds are one of India's biggest exports.

Agriculture remains an important economic sector, contributing roughly 17 percent of the country's GDP and employing almost 52 percent of the workforce. Major crops include rice, wheat, pulses, sugarcane, cotton, jute, oilseeds, tea, coffee, tobacco, onions, and potatoes. Other important agricultural interests include dairy products, sheep, goats, poultry, and fish.

Until the mid-1960s, India imported much of its food. The Green Revolution focused on improving farming techniques, increasing mechanization, and irrigating as well as introducing high-yielding seeds. All of these have increased agricultural production and made the country self-sufficient in food production. The government also provides incentives to farmers to expand production. Most of India's farms tend to be small and provide subsistence for the families that operate them. They aren't geared for commercial purposes. Northern fertile areas, such as those in the state of Punjab, account for much of the export production.

While India has more cattle than any other country, it isn't farmed for food consumption as Hindus are not supposed to eat beef. The animals are used for a variety of other purposes, including plowing land, producing milk for dairy products, and supplying leather.

The growth of Indian industry, which accounts for about 28.2 percent of its GDP and 14 percent of employment, has resulted in widespread improvements and diversity in the country's manufacturing base. The major manufacturing industries include cotton and jute textiles; iron, steel, and other basic metals; petrochemicals; electrical machinery and appliances; transport equipment; chemicals; cement; fertilizers; software; medicines and pharmaceuticals; and food products. The power, electronics, food processing, software, transportation equipment, and telecommunications industries are developing rapidly. The financial sector, including banking and insurance, is well developed, although efforts to modernize it are underway.

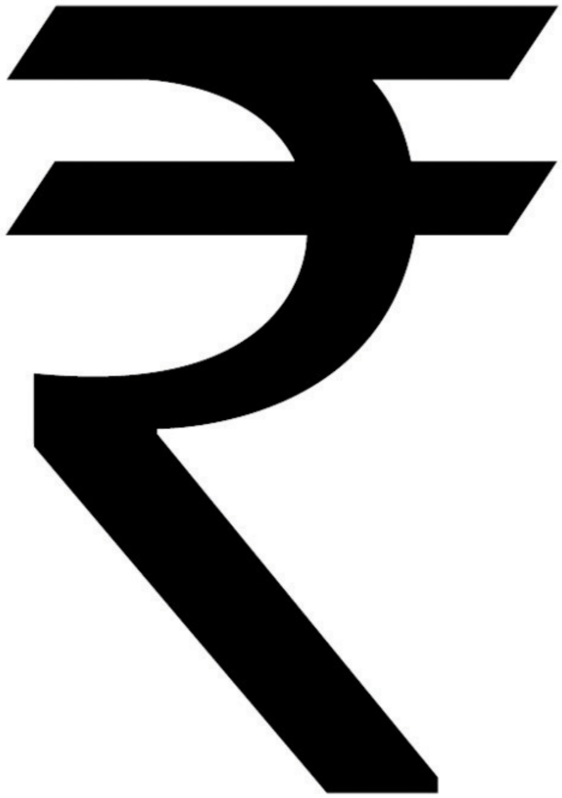
State-run entities continue to control some areas of telecommunications, banking, insurance, public utilities, and defense, as well as the production of minerals, steel, other metals, coal, natural gas, and petroleum. There have been some steps taken to shift more control to the private sector, although on a gradual and closely monitored scale.

Services account for 54.9 percent of the GDP, but employ only 34 percent of the workforce. The most dramatic change in the economy has come from the computer-programming industry, as companies around the world have turned to India for outsourcing. With its skilled, relatively cheap, and English-speaking professional workforce, India has received a much-needed boost in the form of investment and foreign earnings. This is expected to have continued significant impact on the economy, business environment, and the social values and expectations of the Indian population.

India's technology firms have gained global recognition. One of the best known is Infosys. Founded in 1981 by seven Indian entrepreneurs, Infosys today is a NASDAQ-listed global consulting and information technology services company—with $5.4 billion in revenues. Throughout twenty-nine years of growth, Infosys, in addition to other well-managed Indian companies, has been well positioned to take advantage of the Indian government's efforts at economic liberalization that began in the early 1990s. Under this program, the government has systematically reduced trade barriers and embraced globalization. These changes have led to India's emergence as the global destination for software services talent.*CultureQuest Business Multimedia Series: India* (New York: Atma Global, 2010); *bWise: Business Wisdom Worldwide: India* (New York: Atma Global, 2011).

Amusing Anecdote

India's Currency Gets a Visible Promotion



A clear sign of a currency's importance is its symbol. All of the major global economies' currencies (e.g., the dollar, pound , euro, and yen) have one. In July 2010, the Indian government announced that there was a new symbol for the rupee. Not yet available on keyboards or any electronic devices, the symbol will replace the often-used Rs. "The symbol is a matter of national pride, underscoring 'the robustness of the Indian economy,' said Ambika Soni, India's Information Minister" to the *New York Times*."The Rupee Gets Its Own Mark," *New York Times*, July 18, 2010, accessed January 6, 2011, www.nytimes.com/2010/07/18/weekinreview/18grist.html#.

Europe

Spotlight on Russia

Russia is the largest country in the world, stretching across two continents and eleven time zones. Eleven seas and two oceans wash the banks of this 6.6 million square mile territory. The south and southeast of the country are covered with mountains, and the central part is a plain, furrowed with rivers. Around 7,000 lakes spread over the western part of Russia. The border between Europe and Asia runs down the west side of the Ural Mountains, about 807 miles east of Moscow.

Anyone looking to do business in Russia today needs to comprehend the array of changes that have impacted the nation over the past three decades. Rising to power in the 1980s, General Secretary Mikhail Gorbachev was the first leader to end repressive political controls and to suffer nationalist movements in the constituent republics. Gorbachev set the forces in action that would overturn the Communist regime and seal his own expulsion. He relaxed government control on the media and the Russian culture, implementing a policy of *glasnost*, or openness and candor. Gorbachev also sought *perestroika* (i.e., restructuring) of the economy and political system that preserved some of the more positive elements of socialism. Gorbachev gained international fame as the head of the Soviet bloc who helped put an end to the Cold War. To reach a common understanding, Gorbachev met repeatedly with US Presidents Ronald Reagan and George Bush, helping broker arms-reduction agreements.

During Gorbachev's term, Communist regimes began to fall all over Eastern Europe. In an abrupt departure from previous Soviet policy, Gorbachev refused to intervene. The Berlin Wall fell in 1989, and Gorbachev did nothing to stop it. Sensing weakness, republic parliaments all over the Soviet bloc asserted their sovereignty; a few even went so far as to assert complete independence. In 1991, when Gorbachev attempted to negotiate with the republics, alarmed Soviet leaders attempted a coup. The coup failed, but Gorbachev had lost his political cache to rival Boris Yeltsin, who succeeded Gorbachev as the hero of the era. This changed political, economic, and military dynamics around the world.

While the changes Gorbachev implemented did little to develop the Soviet Union's struggling economy, he did overhaul Soviet elections by reintroducing multiparty elections in 1989. This essentially invited political dissidents and reform-minded leaders into the parliament. These individuals soon began to challenge Gorbachev's leadership, pushing him to implement more changes. In 1991, Gorbachev conceded to their demands and installed their leader, Boris Yeltsin, as the president of Russia.

The economic and political challenges the newly independent country faced were considerable. The inefficiency of the Soviet government had left its stamp on every area of the economy. Russia's industries had to update their technology, retrain their workers, and cut back their workforces. Russians were largely unfamiliar with Western ways of doing business and found it difficult to make the changes mandated by capitalism. Unemployment soared, and the plight of most Russians grew increasingly desperate.

In this climate of desperation, Yeltsin's government instituted a so-called shock therapy program intended to galvanize the economy by reducing barriers to free trade. These policies, while well intentioned, produced sweeping inflation that almost completely devalued Russian currency. Western newspapers were plastered with images of Russians waiting in long lines, carrying bags of devalued bills. In an attempt to address the crisis, the government introduced a privatization program, which resulted in rampant cronyism and theft of state property.

While the government encouraged the emergence of small businesses and the already-flourishing black-market trade was finally legitimatized, small businesses faced many obstacles inadvertently caused by the government's inefficiency. The tax system was so disorganized that the government couldn't obtain the funds necessary to sustain adequate police or military forces. Health care and other basic welfare systems collapsed, and organized crime forced small businesses to make regular payoffs.

As quality of life took a precipitous drop for the majority of the Russian population, the gap between the rich and poor broadened dramatically. But crime lords weren't the only ones profiting from the gap, the privatization of government assets enabled a few well-placed individuals to turn those assets into their private property. The **nouveau riche**, as this class of Russians was called, tended to be ostentatious, and the construction of elaborate mansions at a time when ordinary Russians were suffering, outraged the citizens' sense of justice.

Since 1991, Russia has struggled to establish a market economy. The country "has undergone significant changes since the collapse of the Soviet Union, moving from a globally-isolated, centrally-planned economy to a more market-based and globally-integrated economy."US Central Intelligence Agency, "Central Asia: Russia," *World Factbook*, accessed January 6, 2011, www.cia.gov/library/publications/the-world-factbook/geos/rs.html. Today, Russia has shifted back to a more centralized, semi-authoritarian state. "Economic reforms in the 1990s privatized most industry, with notable exceptions in the energy and defense-related sectors. Nonetheless, the rapid privatization process, including a much criticized 'loans-for-shares' scheme that turned over major state-owned firms to politically-connected 'oligarchs', has left equity ownership highly concentrated."US Central Intelligence Agency, "Central Asia: Russia," *World Factbook*, accessed January 6, 2011, www.cia.gov/library/publications/the-world-factbook/geos/rs.html. Corruption remains a challenge for businesses operating in Russia. New business legislation, including a commercial code and the establishment of an arbitration court to resolve business disputes, has passed. However, the "protection of property rights is still weak and the private sector remains subject to heavy state interference."US Central Intelligence Agency, "Central Asia: Russia," *World Factbook*, accessed January 6, 2011, www.cia.gov/library/publications/the-world-factbook/geos/rs.html. However, the system continues to evolve. Additionally, global economic conditions have impacted the value of the ruble and the status of the country's international debts.*CultureQuest Business Multimedia Series: Russia* (New York: Atma Global, 2010); *bWise: Business Wisdom Worldwide: Russia* (New York: Atma Global, 2011).

Russian industry is primarily split between globally competitive commodity producers—in 2009 Russia was the world's largest exporter of natural gas, the second largest exporter of oil, and the third largest exporter of steel and primary aluminum—and other less competitive heavy industries that remain dependent on the Russian domestic market. This reliance on commodity exports makes Russia vulnerable to boom and bust cycles that follow the highly volatile swings in global commodity prices. The government since 2007 has embarked on an ambitious program to reduce this dependency and build up the country's high-technology sectors but with few results so far. A revival of Russian agriculture in recent years has led to Russia shifting from being a net grain **importer** to a net grain exporter. Russia has a highly industrialized and agrarian economy. Almost ten million people are engaged in the agriculture industry. Along with its vast spaces, Russia has always been known for its amazing resources. The country produces 30 percent of the world's nonferrous, rare, and noble metals; 17 percent of the world's crude oil; 30 percent of natural gas; and it holds 40 percent of the world's known natural gas deposits. Today, agriculture accounts for 4.7 percent of the economy, industry represents 34.8 percent, and services total 60.5 percent (based on a 2009 estimate).US Central Intelligence Agency, "Central Asia: Russia," *World Factbook*, accessed January 6, 2011, www.cia.gov/library/publications/the-world-factbook/geos/rs.html.

Did You Know?

Russia, the Summer of 2010 Drought, and Wheat: Understanding the Domino Effect on Countries and Business

Think global business is all about leading-edge, high-tech gadgets, consumer products, or industrial manufacturing items? Think again. Since the early days of ancient trade, commodities, such as wheat, corn, spices, rice, and cotton, have been the primary objects of trade. Even today, wheat and corn, the most basic of foodstuffs across all cultures, can still make governments and economies—developed, developing, and emerging—quiver as a result of natural and unnatural disruptions to their marketplaces. Recently, in the summer of 2010, Russia experienced a crippling drought that led to a four-month ban on all grain exports. "Russia has become an increasingly important force in the global supply of grains and the move reignited fears that nervous governments would begin hoarding their own supplies, potentially causing a shortage….Countries such as Egypt, the world's number one importer of wheat, which had bought Russian wheat, now must consider other options."Liam Pleven, Gregory Zuckerman, and Scott Kilman, "Russian Export Ban Raises Global Food Fears," *Wall Street Journal*, August 6, 2010, accessed January 6, 2011, http://online.wsj.com/article/SB10001424052748703748904575410740617512592.html. Russia provided almost 15 percent of the world's wheat supply for global exports from the 2009–10 crop. As a result of the ban, many global packaged-foods companies, including Swiss giants, Migros-Genossenschafts-Bund and Coop Schweiz, and British-based Premier Foods, considered possible price increases as a result of the wheat ban.Liam Pleven, Gregory Zuckerman, and Scott Kilman, "Russian Export Ban Raises Global Food Fears," *Wall Street Journal*, August 6, 2010, accessed January 6, 2011, http://online.wsj.com/article/SB10001424052748703748904575410740617512592.html.

Like China, Russia's largest companies are either state-run or have state backing, providing the government with access to resources, capital, and markets. Business analysts and investors are eager for the government to privatize more of the largest firms. "The Economic Development Ministry said in July [of 2010] that the privatization list for 2011–2013 included oil pipeline monopoly Transneft, Russia's largest shipping company Sovcomflot, oil major Rosneft, the country's largest banks Sberbank and VTB, the Federal Grid Company of Unified Energy System, the Russian Agricultural Bank, hydropower holding company RusHydro and other assets.""Russia Unlikely to Privatize Largest Companies in 2010," RIA Novosti, August 30, 2010, accessed January 6, 2011, http://en.rian.ru/business/20100830/160394304.html.

RUSAL is one of Russia's largest privately held companies. Headquartered in Moscow, RUSAL is the world's largest aluminum company and accounts for almost 11 percent of the world's primary aluminum output and 13 percent of the world's alumina production. The company has aggressively used a strategy of global mergers and acquisition to grow its operations, which now cover nineteen countries and five continents. To raise capital, the company listed on the Hong Kong Stock Exchange in 2010."Who We Are," RUSAL, accessed May 18, 2011, rusal.ru/en/about.aspx.

Africa

Spotlight on South Africa

South Africa makes up the southern portion of the continent of Africa, from the Atlantic Ocean in the west to the Indian Ocean in the east. With a total land area of 750,000 miles, including the Prince Edward Islands, the country is the twenty-seventh largest in the world, or approximately the same size as France, Spain, and Portugal combined.

Initially a refueling station for Dutch sailors traveling to the East, South Africa gradually developed an agricultural sector, based on fruit, wine, and livestock production, along the coast of the Cape of Good Hope. All of this changed dramatically with the discovery of minerals in the late nineteenth century. Subsequently, the country emerged as the leading manufacturing and industrial economy on the African continent.

Surging prices for gold and the high demand for base metals and other mineral products propelled the country's economy after World War II. South Africa was fortunate to have this strong economic base when international sanctions were applied in the 1970s and 1980s.

Nonetheless, import substitution and sanction busting were necessary for economic survival, and the country as a whole became increasingly isolated. A handful of massive corporations controlled most of the country's wealth and provided the majority of goods and services. The national government controlled those sectors of the economy seen as critical to the national interest of the apartheid state, including transportation, telecommunications, and the media.

South Africa practiced legal racial segregation, under the **apartheid system**. In the 1970s, worldwide disapproval of apartheid led to economic sanctions against South Africa. An international oil embargo was imposed in 1974, and the country was suspended from participating in the United Nations. "Disinvestment (or divestment) from South Africa was first advocated in the 1960s, in protest of South Africa's system of Apartheid, but was not implemented on a significant scale until the mid-1980s. The disinvestment campaign…is credited as pressuring the South African Government to embark on negotiations ultimately leading to the dismantling of the apartheid system."*Wikipedia*, s.v. "Disinvestment from South Africa," last modified February 13, 2011, accessed February 16, 2011, http://en.Wikipedia.org/wiki/Disinvestment_from_South_Africa.

During the 1980s, there was global political and economic isolation. Many global investment firms pulled out of South Africa as a result of the public outcry and investor pressures against apartheid. While global firms, such as PepsiCo, Coca-Cola, IBM, ExxonMobil, and others, didn't leave South Africa, they endured public boycotts and protests in their home countries. The moral arguments against apartheid eventually won. After F. W. de Klerk was elected president in 1989, change was immediate. Political prisoners were released, and a national debate was initiated on the future of the country. The ban was lifted on the African National Congress (ANC), and in February 1990, Nelson Mandela was released from prison after twenty-seven years behind bars. He was elected president in 1994, and to further unite the country, de Klerk agreed to serve as deputy president in his administration.

Following the 1994 election, South Africa's period as an international outcast came to a swift end. The country was readmitted into the United Nations, and sanctions were lifted. For the first time South Africans could travel freely, had a free press, and participated in truly democratic institutions. Global businesses could once again do business with South Africa without fear of investor or public backlash.

South Africa has emerged as a free-market economy with an active private sector. The country strives to develop a prosperous and balanced regional economy that can compete in global markets. As an emerging-market country, South Africa relies heavily on industrial imports and capital. Specialty minerals and metals, machinery, transport equipment, and chemicals are important import sectors.

Minerals and energy are central to South Africa's economic activity, and manufacturing, the country's largest industry, is still based to a large extent on mining. South Africa receives more foreign currency for its gold than for any other single item, although it exports other minerals including platinum, diamonds, coal, chrome, manganese, and iron ore. It is the world's largest producer of platinum, gold, and chromium. Agricultural products, such as fruit, wool, hides, corn, wheat, sugarcane, fruits, vegetables, beef, poultry, mutton, dairy products, and grains, account for 3 percent of its GDP.

Today, industry accounts for 31 percent of the country's GDP, focusing on mining and automobile assembly, metalworking, machinery, textiles, iron and steel, chemicals, fertilizer, foodstuffs, and commercial ship repair.

During the years of apartheid, the economy of South Africa stagnated and appeared directionless. That changed after the election of the Government of National Unity in 1994. The postapartheid government has clear priorities, including economic growth, job creation, and inequality reduction.

Under apartheid, large conglomerates achieved near-cartel status and stifled competition. In many instances, this occurred with tacit government approval, and many promising small companies were bought or forced out of the market by financial muscle. The overall effect was a blunting of innovation and growth throughout the country. Since the end of apartheid, the government has made significant strides in promoting small-business development, in part by offering large corporations incentives to donate funds to small companies.

With the growth of their international market, South African businesses are expanding their focus outward. Companies such as Anglo American and South African Breweries (SAB) are listed on the London Stock Exchange, and Sappi (formerly South African Pulp and Paper Industries), a giant paper concern, has invested in the US market.

As part of its effort to improve South Africa's business climate, the government has made a strong commitment to privatization. To date, it has sold parts of South African Airways and Telkom (the former telecommunications monopoly), as well as other companies. The government is also offering incentives to overseas companies to partner with disadvantaged community-owned South African enterprises and requires businesses with government contracts to make contributions to social programs.

Since the end of apartheid, corporate life in South Africa has changed dramatically, and the business scene is now evolving at a fast pace. The government is committed to liberalizing the country's economy in fundamental ways, and corporate culture is changing in response. Programs to encourage economic growth and globalization have attracted new companies from abroad and introduced new approaches to doing business. Companies have also experienced a boost in creative energy. Today, the hallmarks of the South African business culture are change and transformation.

Day to day, doing business in South Africa is relatively easy and becoming easier as regulations are modified to reflect international norms. At the same time, new policies, particularly in matters of employment and labor, are making business life more complex.

While South African society is officially color free, in practical terms there are many areas of business that are still segregated. Overseas companies looking to break into public-sector contract work would be wise to establish joint ventures with companies owned by blacks.

South Africa has one of the highest union-membership rates in the world—a total of 3.2 million workers, or 25 percent of the employed workforce. Although the labor movement has a reputation for militancy, strikes are virtually unheard of since the job market has become so tight, and labor relations have generally improved.

Because of the country's strong union culture, managers tend to be highly sensitive to union concerns in the workplace, and union issues are never far from the surface in decision making. In fact, unions used rolling mass action to disrupt the apartheid economy, and this weapon is still available.

Services now total 65 percent of the economy. South Africa has a well-developed financial services sector, and the South African Futures Exchange ranks among the top-ten international (i.e., non-US) stock exchanges. Trade with countries on the African continent has been increasing rapidly. Finished goods and prepared foodstuffs, as well as base metals and chemicals, are in particularly high demand.*bWise: Business Wisdom Worldwide: South Africa* (New York: Atma Global, 2011). Overall, the country has the most-sophisticated market economy on the African continent. Between its economic profile and its well-developed physical infrastructure, South Africa has become an attractive place to do business.*CultureQuest Business Multimedia Series: South Africa* (New York: Atma Global, 2010).

"For much of the past decade, Asia has been the go-to continent for companies interested in tapping fast-growing economies. Now, Wal-Mart Stores' agreement on September 27, 2010 to buy South African retailer Massmart Holdings for $4.6 billion may signal a shift toward Africa as another deal-making destination for multinationals."Renee Bonorchis, "Africa Is Looking Like a Dealmaker's Paradise," *BusinessWeek*, September 30, 2010, accessed January 5, 2011, http://www.businessweek.com/magazine/content/10_41/b4198020648051.htm. The deal was Walmart's largest in a decade, which indicates just how serious global businesses are taking the emerging opportunity in Africa. Other large representative acquisitions include HSBC's stake in Nedbank Group and Japan's Nippon Telephone & Telegraph (NTT) purchase of Dimension Data. While these acquisitions are South African companies, it's only a matter of time until the rest of Africa triggers global commercial interest as well.

Latin America

Spotlight on Brazil

With nearly 3.4 million square miles in area, Brazil is about the size of the continental United States and the fifth-largest country in the world. It covers nearly half of the South American continent, and, with the exception of Chile and Ecuador, it shares a border with every country in South America.

Brazil remains Latin America's largest market, the world's fifth-most-populous country, and the world's tenth-largest economy in GDP terms. Government policies for disinflation and income support programs for the poorest families have contributed to a significant reduction in poverty rates and income inequality in recent years. However, poverty remains a stubborn challenge for Brazil.

Brazil's economic history has progressed in cycles, each focused on a single export item. Soon after the arrival of the first Europeans, wood was the hot commodity. In the sixteenth and seventeenth centuries, the scramble was for sugar. Eighteenth-century traders lusted for gems, gold, and silver; and finally, in the nineteenth and twentieth centuries, coffee was king. Rubber had its day as well. Also of economic importance during these cycles were cattle and agriculture, though they mainly served the domestic market.

Brazil is best known as a leading world producer of coffee and sugar. These commodities, no doubt, enable the country to trade on the world's stage and remain critical to the Brazilian economy to this day. Brazil is also one of the largest producers and exporters of soybeans, orange juice, cocoa, and tropical fruits. A little known fact, however, is that today, nonagricultural products—namely, auto parts, aircraft, and machinery—bring in more money. Ironically, it's the oft-maligned industrial programs of the 1960s and 1970s that deserve much of the credit for these successes.

Industry came to Brazil in the mid-1800s. The depression of 1929 threw a wrench in development, but the setback was only temporary; during subsequent decades, expansion was steady. Growth was especially healthy between the 1960s and the oil crisis of 1979. It wasn't until the 1980s, when interest rates busted the charts, that the economy began its descent. The flow of foreign and domestic capital slowed to a trickle, devaluations played havoc with the national currency, and foreign companies initiated debilitating cutbacks or left the country altogether. Severely handicapped in its ability to invest, Brazil plunged into a period of runaway inflation and negative growth rates. To this day, the 1980s are referred to as "the lost decade."

In the 1990s, the government honed in on three economic goals: (1) trade reform, (2) stabilizing the economy, and (3) building the country's relationship with the global financial community. In 1994, Minister of Finance Fernando Henrique Cardoso (often called FHC), launched the Real Plan, which inspired the name for Brazil's currency (i.e., the real). The plan, with its emphasis on the need for a strong currency, high interest rates, strict limits on government spending, and an opening up of the economy, touched off a boom in Brazil. Foreign capital began pouring in. Brazil's economic wizards outwitted the forces that wracked Mexico in the mid-1990s as well as Southeast Asia in 1997 and 1998. Their main premise was a strong (i.e., increasingly overvalued) real and spiraling interest rates. However, this premise lost validity in January 1999, when the Central Bank stopped defending the real and let the currency float freely.

Economically, the remainder of the 1990s was a qualified success. In 2001 and 2002, Brazil managed to avoid the fate of its neighbor, Argentina. Nevertheless, the country's finances remained a disaster. Improved prudent economic policy led to early repayment of IMF loans in 2005 and stabilized the economy. Although Brazil has seen significant rates of economic growth in recent years, this growth hasn't benefited all sectors or all groups to the same extent. Simultaneously, the economy is undergoing major structural changes as large-scale privatization of formerly state-owned enterprises continues.*CultureQuest Business Multimedia Series: Brazil* (New York: Atma Global, 2010); *bWise: Business Wisdom Worldwide: Brazil* (New York: Atma Global, 2011).

Today, "characterized by large and well-developed agricultural, mining, manufacturing, and service sectors, Brazil's economy outweighs that of all other South American countries, and Brazil is expanding its presence in world markets."US Central Intelligence Agency, "Central America: Brazil," *World Factbook*, accessed January 7, 2011, www.cia.gov/library/publications/the-world-factbook/geos/br.html. Its industry accounts for 25.4 percent of the GDP and focuses on textiles, shoes, chemicals, cement, lumber, iron ore, tin, steel, aircraft, motor vehicles and parts, and other machinery and equipment. Agriculture, including coffee, soybeans, wheat, rice, corn, sugarcane, cocoa, citrus, and beef, accounts for 6.1 percent of the economy, while services total 68.5 percent.US Central Intelligence Agency, "Central America: Brazil," *World Factbook*, accessed January 7, 2011, www.cia.gov/library/publications/the-world-factbook/geos/br.html.

Since 2003, Brazil has steadily improved macroeconomic stability, building up foreign reserves, reducing its debt profile by shifting its debt burden toward real-denominated and domestically held instruments, adhering to an inflation target, and committing to fiscal responsibility. Brazil has also experienced the global "recession, as global demand for Brazil's commodity-based exports dwindled and external credit dried up. However, Brazil was one of the first emerging markets to begin a recovery."US Central Intelligence Agency, "Central America: Brazil," *World Factbook*, accessed January 7, 2011, www.cia.gov/library/publications/the-world-factbook/geos/br.html.

Today, Brazil is home to several global firms. Embraer builds innovative small jets and has become the world's biggest producer of smaller jet aircraft. The Brazilian food processors, Sadia and Perdigao, exemplify the international entrepreneurship of modern Brazil. Each is a $2 billion enterprise and exports about half of its annual production. Brazil's abundant resources for producing pork, poultry, and grains and its ideal growing conditions for animal feed provide these companies with many advantages. Both

Sadia and Perdigao also have world-class global distribution and supply-chain management systems for product categories in frozen foods, cereals, and ready-to-eat meals.

KEY TAKEAWAYS

- There are some common characteristics of emerging markets in terms of the size of the local population, the opportunity for growth with changes in the local commercial infrastructure, the regulatory and trade policies, improvements in efficiencies, and an overall investment in the education and well-being of the local population, which in turn is expected to increase local incomes and purchasing capabilities.
- A current definition of an emerging market is a country that can be defined as a society transitioning from a centrally managed economy to a free-market-oriented economy, with increasing economic freedom, gradual integration within the global marketplace, an expanding middle class, and improving standards of living, social stability, and tolerance, as well as an increase in cooperation with multilateral institutions.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Describe the main characteristics of emerging-market economies.
2. Select one emerging-market country. Utilize a combination of the *World Factbook* at www.cia.gov/library/publications/the-world-factbook/geos/xx.html and the HDI at http://hdr.undp.org/en/statistics, and formulate an opinion of why you think the country is an emerging country. Identify its per capita GDP and HDI ranking to assess its level of development.

3.6: Chapter Introduction

Global and Regional Economic Cooperation and Integration

WHAT'S IN IT FOR ME?

1. What is international economic cooperation among nations?
2. What is regional economic integration?
3. What is the United Nations (UN), and how do the UN and peace impact global trade?

Following World War II, there's been a shift in thinking toward trade. Nations have moved away from thinking that trade was a zero-sum game of either win or lose to a philosophy of increasing trade for the benefit of all. Additionally, coming out of a second global war that destroyed nations, resources, and the balance of peace, nations were eager for a new model that would not only focus on promoting and expanding free trade but would also contribute to world peace by creating international economic, political, and social cooperative agreements and institutions to support them. While this may sound impossible to achieve, international agreements and institutions have succeeded—at a minimum—in creating an ongoing forum for dialogue on trade and related issues. Reducing the barriers to trade and expanding global and regional cooperation have functioned as flatteners in an increasingly flat world. Section 5.1 and Section 5.2 review the specific economic agreements governing global and regional trade—the successes and the challenges. Section 5.3 also looks at the United Nations as a key global institution and its impact on free and fair global trade. To start, the opening case study assesses one of the more important trade pacts of the past fifty years, the European Union (EU). What has been the impact of the 2010 debt crisis in Greece on the EU, its members, and its outlook?

Did You Know?

Before the twentieth century, states (nations) usually increased their power by attacking and absorbing others. In 1500, there were about 500 political units in Europe; by 1900 there were just 25—a consolidation brought by (royal) marriage and dynastic expansion but largely through force.Richard Rosecrance, "Bigger Is Better: The Case for a Transatlantic Economic Union," *Foreign Affairs*, May/June 2010, accessed January 2, 2011, www.foreignaffairs.com/articles/66225/richard-rosecrance/bigger-is-better.

Opening Case: Making Sense of the Economic Chaos in the European Union

Source: Wikimedia Commons

In Chapter 2, you saw how political and legal factors impacted trade. In this chapter, you'll learn more about how governments seek to cooperate with one another by entering into trade agreements in order to facilitate business.

The European Union (EU) is one such example. The EU started after World War II, initially as a series of trade agreements between six European countries geared to avoid yet another war on European soil. Six decades later, with free-flowing trade and people, a single currency, and regional peace, it's easy to see why so many believed that an economic union made the best sense. However, the EU is facing its first major economic crisis, and many pundits are questioning how the EU will handle this major stress test. Will it survive? To better answer this question, let's look at what really happened during the financial crisis in Europe and in particular in Greece.

At its most basic level, countries want to encourage the growth of their domestic businesses by expanding trade with other countries—primarily by promoting exports and encouraging investment in their nations. Borders that have fewer rules and regulations can help businesses expand easier and more cheaply. While this sounds great in theory, economists as well as businesspeople often ignore the realities of the political and sociocultural factors that impact relationships between countries, businesses, and people.

Critics have longed argued that while the EU makes economic sense, it goes against the long-standing political, social, and cultural history, patterns, and differences existing throughout Europe. Not until the 2010 economic crisis in Greece did these differences become so apparent.

What Really Happened in Greece?

What is the European debt crisis? While experts continue to debate the causes of the crisis, it's clear that several European countries had been borrowing beyond their capacity.

Let's look at one such country, Greece, which received a lot of press attention in 2010 and has been considered to have a very severe problem. The financial crisis in the EU, in large part, began in Greece, which had concealed the true levels of its debts. Once the situation in Greece came to light, investors began focusing on the debt levels of other EU countries.

In April 2010, following a series of tax increases and budget cuts, the Greek prime minister officially announced that his country needed an international bailout from the EU and International Monetary Fund (IMF) to deal with its debt crisis.

The crisis began in 2009 when the country faced its first negative economic growth rate since 1993. There was a fast-growing crisis, and the country couldn't make its debt payments. Its debt costs were rising because investors and bankers became wary of lending more money to the country and demanded higher rates. Economic historians have accused the country of covering up just how bad the deficits were with a massive deficit revision of the 2009 budget.

This drastic bailout was necessitated by the country's massive budget deficits, the economy's lack of transparency, and its excess corruption. In Greece, corruption has been so widespread that it's an ingrained part of the culture. Greeks have routinely used the terms *fakelaki*, which means bribes offered in envelopes, and *rousfeti*, which means political favors among friends. Compared with its European member countries, Greece has suffered from high levels of political and economic corruption and low global-business competitiveness.

What's the Impact on Europe and the EU?

In the ashes of Europe's debt crisis, some see the seeds of long-term hope. That's because the threat of bankruptcy is forcing governments to implement reforms that economists argue are necessary to help Europe prosper in a globalized world—but were long viewed politically impossible because of entrenched social attitudes. "Together, Europe's banks have funneled $2.5 trillion into the five shakiest euro-zone economies: Greece, Ireland, Belgium, Portugal, and Spain."Stefan Theil, "Worse Than Wall Street," *Newsweek*, July 2, 2010, accessed December 28, 2010, www.newsweek.com/2010/07/02/worse-than-wall-street.html.

So if it's just a handful of European countries, why should the other stronger economies in the EU worry? Well, all of the sixteen member countries that use the euro as their currency now have their economies *interlinked* in a way that other countries don't. Countries that have joined the euro currency have unique challenges when economic times are tough. A one-size-fits-all monetary policy doesn't give the member countries the flexibility needed to stimulate their economies. (Chapter 6 discusses monetary policy in greater detail.) But the impact of one currency for sixteen markets has made countries like Portugal, Spain, and Greece less cost competitive on a global level. In practice, companies in these countries have to pay their wages and costs in euros, which makes their products and services more expensive than goods from cheaper, low-wage countries such as Poland, Turkey, China, and Brazil. Because they share a single common currency, highly indebted EU countries can't just devalue their currency to stimulate exports.

Rigid EU rules don't enable member governments to navigate their country-specific problems, such as deficit spending and public works projects. Of note, a majority of the sixteen countries in the monetary union have completely disregarded the EU's Stability and Growth Pact by running excessive deficits—that is, borrowing or spending more than the country has in its coffers. Reducing deficits and cutting social programs often comes at a high political cost.

As Steven Erlanger noted in the *New York Times*,

The European Union and the 16 nations that use the euro face two crises. One is the immediate problem of too much debt and government spending. Another is the more fundamental divide, roughly north and south, between the more competitive export countries like Germany and France and the uncompetitive, deficit countries that have adopted the high wages and generous social protections of the north without the same economic ethos of strict work habits, innovation, more flexible labor markets and high productivity.

As Europe grapples with its financial crisis, the more competitive, wealthier countries are reluctantly rescuing more profligate economies, including Greece and Ireland, from fiscal and bank woes, while imposing drastic cuts in spending there.Steven Erlanger, "Euro Zone Is Imperiled by North-South Divide," *New York Times*, December 2, 2010, accessed January 2, 2011, www.nytimes.com/2010/12/03/world/europe/03divide.html?_r=1&ref=stevenerlanger.

Early on, EU critics had expressed concern that countries wouldn't want to give up their sovereign right to make economic and political policy. Efforts to create a European constitution and move closer to a political union fell flat in 2005, when Belgium and France rejected the efforts. Critics suggest that a political union is just not culturally feasible. European countries have deep, intertwined histories filled with cultural and ethnic biases, old rivalries, and deep-rooted preferences for their own sovereignty and independence. This first major economic crisis has brought this issue to the forefront.

There were two original arguments against the creation of the EU and euro zone: (1) fiscal independence and sovereignty and (2) centuries-old political, economic, social, and cultural issues, biases, and differences.

Despite these historical challenges, most Europeans felt that the devastation of two world wars were worse. World War I started as a result of the cumulative and somewhat convoluted sequence of political, economic, and military rivalries between European countries and then added in Japan and the United States. World War II started after Germany, intent on expanding its empire throughout Europe, invaded Poland in 1939. All told, these two wars led to almost one hundred million military and civilian deaths, shattered economies, destroyed industries, and severely demoralized and exhausted the global population. European and global leaders were determined that there would never be another world war. This became the early foundations of today's global and regional economic and political alliances, in particular the EU and the United Nations (UN).

Of course, any challenges to the modern-day EU have brought back old rivalries and biases between nations. Strong economies, like Germany, have been criticized for condescending to the challenges in Greece, for example when German commentators used negative Greek stereotypes. Germany was also initially criticized for possibly holding up a bailout of Greece, because it was unpopular with German voters.

European leaders first joined with the IMF in May 2010 and agreed on a $1 trillion rescue fund for financially troubled countries. Then, Greece announced deep budget cuts, Spain cut employer costs, and France raised its retirement age. France also joined Germany and the United Kingdom in imposing harsh budget cuts. Governments now face a crucial test of political will. Can they implement the reforms they've announced? The short-term response to those moves has been a wave of strikes, riots, and—in Spain, Italy, Ireland, and France—demonstrations.

Yet supporters of the EU argue that the mutual common interests of the EU countries will ensure that reforms are implemented. Memories of the fragility of the continent after the wars still lingers. Plus, more realistically, Europeans know that in order to remain globally competitive, they will be stronger as a union than as individual countries—particularly when going up against such formidable economic giants as the United States and China.

What Does This All Mean for Businesses?

The first and most relevant reminder is that global business and trade are intertwined with the political, economic, and social realities of countries. This understanding has led to an expansion of trade agreements and country blocs, all based on the fundamental premise that peace, stability, and trade are interdependent. Both the public and private sectors have embraced this thinking.

Despite the crises in varying European countries, businesses still see opportunity. UK-based Diageo, the giant global beverage company and maker of Ireland's famous Guinness beer, just opened a new distillery in Roseisle, Scotland, located in the northern part of the United Kingdom.

The new distillery is a symbol of optimism for the industry after the uncertainty of the global economic downturn. The scotch industry had been riding high when the financial crisis hit and the subsequent collapse in demand in 2009 ricocheted through important markets like South Korea, where sales contracted by almost 25 percent. Sales in Spain and Singapore were down 5 percent and 9 percent respectively. There was also evidence of drinkers trading down to cheaper spirits—such as hard-up Russians returning to vodka.

David Gates, global category director for whiskies at Diageo, says emerging markets are leading the recovery: "The places we're seeing demand pick up quickest are Asia, Latin America and parts of Eastern Europe. Southern Europe is more concerning because Spain and Greece, which are big scotch markets, remain in very difficult economic situations."…

The renaissance of Scotland's whisky industry has had little to do with Scottish consumption. Drinks groups have concentrated on the emerging middle-class in countries such as Brazil, where sales shot up 44 percent last year.

In Mexico whisky sales were up 25 percent as locals defected from tequila.Zoe Wood, "Diageo Opens the First Major New Whisky Distillery for a Generation," *Guardian*, October 3, 2010, accessed January 2, 2011, http://www.guardian.co.uk/business/2010/oct/03/diageo-roseisle-distillery-opens.

While Europe continues to absorb the impact of the 2008 global recession, there is hope for the future.

It is too soon to write off the EU. It remains the world's largest trading block. At its best, the European project is remarkably liberal: built around a single market of 27 rich and poor countries, its internal borders are far more porous to goods, capital and labour than any comparable trading area….

For free-market liberals, the enlarged union's size and diversity is itself an advantage. By taking in eastern countries with lower labour costs and workers who are far more mobile than their western cousins, the EU in effect brought globalisation within its own borders. For economic liberals, that flexibility and dynamism offers Europe's best chance of survival."Staring into the Abyss," *Economist*, July 8, 2010, accessed December 28, 2010, http://www.economist.com/node/16536898.

Understanding the Basics of Why Countries Borrow Money

Governments operate first from tax revenues before resorting to borrowing. Countries like Saudi Arabia, Brunei, or Qatar that have huge tax revenues from oil don't need to borrow. However, countries that don't have these huge tax revenues might need to borrow money. In addition, if tax revenues go down—for example in a recession or because taxes aren't paid or aren't collected properly—then countries might need to borrow.

Countries usually borrow for four main reasons:

1. **Recession.** During a recession, a country may need to borrow money in order to keep its basic public services operating until the economy improves and businesses and workers can resume paying sufficient tax revenues to make borrowing less of a need.
2. **Investment.** A country may borrow money in order to invest in the public sector and build infrastructure, which may be anything related to keeping a society operating, including roads, airports, telecommunications, schools, and hospitals.
3. **War.** A country may borrow in order to fund wars or military expansion.
4. **Politics.** A country may borrow money in order to reduce tax rates either because of political pressure from its citizens and businesses or to stimulate its economy. Usually countries have a much harder time cutting government spending. People don't want to give up a benefit or service or, in the case of a recession, may need the services, such as food stamps or unemployment benefits, thus making it very difficult to cut government programs.

When countries borrow, they increase their debt. When debt levels become too high, investors get concerned that the country may not be able to repay the money. As a result, investors and bankers (in the form of the credit market) may view the debt as higher risk. Then, investors or bankers ask for a higher interest rate or return as compensation for the higher risk. This, in turn, leads to higher borrowing costs for the country.

The national deficit is the amount of borrowing that a country does from either the private sector or other countries. However, the national deficit is different from the current account deficit, which refers to imports being greater than exports.

Even healthy countries run national deficits. For example, in the case of borrowing to invest long term in domestic facilities and programs, the rationale is that a country is investing in its future by improving infrastructure, much like a business would borrow to build a new factory.

Opening Case Exercises

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. What are two reasons for the creation of the European Union (EU)?
2. What are four reasons a country might have for borrowing money?

3.7: International Economic Cooperation among Nations

Learning Objectives

1. Understand the global trading system.
2. Explain how and why the GATT was created and what its historical role in international trade is.
3. Know what the WTO is and what its current impact on international trade is.

In the post–World War II environment, countries came to realize that a major component of achieving any level of global peace was global cooperation—politically, economically, and socially. The intent was to level the trade playing field and reduce economic areas of disagreement, since inequality in these areas could lead to more serious conflicts. Among the initiatives, nations agreed to work together to promote free trade, entering into bilateral and multilateral agreements. The General Agreement on Tariffs and Trade (GATT) resulted from these agreements. In this section, you'll review GATT—why it was created and what its historical successes and challenges are. You'll then look at the World Trade Organization (WTO), which replaced GATT in 1995, and study the impact of both these organizations on international trade. While GATT started as a set of rules between countries, the WTO has become an institution overseeing international trade.

General Agreement on Tariffs and Trade (GATT)

The **General Agreement on Tariffs and Trade (GATT)** is a series of rules governing trade that were first created in 1947 by twenty-three countries. By the time it was replaced with the WTO, there were 125 member nations. GATT has been credited with substantially expanding global trade, primarily through the reduction of tariffs.

The basic underlying principle of GATT was that trade should be free and equal. In other words, countries should open their markets equally to member nations, and there should be neither discrimination nor preferential treatment. One of GATT's key provisions was the **most-favored-nation clause (MFN)**. It required that once a benefit, usually a tariff reduction, was agreed on between two or more countries, it was automatically extended to all other member countries. GATT's initial focus was on tariffs, which are taxes placed on imports or exports.

Did You Know?

MFN Is Everywhere

As a concept, MFN can be seen in many aspects of business; it's an important provision. Companies require MFN of their trading partners for pricing, access, and other provisions. Corporate or government customers require it of the company from which they purchase goods or services. Venture capitalists (VC) require it of the companies in which they invest. For example, a VC wants to make sure that it has negotiated the best price for equity and will ask for this provision in case another financier negotiates a cheaper purchase price for the equity. The idea behind the concept of MFN is that the country, company, or entity that has MFN status shouldn't be disadvantaged in comparison with others in similar roles as a trading partner, buyer, or investor. In practice, the result is that the signing party given MFN status benefits from any better negotiation and receives the cheaper price point or better term. This terminology is also used in sales contracts or other business legal agreements.

Gradually, the GATT member countries turned their attention to other nontariff trade barriers. These included government procurement and bidding, industrial standards, subsidies, duties and customs, taxes, and licensing. GATT countries agreed to limit or remove trade barriers in these areas. The only agreed-on export subsidies were for agricultural products. Countries agreed to permit a wider range of imported products to enter their home markets by simplifying licensing guidelines and developing consistent product standards between imports and domestically produced goods. Duties had to result from uniform and consistent procedures for the same foreign and domestically produced items.

The initial successes in these categories led some countries to get more creative with developing barriers to trade as well as entering into bilateral agreements and providing more creative subsidies for select industries. The challenge for the member countries of GATT was enforcement. Other than complaining and retaliating, there was little else that a country could do to register disapproval of another country's actions and trade barriers.

Gradually, trade became more complex, leading to the Uruguay Round beginning in 1986 and ending in 1994. These trade meetings were called rounds in reference to the series of meetings among global peers held at a "roundtable." Prior to a round, each series of trade discussions began in one country. The round of discussions was then named after that country. It sometimes took several years to conclude the topic discussions for a round. The Uruguay Round took eight years and actually resulted in the end of GATT and the creation of the World Trade Organization (WTO). The current Doha Development Round began in 2001 and is actually considered part of the WTO.

World Trade Organization (WTO)

Brief History and Purpose

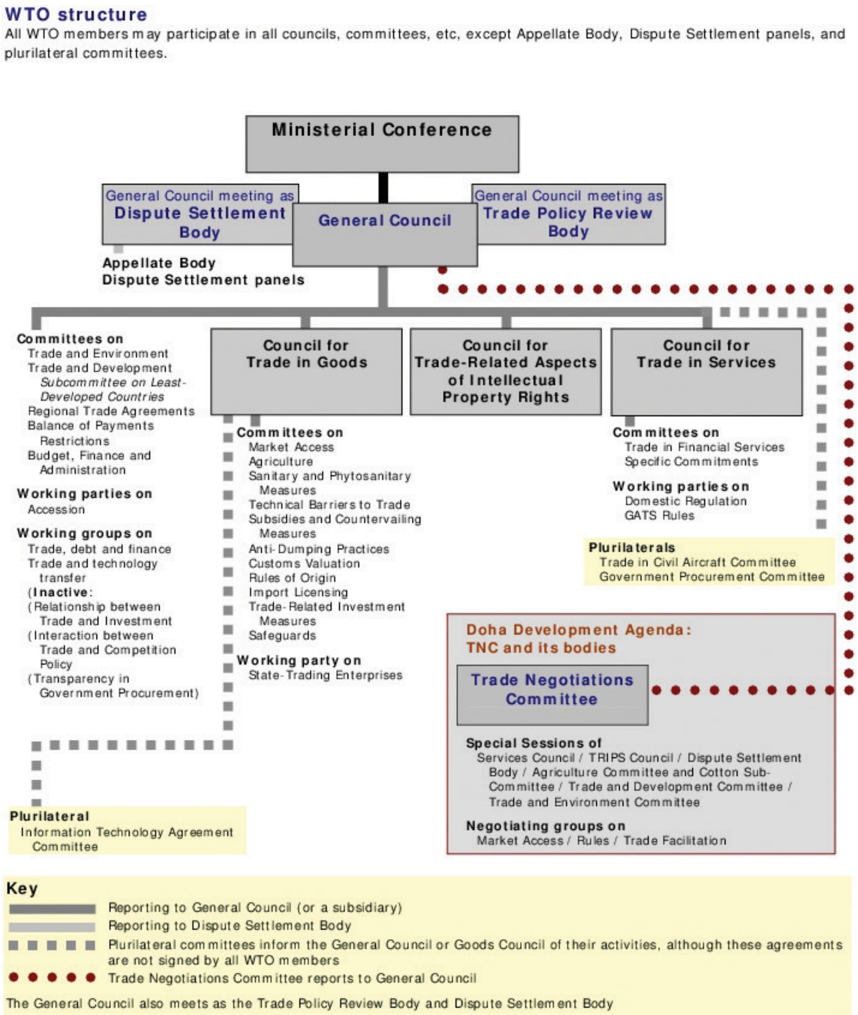
The **World Trade Organization (WTO)** developed as a result of the Uruguay Round of GATT. Formed officially on January 1, 1995, the concept of the WTO had been in development for several years. When the WTO replaced GATT, it absorbed all of GATT's standing agreements. In contrast to GATT, which was a series of agreements, the WTO was designed to be an actual institution charged with the mission of promoting free and fair trade. As explained on its website, the WTO "is the only global international organization dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments. The goal is to help producers of goods and services, exporters, and importers conduct their business.""What Is the WTO?," World Trade Organization, accessed December 29, 2010, http://www.wto.org/english/thewto_e/whatis_e/whatis_e.htm.

The global focus on multilateral trade agreements and cooperation has expanded trade exponentially. "The past 50 years have seen an exceptional growth in world trade. Merchandise exports grew on average by 6 percent annually. Total trade in 2000 was 22-times the level of 1950. GATT and the WTO have helped to create a strong and prosperous trading system contributing to unprecedented growth.""The Multilateral Trading System—Past, Present and Future," World Trade Organization, accessed December 29, 2010, http://www.wto.org/english/thewto_e/whatis_e/inbrief_e/inbr01_e.htm.

The WTO's primary purpose is to serve as a negotiating forum for member nations to dispute, discuss, and debate trade-related matters. More than just a series of trade agreements, as it was under GATT, the WTO undertakes discussions on issues related to globalization and its impact on people and the environment, as well as trade-specific matters. It doesn't necessarily establish formal agreements in all of these areas but does provide a forum to discuss how global trade impacts other aspects of the world.

Headquartered in Geneva, Switzerland, the current round is called the Doha Round and began in 2001. With 153 member nations, the WTO is the largest, global trade organization. Thirty nations have observer status, and many of these are seeking membership. With so many member nations, the concept of MFN has been eased into a new principle of normal trade relations (NTR). Advocates say that no nation really has a favored nation status; rather, all interact with each other as a normal part of global trade.

Figure 5.2 The Structure of the WTO



Source: World Trade Organization, 2011.

The biggest change from GATT to the WTO is the provision for the settlement of disputes. If a country finds another country's trade practices unfair or discriminatory, it may bring the charges to the WTO, which will hear from both countries and mediate a solution.

The WTO has also undertaken the effort to focus on services rather than just goods. Resulting from the Uruguay Round, the General Agreement on Trade in Services (GATS) seeks to reduce the barriers to trade in services. Following the GATT commitment to nondiscrimination, GATS requires member nations to treat foreign service companies as they would domestic ones. For example, if a country requires banks to maintain 10 percent of deposits as reserves, then this percentage should be the same for foreign and domestic banks. Services have proven to be more complex to both define and regulate, and the member nations are continuing the discussions.

Similar to GATS is the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). Intellectual property refers to just about anything that a person or entity creates with the mind. It includes inventions, music, art, and writing, as well as words, phrases, sayings, and graphics—to name a few. The basic premise of intellectual property rights (IPR) law is that the creator of the property has the right to financially benefit from his or her creation. This is particularly important for protecting the development for the creation, known as the research and development (R&D) costs. Companies can also own the intellectual property that their employees generate. This section focuses on the protection that countries agree to give to intellectual property created in another country. (For more information on IPR, see Chapter 13, Section 13.2.)

Over the past few decades, companies have become increasingly diligent in protecting their intellectual property and pursuing abusers. Whether it's the knock-off designer handbag from China that lands on the sidewalks of New York or the writer protecting her thoughts in the written words of a book (commonly understood as content), or the global software company combating piracy of its technical know-how, IPR is now formally a part of the WTO agreements and ongoing dialogue.

Current Challenges and Opportunities

Agriculture and textiles are two key sectors in which the WTO faces challenges. Trade in agriculture has been impacted by export-country subsidies, import-country tariffs and restrictions, and nontariff barriers. Whether the United States provides low-cost loans and subsidies to its farmers or Japan restricts the beef imports, agriculture trade barriers are an ongoing challenge for the WTO. Global companies and trade groups that support private-sector firms seek to have their governments raise critical trade issues on their behalf through the WTO.

For example, Japan's ban of beef imports in response to mad cow disease has had a heavy impact on the US beef industry.

At the moment, unfortunately there's some distance between Japan and the U.S.," Japan Agriculture Minister Hirotaka Akamatsu told reporters in 2010 after meeting [US Agriculture Secretary Tom] Vilsack in Tokyo. "For us, food safety based on Japan's scientific standards is the priority. The OIE standards are different from the Japanese scientific ones.

The U.S. beef industry is losing about $1 billion a year in sales because of the restrictions, according to the National Cattlemen's Beef Association, [a trade group supporting the interests of American beef producers]. Japan was the largest foreign buyer of U.S. beef before it banned all imports when the first case of the brain-wasting disease, also known bovine spongiform encephalopathy [i.e., mad cow disease], was discovered in the U.S.

The ban was eased in 2005 to allow meat from cattle aged 20 months or less, which scientists say are less likely to have contracted the fatal illness….

Japan was the third-largest destination for U.S. beef [in 2009], with trade totaling $470 million, up from $383 million in 2008, according to the U.S. Meat Export Federation. That compares with $1.39 billion in 2003.

Mexico and Canada were the biggest buyers of U.S. beef [in 2009].Jae Hur and Ichiro Suzuki, "Japan, U.S. to Continue Dialogue on Beef Import Curbs (Update 1)," *BusinessWeek*, April 7, 2010, accessed December 29, 2010, http://www.businessweek.com/news/2010-04-07/japan-u-s-to-continue-dialogue-on-beef-import-curbs-update1-.html.

The role of the WTO is to facilitate agreements in difficult bilateral and multilateral trade disputes, but this certainly isn't easy. Japan's reluctance for American beef may appear to be the result of mad cow disease, but business observers note Japan's historical cultural preference for Japanese goods, which the country often claims are superior. A similar trade conflict was triggered in the 1980s when Japan discouraged the import of rice from other countries. The prevailing Japanese thought was that its local rice was easier for the Japanese to digest. After extensive discussions in the Uruguay Round, on "December 14, 1993 the Japanese government accepted a limited opening of the rice market under the GATT plan.""Japan Rice Trade," case study on American University website, accessed January 2, 2010, www1.american.edu/ted/japrice.htm.

Antidumping is another area on which the WTO has focused its attention. Dumping occurs when a company exports to a foreign market at a price that is either lower than the domestic prices in that country or less than the cost of production. Antidumping charges can be harder to settle, as the charge is against a company and not a country. One example is in India, which has, in the past, accused Japan and Thailand of dumping acetone, a chemical used in drugs and explosives, in the Indian market. In an effort to protect domestic manufacturers, India has raised the issue with the WTO. In fact, India was second only to Argentina among the G-20 (or Group of Twenty) nations in initiating antidumping investigations during 2009, according to a recent WTO report.Press Trust of India, "Govt Initiates Anti-Dumping Probe against Acetone Imports," *Business Standard*, November 3, 2009, accessed December 29, 2010, www.business-standard.com/india/news/govt-initiates-anti-dumping-probe-against-acetone-imports/375153/.

Future Outlook

While the end of the Doha Round is uncertain, the future for the WTO and any related organizations remains strong. With companies and countries facing a broader array of trade issues than ever before, the WTO plays a critical role in promoting and ensuring free and fair trade. Many observers expect that the WTO will have to emphasize the impact of the Internet on trade. In most cases, the WTO provides companies and countries with the best options to dispute, discuss, and settle unfair business and trade practices.

KEY TAKEAWAYS

- The General Agreement on Tariffs and Trade (GATT) is a series of rules governing trade that were first created in 1947 by twenty-three countries. It remained in force until 1995, when it was replaced by the WTO.
- The World Trade Organization (WTO) is the only global, international organization dealing with the rules of trade between nations. The WTO agreements that have been negotiated and signed by the organization's 153 member nations and ratified in their parliaments are the heart of the organization. Its goal is to help the producers, exporters, and importers of goods and services conduct business. The current round of the WTO is called the Doha Round.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Define GATT and discuss the importance of the successive rounds. Do you think that GATT was essential to promoting world trade or would we be in the same place today without it? Why or why not?
2. Define WTO. In what ways do you think the WTO is still essential to global trade? Discuss how a private-sector firm would use the WTO to protect its business interests.
3. Read the following excerpt from a 2010 *Wall Street Journal* article about the WTO:

   The World Trade Organization formally condemned European subsidies to civil-aircraft maker Airbus, concluding the first half of the most expensive trade dispute in WTO history.

   Its main finding was that more than $20 billion in low-interest government loans used to develop six models of passenger jet constituted prohibited export subsidies.

   The ruling could force the parent company of Airbus, European Aeronautic Defence & Space Co., to repay some aid money or risk giving the U.S. the right to raise import tariffs in retaliation on goods imported from Europe, such as cars, wines and cheese.John W. Miller and Daniel Michaels, "WTO Condemns Airbus Subsidies," *Wall Street Journal*, July 1, 2010, accessed December 29, 2010, http://online.wsj.com/article/SB10001424052748703426004575338773153793294.html.

   Do you agree with the WTO's assessment? Is it fair for the United States to retaliate against the airplane manufacturer with tariffs on other imported products? How might US consumers react to additional taxes imposed on popular imported products such as cars, wine, and cheese?

3.8: Regional Economic Integration

Learning Objectives

1. Understand regional economic integration.
2. Identify the major regional economic areas of cooperation.

What Is Regional Economic Integration?

Regional economic integration has enabled countries to focus on issues that are relevant to their stage of development as well as encourage trade between neighbors.

There are four main types of regional economic integration.

1. **Free trade area.** This is the most basic form of economic cooperation. Member countries remove all barriers to trade between themselves but are free to independently determine trade policies with nonmember nations. An example is the North American Free Trade Agreement (NAFTA).
2. **Customs union.** This type provides for economic cooperation as in a free-trade zone. Barriers to trade are removed between member countries. The primary difference from the free trade area is that members agree to treat trade with nonmember countries in a similar manner. The Gulf Cooperation Council (GCC)Cooperation Council for the Arab States of the Gulf website, accessed April 30, 2011, www.gcc-sg.org/eng/index.html. is an example.
3. **Common market.** This type allows for the creation of economically integrated markets between member countries. Trade barriers are removed, as are any restrictions on the movement of labor and capital between member countries. Like customs unions, there is a common trade policy for trade with nonmember nations. The primary advantage to workers is that they no longer need a visa or work permit to work in another member country of a common market. An example is the Common Market for Eastern and Southern Africa (COMESA).Common Market for Eastern and Southern Africa website, accessed April 30, 2011, http://www.comesa.int.
4. **Economic union.** This type is created when countries enter into an economic agreement to remove barriers to trade and adopt common economic policies. An example is the European Union (EU).Europa, the Official Website of the European Union, accessed April 30, 2011, http://europa.eu.

In the past decade, there has been an increase in these trading blocs with more than one hundred agreements in place and more in discussion. A trade bloc is basically a free-trade zone, or near-free-trade zone, formed by one or more tax, tariff, and trade agreements between two or more countries. Some trading blocs have resulted in agreements that have been more substantive than others in creating economic cooperation. Of course, there are pros and cons for creating regional agreements.

Pros

The pros of creating regional agreements include the following:

- **Trade creation.** These agreements create more opportunities for countries to trade with one another by removing the barriers to trade and investment. Due to a reduction or removal of tariffs, cooperation results in cheaper prices for consumers in the bloc countries. Studies indicate that regional economic integration significantly contributes to the relatively high growth rates in the less-developed countries.
- **Employment opportunities.** By removing restrictions on labor movement, economic integration can help expand job opportunities.
- **Consensus and cooperation.** Member nations may find it easier to agree with smaller numbers of countries. Regional understanding and similarities may also facilitate closer political cooperation.

Cons

The cons involved in creating regional agreements include the following:

- **Trade diversion.** The flip side to trade creation is trade diversion. Member countries may trade more with each other than with nonmember nations. This may mean increased trade with a less efficient or more expensive producer because it is in a member country. In this sense, weaker companies can be protected inadvertently with the bloc agreement acting as a trade barrier. In essence, regional agreements have formed new trade barriers with countries outside of the trading bloc.

- **Employment shifts and reductions.** Countries may move production to cheaper labor markets in member countries. Similarly, workers may move to gain access to better jobs and wages. Sudden shifts in employment can tax the resources of member countries.
- **Loss of national sovereignty.** With each new round of discussions and agreements within a regional bloc, nations may find that they have to give up more of their political and economic rights. In the opening case study, you learned how the economic crisis in Greece is threatening not only the EU in general but also the rights of Greece and other member nations to determine their own domestic economic policies.

Major Areas of Regional Economic Integration and Cooperation

There are more than one hundred regional trade agreements in place, a number that is continuously evolving as countries reconfigure their economic and political interests and priorities. Additionally, the expansion of the World Trade Organization (WTO) has caused smaller regional agreements to become obsolete. Some of the regional blocs also created side agreements with other regional groups leading to a web of trade agreements and understandings.

North America: NAFTA

Brief History and Purpose

The North American Free Trade Agreement (NAFTA) came into being during a period when free trade and trading blocs were popular and positively perceived. In 1988, the United States and Canada signed the Canada–United States Free Trade Agreement. Shortly after it was approved and implemented, the United States started to negotiate a similar agreement with Mexico. When Canada asked to be party to any negotiations to preserve its rights under the most-favored-nation clause (MFN), the negotiations began for NAFTA, which was finally signed in 1992 and implemented in 1994.

The goal of NAFTA has been to encourage trade between Canada, the United States, and Mexico. By reducing tariffs and trade barriers, the countries hope to create a free-trade zone where companies can benefit from the transfer of goods. In the 1980s, Mexico had tariffs as high as 100 percent on select goods. Over the first decade of the agreement, almost all tariffs between Mexico, Canada, and the United States were phased out.

The rules governing origin of content are key to NAFTA. As a free trade agreement, the member countries can establish their own trading rules for nonmember countries. NAFTA's rules ensure that a foreign exporter won't just ship to the NAFTA country with the lowest tariff for nonmember countries. NAFTA rules require that at least 50 percent of the net cost of most products must come from or be incurred in the NAFTA region. There are higher requirements for footwear and cars. For example, this origin of content rule has ensured that cheap Asian manufacturers wouldn't negotiate lower tariffs with one NAFTA country, such as Mexico, and dump cheap products into Canada and the United States. Mexican *maquiladoras* have fared well in this arrangement by being the final production stop before entering the United States or Canada. *Maquiladoras* are production facilities located in border towns in Mexico that take imported materials and produce the finished good for export, primarily to Canada or the United States.

Current Challenges and Opportunities

Canadian and US consumers have benefited from the lower-cost Mexican agricultural products. Similarly, Canadian and US companies have sought to enter the expanding Mexican domestic market. Many Canadian and US companies have chosen to locate their manufacturing or production facilities in Mexico rather than Asia, which was geographically far from their North American bases.

When it was introduced, NAFTA was highly controversial, particularly in the United States, where many felt it would send US jobs to Mexico. In the long run, NAFTA hasn't been as impactful as its supporters had hoped nor as detrimental to workers and companies as its critics had feared. As part of NAFTA, two side agreements addressing labor and environmental standards were put into place. The expectation was that these side agreements would ensure that Mexico had to move toward improving working conditions.

Mexico has fared the best from NAFTA as trade has increased dramatically. *Maquiladoras* in Mexico have seen a 15 percent annual increase in income. By and large, Canadians have been supportive of NAFTA and exports to the region have increased in the period since implementation. "Tri-lateral [merchandise] trade has nearly tripled since NAFTA came into force in 1994. It topped $1 trillion in 2008."Foreign Affairs and International Trade Canada, "Fast Facts: North American Free Trade Agreement," December 15, 2009, accessed December 30, 2010, www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/nafta-alena/fast_facts-faits_saillants.aspx?lang=eng.

Future Outlook

Given the 2008 global economic recession and challenging impact on the EU, it isn't likely that NAFTA will move beyond the free-trade zone status to anything more comprehensive (e.g., the EU's economic union). In the opening case study, you read about the pressures on the EU and the resistance by each of the governments in Europe to make policy adjustments to address the recession. The United States, as the largest country member in NAFTA, won't give up its rights to independently determine its economic and trade policies. Observers note that there may be the opportunity for NAFTA to expand to include other countries in Latin America.William M. Pride, Robert James Hughes, and Jack R. Kapoor, *Business*, 9th ed. (Boston: Houghton Mifflin, 2008), 89, accessed April 30, 2011, http://books.google.com/books?id=z2tEhXnm1rAC&pg=PA88&lpg=PA88&dq=will+chile+join+nafta+2009&source=bl&ots=iohSe7YV0E&sig=BjQr2KOx0lsrAGhv5vMqeb9LhFU&hl=en&ei=hLu8TZ3LPNDAgQeZusjqBQ&sa=X&oi=book_result&ct=result&resnum=6&ved=0CDoQ6AEwBQ#v=onepage&q=will%20chile%20join%20nafta%202009&f=false. Chile was originally supposed to be part of NAFTA in 1994, but President Clinton was hampered by Congress in his ability to formalize that decision.David A. Sanger, "Chile Is Admitted as North American Free Trade Partner," *New York Times*, December 12, 1994, accessed April 30, 2011, www.nytimes.com/1994/12/12/world/chile-is-admitted-as-north-american-free-trade-partner.html. Since then, Canada, Mexico, and the United States have each negotiated bilateral trade agreements with Chile, but there is still occasional mention that Chile may one day join NAFTA.Anthony DePalma, "Passing the Torch on a Chile Trade Deal," *New York Times*, January 7, 2001, accessed April 30, 2011, www.nytimes.com/2001/01/07/business/economic-view-passing-the-torch-on-a-chile-trade-deal.html.

Did You Know?

Mexico, NAFTA, and the *Maquiladoras*

The Mexican economy has undergone dramatic changes during the last decade and a half as the country has become integrated into the global marketplace. Once highly protected, Mexico is now open for business. Successive governments have instituted far-reaching economic reforms, which have had a major impact on the way business is conducted. The scale of business has changed as well. Forced to compete with large multinationals and Mexican conglomerates, many traditional family-owned firms have had to close because they were unable to compete in the global marketplace.

NAFTA has added to the already-strong US influence on Mexico's corporate and business practices. In particular, competitiveness and efficiency have become higher priorities, although company owners and managers still like to surround themselves with people they know and to groom their sons and sometimes their daughters to be their successors. US influence is also pervasive in the products and services offered throughout Mexico.

Mexico has always had a strong entrepreneurial business culture, but until NAFTA, it was protected from the pressures of international finance and the global marketplace. Business and particularly interpersonal business relationships were viewed as something that should be pleasurable, like other important aspects of life.

Long-term relationships are still the foundation on which trust is established and business is built. In Mexico, patience and the willingness to wait are still highly valued—and necessary—in business transactions. This is slowly changing, spurred in part by an aggressive cadre of young professionals who pursued graduate education in the United States.

Since the mid-1960s, production facilities known as *maquiladoras* have been a regular feature of Mexican border towns, especially along the Texas and New Mexico borders. US multinational companies, such as John Deere, Zenith, Mattel, and Xerox, run the majority of the more than 3,600 maquiladoras in northern Mexico. Billions of dollars' worth of products—from televisions to clothes to auto parts—are assembled in maquiladoras and then shipped back, tax free, to the United States for sale to US consumers.

Maquiladoras employ more than a million Mexicans, mostly unskilled women in their twenties and early thirties who work long hours. Wages and benefits are generally poor but much better than in the rest of Mexico. The huge growth in trade between the United States and Mexico has greatly expanded the role—and scale—of these assembly operations.

Along with the benefits, challenges have also come with the increased trade. A large number of Mexicans are concerned that wealth is distributed more unevenly than ever. For example, many commentators see the political situation in the state of Chiapas as underscoring the alienation large groups have suffered as a result of the opening of the Mexican economy to global forces. A rural region in southern Mexico, Chiapas is home to extremely poor Mayan, Ch'ol, Zoque, and Lacandón Indians. Although it is the poorest state in Mexico, Chiapas has the richest natural resources, including oil, minerals, and electrical power.

On January 1, 1994, the day NAFTA officially took effect, a group of Indian peasants, commanded by Subcomandante Marcos, rose up in armed rebellion. This was shocking not only to Mexico's leadership but to the international community. The unrest in Chiapas stems from long-standing economic and social injustice in the region and from the Indians' isolation and exploitation by the local oligarchy of landowners and mestizo bosses (*caciques*). While NAFTA clearly advanced the goals of free trade, global businesses are often forced to deal with local economic, political, and social realities within a country.

The Mexican government has indicated that improving the social conditions in the region is a high priority. However, only partial accords have been reached between the government and the peasants. At the same time, the army continues to exert tight control over the state, particularly in and around towns where residents are known to support the rebels.

The low standard of living in Chiapas and of Indians throughout Mexico remains a significant challenge for the Mexican government. In the years following the Chiapas uprising, poverty in southern Mexico has risen to about 40 percent, while in the north, poverty has decreased thanks to closer economic links with the United States.*CultureQuest Doing Business in Mexico* (New York: Atma Global, 2011).

South America: MERCOSUR

The Common Market of the South, Mercado Común del Sur or MERCOSUR, was originally established in 1988 as a regional trade agreement between Brazil and Argentina and then was expanded in 1991 to include Uruguay and Paraguay. Over the past decade, Bolivia, Chile, Colombia, Ecuador, and Peru have become associate members, and Venezuela is in the process for full membership.

MERCOSUR constituents compose nearly half of the wealth created in all of Latin America as well as 40 percent of the population. Now the world's fourth-largest trading bloc after the EU, NAFTA, and the Association of South East Asian Nations (ASEAN),Joanna Klonsky and Stephanie Hanson, "Mercosur: South America's Fractious Trade Bloc," *Council on Foreign Relations*, August 20, 2009, accessed April 30, 2011, www.cfr.org/trade/mercosur-south-americas-fractious-trade-bloc/p12762. the group has been strategically oriented to develop the economies of its constituents, helping them become more internationally competitive so that they would not have to rely on the closed market arena. MERCOSUR has brought nations with long-standing rivalries together. Although this is an economic trade initiative, it has also been designed with clear political goals. MERCOSUR is committed to the consolidation of democracy and the maintenance of peace throughout the southern cone. For example, it has taken stride to reach agreements between Brazil and Argentina in the nuclear field.Joanna Klonsky and Stephanie Hanson, "Mercosur: South America's Fractious Trade Bloc," *Council on Foreign Relations*, August 20, 2009, accessed April 30, 2011, www.cfr.org/trade/mercosur-south-americas-fractious-trade-bloc/p12762.

MERCOSUR has emerged as one of the most dynamic and imaginative initiatives in the region. Surging trade, rising investment, and expanding output are the economic indicators that point to the group's remarkable achievement. More than this, the integration is helping transform national relations among South American nations and with the world as a whole, forging a new sense of shared leadership and shared purpose, which is sending ripples of hope across the continent and beyond.

Other Trade Agreements in the Americas

CARICOM and Andean Community

The Caribbean Community and Common Market (CARICOM), or simply the Caribbean Community, was formed in 1973 by countries in the Caribbean with the intent of creating a single market with the free flow of goods, services, labor, and investment.Caribbean Community (CARICOM) Secretariat website, accessed April 30, 2011, www.caricom.org/index.jsp. The Andean Community (called the Andean Pact until 1996)Andean Community of Nations—Andean Pact website, accessed April 30, 2011, www.grouplamerica.com/andean_pact.htm. is a free trade agreement signed in 1969 between Bolivia, Chile, Colombia, Ecuador, and Peru. Eventually Chile dropped out, while Venezuela joined for about twenty years and left in 2006. This trading bloc had limited impact for the first two decades of its existence but has experienced a renewal of interest after MERCOSUR's implementation. In 2007, MERCOSUR members became associate members of the Andean Community, and more cooperative interaction between the trading groups is expected.European Commission, "Andean Community Regional Strategy Paper 2007–2013," December 4, 2007, accessed April 30, 2011, www.eeas.europa.eu/andean/rsp/07_13_en.pdf.

CAFTA-DR

The Dominican Republic–Central America–United States Free Trade Agreement (CAFTA-DR) is a free trade agreement signed into existence in 2005. Originally, the agreement (then called the Central America Free Trade Agreement, or CAFTA) encompassed discussions between the US and the Central American countries of Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua.

A year before the official signing, the Dominican Republic joined the negotiations, and the agreement was renamed CAFTA-DR.“Dominican Republic–Central America–United States Free Trade Agreement (CAFTA-DR),” Export.gov, accessed April 30, 2011, http://www.export.gov/FTA/cafta-dr/index.asp.

The goal of the agreement is the creation of a free trade area similar to NAFTA. For free trade advocates, the CAFTA-DR is also seen as a stepping stone toward the eventual establishment of the Free Trade Area of the Americas (FTAA)—the more ambitious grouping for a free trade agreement that would encompass all the South American and Caribbean nations as well as those of North and Central America (except Cuba). Canada is currently negotiating a similar treaty called the Canada Central American Free Trade Agreement. It’s likely that any resulting agreements will have to reconcile differences in rules and regulations with NAFTA as well as any other existing agreements.“What Is CAFTA?,” CAFTA Intelligence Center, accessed April 30, 2011, www.caftaintelligencecenter.com/subpages/What_is_CAFTA.asp.

Did You Know?

As a result of CAFTA-DR, more than 80 percent of goods exported from the United States into the region are no longer subject to tariffs.“Dominican Republic–Central America–United States Free Trade Agreement (CAFTA-DR),” Export.gov, accessed April 30, 2011, http://www.export.gov/FTA/cafta-dr/index.asp. Given its physical proximity, Florida is the main investment gateway to the CAFTA-DR countries: about three hundred multinational firms have their Latin American and Caribbean regional headquarters in Florida. In all, more than two thousand companies headquartered outside the United States operate in Florida.

US companies, for example, sell more than $25 billion in products to the Latin American and Caribbean regions annually, ranking it among the top US export markets. With the removal of virtually all tariffs and other barriers to trade, the CAFTA-DR agreement is making commerce with these countries even easier, opening opportunities to a range of industries. At the same time, it’s making the CAFTA-DR countries richer and increasing the purchasing power of their citizens.

For international companies looking to access these markets, the United States, recognized worldwide for its stable regulatory and legal framework and for its robust infrastructure, is the most logical place to set up operations. And within the United States, no location is as well positioned as Florida to act as the gateway to the CAFTA-DR markets. For a variety of reasons—from geography and language to well-developed business and family connections—this is a role that Florida has been playing very successfully for a number of years and which, with the implementation of CAFTA-DR, is only gaining in importance.Enterprise Florida, “Your Business: International,” The CAFTA Intelligence Center, accessed December 30, 2010, www.caftaintelligencecenter.com/subpages/location-International.asp.

Europe: EU

Brief History and Purpose

The European Union (EU) is the most integrated form of economic cooperation. As you learned in the opening case study, the EU originally began in 1950 to end the frequent wars between neighboring countries in the Europe. The six founding nations were France, West Germany, Italy, and the **Benelux countries** (Belgium, Luxembourg, and the Netherlands), all of which signed a treaty to run their coal and steel industries under a common management. The focus was on the development of the coal and steel industries for peaceful purposes.

In 1957, the six nations signed the Treaty of Rome, which established the European Economic Community (EEC) and created a common market between the members. Over the next fifty years, the EEC added nine more members and changed its name twice—to European Community (EC) in the 1970s and the European Union (EU) in 1993.“History of the European Union,” Europa, accessed April 30, 2011, http://europa.eu/abc/history/index_en.htm.

The entire history of the transformation of the EEC to the EU has been an evolutionary process. However, the Treaty of Maastricht in 1993 stands out as an important moment; it’s when the *real* economic union was created. With this treaty, the EU identified three aims. The first was to establish a single, common currency, which went into effect in 1999. The second was to set up monetary and fiscal targets for member countries. Third, the treaty called for a political union, which would include the development of a common foreign and defense policy and common citizenship. The opening case study addressed some of the current challenges the EU is facing as a result of the impact of these aims. Despite the challenges, the EU is likely to endure given its historic legacy. Furthermore, a primary goal for the development of the EU was that Europeans realized that they needed a larger trading platform to compete against the US and the emerging markets of China and India. Individually, the European countries would never have the economic power they now have collectively as the EU.

Today, the EU has twenty-seven member countries. Croatia, Iceland, Macedonia, and Turkey are the next set of candidates for future membership. In 2009, the twenty-seven EU countries signed the Treaty of Lisbon, which amends the previous treaties. It is designed to make the EU more democratic, efficient, and transparent and to tackle global challenges, such as climate change, security, and sustainable development.

The European Economic Area (EEA) was established on January 1, 1994, following an agreement between the member states of the European Free Trade Association (EFTA) and the EC (later the EU). Specifically, it has allowed Iceland (now an EU candidate), Liechtenstein, and Norway to participate in the EU's single market without a conventional EU membership. Switzerland has also chosen to not join the EU, although it is part of similar bilateral agreements.

Figure 5.3 Countries in the EU (as of May 1, 2011)

Countries in the EU (as May 1, 2011)	
Austria	Italy
Belgium	Latvia
Bulgaria	Lithuania
Cyprus	Luxembourg
Czech Republic	Malta
Denmark	Netherlands
Estonia	Poland
Finland	Portugal
France	Romania
Germany	Slovakia
Greece	Slovenia
Hungary	Sweden
Ireland	United Kingdom

Candidate Countries
Croatia
The former Yugoslav Republic of Macedonia
Turkey

Iceland
Potential Candidate Countries
Albania Bosnia and Herzegovina Kosovo under UN Security Council Resolution 1244 Montenegro Serbia

Source: "The Member Countries of the European Union," Europa, accessed May 1, 2011, europa.eu/about-eu/member-countries/index_en.htm.

CEFTA

Central European Free Trade Agreement (CEFTA) is a trade agreement between non-EU countries in Central and Southeastern Europe, which currently includes Albania, Bosnia and Herzegovina, Croatia, Macedonia, Moldova, Montenegro, Serbia, and the United Nations Interim Administration Mission on behalf of Kosovo (UNMIK)—all of whom joined in 2006.Andzej Arendarski, Ludovit Cernak, Vladimir Dlouhy, and Bela Kadar, "Central European Free Trade Agreement," December 21, 1992, accessed April 30, 2011, http://www.worldtradelaw.net/fta/agreements/cefta.pdf.

Originally signed in 1992, CEFTA's founding members were the Visegrad Group, also called the Visegrad Four or V4, which is an alliance of four Central European states—the Czech Republic, Hungary, Poland, and Slovakia. All of the Visegrad Group have relatively developed free-market economies and have formal ties."About the Visegrad Group," International Visegrad Fund, accessed December 30, 2010, http://visegradgroup.eu/main.php?folderID=858.

Many of the Central European nations have left CEFTA to become members of the EU. In fact, CEFTA has served as a preparation for full EU membership and a large proportion of CEFTA foreign trade is with EU countries. Poland, the Czech Republic, Hungary, Slovakia, and Slovenia joined the EU on May 1, 2004, with Bulgaria and Romania following suit on January 1, 2007."About CEFTA," Central European Free Trade Agreement, accessed April 30, 2011, cefta.net. Croatia and Macedonia are in the process of becoming EU members."About CEFTA," Central European Free Trade Agreement, accessed April 30, 2011, cefta.net; Andzej Arendarski, Ludovit Cernak, Vladimir Dlouhy, and Bela Kadar, "Central European Free Trade Agreement," December 21, 1992, accessed April 30, 2011, http://www.worldtradelaw.net/fta/agreements/cefta.pdf; *Wikipedia*, s.v. "Central European Free Trade Agreement," last modified February 12, 2011, accessed February 16, 2011, http://en.Wikipedia.org/wiki/Central_European_Free_Trade_Agreement.

Amusing Anecdote

There are twenty-three official and working languages within the EU, and all official documents and legislation are translated into all of these languages. With this in mind, it's easy to see why so many Europeans see the need to speak more than one language fluently!

Official and Working Languages of the EU	
Bulgarian	Italian
Czech	Irish
Danish	Latvian
Dutch	Lithuanian
English	Maltese
Estonian	Polish
Finnish	Portuguese
French	Romanian
German	Slovene
Greek	Spanish
Hungarian	Swedish

EU Governance

The EU is a unique organization in that it is not a single country but a group of countries that have agreed to closely cooperate and coordinate key aspects of their economic policy. Accordingly, the organization has its own governing and decision-making institutions.

- **European Council.** The European Council provides the political leadership for the EU. The European Council meets four times per year, and each member has a representative, usually the head of its government. Collectively it functions as the EU's "Head of State."
- **European Commission.** The European Commission provides the day-to-day leadership and initiates legislation. It's the EU's executive arm.
- **European Parliament.** The European Parliament forms one-half of the EU's legislative body. The parliament consists of 751 members, who are elected by popular vote in their respective countries. The term for each member is five years. The purpose of the parliament is to debate and amend legislation proposed by the European Commission.
- **Council of the European Union.** The Council of the European Union functions as the other half of the EU's legislative body. It's sometimes called the Council or the Council of Ministers and should not be confused with the European Council above. The Council of the European Union consists of a government minister from each member country and its representatives may change depending on the topic being discussed.
- **Court of Justice.** The Court of Justice makes up the judicial branch of the EU. Consisting of three different courts, it reviews, interprets, and applies the treaties and laws of the EU."Institutions and Bodies of the European Union," Europa, accessed April 30, 2011, http://europa.eu/about-eu/institutions-bodies/index_en.htm.

Current Challenges and Opportunities

The biggest advantage of EU membership is the monetary union. Today, sixteen member countries use the the euro. Since its launch, the euro has become the world's second-largest reserve currency behind the US dollar. It's important to remember several distinctions. First, the EU doesn't consist of the same countries as the continent of Europe. Second, there are more EU member countries than there are countries using the euro. Euro markets, or euro countries, are the countries using the euro.

The European single market is the foremost advantage of being a member of EU. According to Europa, which is the official website of the EU (http://europa.eu), the EU member states have formed a single market with more than five hundred million people, representing 7 percent of the world's population. This single market permits the free flow of goods, service, capital, and people within the EU."Four Market Freedom Which Benefit Us All," Europa, accessed December 30, 2010, http://europa.eu/pol/singl/index_en.htm. Although there is a single tariff on goods entering an EU country, once in the market, no additional tariffs or taxes can be levied on the goods."Basic Information on the European Union," Europa, accessed April 30, 2011, europa.eu/about-eu/basic-information/index_en.htm.

Businesses conducting business with one country in the EU now find it easier and cheaper, in many cases, to transact business with the other EU countries. There's no longer a currency–exchange rate risk, and the elimination of the need to convert currencies within euro markets reduces transaction costs. Further, having a single currency makes pricing more transparent and consistent between countries and markets.

Despite the perceived benefits, economic policymakers in the EU admit that the Union's labor markets are suffering from rigidity, regulation, and tax structures that have contributed to high unemployment and low employment responsiveness to economic growth. This is the case, particularly, for relatively low-skilled labor.

Future Outlook

Europe's economy faces a deeper recession and a slower recovery than the United States or other parts of the world. Because the EU's $18.4 trillion economy makes up 30 percent of the world economy, its poor prospects are likely to rebound on the United States, Asia, and other regions."Staring into the Abyss," *Economist*, July 8, 2010, accessed December 28, 2010, http://www.economist.com/node/16536898. Fixing the EU's banking system is particularly tricky, because sixteen of the twenty-seven countries share the euro currency and a central bank, but banking regulation mostly remains under the control of the national governments.Liz Alderman, "Contemplating the Future of the European Union," *New York Times*, February 13, 2010, accessed April 30, 2011, www.nytimes.com/2010/02/14/weekinreview/14alderman.html.

The Europe 2020 strategy put forth by the European Commission sets out a vision of the EU's social market economy for the twenty-first century. It shows how the EU can come out stronger from this crisis and how it can be turned into a smart, sustainable, and inclusive economy delivering high levels of employment, productivity, and social cohesion. It calls for stronger economic governance in order to deliver rapid and lasting results."Future for Europe," Europa, accessed April 30, 2011, http://europa.eu/abc/12lessons/lesson_12/index_en.htm.

Asia: ASEAN

The Association of Southeast Asian Nations (ASEAN) was created in 1967 by five founding-member countries: Malaysia, Thailand, Indonesia, Singapore, and the Philippines. Since inception, Myanmar (Burma), Vietnam, Cambodia, Laos, and Brunei have joined the association.Sanjyot P. Dunung, *Doing Business in Asia: The Complete Guide*, 2nd ed. (San Francisco: Jossey-Bass, 1998).

ASEAN's primary focus is on economic, social, cultural, and technical cooperation as well as promoting regional peace and stability. Although less emphasized today, one of the primary early missions of ASEAN was to prevent the domination of Southeast Asia by external powers—specifically China, Japan, India, and the United States.

In 2002, ASEAN and China signed a free trade agreement that went into effect in 2010 as the ASEAN–China Free Trade Area (ACFTA). In 2009, ASEAN and India also signed the ASEAN–India Free Trade Agreement (FTA). In 2009, ASEAN signed a free trade agreement with New Zealand and Australia. It also hopes to create an ASEAN Economic Community by 2015."ASEAN Countries to Integrate Regional Capital Markets by 2015," Asia Economic Institute, accessed April 30, 2011, www.asiaecon.org/special_articles/read_sp/12174. While the focus and function remains in discussion, the intent is to forge even closer ties among the ten member nations, enabling them to negotiate more effectively with global powers like the EU and the

United States."About ASEAN," Association of Southeast Asian Nations, accessed April 30, 2011, www.aseansec.org/about_ASEAN.html.

Asia: APEC

The Asia–Pacific Economic Cooperation (APEC) was founded in 1989 by twelve countries as an informal forum. It now has twenty-one member economies on both sides of the Pacific Ocean. APEC is the only regional trading group that uses the term *member economies*, rather than countries, in deference to China. Taiwan was allowed to join the forum, but only under the name Chinese Taipei.Sanjyot P. Dunung, *Doing Business in Asia: The Complete Guide*, 2nd ed. (San Francisco: Jossey-Bass, 1998).

As a result of the Pacific Ocean connection, this geographic grouping includes the United States, Canada, Mexico, Chile, Peru, Russia, Papua New Guinea, New Zealand, and Australia with their Asia Pacific Rim counterparts."About APEC: History," Asia–Pacific Economic Cooperation, accessed April 30, 2011, http://www.apec.org/About-Us/About-APEC/History.aspx. This assortment of economies and cultures has, at times, made for interesting and heated discussions. Focused primarily on economic growth and cooperation, the regional group has met with success in liberalizing and promoting free trade as well as facilitating business, economic, and technical cooperation between member economies. With the Doha Round of the WTO dragging, APEC members have been discussing establishing a free-trade zone. Given its broader membership than ASEAN, APEC has found good success—once its member countries agree. The two organizations often share common goals and seek to coordinate their efforts.

China Seeks to Create a Trading Bloc

On June 29, 2010, China and Taiwan signed the Economic Cooperation Framework Agreement (ECFA), a preferential trade agreement between the two governments that aims to reduce tariffs and commercial barriers between the two sides. It's the most significant agreement since the two countries split at the end of the Chinese Civil War in 1949.Keith B. Richburg, "China, Taiwan Sign Trade Pact," *Washington Post*, June 30, 2010, accessed April 30, 2011, www.washingtonpost.com/wp-dyn/content/article/2010/06/29/AR2010062900163.html. It will boost the current $110 billion bilateral trade between both sides. China already absorbed Hong Kong in 1999, after the hundred-year lease to Britain ended. While Hong Kong is now managed by China as a Special Administrative Region (SAR), it continues to enjoy special economic status. China is eager for Hong Kong and Taiwan to serve as gateways to its massive market. Taiwan's motivation for signing the agreement was in large part an effort to get China to stop pressuring other countries from signing trade agreements with it.Lucy Hornby, "Taiwan and China Sign Trade Pact," *Reuters*, June 29, 2010, accessed April 30, 2011, www.reuters.com/article/2010/06/29/us-china-taiwan-signing-idUSTRE65S17Z20100629.

"An economically stronger Taiwan would not only gain clout with the mainland but also have more money to entice allies other than the 23 nations around the globe that currently recognize the island as an independent state. Beijing is hoping closer economic ties will draw Taiwan further into its orbit."Isaac Stone Fish, "Taiwan Inks Risky Deal with China," *Newsweek*, July 2, 2010, accessed December 31, 2010, www.newsweek.com/2010/07/02/taiwan-inks-a-risky-deal-with-china.html. While opposition in Taiwan sees the agreement as a cover for reunification with China, the agreement does reduce tariffs on both sides, enabling businesses from both countries to engage in more trade.

Middle East and Africa: GCC

The Cooperation Council for the Arab States of the Gulf, also known as the Gulf Cooperation Council (GCC), was created in 1981. The six member states are Bahrain, Kuwait, Saudi Arabia, Oman, Qatar, and the United Arab Emirates (UAE). As a political and economic organization, the group focuses on trade, economic, and social issues.Cooperation Council for the Arab States of the Gulf website, accessed April 30, 2011, www.gcc-sg.org/eng/index.html. The GCC has become as much a political organization as an economic one. Among its various initiatives, the GCC calls for the coordination of a unified military presence in the form of a Peninsula Shield Force."Stop Meddling in Our Affairs: GCC Countries Tell Iran," *The Middle East Times*, April 4, 2011, accessed April 30, 2011, http://www.mideast-times.com/left_news.php?newsid=1628.

In 1989, the GCC and the EU signed a cooperation agreement. "Trade between the EU and the GCC countries totalled €79 billion in 2009 and should increase under the FTA. And while strong economic relations remain the basis for mutual ties, the EU and the GCC also share common interests in areas such as the promotion of alternative energy, thus contributing to the resolution of climate change and other pressing environmental concerns; the promotion of proper reform for the global economic and financial policies; and the enhancement of a comprehensive rules-based international system."Gonzalo de Benito, Luigi Narbone, and Christian Koch, "The Bonds between the GCC and EU Grow Deeper," *The National*, June 12, 2010, accessed May 23, 2011, www.grc.ae/index.php?frm_module=contents&frm_action=detail_book&frm_type_id=&op_lang

=en&override=Articles+%3E+The+Bonds+between+the+GCC+and+EU+Grow+Deeper&sec=Contents&frm_title=&book_id=69542.

In 2008, the GCC formed a common market, enabling free flow of trade, investment, and workers.P. K. Abdul Ghafour, "GCC Common Market Becomes a Reality," *Arab News*, January 2, 2008, accessed April 30, 2011, archive.arabnews.com/?page=1&section=0&article=105173&d=1&m=1&y=2008. In December 2009, Bahrain, Saudi Arabia, Kuwait, and Qatar created a monetary council with the intent of eventually creating a shared currency.Mohsin Khan, "The GCC Monetary Union: Choice of Exchange Rate Regime," Peterson Institute for International Economics, April 2009, accessed April 30, 2011, www.iie.com/publications/wp/wp09-1.pdf. Since its creation, the GCC has contributed not only to the expansion of trade but also to the development of its countries and the welfare of its citizens, as well as promoting peace and stability in the region.Nadim Kawach, "Unrest Will Not Affect GCC Monetary Union: Bahrain Central Bank Governor Says Union Remains Open for Other Members," *Emirates 24/7*, March 12, 2011, accessed April 30, 2011, www.emirates247.com/2.266/finance/unrest-will-not-affect-gcc-monetary-union-2011-03-12-1.366972.

Middle East and Africa: AEC

The African Economic Community (AEC) is an organization of the African Union states. Signed in 1991 and implemented in 1994, it provides for a staged integration of the regional economic agreements. Several regional agreements function as pillars of the AEC:*Wikipedia*, s.v. "African Economic Community," accessed April 30, 2011, http://en.Wikipedia.org/wiki/African_Economic_Community.

- Community of Sahel-Saharan States (CEN-SAD)
- Common Market for Eastern and Southern Africa (COMESA)
- East African Community (EAC)
- Economic Community of Central African States (ECCAS/CEEAC)
- Economic Community of West African States (ECOWAS)
- Intergovernmental Authority on Development (IGAD)
- Southern African Development Community (SADC)
- Arab Maghreb Union (AMU/UMA)

Economists argue that free trade zones are particularly suited to African countries which were created under colonial occupation when land was divided up, often with little regard for the economic sustainability of the newly created plot.

Plus, post-independence conflict in Africa has left much of the continent with a legacy of poor governance and a lack of political integration which free trade zones aim to address….

[In October 2008,] plans were agreed to create a "super" free trade zone encompassing 26 African countries, stretching from Libya in the north to South Africa. The GDP of this group of nations is put at $624bn (£382.9bn).Louise Greenwood, "Q&A: Free Trade Zones in Africa," BBC Africa Business Report, *BBC News*, August 21, 2009, accessed December 31, 2010, http://news.bbc.co.uk/2/hi/business/8208254.stm.

Ambitiously, in 2017 and after, the AEC intends to foster the creation of a free-trade zone and customs union in its regional blocs. Beyond that, there are hopes for a shared currency and eventual economic and monetary union.

How Do These Trade Agreements and Efforts Impact Business?

Overall, global businesses have benefited from the regional trade agreements by having more consistent criteria for investment and trade as well as reduced barriers to entry. Companies that choose to manufacture in one country find it easier and cheaper to move goods between member countries in that trading bloc without incurring tariffs or additional regulations.

The challenges for businesses include finding themselves outside of a new trading bloc or having the "rules" for their industry change as a result of new trade agreements. Over the past few decades, there has been an increase in bilateral and multilateral trade agreements. It's often called a "spaghetti bowl" of global bilateral and multilateral trade agreements, because the agreements are not linear strands lining up neatly; instead they are a messy mix of crisscrossing strands, like a bowl of spaghetti, that link countries and trading blocs in self-benefiting trading alliances. Businesses have to monitor and navigate these evolving trade agreements to make sure that one or more agreements don't negatively impact their businesses in key countries. This is one reason why global businesses have teams of in-house professionals monitoring the WTO as well as the regional trade alliances.

For example, American companies doing business in one of the ASEAN countries often choose to become members of the US–ASEAN Business Council, so that they can monitor and possibly influence new trade regulations as well as advance their business interests with government entities.

The US–ASEAN Business Council is the premiere advocacy organization for U.S. corporations operating within the dynamic Association of Southeast Asian Nations (ASEAN). ASEAN represents nearly 600 million people and a combined GDP of USD $1.5 trillion across Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam. The Council's members include the largest U.S. companies working in ASEAN, and range from newcomers to the region to companies that have been working in Southeast Asia for over 100 years….

The Council leads major business missions to key economies; convenes multiple meetings with ASEAN heads of state and ministers; and is the only U.S. organization to be given the privilege of raising member company concerns in consultations with the ASEAN Finance and Economic Ministers, as well as with the ASEAN Customs Directors-General at their annual meetings. Having long-established personal and professional relationships with key ASEAN decision makers, the Council is able to arrange genuine dialogues, solve problems and facilitate opportunities in all types of market conditions, and provide market entry and exclusive advisory services."About the US–ASEAN Business Council," US–ASEAN Business Council, accessed December 31, 2010, www.usasean.org/Aboutus/index.asp.

US–ASEAN member companies read like the *Fortune* Global 500 and include AT&T, Coca-Cola, Microsoft, Johnson & Johnson, Chevron, Ford Motor Company, and General Electric. While other countries and the EU have ongoing dialogues with ASEAN, the US–ASEAN Business Council is the most formal approach. For a list of ongoing ASEAN relationships with key trading partners, visit www.aseansec.org/9731.htm.

It's easy to see how complicated the relationships can be with just one trading bloc. A global firm with operations in North America, the EU, and Asia could easily find itself at the crosshairs of competing trade interests. Staffed with lawyers in an advocacy department, global firms work to maintain relationships with all of the interested parties. If you are curious about a business career in trade, then you may want to consider combining a business degree with a legal degree for the most impact.

KEY TAKEAWAYS

- Regional economic integration refers to efforts to promote free and fair trade on a regional basis.

  There are four main types of economic integration:

  1. *Free trade area* is the most basic form of economic cooperation. Member countries remove all barriers to trade between themselves, but are free to independently determine trade policies with nonmember nations.
  2. *Customs union* provides for economic cooperation. Barriers to trade are removed between member countries, and members agree to treat trade with nonmember countries in a similar manner.
  3. *Common market* allows for the creation of an economically integrated market between member countries. Trade barriers and any restrictions on the movement of labor and capital between member countries are removed. There is a common trade policy for trade with nonmember nations, and workers no longer need a visa or work permit to work in another member country of a common market.
  4. *Economic union* is created when countries enter into an economic agreement to remove barriers to trade and adopt common economic policies.
- The largest regional trade cooperative agreements are the European Union (EU), the North American Free Trade Agreement (NAFTA), and the Asia–Pacific Economic Cooperation (APEC). The African Economic Community (AEC) has more member countries than the EU, NAFTA, and APEC but represents a substantially smaller portion of global trade than these other cooperatives.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Describe the EU and why it's considered the most integrated economic cooperative agreement.
2. What are two ways that regional economic integration can help global companies?

- **5.3: Regional Economic Integration** by Anonymous is licensed CC BY-NC-SA 3.0. Original source: https://2012books.lardbucket.org/books/challenges-and-opportunities-in-international-business/.

3.9: The United Nations and the Impact on Trade

LEARNING OBJECTIVE

1. Understand how and why peace impacts business.
2. Describe the role of the United Nations.
3. Identify how global businesses benefit from political and economic stability

The final section in this chapter reviews an institution, the United Nations, whose primary purpose is to promote peace between countries. Peace fosters stability and that stability provides the framework for the expansion of business interests and trade.

Why Does Peace Impact Business?

The opening case study demonstrated how political, economic, and military instability in Europe led to two world wars and eventually the development of the EU. It's clear that conflict between countries significantly reduces international trade and seriously damages national and global economic welfare.

It's worth noting that there is a wide range of businesses that benefit from war—for example, companies in industries that manufacture arms, plastics, clothing (uniforms), and a wide range of supplies and logistics. Companies such as BAE Systems, Lockheed Martin, Finmeccanica, Thales Group, General Dynamics, KBR (Halliburton), Rolls-Royce, Boeing, and Honeywell are just some of the world's largest companies in this sector, and all receive benefits that are woven into economic and trade policy from their respective governments directly as well as through general preferences in trade policies and agreements.

Did You Know?

Industrialized countries negotiate free trade and investment agreements with other countries, but exempt military spending from the liberalizing demands of the agreement. Since only the wealthy countries can afford to devote billions on military spending, they will always be able to give their corporations hidden subsidies through defence contracts, and maintain a technologically advanced industrial capacity.

And so, in every international trade and investment agreement one will find a clause which exempts government programs and policies deemed vital for national security.Stephen Staples, "Confronting the Military-Corporate Complex" (presented at the Hague Appeal for Peace, The Hague, May 12, 1999).

Nevertheless, military conflict can be extremely disruptive to economic activity and impede long-term economic performance. As a result, most global businesses find that operating in stable environments leads to the best business operations for a range of reasons:

- **Staffing.** It's easier to recruit skilled labor if the in-country conditions are stable and relatively risk-free. Look at the challenges companies have in recruiting nonmilitary personnel to work in the fledging private sectors of Iraq or Afghanistan. Even development organizations have been challenged to send in skilled talent to develop banking-, finance-, and service-sector initiatives. Historically, regardless of which country or conflict, development staff has only been sent into a country after stability has been secured by military force. Companies have to pay even higher levels of hardship and risk pay and may still not necessarily be able to bring in the best talent.
- **Operations.** In unstable environments, companies fear loss or damage to property and investment. For example, goods in transit can easily be stolen, and factories or warehouses can be damaged.
- **Regulations.** Unclear and constantly changing business rules make it hard for firms to plan for the long term.
- **Currency convertibility and free-flowing capital.** Often countries experiencing conflict often impose capital controls (i.e., restrictions on money going in and out of their countries) as well as find that their currency may be devalued or illiquid. Financial management is a key component of global business management. (Chapter 6 discusses the value of stable, liquid, and freely floating currencies, and Chapter 15 covers financial management.)

While bilateral or multilateral trade doesn't always dissuade countries from pursuing military options, countries that are engaged in trade discussions are more likely to use these forums to discuss other conflict areas. Furthermore, the largest global companies—Siemens, General Electric, Boeing, Airbus, and others—have the economic might to influence governments to promote initiatives to benefit their companies or industries.

Ethics in Action

Business in Conflict Zones: Angola and Conflict Diamonds

Angola, located in southern Africa, is a country that faced internal devastation from an intense civil war raging from its independence in 1975 until 2002. For many businesspeople, Angola may seem a relatively obscure country. However, it is the second-largest petroleum and diamond producer in sub-Saharan Africa. While the oil has brought economic success, the diamonds, known as conflict or blood diamonds, have garnered global attention. Even Hollywood has called attention to this illicit trade in a 2006 movie entitled *Blood Diamond* as well as numerous other movie plots focusing on conflict diamonds, including one in the James Bond franchise.

So what are conflict diamonds? The United Nations (UN) defines them as follows:

Conflict diamonds are diamonds that originate from areas controlled by forces or factions opposed to legitimate and internationally recognized governments, and are used to fund military action in opposition to those governments, or in contravention of the decisions of the Security Council….

Rough diamond caches have often been used by rebel forces to finance arms purchases and other illegal activities. Neighbouring and other countries can be used as trading and transit grounds for illicit diamonds. Once diamonds are brought to market, their origin is difficult to trace and once polished, they can no longer be identified.United Nations Department of Public Information in cooperation with the Sanctions Branch, Security Council Affairs Division, Department of Political Affairs, "Conflict Diamonds: Sanctions and War," United Nations, March 21, 2001, accessed December 31, 2010, www.un.org/peace/africa/Diamond.html.

First discovered in 1912, diamonds are a key industry for Angola. During its twenty-seven years of conflict, which cost up to 1.5 million lives, rebel groups in Angola traded diamonds to fund armed conflict, hence the term *conflict diamonds*. Some estimate that Angola's main rebel group, National Union for the Total Independence of Angola (UNITA), sold more than $3.72 billion in conflict diamonds to finance its war against the government.*Wikipedia*, s.v. "Blood diamond," last modified February 9, 2011, accessed February 15, 2011, http://en.Wikipedia.org/wiki/Blood_diamond.

These morally tainted conflict diamonds, along with those from other conflict countries, were bad for the global diamond industry—damaging the reputation and integrity of their key commodity product.

In 1999, the UN applied sanctions to ban the Angolan rebels' trade in conflict diamonds, but a portion of diamonds continued to be traded by the rebels. The UN conducted extensive investigations. "The Security Council's diamond campaign is part of an ongoing UN effort to make sanctions more selective, better targeted and more rigorously enforced instruments for maintaining international peace and security."Michael Fleshman, "Targeting 'Conflict Diamonds' in Africa," *Africa Recovery* 14, no. 4 (January 2001): 6, accessed December 31, 2010, www.un.org/ecosocdev/geninfo/afrec/subjindx/144diam.htm.

Eventually, the UN, various governments, the diamond industry, and nongovernmental organizations, including Global Witness, Amnesty International, and Partnership Africa Canada (PAC), recognized the need for a global system to prevent conflict diamonds from entering the legitimate diamond supply chain and thus helping fund conflicts. The process that was established in 2003 provides for certification process to assure consumers that by purchasing certified diamonds they weren't financing war and human rights abuses. As a result, seventy-four governments have adopted the Kimberley Process certification system, and more than 99 percent of the world's diamonds are from conflict- free sources.World Diamond Council, "Eliminating Conflict Diamonds," accessed December 31, 2010, diamondfacts.org/conflict/eliminating_conflict_diamonds.html#kim.

The Kimberley Process and global attention have addressed a critical global-business ethics issue. By taking collective ethical action, the global diamond industry, including firms such as De Beers, Cartier, and Zale, have not only done the right thing but have also helped preserve and grow their businesses while restoring the reputation of their industry.

For example, South African De Beers is the world's largest diamond mining and trading company. Prior to UN action and the Kimberley Process, De Beers was buying conflict diamonds from guerilla movements in three African countries, thereby financing regional conflicts. One UN investigation in Angola found that rebel forces bartered uncut diamonds for weaponry, thereby allowing the civil war to continue in 1998 despite international economic and diplomatic sanctions. In 1999, under UN pressure, De Beers decided to stop buying any outside diamonds in order to guarantee the conflict-free status of its diamond.Dick Durham, "De Beers Sees Threat of Blood Diamonds," January 18, 2001, accessed April 30, 2011, www.cnnstudentnews.cnn.com/2001/WORLD/africa/01/18/diamonds.debeers/index.html.

Today, De Beers states that 100 percent of the diamonds it sells are conflict-free and that all De Beers diamonds are purchased in compliance with national law, the Kimberley Process, and its own Best Practice Principles.De Beers Group, "FAQs: What Has De Beers Done about Conflict Diamonds?," 2008, accessed December 31, 2010, www.debeersgroup.com/en/Global/FAQs/#Section755.

Angola is still dealing with the loss and devastation of an almost thirty-year conflict with its quality of life among the worst in the world in terms of life expectancy and infant mortality. Nevertheless, the country has made rapid economic strides since 2002 and is now one of the fastest-growing economies in Africa. Conflict diamonds are no longer traded in Angola. The country is a Kimberley Process participant and currently produces approximately 9 percent of the world's diamonds.*Wikipedia*, s.v. "Angola," last modified February 13, 2011, accessed February 16, 2011, http://en.Wikipedia.org/wiki/Angola.

The United Nations

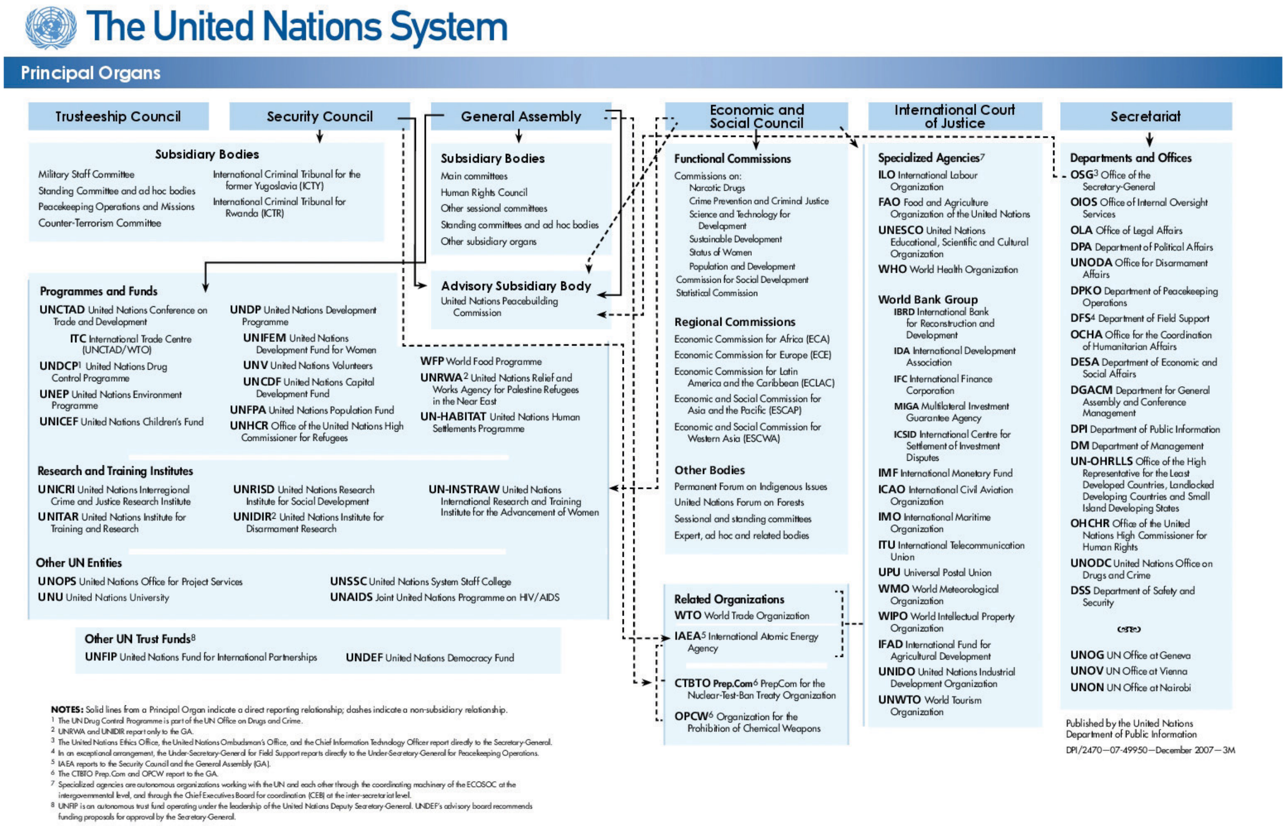
The United Nations (UN) was formed in 1945 at the end of World War II to replace the League of Nations, which had been formed in 1919. Its original goals remain the same today: to maintain international peace and security; to develop friendly relations between nations; and to foster international cooperation in solving economic, social, humanitarian, and cultural issues. There is an underlying premise of human rights and equality. Almost all of the world's countries are members—currently 192 nations—with only a few smaller territories and Taiwan, out of deference to China, given observer status and not membership. The UN is funded by member countries' assessments and contributions.

The work of the UN reaches every corner of the globe. Throughout the world, the UN and its agencies assist refugees, set up programs to clear landmines, help expand food production, and lead the fight against AIDS. They also help protect the environment, fight diseases, reduce poverty, and strive for better living standards and human rights. Although the UN is often best known for peacekeeping, peace building, conflict prevention, and humanitarian assistance, the organization also works on a broad range of fundamental social, economic, environment, and health issues. In the Ethics in Action sidebar on Angola, you learned how the UN led the way to resolving the problem of conflict diamonds and partnered with the global diamond industry to develop a long-term solution to a thorny ethical trading problem and promote peace and stability in former conflict countries like Angola.

A secretary-general leads the UN and serves for a five-year term. Structurally, the UN consists of six main bodies:

1. **General Assembly.** This is the deliberative body of the UN and consists of all of the member countries that meet in regular sessions throughout the year. All of the members have an equal vote in the General Assembly.
2. **Security Council.** This body is responsible for addressing issues related to peace and security. It has fifteen members, five of which are permanent country representations—the United States, the United Kingdom, Russia, China, and France. The remaining ten are elected by the General Assembly every two years. As you may expect, there's a great deal of political wrangling by countries to be on the Security Council, which is deemed to have significant power. All decisions by the Security Council are supposed to be binding on the rest of the member nations of the UN.
3. **Economic and Social Council (ECOSOC).** This body is responsible for issues related to economics, human rights, and social matters. A number of smaller commissions and specialized agencies carry out this council's work. The ECOSOC works closely with the World Bank and the International Monetary Fund, both of which are covered in Chapter 6.
4. **Secretariat.** The Secretariat oversees the operations of the UN and is technically headed by the Secretary-General
5. **International Court of Justice.** Located in The Hague, this body hears disputes between nations. The court consists of fifteen judges who are elected by the General Assembly and the Security Council. The court reviews cases concerning war crimes, genocide, ethnic cleansing, and illegal interference by one country in the affairs of another, among others.
6. **UN Trusteeship Council.** While an official part of the UN Charter charged with overseeing all trustee territories under UN custody, this body is currently inactive.

Figure 5.4 The United Nations System



Source: The United Nations

Did You Know?

A strong UN is the world's most effective voice for international cooperation on behalf of peace, development, human rights, and the environment. The UN has also sought to forge partnerships outside of the traditional diplomatic arena. One such partnership that is of growing interest to private sector businesses is the UN Global Compact. This is a strategic policy initiative for businesses that are committed to aligning their operations and strategies with ten universally accepted principles. Why would companies want to align their businesses with these principles? For starters, some businesses see it as a way to be a good global corporate citizen, a label that they can use to attract and retain the best workforce as well as use in marketing efforts to exhibit their global corporate responsibility. The UN is motivated to engage the private sector in helping solve the world's most pressing problems, often with for-profit solutions.

The United Nations Global Compact presents a unique strategic platform for participants to advance their commitments to sustainability and corporate citizenship. Structured as a public-private initiative, the Global Compact offers a policy framework for the development, implementation, and disclosure of sustainability principles and practices related to its four core areas: human rights, labour, the environment and anti-corruption. Indeed, managing the enterprise risks and opportunities related to these areas is today a widely understood aspect of long-term "value creation"—value creation that can simultaneously benefit the private sector and societies at large.

With over 7700 business participants and other stakeholders from more than 130 countries, the Global Compact offers participants a wide spectrum of specialized work streams, management tools and resources, and topical programs and projects—all designed to help advance sustainable business models and markets in order to contribute to the initiative's overarching objective of helping to build a more sustainable and inclusive global economy."How to Participate," United Nations Global Compact, accessed January 1, 2011, http://www.unglobalcompact.org/HowToParticipate/Business_Participation/index.html.

Companies use their participation in the UN Global Compact to illustrate that they are good global corporate citizens, in an effort to satisfy the objectives of consumers, suppliers, and investors as well as government and nongovernment entities—all of whose support a global company needs to achieve its global business objectives.

One example is Coca-Cola and its adherence to maintaining its good global business citizenship also earns it the ability to influence trade and economic policy with governments and organizations that can positively impact its business interests in select markets around the world. For example, Coca-Cola highlights its commitment on its website and in global reports. The company explains on its website, “In March 2006, The Coca-Cola Company became a signatory to the United Nations (UN) Global Compact, affirming our commitment to the advancement of its 10 universal accepted principles…in the areas of human rights, labor, the environment and anti-corruption. Several of our bottling partners are also signatories.”“UN Global Compact,” Coca-Cola Company, accessed January 1, 2011, www.thecoca-colacompany.com/citizenship/un_global_compact.html.

The Ten Principles of the UN Global Compact

Human Rights

- Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights; and
- Principle 2: make sure that they are not complicit in human rights abuses.

Labour

- Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
- Principle 4: the elimination of all forms of forced and compulsory labour;
- Principle 5: the effective abolition of child labour; and
- Principle 6: the elimination of discrimination in respect of employment and occupation.

Environment

- Principle 7: Businesses should support a precautionary approach to environmental challenges;
- Principle 8: undertake initiatives to promote greater environmental responsibility; and
- Principle 9: encourage the development and diffusion of environmentally friendly technologies.

Anti-Corruption

- Principle 10: Businesses should work against corruption in all its forms, including extortion and bribery.“The Ten Principles,” United Nations Global Compact, accessed April 30, 2011, http://www.unglobalcompact.org/AboutTheGC/TheTenPrinciples/index.html.

UN as a Business Partner

The UN has a very clear diplomatic role on the global stage. It’s also important to remember that it works closely with the private sector, which actually carries out the vast amount of services and projects around the world. Global businesses sell to the UN just as they do to their own governments and public-sector organizations. Each arm of the UN has a procurement office. The UN Procurement Division does business with vendors from all over the world and is actively working to increase its sources of supply from developing countries and countries with economies in transition.

KEY TAKEAWAYS

- While certain industries (e.g., defense companies) benefit from conflict, in general global firms prosper best in peaceful times. The primary impact for businesses is in the areas of staffing, operations, regulations, and currency convertibility and financial management.
- The United Nations (UN) was formed at the end of World War II in 1945. Its original intent remains the same: to maintain international peace and security; to develop friendly relations between nations; and to foster international cooperation in solving economic, social, humanitarian, and cultural issues.
- The six main bodies of the UN are the (1) Secretariat, (2) Security Council, (3) General Assembly, (4) Economic and Social Council, (5) International Court of Justice, and (6) UN Trusteeship Council. The Secretary-General leads the UN.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. GE makes both military equipment and consumer products. Research GE and its product range on its website (www.ge.com/products_services/directory/by_product.html). Do you think a company like GE prefers conflict zones or peaceful countries? What issues do you think senior management has to consider when reviewing the company’s operations in

Angola? Use what you learned in the Ethics in Action sidebar on Angola and research the country's civil war. Visit GE's Angola website at http://www.ge.com/ao/ to obtain more information on the company's in-country operations.
2. The Did You Know? sidebar on the UN Global Compact reviewed how the UN is partnering with global businesses. Visit http://www.unglobalcompact.org. List the ten principles to which businesses must agree. Select one global company and evaluate if you think the ten principles are reasonable and worthwhile for the company to follow.

3.10: End-of-Chapter Questions and Exercises

These exercises are designed to ensure that the knowledge you gain from this book about international business meets the learning standards set out by the international Association to Advance Collegiate Schools of Business (AACSB International).Association to Advance Collegiate Schools of Business website, accessed January 26, 2010, http://www.aacsb.edu. AACSB is the premier accrediting agency of collegiate business schools and accounting programs worldwide. It expects that you will gain knowledge in the areas of communication, ethical reasoning, analytical skills, use of information technology, multiculturalism and diversity, and reflective thinking.

EXPERIENTIAL EXERCISES

(AACSB: Communication, Use of Information Technology, Analytical Skills)

1. Review the WTO and the regional trading agreements. Which do you think is more effective in promoting free trade, the global or regional cooperative agreements? Why?
2. Based on what you have learned in Chapter 3, the opening case study on the EU in this chapter, and Section 5.2, do you think countries with distinctively different cultural, historical, and economic histories can effectively enter into a trade agreement? Select one regional trading bloc and discuss the economic motivations for that group of countries to form an agreement. Use Hofstedes cultural dimensions at www.geert-hofstede.com/geert_hofstede_resources.shtml. Do you think the countries in the trading bloc you selected are likely to have cross-cultural similarities or differences?

Ethical Dilemma

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. Based on what you learned in Chapter 3 and this chapter, do you feel that countries enforce trade rules fairly? What factors might affect how one government interprets violations of trade rules? Using a sports analogy, is the WTO a fair referee for trade issues? Is the UN a fair referee for trade and other issues? Why or why not? Research the voting rules for each organization to support for your answer.
2. Based on what you have learned about economic unions and the current issues facing the EU, do you think that NAFTA could become an economic union in the foreseeable future? Why or why not? Use your understanding of economic and monetary unions as well as your understanding of the cultures of the countries in NAFTA. Review the two arguments against the EU as outlined in the opening case. How do you feel that culture, politics, society, and history would impact any possible economic union for NAFTA?
3. The *Wall Street Journal* highlighted the issue of conflict minerals in an article entitled "Retailers Fight to Escape 'Conflict Minerals' Law." Retailers, including Walmart and Target, are protesting part of a new US law that requires companies to verify that products with minerals from Central Africa are not taxed or controlled by rebel regimes: "Some of the largest U.S. retailers argue they shouldn't have to comply with the rule if they don't exercise direct control over the manufacturing of goods carrying their own brands….Tracing the source of minerals is a tricky task, companies say, because many intermediaries stand between them and the mines."Jessica Holzer, "Retailers Fight to Escape Conflict Minerals Law," *Wall Street Journal*, December 2, 2010, accessed January 2, 2010, http://online.wsj.com/article/SB10001424052748703865004575648992964733232.html. Based on what you learned in this chapter and the sidebar on conflict diamonds in Angola, do you agree or disagree with the statement above and the retailers' position? Why or why not? Should retailers that have their name on a product be responsible for how the product is made?

3.11: Chapter Introduction

International Trade and Foreign Direct Investment

WHAT'S IN IT FOR ME?

1. What is international trade theory?
2. How do political and legal factors impact international trade?
3. What is foreign direct investment?

It's easy to think that trade is just about business interests in each country. But global trade is much more. There's a convergence and, at times, a conflict of the interests of the different stakeholders—from businesses to governments to local citizens. In recent years, advancements in technology, a renewed enthusiasm for entrepreneurship, and a global sentiment that favors free trade have further connected people, businesses, and markets—all flatteners that are helping expand global trade and investment. An essential part of international business is understanding the history of international trade and what motivates countries to encourage or discourage trade within their borders. In this chapter we'll look at the evolution of international trade theory to our modern time. We'll explore the political and legal factors impacting international trade. This chapter will provide an introduction to the concept and role of foreign direct investment, which can take many forms of incentives, regulations, and policies. Companies react to these business incentives and regulations as they evaluate with which countries to do business and in which to invest. Governments often encourage foreign investment in their own country or in another country by providing loans and incentives to businesses in their home country as well as businesses in the recipient country in order to pave the way for investment and trade in the country. The opening case study shows how and why China is investing in the continent of Africa.

Opening Case: China in Africa

Foreign companies have been doing business in Africa for centuries. Much of the trade history of past centuries has been colored by European colonial powers promoting and preserving their economic interests throughout the African continent.Martin Meredith, *The Fate of Africa* (New York: Public Affairs, 2005). After World War II and since independence for many African nations, the continent has not fared as well as other former colonial countries in Asia. Africa remains a continent plagued by a continued combination of factors, including competing colonial political and economic interests; poor and corrupt local leadership; war, famine, and disease; and a chronic shortage of resources, infrastructure, and political, economic, and social will."Why Africa Is Poor: Ghana Beats Up on Its Biggest Foreign Investors," *Wall Street Journal*, February 18, 2010, accessed February 16, 2011, http://online.wsj.com/article/SB10001424052748704804204575069511746613890.html. And yet, through the bleak assessments, progress is emerging, led in large part by the successful emergence of a free and locally powerful South Africa. The continent generates a lot of interest on both the corporate and humanitarian levels, as well as from other countries. In particular in the past decade, Africa has caught the interest of the world's second largest economy, China.Andrew Rice, "Why Is Africa Still Poor?," *The Nation*, October 24, 2005, accessed December 20, 2010, www.thenation.com/article/why-africa-still-poor?page=0,1.

At home, over the past few decades, China has undergone its own miracle, managing to move hundreds of millions of its people out of poverty by combining state intervention with economic incentives to attract private investment. Today, China is involved in economic engagement, bringing its success story to the continent of Africa. As professor and author Deborah Brautigam notes, China's "current experiment in Africa mixes a hard-nosed but clear-eyed self-interest with the lessons of China's own successful development and of decades of its failed aid projects in Africa."Deborah Brautigam, "Africa's Eastern Promise: What the West Can Learn from Chinese Investment in Africa," *Foreign Affairs*, January 5, 2010, accessed December 20, 2010, www.foreignaffairs.com/articles/65916/deborah-brautigam/africa%E2%80%99s-eastern-promise.

According to *CNN*, "China has increasingly turned to resource-rich Africa as China's booming economy has demanded more and more oil and raw materials.""China: Trade with Africa on Track to New Record," *CNN*, October 15, 2010, accessed April 23, 2011, articles.cnn.com/2010-10-15/world/china.africa.trade_1_china-and-africa-link-trade-largest-trade-partner?_s=PM:WORLD. Trade between the African continent and China reached $106.8 billion in 2008, and over the past decade, Chinese investments and the country's development aid to Africa have been increasing steadily."China-Africa Trade up 45 percent in 2008 to $107 Billion," *China Daily*, February 11, 2009, accessed April 23, 2011, http://www.chinadaily.com.cn/china/2009-02/11/content_7467460.htm. "Chinese activities in Africa are highly diverse, ranging from government to government relations and large state owned companies (SOE) investing in Africa financed by China's policy banks, to private entrepreneurs entering African countries at their own initiative to pursue commercial activities."Tracy Hon, Johanna Jansson, Garth Shelton, Liu Haifang, Christopher Burke, and Carine Kiala, *Evaluating China's FOCAC Commitments to Africa and Mapping the Way Ahead* (Stellenbosch, South Africa: Centre for

Chinese Studies, University of Stellenbosch, 2010), 1, accessed December 20, 2010, www.ccs.org.za/wp-content/uploads/2010/03/ENGLISH-Evaluating-Chinas-FOCAC-commitments-to-Africa-2010.pdf.

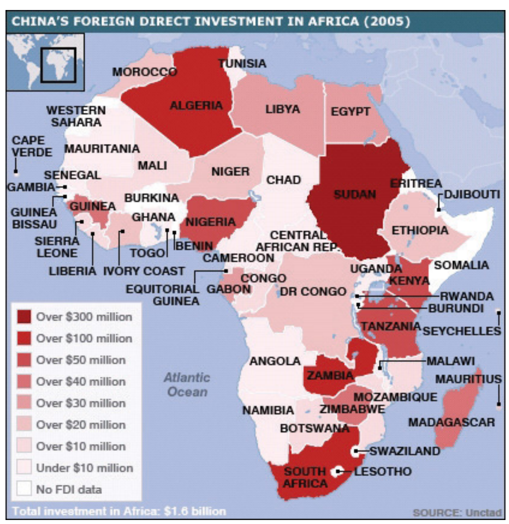
Since 2004, eager for access to resources, oil, diamonds, minerals, and commodities, China has entered into arrangements with resource-rich countries in Africa for a total of nearly $14 billion in resource deals alone. In one example with Angola, China provided loans to the country secured by oil. With this investment, Angola hired Chinese companies to build much-needed roads, railways, hospitals, schools, and water systems. Similarly, China provided nearby Nigeria with oil-backed loans to finance projects that use gas to generate electricity. In the Republic of the Congo, Chinese teams are building a hydropower project funded by a Chinese government loan, which will be repaid in oil. In Ghana, a Chinese government loan will be repaid in cocoa beans.Deborah Brautigam, “Africa’s Eastern Promise: What the West Can Learn from Chinese Investment in Africa,” *Foreign Affairs*, January 5, 2010, accessed December 20, 2010, www.foreignaffairs.com/articles/65916/deborah-brautigam/africa%E2%80%99s-eastern-promise.

The Export-Import Bank of China (Ex-Im Bank of China) has funded and has provided these loans at market rates, rather than as foreign aid. While these loans certainly promote development, the risk for the local countries is that the Chinese bids to provide the work aren’t competitive. Furthermore, the benefit to local workers may be diminished as Chinese companies bring in some of their own workers, keeping local wages and working standards low.

In 2007, the UNCTAD (United Nations Conference on Trade and Development) Press Office noted the following:

Over the past few years, China has become one of Africa´s important partners for trade and economic cooperation. Trade (exports and imports) between Africa and China increased from US$11 billion in 2000 to US$56 billion in 2006….with Chinese companies present in 48 African countries, although Africa still accounts for only 3 percent of China´s outward FDI [foreign direct investment]. A few African countries have attracted the bulk of China´s FDI in Africa: Sudan is the largest recipient (and the 9th largest recipient of Chinese FDI worldwide), followed by Algeria (18th) and Zambia (19th).United Nations Conference on Trade and Development, “Asian Foreign Direct Investment in Africa: United Nations Report Points to a New Era of Cooperation among Developing Countries,” press release, March 27, 2007, accessed December 20, 2010, www.unctad.org/Templates/Webflyer.asp?docID=8172&intItemID=3971&lang=1.

Observers note that African governments can learn from the development history of China and many Asian countries, which now enjoy high economic growth and upgraded industrial activity. These Asian countries made strategic investments in education and infrastructure that were crucial not only for promoting economic development in general but also for attracting and benefiting from efficiency-seeking and export-oriented FDI.United Nations Conference on Trade and Development, “Foreign Direct Investment in Africa Remains Buoyant, Sustained by Interest in Natural Resources,” press release, September 29, 2005, accessed December 20, 2010, http://news.bbc.co.uk/2/hi/africa/7086777.stm.



Source: “China in Africa: Developing Ties,” BBC News, last updated November 26, 2007, accessed June 3, 2011, http://news.bbc.co.uk/2/hi/africa/7086777.stm.

Criticized by some and applauded by others, it’s clear that China’s investment is encouraging development in Africa. China is accused by some of ignoring human rights crises in the continent and doing business with repressive regimes. China’s success in

Africa is due in large part to the local political environment in each country, where either one or a small handful of leaders often control the power and decision making. While the countries often open bids to many foreign investors, Chinese firms are able to provide low-cost options thanks in large part to their government's project support. The ability to forge a government-level partnership has enabled Chinese businesses to have long-term investment perspectives in the region. China even hosted a summit in 2006 for African leaders, pledging to increase trade, investment, and aid over the coming decade."Summit Shows China's Africa Clout," *BBC News*, November 6, 2006, accessed December 20, 2010, http://news.bbc.co.uk/2/hi/business/6120500.stm. The 2008 global recession has led China to be more selective in its African investments, looking for good deals as well as political stability in target countries. Nevertheless, whether to access the region's rich resources or develop local markets for Chinese goods and services, China intends to be a key foreign investor in Africa for the foreseeable future."China in Africa: Developing Ties," *BBC News*, November 26, 2007, accessed December 20, 2010, http://news.bbc.co.uk/2/hi/africa/7086777.stm.

Opening Case Exercises

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. Describe China's strategy in Africa.
2. If you were the head of a Chinese business that was operating in Sudan, how would you address issues of business ethics and doing business with a repressive regime? Should businesses care about local government ethics and human rights policies?
3. If you were a foreign businessperson working for a global oil company that was eager to get favorable government approval to invest in a local oil refinery in an African country, how would you handle any demands for paybacks (i.e., bribes)?

3.12: What Is International Trade Theory?

Learning Objectives

1. Understand international trade.
2. Compare and contrast different trade theories.
3. Determine which international trade theory is most relevant today and how it continues to evolve.

What Is International Trade?

International trade theories are simply different theories to explain international trade. Trade is the concept of exchanging goods and services between two people or entities. *International trade* is then the concept of this exchange between people or entities in two different countries.

People or entities trade because they believe that they benefit from the exchange. They may need or want the goods or services. While at the surface, this many sound very simple, there is a great deal of theory, policy, and business strategy that constitutes international trade.

In this section, you'll learn about the different trade theories that have evolved over the past century and which are most relevant today. Additionally, you'll explore the factors that impact international trade and how businesses and governments use these factors to their respective benefits to promote their interests.

What Are the Different International Trade Theories?

"Around 5,200 years ago, Uruk, in southern Mesopotamia, was probably the first city the world had ever seen, housing more than 50,000 people within its six miles of wall. Uruk, its agriculture made prosperous by sophisticated irrigation canals, was home to the first class of middlemen, trade intermediaries…A cooperative trade network…set the pattern that would endure for the next 6,000 years."Matt Ridley, "Humans: Why They Triumphed," *Wall Street Journal*, May 22, 2010, accessed December 20, 2010, http://online.wsj.com/article/SB10001424052748703691804575254533386933138.html.

In more recent centuries, economists have focused on trying to understand and explain these trade patterns. Chapter 1, Section 1.4 discussed how Thomas Friedman's flat-world approach segments history into three stages: Globalization 1.0 from 1492 to 1800, 2.0 from 1800 to 2000, and 3.0 from 2000 to the present. In Globalization 1.0, nations dominated global expansion. In Globalization 2.0, multinational companies ascended and pushed global development. Today, technology drives Globalization 3.0.

To better understand how modern global trade has evolved, it's important to understand how countries traded with one another historically. Over time, economists have developed theories to explain the mechanisms of global trade. The main historical theories are called *classical* and are from the perspective of a country, or country-based. By the mid-twentieth century, the theories began to shift to explain trade from a firm, rather than a country, perspective. These theories are referred to as *modern* and are firm-based or company-based. Both of these categories, classical and modern, consist of several international theories.

Classical Country-Based Theories	Modern Firm-Based Theories
Mercantilism	Country Similarity
Absolute Advantage	Product Life Cycle
Comparative Advantage	Global strategic Rivalry
Heckscher-Ohlin	Porter's National Competitive Advantage

Classical or Country-Based Trade Theories

Mercantilism

Developed in the sixteenth century, **mercantilism** was one of the earliest efforts to develop an economic theory. This theory stated that a country's wealth was determined by the amount of its gold and silver holdings. In it's simplest sense, mercantilists believed that a country should increase its holdings of gold and silver by promoting exports and discouraging imports. In other words, if people in other countries buy more from you (exports) than they sell to you (imports), then they have to pay you the difference in gold and silver. The objective of each country was to have a **trade surplus**, or a situation where the value of exports are greater than the value of imports, and to avoid a **trade deficit**, or a situation where the value of imports is greater than the value of exports.

A closer look at world history from the 1500s to the late 1800s helps explain why mercantilism flourished. The 1500s marked the rise of new nation-states, whose rulers wanted to strengthen their nations by building larger armies and national institutions. By increasing exports and trade, these rulers were able to amass more gold and wealth for their countries. One way that many of these new nations promoted exports was to impose restrictions on imports. This strategy is called **protectionism** and is still used today.

Nations expanded their wealth by using their colonies around the world in an effort to control more trade and amass more riches. The British colonial empire was one of the more successful examples; it sought to increase its wealth by using raw materials from places ranging from what are now the Americas and India. France, the Netherlands, Portugal, and Spain were also successful in building large colonial empires that generated extensive wealth for their governing nations.

Although mercantilism is one of the oldest trade theories, it remains part of modern thinking. Countries such as Japan, China, Singapore, Taiwan, and even Germany still favor exports and discourage imports through a form of neo-mercantilism in which the countries promote a combination of protectionist policies and restrictions and domestic-industry subsidies. Nearly every country, at one point or another, has implemented some form of protectionist policy to guard key industries in its economy. While export-oriented companies usually support protectionist policies that favor their industries or firms, other companies and consumers are hurt by protectionism. Taxpayers pay for government subsidies of select exports in the form of higher taxes. Import restrictions lead to higher prices for consumers, who pay more for foreign-made goods or services. Free-trade advocates highlight how free trade benefits all members of the global community, while mercantilism's protectionist policies only benefit select industries, at the expense of both consumers and other companies, within and outside of the industry.

Absolute Advantage

In 1776, Adam Smith questioned the leading mercantile theory of the time in *The Wealth of Nations*.Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (London: W. Strahan and T. Cadell, 1776). Recent versions have been edited by scholars and economists. Smith offered a new trade theory called **absolute advantage**, which focused on the ability of a country to produce a good more efficiently than another nation. Smith reasoned that trade between countries shouldn't be regulated or restricted by government policy or intervention. He stated that trade should flow naturally according to market forces. In a hypothetical two-country world, if Country A could produce a good cheaper or faster (or both) than Country B, then Country A had the advantage and could focus on specializing on producing that good. Similarly, if Country B was better at producing another good, it could focus on specialization as well. By specialization, countries would generate efficiencies, because their labor force would become more skilled by doing the same tasks. Production would also become more efficient, because there would be an incentive to create faster and better production methods to increase the specialization.

Smith's theory reasoned that with increased efficiencies, people in both countries would benefit and trade should be encouraged. His theory stated that a nation's wealth shouldn't be judged by how much gold and silver it had but rather by the living standards of its people.

Comparative Advantage

The challenge to the absolute advantage theory was that some countries may be better at producing both goods and, therefore, have an advantage in *many* areas. In contrast, another country may not have *any* useful absolute advantages. To answer this challenge, David Ricardo, an English economist, introduced the theory of comparative advantage in 1817. Ricardo reasoned that even if Country A had the absolute advantage in the production of *both* products, specialization and trade could still occur between two countries.

Comparative advantage occurs when a country cannot produce a product more efficiently than the other country; however, it *can* produce that product better and more efficiently than it does other goods. The difference between these two theories is subtle. Comparative advantage focuses on the relative productivity differences, whereas absolute advantage looks at the absolute productivity.

Let's look at a simplified hypothetical example to illustrate the subtle difference between these principles. Miranda is a Wall Street lawyer who charges $500 per hour for her legal services. It turns out that Miranda can also type faster than the administrative assistants in her office, who are paid $40 per hour. Even though Miranda clearly has the absolute advantage in both skill sets, should she do both jobs? No. For every hour Miranda decides to type instead of do legal work, she would be giving up $460 in income. Her productivity and income will be highest if she specializes in the higher-paid legal services and hires the most qualified administrative assistant, who can type fast, although a little slower than Miranda. By having both Miranda and her assistant concentrate on their respective tasks, their overall productivity as a team is higher. This is comparative advantage. A person or a country will specialize in doing what they do *relatively* better. In reality, the world economy is more complex and consists of more than two countries and products. Barriers to trade may exist, and goods must be transported, stored, and distributed. However, this simplistic example demonstrates the basis of the comparative advantage theory.

Heckscher-Ohlin Theory (Factor Proportions Theory)

The theories of Smith and Ricardo didn't help countries determine which products would give a country an advantage. Both theories assumed that free and open markets would lead countries and producers to determine which goods they could produce more efficiently. In the early 1900s, two Swedish economists, Eli Heckscher and Bertil Ohlin, focused their attention on how a country could gain comparative advantage by producing products that utilized factors that were in abundance in the country. Their theory is based on a country's production factors—land, labor, and capital, which provide the funds for investment in plants and equipment. They determined that the cost of any factor or resource was a function of supply and demand. Factors that were in great supply relative to demand would be cheaper; factors in great demand relative to supply would be more expensive. Their theory, also called the **factor proportions theory**, stated that countries would produce and export goods that required resources or factors that were in great supply and, therefore, cheaper production factors. In contrast, countries would import goods that required resources that were in short supply, but higher demand.

For example, China and India are home to cheap, large pools of labor. Hence these countries have become the optimal locations for labor-intensive industries like textiles and garments.

Leontief Paradox

In the early 1950s, Russian-born American economist Wassily W. Leontief studied the US economy closely and noted that the United States was abundant in capital and, therefore, should export more capital-intensive goods. However, his research using actual data showed the opposite: the United States was importing more capital-intensive goods. According to the factor proportions theory, the United States should have been importing labor-intensive goods, but instead it was actually exporting them. His analysis became known as the **Leontief Paradox** because it was the reverse of what was expected by the factor proportions theory. In subsequent years, economists have noted historically at that point in time, labor in the United States was both available in steady supply and more productive than in many other countries; hence it made sense to export labor-intensive goods. Over the decades, many economists have used theories and data to explain and minimize the impact of the paradox. However, what remains clear is that international trade is complex and is impacted by numerous and often-changing factors. Trade cannot be explained neatly by one single theory, and more importantly, our understanding of international trade theories continues to evolve.

Modern or Firm-Based Trade Theories

In contrast to classical, country-based trade theories, the category of modern, firm-based theories emerged after World War II and was developed in large part by business school professors, not economists. The firm-based theories evolved with the growth of the multinational company (MNC). The country-based theories couldn't adequately address the expansion of either MNCs or **intraindustry trade**, which refers to trade between two countries of goods produced in the same industry. For example, Japan exports Toyota vehicles to Germany and imports Mercedes-Benz automobiles from Germany.

Unlike the country-based theories, firm-based theories incorporate other product and service factors, including brand and customer loyalty, technology, and quality, into the understanding of trade flows.

Country Similarity Theory

Swedish economist Steffan Linder developed the **country similarity theory** in 1961, as he tried to explain the concept of intraindustry trade. Linder's theory proposed that consumers in countries that are in the same or similar stage of development would have similar preferences. In this firm-based theory, Linder suggested that companies first produce for domestic consumption. When they explore exporting, the companies often find that markets that look similar to their domestic one, in terms of customer preferences, offer the most potential for success. Linder's country similarity theory then states that most trade in manufactured goods will be between countries with similar per capita incomes, and intraindustry trade will be common. This theory is often most useful in understanding trade in goods where brand names and product reputations are important factors in the buyers' decision-making and purchasing processes.

Product Life Cycle Theory

Raymond Vernon, a Harvard Business School professor, developed the **product life cycle theory** in the 1960s. The theory, originating in the field of marketing, stated that a product life cycle has three distinct stages: (1) new product, (2) maturing product, and (3) standardized product. The theory assumed that production of the new product will occur completely in the home country of its innovation. In the 1960s this was a useful theory to explain the manufacturing success of the United States. US manufacturing was the globally dominant producer in many industries after World War II.

It has also been used to describe how the personal computer (PC) went through its product cycle. The PC was a new product in the 1970s and developed into a mature product during the 1980s and 1990s. Today, the PC is in the standardized product stage, and the majority of manufacturing and production process is done in low-cost countries in Asia and Mexico.

The product life cycle theory has been less able to explain current trade patterns where innovation and manufacturing occur around the world. For example, global companies even conduct research and development in developing markets where highly skilled labor and facilities are usually cheaper. Even though research and development is typically associated with the first or new product stage and therefore completed in the home country, these developing or emerging-market countries, such as India and China, offer both highly skilled labor and new research facilities at a substantial cost advantage for global firms.

Global Strategic Rivalry Theory

Global strategic rivalry theory emerged in the 1980s and was based on the work of economists Paul Krugman and Kelvin Lancaster. Their theory focused on MNCs and their efforts to gain a competitive advantage against other global firms in their industry. Firms will encounter global competition in their industries and in order to prosper, they must develop competitive advantages. The critical ways that firms can obtain a sustainable competitive advantage are called the barriers to entry for that industry. The **barriers to entry** refer to the obstacles a new firm may face when trying to enter into an industry or new market. The barriers to entry that corporations may seek to optimize include:

- research and development,
- the ownership of intellectual property rights,
- economies of scale,

- unique business processes or methods as well as extensive experience in the industry, and
- the control of resources or favorable access to raw materials.

Porter’s National Competitive Advantage Theory

In the continuing evolution of international trade theories, Michael Porter of Harvard Business School developed a new model to explain national competitive advantage in 1990. **Porter’s theory** stated that a nation’s competitiveness in an industry depends on the capacity of the industry to innovate and upgrade. His theory focused on explaining why some nations are more competitive in certain industries. To explain his theory, Porter identified four determinants that he linked together. The four determinants are (1) local market resources and capabilities, (2) local market demand conditions, (3) local suppliers and complementary industries, and (4) local firm characteristics.

1. **Local market resources and capabilities (factor conditions).** Porter recognized the value of the factor proportions theory, which considers a nation’s resources (e.g., natural resources and available labor) as key factors in determining what products a country will import or export. Porter added to these basic factors a new list of advanced factors, which he defined as skilled

labor, investments in education, technology, and infrastructure. He perceived these advanced factors as providing a country with a sustainable competitive advantage.
2. **Local market demand conditions.** Porter believed that a sophisticated home market is critical to ensuring ongoing innovation, thereby creating a sustainable competitive advantage. Companies whose domestic markets are sophisticated, trendsetting, and demanding forces continuous innovation and the development of new products and technologies. Many sources credit the demanding US consumer with forcing US software companies to continuously innovate, thus creating a sustainable competitive advantage in software products and services.
3. **Local suppliers and complementary industries.** To remain competitive, large global firms benefit from having strong, efficient supporting and related industries to provide the inputs required by the industry. Certain industries cluster geographically, which provides efficiencies and productivity.
4. **Local firm characteristics.** Local firm characteristics include firm strategy, industry structure, and industry rivalry. Local strategy affects a firm's competitiveness. A healthy level of rivalry between local firms will spur innovation and competitiveness.

In addition to the four determinants of the diamond, Porter also noted that government and chance play a part in the national competitiveness of industries. Governments can, by their actions and policies, increase the competitiveness of firms and occasionally entire industries.

Porter's theory, along with the other modern, firm-based theories, offers an interesting interpretation of international trade trends. Nevertheless, they remain relatively new and minimally tested theories.

Which Trade Theory Is Dominant Today?

The theories covered in this chapter are simply that—theories. While they have helped economists, governments, and businesses better understand international trade and how to promote, regulate, and manage it, these theories are occasionally contradicted by real-world events. Countries don't have absolute advantages in many areas of production or services and, in fact, the factors of production aren't neatly distributed between countries. Some countries have a disproportionate benefit of some factors. The United States has ample arable land that can be used for a wide range of agricultural products. It also has extensive access to capital. While it's labor pool may not be the cheapest, it is among the best educated in the world. These advantages in the factors of production have helped the United States become the largest and richest economy in the world. Nevertheless, the United States also imports a vast amount of goods and services, as US consumers use their wealth to purchase what they need and want—much of which is now manufactured in other countries that have sought to create their own comparative advantages through cheap labor, land, or production costs.

As a result, it's not clear that any one theory is dominant around the world. This section has sought to highlight the basics of international trade theory to enable you to understand the realities that face global businesses. In practice, governments and companies use a combination of these theories to both interpret trends and develop strategy. Just as these theories have evolved over the past five hundred years, they will continue to change and adapt as new factors impact international trade.

KEY TAKEAWAYS

- Trade is the concept of exchanging goods and services between two people or entities. International trade is the concept of this exchange between people or entities in two different countries. While a simplistic definition, the factors that impact trade are complex, and economists throughout the centuries have attempted to interpret trends and factors through the evolution of trade theories.
- There are two main categories of international trade—classical, country-based and modern, firm-based.
- Porter's theory states that a nation's competitiveness in an industry depends on the capacity of the industry to innovate and upgrade. He identified four key determinants: (1) local market resources and capabilities (factor conditions), (2) local market demand conditions, (3) local suppliers and complementary industries, and (4) local firm characteristics.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What is international trade?
2. Summarize the classical, country-based international trade theories. What are the differences between these theories, and how did the theories evolve?
3. What are the modern, firm-based international trade theories?

4. Describe how a business may use the trade theories to develop its business strategies. Use Porter’s four determinants in your explanation.

3.13: Political and Legal Factors That Impact International Trade

Learning Objectives

1. Know the different political systems.
2. Identify the different legal systems.
3. Understand government-business trade relations and how political and legal factors impact international business.

Why should businesses care about the different political and legal systems around the world? To begin with, despite the globalization of business, firms must abide by the local rules and regulations of the countries in which they operate. In the case study in Chapter 1, you discovered how US-based Google had to deal with the Chinese government's restrictions on the freedom of speech in order to do business in China. China's different set of political and legal guidelines made Google choose to discontinue its mainland Chinese version of its site and direct mainland Chinese users to a Hong Kong version.

Until recently, governments were able to directly enforce the rules and regulations based on their political and legal philosophies. The Internet has started to change this, as sellers and buyers have easier access to each other. Nevertheless, countries still have the ability to regulate or strong-arm companies into abiding by their rules and regulations. As a result, global businesses monitor and evaluate the political and legal climate in countries in which they currently operate or hope to operate in the future.

Before we can evaluate the impact on business, let's first look at the different political and legal systems.

What Are the Different Political Systems?

The study of political systems is extensive and complex. A **political system** is basically the system of politics and government in a country. It governs a complete set of rules, regulations, institutions, and attitudes. A main differentiator of political systems is each system's philosophy on the rights of the individual and the group as well as the role of government. Each political system's philosophy impacts the policies that govern the local economy and business environment.

There are more than thirteen major types of government, each of which consists of multiple variations. Let's focus on the overarching modern political philosophies. At one end of the extremes of political philosophies, or ideologies, is **anarchism**, which contends that individuals should control political activities and public government is both unnecessary and unwanted. At the other extreme is **totalitarianism**, which contends that every aspect of an individual's life should be controlled and dictated by a strong central government. In reality, neither extreme exists in its purest form. Instead, most countries have a combination of both, the balance of which is often a reflection of the country's history, culture, and religion. This combination is called **pluralism**, which asserts that both public and private groups are important in a well-functioning political system. Although most countries are pluralistic politically, they may lean more to one extreme than the other.

In some countries, the government controls more aspects of daily life than in others. While the common usage treats totalitarian and authoritarian as synonyms, there is a distinct difference. For the purpose of this discussion, the main relevant difference is in ideology. Authoritarian governments centralize all control in the hands of one strong leader or a small group of leaders, who have full authority. These leaders are not democratically elected and are not politically, economically, or socially accountable to the people in the country. Totalitarianism, a more extreme form of authoritarianism, occurs when an authoritarian leadership is motivated by a distinct ideology, such as communism. In totalitarianism, the ideology influences or controls the people, not just a person or party. Authoritarian leaders tend not to have a guiding philosophy and use more fear and corruption to maintain control.

Democracy is the most common form of government around the world today. Democratic governments derive their power from the people of the country, either by direct referendum (called a direct democracy) or by means of elected representatives of the people (a representative democracy). Democracy has a number of variations, both in theory and practice, some of which provide better representation and more freedoms for their citizens than others.

Did You Know?

It may seem evident that businesses would prefer to operate in open, democratic countries; however, it can be difficult to determine which countries fit the democratic criteria. As a result, there are a variety of institutions, including the *Economist*, which analyze and rate countries based on their openness and adherence to democratic principles.

There is no consensus on how to measure democracy, definitions of democracy are contested and there is an ongoing lively debate on the subject. Although the terms "freedom" and "democracy" are often used interchangeably, the two are not synonymous.

Democracy can be seen as a set of practices and principles that institutionalise and thus ultimately protect freedom. Even if a consensus on precise definitions has proved elusive, most observers today would agree that, at a minimum, the fundamental features of a democracy include government based on majority rule and the consent of the governed, the existence of free and fair elections, the protection of minorities and respect for basic human rights. Democracy presupposes equality before the law, due process and political pluralism."Liberty and Justice for Some," *Economist*, August 22, 2007, accessed December 21, 2010, http://www.economist.com/node/8908438.

To further illustrate the complexity of the definition of a democracy, the *Economist* Intelligence Unit's annual "Index of Democracy" uses a detailed questionnaire and analysis process to provide "a snapshot of the current state of democracy worldwide for 165 independent states and two territories (this covers almost the entire population of the world and the vast majority of the world's independent states (27 micro states are excluded) [as of 2008)]."Economist Intelligence Unit, "The Economist Intelligence Unit's Index of Democracy 2008," *Economist*, October 29, 2008, accessed December 21, 2010, http://graphics.eiu.com/PDF/Democracy%20Index%202008.pdf. Several things stand out in the 2008 index.

Although almost half of the world's countries can be considered to be democracies, the number of "full democracies" is relatively low (only 30); 50 are rated as "flawed democracies." Of the remaining 87 states, 51 are authoritarian and 36 are considered to be "hybrid regimes." As could be expected, the developed OECD countries dominate among full democracies, although there are two Latin American, two central European and one African country, which suggest that the level of development is not a binding constraint. Only two Asian countries are represented: Japan and South Korea.

Half of the world's population lives in a democracy of some sort, although only some 14 percent reside in full democracies. Despite the advances in democracy in recent decades, more than one third the world's population still lives under authoritarian rule. Economist Intelligence Unit, "The Economist Intelligence Unit's Index of Democracy 2008," *Economist*, October 29, 2008, accessed December 21, 2010, http://graphics.eiu.com/PDF/Democracy%20Index%202008.pdf.

What businesses must focus on is how a country's political system impacts the economy as well as the particular firm and industry. Firms need to assess the balance to determine how local policies, rules, and regulations will affect their business. Depending on how long a company expects to operate in a country and how easy it is for it to enter and exit, a firm may also assess the country's political risk and stability. A company may ask several questions regarding a prospective country's government to assess possible risks:

1. How stable is the government?
2. Is it a democracy or a dictatorship?
3. If a new party comes into power, will the rules of business change dramatically?
4. Is power concentrated in the hands of a few, or is it clearly outlined in a constitution or similar national legal document?
5. How involved is the government in the private sector?
6. Is there a well-established legal environment both to enforce policies and rules as well as to challenge them?
7. How transparent is the government's political, legal, and economic decision-making process?

While any country can, in theory, pose a risk in all of these factors, some countries offer a more stable business environment than others. In fact, political stability is a key part of government efforts to attract foreign investment to their country. Businesses need to assess if a country believes in free markets, government control, or heavy intervention (often to the benefit of a few) in industry. The country's view on capitalism is also a factor for business consideration. In the broadest sense, **capitalism** is an economic system in which the means of production are owned and controlled privately. In contrast, a **planned economy** is one in which the government or state directs and controls the economy, including the means and decision making for production. Historically, democratic governments have supported capitalism and authoritarian regimes have tended to utilize a state-controlled approach to managing the economy.

As you might expect, established democracies, such as those found in the United States, Canada, Western Europe, Japan, and Australia, offer a high level of political stability. While many countries in Asia and Latin America also are functioning democracies, their stage of development impacts the stability of their economic and trade policy, which can fluctuate with government changes. Chapter 4 provides more details about developed and developing countries and emerging markets.

Within reason, in democracies, businesses understand that most rules survive changes in government. Any changes are usually a reflection of a changing economic environment, like the world economic crisis of 2008, and not a change in the government players.

This contrasts with more authoritarian governments, where democracy is either not in effect or simply a token process. China is one of the more visible examples, with its strong government and limited individual rights. However, in the past two decades, China has pursued a new balance of how much the state plans and manages the national economy. While the government still remains the dominant force by controlling more than a third of the economy, more private businesses have emerged. China has successfully combined state intervention with private investment to develop a robust, market-driven economy—all within a communist form of government. This system is commonly referred to as "a socialist market economy with Chinese characteristics." The Chinese are eager to portray their version of combining an authoritarian form of government with a market-oriented economy as a better alternative model for fledging economies, such as those in Africa. This new combination has also posed more questions for businesses that are encountering new issues—such as privacy, individual rights, and intellectual rights protections—as they try to do business with China, now the second-largest economy in the world behind the United States. The Chinese model of an authoritarian government and a market-oriented economy has, at times, tilted favor toward companies, usually Chinese, who understand how to navigate the nuances of this new system. Chinese government control on the Internet, for example, has helped propel homegrown, Baidu, a Chinese search engine, which earns more than 73 percent of the Chinese search-engine revenues. Baidu self-censors and, as a result, has seen its revenues soar after Google limited its operations in the country.Rolfe Winkler, "Internet Plus China Equals Screaming Baidu," *Wall Street Journal*, November 9, 2010, accessed December 21, 2010, http://online.wsj.com/article/SB10001424052748703514904575602781130437538.html.

It might seem straightforward to assume that businesses prefer to operate only in democratic, capitalist countries where there is little or no government involvement or intervention. However, history demonstrates that, for some industries, global firms have chosen to do business with countries whose governments control that industry. Businesses in industries, such as commodities and oil, have found more authoritarian governments to be predictable partners for long-term access and investment for these commodities. The complexity of trade in these situations increases, as throughout history, governments have come to the aid and protection of their nation's largest business interests in markets around the world. The history of the oil industry shows how various governments have, on occasion, protected their national companies' access to oil through political force. In current times, the Chinese government has been using a combination of government loans and investment in Africa to obtain access for Chinese companies to utilize local resources and commodities. Many business analysts mention these issues in discussions of global business ethics and the role and responsibility of companies in different political environments.

What Are the Different Legal Systems?

Let's focus briefly on how the political and economic ideologies that define countries impact their legal systems. In essence, there are three main kinds of legal systems—common law, civil law, and religious or theocratic law. Most countries actually have a combination of these systems, creating hybrid legal systems.

Civil law is based on a detailed set of laws that constitute a code and focus on how the law is applied to the facts. It's the most widespread legal system in the world.

Common law is based on traditions and precedence. In common law systems, judges interpret the law and judicial rulings can set precedent.

Religious law is also known as theocratic law and is based on religious guidelines. The most commonly known example of religious law is Islamic law, also known as **Sharia**. Islamic law governs a number of Islamic nations and communities around the world and is the most widely accepted religious law system. Two additional religious law systems are the Jewish Halacha and the Christian Canon system, neither of which is practiced at the national level in a country. The Christian Canon system is observed in the Vatican City.

The most direct impact on business can be observed in Islamic law—which is a moral, rather than a commercial, legal system. Sharia has clear guidelines for aspects of life. For example, in Islamic law, business is directly impacted by the concept of interest. According to Islamic law, banks cannot charge or benefit from interest. This provision has generated an entire set of financial products and strategies to simulate interest—or a gain—for an Islamic bank, while not technically being classified as interest. Some banks will charge a large up-front fee. Many are permitted to engage in sale-buyback or leaseback of an asset. For example, if a company wants to borrow money from an Islamic bank, it would sell its assets or product to the bank for a fixed price. At the same time, an agreement would be signed for the bank to sell back the assets to the company at a later date and at a higher price. The difference between the sale and buyback price functions as the interest. In the Persian Gulf region alone, there are twenty-two Sharia-compliant, Islamic banks, which in 2008 had approximately $300 billion in assets.Tala Malik, "Gulf Islamic Bank Assets to Hit $300bn," *Arabian Business*, February 20, 2008, accessed December 21, 2010, www.arabianbusiness.com/511804-gulf-islamic-banks-assets-to-hit-300bn. Clearly, many global businesses and investment banks are finding creative ways to do business with these Islamic banks so that they can comply with Islamic law while earning a profit.

Government—Business Trade Relations: The Impact of Political and Legal Factors on International Trade

How do political and legal realities impact international trade, and what do businesses need to think about as they develop their global strategy? Governments have long intervened in international trade through a variety of mechanisms. First, let's briefly discuss some of the reasons behind these interventions.

Why Do Governments Intervene in Trade?

Governments intervene in trade for a combination of political, economic, social, and cultural reasons.

Politically, a country's government may seek to protect jobs or specific industries. Some industries may be considered essential for national security purposes, such as defense, telecommunications, and infrastructure—for example, a government may be concerned about who owns the ports within its country. National security issues can impact both the import and exports of a country, as some governments may not want advanced technological information to be sold to unfriendly foreign interests. Some governments use trade as a retaliatory measure if another country is politically or economically unfair. On the other hand, governments may influence trade to reward a country for political support on global matters.

Did You Know?

State Capitalism: Governments Seeking to Control Key Industries

Despite the movement toward privatizing industry and free trade, government interests in their most valuable commodity, oil, remains constant. The thirteen largest oil companies (as measured by the reserves they control) in the world are all state-run and all are bigger than ExxonMobil, which is the world's largest private oil company. State-owned companies control more than 75 percent of all crude oil production, in contrast with only 10 percent for private multinational oil firms.Ian Bremmer, "The Long Shadow of the Visible Hand," *Wall Street Journal*, May 22, 2010, accessed December 21, 2010, http://online.wsj.com/article/SB10001424052748704852004575258541875590852.html; "Really Big Oil," *Economist*, August 10, 2006, accessed December 21, 2010, http://www.economist.com/node/7276986.

Table 2.1 The Major Global State-Owned Oil Companies

Aramco	Saudi Arabia
Gazprom	Russia
China National Petroleum Corp.	China
National Iranian Oil Co.	Iran
Petróleos de Venezuela	Venezuela
Petrobras	Brazil
Petronas	Malaysia

Source: Energy Intelligence Group, "*Petroleum Intelligence Weekly* Ranks World's Top 50 Oil Companies (2009)," news release, December 1, 2008, accessed December 21, 2010, www.energyintel.com/documentdetail.asp?document_id=245527.

In the past thirty years, governments have increasingly privatized a number of industries. However, "in defense, power generation, telecoms, metals, minerals, aviation, and other sectors, a growing number of emerging-market governments, not content with simply regulating markets, are moving to dominate them."Ian Bremmer, "The Long Shadow of the Visible Hand," *Wall Street Journal*, May 22, 2010, accessed December 21, 2010, http://online.wsj.com/article/SB10001424052748704852004575258541875590852.html.

State companies, like their private sector counterparts, get to keep the profits from oil production, creating a significant incentive for governments to either maintain or regain control of this very lucrative industry. Whether the motive is economic (i.e., profit) or political (i.e., state control), "foreign firms and investors find that national and local rules and regulations are increasingly designed to favor domestic firms at their expense. Multinationals now find themselves competing as never before with state-owned companies armed with substantial financial and political support from their governments."Ian Bremmer, "The Long Shadow of the Visible Hand," *Wall Street Journal*, May 22, 2010, accessed December 21, 2010, http://online.wsj.com/article/SB10001424052748704852004575258541875590852.html.

Governments are also motivated by economic factors to intervene in trade. They may want to protect young industries or to preserve access to local consumer markets for domestic firms.

Cultural and social factors might also impact a government's intervention in trade. For example, some countries' governments have tried to limit the influence of American culture on local markets by limiting or denying the entry of American companies operating in the media, food, and music industries.

How Do Governments Intervene in Trade?

While the past century has seen a major shift toward free trade, many governments continue to intervene in trade. Governments have several key policy areas that can be used to create rules and regulations to control and manage trade.

- **Tariffs.** Tariffs are taxes imposed on imports. Two kinds of tariffs exist—**specific tariffs**, which are levied as a fixed charge, and **ad valorem tariffs**, which are calculated as a percentage of the value. Many governments still charge ad valorem tariffs as a way to regulate imports and raise revenues for their coffers.
- **Subsidies.** A subsidy is a form of government payment to a producer. Types of subsidies include tax breaks or low-interest loans; both of which are common. Subsidies can also be cash grants and government-equity participation, which are less common because they require a direct use of government resources.
- **Import quotas and VER.** Import quotas and voluntary export restraints (VER) are two strategies to limit the amount of imports into a country. The importing government directs import quotas, while VER are imposed at the discretion of the exporting nation in conjunction with the importing one.
- **Currency controls.** Governments may limit the convertibility of one currency (usually its own) into others, usually in an effort to limit imports. Additionally, some governments will manage the exchange rate at a high level to create an import disincentive.
- **Local content requirements.** Many countries continue to require that a certain percentage of a product or an item be manufactured or "assembled" locally. Some countries specify that a local firm must be used as the domestic partner to conduct business.
- **Antidumping rules.** Dumping occurs when a company sells product below market price often in order to win market share and weaken a competitor.
- **Export financing.** Governments provide financing to domestic companies to promote exports.
- **Free-trade zone.** Many countries designate certain geographic areas as free-trade zones. These areas enjoy reduced tariffs, taxes, customs, procedures, or restrictions in an effort to promote trade with other countries.
- **Administrative policies.** These are the bureaucratic policies and procedures governments may use to deter imports by making entry or operations more difficult and time consuming.

Did You Know?

Government Intervention in China

As shown in the opening case study, China is using its economic might to invest in Africa. China's ability to focus on dominating key industries inspires both fear and awe throughout the world. A closer look at the solar industry in China illustrates the government's ability to create new industries and companies based on its objectives. With its huge population, China is in constant need of energy to meet the needs of its people and businesses.

As a result, the government has placed a priority on energy related technologies, including solar energy. China's expanding solar-energy industry is dependent on polycrystalline silicon, the main raw material for solar panels. Facing a shortage in 2007, growing domestic demand, and high prices from foreign companies that dominated production, China declared the development of domestic polysilicon supplies a priority. Domestic Chinese manufacturers received quick loans with favorable terms as well as speedy approvals. One entrepreneur, Zhu Gongshan, received $1 billion in funding, including a sizeable investment from China's sovereign wealth fund, in record time, enabling his firm GCL-Poly Energy Holding to become one of the world's biggest in less than three years. The company now has a 25 percent market share of polysilicon and almost 50 percent of the global market for solar-power equipment.Jason Dean, Andrew Browne, and Shai Oster, "China's 'State Capitalism' Sparks Global Backlash," *Wall Street Journal*, November 16, 2010, accessed December 22, 2010, http://online.wsj.com/article/SB10001424052748703514904575602731006315198.html.

How did this happen so fast? Many observers note that it was the direct result of Chinese government intervention in what was deemed a key industry.

Central to China's approach are policies that champion state-owned firms and other so-called national champions, seek aggressively to obtain advanced technology, and manage its exchange rate to benefit exporters. It leverages state control of the financial system to channel low-cost capital to domestic industries—and to resource-rich foreign nations (such as those we read in the opening case) whose oil and minerals China needs to maintain rapid growth.Jason Dean, Andrew Browne, and Shai Oster, "China's 'State Capitalism' Sparks Global Backlash," *Wall Street Journal*, November 16, 2010, accessed December 22, 2010, http://online.wsj.com/article/SB10001424052748703514904575602731006315198.html.

Understanding the balance between China's government structure and its ideology is essential to doing business in this complex country. China is both an emerging market and a rising superpower. Its leaders see the economy as a tool to preserving the state's power, which in turn is essential to maintaining stability and growth and ensuring the long-term viability of the Communist Party.Jason Dean, Andrew Browne, and Shai Oster, "China's 'State Capitalism' Sparks Global Backlash," *Wall Street Journal*, November 16, 2010, accessed December 22, 2010, http://online.wsj.com/article/SB10001424052748703514904575602731006315198.html.

Contrary to the approach of much of the world, which is moving more control to the private sector, China has steadfastly maintained its state control. For example, the Chinese government owns almost all the major banks, the three largest oil companies, the three telecommunications carriers, and almost all of the media.

China's Communist Party outlines its goals in five-year plans. The most recent one emphasizes the government's goal for China to become a technology powerhouse by 2020 and highlights key areas such as green technology, hence the solar industry expansion. Free trade advocates perceive this government-directed intervention as an unfair tilt against the global private sector. Nevertheless, global companies continue to seek the Chinese market, which offers much-needed growth and opportunity.Jason Dean, Andrew Browne, and Shai Oster, "China's 'State Capitalism' Sparks Global Backlash," *Wall Street Journal*, November 16, 2010, accessed December 22, 2010, http://online.wsj.com/article/SB10001424052748703514904575602731006315198.html.

KEY TAKEAWAYS

- There are more than thirteen major types of government and each type consists of multiple variations. At one end of the political ideology extremes is anarchism, which contends that individuals should control political activities and public government is both unnecessary and unwanted. The other extreme is totalitarianism, which contends that every aspect of an individual's life should be controlled and dictated by a strong central government. Neither extreme exists in its purest form in the real world. Instead, most countries have a combination of both. This combination is called pluralism, which asserts that both public and private groups are important in a well-functioning political system. Democracy is the most common form of government today. Democratic governments derive their power from the people of the country either by direct referendum, called a direct democracy, or by means of elected representatives of the people, known as a representative democracy.
- Capitalism is an economic system in which the means of production are owned and controlled privately. In contrast a planned economy is one in which the government or state directs and controls the economy.
- There are three main types of legal systems: (1) civil law, (2) common law, and (3) religious law. In practice, countries use a combination of one or more of these systems and often adapt them to suit the local values and culture.
- Government-business trade relations are the relationships between national governments and global businesses. Governments intervene in trade to protect their nation's economy and industry, as well as promote and preserve their social, cultural, political, and economic structures and philosophies. Governments have several key policy areas in which they can create rules and regulations in order to control and manage trade, including tariffs, subsidies; import quotas and VER, currency controls, local content requirements, antidumping rules, export financing, free-trade zones, and administrative policies.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Identify the main political ideologies.
2. What is capitalism? What is a planned economy? Compare and contrast the two forms of economic ideology discussed in this section.
3. What are three policy areas in which governments can create rules and regulations in order to control, manage, and intervene in trade.

3.14: Corporations and Politics - After Citizens United

Source: courtesy of John Montgomery, (CC-BY 2012), http://www.commondreams.org/views/2012/10/17/freedom-beach-dump-citizens-united Figure 11.1 The Supreme Court's decision in Citizens United v. Federal Elections Committee gave First Amendment rights to corporations in election periods, allowing business interests to spend unlimited amounts on U.S. elections. Do corporations deserve the same rights as individuals when it comes to political speech?

Corporate Influence on Politics

Corporations today exert a considerable (and occasionally overwhelming) influence on global politics. In some countries, the influence of corporations on government is so great as to give rise to the suspicion that the government is actually controlled by corporations. Even in those countries that strictly limit corporate influence on political campaigns, the corporate sector can still play an important role in the development of governmental policies through sophisticated, high-level lobbying. In this chapter we ask, how much of this corporate influence is acceptable? We will also explore the following related questions: How can corporate influence be controlled? What is the appropriate level of corporate participation in the drafting of laws and regulations? Should corporations be allowed to contribute freely to political campaigns? What is the role of foreign and multinational corporations? Should they also be allowed to influence domestic politics?

Although we will focus on corporate influence, let us note at the outset that they are not the only source of money in politics; wealthy individuals, unions, and other participants in the electoral process also contribute significant funds and resources to campaigns. In the United States, as in most other industrialized democracies, electoral campaigns have become increasingly expensive despite attempts to limit allowable expenditures.

Given the importance of the issue, it is not surprising that a storm of controversy arose over a US Supreme Court's ruling in 2010 that government limits on corporate spending in political campaigns violated the First Amendment right to freedom of speech. In the view of an openly dismayed President Barack Obama, the Court's decision in *Citizens United v. Federal Elections Commission* "reversed a century of law to open the floodgates for special interests—including foreign corporations—to spend without limit in our elections."[1]

The validity of President Obama's objection to Citizen United has been hotly contested, and it will provide us with a focal point for our discussion: Is it true that corporations have achieved excessive influence over national politics? Are corporations entitled to be treated as "persons" when it comes to freedom of speech?

A Basic Distinction: Private vs. Public Funding of Campaigns

While private election spending in the United States is increasing, the situation around the world is quite diverse. In some countries, expenditures are increasing while elsewhere they are decreasing. A basic distinction in national campaign finance regulations is that some countries allow private support for political campaigns while other countries provide public funds to candidates.

Private Finance

In the United Kingdom there are no limits on corporate or individual giving in the general election, yet total spending on the 2010 general election was down 26 percent from 2005.[2] However, in the United Kingdom, the Prime Minister may call for elections at any time within a maximum period, which shortens the total time available for campaigning and explains the need for funds. National elections tend to be more expensive in the United States because they come along at predictable four-year intervals.

In Brazil, it is estimated that $2 billion was spent by parties and candidates in the 2010 presidential election, with nearly 100 percent of total campaign donations coming from corporations.

Public Funding

In countries such as Norway, government funding accounts for up to 74 percent of political campaigns, and political ads are banned from television and radio.

In Canada, candidates are given strict spending limits based on the number of voters in their districts, in order to even the playing field in elections, and private donations (a maximum of $1,200 to any party) are heavily subsidized by public funds paid out through tax credits. Although the price of elections has grown 50 percent in the past decade, Canadians spent just $300 million on the 2008 general election.[3]

Campaign Finance in the U.S.

US Campaign Finance Law, PACs and Super PACs

"There are two things that are important in politics. The first is money, and I can't remember what the second one is."

—Mark Hanna, campaign manager of President McKinley's successful bid for the Presidency in 1896.

Concern over the influence of money in politics began at an early stage in the life of the United States, with Thomas Jefferson stating in 1816 that he feared it would be necessary to "crush in its birth the aristocracy of our moneyed corporations, which dare already to challenge our government to a trial of strength and bid defiance to the laws of our country."[4]

Despite Jefferson's hopes, the influence of corporations on politics grew substantially in the latter half of the nineteenth century. The presidential elections of 1896 and 1904 left much of the American populace disgusted and convinced that political office in the United States was up for sale. In 1896, the victor in the presidential election, William McKinley, outspent his competitor, the populist William Jennings Bryan, by a factor of 10 to 1. In 1904, the Democratic candidate, Alton Parker, lost the election and complained bitterly afterward that he had been defeated by large insurance companies. Parker challenged the nation to face the reality that corporations were taking over the political process: "The greatest moral question which now confronts us is shall the trusts and corporations be prevented from contributing money to control or aid in controlling elections?"[5]

President-elect Theodore Roosevelt took the accusation seriously and joined his own voice in the call for control of corporate contributions. In a 1905 address to Congress, Roosevelt called for legislation:

All contributions by corporations to any political committee or for any political purpose should be forbidden by law; directors should not be permitted to use stockholders' money for such purposes; and, moreover, a prohibition of this kind would be, as far as it went, an effective method of stopping the evils aimed at in corrupt practices acts. Not only should both the National and the several State Legislatures forbid any officer of a corporation from using the money of the corporation in or about any election, but they should also forbid such use of money in connection with any legislation save by the employment of counsel in public manner for distinctly legal services.[6]

As a result, Congress passed the 1907 Tillman Act, the first US law prohibiting corporations from contributing directly to federal elections. However, it turned out that the law was easy to circumvent. Not only was there no enforcement mechanism or agency, the Tillman Act did not prevent corporate contributions to party primaries, and in many Congressional districts these were even more determinative than the general election. Moreover, the Tillman Act did not prohibit corporate officers from giving money personally to campaigns (the executives were then often reimbursed by bonuses from the corporations). It rapidly became clear that the Tillman Act would only be the beginning of a long and tortuous effort to curtail corporate influence.

After World War II, labor unrest reached a historical high. From 1945–1946, millions of railroad, auto, meatpacking, electric, steel, and coal workers went on strike, protesting falling wages amid rising corporate profits. Corporate fears of powerful labor unions and the perception among politicians that labor unions had communist leanings convinced Congress to pass the Taft–Hartley Act (also known as the Labor Management Relations Act) in 1947, which limited workers' rights to strike, boycott, and picket. The law also prohibited labor unions from spending money in federal elections and campaigns. As an extension of the Tillman Act of 1907, Taft–Hartley constrained labor unions to raising money for campaign contributions only through so-called political action committees (PACs).

It was not until the 1970s that PACs were firmly regulated by the federal government. With the passing of the Federal Election Campaign Act (FECA) in 1971 (and subsequent Amendments in 1974, 1976, and 1979), the modern campaign finance system was born, along with an independent body to enforce it—the Federal Election Commission (FEC). The new law defined how PACs could operate, set contribution limits, and instituted public financing for presidential elections.[7]

Until 2010, individuals were limited to $2,500 contributions to PACs, and corporations were strictly banned from donating. However, as we shall see below, the *Citizens United* case radically altered this landscape, removing all corporate restrictions and giving rise to the so-called Super PAC—a political action committee that can accept unlimited donations from individuals, corporations, and unions, and engage in unlimited spending. The only restriction on Super PACs is that the donors cannot coordinate activities with any candidate or campaign. As we can see below from the satirical commentary by television personality Stephen Colbert on the effectiveness of such a bar on coordination, many felt that Super PACs were in reality little more than funding mechanisms under the control of politicians themselves. It seemed that the efforts to control corporate contributions, begun with the Tillman Act, had finally reached a dead end.

Source: Cliff, (CC-BY 2.0 2010) Figure 11.2 In 2011, comedian Stephen Colbert formed a Super PAC called, “Americans for a Better Tomorrow, Tomorrow.” While it was intended as a satire of existing Super PACs, it was also a way to educate viewers about the Citizens United decision. In January 2012, Colbert decided to run for “President of the United States of South Carolina.” As was legally required, he passed off control of his Super PAC to someone totally unconnected to the committee—his Comedy Central cohort Jon Stewart.

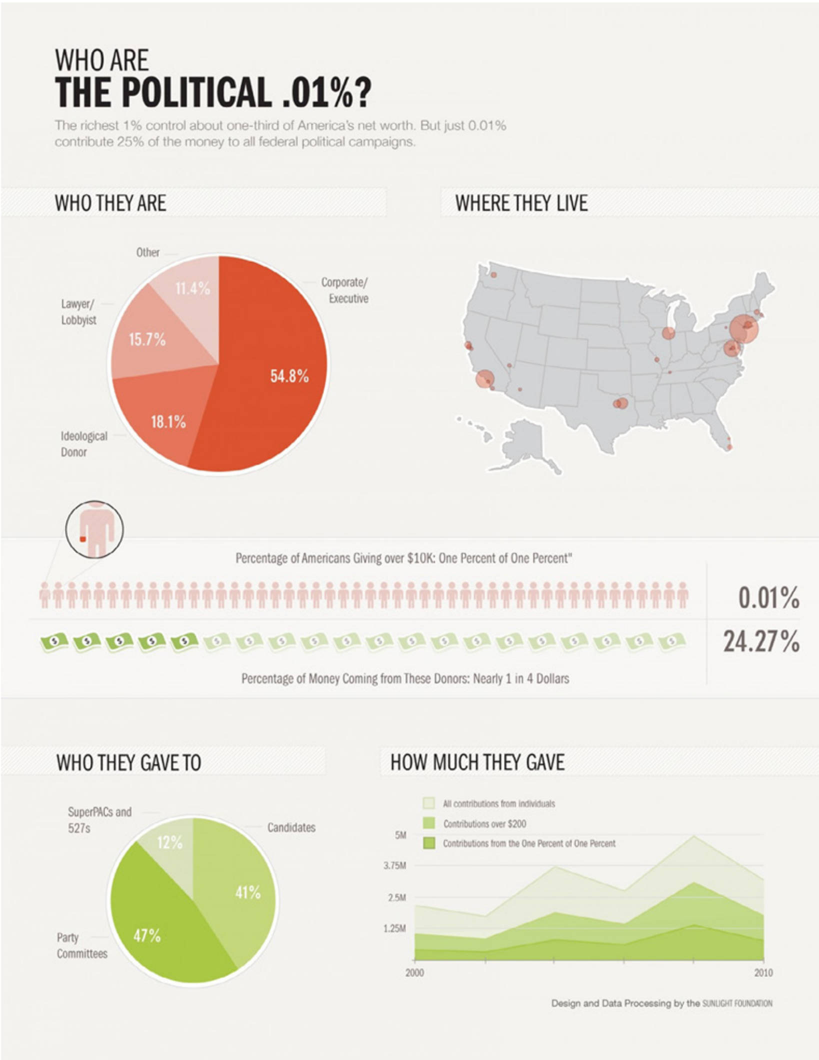
Milestones in Campaign Finance [8]

- 1907: Passage of the Tillman Act, which banned corporate political contributions to national campaigns.
- 1925: The Federal Corrupt Practices Act increased disclosure requirements and spending limits on general elections.
- 1971: Passage of the Federal Election Campaign Act (FECA), the first comprehensive campaign finance law.
- 1974: Amendments made to the Federal Election Campaign Act: limits on contributions, increased disclosure, creation of the Federal Election Commission (FEC) as a regulatory agency, government funding of presidential campaigns.
- 1976: *Buckley v. Valeo*: The Supreme Court upheld limits on campaign contributions, but held that spending money to influence elections is protected speech under the First Amendment.
- 1978: *First National Bank of Boston v. Bellotti*: The Supreme Court upheld the rights of corporations to spend money in non-candidate elections (i.e., ballot initiatives and referendums).
- 1990: *Austin v. Michigan Chamber of Commerce*: The Supreme Court upheld the right of the state of Michigan to prohibit corporations from using money from their corporate treasuries to support or oppose candidates in elections, noting: “corporate wealth can unfairly influence elections.”[9]
- 2002: Passage of the Bipartisan Campaign Reform Act of 2002 (McCain–Feingold), which banned corporate funding of issue advocacy ads that mentioned candidates close to an election.
- 2010: *Citizens United v. FEC*: The Supreme Court held that corporate funding of independent political broadcasts in candidate elections cannot be limited under the First Amendment, overruling *Austin* (1990).

The 2012 Presidential Election

The 2012 US presidential race was the most expensive in history. According to the Federal Election Commission, approximately $6 billion was spent on the election by candidates, parties, and outside groups. Of that, $933 million came directly from companies, unions, and individuals funneling money into Super PACs specifically enabled by Citizens United. The Center for Public Integrity found that nearly two-thirds (approximately $611 million) went to just ten political consulting firms, who spent 89 percent of the money on negative advertising spots attacking candidates.[10]*Influence of the Wealthy: The One Percent of the One Percent*

According to the Sunlight Foundation, there is a growing dependence on the One Percent of the One Percent—an elite group of the wealthiest Americans, including corporate executives, investors, lobbyists, and lawyers in metropolitan areas who give to multiple candidates, parties, and independent issue groups. Data suggests that, while these ideological donors make up less than 1 percent of the US population, they control about one-third of America's net worth and contribute up to 25 percent of the money provided to all federal political campaigns.[11]



Source: Courtesy of Sunlight Foundation (2013) Figure 11.3 Statistics show that the wealthiest 0.01% of the U.S. population contributes a major share of all American political campaign funding.

Case Study: Citizens United v. Federal Elections Commission

In early 2010, the United States Supreme Court shocked much of the nation when it ruled that corporations have the same rights of political free speech as individuals under the First Amendment to the US Constitution.

Citizens United v. Federal Elections Commission was a constitutional law case challenging the Bipartisan Campaign Reform Act (BCRA) of 2002, otherwise known as the McCain–Feingold campaign finance law. The BCRA barred corporations and unions from running broadcast, cable, or television ads for or against Presidential candidates for thirty days before primary elections, and within 60 days of general elections. In addition, the law required donor disclosure and disclaimers on all materials not authorized or endorsed by the candidate.

The Supreme Court

The United States Supreme Court plays a central and occasionally polarizing role in the American democratic system. Created by the Judiciary Act of 1789, the Supreme Court is the only court specifically prescribed by the Constitution. As the "highest court in the land," it remains the functional and symbolic defender of American civil rights and liberties.

As the United States' final court of appeal, the Supreme Court is the ultimate interpreter of law in the United States. With the authority to strike down any federal and state law it deems unconstitutional, the Court acts as a check on the power of the executive and legislative branches of government. In theory, the Supreme Court guarantees that changing majority views don't subjugate vulnerable minorities or undermine fundamental American values such as freedom of speech.

Because it often appears to defend these values in direct opposition to popular opinion, the Supreme Court has been criticized as an antidemocratic institution that fails to take into account progressive social evolution. Indeed, justices are often accused of ideological activism, constitutional fundamentalism, and ignorance of the changing face of the American public. It can also be argued, however, that the Supreme Court's decisions historically have reflected growing national sentiments about constitutional issues more consistently than it has rejected them.

Virtually every political and social hot-button issue—abortion, gay marriage, affirmative action, civil rights, immigration, and so on—appears before the Supreme Court at some point. Justices are appointed for life so that, ideally, they will not be swayed by outside political influences; unlike the president or Congress, they do not have to worry about re-election campaigns or approval ratings. The Supreme Court's decisions have often had sweeping and profound consequences to society, and they almost always inflame passions on both sides of the political spectrum.

The Plaintiff

Citizens United, a conservative nonprofit corporation, wanted to run an on-demand cable documentary called *Hillary: The Movie*, which harshly criticized then-Senator Hillary Clinton during the Democratic presidential primary in 2008. The documentary featured interviews with conservative pundits and politicians who claimed that Clinton would be a presidential disaster.

The Federal Elections Committee (FEC) blocked the documentary from being broadcast, designating it as "electioneering communication" under the BCRA. Citizens United brought its case to the United States District Court for the District of Columbia, citing violation of the group's First Amendment rights, but the lower court sided with the FEC. The case was appealed and appeared before the Supreme Court in early 2009.

Origins

In 2004, Michael Moore released a documentary, *Fahrenheit 9/11*, shortly before the GOP primary elections. The movie was a scathing indictment of George W. Bush, his administration's War on Terror, and the far-reaching consequences of his first term as President. Citizens United filed a complaint with the FEC, stating that ads for the film were television broadcast communications designed to influence voters, and therefore violated federal election law. The FEC dismissed the complaint, saying it was clear that *Fahrenheit 9/11*, along with its television trailers and website, were purely commercial pursuits. In response, Citizens United decided to start producing its own "commercial" documentaries.

Arguments

Before the Supreme Court, Citizens United argued that the BCRA (the McCain–Feingold Act) only applied to commercial advertisements, not to video-on-demand, 90-minute documentaries such as *Hillary: The Movie*. The group's lawyer, Ted Olson, did not even mention the First Amendment, nor did he call for the repeal of any part of federal election law.

Taking the opposite position was the deputy solicitor general, who argued that the Clinton documentary was the equivalent of an extended campaign advertisement, recalling the Supreme Court's decisions in *Austin v. Michigan Chamber of Commerce* (1990), which held that state legislatures may prohibit corporations from using treasury funds on electoral speech, and *McConnell v. Federal Election Commission* (2003), which validated the BCRA's spending limitations, stating that "express advocacy and its functional equivalent may be treated alike, and that BCRA's definition of 'electioneering communication' is not facially overbroad."[12]

First Opinion

After the case was argued, the Court decided that the BCRA did not apply to *Hillary: The Movie*, and therefore Citizens United could air it unhindered. Chief Justice John Roberts drafted an opinion, but it soon became clear that many of the justices didn't think it went far enough. The conservative majority felt that the case was a perfect opportunity to broaden the discussion to address whether or not corporate speech should be regulated at all under the Constitution.

Roberts withdrew his opinion, and the Court called for the case to be reargued in September, almost a month before the official start of the fall term and two months before the 2010 midterm election. The justices directed the parties to file supplemental briefs addressing the question of whether the Court should overrule *Austin v. Michigan* and parts of *McConnell v. FEC*, which would amount to eliminating decades of restrictions on corporate electoral spending.

Second Opinion

The Citizens United case was reargued on September 9, 2009. By a five-to-four vote, the conservative majority held that the First Amendment to the United States Constitution prohibits the government from imposing any limits on political spending by corporations, associations, and unions. Justice Anthony Kennedy wrote the majority opinion, which he summarized from the bench in this way: "Political speech is indispensable to decision making in a democracy and this is no less true because the speech comes from a corporation rather than an individual."[13]

Justice Kennedy was joined by Chief Justice John Roberts and Justices Antonin Scalia, Samuel Alito, and Clarence Thomas. To the conservative judges, the ruling was a vindication of the power of free speech; because of *Citizens United*, the First Amendment could now be applied universally and without prejudice.

Dissent

Justice John Paul Stevens wrote a highly critical 90-page dissent, arguing that Justice Kennedy's opinion constituted "a rejection of the common sense of the American people, who have recognized a need to prevent corporations from undermining self-government since the founding."[14] Stevens believed that the limits Congress had for years imposed on corporate spending were necessary to curb political corruption by the wealthiest Americans, who would inevitably out-spend, out-lobby, and "out-speech" the vast majority of Americans. Stevens also argued that corporations are not "people" in the real sense—they do not have consciences, feelings, beliefs, or desires—and therefore are not true members of society, or "'We the People,' by whom and for whom [the] Constitution was established."

Justice Stevens was joined in his dissent by Justices Ruth Bader Ginsburg, Stephen Breyer, and Sonia Sotomayor. These liberal justices recognized that the decision would open the floodgates for spending in electoral campaigns, making it "exceedingly difficult to maintain that independent expenditures by corporations 'do not give rise to corruption or the appearance of corruption.'"[15]

Corporate "Personhood"

Widespread public criticism of the *Citizens United* decision has not diminished with time, particularly from liberal or progressive voters and pundits. Protesters, lawmakers, and organizations such as Move to Amend have called for a constitutional amendment to overturn the ruling. Across the country, a number of public demonstrations were held where participants waved signs reading, "Corporations Are Not People." Despite the widespread outrage, the reality is that corporations have had many of the same rights as individuals for a very long time.

Corporate personhood refers to the legal concept that allows organizations of people, as individuals acting collectively, to be both protected by the Constitution and subject to the same laws as citizens. The word *corporation* derives from the Latin, *corpus*, meaning *body*, and is defined as "a body of people acting jointly, …recognized by law as acting as an individual."[16]

The Romans first devised corporate personhood as a way for cities and churches to legally organize for the purposes of joint land ownership, taxation, and institutional perpetuity. Creating a "legal" or "artificial" person made it unnecessary to develop separate laws enabling large groups of people to do the same things as individuals: for instance, make contracts, own property, pay taxes, borrow money, enter into law suits, and be protected from persecution.

Since at least 1819, in *Trustees of Dartmouth College v. Woodward*, the Supreme Court has recognized corporations as having the same rights as "natural persons" for the purpose of contracts. Since then, the Supreme Court has given corporations increasingly more rights traditionally reserved for natural people: Fourteenth Amendment rights of equal protection (*Pembina Consolidated Silver Mining Co. v. Pennsylvania*, 1888), Fifth Amendment protections of due process (Noble v. Union River Logging, 1893), Fourth Amendment search and seizure protection (*Hale v. Henkel*, 1906), double-jeopardy immunity (*Fong Foo v. United States*, 1962), First Amendment protection (*Grosjean v. American Press Company*, 1936), Seventh Amendment rights to trial by jury (*Ross v. Bernhard*, 1970), the right to spend money in noncandidate elections (*First National Bank of Boston v. Bellotti*, 1978), and the right to spend in campaigns as a form of "speech" (*Buckley v Valeo*, 1976).[17]

Amending the Constitution to Overrule Citizens United

Move to Amend, a coalition of political interest organizations, lead the campaign for a Constitutional amendment that would overturn the Supreme Court's decision in *Citizens United*. MoveToAmend.org clearly states:

We, the People of the United States of America, reject the US Supreme Court's ruling in *Citizens United* and other related cases, and move to amend our Constitution to firmly establish that money is not speech, and that human beings, not corporations, are persons entitled to constitutional rights.[18]

Consequences

Specialists in campaign finance law predict that the Supreme Court's ruling will shape the US electoral process for years to come. The matter is far from settled, however, as there is a growing movement of nonpartisan municipal, county, and state bodies calling for a constitutional amendment to overturn the decision. *Citizens United*'s legacy is far from over.

Topic for Debate: Overrule Citizens United

In this debate section, you will be asked to assume the role of a college student at a SUNY campus in New York State. The Congressional representative who has been elected from your university's district has introduced a bill in Congress that would authorize a constitutional amendment to overturn *Citizens United*. The university newspaper has sponsored a public debate so that the it can determine what position to take—should the newspaper endorse (or not) the proposed amendment? You have been invited to be a part of one of the two debate teams that will address the issue at a public forum. You are expected to base your arguments to some extent on the statements and publications of legal and public policy experts.

Affirmative

The university newspaper should endorse a constitutional amendment to overturn *Citizens United*.

Possible Arguments

- Corporations are not people, and should not have the same rights as individuals.
- The Supreme Court erred with its decision in *Citizens United*, due to judicial activism.
- Electoral issues should be decided by elected officials and not by the Supreme Court.
- Corporate money inherently leads to political corruption and "secret" financing.
- Wealthy Americans by and large represent the corporate interests of America and should not drown out the voices of those with less power and money.

Negative

The university newspaper should oppose a constitutional amendment to overturn *Citizens United*.

Possible Arguments

- American democracy relies on freedom of speech, which should therefore be enjoyed by everyone, regardless of their legal status.
- Corporate money in elections increases political competition and awareness of issues.
- Americans can decide for themselves whether or not to elect a candidate; ads don't make a difference either way.
- Corporations advocate for their employees, customers, and communities, and regulation will only constrain this ability.

- Corporations are fundamental to American economic progress and should be allowed to influence the political process to maintain their positive contributions to society.

Readings

11.1 Supreme Court Opinion and Pleadings

The Supreme Court's majority opinion, the various dissenting and concurring opinions, and the parties' briefs, may be accessed on the Internet at the following links:

The official arguments and decision can be found at "*Citizens United v. Federal Election Commission*." The Oyez Project at IIT Chicago-Kent College of Law. Last updated August 25, 2014. http://www.oyez.org/cases/2000-2009/2008/2008_08_205.

The official briefs and amicus briefs can be found at "*Citizens United v. Federal Election Commission*." SCOTUSblog. June 17, 2010.http://www.scotusblog.com/case-files/cases/citizens-united-v-federal-election-commission/

A video can be found at "The Story of *Citizens United v. FEC* (2011)." YouTube video, 8:50. Posted by "storyofstuffproject" on February 25, 2011. https://www.youtube.com/watch?v=k5kHACjrdEY.

11.2 "Why Super PACs Are Good for Democracy: Super PACs Get Government out of the Business of Regulating Speech"

Smith, Bradley A. "Why Super PACs Are Good for Democracy: Super PACs Get Government out of the Business of Regulating Speech." *U.S. News and World Report*. February 17, 2012. www.usnews.com/opinion/articles/2012/02/17/why-super-pacs-are-good-for-democracy.

11.3 "The New York Times' Disingenuous Campaign against Citizens United"

Kaminer, Wendy. "The *New York Times*' Disingenuous Campaign against *Citizens United*." *The Atlantic*. February 24, 2012. http://www.theatlantic.com/politics/archive/2012/02/the-new-york-times-disingenuous-campaign-against-citizens-united/253560/.

The paper is promoting the misconception that the ruling allowed for unlimited campaign contributions from super-rich individuals. It didn't.

Like Fox News, the *New York Times* has a First Amendment right to spread misinformation about important public issues, and it is exercising that right in its campaign against the *Citizens United* ruling. In news stories, as well as columns, it has repeatedly mischaracterized *Citizens United*, explicitly or implicitly blaming it for allowing unlimited "super PAC" contributions from megarich individuals. In fact, *Citizens United* enabled corporations and unions to use general treasury funds for independent political expenditures; it did not expand or address the longstanding, individual rights of the rich to support independent groups. And, as recent reports have made clear, individual donors, not corporations, are the primary funders of super PACs.

When I first focused on the inaccurate reference to *Citizens United* in a front-page story about Sheldon Adelson, I assumed it was a more or less honest if negligent mistake. (And I still don't blame columnists for misconceptions about a complicated case that are gleaned from news stories and apparently shared by their editors.) But mistakes about *Citizens United* are beginning to look more like propaganda, because even after being alerted to its misstatements, the *Times* has continued to repeat them. First Amendment lawyer Floyd Abrams wrote to the editors pointing out mischaracterizations of *Citizens United* in two news stories, but instead of publishing corrections, the *Times* published Abrams' letter on the editorial page, effectively framing a factual error as a difference of opinion…

As these examples suggest, …campaign-finance reforms dating back decades have produced an overcomplicated, overreaching web of laws and regulations that are easily abused, misunderstood, or intentionally obfuscated. The complexities of campaign finance law (and tax-code provisions governing independent groups) also create incentives to oversimplify the problems caused by the campaign-finance regime by naming *Citizens United* as the root of all evils. This helps advance what appears to be a simple solution—repeal *Citizens United* with a "free speech for people" constitutional amendment declaring that corporations aren't people. Putting aside the dangers of this approach, it wouldn't solve the problem of super PACs: The billionaires funding them may lack personal appeal but they are, after all, people, whose expenditures were not at issue in *Citizens United*. When the press promotes false understandings of *Citizens United* and the problems of campaign finance, it "paves the way" for false solutions.

It's worth noting that the *Times* is not alone among proponents of reform in scapegoating *Citizens United* (although it seems to have taken the lead.) The *New York Times*, the *Washington Post*, and MSNBC regularly and routinely misstate the meaning and impact of the Supreme Court's *Citizens United* decision on campaign finance rules," Steve Brill recently observed, citing a post by Dan Abrams. Brill recommends confronting reporters and commentators with their frequent misstatements. Former ACLU Executive Director Ira Glasser has gamely tried engaging *New York Times* Public Editor Arthur Brisbane in an effort to stop misleading readers…Are you confused yet? What does the *Times* believe or want you to believe about *Citizens United*? Whatever.

11.4 "The Citizens United Catastrophe"

Dionne, E. J., Jr. "The Citizens United Catastrophe." *The Washington Post*. February 5, 2012. www.washingtonpost.com/opinions/the-citizens-unitedcatastrophe/2012/02/05/gIQATOEfsQ_story.html

11.5 Experts Assess Impact of Citizens United: HLS Professor Suggests Constitutional Amendment Stating Corporations Are Not People

Greenfield, Jill. "Experts Assess Impact of Citizens United." *Harvard Gazette*. February 3, 2012. http://news.harvard.edu/gazette/story/2012/02/experts-assess-impact-of-citizens-united/.

Few recent Supreme Court cases have received as much attention—and drawn as much ire—as *Citizens United v. Federal Election Commission*. In a 5–4 decision, the court ruled that the First Amendment prohibits government from placing limits on independent spending for political purposes by corporations and unions. To proponents of campaign finance reform, *Citizens United* had the detrimental effect of inundating an already-broken campaign finance system with corporate influence. At an event sponsored by the Harvard Law School (HLS) American Constitution Society on Tuesday, HLS Professor Lawrence Lessig, author of *Republic Lost*, and Jeff Clements, author of *Corporations Are Not People*, reviewed the impact that *Citizens United* has had on the political process.

Clements said that the court's decision exacerbates two problems that the American political and electoral system had already been facing—the large amount of campaign spending and the growing influence of corporate power on the political process. Clements said that both problems need to be fixed in order to restore democracy but that, rather than addressing these problems, the *Citizens United* decision instead requires that the American people fundamentally reframe their notion of corporations.

"We need to look at what *Citizens United* really asks us to do, which is to accept a lot. The court asks us to pretend that corporations are not massive creations of state, federal, and foreign laws. It asks us to pretend that they're just like people, that they have voices, and that we're not allowed to make separate rules for them," he said.

Although some legal observers regard the decision as simply a bad day on the court, Clements said that *Citizens United* actually represents the culmination of a steady creation of a corporate rights doctrine that is radical in terms of American jurisprudence. He provided a history of the idea of corporate personhood and corporate speech, which began only in the 1970s under Chief Justice William Rehnquist. Lessig added that the system that has resulted is one in which elected officials must spend 30 to 50 percent of their time fundraising, and thus make decisions based not on what is best for their constituents, but on what their super PACs and other major donors want to see.

"We have a corrupt government, yet one that is perfectly legal," said Lessig. "We've allowed a government to evolve in which Congress isn't dependent on people alone, but is instead increasingly dependent on its funders. As you bend to the green, that corrupts the government."

As a result, he said, members of Congress develop a sixth sense as to what will raise money, which has led them to bend government away from what the people want government to do and toward what their funders want government to do. To fix the problem, we need to produce a system where the funders and the people are one and the same. The solution, Lessig said, is a multipronged approach that includes a constitutional amendment explicitly stating that corporations are not people, as well as a movement to publicly fund elections and provide Congress with the power to limit independent expenditures.

Synthesis Questions

1. Do corporations have too much influence on American politics? Support your arguments with examples of excessive influence or lack of excessive influence.
2. Why do so many people find it repugnant to treat corporations as "persons"? Is this disfavor justifiable?

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3.15: Foreign Direct Investment

Learning Objectives

1. Understand the types of international investments.
2. Identify the factors that influence foreign direct investment (FDI).
3. Explain why and how governments encourage FDI in their countries.

Understand the Types of International Investments

There are two main categories of international investment—portfolio investment and foreign direct investment. **Portfolio investment** refers to the investment in a company's stocks, bonds, or assets, but not for the purpose of controlling or directing the firm's operations or management. Typically, investors in this category are looking for a financial rate of return as well as diversifying investment risk through multiple markets.

Foreign direct investment (FDI) refers to an investment in or the acquisition of foreign assets with the intent to control and manage them. Companies can make an FDI in several ways, including purchasing the assets of a foreign company; investing in the company or in new property, plants, or equipment; or participating in a joint venture with a foreign company, which typically involves an investment of capital or know-how. FDI is primarily a long-term strategy. Companies usually expect to benefit through access to local markets and resources, often in exchange for expertise, technical know-how, and capital. A country's FDI can be both inward and outward. As the terms would suggest, **inward FDI** refers to investments coming into the country and **outward FDI** are investments made by companies from that country into foreign companies in other countries. The difference between inward and outward is called the net FDI inflow, which can be either positive or negative.

Governments want to be able to control and regulate the flow of FDI so that local political and economic concerns are addressed. Global businesses are most interested in using FDI to benefit their companies. As a result, these two players—governments and companies—can at times be at odds. It's important to understand why companies use FDI as a business strategy and how governments regulate and manage FDI.

Factors That Influence a Company's Decision to Invest

Let's look at why and how companies choose to invest in foreign markets. Simply purchasing goods and services or deciding to invest in a local market depends on a business's needs and overall strategy. Direct investment in a country occurs when a company chooses to set up facilities to produce or market their products; or seeks to partner with, invest in, or purchase a local company for control and access to the local market, production, or resources. Many considerations influence its decisions:

- **Cost.** Is it cheaper to produce in the local market than elsewhere?
- **Logistics.** Is it cheaper to produce locally if the transportation costs are significant?
- **Market.** Has the company identified a significant local market?
- **Natural resources.** Is the company interested in obtaining access to local resources or commodities?
- **Know-how.** Does the company want access to local technology or business process knowledge?
- **Customers and competitors.** Does the company's clients or competitors operate in the country?
- **Policy.** Are there local incentives (cash and noncash) for investing in one country versus another?
- **Ease.** Is it relatively straightforward to invest and/or set up operations in the country, or is there another country in which setup might be easier?
- **Culture.** Is the workforce or labor pool already skilled for the company's needs or will extensive training be required?
- **Impact.** How will this investment impact the company's revenue and profitability?
- **Expatriation of funds.** Can the company easily take profits out of the country, or are there local restrictions?
- **Exit.** Can the company easily and orderly exit from a local investment, or are local laws and regulations cumbersome and expensive?

These are just a few of the many factors that might influence a company's decision. Keep in mind that a company doesn't need to sell in the local market in order to deem it a good option for direct investment. For example, companies set up manufacturing facilities in low-cost countries but export the products to other markets.

There are two forms of FDI—horizontal and vertical. **Horizontal FDI** occurs when a company is trying to open up a new market—a retailer, for example, that builds a store in a new country to sell to the local market. **Vertical FDI** is when a company invests internationally to provide input into its core operations—usually in its home country. A firm may invest in production facilities in another country. When a firm brings the goods or components back to its home country (i.e., acting as a supplier), this is referred to as backward vertical FDI. When a firm sells the goods into the local or regional market (i.e., acting as a distributor), this is termed forward vertical FDI. The largest global companies often engage in both backward and forward vertical FDI depending on their industry.

Many firms engage in backward vertical FDI. The auto, oil, and infrastructure (which includes industries related to enhancing the infrastructure of a country—that is, energy, communications, and transportation) industries are good examples of this. Firms from these industries invest in production or plant facilities in a country in order to supply raw materials, parts, or finished products to their home country. In recent years, these same industries have also started to provide forward FDI by supplying raw materials, parts, or finished products to newly emerging local or regional markets.

There are different kinds of FDI, two of which—greenfield and brownfield—are increasingly applicable to global firms. **Greenfield FDIs** occur when multinational corporations enter into developing countries to build new factories or stores. These new facilities are built from scratch—usually in an area where no previous facilities existed. The name originates from the idea of building a facility on a green field, such as farmland or a forested area. In addition to building new facilities that best meet their needs, the firms also create new long-term jobs in the foreign country by hiring new employees. Countries often offer prospective companies tax breaks, subsidies, and other incentives to set up greenfield investments.

A **brownfield FDI** is when a company or government entity purchases or leases existing production facilities to launch a new production activity. One application of this strategy is where a commercial site used for an "unclean" business purpose, such as a steel mill or oil refinery, is cleaned up and used for a less polluting purpose, such as commercial office space or a residential area. Brownfield investment is usually less expensive and can be implemented faster; however, a company may have to deal with many challenges, including existing employees, outdated equipment, entrenched processes, and cultural differences.

You should note that the terms *greenfield* and *brownfield* are not exclusive to FDI; you may hear them in various business contexts. In general, greenfield refers to starting from the beginning, and brownfield refers to modifying or upgrading existing plans or projects.

Why and How Governments Encourage FDI

Many governments encourage FDI in their countries as a way to create jobs, expand local technical knowledge, and increase their overall economic standards.Ian Bremmer, *The End of the Free Market: Who Wins the War Between States and Corporations* (New York: Portfolio, 2010). Countries like Hong Kong and Singapore long ago realized that both global trade and FDI would help them grow exponentially and improve the standard of living for their citizens. As a result, Hong Kong (before its return to China) was one of the easiest places to set up a new company. Guidelines were clearly available, and businesses could set up a new office within days. Similarly, Singapore, while a bit more discriminatory on the size and type of business, offered foreign companies a clear, streamlined process for setting up a new company.

In contrast, for decades, many other countries in Asia (e.g., India, China, Pakistan, the Philippines, and Indonesia) restricted or controlled FDI in their countries by requiring extensive paperwork and bureaucratic approvals as well as local partners for any new foreign business. These policies created disincentives for many global companies. By the 1990s (and earlier for China), many of the countries in Asia had caught the global trade bug and were actively trying to modify their policies to encourage more FDI. Some were more successful than others, often as a result of internal political issues and pressures rather than from any repercussions of global trade.UNCTAD compiles statistics on foreign direct investment (FDI): "Foreign Direct Investment database," UNCTAD United Nations Conference on Trade and Development, accessed February 16, 2011, http://unctadstat.unctad.org/ReportFolders/reportFolders.aspx?sRF_ActivePath=P,5,27&sRF_Expanded=,P,5,27&sCS_ChosenLang=en.

How Governments Discourage or Restrict FDI

In most instances, governments seek to limit or control foreign direct investment to protect local industries and key resources (oil, minerals, etc.), preserve the national and local culture, protect segments of their domestic population, maintain political and economic independence, and manage or control economic growth. A government use various policies and rules:

- **Ownership restrictions.** Host governments can specify ownership restrictions if they want to keep the control of local markets or industries in their citizens' hands. Some countries, such as Malaysia, go even further and encourage that ownership be maintained by a person of Malay origin, known locally as *bumiputra*. Although the country's Foreign Investment Committee guidelines are being relaxed, most foreign businesses understand that having a *bumiputra* partner will improve their chances of obtaining favorable contracts in Malaysia.

- **Tax rates and sanctions.** A company's home government usually imposes these restrictions in an effort to persuade companies to invest in the domestic market rather than a foreign one.

How Governments Encourage FDI

Governments seek to promote FDI when they are eager to expand their domestic economy and attract new technologies, business know-how, and capital to their country. In these instances, many governments still try to manage and control the type, quantity, and even the nationality of the FDI to achieve their domestic, economic, political, and social goals.

- **Financial incentives.** Host countries offer businesses a combination of tax incentives and loans to invest. Home-country governments may also offer a combination of insurance, loans, and tax breaks in an effort to promote their companies' overseas investments. The opening case on China in Africa illustrated these types of incentives.
- **Infrastructure.** Host governments improve or enhance local infrastructure—in energy, transportation, and communications—to encourage specific industries to invest. This also serves to improve the local conditions for domestic firms.
- **Administrative processes and regulatory environment.** Host-country governments streamline the process of establishing offices or production in their countries. By reducing bureaucracy and regulatory environments, these countries appear more attractive to foreign firms.
- **Invest in education.** Countries seek to improve their workforce through education and job training. An educated and skilled workforce is an important investment criterion for many global businesses.
- **Political, economic, and legal stability.** Host-country governments seek to reassure businesses that the local operating conditions are stable, transparent (i.e., policies are clearly stated and in the public domain), and unlikely to change.

Ethics in Action

Encouraging Foreign Investment

Governments seek to encourage FDI for a variety of reasons. On occasion, though, the process can cross the lines of ethics and legality. In November 2010, seven global companies paid the US Justice Department "a combined $236 million in fines to settle allegations that they or their contractors bribed foreign officials to smooth the way for importing equipment and materials into several countries."Kara Scannell, "Shell, Six Other Firms Settle Foreign-Bribery Probe," *Wall Street Journal*, November 5, 2010, accessed December 23, 2010, http://online.wsj.com/article/SB10001424052748704805204575594311301043920.html. The companies included Shell and contractors Transocean, Noble, Pride International, Global Santa Fe, Tidewater, and Panalpina World Transport. The bribes were paid to officials in oil-rich countries—Nigeria, Brazil, Azerbaijan, Russia, Turkmenistan, Kazakhstan, and Angola. In the United States, global firms—including ones headquartered elsewhere, but trading on any of the US stock exchanges—are prohibited from paying or even offering to pay bribes to foreign government officials or employees of state-owned businesses with the intent of currying business favors. While the law and the business ethics are clear, in many cases, the penalty fines remain much less onerous than losing critical long-term business revenues.Kara Scannell, "Shell, Six Other Firms Settle Foreign-Bribery Probe," *Wall Street Journal*, November 5, 2010, accessed December 23, 2010, http://online.wsj.com/article/SB10001424052748704805204575594311301043920.html.

Did You Know?

Hong Kong: From Junks to Jets? The Rise of a Global Powerhouse

Policies of openness to FDI and international trade have enabled countries around the world to leapfrog economically over their neighbors. The historical rise of Hong Kong is one example. Hong Kong's economic strengths can be traced to a combination of factors, including its business-friendly laws and policies, a local population that is culturally oriented to transacting trade and business, and Hong Kong's geographic proximity to the major economies of China, Japan, and Taiwan.

Hong Kong has always been open to global trade. Many people, from the Chinese to the Japanese to the British, have occupied Hong Kong over the centuries, and all of them have contributed to its development as one of the world's great ports and trading centers.

In 1997, Hong Kong reverted back to Chinese control; however, free enterprise will be governed under the agreement of Basic Law, which established Hong Kong as a separate Special Administrative Region (SAR) of China. Under its Basic Law, in force until 2047, Hong Kong will retain its legal, social, economic, and political systems apart from China's. Thus, Hong Kong is guaranteed the right to its own monetary system and financial autonomy. Hong Kong is allowed to work independently with the international community; to control trade in strategic commodities, drugs, and illegal transshipments; and to protect intellectual property rights. Under the Basic Law, the Hong Kong SAR maintains an independent tax system and the right to free trade.

Hong Kong has an open business structure, which freely encourages foreign direct investment. Any company that wishes to do business here is free to do so as long as it complies with local laws. Hong Kong's legal and institutional framework combined with its good banking and financial facilities and business-friendly tax systems have encouraged foreign direct investment as many multinationals located their regional headquarters in Hong Kong.

As a base for doing business with China, Hong Kong now accounts for half of all direct investments in the mainland and is China's main conduit for investment and trade. China has also become a major investor in Hong Kong.

Culturally, many foreign firms are attracted to Hong Kong by its skilled workforce and the fact that Hong Kong still conducts business in English, a remnant of its British colonial influence. The imprint of the early British trading firms, known as *hongs*, is particularly strong today in the area of property development. Jardine Matheson and Company, for instance, founded by trader William Jardine, remains one of Hong Kong's preeminent firms. In many of these companies, British management practices remain firmly in place. Every aspect of Hong Kong's business laws—whether pertaining to contracts, taxes, or trusts—bears striking similarities to the laws in Britain. All these factors contribute to a business culture that is familiar to people in many multinationals.

Chinese cultural influences have always affected business and are increasingly so today. Many pundits claim that Hong Kong already resembles China's free-trade zone. And, indeed, the two economies are becoming increasingly intertwined. Much of this economic commingling began in the 1990s, when Hong Kong companies began relocating production centers to the mainland—especially to Guangdong province.

Because of the shift in production to mainland China and other Asian countries, there is not much manufacturing left in Hong Kong. What remains is light in nature and veers toward high-value-added products. In fact, 80 percent of Hong Kong's gross domestic product now comes from its high value-added service sector: finance, business and legal services, brokerage services, the shipping and cargo industries, and the hotel, food, and beverage industry.

Local Hong Kong companies, as well as foreign businesses based there, are uniquely positioned to play important roles as brokers and intermediaries between the mainland and global corporations. Doing business in China is not only complex and daunting but also requires connections, locally known as *guanxi*, to influential people and an understanding of local laws and protocol. Developing these relationships and this knowledge is almost impossible without the assistance of an insider. It is in this role that the Hong Kong business community stands to contribute enormously.

Hong Kong's openness to foreign investment coupled with its proximity to China will ensure its global economic competitiveness for decades to come.

KEY TAKEAWAYS

- There are two main categories of international investment: portfolio investment and foreign direct investment (FDI). Portfolio investment refers to the investment in a company's stocks, bonds, or assets, but not for the purpose of controlling or directing the firm's operations or management. FDI refers to an investment in or the acquisition of foreign assets with the intent to control and manage them.
- Direct investment in a country occurs when a company chooses to set up facilities to produce or market its products or seeks to partner with, invest in, or purchase a local company for control and access to the local market, production, or resources. Many considerations can influence the company's decisions, including cost, logistics, market, natural resources, know-how, customers and competitors, policy, ease of entry and exit, culture, impact on revenue and profitability, and expatriation of funds.
- Governments discourage or restrict FDI through ownership restrictions, tax rates, and sanctions. Governments encourage FDI through financial incentives; well-established infrastructure; desirable administrative processes and regulatory environment; educational investment; and political, economic, and legal stability.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What are three factors that impact a company's decision to invest in a country?
2. What is the difference between vertical and horizontal FDI? Give one example of an industry for each type.
3. How can governments encourage or discourage FDI?

3.16: End-of-Chapter Questions and Exercises

These exercises are designed to ensure that the knowledge you gain from this book about international business meets the learning standards set out by the international Association to Advance Collegiate Schools of Business (AACSB International).Association to Advance Collegiate Schools of Business website, accessed January 26, 2010, http://www.aacsb.edu. AACSB is the premier accrediting agency of collegiate business schools and accounting programs worldwide. It expects that you will gain knowledge in the areas of communication, ethical reasoning, analytical skills, use of information technology, multiculturalism and diversity, and reflective thinking.

EXPERIENTIAL EXERCISES

(AACSB: Communication, Use of Information Technology, Analytical Skills)

1. Define the differences between the classical, country-based trade theories and the modern, firm-based trade theories. If you were a manager for a large manufacturing company charged with developing your firm's global strategy, how would you use these theories in your analysis? Which theories seem most appealing to you and which don't seem to apply?
2. Pick a country as a potential new market for your firm's operations. Using what you have learned in this chapter and from online resources (e.g., www.cia.gov/library/publications/the-world-factbook/index.html and http://globaledge.msu.edu/),Central Intelligence Agency, *World Factbook*, Central Intelligence Agency website, accessed February 16, 2011, www.cia.gov/library/publications/the-world-factbook/index.html; globalEDGE website, International Business Center, Michigan State University, accessed February 16, 2011, http://globaledge.msu.edu. assess the local political, economic, and legal factors of the country. Would you recommend to your senior management that your firm establish operations and invest in this country? Which factors do you think are most important in this decision?

Ethical Dilemmas

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. Imagine that you are working for a US business that is evaluating whether it should move its manufacturing to India or China. You have been asked to present the pros and cons of this investment. Based on what you have learned in this chapter, what political, legal, economic, social, and business factors would you need to assess for each country? Use the Internet for country-specific research.globalEDGE website, International Business Center, Michigan State University, accessed February 16, 2011, http://globaledge.msu.edu.
2. Imagine that you work for a large, global company that builds power plants for electricity. This industry has a long-term perspective and requires stable, reliable countries in order to make FDIs. You are assigned to evaluate which of the following would be better for a long-term investment: South Africa, Nigeria, Algeria, or Kenya. Recall what you've learned in this chapter about political and legal factors and political ideologies—as well as earlier discussions about global business ethics and bribery. Then, using online resources to support your opinion, provide your recommendations to senior management.

CHAPTER OVERVIEW

4: Global Monetary System

4.1: Chapter Introduction

International Monetary System

WHAT'S IN IT FOR ME?

1. What is the international monetary system?
2. What role do the International Monetary Fund (IMF) and the World Bank play?
3. How do the global monetary institutions impact global business?

Global trade depends on the smooth exchange of currencies between countries. Businesses rely on a predictable and stable mechanism. This chapter takes a look at the recent history of global monetary systems and how they have evolved over the past two centuries. While the current monetary system continues to evolve, lessons learned over the past fifty years help determine the best future options. As part of the post–World War II monetary environment, two institutions were created; these institutions have expanded to play an increasingly larger role in world economy. Understanding the role of the IMF and the World Bank provides insight into how governments in developing countries prioritize and fund projects and work with the private sector to implement these initiatives.

Opening Case: McKinsey & Company: Linking the Business World, Governments, and Global Institutions

Who Is McKinsey?

McKinsey & Company is a privately held global management-consulting firm that serves as a trusted adviser to the world's leading businesses, governments, and institutions. Recognized as a global leader, it has ranked first as the most prestigious firm in the management consulting industry by Vault.com.“McKinsey & Company,” *Vault*, accessed February 9, 2011, www.vault.com/wps/portal/usa/companies/company-profile?WCM_GLOBAL_CONTEXT=/wps/wcm/connect/Vault_Content_Library/companies+site/companies/parent_mckinsey+_+company/mckinsey+_+company_0/mckinsey+_+company_0&companyId=328.

James O. “Mac” McKinsey, an accounting professor at the University of Chicago, founded McKinsey & Company in Chicago in 1926. Over the decades, McKinsey & Company has grown to global prominence by providing expert consulting services and garnering results for companies in a wide range of industries and governments.

Today, McKinsey has a revenue of $6 billion and employs almost 17,000 people worldwide, with more than 9,000 at the director level. “The firm is among the *largest hirers of newly minted MBAs* in the United States.”“America's Largest Private Companies: #54 McKinsey & Co.,” *Forbes*, October 28, 2009, accessed February 9, 2011, http://www.forbes.com/lists/2009/21/private-companies-09_McKinsey-Co_IPPW.html (emphasis added). McKinsey's employees come from around the world, speaking over 120 languages and representing more than one hundred nationalities.

What Does the Firm Do?

As a management consultant firm, McKinsey is approached by its clients to analyze and solve complex problems. Its industry expertise ranges from media and entertainment to the automotive industry, chemicals, and manufacturing. Functional expertise includes all aspects of running a business, including, finance, technology, sales, marketing, risk, and operations. McKinsey has its own Global Institute whose “independent investigations combine McKinsey's microeconomic understanding of companies and industries with the rigor of leading macroeconomic thinking to derive perspectives on the global forces shaping business, government, and society.”“McKinsey Global Institute,” McKinsey & Company, accessed February 9, 2011, www.mckinsey.com/mgi.

The Global Institute is one of McKinsey's paths to assisting governments and global institutions with complex economic and business issues. “Twenty years of McKinsey Global Institute research shows that the mix of sectors within an economy explains very little of the difference in a country's GDP growth rate. In other words, dynamism doesn't turn on whether an economy has a large financial sector, or big manufacturers, or a semiconductor industry, but instead on whether the sectors are competitive or not. Instead of picking winners and funneling subsidies to them, countries must get the basics right. These include a solid rule of law, with patents and protections for intellectual property, enforceable contracts, and courts to resolve disputes; access to finance, particularly for startups; and an efficient physical and communications infrastructure.”James Manyika, Susan Lund, and Byron Auguste, “From the Ashes,” *Newsweek*, August 16, 2010, accessed February 9, 2011, www.newsweek.com/2010/08/16/mckinsey-institute-create-jobs-by-losing-them.html.

Why Does the Firm Matter to International Business?

This chapter discusses the international monetary system, the IMF and the World Bank. In learning about these critical parts of the global business environment, you may find yourself wondering how exactly these institutions and government-led monetary systems interact with the business world. Learning about the business of a management consulting firm like McKinsey helps to illustrate this link.

Over the decades, McKinsey has helped global businesses understand how to enter new markets around the world, how to compete more effectively against their global competitors, and how to harness efficiencies and make improvements in all levels of business. Simultaneously, McKinsey has discreetly been an advisor to governments around the world on diverse issues, including how to amend policy and regulation to encourage more trade and investment in their countries; developing and implementing processes for privatizing industries; and creating more efficiencies in the public sector. At the same time, McKinsey has helped the IMF and the World Bank craft policy to meet their evolving roles in the world economy. Given the often politically charged global environment, it's clear why a company like McKinsey prefers to remain out of the public eye. Much of the work that the firm is engaged in impacts the daily lives of people around the world. Businesses and governments are attracted to McKinsey not only for its sound analysis and advice but also for its discretion and long-term perspective.

McKinsey's consultants form an enviable global network that extends even to former employees. McKinsey operates under a practice of "up or out," meaning that consultants must either advance in their consulting careers within a predefined time frame or leave the firm. It's not uncommon to find that a consultant will leave McKinsey to join their clients in the private sector or work for a government or global institution. This network of "McKinsey-ites," as they are sometimes called, is evident in their influence on policy that could impact their business clients—either on a country basis or industry basis. This network helps attract some of the best business school graduates to the firm.

As noted on its website, people "who join McKinsey find themselves part of a unique culture, shaped by shared values and a desire to help clients make substantial improvements in their performance. When consultants leave, their connection to our firm and their former colleagues remains strong. Our alumni number nearly 23,000 and work in virtually every business sector in almost 120 countries. Through formal events and informal networking, former McKinsey consultants make and sustain professional relationships. This dynamic network is a lasting benefit of a career with McKinsey. Our firm provides support to alumni who want to stay in touch with us and with each other, sponsoring events worldwide.""Alumni," McKinsey & Company, accessed February 9, 2011, www.mckinsey.com/aboutus/alumni.

One of the more interesting aspects of McKinsey's business approach is its nonexclusivity. Consultants develop expertise and can work for direct competitors after short holding periods of one or two years. Other companies in the same industry often see this as an opportunity to learn more about their competitors' strategies—knowing that a competitor has hired McKinsey provides a strong impetus for companies to seek McKinsey's assistance themselves. However, McKinsey does keep its client list confidential, and consultants themselves are not allowed to discuss their work with other teams.

The McKinsey mystique is another interesting aspect of the firm that adds to the secrecy that surrounds it. Despite its size, the firm does not discuss specific client situations and maintains a carefully crafted and low-profile external image, which also protects it from public scrutiny. The McKinsey commitment to discretion has earned it global private and public-sector clients and respect.

Roundly considered to be the most prestigious company of its kind, it has achieved a level of renown so great as to be known even to laymen, despite shrouding details of its work—and its client list—in secrecy. In its practice areas, it addresses strategic, organizational, operational and technological issues, always with a focus—according to the firm—of doing what is right for the client's business, not what is best for McKinsey's bottom line. As for the range of those specialties, the list of industrial sectors the firm serves encompasses everything from commodities and natural resources to the worlds of media, entertainment and high tech. While it doesn't give up the names of its clients (even in case studies it refers to them with pseudonyms such as "BigBank") the firm does claim to serve more than 70 percent of Fortune's Most Admired Companies list, roughly 90 percent of the top-100 corporations worldwide and 80 percent of the 100 largest U.S.-based companies."McKinsey & Company," *Vault*, accessed February 9, 2011, www.vault.com/wps/portal/usa/companies/company-profile?WCM_GLOBAL_CONTEXT=/wps/wcm/connect/Vault_Content_Library/companies+site/companies/parent_mckinsey+_+company/mckinsey+_+company_0/mckinsey+_+company_0&companyId=328.

While it's hard to know exact details of its pricing, client base, success rate, and profitability, it's clear that the company continues to earn the trust and loyalty of many of the world's companies, governments, and global institutions.

Opening Case Exercises

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. How does the business of a management consultant illustrate the link between businesses, governments, and global institutions?
2. Discuss how a global consulting firm might assist a government client.
3. Why would a global business in the private sector want to hire McKinsey if McKinsey had already done consulting work for a competitor?

4.2: What Is the International Monetary System?

Learning Objectives

1. Understand the role and purpose of the international monetary system.
2. Describe the purpose of the gold standard and why it collapsed.
3. Describe the Bretton Woods Agreement and why it collapsed.
4. Understand today's current monetary system, which developed after the Bretton Woods Agreement collapse.

Why do economies need money? This chapter defines *money* as a unit of account that is used as a medium of exchange in trasactions. Without money, individuals and businesses would have a harder time obtaining (purchasing) or exchanging (selling) what they need, want, or make. Money provides us with a universally accepted medium of exchange.

Before the current monetary system can be fully appreciated, it's helpful to look back at history and see how money and systems governing the use of money have evolved. Thousands of years ago, people had to barter if they wanted to get something. That worked well if the two people each wanted what the other had. Even today, bartering exists. (Chapter 9 discusses modern bartering and countertrade.)

History shows that ancient Egypt and Mesopotamia—which encompasses the land between the Euphrates and Tigris Rivers and is modern-day Iraq, parts of eastern Syria, southwest Iran, and southeast Turkey—began to use a system based on the highly coveted coins of gold and silver, also known as **bullion**, which is the purest form of the precious metal. However, bartering remained the most common form of exchange and trade.

Gold and silver coins gradually emerged in the use of trading, although the level of pure gold and silver content impacted the coins value. Only coins that consist of the pure precious metal are bullions; all other coins are referred to simply as *coins*. It is interesting to note that gold and silver lasted many centuries as the basis of economic measure and even into relatively recent history of the gold standard, which we'll cover in the next section. Fast-forward two thousand years and bartering has long been replaced by a currency-based system. Even so, there have been evolutions in the past century alone on how—globally—the monetary system has evolved from using gold and silver to represent national wealth and economic exchange to the current system.

Did You Know?

Throughout history, some types of money have gained widespread circulation outside of the nations that issued them. Whenever a country or empire has regional or global control of trade, its currency becomes the dominant currency for trade and governs the monetary system of that time. In the middle of a period that relies on one major currency, it's easy to forget that, throughout history, there have been other primary currencies—a historical cycle. Generally, the best currency to use is the most liquid one, the one issued by the nation with the biggest economy as well as usually the largest import-export markets. Rarely has a single currency been the exclusive medium of world trade, but a few have come close. Here's a quick look at some of some of the most powerful currencies in history:

- **Persian daric.** The daric was a gold coin used in Persia between 522 BC and 330 BC.
- **Roman currency.** Currencies such as the aureus (gold), the denarius (silver), the sestertius (bronze), the dupondius (bronze), and the as (copper) were used during the Roman Empire from around 250 BC to AD 250.
- **Thaler.** From about 1486 to 1908, the thaler and its variations were used in Europe as the standard against which the various states' currencies could be valued.
- **Spanish American pesos.** Around 1500 to the early nineteenth century, this contemporary of the thaler was widely used in Europe, the Americas, and the Far East; it became the first world currency by the late eighteenth century.
- **British pound.** The pound's origins date as early as around AD 800, but its influence grew in the 1600s as the unofficial gold standard; from 1816 to around 1939 the pound was the global reserve currency until the collapse of the gold standard.
- **US dollar.** The Coinage Act of 1792 established the dollar as the basis for a monetary account, and it went into circulation two years later as a silver coin. Its strength as a global reserve currency expanded in the 1800s and continues today.
- **Euro.** Officially in circulation on January 1, 1999, the euro continues to serve as currency in many European countries today.

Let's take a look at the last century of the international monetary system evolution. **International monetary system** refers to the system and rules that govern the use and exchange of money around the world and between countries. Each country has its own currency as money and the international monetary system governs the rules for valuing and exchanging these currencies.

Until the nineteenth century, the major global economies were regionally focused in Europe, the Americas, China, and India. These were loosely linked, and there was no formal monetary system governing their interactions. The rest of this section reviews the distinct chronological periods over the past 150 years leading to the development of the modern global financial system. Keep in mind that the system continues to evolve and each crisis impacts it. There is not likely to be a final international monetary system, simply one that reflects the current economic and political realities. This is one main reason why understanding the historical context is so critical. As the debate about the pros and cons of the current monetary system continues, some economists are tempted to advocate a return to systems from the past. Businesses need to be mindful of these arguments and the resulting changes, as they will be impacted by new rules, regulations, and structures.

Pre–World War I

As mentioned earlier in this section, ancient societies started using gold as a means of economic exchange. Gradually more countries adopted gold, usually in the form of coins or bullion, and this international monetary system became known as the **gold standard**. This system emerged gradually, without the structural process in more recent systems. The gold standard, in essence, created a **fixed exchange rate system**. An **exchange rate** is the price of one currency in terms of a second currency. In the gold standard system, each country sets the price of its currency to gold, specifically to one ounce of gold. A fixed exchange rate stabilizes the value of one currency vis-à-vis another and makes trade and investment easier.

Our modern monetary system has its roots in the early 1800s. The defeat of Napoleon in 1815, when France was beaten at the Battle of Waterloo, made Britain the strongest nation in the world, a position it held for about one hundred years. In Africa, British rule extended at one time from the Cape of Good Hope to Cairo. British dominance and influence also stretched to the Indian subcontinent, the Malaysian peninsula, Australia, New Zealand—which attracted British settlers—and Canada. Under the banner of the British government, British companies advanced globally and were the largest companies in many of the colonies, controlling trade and commerce. Throughout history, strong countries, as measured mainly in terms of military might, were able to advance the interests of companies from their countries—a fact that has continued to modern times, as seen in the global prowess of American companies. Global firms in turn have always paid close attention to the political, military, and economic policies of their and other governments.

In 1821, the United Kingdom, the predominant global economy through the reaches of its colonial empire, adopted the gold standard and committed to fixing the value of the British pound. The major trading countries, including Russia, Austria-Hungary, Germany, France, and the United States, also followed and fixed the price of their currencies to an ounce of gold.

The United Kingdom officially set the price of its currency by agreeing to buy or sell an ounce of gold for the price of 4.247 pounds sterling. At that time, the United States agreed to buy or sell an ounce of gold for $20.67. This enabled the two currencies to be freely exchanged in terms of an ounce of gold. In essence,

£4.247 = 1 ounce of gold = $20.67.

The exchange rate between the US dollar and the British pound was then calculated by

$20.67/£4.247 = $4.867 to £1.

The Advantages of the Gold Standard

The gold standard dramatically reduced the risk in exchange rates because it established fixed exchange rates between currencies. Any fluctuations were relatively small. This made it easier for global companies to manage costs and pricing. International trade grew throughout the world, although economists are not always in agreement as to whether the gold standard was an essential part of that trend.

The second advantage is that countries were forced to observe strict monetary policies. They could not just print money to combat economic downturns. One of the key features of the gold standard was that a currency had to actually have in reserve enough gold to convert all of its currency being held by anyone into gold. Therefore, the volume of paper currency could not exceed the gold reserves.

The third major advantage was that gold standard would help a country correct its trade imbalance. For example, if a country was importing more than it is exporting, (called a **trade deficit**), then under the gold standard the country had to pay for the imports with gold. The government of the country would have to reduce the amount of paper currency, because there could not be more currency in circulation than its gold reserves. With less money floating around, people would have less money to spend (thus causing a decrease in demand) and prices would also eventually decrease. As a result, with cheaper goods and services to offer, companies from the country could export more, changing the international trade balance gradually back to being in balance. For these three primary reasons, and as a result of the 2008 global financial crises, some modern economists are calling for the return of the gold standard or a similar system.

Collapse of the Gold Standard

If it was so good, what happened? The gold standard eventually collapsed from the impact of World War I. During the war, nations on both sides had to finance their huge military expenses and did so by printing more paper currency. As the currency in circulation exceeded each country's gold reserves, many countries were forced to abandon the gold standard. In the 1920s, most countries, including the United Kingdom, the United States, Russia, and France, returned to the gold standard at the same price level, despite the political instability, high unemployment, and inflation that were spread throughout Europe.

However, the revival of the gold standard was short-lived due to the Great Depression, which began in the late 1920s. The Great Depression was a worldwide phenomenon. By 1928, Germany, Brazil, and the economies of Southeast Asia were depressed. By early 1929, the economies of Poland, Argentina, and Canada were contracting, and the United States economy followed in the middle of 1929. Some economists have suggested that the larger factor tying these countries together was the international gold standard, which they believe prolonged the Great Depression.*The Concise Encyclopedia of Economics*, s.v. "Great Depression," accessed July 23, 2010, http://www.econlib.org/library/Enc/GreatDepression.html. The gold standard limited the flexibility of the monetary policy of each country's central banks by limiting their ability to expand the money supply. Under the gold standard, countries could not expand their money supply beyond what was allowed by the gold reserves held in their vaults.

Too much money had been created during World War I to allow a return to the gold standard without either large currency devaluations or price deflations. In addition, the US gold stock had doubled to about 40 percent of the world's monetary gold. There simply was not enough monetary gold in the rest of the world to support the countries' currencies at the existing exchange rates.

By 1931, the United Kingdom had to officially abandon its commitment to maintain the value of the British pound. The currency was allowed to **float**, which meant that its value would increase or decrease based on demand and supply. The US dollar and the French franc were the next strongest currencies and nations sought to peg the value of their currencies to either the dollar or franc. However, in 1934, the United States devalued its currency from $20.67 per ounce of gold to $35 per ounce. With a cheaper US dollar, US firms were able to export more as the price of their goods and services were cheaper vis-à-vis other nations. Other countries devalued their currencies in retaliation of the lower US dollar. Many of these countries used arbitrary par values rather than a price relative to their gold reserves. Each country hoped to make its exports cheaper to other countries and reduce expensive imports. However, with so many countries simultaneously devaluing their currencies, the impact on prices was canceled out. Many countries also imposed tariffs and other trade restrictions in an effort to protect domestic industries and jobs. By 1939, the gold standard was dead; it was no longer an accurate indicator of a currency's real value.

Post–World War II

The demise of the gold standard and the rise of the Bretton Woods system pegged to the US dollar was also a changing reflection of global history and politics. The British Empire's influence was dwindling. In the early 1800s, with the strength of both their currency and trading might, the United Kingdom had expanded its empire. At the end of World War I, the British Empire spanned more than a quarter of the world; the general sentiment was that "the sun would never set on the British empire." British maps and globes of the time showed the empire's expanse proudly painted in red. However, shortly after World War II, many of the colonies fought for and achieved independence. By then, the United States had clearly replaced the United Kingdom as the dominant global economic center and as the political and military superpower as well.

Did You Know?

Just as the United States became a global military and political superpower, US businesses were also taking center stage. Amoco (today now part of BP), General Motors (GM), Kellogg's, and Ford Motor Company sought to capitalize on US political and military strength to expand in new markets around the world. Many of these companies followed global political events and internally debated the strategic directions of their firms. For example, GM had an internal postwar planning policy group.

Notwithstanding the economic uncertainties that were bound to accompany the war's end, a few of the largest U.S. corporations, often with considerable assets seized or destroyed during the war, began to plan for the postwar period. Among these was General Motors. As early as 1942 the company had set up a postwar planning policy group to estimate the likely shape of the world after the war and to make recommendations on GM's postwar policies abroad.

In 1943 the policy group reported the likelihood that relations between the Western powers and the Soviet Union would deteriorate after the war. It also concluded that, except for Australia, General Motors should not buy plants and factories to make cars in any country that had not had facilities before the conflict. At the same time, though, it stated that after the war the United States would be in a stronger state politically and economically than it had been after World War I and that overseas operations would flourish in much of the world. The bottom line for GM, therefore, was to proceed with caution once the conflict ended but to stick to the policy it had enunciated in the 1920s—seeking out markets wherever they were available and building whatever facilities were needed to improve GM's market share.*Encyclopedia of the New American Nation*, s.v. "Multinational Corporations—Postwar Investment: 1945–1955," accessed February 9, 2011, http://www.americanforeignrelations.com/E-N/Multinational-Corporations-Postwar-investment-1945-1955.html#ixzz18TCwg8VJ.

Bretton Woods

In the early 1940s, the United States and the United Kingdom began discussions to formulate a new international monetary system. John Maynard Keynes, a highly influential British economic thinker, and Harry Dexter White, a US Treasury official, paved the way to create a new monetary system. In July 1944, representatives from forty-four countries met in Bretton Woods, New Hampshire, to establish a new international monetary system.

"The challenge," wrote Ngaire Woods in his book *The Globalizers: The IMF, the World Bank, and Their Borrowers*, "was to gain agreement among states about how to finance postwar reconstruction, stabilize exchange rates, foster trade, and prevent balance of payments crises from unraveling the system."Ngaire Woods, *Globalizers: The IMF, the World Bank, and Their Borrowers* (Ithaca, NY: Cornell University Press, 2006), 16.

Did You Know?

Throughout history, political, military, and economic discussions between nations have always occurred simultaneously in an effort to create synergies between policies and efforts. A key focus of the 1940s efforts for a new global monetary system was to stabilize war-torn Europe.

In the decade following the war the administrations of both Harry Truman and Dwight Eisenhower looked to the private sector to assist in the recovery of western Europe, both through increased trade and direct foreign investments. In fact, the $13 billion Marshall Plan, which became the engine of European recovery between 1948 and 1952, was predicated on a close working relationship between the public and private sectors. Similarly, Eisenhower intended to bring about world economic recovery through liberalized world commerce and private investment abroad rather than through foreign aid. Over the course of his two administrations (1953–1961), the president modified his policy of "trade not aid" to one of "trade and aid" and changed his focus from western Europe to the Third World, which he felt was most threatened by communist expansion. In particular he was concerned by what he termed a "Soviet economic offensive" in the Middle East, that is, Soviet loans and economic assistance to such countries as Egypt and Syria. But even then he intended that international commerce and direct foreign investments would play a major role in achieving global economic growth and prosperity.*Encyclopedia of the New American Nation*, s.v. "Multinational Corporations—Postwar Investment: 1945–1955," accessed February 9, 2011, http://www.americanforeignrelations.com/E-N/Multinational-Corporations-Postwar-investment-1945-1955.html#ixzz18TCwg8VJ.

The resulting Bretton Woods Agreement created a new dollar-based monetary system, which incorporated some of the disciplinary advantages of the gold system while giving countries the flexibility they needed to manage temporary economic setbacks, which had led to the fall of the gold standard. The Bretton Woods Agreement lasted until 1971 and established several key features.

Fixed Exchange Rates

Fixed exchange rates are also sometimes called pegged rates. One of the critical factors that led to the fall of the gold standard was that after the United Kingdom abandoned its commitment to maintaining the value of the British pound, countries sought to peg their currencies to the US dollar. With the strength of the US economy, the gold supply in the United States increased, while many countries had less gold in reserve than they did currency in circulation. The Bretton Woods system worked to fix this by tying the value of the US dollar to gold but also by tying all of the other countries to the US dollar rather than directly to gold. The par value of the US dollar was fixed at $35 to one ounce of gold. All other countries then set the value of their currencies to the US dollar. In reflection of the changing times, the British pound had undergone a substantial loss in value and by that point, its value was $2.40 to £1. Member countries had to maintain the value of their currencies within 1 percent of the fixed exchange rate. Lastly, the agreement established that only governments, rather than anyone who demanded it, could convert their US dollar holdings into gold—a major improvement over the gold standard. In fact, most businesspeople eventually ignored the technicality of pegging the

US dollar to gold and simply utilized the actual exchange rates between countries (e.g., the pound to the dollar) as an economic measure for doing business.

National Flexibility

To enable countries to manage temporary but serious downturns, the Bretton Woods Agreement provided for a devaluation of a currency—more than 10 percent if needed. Countries could not use this tool to competitively manipulate imports and exports. Rather, the tool was intended to prevent the large-scale economic downturn that took place in the 1930s.

Creation of the International Monetary Fund and the World Bank

Section 6.2 looks at the International Monetary Fund and the World Bank more closely, as they have survived the collapse of the Bretton Woods Agreement. In essence, the IMF's initial primary purpose was to help manage the fixed rate exchange system; it eventually evolved to help governments correct temporary trade imbalances (typically deficits) with loans. The World Bank's purpose was to help with post–World War II European reconstruction. Both institutions continue to serve these roles but have evolved into broader institutions that serve essential global purposes, even though the system that created them is long gone. Section 6.2 explores them in greater detail and addresses the history, purpose, evolution, and current opportunities and challenges of both institutions.

Collapse of Bretton Woods

Despite a fixed exchange rate based on the US dollar and more national flexibility, the Bretton Woods Agreement ran into challenges in the early 1970s. The US trade balance had turned to a deficit as Americans were importing more than they were exporting. Throughout the 1950s and 1960s, countries had substantially increased their holdings of US dollars, which was the only currency pegged to gold. By the late 1960s, many of these countries expressed concern that the US did not have enough gold reserves to exchange all of the US dollars in global circulation. This became known as the **Triffin Paradox**, named after the economist Robert Triffin, who identified this problem. He noted that the more dollars foreign countries held, the less faith they had in the ability of the US government to convert those dollars. Like banks, though, countries do not keep enough gold or cash on hand to honor all of their liabilities. They maintain a percentage, called a **reserve**. Bank reserve ratios are usually 10 percent or less. (The low reserve ratio has been blamed by many as a cause of the 2008 financial crisis.) Some countries state their reserve ratios openly, and most seek to actively manage their ratios daily with open-market monetary policies—that is, buying and selling government securities and other financial instruments, which indirectly controls the total money supply in circulation, which in turn impacts supply and demand for the currency.

The expense of the Vietnam War and an increase in domestic spending worsened the Triffin Paradox; the US government began to run huge budget deficits, which further weakened global confidence in the US dollar. When nations began demanding gold in exchange for their dollars, there was a huge global sell-off of the US dollar, resulting in the Nixon Shock in 1971.

The Nixon Shock was a series of economic decisions made by the US President Richard Nixon in 1971 that led to the demise of the Bretton Woods system. Without consulting the other member countries, on August 15, 1971, Nixon ended the free convertibility of the US dollar into gold and instituted price and wage freezes among other economic measures.

Later that same year, the member countries reached the Smithsonian Agreement, which devalued the US dollar to $38 per ounce of gold, increased the value of other countries' currencies to the dollar, and increased the band within which a currency was allowed to float from 1 percent to 2.25 percent. This agreement still relied on the US dollar to be the strong reserve currency and the persistent concerns over the high inflation and trade deficits continued to weaken confidence in the system. Countries gradually dropped out of system—notably Germany, the United Kingdom, and Switzerland, all of which began to allow their currencies to float freely against the dollar. The Smithsonian Agreement was an insufficient response to the economic challenges; by 1973, the idea of fixed exchange rates was over.

Before moving on, recall that the major significance of the Bretton Woods Agreement was that it was the first formal institution that governed international monetary systems. By having a formal set of rules, regulations, and guidelines for decision making, the Bretton Woods Agreement established a higher level of economic stability. International businesses benefited from the almost thirty years of stability in exchange rates. Bretton Woods established a standard for future monetary systems to improve on; countries today continue to explore how best to achieve this. Nothing has fully replaced Bretton Woods to this day, despite extensive efforts.

Post–Bretton Woods Systems and Subsequent Exchange Rate Efforts

When Bretton Woods was established, one of the original architects, Keynes, initially proposed creating an international currency called Bancor as the main currency for clearing. However, the Americans had an alternative proposal for the creation of a central currency called unitas. Neither gained momentum; the US dollar was the reserve currency. **Reserve currency** is a main currency that many countries and institutions hold as part of their foreign exchange reserves. Reserve currencies are often international pricing currencies for world products and services. Examples of current reserve currencies are the US dollar, the euro, the British pound, the Swiss franc, and the Japanese yen.

Many feared that the collapse of the Bretton Woods system would bring the period of rapid growth to an end. In fact, the transition to floating exchange rates was relatively smooth, and it was certainly timely: flexible exchange rates made it easier for economies to adjust to more expensive oil, when the price suddenly started going up in October 1973. Floating rates have facilitated adjustments to external shocks ever since.

The IMF responded to the challenges created by the oil price shocks of the 1970s by adapting its lending instruments. To help oil importers deal with anticipated current account deficits and inflation in the face of higher oil prices, it set up the first of two oil facilities."The End of the Bretton Woods System (1972–81)," International Monetary Fund, accessed July 26, 2010, http://www.imf.org/external/about/histend.htm.

After the collapse of Bretton Woods and the Smithsonian Agreement, several new efforts tried to replace the global system. The most noteworthy regional effort resulted in the European Monetary System (EMS) and the creation of a single currency, the euro. While there have been no completely effective efforts to replace Bretton Woods on a global level, there have been efforts that have provided ongoing exchange rate mechanisms.

Jamaica Agreement

In 1976, countries met to formalize a floating exchange rate system as the new international monetary system. The Jamaica Agreement established a **managed float system of exchange rates**, in which currencies float against one another with governments intervening only to stabilize their currencies at set target exchange rates. This is in contrast to a completely **free floating exchange rate system**, which has no government intervention; currencies float freely against one another. The Jamaica Agreement also removed gold as the primary reserve asset of the IMF. Additionally, the purpose of the IMF was expanded to include lending money as a last resort to countries with balance-of-payment challenges.

The Gs Begin

In the early 1980s, the value of the US dollar increased, pushing up the prices of US exports and thereby increasing the trade deficit. To address the imbalances, five of the world's largest economies met in September 1985 to determine a solution. The five countries were Britain, France, Germany, Japan, and the United States; this group became known as the **Group of Five**, shortened to G5. The 1985 agreement, called the Plaza Accord because it was held at the Plaza Hotel in New York City, focused on forcing down the value of the US dollar through collective efforts.

By February 1987, the markets had pushed the dollar value down, and some worried it was now valued too low. The G5 met again, but now as the Group of Seven, adding Italy and Canada—it became known as the G7. The Louvre Accord, so named for being agreed on in Paris, stabilized the dollar. The countries agreed to support the dollar at the current valuation. The G7 continued to meet regularly to address ongoing economic issues.

The G7 was expanded in 1999 to include twenty countries as a response to the financial crises of the late 1990s and the growing recognition that key emerging-market countries were not adequately included in the core of global economic discussions and governance. It was not until a decade later, though, that the G20 effectively replaced the G8, which was made up of the original G7 and Russia. The European Union was represented in G20 but could not host or chair the group.

Keeping all of these different groups straight can be very confusing. The news may report on different groupings as countries are added or removed from time to time. The key point to remember is that anything related to a G is likely to be a forum consisting of finance ministers and governors of central banks who are meeting to discuss matters related to cooperating on an international monetary system and key issues in the global economy.

The G20 is likely to be the stronger forum for the foreseeable future, given the number of countries it includes and the amount of world trade it represents. "Together, member countries represent around 90 per cent of global gross national product, 80 per cent of world trade (including EU intra-trade) as well as two-thirds of the world’s population.”“About G-20,” G-20, accessed July 25, 2010, www.g20.org/en.

Did You Know?

G-ology

“At present, a number of groups are jostling to be the pre-eminent forum for discussions between world leaders. The G20 ended 2009 by in effect replacing the old G8. But that is not the end of the matter. In 2010 the G20 began to face a new challenger—G2 [the United States and China]. To confuse matters further, lobbies have emerged advocating the formation of a G13 and a G3.”Gideon Rachman, “A Modern Guide to G-ology,” *Economist*, November 13, 2009, accessed February 9, 2011, http://www.economist.com/node/14742524. The G20 is a powerful, informal group of nineteen countries and the European Union. It also includes a representative from the World Bank and the International Monetary Fund. The list developed from an effort to include major developing countries with countries with developed economies. Its purpose is to address issues of the international financial system.

So just who’s in the current G20?

G20 Countries	
Argentina	Japan
Australia	Mexico
Brazil	Russia
Canada	Saudia Arabia
China	South Africa
France	South Korea
Germany	Turkey
India	United Kingdom
Indonesia	United States
Italy	European Union

Today’s Exchange Rate System

While there is not an official replacement to the Bretton Woods system, there are provisions in place through the ongoing forum discussions of the G20. Today’s system remains—in large part—a managed float system, with the US dollar and the euro jostling to be the premier global currency. For businesses that once quoted primarily in US dollars, pricing is now just as often noted in the euro as well.

Ethics in Action

The *Wall Street Journal*'s July 30, 2010, edition noted how gangsters are helping provide stability in the euro zone. The highest denomination of a euro is a €500 bill, in contrast to the United States, where the largest bill is a $100 bill.

The high-value bills are increasingly "making the euro the currency of choice for underground and black economies, and for all those who value anonymity in their financial transactions and investments," wrote Willem Buiter, the chief economist at Citigroup….

When euro notes and coins went into circulation in January 2002, the value of €500 notes outstanding was €30.8 billion ($40 billion), according to the ECB [European Central Bank].

Today some €285 billion worth of such euro notes are in existence, an annual growth rate of 32 percent. By value, 35 percent of euro notes in circulation are in the highest denomination, the €500 bill that few people ever see.

In 1998, then-U.S. Treasury official Gary Gensler worried publicly about the competition to the $100 bill, the biggest U.S. bank note, posed by the big euro notes and their likely use by criminals. He pointed out that $1 million in $100 bills weighs 22 pounds; in hypothetical $500 bills, it would weigh just 4.4 pounds.

Police forces have found the big euro notes in cereal boxes, tires and in hidden compartments in trucks, says Soren Pedersen, spokesman for Europol, the European police agency based in The Hague. "Needless to say, this cash is often linked to the illegal drugs trade, which explains the similarity in methods of concealment that are used."Stephen Fidler, "How Gangsters Are Saving Euro Zone," *Wall Street Journal*, July 30, 2010, accessed February 9, 2011, http://online.wsj.com/article/SB10001424052748704532204575397543634034112.html.

While you might think that the ECB should just stop issuing the larger denominations, it turns out that the ECB and the member governments of the euro zone actually benefit from this demand.

The profit a central bank gains from issuing currency—as well as from other privileges of a central bank, such as being able to demand no-cost or low-cost deposits from banks—is known as seigniorage. It normally accrues to national treasuries once the central banks account for their own costs.

The ECB's gains from seigniorage are becoming increasingly important this year….

In recent years, the profits on its issue of new paper currency have been running at €50 billion."Stephen Fidler, "How Gangsters Are Saving Euro Zone," *Wall Street Journal*, July 30, 2010, accessed February 9, 2011, http://online.wsj.com/article/SB10001424052748704532204575397543634034112.html.

Some smaller nations have chosen to voluntarily set exchange rates against the dollar while other countries have selected the euro. Usually a country makes the decision between the dollar and the euro by reviewing their largest trading partners. By choosing the euro or the dollar, countries seek currency stability and a reduction in inflation, among other various perceived benefits. Many countries in Latin America once dollarized to provide currency stability for their economy. Today, this is changing, as individual economies have strengthened and countries are now seeking to dedollarize.

Spotlight on Dollarizing and Dedollarizing in Latin America

Many countries in Latin America have endured years of political and economic instability, which has exacerbated the massive inequality that has characterized the societies in modern times. Most of the wealth is in the hands of the white elite, who live sophisticated lives in the large cities, eating in fancy restaurants and flying off to Miami for shopping trips. Indeed, major cities often look much like any other modern, industrialized cities, complete with cinemas, fast-food restaurants, Internet cafés, and shopping malls.

But while the rich enjoy an enviable lifestyle, the vast majority of the continent's large indigenous population often lives in extreme poverty. While international aid programs attempt to alleviate the poverty, a lot depends on the country's government. Corrupt governments slow down the pace of progress.

Over the past two decades, governments in Ecuador and Peru—as well as others in Latin America including Bolivia, Paraguay, Panama, El Salvador, and Uruguay—have opted to dollarize to stabilize their countries' economies. Each country replaced its national currency with the US dollar. Each country has struggled economically despite abundant natural resources. Economic cycles in key industries, such as oil and commodities, contributed to high inflation. While the move to dollarize was not always popular domestically initially, its success has been clearly evident. In both Ecuador and Peru, dollarizing has provided a much needed benefit, although one country expects to continue aligning with the US dollar and the other hopes to move away from it.

In Ecuador, for example, a decade after dollarizing, one cannot dismiss the survival of dollarization as coincidence. Dollarization has provided Ecuador with the longest period of a stable, fully convertible currency in a century. Its foremost result has been that inflation has dropped to single digits and remained there for the first time since 1972. The stability that dollarization has provided has also helped the economy grow an average of 4.3 percent a year in real terms, fostering a drop in the poverty rate from 56 percent of the population in 1999 to 35 percent in 2008. As a result, dollarization has been popular, with polls showing that more than three-quarters of Ecuadorians approve of it.Pedro P. Romero, "Ecuador Dollarization: Anchor in a Storm," *Latin Business Chronicle*, January 23, 2009, accessed February 9, 2011, www.latinbusinesschronicle.com/app/article.aspx?id=3096.

However, this success could not protect the country from the effects of the 2008 global financial crisis and economic downturn, which led to falling remittances and declining oil revenue for Ecuador. The country "lacks a reliable political system, legal system, or investment climate. Dollarization is the only government policy that provides Ecuadorians with a trustworthy basis for earning, saving, investing, and paying."Pedro P. Romero, "Ecuador Dollarization: Anchor in a Storm," *Latin Business Chronicle*, January 23, 2009, accessed February 9, 2011, www.latinbusinesschronicle.com/app/article.aspx?id=3096.

Peru first opted to dollarize in the early 1970s as a result of the high inflation, which peaked during the hyperinflation of 1988−90. "With high inflation, the U.S. dollar started to be the preferred means of payments and store of value."Mercedes García-Escribano, "Peru: Drivers of De-dollarization," International Monetary Fund, July 2010, accessed May 9, 2011, www.bcrp.gob.pe/docs/Publicaciones/Documentos-de-Trabajo/2010/Documento-de-Trabajo-11-2010.pdf. Dollarization was the only option to stabilize prices. A key cost of dollarizing, however, is losing monetary independence. Another cost is that the business cycle in the country is tied more closely to fluctuations in the US economy and currency. Balancing the benefits and the costs is an ongoing concern for governments.

Despite attempts to dedollarize in the 1980s, it was not until the recent decade that Peru has successfully pursued a market-driven financial dedollarization. Dedollarization occurs when a country reduces its reliance on dollarizing credit and deposit of commercial banks. In Peru, as in some other Latin American countries—such as Bolivia, Uruguay and Paraguay—dedollarization has been "driven by macroeconomic stability, introduction of prudential policies to better reflect currency risk (such as the management of reserve requirements), and the development of the capital market in soles" (the local Peruvian currency).Mercedes García-Escribano, "Peru: Drivers of De-dollarization, International Monetary Fund," July 2010, accessed May 9, 2011, www.bcrp.gob.pe/docs/Publicaciones/Documentos-de-Trabajo/2010/Documento-de-Trabajo-11-2010.pdf.

Dedollarizing is still a relatively recent phenomenon, and economists are still trying to understand the implications and impact on businesses and the local economy in each country. What is clear is that governments view dedollarizing as one more tool toward having greater control over their economies.

KEY TAKEAWAYS

- The international monetary system had many informal and formal stages. For more than one hundred years, the gold standard provided a stable means for countries to exchange their currencies and facilitate trade. With the Great Depression, the gold standard collapsed and gradually gave way to the Bretton Woods system.
- The Bretton Woods system established a new monetary system based on the US dollar. This system incorporated some of the disciplinary advantages of the gold system while giving countries the flexibility they needed to manage temporary economic setbacks, which had led to the fall of the gold standard.
- The Bretton Woods system lasted until 1971 and provided the longest formal mechanism for an exchange-rate system and forums for countries to cooperate on coordinating policy and navigating temporary economic crises.
- While no new formal system has replaced Bretton Woods, some of its key elements have endured, including a modified managed float of foreign exchange, the International Monetary Fund (IMF), and the World Bank—although each has evolved to meet changing world conditions.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What is the international monetary system?
2. What was the gold standard, and why did it collapse?
3. What was Bretton Woods, and why did it collapse?
4. What is the current system of exchange rates?

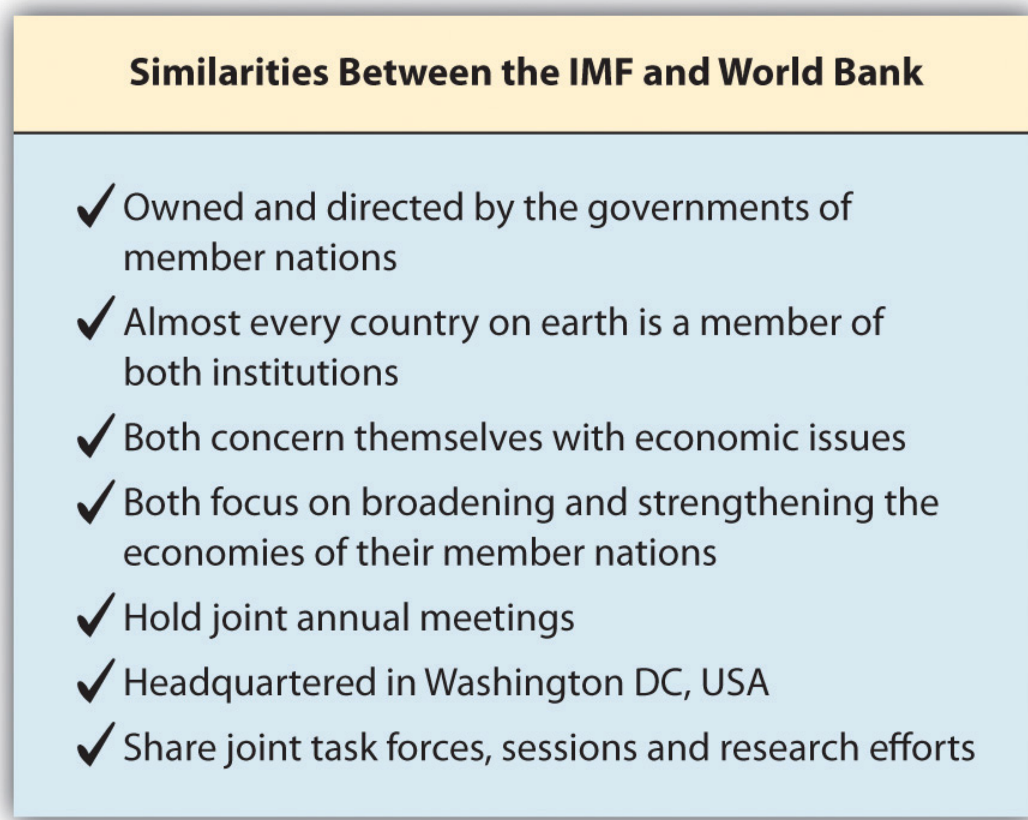
4.3: What Is the Role of the IMF and the World Bank?

Learning Objectives

1. Understand the history and purpose of the IMF.
2. Describe the IMF's current role and major challenges and opportunities.
3. Understand the history and purpose of the World Bank.
4. Describe the World Bank's current role and major challenges and opportunities.

Section 6.1 discusses how, during the 1930s, the Great Depression resulted in failing economies. The fall of the gold standard led countries to raise trade barriers, devalue their currencies to compete against one another for export markets and curtail usage of foreign exchange by their citizens. All these factors led to declining world trade, high unemployment, and plummeting living standards in many countries. In 1944, the Bretton Woods Agreement established a new international monetary system. The creation of the International Monetary Fund (IMF) and the World Bank were two of its most enduring legacies.

The World Bank and the IMF, often called the Bretton Woods Institutions, are twin intergovernmental pillars supporting the structure of the world's economic and financial order. Both have taken on expanding roles, and there have been renewed calls for additional expansion of their responsibilities, particularly in the continuing absence of a single global monetary agreement. The two institutions may seem to have confusing or overlapping functions. However, while some similarities exist (see the following figure), they are two distinct organizations with different roles.



"Despite these and other similarities, however, the Bank and the IMF remain distinct. The fundamental difference is this: the Bank is primarily a *development* institution; the IMF is a *cooperative* institution that seeks to maintain an orderly system of payments and receipts between nations. Each has a different purpose, a distinct structure, receives its funding from different sources, assists different categories of members, and strives to achieve distinct goals through methods peculiar to itself."David D. Driscoll, "The IMF and the World Bank: How Do They Differ?," International Monetary Fund, last updated August 1996, accessed February 9, 2011, http://www.imf.org/external/pubs/ft/exrp/differ/differ.htm (emphasis added). This section explores both of these institutions and how they have evolved in the almost seventy years since their creation.

International Monetary Fund

History and Purpose

Figure 6.1 IMF Headquarters in Washington, DC

Source: International Monetary Fund, 2011.

The architects of the Bretton Woods Agreement, John Maynard Keynes and Harry Dexter White, envisioned an institution that would oversee the international monetary system, exchange rates, and international payments to enable countries and their citizens to buy goods and services from each other. They expected that this new global entity would ensure exchange rate stability and encourage its member countries to eliminate the exchange restrictions that hindered trade. Officially, the IMF came into existence in December 1945 with twenty-nine member countries. (The Soviets, who were at Bretton Woods, refused to join the IMF.)

In 1947, the institution's first formal year of operations, the French became the first nation to borrow from the IMF. Over the next thirty years, more countries joined the IMF, including some African countries in the 1960s. The Soviet bloc nations remained the exception and were not part of the IMF until the fall of the Berlin Wall in 1989. The IMF experienced another large increase in members in the 1990s with the addition of Russia; Russia was also placed on the IMF's executive committee. Today, 187 countries are members of the IMF; twenty-four of those countries or groups of countries are represented on the executive board.

The purposes of the International Monetary Fund are as follows:

1. To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
2. To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
3. To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
4. To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
5. To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
6. In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members."Articles of Agreement: Article I—Purposes," International Monetary Fund, accessed May 23, 2011, http://www.imf.org/external/pubs/ft/aa/aa01.htm.

In addition to financial assistance, the IMF also provides member countries with technical assistance to create and implement effective policies, particularly economic, monetary, and banking policy and regulations.

Special Drawing Rights (SDRs)

A **Special Drawing Right (SDR)** is basically an international monetary reserve asset. SDRs were created in 1969 by the IMF in response to the Triffin Paradox. The Triffin Paradox stated that the more US dollars were used as a base reserve currency, the less faith that countries had in the ability of the US government to convert those dollars to gold. The world was still using the Bretton Woods system, and the initial expectation was that SDRs would replace the US dollar as the global monetary reserve currency, thus solving the Triffin Paradox. Bretton Woods collapsed a few years later, but the concept of an SDR solidified. Today the value of an SDR consists of the value of four of the IMF's biggest members' currencies—the US dollar, the British pound, the Japanese yen, and the euro—but the currencies do not hold equal weight. SDRs are quoted in terms of US dollars. The basket, or group of currencies, is reviewed every five years by the IMF executive board and is based on the currency's role in international trade and finance. The following chart shows the current valuation in percentages of the four currencies.

Currency	Weighting
US dollar	44 percent
Euro	34 percent
Japanese yen	11 percent
British pound	11 percent

The SDR is not a currency, but some refer to it as a form of IMF currency. It does not constitute a claim on the IMF, which only serves to provide a mechanism for buying, selling, and exchanging SDRs. Countries are allocated SDRs, which are included in the member country's reserves. SDRs can be exchanged between countries along with currencies. The SDR serves as the unit of account of the IMF and some other international organizations, and countries borrow from the IMF in SDRs in times of economic need.

The IMF's Current Role and Major Challenges and Opportunities

Criticism and Challenging Areas for the IMF

The IMF supports many developing nations by helping them overcome monetary challenges and to maintain a stable international financial system. Despite this clearly defined purpose, the execution of its work can be very complicated and can have wide repercussions for the recipient nations. As a result, the IMF has both its critics and its supporters. The challenges for organizations like the the IMF and the World Bank center not only on some of their operating deficiencies but also on the global political environment in which they operate. The IMF has been subject to a range of criticisms that are generally focused on the conditions of its loans, its lack of accountability, and its willingness to lend to countries with bad human rights records.David N. Balaam and Michael Veseth, *Introduction to International Political Economy*, 4th ed. (Upper Saddle River, NJ: Pearson Education International/Prentice Hall), 2005.

These criticisms include the following:

1. **Conditions for loans.** The IMF makes the loan given to countries conditional on the implementation of certain economic policies, which typically include the following:
   - Reducing government borrowing (higher taxes and lower spending)
   - Higher interest rates to stabilize the currency
   - Allowing failing firms to go bankrupt
   - Structural adjustment (privatization, deregulation, reducing corruption and bureaucracy)"Criticism of IMF," Economics Help, accessed June 28, 2010, http://www.economicshelp.org/dictionary/i/imf-criticism.html.

   The austere policies have worked at times but always extract a political toll as the impact on average citizens is usually quite harsh. The opening case in Chapter 2 presents the current impact of IMF policies on Greece. Some suggest that the loan conditions are "based on what is termed the 'Washington Consensus,' focusing on liberalisation—of trade, investment and the financial sector—, deregulation and privatisation of nationalised industries. Often the conditionalities are attached without due regard for the borrower countries' individual circumstances and the prescriptive recommendations by the World Bank and IMF fail to resolve the economic problems within the countries. IMF conditionalities may additionally result in the loss of a state's authority to govern its own economy as national economic policies are predetermined under IMF packages.""What Are the

Main Concerns and Criticism about the World Bank and IMF?," Bretton Woods Project, January 25, 2007, accessed February 9, 2011, www.brettonwoodsproject.org/item.shtml?x=320869.

2. **Exchange rate reforms.** "When the IMF intervened in Kenya in the 1990s, they made the Central bank remove controls over flows of capital. The consensus was that this decision made it easier for corrupt politicians to transfer money out of the economy (known as the Goldman scandal). Critics argue this is another example of how the IMF failed to understand the dynamics of the country that they were dealing with—insisting on blanket reforms.""Criticism of IMF," Economics Help, accessed June 28, 2010, http://www.economicshelp.org/dictionary/i/imf-criticism.html.
3. **Devaluations.** In the initial stages, the IMF has been criticized for allowing inflationary devaluations."Criticism of IMF," Economics Help, accessed June 28, 2010, http://www.economicshelp.org/dictionary/i/imf-criticism.html.
4. **Free-market criticisms of the IMF.** "Believers in free markets argue that it is better to let capital markets operate without attempts at intervention. They argue attempts to influence exchange rates only make things worse—it is better to allow currencies to reach their market level.""Criticism of IMF," Economics Help, accessed June 28, 2010, http://www.economicshelp.org/dictionary/i/imf-criticism.html. They also assert that bailing out countries with large debts is morally hazardous; countries that know that there is always a bailout provision will borrow and spend more recklessly.
5. **Lack of transparency and involvement.** The IMF has been criticized for "imposing policy with little or no consultation with affected countries.""Criticism of IMF," Economics Help, accessed June 28, 2010, http://www.economicshelp.org/dictionary/i/imf-criticism.html.
6. **Supporting military dictatorships.** The IMF has been criticized over the decades for supporting military dictatorships."Criticism of IMF," Economics Help, accessed June 28, 2010, http://www.economicshelp.org/dictionary/i/imf-criticism.html.

Opportunities and Future Outlook for the IMF

The 2008 global economic crisis is one of the toughest situations that the IMF has had to contend with since the Great Depression.

For most of the first decade of the twenty-first century, global trade and finance fueled a global expansion that enabled many countries to repay any money they had borrowed from the IMF and other official creditors. These countries also used surpluses in trade to accumulate foreign exchange reserves. The global economic crisis that began with the 2007 collapse of mortgage lending in the United States and spread around the world in 2008 was preceded by large imbalances in global capital flows. Global capital flows fluctuated between 2 and 6 percent of world GDP between 1980 and 1995, but since then they have risen to 15 percent of GDP. The most rapid increase has been experienced by advanced economies, but emerging markets and developing countries have also become more financially integrated.

The founders of the Bretton Woods system had taken for granted that private capital flows would never again resume the prominent role they had in the nineteenth and early twentieth centuries, and the IMF had traditionally lent to members facing current account difficulties. The 2008 global crisis uncovered fragility in the advanced financial markets that soon led to the worst global downturn since the Great Depression. Suddenly, the IMF was inundated with requests for standby arrangements and other forms of financial and policy support.

The international community recognized that the IMF's financial resources were as important as ever and were likely to be stretched thin before the crisis was over. With broad support from creditor countries, the IMF's lending capacity tripled to around $750 billion. To use those funds effectively, the IMF overhauled its lending policies. It created a flexible credit line for countries with strong economic fundamentals and a track record of successful policy implementation. Other reforms targeted low-income countries. These factors enabled the IMF to disburse very large sums quickly; the disbursements were based on the needs of borrowing countries and were not as tightly constrained by quotas as in the past."Globalization and the Crisis (2005–Present)," International Monetary Fund, accessed July 26, 2010, http://www.imf.org/external/about/histglob.htm.

Many observers credit the IMF's quick responses and leadership role in helping avoid a potentially worse global financial crisis. As noted in the Chapter 5 opening case on Greece, the IMF has played a role in helping countries avert widespread financial disasters. The IMF's requirements are not always popular but are usually effective, which has led to its expanding influence. The IMF has sought to correct some of the criticisms; according to a Foreign Policy in Focus essay designed to stimulate dialogue on the IMF, the fund's strengths and opportunities include the following:

1. **Flexibility and speed.** "In March 2009, the IMF created the Flexible Credit Line (FCL), which is a fast-disbursing loan facility with low conditionality aimed at reassuring investors by injecting liquidity…Traditionally, IMF loan programs require the imposition of austerity measures such as raising interest rates that can reduce foreign investment…In the case of the FCL,

countries qualify for it not on the basis of their promises, but on the basis of their history. Just as individual borrowers with good credit histories are eligible for loans at lower interest rates than their risky counterparts, similarly, countries with sound macroeconomic fundamentals are eligible for drawings under the FCL. A similar program has been proposed for low-income countries. Known as the Rapid Credit Facility, it is front-loaded (allowing for a single, up-front payout as with the FCL) and is also intended to have low conditionality."Martin S. Edwards, "The IMF's New Toolkit: New Opportunities, Old Challenges," Foreign Policy in Focus, September 17, 2009, accessed June 28, 2010, http://www.fpif.org/articles/the_imfs_new_toolkit_new_opportunities_old_challenges.

2. **Cheerleading.** "The Fund is positioning itself to be less of an adversary and more of a cheerleader to member countries. For some countries that need loans more for reassurance than reform, these changes to the Fund toolkit are welcome."Martin S. Edwards, "The IMF's New Toolkit: New Opportunities, Old Challenges," Foreign Policy in Focus, September 17, 2009, accessed June 28, 2010, http://www.fpif.org/articles/the_imfs_new_toolkit_new_opportunities_old_challenges. This enables more domestic political and economic stability.
3. **Adaptability.** "Instead of providing the same medicine to all countries regardless of their particular problems, the new loan facilities are intended to aid reform-minded governments by providing short-term resources to reassure investors. In this manner, they help politicians in developing countries manage the downside costs of integration."Martin S. Edwards, "The IMF's New Toolkit: New Opportunities, Old Challenges," Foreign Policy in Focus, September 17, 2009, accessed June 28, 2010, http://www.fpif.org/articles/the_imfs_new_toolkit_new_opportunities_old_challenges.
4. **Transparency.** The IMF has made efforts to improve its own transparency and continues to encourage its member countries to do so. Supporters note that this creates a barrier to any one or more countries that have more geopolitical influence in the organization. In reality, the major economies continue to exert influence on policy and implementation.

To underscore the global expectations for the IMF's role, China, Russia, and other global economies have renewed calls for the G20 to replace the US dollar as the international reserve currency with a new global system controlled by the IMF.

The *Financial Times* reported that Zhou Xiaochuan, the Chinese central bank's governor, said the goal would be to create a reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies. "'This is a clear sign that China, as the largest holder of US dollar financial assets, is concerned about the potential inflationary risk of the US Federal Reserve printing money,' said Qu Hongbin, chief China economist for HSBC."Jamil Anderlini, "China Calls for New Reserve Currency," *Financial Times*, March 24, 2009, accessed February 9, 2011, http://www.ft.com/cms/s/0/7851925a-17a2-11de-8c9d-0000779fd2ac.html#axzz1DTvW5KyI.

Although Mr. Zhou did not mention the US dollar, the essay gave a pointed critique of the current dollar-dominated monetary system:

"The outbreak of the [current] crisis and its spillover to the entire world reflected the inherent vulnerabilities and systemic risks in the existing international monetary system," Mr Zhou wrote.

China has little choice but to hold the bulk of its $2,000bn of foreign exchange reserves in US dollars, and this is unlikely to change in the near future.

To replace the current system, Mr. Zhou suggested expanding the role of special drawing rights, which were introduced by the IMF in 1969 to support the Bretton Woods fixed exchange rate regime but became less relevant once that collapsed in the 1970s….

Mr Zhou said the proposal would require "extraordinary political vision and courage" and acknowledged a debt to John Maynard Keynes, who made a similar suggestion in the 1940s.Jamil Anderlini, "China Calls for New Reserve Currency," *Financial Times*, March 24, 2009, accessed February 9, 2011, http://www.ft.com/cms/s/0/7851925a-17a2-11de-8c9d-0000779fd2ac.html#axzz1DTvW5KyI.

China is politically and economically motivated to recommend an alternative reserve currency. Politically, the country whose currency is the reserve currency is perceived as the dominant economic power, as Section 6.1 discusses. Economically, China has come under increasing global pressure to increase the value of its currency, the renminbi, which Section 6.3 discusses in greater depth.

The World Bank and the World Bank Group

History and Purpose

Figure 6.2 World Bank Headquarters in Washington, DC

Source: World Bank, 2011.

The World Bank came into existence in 1944 at the Bretton Woods conference. Its formal name is the International Bank for Reconstruction and Development (IBRD), which clearly states its primary purpose of financing economic development. The World Bank's first loans were extended during the late 1940s to finance the reconstruction of the war-ravaged economies of Western Europe. When these nations recovered some measure of economic self-sufficiency, the World Bank turned its attention to assisting the world's poorer nations. The World Bank has one central purpose: to promote economic and social progress in developing countries by helping raise productivity so that their people may live a better and fuller life:

[In 2009,] the World Bank provided $46.9 billion for 303 projects in developing countries worldwide, with our financial and/or technical expertise aimed at helping those countries reduce poverty.

The Bank is currently involved in more than 1,800 projects in virtually every sector and developing country. The projects are as diverse as providing microcredit in Bosnia and Herzegovina, raising AIDS-prevention awareness in Guinea, supporting education of girls in Bangladesh, improving health care delivery in Mexico, and helping East Timor rebuild upon independence and India rebuild Gujarat after a devastating earthquake."Projects," The World Bank, accessed February 9, 2011, go.worldbank.org/M7ARDFNB60.

Today, The World Bank consists of two main bodies, the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA), established in 1960. The World Bank is part of the broader World Bank Group, which consists of five interrelated institutions: the IBRD; the IDA; the International Finance Corporation (IFC), which was established in 1956; the Multilateral Investment Guarantee Agency (MIGA), which was established in 1988; and the International Centre for Settlement of Investment Disputes (ICSID), which was established in 1966. These additional members of the World Bank Group have specific purposes as well. The IDA typically provides interest-free loans to countries with sovereign guarantees. The IFC provides loans, equity, risk-management tools, and structured finance. Its goal is to facilitate sustainable development by improving investments in the private sector. The MIGA focuses on improving the foreign direct investment of developing countries. The ICSID provides a means for dispute resolution between governments and private investors with the end goal of enhancing the flow of capital.

The current primary focus of the World Bank centers on six strategic themes:

1. **The poorest countries.** Poverty reduction and sustainable growth in the poorest countries, especially in Africa.
2. **Postconflict and fragile states.** Solutions to the special challenges of postconflict countries and fragile states.
3. **Middle-income countries.** Development solutions with customized services as well as financing for middle-income countries.
4. **Global public goods.** Addressing regional and global issues that cross national borders, such as climate change, infectious diseases, and trade.

5. **The Arab world.** Greater development and opportunity in the Arab world.
6. **Knowledge and learning.** Leveraging the best global knowledge to support development.“To Meet Global Challenges, Six Strategic Themes,” The World Bank, accessed February 9, 2011, go.worldbank.org/56O9ZVPO70.

The World Bank provides low-interest loans, interest-free credits, and grants to developing countries. There’s always a government (or “sovereign”) guarantee of repayment subject to general conditions. The World Bank is directed to make loans for projects but never to fund a trade deficit. These loans must have a reasonable likelihood of being repaid. The IDA was created to offer an alternative loan option. IDA loans are free of interest and offered for several decades, with a ten-year grace period before the country receiving the loan needs to begin repayment. These loans are often called **soft loans**.

Since it issued its first bonds in 1947, the IBRD generates funds for its development work through the international capital markets (which Chapter 7 covers). The World Bank issues bonds, typically about $25 billion a year. These bonds are rated AAA (the highest possible rating) because they are backed by member states’ shared capital and by borrowers’ sovereign guarantees. Because of the AAA credit rating, the World Bank is able to borrow at relatively low interest rates. This provides a cheaper funding source for developing countries, as most developing countries have considerably low credit ratings. The World Bank charges a fee of about 1 percent to cover its administrative overheads.

What Are the World Bank’s Current Role and Major Challenges and Opportunities?

Like the IMF, the World Bank has both its critics and its supporters. The criticisms of the World Bank extend from the challenges that it faces in the global operating environment. Some of these challenges have complicated causes; some result from the conflict between nations and the global financial crisis. The following are four examples of the world’s difficult needs that the World Bank tries to address:

1. Even in 2010, over 3 billion people lived on less than $2.50 a day.
2. At the start of the twenty-first century, almost a billion people couldn’t read a book or sign their names.
3. Less than 1 percent of what the world spends each year on weapons would have put every child into school by the year 2000, but it didn’t happen.
4. Fragile states such as Afghanistan, Rwanda, and Sri Lanka face severe development challenges: weak institutional capacity, poor governance, political instability, and often ongoing violence or the legacy of past conflict.Anup Shah, “Causes of Poverty,” *Global Issues*, last modified April 25, 2010, accessed August 1, 2010, http://www.globalissues.org/issue/2/causes-of-poverty.

According to the *Encyclopedia of the New American Nation* and the *New York Times*, the World Bank is criticized primarily for the following reasons:

- **Administrative incompetence.** The World Bank and its lending practices are increasingly scrutinized, with critics asserting that “the World Bank has shifted from being a ‘lender of last resort’ to an international welfare organization,” resulting in an institution that is “bloated, incompetent, and even corrupt.” Also incriminating is that “the bank’s lax lending standards have led to a rapidly deteriorating loan portfolio.”*Encyclopedia of the New American Nation*, s.v., “International Monetary Fund and World Bank—World Bank Critics on the Right and Left,” accessed June 29, 2010, http://www.americanforeignrelations.com/E-N/International-Monetary-Fund-and-World-Bank-World-bank-critics-on-the-right-and-left.html.
- **Rewarding or supporting inefficient or corrupt countries.** The bank’s lending policies often reward macroeconomic inefficiency in the underdeveloped world, allowing inefficient nations to avoid the types of fundamental reforms that would in the long run end poverty in their countries. Many analysts note that the best example is to compare

the fantastic growth in East Asia to the deplorable economic conditions of Africa. In 1950 the regions were alike—South Korea had a lower per capita GDP than Nigeria. But by pursuing macroeconomic reforms, high savings, investing in education and basic social services, and opening their economies to the global trading order, the “Pacific Tigers” have been able to lift themselves out of poverty and into wealth with very little help from the World Bank. Many countries in Africa, however, have relied primarily on multilateral assistance from organizations like the World Bank while avoiding fundamental macroeconomic reforms, with deplorable but predictable results.

Conservatives point out that the World Bank has lent more than $350 billion over a half-century, mostly to the underdeveloped world, with little to show for it. One study argued that of the sixty-six countries that received funding from the bank from 1975 to 2000, well over half were no better off than before, and twenty were actually worse off. The study pointed out that Niger received $637 million between 1965 and 1995, yet its per capita GNP had fallen, in real terms, more than 50 percent during that time. In the same period Singapore, which received one-seventh as much World Bank aid, had seen its per capita GNP increase by more than 6 percent a year.*Encyclopedia of the New American Nation*, s.v., “International Monetary Fund and World Bank—World Bank Critics on the Right and Left," accessed June 29, 2010, http://www.americanforeignrelations.com/E-N/International-Monetary-Fund-and-World-Bank-World-bank-critics-on-the-right-and-left.html.

- **Focusing on large projects rather than local initiatives.** Some critics claim that World Bank loans give preference to "large infrastructure projects like building dams and electric plants over projects that would benefit the poor, such as education and basic health care." The projects often destroy the local environment, including forests, rivers, and fisheries. Some estimates suggest "that more than two and a half million people have been displaced by projects made possible through World Bank loans." Failed projects, argue environmentalists and antiglobalization groups, are particularly illustrative: "The Sardar Sarovar dam on the Narmada River in India was expected to displace almost a quarter of a million people into squalid resettlement sites. The Polonoroeste Frontier Development scheme has led to large-scale deforestation in the Brazilian rain forest. In Thailand, the Pak Mun dam has destroyed the fisheries of the Mun River, impoverishing thousands who had made their living fishing and forever altering the diet of the region."*Encyclopedia of the New American Nation*, s.v., "International Monetary Fund and World Bank—World Bank Critics on the Right and Left," accessed June 29, 2010, http://www.americanforeignrelations.com/E-N/International-Monetary-Fund-and-World-Bank-World-bank-critics-on-the-right-and-left.html. Further, the larger projects become targets for corruption by local government officials because there is so much money involved.

  Another example was in 2009, when an internal audit found that the IFC had "ignored its own environmental and social protection standards when it approved nearly $200 million in loan guarantees for palm oil production in Indonesia…Indonesia is home to the world's second-largest reserves of natural forests and peat swamps, which naturally trap carbon dioxide—the main greenhouse gas that causes climate change. But rampant destruction of the forests to make way for palm oil plantations has caused giant releases of CO_2 into the atmosphere, making Indonesia the third-largest emitter of greenhouse gases on the planet…'For each investment, commercial pressures were allowed to prevail,' auditors wrote."Lisa Friedman, "How the World Bank Let 'Deal Making' Torch the Rainforests," *New York Times*, August 19, 2009, accessed February 9, 2011, http://www.nytimes.com/cwire/2009/08/19/19climatewire-how-the-world-bank-let-deal-making-torch-the-33255.html.
  However, such issues are not always as clear-cut as they may seem. The IFC responded to the audit by acknowledging "shortcomings in the review process. But the lender also defended investment in palm oil production as a way to alleviate poverty in Indonesia. 'IFC believes that production of palm oil, when carried out in an environmentally and socially sustainable fashion, can provide core support for a strong rural economy, providing employment and improved quality of life for millions of the rural poor in tropical areas,' it said."Lisa Friedman, "How the World Bank Let 'Deal Making' Torch the Rainforests," *New York Times*, August 19, 2009, accessed February 9, 2011, http://www.nytimes.com/cwire/2009/08/19/19climatewire-how-the-world-bank-let-deal-making-torch-the-33255.html.

- **Negative influence on theory and practice.** As one of the two Bretton Woods Institutions, the World Bank plays a large role in research, training, and policy formulation. Critics worry that because "the World Bank and the IMF are regarded as experts in the field of financial regulation and economic development, their views and prescriptions may undermine or eliminate alternative perspectives on development.""What Are the Main Concerns and Criticism about the World Bank and IMF?," Bretton Woods Project, January 25, 2007, accessed February 9, 2011, www.brettonwoodsproject.org/item.shtml?x=320869.
- **Dominance of G7 countries.** The industrialized countries dominate the World Bank (and IMF) governance structures. Decisions are typically made and policies implemented by these leading countries—the G7—because they are the largest donors, some suggest without sufficient consultation with poor and developing countries."What Are the Main Concerns and Criticism about the World Bank and IMF?," Bretton Woods Project, January 25, 2007, accessed February 9, 2011, www.brettonwoodsproject.org/item.shtml?x=320869.

Opportunities and Future Outlook for the World Bank

As vocal as the World Bank's critics are, so too are its supporters. The World Bank is praised by many for engaging in development projects in remote locations around the globe to improve living standards and reduce poverty. The World Bank's current focus is on helping countries achieve the Millennium Development Goals (MDGs), which are eight international development goals, established in 2000 at the Millennium Summit, that all 192 United Nations member states and twenty-three international organizations have agreed to achieve by the year 2015. They include reducing extreme poverty, reducing child mortality rates, fighting disease epidemics such as AIDS, and developing a global partnership for development. The World Bank is focused on the following four key issues:

1. **Increased transparency.** In response to the criticisms over the decades, the World Bank has made progress. More of the World Bank's decision making and country assessments are available publicly. The World Bank has continued to work with countries to combat corruption both at the country and bank levels.

2. **Expanding social issues in the fight on poverty.** In 2001, the World Bank began to incorporate gender issues into its policy. "Two years later the World Bank announced that it was starting to evaluate all of its projects for their effects on women and girls," noting that "poverty is experienced differently by men and women" and "a full understanding of the gender dimensions of poverty can significantly change the definition of priority policy and program interventions."Robert J. Brym et al., "In Faint Praise of the World Bank's Gender Development Policy," *Canadian Journal of Sociology Online*, March–April 2005, accessed May 23, 2011, www.cjsonline.ca/articles/brymetal05.html.
3. **Improvements in countries' competitiveness and increasing exports.** The World Bank's policies and its role as a donor have helped improve the ability of some countries to secure more of the global revenues for basic commodities. In Rwanda, for example, reforms transformed the country's coffee industry and increased exports. Kenya has expanded its exports of cut flowers, and Uganda has improved its fish-processing industry. World Bank efforts have also helped African financial companies develop.Shanta Devarajan, "African Successes—Listing the Success Stories," *Africa Can…End Poverty* (blog), The World Bank Group, September 17, 2009, accessed May 23, 2011, blogs.worldbank.org/africacan/african-successes-listing-the-success-stories.
4. **Improving efficiencies in diverse industries and leveraging the private sector.** The World Bank has worked closely with businesses in the private sector to develop local infrastructure, including power, transportation, telecommunications, health care, and education.Shanta Devarajan, "African Successes—Listing the Success Stories," *Africa Can…End Poverty* (blog), The World Bank Group, September 17, 2009, accessed May 23, 2011, blogs.worldbank.org/africacan/african-successes-listing-the-success-stories. In Afghanistan, for example, small dams are built and maintained by the locals themselves to support small industries processing local produce.

The World Bank continues to play an integral role in helping countries reduce poverty and improve the well-being of their citizens. World Bank funding provides a resource to countries to utilize the services of global companies to accomplish their objectives.

KEY TAKEAWAYS

- The IMF is playing an expanding role in the global monetary system. The IMF's key roles are the following:
  - To promote international monetary cooperation
  - To facilitate the expansion and balanced growth of international trade
  - To promote exchange stability
  - To assist in the establishment of a multilateral system of payments
  - To give confidence to members by making the IMF's general resources temporarily available to them under adequate safeguards
  - To shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members
- The World Bank consists of two main bodies, the IBRD and the International Development Association (IDA).
- The World Bank Group includes the following interrelated institutions:
  - IBRD, which makes loans to countries with the purpose of building economies and reducing poverty
  - IDA, which typically provides interest-free loans to countries with sovereign guarantees
  - International Finance Corporation (IFC), which provides loans, equity, risk-management tools, and structured finance with the goal of facilitating sustainable development by improving investments in the private sector
  - Multilateral Investment Guarantee Agency (MIGA), which focuses on improving the foreign direct investment of the developing countries
  - International Centre for Settlement of Investment Disputes (ICSID), which provides a means for dispute resolution between governments and private investors, with the end goal of enhancing the flow of capital

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What is the IMF, and what role does it play?
2. What are two criticisms of the IMF and two of its opportunities for the future?
3. Discuss whether SDRs or another global currency created by the IMF should replace the US dollar as the international reserve currency.
4. What is the World Bank, and what role does it play?
5. What are two criticisms of the World Bank and two of its opportunities for the future?

4.4: Understanding How International Monetary Policy, the IMF, and the World Bank Impact Business Practices

> **Learning Objectives**
>
> 1. Understand how the current monetary environment, the IMF, and the World Bank impact business.
> 2. Explore how you can work in the international development arena with a business background.

How Business Is Impacted by the Current Monetary Environment, the IMF, and the World Bank

All businesses seek to operate in a stable and predictable environment. International businesses make efforts to reduce risks and unexpected issues that can impact both operations and profitability. The global monetary system in essence provides a predictable mechanism for companies to exchange currencies. Global firms monitor the policies and discussions of the G20 and other economic organizations so that they can identify new opportunities and use their leverage to protect their markets and businesses.

Did You Know?

There's even an annual forum that the world's largest businesses attend with senior government officials from around the world and leaders of thought on economic, social, and political issues. The five-day meeting is known more commonly as Davos, in reference to the Swiss town in which it is held. Attendees must be invited; the price tag is rather hefty at about $50,000, but the meeting attracts the world's business and political elite. Davos is run by the World Economic Forum (www.weforum.org/en/index.htm). The event started in 1971 as the brainchild of Swiss economics professor Klaus Schwab. Originally it served as a small, private, and discreet way of bringing business and political leaders together to establish common ground and objectives. It has since grown exponentially in size and influence and now attracts media and celebrities—but still only by invitation.

The Bretton Woods Institutions have extensive global influence and occasionally use it to nudge countries to reduce trade barriers and adjust the value of their currency. One recent example involves the International Monetary Fund (IMF) and China. A July 2010 report from the IMF stated that China's trade surplus will increase unless the government takes steps to increase more domestic consumption by the Chinese and also by letting the Chinese currency, the **renminbi**, appreciate or increase in value.Andrew Batson, "IMF Report Urges China to Consume More," *Wall Street Journal*, July 30, 2010, accessed February 9, 2011, http://online.wsj.com/article/SB10001424052748703578104575396953580078456.html. China's export machine has been fueled in large part by the low value of the renminbi, as set and maintained by the government. Letting it currently trade with reduced or no government intervention would likely reduce the country's massive exports. "Both the IMF and China's government agree [that China] still depends too much on exports. Supporting domestic consumption instead 'will reduce China's reliance on external demand and better insulate the economy from shocks in overseas markets,' the IMF said. China gave domestic demand an enormous boost with its stimulus program to combat the effects of the financial crisis, resulting in a surge in imports of raw materials and equipment to feed a construction boom."Andrew Batson, "IMF Report Urges China to Consume More," *Wall Street Journal*, July 30, 2010, accessed February 9, 2011, http://online.wsj.com/article/SB10001424052748703578104575396953580078456.html.

While the IMF can only issue a report, action is completely at the discretion of the country's government. However, for global businesses, this can be encouraging in several ways. In this case, companies that are eager to enter the Chinese market to sell their goods and services may find it easier or the general climate more welcoming of foreign businesses. Second, if the renminbi increases in value, the Chinese can purchase more goods and services from overseas firms. On the flip side, companies that compete with Chinese firms in other markets may be frustrated by China's cheap costs and undervalued currency. If the Chinese currency increases in value, Chinese exports will become more expensive, allowing other companies to compete more effectively against Chinese firms. These are just a couple of simple scenarios, but they illustrate the range of issues and concerns that China may have with the IMF report and the opportunities that may arise for global businesses. IMF reports are based on years of research, and it's rare that markets, countries, and businesses are not already aware of the issues in any report. However, by actually releasing the report, the IMF is officially prioritizing and legitimizing the concerns. In this case, the initial report from the IMF was ready for release in 2006, but China effectively blocked the release until some changes were made. It was finally released in July 2010. The impact of the report will take several years to unfold. However, already in early 2011, China announced its intentions to let the renminbi begin to trade more freely. "The People's Bank of China…is pushing for a greater role for the renminbi in global trade and investment so that China can reduce its almost total reliance on the US dollar.""Singapore Aims to Be a Renminbi Hub," *Financial Times*, April 19, 2011, accessed May 7, 2011, http://www.ft.com/cms/s/0/64bac520-6a4f-11e0-a464-

00144feab49a.html#ixzz1LgVcCJKM. Recent efforts have included allowing for individuals and institutions to buy the renminbi outside of China and also to permit select trading of the currency in other countries, such as Russia and Singapore, as well as in its own territory of Hong Kong. The Chinese government hope is that by internationalizing the currency, it will eventually will be perceived as a reserve currency, a key component of its ambitions to be a global power.Wieland Wagner, "China Plans Path to Economic Hegemony," *Spiegel Online International*, January 26, 2011, accessed May 7, 2011, http://www.spiegel.de/international/business/0,1518,741303,00.html.

Working in the International Development Arena with a Business Background

Why would international businesses care about quasi-government institutions such as the World Bank and IMF? The opening case discusses how a management consulting firm links businesses, governments, and global institutions by advising on policy and strategy. What many people don't realize at first glance is that the global business in the private sector is heavily impacted by the IMF, the World Bank, and other development organizations.

Many of the projects that the World Bank Group funds in specific countries are put up for competitive bidding by the government of the country receiving the funds; the projects are then managed by a government department. However, global companies in the private sector almost always carry out the actual work. Hence there is a vast industry focused on obtaining these often lucrative and secure contracts. The World Bank has worked hard to increase transparency in the bidding process and to closely monitor and audit how its monies are spent.

Let's look at some of the companies and industries that get involved in World Bank projects. Consulting companies, particularly the large global firms—McKinsey, BearingPoint, and PricewaterhouseCoopers (PwC), for example—are high-profile examples of firms that actively solicit projects from the World Bank and other development organizations. Their capabilities range across diverse industries, from finance and regulation to project management and auditing of infrastructure development. Engineering, chemical, and telecommunications firms also have departments that solicit and bid on World Bank projects.

These firms routinely hire people with business degrees. Those with additional qualifications in foreign languages or technical skills have increased chances of being hired. So how do you find out which companies are getting contracts? Try the following method:

- Start by looking at the Devex site. While it's the biggest and best-known website resource for development work, there are others.
- Explore organizational training programs, such as the World Bank's Young Professionals Program, which is designed for highly qualified, experienced, and motivated individuals (under the age of thirty-two) who are skilled in areas relevant to the World Bank's operations, such as economics, finance, education, public health, social sciences, engineering, urban planning, and natural resource management.
- Research the World Bank site and sites of the other institutions in the World Bank Group to identify which firms are winning bids; then apply to those firms. In an effort to combat the ethics issues, each of these organizations now requires complete transparency in contract awards and has sections where you can search. For example, use the following link for the World Bank contractors search: web.worldbank.org/wbsite/external/projects/0,,menuPK:51565~pagePK:95864~piPK:95915~theSitePK:40941,00.html.
- Read the *Economist*, the *Wall Street Journal*, and other global business publications to learn more about projects, loans, and activities of the World Bank, private sector firms, and countries. Many of these publications have job ads. Even if it is for more senior positions, you can learn which companies are working in which sectors and countries.

KEY TAKEAWAYS

- Businesses seek to operate in a stable and predictable environment by reducing risks and unexpected issues that can impact both operations and profitability.
- Global firms monitor the policies and discussions of the G20 and other economic organizations so that they can identify new opportunities and use their leverage to protect their markets and businesses.
- Global business in the private sector is heavily impacted by the IMF, the World Bank, and other development organizations.
- Many of the projects that the World Bank Group funds in specific countries are managed by the local governments, but the actual work is typically done by a private sector firm.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Why are the World Bank and the IMF relevant for global businesses?
2. What types of entities carry out the projects funded by the World Bank?

4.5: Chapter Introduction

Foreign Exchange and the Global Capital Markets

WHAT'S IN IT FOR ME?

1. What do we mean by currency and foreign exchange?
2. How do you determine exchange rates?
3. What are the global capital markets?
4. What is the impact of the global capital markets (particularly the venture capital and global capital markets) on international business?

This chapter explores currencies, foreign exchange rates, and how they are determined. It also discusses the global capital markets—the key components and how they impact global business. Foreign exchange is one aspect of the global capital markets. Companies access the global capital markets to utilize both the debt and equity markets; these are important for growth. Being able to access transparent and efficient capital markets around the world is another important component in the flattening world for global firms. Finally, this chapter discusses how the expansion of the global capital markets has benefited entrepreneurship and venture capitalists.

Opening Case: Why a Main Street Firm, Walmart, Is Impacted by Foreign Exchange Fluctuations

Most people in North America are familiar with the name Walmart. It conjures up an image of a gigantic, box-like store filled with a wide range of essential and nonessential products. What's less known is that Walmart is the world's largest company, in terms of revenues, as ranked by the Fortune 500 in 2010. With $408 billion in sales, it operates in fifteen global markets and has 4,343 stores *outside* of the United States, which amounts to about 50 percent of its total stores. More than 700,000 people work for Walmart *internationally*. With numbers like this, it's easy to see how important the global markets have become for this company."Walmart Stores Inc. Data Sheet—Worldwide Unit Details November 2010," Walmart Corporation, accessed May 25, 2011, http://walmartstores.com/pressroom/news/10497.aspx.

Walmart's strength comes from the upper hand it has in its negotiations with suppliers around the world. Suppliers are motivated to negotiate with Walmart because of the huge sales volume the stores offer manufacturers. The business rationale for many suppliers is that while they may lose a certain percentage of profitability per product, the overall sales volume of an order from Walmart can make them far more money overall than orders from most other stores. Walmart's purchasing professionals are known for being aggressive negotiators on purchases and for extracting the best terms for the company.

In order to buy goods from around the world, Walmart has to deal extensively in different currencies. Small changes in the daily foreign currency market can significantly impact the costs for Walmart and in turn both its profitability and that of its global suppliers.

A company like Walmart needs foreign exchange and capital for different reasons, including the following common operational uses:

1. To build new stores, expand stores, or refurbish stores in a specific country
2. To purchase products locally by paying in local currencies or the US dollar, whichever is cheaper and works to Walmart's advantage
3. To pay salaries and benefits for its local employees in each country as well as its expatriate and global workforce
4. To take profits out of a country and either reinvest the money in another country or market or save it and make profits from returns on investment

To illustrate this impact of foreign currency, let's look at the currency of China, the renminbi (RMB), and its impact on a global business like Walmart. Many global analysts argue that the Chinese government tries to keep the value of its currency low or cheap to help promote exports. When the local RMB is valued cheaply or low, Chinese importers that buy foreign goods find that the prices are more expensive and higher.

However, Chinese exporters, those businesses that sell goods and services to foreign buyers, find that sales increase because their prices are cheaper or lower for the foreign buyers. Economists say that the Chinese government has intervened to keep the renminbi cheap in order to keep Chinese exports cheap; this has led to a huge trade surplus with the United States and most of the world. Each country tries to promote its exports to generate a trade advantage or surplus in its favor. When China has a trade surplus, it means the other country or countries are running trade deficits, which has "become an irritant to a lot of China's trading partners and those who are competing with China to sell goods around the world."David Barboza, "Currency Fight with China Divides U.S. Business," *New York Times*, November 16, 2010, accessed May 25, 2011, www.nytimes.com/2010/11/17/business/global/17yuan.html?_r=1&pagewanted=2.

For Walmart, an American company, a cheap renminbi means that it takes fewer US dollars to buy Chinese products. Walmart can then buy cheap Chinese products, add a small profit margin, and then sell the goods in the United States at a price lower than what its competitors can offer. If the Chinese RMB increased in value, then Walmart would have to spend more US dollars to buy the same products, whether the products are clothing, electronics, or furniture. Any increase in cost for Walmart will mean an increase in cost for their customers in the United States, which could lead to a decrease in sales. So we can see why Walmart would be opposed to an increase in the value of the RMB.

To manage this currency concern, Walmart often requires that the currency exchange rate be fixed in its purchasing contracts with Chinese suppliers. By fixing the currency exchange rate, Walmart locks in its product costs and therefore its profitability. Fixing the exchange rate means setting the price that one currency will convert into another. This is how a company like Walmart can avoid unexpected drops or increases in the value of the RMB and the US dollar.

While global companies have to buy and sell in different currencies around the world, their primary goal is to avoid losses and to fix the price of the currency exchange so that they can manage their profitability with surety. This chapter takes a look at some of the currency tools that companies use to manage this risk.

Global firms like Walmart often set up local operations that help them balance or manage their risk by doing business in local currencies. Walmart now has 304 stores in China. Each store generates sales in renminbi, earning the company local currency that it can use to manage its local operations and to purchase local goods for sale in its other global markets.David Barboza, "Currency Fight with China Divides U.S. Business," *New York Times*, November 16, 2010, accessed May 25, 2011, www.nytimes.com/2010/11/17/business/global/17yuan.html?_r=1&pagewanted=2.

Opening Case Exercises

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. List two reasons a global company needs foreign exchange.
2. Why is Walmart concerned about foreign exchange rates?

4.6: 7.1 What Do We Mean by Currency and Foreign Exchange?

Learning Objectives

1. Understand what is meant by currency and foreign exchange.
2. Explore the purpose of the foreign exchange market.
3. Understand how to determine exchange rates.

What Are Currency and Foreign Exchange?

In order to understand the global financial environment, how capital markets work, and their impact on global business, we need to first understand how currencies and foreign exchange rates work.

Briefly, **currency** is any form of money in general circulation in a country. What exactly is a foreign exchange? In essence, **foreign exchange** is money denominated in the currency of another country or—now with the euro—a group of countries. Simply put, an **exchange rate** is defined as the rate at which the market converts one currency into another.

Any company operating globally must deal in foreign currencies. It has to pay suppliers in other countries with a currency different from its home country's currency. The home country is where a company is headquartered. The firm is likely to be paid or have profits in a different currency and will want to exchange it for its home currency. Even if a company expects to be paid in its own currency, it must assess the risk that the buyer may not be able to pay the full amount due to currency fluctuations.

If you have traveled outside of your home country, you may have experienced the currency market—for example, when you tried to determine your hotel bill or tried to determine if an item was cheaper in one country versus another. In fact, when you land at an airport in another country, you're likely to see boards indicating the foreign exchange rates for major currencies. These rates include two numbers: the bid and the offer. The **bid (or buy)** is the price at which a bank or financial services firm is willing to buy a specific currency. The **ask (or the offer or sell)**, refers to the price at which a bank or financial services firm is willing to sell that currency. Typically, the bid or the buy is always cheaper than the sell; banks make a profit on the transaction from that difference. For example, imagine you're on vacation in Thailand and the exchange rate board indicates that the Bangkok Bank is willing to exchange currencies at the following rates (see the following figure). GBP refers to the British pound; JPY refers to the Japanese yen; and HKD refers to the Hong Kong dollar, as shown in the following figure. Because there are several countries that use the dollar as part or whole of their name, this chapter clearly states "US dollar" or uses US$ or USD when referring to American currency.

Foreign Exchange Rates: Bangkok Bank

Currency/Baht	Banknotes Buy	Banknotes Sell
USD	31.67	32.32
GBP	50.19	51.80
Euro	41.74	43.00
JOY	36.56	39.01
HKD	4.03	4.22

This chart tells us that when you land in Thailand, you can use 1 US dollar to buy 31.67 Thai baht. However, when you leave Thailand and decide that you do not need to take all your baht back to the United States, you then convert baht back to US dollars. We then have to use more baht—32.32 according to the preceding figure—to buy 1 US dollar. The **spread** between these numbers, 0.65 baht, is the profit that the bank makes for each US dollar bought and sold. The bank charges a fee because it performed a service—facilitating the currency exchange. When you walk through the airport, you'll see more boards for different banks with different buy and sell rates. While the difference may be very small, around 0.1 baht, these numbers add up if you are a global company engaged in large foreign exchange transactions. Accordingly, global firms are likely to shop around for the best rates before they exchange any currencies.

What Is the Purpose of the Foreign Exchange Market?

The foreign exchange market (or FX market) is the mechanism in which currencies can be bought and sold. A key component of this mechanism is pricing or, more specifically, the rate at which a currency is bought or sold. We'll cover the determination of exchange rates more closely in this section, but first let's understand the purpose of the FX market. International businesses have four main uses of the foreign exchange markets.

Currency Conversion

Companies, investors, and governments want to be able to convert one currency into another. A company's primary purposes for wanting or needing to convert currencies is to pay or receive money for goods or services. Imagine you have a business in the United States that imports wines from around the world. You'll need to pay the French winemakers in euros, your Australian wine suppliers in Australian dollars, and your Chilean vineyards in pesos. Obviously, you are not going to access these currencies physically. Rather, you'll instruct your bank to pay each of these suppliers in their local currencies. Your bank will convert the currencies for you and debit your account for the US dollar equivalent based on the exact exchange rate at the time of the exchange.

Currency Hedging

One of the biggest challenges in foreign exchange is the risk of rates increasing or decreasing in greater amounts or directions than anticipated. **Currency hedging** refers to the technique of protecting against the potential losses that result from adverse changes in exchange rates. Companies use hedging as a way to protect themselves if there is a time lag between when they bill and receive payment from a customer. Conversely, a company may owe payment to an overseas vendor and want to protect against changes in the exchange rate that would increase the amount of the payment. For example, a retail store in Japan imports or buys shoes from Italy. The Japanese firm has ninety days to pay the Italian firm. To protect itself, the Japanese firm enters into a contract with its bank to exchange the payment in ninety days at the agreed-on exchange rate. This way, the Japanese firm is clear about the amount to pay and protects itself from a sudden depreciation of the yen. If the yen depreciates, more yen will be required to purchase the same euros, making the deal more expensive. By hedging, the company locks in the rate.

Currency Arbitrage

Arbitrage is the simultaneous and instantaneous purchase and sale of a currency for a profit. Advances in technology have enabled trading systems to capture slight differences in price and execute a transaction, all within seconds. Previously, arbitrage was conducted by a trader sitting in one city, such as New York, monitoring currency prices on the Bloomberg terminal. Noticing that the value of a euro is cheaper in Hong Kong than in New York, the trader could then buy euros in Hong Kong and sell them in New York for a profit. Today, such transactions are almost all handled by sophisticated computer programs. The programs constantly search different exchanges, identify potential differences, and execute transactions, all within seconds.

Currency Speculation

Speculation refers to the practice of buying and selling a currency with the expectation that the value will change and result in a profit. Such changes could happen instantly or over a period of time.

High-risk, speculative investments by nonfinance companies are less common these days than the current news would indicate. While companies can engage in all four uses discussed in this section, many companies have determined over the years that arbitrage and speculation are too risky and not in alignment with their core strategies. In essence, these companies have determined that a loss due to high-risk or speculative investments would be embarrassing and inappropriate for their companies.

Understand How to Determine Exchange Rates

How to Quote a Currency

There are several ways to quote currency, but let's keep it simple. In general, when we quote currencies, we are indicating how much of one currency it takes to buy another currency. This quote requires two components: the **base currency** and the **quoted currency**. The quoted currency is the currency with which another currency is to be purchased. In an exchange rate quote, the quoted currency is typically the numerator. The base currency is the currency that is to be purchased with another currency, and it is noted in the denominator. For example, if we are quoting the number of Hong Kong dollars required to purchase 1 US dollar, then we note HKD 8 / USD 1. (Note that 8 reflects the general exchange rate average in this example.) In this case, the Hong Kong dollar is the quoted currency and is noted in the numerator. The US dollar is the base currency and is noted in the denominator. We read this quote as "8 Hong Kong dollars are required to purchase 1 US dollar." If you get confused while reviewing exchanging rates, remember the currency that you want to buy or sell. If you want to sell 1 US dollar, you can buy 8 Hong Kong dollars, using the example in this paragraph.

Direct Currency Quote and Indirect Currency Quote

Additionally, there are two methods—the **American terms** and the **European terms**—for noting the base and quoted currency. These two methods, which are also known as direct and indirect quotes, are opposite based on each reference point. Let's understand what this means exactly.

The American terms, also known as US terms, are from the point of view of someone in the United States. In this approach, foreign exchange rates are expressed in terms of how many US dollars can be exchanged for one unit of another currency (the non-US currency is the *base currency*). For example, a dollar-pound quote in American terms is USD/GP (US$/£) equals 1.56. This is read as "1.56 US dollars are required to buy 1 pound sterling." This is also called a **direct quote**, which states the domestic currency price of one unit of foreign currency. If you think about this logically, a business that needs to buy a foreign currency needs to know how many US dollars must be sold in order to buy one unit of the foreign currency. In a direct quote, the domestic currency is a variable amount and the foreign currency is fixed at one unit.

Conversely, the European terms are the other approach for quoting rates. In this approach, foreign exchange rates are expressed in terms of how many currency units can be exchanged for a US dollar (the US dollar is the base currency). For example, the pound-dollar quote in European terms is £0.64/US$1 (£/US$1). While this is a direct quote for someone in Europe, it is an **indirect quote** in the United States. An indirect quote states the price of the domestic currency in foreign currency terms. In an indirect quote, the foreign currency is a variable amount and the domestic currency is fixed at one unit.

A direct and an indirect quote are simply reverse quotes of each other. If you have either one, you can easily calculate the other using this simple formula:

direct quote = 1 / indirect quote.

To illustrate, let's use our dollar-pound example. The direct quote is US$1.56 = 1/£0.64 (the indirect quote). This can be read as

1 divided by 0.64 equals 1.56.

In this example, the direct currency quote is written as US$/£ = 1.56.

While you are performing the calculations, it is important to keep track of which currency is in the numerator and which is in the denominator, or you might end up stating the quote backward. The direct quote is the rate at which you buy a currency. In this example, you need US$1.56 to buy a British pound.

Tip: Many international business professionals become experienced over their careers and are able to correct themselves in the event of a mix-up between currencies. To illustrate using the example mentioned previously, the seasoned global professional knows that the British pound is historically higher in value than the US dollar. This means that it takes more US dollars to buy a pound than the other way around. When we say "higher in value," we mean that the value of the British pound buys you more US dollars. Using this logic, we can then deduce that 1.56 US dollars are required to buy 1 British pound. As an international businessperson, we would know instinctively that it cannot be less—that is, only 0.64 US dollars to buy a British pound. This would imply that the dollar value was higher in value. While major currencies have changed significantly in value vis-à-vis each other, it tends to happen over long periods of time. As a result, this self-test is a good way to use logic to keep track of tricky exchange rates. It works best with major currencies that do not fluctuate greatly vis-à-vis others.

A useful side note: traders always list the base currency as the first currency in a currency pair. Let's assume, for example, that it takes 85 Japanese yen to purchase 1 US dollar. A currency trader would note this as follows: USD 1 / JPY 85. This quote indicates that the base currency is the US dollar and 85 yen are required to purchase a dollar. This is also called a direct quote, although FX traders are more likely to call it an American rate rather than a direct rate. It can be confusing, but try to keep the logic of which currency you are selling and which you are buying clearly in your mind, and say the quote as full sentences in order to keep track of the currencies.

These days, you can easily use the Internet to access up-to-date quotes on all currencies, although the most reliable sites remain the *Wall Street Journal*, the *Financial Times*, or any website of a trustworthy financial institution.

Spot Rates

The exchange rates discussed in this chapter are spot rates—exchange rates that require immediate settlement with delivery of the traded currency. "Immediate" usually means within two business days, but it implies an "on the spot" exchange of the currencies, hence the term *spot rate*. The **spot exchange rate** is the exchange rate transacted at a particular moment by the buyer and seller of a currency. When we buy and sell our foreign currency at a bank or at American Express, it's quoted at the rate for the day. For currency traders though, the spot can change throughout the trading day even by tiny fractions.

To illustrate, assume that you work for a clothing company in the United States and you want to buy shirts from either Malaysia or Indonesia. The shirts are exactly the same; only the price is different. (For now, ignore shipping and any taxes.) Assume that you are using the spot rate and are making an immediate payment. There is no risk of the currency increasing or decreasing in value. (We'll cover forward rates in the next section.)

The currency in Malaysia is the Malaysian ringgit, which is abbreviated MYR. The supplier in Kuala Lumpur e-mails you the quote—you can buy each shirt for MYR 35. Let's use a spot exchange rate of MYR 3.13 / USD 1.

The Indonesian currency is the rupiah, which is abbreviated as Rp. The supplier in Jakarta e-mails you a quote indicating that you can buy each shirt for Rp 70,000. Use a spot exchange rate of Rp 8,960 / USD 1.

It would be easy to instinctively assume that the Indonesian firm is more expensive, but look more closely. You can calculate the price of one shirt into US dollars so that a comparison can be made:

For Malaysia: MYR 35 / MYR 3.13 = USD 11.18For Indonesia: Rp 70,000 / Rp 8,960 = USD 7.81

Indonesia is the cheaper supplier for our shirts on the basis of the spot exchange rate.

Cross Rates

There's one more term that applies to the spot market—the **cross rate**. This is the exchange rate between two currencies, neither of which is the official currency in the country in which the quote is provided. For example, if an exchange rate between the euro and the yen were quoted by an American bank on US soil, the rate would be a cross rate.

The most common cross-currency pairs are EUR/GBP, EUR/CHF, and EUR/JPY. These currency pairs expand the trading possibilities in the foreign exchange market but are less actively traded than pairs that include the US dollar, which are called the "majors" because of their high degree of liquidity. The majors are EUR/USD, GBP/ USD, USD/JPY, USD/CAD (Canadian dollar), USD/CHF (Swiss franc), and USD/AUD (Australian dollar). Despite the changes in the international monetary system and the expansion of the capital markets, the currency market is really a market of dollars and nondollars. The dollar is still the reserve currency for the world's central banks. Table 7.1 contains some currency cross rates between the major currencies. We can see, for example, that the rate for the cross-currency pair of EUR/GBP is 1.1956. This is read as "it takes 1.1956 euros to buy one British pound." Another example is the EUR/JPY rate, which is 0.00901. However, a seasoned trader would not say that it takes 0.00901 euros to buy 1 Japanese yen. He or she would instinctively know to quote the currency pair as the JPY/EUR rate or—more specifically—that it takes 111.088 yen to purchase 1 euro.

Table 7.1 Currency Cross Rates

Currency codes / names	United Kingdom Pound	Canadian Dollar	Euro	Hong Kong Dollar	Japanese Yen	Swiss Franc	US Dollar	Chinese Yuan Renminbi

Currency codes / names	United Kingdom Pound	Canadian Dollar	Euro	Hong Kong Dollar	Japanese Yen	Swiss Franc	US Dollar	Chinese Yuan Renminbi
GBP	1	0.6177	0.8374	0.08145	0.007544	0.6455	0.633	0.09512
CAD	1.597	1	1.3358	0.1299	0.012032	1.0296	1.0095	0.1517
EUR	1.1956	0.7499	1	0.09748	0.00901	0.771	0.7563	0.1136
HKD	12.2896	7.7092	10.2622	1	0.09267	7.9294	7.7749	1.1682
JPY	132.754	83.2905	111.088	10.8083	1	85.65	84.001	12.6213
CHF	1.5512	0.9732	1.2981	0.1263	0.011696	1	0.9815	0.1475
USD	1.5807	0.9915	1.3232	0.1287	0.011919	1.0199	1	0.1503
CNY	10.5218	6.6002	8.8075	0.8565	0.07934	6.7887	6.6565	1

Note: The official name for the Chinese currency is renminbi and the main unit of the currency is the yuan.

Source: "Currency Cross Rates: Results," Oanda, accessed May 25, 2011, http://www.oanda.com/currency/cross- rate/result?quotes=GBP&quotes=CAD&quotes=EUR&quotes=HKD&quotes=JPY&quotes=CHF&quotes=USD&quotes=CNY&go=Get+my+Table+++.

Forward Rates

The **forward exchange rate** is the exchange rate at which a buyer and a seller agree to transact a currency at some date in the future. Forward rates are really a reflection of the market's expectation of the future spot rate for a currency. The **forward market** is the currency market for transactions at forward rates. In the forward markets, foreign exchange is always quoted against the US dollar. This means that pricing is done in terms of how many US dollars are needed to buy one unit of the other currency. Not all currencies are traded in the forward market, as it depends on the demand in the international financial markets. The majors are routinely traded in the forward market.

For example, if a US company opted to buy cell phones from China with payment due in ninety days, it would be able to access the forward market to enter into a forward contract to lock in a future price for its payment. This would enable the US firm to protect itself against a depreciation of the US dollar, which would require more dollars to buy one Chinese yuan. A **forward contract** is a contract that requires the exchange of an agreed-on amount of a currency on an agreed-on date and a specific exchange rate. Most forward contracts have fixed dates at 30, 90, or 180 days. Custom forward contracts can be purchased from most financial firms. Forward contracts, currency swaps, options, and futures all belong to a group of financial instruments called derivatives. In the term's broadest definition, **derivatives** are financial instruments whose underlying value comes from (derives from) other financial instruments or commodities—in this case, another currency.

Swaps, Options, and Futures

Swaps, options, and futures are three additional currency instruments used in the forward market.

A **currency swap** is a simultaneous buy and sell of a currency for two different dates. For example, an American computer firm buys (imports) components from China. The firm needs to pay its supplier in renminbi today. At the same time, the American computer is expecting to receive RMB in ninety days for its netbooks sold in China. The American firm enters into two transactions. First, it exchanges US dollars and buys yuan renminbi today so that it can pay its supplier. Second, it simultaneously enters into a forward contract to sell yuan and buy dollars at the ninety-day forward rate. By entering into both transactions, the firm is able to reduce its foreign exchange rate risk by locking into the price for both.

Currency options are the option or the right—but not the obligation—to exchange a specific amount of currency on a specific future date and at a specific agreed-on rate. Since a currency option is a right but not a requirement, the parties in an option do not have to actually exchange the currencies if they choose not to. This is referred to as not exercising an option.

Currency futures contracts are contracts that require the exchange of a specific amount of currency at a specific future date and at a specific exchange rate. Futures contracts are similar to but not identical to forward contracts.

Exchange-Traded and Standardized Terms

Futures contracts are actively traded on exchanges, and the terms are standardized. As a result, futures contracts have clearinghouses that guarantee the transactions, substantially reducing any risk of default by either party. Forward contracts are private contracts between two parties and are not standardized. As a result, the parties have a higher risk of defaulting on a contract.

Settlement and Delivery

The settlement of a forward contract occurs at the end of the contract. Futures contracts are marked-to-market daily, which means that daily changes are settled day by day until the end of the contract. Furthermore, the settlement of a futures contract can occur over a range of dates. Forward contracts, on the other hand, only have one settlement date at the end of the contract.

Maturity

Futures contracts are frequently employed by speculators, who bet on the direction in which a currency's price will move; as a result, futures contracts are usually closed out prior to maturity and delivery usually never happens. On the other hand, forward contracts are mostly used by companies, institutions, or hedgers that want to eliminate the volatility of a currency's price in the future, and delivery of the currency will usually take place.

Companies routinely use these tools to manage their exposure to currency risk. One of the complicating factors for companies occurs when they operate in countries that limit or control the convertibility of currency. Some countries limit the profits (currency) a company can take out of a country. As a result, many companies resort to countertrade, where companies trade goods and services for other goods and services and actual monies are less involved.

The challenge for companies is to operate in a world system that is not efficient. Currency markets are influenced not only by market factors, inflation, interest rates, and market psychology but also—more importantly—by government policy and intervention. Many companies move their production and operations to overseas locations to manage against unforeseen currency risks and to circumvent trade barriers. It's important for companies to actively monitor the markets in which they operate around the world.

KEY TAKEAWAYS

In this section you learned about the following:

1. An exchange rate is the rate at which the market converts one currency into another. An exchange rate can be quoted as direct or indirect.
2. The spot rate is an exchange rate that requires immediate settlement with delivery of the traded currency. The forward exchange rate is the exchange rate at which a buyer and seller agree to transact a currency at some date in the future. Swaps, options, and futures are additional types of currency instruments used in the forward market.
3. Companies routinely use these tools to manage their exposure to currency risk. Well-functioning currency markets are a component of the global financial markets and an essential mechanism for global firms that need to exchange currencies.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What is currency and foreign exchange? Why are they so important to international business?
2. What is the difference between American and European terms for quoting currencies? Give an example. If you have traveled outside your home country, discuss how you exchanged currency while abroad. What process did you follow?
3. Describe a spot rate and a forward rate.
4. What are the main differences between a forward contract and a futures contract?

4.7: Understanding International Capital Markets

Learning Objectives

1. Understand the purpose of capital markets, domestic and international.
2. Explore the major components of the international capital markets.
3. Understand the role of international banks, investment banks, securities firms, and financial institutions.

What Are International Capital Markets?

A **capital market** is basically a system in which people, companies, and governments with an excess of funds transfer those funds to people, companies, and governments that have a shortage of funds. This transfer mechanism provides an efficient way for those who wish to borrow or invest money to do so. For example, every time someone takes out a loan to buy a car or a house, they are accessing the capital markets. Capital markets carry out the desirable economic function of directing capital to productive uses.

There are two main ways that someone accesses the capital markets—either as debt or equity. While there are many forms of each, very simply, **debt** is money that's borrowed and must be repaid, and **equity** is money that is invested in return for a percentage of ownership but is not guaranteed in terms of repayment.

In essence, governments, businesses, and people that save some portion of their income invest their money in capital markets such as stocks and bonds. The borrowers (governments, businesses, and people who spend more than their income) borrow the savers' investments through the capital markets. When savers make investments, they convert risk-free assets such as cash or savings into risky assets with the hopes of receiving a future benefit. Since all investments are risky, the only reason a saver would put cash at risk is if returns on the investment are greater than returns on holding risk-free assets. Basically, a higher rate of return means a higher risk.

For example, let's imagine a beverage company that makes $1 million in gross sales. If the company spends $900,000, including taxes and all expenses, then it has $100,000 in profits. The company can invest the $100,000 in a mutual fund (which are pools of money managed by an investment company), investing in stocks and bonds all over the world. Making such an investment is riskier than keeping the $100,000 in a savings account. The financial officer hopes that over the long term the investment will yield greater returns than cash holdings or interest on a savings account. This is an example of a form of **direct finance**. In other words, the beverage company bought a security issued by another company through the capital markets. In contrast, **indirect finance** involves a financial intermediary between the borrower and the saver. For example, if the company deposited the money in a savings account, and then the savings bank lends the money to a company (or a person), the bank is an intermediary. Financial intermediaries are very important in the capital marketplace. Banks lend money to many people, and in so doing create economies of scale. This is one of the primary purposes of the capital markets.

Capital markets promote economic efficiency. In the example, the beverage company wants to invest its $100,000 productively. There might be a number of firms around the world eager to borrow funds by issuing a debt security or an equity security so that it can implement a great business idea. Without issuing the security, the borrowing firm has no funds to implement its plans. By shifting the funds from the beverage company to other firms through the capital markets, the funds are employed to their maximum extent. If there were no capital markets, the beverage company might have kept its $100,000 in cash or in a low-yield savings account. The other firms would also have had to put off or cancel their business plans.

International capital markets are the same mechanism but in the global sphere, in which governments, companies, and people borrow and invest across national boundaries. In addition to the benefits and purposes of a domestic capital market, international capital markets provide the following benefits:

1. **Higher returns and cheaper borrowing costs.** These allow companies and governments to tap into foreign markets and access new sources of funds. Many domestic markets are too small or too costly for companies to borrow in. By using the international capital markets, companies, governments, and even individuals can borrow or invest in other countries for either higher rates of return or lower borrowing costs.
2. **Diversifying risk.** The international capital markets allow individuals, companies, and governments to access more opportunities in different countries to borrow or invest, which in turn reduces risk. The theory is that not all markets will experience contractions at the same time.

The structure of the capital markets falls into two components—primary and secondary. The **primary market** is where new securities (stocks and bonds are the most common) are issued. If a corporation or government agency needs funds, it issues (sells) securities to purchasers in the primary market. Big investment banks assist in this issuing process as intermediaries. Since the primary market is limited to issuing only new securities, it is valuable but less important than the secondary market.

The vast majority of capital transactions take place in the **secondary market**. The secondary market includes stock exchanges (the New York Stock Exchange, the London Stock Exchange, and the Tokyo Nikkei), bond markets, and futures and options markets, among others. All these secondary markets deal in the trade of securities. The term **securities** includes a wide range of financial instruments. You're probably most familiar with stocks and bonds. Investors have essentially two broad categories of securities available to them: equity securities, which represent ownership of a part of a company, and debt securities, which represent a loan from the investor to a company or government entity.

Creditors, or debt holders, purchase debt securities and receive future income or assets in return for their investment. The most common example of a debt instrument is the **bond**. When investors buy bonds, they are lending the issuers of the bonds their money. In return, they will receive interest payments usually at a fixed rate for the life of the bond and receive the principal when the bond expires. All types of organizations can issue bonds.

Stocks are the type of equity security with which most people are familiar. When investors buy stock, they become owners of a share of a company's assets and earnings. If a company is successful, the price that investors are willing to pay for its stock will often rise; shareholders who bought stock at a lower price then stand to make a profit. If a company does not do well, however, its stock may decrease in value and shareholders can lose money. Stock prices are also subject to both general economic and industry-specific market factors.

The key to remember with either debt or equity securities is that the issuing entity, a company or government, only receives the cash in the primary market issuance. Once the security is issued, it is traded; but the company receives no more financial benefit from that security. Companies are motivated to maintain the value of their equity securities or to repay their bonds in a timely manner so that when they want to borrow funds from or sell more shares in the market, they have the credibility to do so.

For companies, the global financial, including the currency, markets (1) provide stability and predictability, (2) help reduce risk, and (3) provide access to more resources. One of the fundamental purposes of the capital markets, both domestic and international, is the concept of **liquidity**, which basically means being able to convert a noncash asset into cash without losing any of the principal value. In the case of global capital markets, liquidity refers to the ease and speed by which shareholders and bondholders can buy and sell their securities and convert their investment into cash when necessary. Liquidity is also essential for foreign exchange, as companies don't want their profits locked into an illiquid currency.

Major Components of the International Capital Markets

International Equity Markets

Companies sell their stock in the equity markets. International equity markets consists of all the stock traded outside the issuing company's home country. Many large global companies seek to take advantage of the global financial centers and issue stock in major markets to support local and regional operations.

For example, ArcelorMittal is a global steel company headquartered in Luxembourg; it is listed on the stock exchanges of New York, Amsterdam, Paris, Brussels, Luxembourg, Madrid, Barcelona, Bilbao, and Valencia. While the daily value of the global markets changes, in the past decade the international equity markets have expanded considerably, offering global firms increased options for financing their global operations. The key factors for the increased growth in the international equity markets are the following:

- **Growth of developing markets.** As developing countries experience growth, their domestic firms seek to expand into global markets and take advantage of cheaper and more flexible financial markets.
- **Drive to privatize.** In the past two decades, the general trend in developing and emerging markets has been to privatize formerly state-owned enterprises. These entities tend to be large, and when they sell some or all of their shares, it infuses billions of dollars of new equity into local and global markets. Domestic and global investors, eager to participate in the growth of the local economy, buy these shares.
- **Investment banks.** With the increased opportunities in new emerging markets and the need to simply expand their own businesses, investment banks often lead the way in the expansion of global equity markets. These specialized banks seek to be

retained by large companies in developing countries or the governments pursuing privatization to issue and sell the stocks to investors with deep pockets outside the local country.
- **Technology advancements.** The expansion of technology into global finance has opened new opportunities to investors and companies around the world. Technology and the Internet have provided more efficient and cheaper means of trading stocks and, in some cases, issuing shares by smaller companies.

International Bond Markets

Bonds are the most common form of debt instrument, which is basically a loan from the holder to the issuer of the bond. The international bond market consists of all the bonds sold by an issuing company, government, or entity outside their home country. Companies that do not want to issue more equity shares and dilute the ownership interests of existing shareholders prefer using bonds or debt to raise capital (i.e., money). Companies might access the international bond markets for a variety of reasons, including funding a new production facility or expanding its operations in one or more countries. There are several types of international bonds, which are detailed in the next sections.

Foreign Bond

A foreign bond is a bond sold by a company, government, or entity in another country and issued in the currency of the country in which it is being sold. There are foreign exchange, economic, and political risks associated with foreign bonds, and many sophisticated buyers and issuers of these bonds use complex hedging strategies to reduce the risks. For example, the bonds issued by global companies in Japan denominated in yen are called *samurai bonds*. As you might expect, there are other names for similar bond structures. Foreign bonds sold in the United States and denominated in US dollars are called *Yankee bonds*. In the United Kingdom, these foreign bonds are called *bulldog bonds*. Foreign bonds issued and traded throughout Asia except Japan, are called *dragon bonds*, which are typically denominated in US dollars. Foreign bonds are typically subject to the same rules and guidelines as domestic bonds in the country in which they are issued. There are also regulatory and reporting requirements, which make them a slightly more expensive bond than the Eurobond. The requirements add small costs that can add up given the size of the bond issues by many companies.

Eurobond

A Eurobond is a bond issued outside the country in whose currency it is denominated. Eurobonds are not regulated by the governments of the countries in which they are sold, and as a result, Eurobonds are the most popular form of international bond. A bond issued by a Japanese company, denominated in US dollars, and sold only in the United Kingdom and France is an example of a Eurobond.

Global Bond

A global bond is a bond that is sold simultaneously in several global financial centers. It is denominated in one currency, usually US dollars or Euros. By offering the bond in several markets at the same time, the company can reduce its issuing costs. This option is usually reserved for higher rated, creditworthy, and typically very large firms.

Did You Know?

As the international bond market has grown, so too have the creative variations of bonds, in some cases to meet the specific needs of a buyer and issuer community. *Sukuk*, an Arabic word, is a type of financing instrument that is in essence an Islamic bond. The religious law of Islam, Sharia, does not permit the charging or paying of interest, so Sukuk securities are structured to comply with the Islamic law. “An IMF study released in 2007 noted that the Issuance of Islamic securities (sukuk) rose fourfold to $27 billion during 2004–06. While 14 types of sukuk are recognized by the Accounting and Auditing Organization of Islamic Finance Institutions, their structure relies on one of the three basic forms of legitimate Islamic finance, murabahah (synthetic loans/purchase orders), musharakah/mudharabah (profit-sharing arrangements), and ijara (sale-leasebacks), or a combination thereof.”Andy Jobst, Peter Kunzel, Paul Mills, and Amadou Sy, “Islamic Finance Expanding Rapidly,” International Monetary Fund, September 19, 2007, accessed February 2, 2011, http://www.imf.org/external/pubs/ft/survey/so/2007/res0919b.htm.

The *Economist* notes “that by 2000, there were more than 200 Islamic banks…and today $700 billion of global assets are said to comply with *sharia* law. Even so, traditional finance houses rather than Islamic institutions continue to handle most Gulf oil money and other Muslim wealth.”

“More worrying still, the rules for Islamic finance are not uniform around the world. A Kuwaiti Muslim cannot buy a Malaysian *sukuk* (*sharia*-compliant bond) because of differing definitions of what constitutes usury (interest). Indeed, a respected Islamic jurist recently denounced most *sukuk* as godless. Nor are banking licenses granted easily in most Muslim countries. That is why big Islamic banks are so weak. Often they are little more than loose collections of subsidiaries. They also lack home-grown talent: most senior staff are poached from multinationals.” But in 2009, one entrepreneur, Adnan Yousif, made headlines as he tried to change that and create the world’s biggest Islamic bank. While his efforts are still in progress, it’s clear that Islamic banking is a growing and profitable industry niche.“Godly but Ambitious,” *Economist*, June 18, 2009, accessed February 2, 2011, http://www.economist.com/node/13856281.

Eurocurrency Markets

The Eurocurrency markets originated in the 1950s when communist governments in Eastern Europe became concerned that any deposits of their dollars in US banks might be confiscated or blocked for political reasons by the US government. These communist governments addressed their concerns by depositing their dollars into European banks, which were willing to maintain dollar accounts for them. This created what is known as the **Eurodollar**—US dollars deposited in European banks. Over the years, banks in other countries, including Japan and Canada, also began to hold US dollar deposits and now Eurodollars are any dollar deposits in a bank outside the United States. (The prefix *Euro-* is now only a historical reference to its early days.) An extension of the Eurodollar is the **Eurocurrency**, which is a currency on deposit outside its country of issue. While Eurocurrencies can be in any denominations, almost half of world deposits are in the form of Eurodollars.

The Euroloan market is also a growing part of the Eurocurrency market. The Euroloan market is one of the least costly for large, creditworthy borrowers, including governments and large global firms. Euroloans are quoted on the basis of **LIBOR**, the London Interbank Offer Rate, which is the interest rate at which banks in London charge each other for short-term Eurocurrency loans.

The primary appeal of the Eurocurrency market is that there are no regulations, which results in lower costs. The participants in the Eurocurrency markets are very large global firms, banks, governments, and extremely wealthy individuals. As a result, the transaction sizes tend to be large, which provides an economy of scale and nets overall lower transaction costs. The Eurocurrency markets are relatively cheap, short-term financing options for Eurocurrency loans; they are also a short-term investing option for entities with excess funds in the form of Eurocurrency deposits.

Offshore Centers

The first tier of centers in the world are the **world financial centers**, which are in essence central points for business and finance. They are usually home to major corporations and banks or at least regional headquarters for global firms. They all have at least one globally active stock exchange. While their actual order of importance may differ both on the ranking format and the year, the following cities rank as global financial centers: New York, London, Tokyo, Hong Kong, Singapore, Chicago, Zurich, Geneva, and Sydney.

Did You Know?

The *Economist* reported in December 2009 that a “poll of Bloomberg subscribers in October found that Britain had dropped behind Singapore into third place as the city most likely to be the best financial hub two years from now. A survey of executives…by Eversheds, a law firm, found that Shanghai could overtake London within the next ten years.”“Foul-Weather Friends,” *Economist*, December 17, 2009, accessed February 2, 2011, http://www.economist.com/node/15127550. Many of these changes in rank are due to local costs, taxes, and regulations. London has become expensive for financial professionals, and changes in the regulatory and political environment have also lessened the city’s immediate popularity. However, London has remained a premier financial center for more than two centuries, and it would be too soon to assume its days as one of the global financial hubs is over.

In addition to the global financial centers are a group of countries and territories that constitute offshore financial centers. An **offshore financial center** is a country or territory where there are few rules governing the financial sector as a whole and low overall taxes. As a result, many offshore centers are called tax havens. Most of these countries or territories are politically and economically stable, and in most cases, the local government has determined that becoming an offshore financial center is its main industry. As a result, they invest in the technology and infrastructure to remain globally linked and competitive in the global finance marketplace.

Examples of well-known offshore financial centers include Anguilla, the Bahamas, the Cayman Islands, Bermuda, the Netherlands, the Antilles, Bahrain, and Singapore. They tend to be small countries or territories, and while global businesses may not locate any of their operations in these locations, they sometimes incorporate in these offshore centers to escape the higher taxes they would have to pay in their home countries and to take advantage of the efficiencies of these financial centers. Many global firms may house financing subsidiaries in offshore centers for the same benefits. For example, Bacardi, the spirits manufacturer, has $6 billion in revenues, more than 6,000 employees worldwide, and twenty-seven global production facilities. The firm is headquartered in Bermuda, enabling it to take advantage of the lower tax rates and financial efficiencies for managing its global operations.

As a result of the size of financial transactions that flow through these offshore centers, they have been increasingly important in the global capital markets.

Ethics in Action

Offshore financial centers have also come under criticism. Many people criticize these countries because corporations and individuals hide wealth there to avoid paying taxes on it. Many offshore centers are countries that have a zero-tax basis, which has earned them the title of *tax havens*.

The *Economist* notes that offshore financial centers

are typically small jurisdictions, such as Macau, Bermuda, Liechtenstein or Guernsey, that make their living mainly by attracting overseas financial capital. What they offer foreign businesses and well-heeled individuals is low or no taxes, political stability, business-friendly regulation and laws, and above all discretion. Big, rich countries see OFCs as the weak link in the global financial chain…

The most obvious use of OFCs is to avoid taxes. Many successful offshore jurisdictions keep on the right side of the law, and many of the world's richest people and its biggest and most reputable companies use them quite legally to minimise their tax liability. But the onshore world takes a hostile view of them. Offshore tax havens have "declared economic war on honest US taxpayers," says Carl Levin, an American senator. He points to a study suggesting that America loses up to $70 billion a year to tax havens…

Business in OFCs is booming, and as a group these jurisdictions no longer sit at the fringes of the global economy. Offshore holdings now run to $5 trillion–7 trillion, five times as much as two decades ago, and make up perhaps 6–8 percent of worldwide wealth under management, according to Jeffrey Owens, head of fiscal affairs at the OECD. Cayman, a trio of islands in the Caribbean, is the world's fifth-largest banking centre, with $1.4 trillion in assets. The British Virgin Islands (BVI) are home to almost 700,000 offshore companies.

All this has been very good for the OFCs' economies. Between 1982 and 2003 they grew at an annual average rate per person of 2.8 percent, over twice as fast as the world as a whole (1.2 percent), according to a study by James Hines of the University of Michigan. Individual OFCs have done even better. Bermuda is the richest country in the world, with a GDP per person estimated at almost $70,000, compared with $43,500 for America…On average, the citizens of Cayman, Jersey, Guernsey and the BVI are richer than those in most of Europe, Canada and Japan. This has encouraged other countries with small domestic markets to set up financial centres of their own to pull in offshore money—most spectacularly Dubai but also Kuwait, Saudi Arabia, Shanghai and even Sudan's Khartoum, not so far from war-ravaged Darfur.

Globalisation has vastly increased the opportunities for such business. As companies become ever more multinational, they find it easier to shift their activities and profits across borders and into OFCs. As the well-to-do lead increasingly peripatetic lives, with jobs far from home, mansions scattered across continents and investments around the world, they can keep and manage their wealth anywhere. Financial liberalisation—the elimination of capital controls and the like—has made all of this easier. So has the internet, which allows money to be shifted around the world quickly, cheaply and anonymously.Joanne Ramos, "Places in the Sun," *Economist*, February 22, 2007, accessed March 2, 2011, http://www.economist.com/node/8695139.

For more on these controversial offshore centers, please see the full article at http://www.economist.com/node/8695139.

The Role of International Banks, Investment Banks, Securities Firms, and Global Financial Firms

The role of international banks, investment banks, and securities firms has evolved in the past few decades. Let's take a look at the primary purpose of each of these institutions and how it has changed, as many have merged to become global financial powerhouses.

Traditionally, international banks extended their domestic role to the global arena by servicing the needs of multinational corporations (MNC). These banks not only received deposits and made loans but also provided tools to finance exports and imports and offered sophisticated cash-management tools, including foreign exchange. For example, a company purchasing products from another country may need short-term financing of the purchase; electronic funds transfers (also called wires); and foreign exchange transactions. International banks provide all these services and more.

In broad strokes, there are different types of banks, and they may be divided into several groups on the basis of their activities. Retail banks deal directly with consumers and usually focus on mass-market products such as checking and savings accounts, mortgages and other loans, and credit cards. By contrast, private banks normally provide wealth-management services to families and individuals of high net worth. Business banks provide services to businesses and other organizations that are medium sized, whereas the clients of corporate banks are usually major business entities. Lastly, investment banks provide services related to financial markets, such as mergers and acquisitions. Investment banks also focused primarily on the creation and sale of securities (e.g., debt and equity) to help companies, governments, and large institutions achieve their financing objectives. Retail, private, business, corporate, and investment banks have traditionally been separate entities. All can operate on the global level. In many cases, these separate institutions have recently merged, or were acquired by another institution, to create global financial powerhouses that now have all types of banks under one giant, global corporate umbrella.

However the merger of all of these types of banking firms has created global economic challenges. In the United States, for example, these two types—retail and investment banks—were barred from being under the same corporate umbrella by the **Glass-Steagall Act**. Enacted in 1932 during the Great Depression, the Glass-Steagall Act, officially called the Banking Reform Act of 1933, created the Federal Deposit Insurance Corporations (FDIC) and implemented bank reforms, beginning in 1932 and continuing through 1933. These reforms are credited with providing stability and reduced risk in the banking industry for decades. Among other things, it prohibited bank-holding companies from owning other financial companies. This served to ensure that investment banks and banks would remain separate—until 1999, when Glass-Steagall was repealed. Some analysts have criticized the repeal of Glass-Steagall as one cause of the 2007–8 financial crisis.

Because of the size, scope, and reach of US financial firms, this historical reference point is important in understanding the impact of US firms on global businesses. In 1999, once bank-holding companies were able to own other financial services firms, the trend toward creating global financial powerhouses increased, blurring the line between which services were conducted on behalf of clients and which business was being managed for the benefit of the financial company itself. Global businesses were also part of this trend, as they sought the largest and strongest financial players in multiple markets to service their global financial needs. If a company has operations in twenty countries, it prefers two or three large, global banking relationships for a more cost-effective and lower-risk approach. For example, one large bank can provide services more cheaply and better manage the company's currency exposure across multiple markets. One large financial company can offer more sophisticated risk-management options and products. The challenge has become that in some cases, the party on the opposite side of the transaction from the global firm has turned out to be the global financial powerhouse itself, creating a conflict of interest that many feel would not exist if Glass-Steagall had not been repealed. The issue remains a point of ongoing discussion between companies, financial firms, and policymakers around the world. Meanwhile, global businesses have benefited from the expanded services and capabilities of the global financial powerhouses.

For example, US-based Citigroup is the world's largest financial services network, with 16,000 offices in 160 countries and jurisdictions, holding 200 million customer accounts. It's a financial powerhouse with operations in retail, private, business, and investment banking, as well as asset management. Citibank's global reach make it a good banking partner for large global firms that want to be able to manage the financial needs of their employees and the company's operations around the world.

In fact this strength is a core part of its marketing message to global companies and is even posted on its website (www.citigroup.com/citi/products/instinvest.htm): "Citi puts the world's largest financial network to work for you and your organization."

Ethics in Action

Outsourcing Day Trading to China

American and Canadian trading firms are hiring Chinese workers to "day trade" from China during the hours the American stock market is open. In essence, day trading or speculative trading occurs when a trader buys and sells stock quickly throughout the day in the hopes of making quick profits. The *New York Times* reported that as many as 10,000 Chinese, mainly young men, are busy working the night shift in Chinese cities from 9:30 p.m. to 4 a.m., which are the hours that the New York Stock Exchange is open in New York.

The motivation is severalfold. First, American and Canadian firms are looking to access wealthy Chinese clients who are technically not allowed to use Chinese currency to buy and sell shares on a foreign stock exchange. However, there are no restrictions for trading stocks in accounts owned by a foreign entity, which in this case usually belongs to the trading firms. Chinese traders also get paid less than their American and Canadian counterparts.

There are ethical concerns over this arrangement because it isn't clear whether the use of traders in China violates American and Canadian securities laws. In a *New York Times* article quotes Thomas J. Rice, an expert in securities law at Baker & McKenzie, who states, "This is a jurisdictional mess for the U.S. regulators. Are these Chinese traders essentially acting as brokers? If they are, they would need to be registered in the U.S." While the regulatory issues may not be clear, the trading firms are doing well and growing: "many Chinese day traders see this as an opportunity to quickly gain new riches." Some American and Canadian trading firms see the opportunity to get "profit from trading operations in China through a combination of cheap overhead, rebates and other financial incentives from the major stock exchanges, and pent-up demand for broader investment options among China's elite."David Barboza, "Day Trading, Conducted Overnight, Grows in China," *New York Times*, December 10, 2010.

KEY TAKEAWAYS

- Capital markets provide an efficient mechanism for people, companies, and governments with more funds than they need to transfer those funds to people, companies, or governments who have a shortage of funds.
- The international equity and bond markets have expanded exponentially in recent decades. This expansion has been fueled by the growth of developing markets, the drive to privatize, the emergence of global financial powerhouses including investment banks, and technology advancements.
- The international bond market consists of major categories of bonds—including foreign bonds, Eurobonds, and global bonds—all of which help companies borrow funds to invest and grow their global businesses.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What is a capital market? What is an international capital market?
2. What is the role of bond and equity markets.
3. Select one global financial center and research its history and evolution to present times. Do you feel that the center will remain influential? Why or why not? Which other global financial centers compete with the one you have chosen?

4.8: Venture Capital and the Global Capital Markets

> **Learning Objectives**
>
> 1. Understand the impact of the global capital markets on international business through the expansion of international venture capital.
> 2. Understand international venture capital.
> 3. Understand the perspective of international venture capitalists.

Every start-up firm and young, growing business needs capital—money to invest to grow the business. Some companies access capital from the company founders or the friends and family of the founders. Growing companies that are profitable may be able to turn to banks and traditional lending companies. Another increasingly visible and popular source of capital is venture capital. Venture capital (VC) refers to the investment made in an early- or growth-stage company. **Venture capitalist** (also known as VC) refers to the investor.

One of the unintended benefits of the expansion of the global capital markets has been the expansion of international VC. Typically, VCs establish a venture fund with monies from institutions and individuals of high net worth. VCs, in turn, use the venture funds to invest in early- and growth-stage companies. VCs are characterized primarily by their investments in smaller, high-growth firms that are considered riskier than traditional investments. These investments are not liquid (i.e., they cannot be quickly bought and sold through the global financial markets). For this riskier and illiquid feature, VCs earn much higher rates of return that are sometimes astronomical if the VC times the exit correctly.

One of the factors that any VC assesses while determining whether or not to invest in a young and growing company is the **exit strategy**. The exit strategy is the way that a VC or investor can liquidate an investment, usually for a liquid security or cash. It's great if a company does well, but any investor, including VCs, wants to know how and when they're going to get their money out. While an initial public offering (IPO) is certainly a lucrative exit strategy, it's not for every company. Many VCs also like to see a list of possible strategic acquirers.

Did You Know?

Many large global firms also have internal investment groups that make corporate venture investments in early-stage and growing companies. These corporate VC firms may actually be the exit strategy and eventually acquire the young company if it fits their business objectives. This type of corporate VC is often called a strategic investor because they are more likely to place a higher priority on the strategic value of the investment rather than just the pure financial return on investment.

For example, US-based Intel Corporation, one of the world's largest technology companies, has an internal group called Intel Capital. The vision of Intel Capital is "to be the preeminent global investing organization in the world" and its mission "to make and manage financially attractive investments in support of Intel's strategic objectives."“Intel Capital,” Intel Capital Corporation, accessed March 2, 2011, http://www.intel.com/about/companyinfo/capital/index.htm.

Intel Capital makes investments in companies around the world to encourage the development and deployment of new technologies, enter into or expand in new markets, and generate returns on their investments. "Since 1991, Intel Capital has invested more than USD 9.5 billion in over 1,050 companies in 47 countries. In that timeframe, 175 portfolio companies have gone public on various exchanges around the world and 241 were acquired or participated in a merger. In 2009, Intel Capital invested USD 327 million in 107 investments with approximately 50 percent of funds invested outside the U.S. and Canada."“About Intel Capital,” Intel Capital Corporation, accessed March 2, 2011, www.intel.com/about/companyinfo/capital/info/earnings.htm.

Table 7.2 shows a sample of the global investments made by Intel Capital.

Table 7.2 Intel Capital Investments Announced in November 2010

Company	Country	Business
Althea Systems	India	Makes a cloud-based video platform to find and share online videos across devices (Shufflr is its social video browser)
Anobit	Israel	Memory signal processing technology

Company	Country	Business
Boo-box	Brazil	Software-based ad system for social media
De Novo	Ukraine	Provides enterprise-class data centers and services in Ukraine
Iptego	Berlin	Makes software to optimize Next Generation Networks
Layar	Netherlands	Reality platform available on Android, iPhone, and Bada mobile devices
Rock Flow Dynamics	Russia	Makes modeling software that simulates fluid and gas filtration
Select-TV	Malaysia	Makes set-top boxes for IP TVs
Taifatech	Taiwan	Fabless semiconductor company that makes wireless system on a chip
WinChannel	Beijing	Makes software that manages replenishment orders, sales, inventory, and other activities in near-real time

Source: Copyright Intel Capital, 2010.

As a result, the expanded global markets offer VCs access to (1) new potential investors in their venture funds; (2) a wider selection of firms in which to invest; (3) more exit strategies, including IPOs in other countries outside their home country; and (4) the opportunity for their portfolio companies to merge or be acquired by foreign firms. Tech-savvy American and European VCs have traced the source of the high-tech talent pool and increased their investments in growing companies in many countries, including Israel, China, India, Brazil, and Russia.

Did You Know?

A July 2010 research survey conducted by Deloitte uncovered the following sentiments among VCs from around the world.

'Traditionally strong markets like the U.S. and Europe will continue to be important hubs despite consolidation in the number of venture firms,' said Mark Jensen, partner, Deloitte & Touche LLP and national managing partner for VC services. 'However, the stage has now been set for emerging markets like China, India and Brazil to rise as drivers of innovation as they are increasingly becoming more competitive with the traditional markets.'…

Overall, only 34 percent of all respondents indicated that they expect to increase their investment activity outside their own country….The countries with the most interest in cross border investing include: France (56 percent), Israel (50 percent) and the United Kingdom (49 percent). Countries indicating the least interest in outside investing were Brazil (19 percent), India (15 percent) and China (11 percent).

'The Asian markets, in particular, are abundant in entrepreneurial spirit, energy and a dedication from both the private and public sectors to push the economic growth pendulum as far as possible,' said Trevor Loy, general partner of Flywheel Ventures. 'The continued rapid growth of emerging markets is also creating a new source of customer revenue, investment capital, job creation, and shareholder liquidity for U.S. based technology start-ups, particularly those leveraging America's deep research and development (R&D) resources to address critical infrastructure needs in energy, water, materials and communications.'…

Top challenges varied in countries around the globe with the exit market being cited the most in the United Kingdom (80 percent), Canada (75 percent), India (71 percent) and Israel (70 percent). Eighty-one percent of respondents in Brazil cited unfavorable tax policies as being a hindrance. An unstable regulatory environment was the most common factor cited by respondents in France (72 percent) and China (62 percent).

'The challenges for a U.S. venture firm trying to do business in Europe include the current weakness in the euro-zone economy, language and cultural differences, and the tendency towards inflexible employment regulations,' said Bruce Evans, managing director of Summit Partners. 'On top of this, U.S. firms have to fund their European expansion from their own profits, and the proposed U.S. tax changes to carried interest—and the taxation of equity interests in fund managers more generally—would serve as an impediment to U.S. venture funds' growth aspirations.'

'Yet, opportunities remain as well,' Evans continued. 'The psychological make-up of successful, driven entrepreneurs in Europe mirrors what we have found in the U.S. In addition, the globalization of technology markets means that successful products are as likely to be developed in Europe as elsewhere. Finally, the days of missionary selling of venture capital in Europe are over, and today there is a broad understanding of our type of financing.'"U.S. Venture Capital Industry Expected to Shrink While Emerging Markets Grow: Deloitte, NVCA Study," Deloitte Corporation, July 14, 2010, accessed February 2, 2011, www.deloitte.com/view/en_US/us/Insights/browse-by-role/media-role/a8e40f2f800d9210VgnVCM200000bb42f00aRCRD.htm.

Key Takeaways

In this section, you learned

1. VC is the investment made by an investor in an early- or growth-stage company. *Venture capitalist* (also known as VC) refers to the investor. Typically, VCs establish a venture fund with monies from institutions and individuals of high net worth. Venture capitalists, in turn, use the venture fund(s) to invest in early- and growth-stage companies.
2. VC investments are characterized primarily by the fact that they invest in smaller, high-growth firms that are considered higher risk than traditional investments and that the investments are not liquid—that is, they cannot be quickly bought and sold through the global financial markets. For this riskier and illiquid feature, VCs earn much higher rates of return that are sometimes astronomical if the exit is timed correctly.
3. One of the key factors that any VC assesses while determining whether or not to invest in a young and growing company is the exit strategy. The exit strategy is the way a VC or investor can liquidate investments, usually for a liquid security or cash. As a result, the expansion of the global capital markets has benefited VCs who now have more access to the following:
   - New potential investors in their venture funds
   - A wider selection of firms in different countries in which to invest
   - More exit strategies, including IPOs, in other countries outside their home country and the opportunity for their portfolio companies to merge or be acquired by foreign firms

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Why do VCs benefit from increased globalization? List three reasons. If you were a research analyst at a US-based VC firm, what would you recommend to your senior partners about the global market opportunity?
2. What is an exit strategy? Why is it so important to a VC?

CHAPTER OVERVIEW

5: International Business Strategy

5.1: The Five Stages of Going Global

In the first stage (market entry), companies tend to enter new countries using business models that are very similar to the ones they deploy in their home markets. To gain access to local customers, however, they often need to establish a production presence, either because of the nature of their businesses (as in service industries like food retail or banking) or because of local countries' regulatory restrictions (as in the auto industry).

In the second stage (product specialization), companies transfer the full production process of a particular product to a single, low-cost location and export the goods to various consumer markets. Under this scenario, different locations begin to specialize in different products or components and trade in finished goods.

The third stage (value chain disaggregation) represents the next step in the company's globalization of the supply-chain infrastructure. In this stage, companies start to disaggregate the production process and focus each activity in the most advantageous location. Individual components of a single product might be manufactured in several different locations and assembled into final products elsewhere. Examples include the PC industry market and the decision by companies to offshore some of their business processes and information technology services.

In the fourth stage (value chain reengineering) companies seek to further increase their cost savings by reengineering their processes to suit local market conditions, notably by substituting lower-cost labor for capital. General Electric's (GE) medical equipment division, for example, has tailored its manufacturing processes abroad to take advantage of low labor costs. Not only does it use more labor-intensive production processes—it also designs and builds the capital equipment for its plants locally.

Finally, in the fifth stage (the creation of new markets), the focus is on market expansion. The McKinsey Global Institute estimates that the third and fourth stages together have the potential to reduce costs by more than 50% in many industries, which gives companies the opportunity to substantially lower their sticker prices in both old and new markets and to expand demand. Significantly, the value of new revenues generated in this last stage is often greater than the value of cost savings in the other stages.

It should be noted that the five stages described above do not define a rigid sequence that all industries follow. As the McKinsey study notes, companies can skip or combine steps. For example, in consumer electronics, product specialization and value chain disaggregation (the second and third stages) occurred together as different locations started to specialize in producing different components (Taiwanese manufacturers focused on semiconductors, while Chinese companies focused on computer keyboards and other components).

5.2: Understanding Industry Globalization

Executives often ask whether their industry is becoming more global and, if so, what strategies they should consider to take advantage of this development and stake out an enduring global competitive advantage. This may be the wrong question. Simple characterizations such as "the electronics industry is global" are not particularly useful. A better question is *how* global an industry is, or is likely, to become. Virtually all industries are global in some respects. However, only a handful of industries can be considered truly global today or are likely to become so in the future. Many more will remain hybrids, that is, global in some respects, local in others. *Industry globalization, therefore, is a matter of degree*. What counts is which elements of an industry are becoming global and how they affect strategic choice. In approaching this issue, we must focus on the drivers of industry globalization and think about how these elements shape strategic choice.

We should also make a distinction between *industry globalization, global competition,* and the degree to which a *company has globalized* its operations. In traditionally global industries, competition is mostly waged on a worldwide basis and the leaders have created global corporate structures. But the fact that an industry is not truly global does not prevent global competition. And a competitive global posture does not necessarily require a global reorganization of every aspect of a company's operations. Economies of scale and scope are among the most important drivers of industry globalization; in global industries, the minimum volume required for cost efficiency is simply no longer available in a single country or region. Global competition begins when companies cross-subsidize national market-share battles in pursuit of global brand and distribution positions. A global company structure is characterized by production and distribution systems in key markets around the world that enable cross-subsidization, competitive retaliation on a global basis, and world-scale volume. (Hamel and Prahalad (1985, July-August)).

So why are some industries more global than others? And why do global industries appear to be concentrated in certain countries or regions? Most would consider the oil, auto, and pharmaceutical industries global industries, while tax preparation, many retailing sectors, and real estate are substantially domestic in nature. Others, such as furniture, lie somewhere in the middle. What accounts for the difference? The dominant location of global industries also poses interesting questions. Although the machine tool and semiconductor industries originated in the United States, Asia has emerged as the dominant player in most of their segments today. What accounts for this shift? Why is the worldwide chemical industry concentrated in Germany while the United States continues to dominate in software and entertainment? Can we predict that France and Italy will remain the global centers for fashion and design? These issues are important to strategists. They are also relevant as a matter of public policy as governments attempt to shape effective policies to attract and retain the most attractive industries, and companies must anticipate changes in global competition and locational advantage.

Minicase: Cemex's Globlization Path: First Cement, Then Services

When Lorenzo Zambrano became chairman and chief executive officer of Cemex in the 1980s, he pushed the company into foreign markets to protect it from the Latin American debt crisis. Now the giant cement company is moving into services. (Lindquist (2002, November 1); and www.cemex.com/)

Zambrano first focused on the United States. But attempts to sell cement north of the border were greeted by hostility from producers, who convinced the U.S. International Trade Commission to levy a stiff antidumping duty. Despite a a General Agreement on Tariffs and Trade's (GATT) ruling in Cemex's favor, the company was still paying the fine a dozen years later.

Rebuffed in the world's biggest market, Zambrano turned to Spain, investing in port facilities and outmaneuvering European rivals for control of the country's two largest cement firms. When he discovered how inefficiently they were run, Zambrano sent a team of his Mexican managers to Spain to introduce his distinctive way of doing business. Called the "Cemex Way," it is a culture that blends modern, flexible management practices with cutting-edge technology.

From Spain, where profits increased from 7% to 24% during Cemex's first 2 years there, the company expanded around the globe. Blending state-of-the-art technology with the making and selling of one of the world's most basic products, Cemex has achieved remarkable customer service in some of the most logistically challenged countries. Whether Venezuela, Mexico, or the Philippines, Cemex trucks equipped with GPS navigational systems promise deliveries within 20 minutes.

After gaining a solid international footing, Zambrano went back to the United States. In 2000, he bought Houston-based Southdown Cement—one of the largest purchases ever by a Mexican company in the United States. Soon, Cemex was the biggest U.S. cement seller. In less than two decades, Zambrano had transformed Cemex from a domestic company into the world's third-largest cement firm by investing heavily and imaginatively not only in plants and equipment, which is what one would expect in the cement industry, but also in information technology and particularly in Cemex's people.

The corporation has consistently been more profitable than either of its two biggest competitors, France's Lafarge and Switzerland's Holcim. Sales in 2008 were almost $22 billion, with an operating margin of almost 12%.

Today, Cemex has a presence in more than 50 countries across 5 continents. It has an annual production capacity of close to 96 million metric tons of cement, approximately 77 million cubic meters of ready-mix concrete and more than 240 million metric tons of aggregates. Its resource base includes 64 cement plants, over 2,200 ready-mix concrete facilities, and a minority participation in 15 cement plants, and it operates 493 aggregate quarries, 253 land-distribution centers, and 88 marine terminals.

Zambrano's embrace of technology is central to Cemex's efficiency. Fiber optics link the system, and satellite communications are used to connect remote outposts. Whether at the Monterrey headquarters or on the road, the chief executive officer can tap into his computer to check kiln temperatures in Bali or cement truck deliveries in Cairo.

Because he believes many companies use technology ineffectively, Zambrano spun off Cemex's technology arm to sell its services. Organized under the CxNetworks Miami subsidiary, which is devoted to creating growth by building innovative businesses around Cemex's strengths, Zambrano formed a consulting service called Neoris. With more than half of its customers coming from outside Cemex, the operation has already become hugely profitable. It has been grouped with another start-up—Arkio, a distributor of building material products to construction companies in developing nations. "We're selling logistics," says the president of CxNetworks. "We can assure our customers that they can have the materials from our warehouse to their construction site within 48 hours."

5.3: Porter’s National Diamond

The theory of comparative economic advantage holds that as a result of natural endowments, some countries or regions of the world are more efficient than others in producing particular goods. Australia, for example, is naturally suited to the mining industry; the United States, with its vast temperate landmass, has a natural advantage in agriculture; and more-wooded parts of the world may have a natural advantage in producing timber-based products. This theory is persuasive for industries such as agriculture, mining, and timber. But what about industries such as electronics, entertainment, or fashion design? To explain the clustering of these industries in particular countries or regions, a more comprehensive theory of the geography of competition is needed.

In the absence of natural comparative advantages, industrial clustering occurs as a result of a relative advantage that is created by the industry itself. (Krugman (1993)). Producers tend to locate manufacturing facilities close to their primary customers. If transportation costs are not too high, and there are strong economies of scale in manufacturing, a large geographic area can be served from this single location. This, in turn, attracts suppliers to the industry. A labor market is likely to develop that begins to act like a magnate for “like” industries requiring similar skills. This colocation of “like” industries can lead to technological interdependencies, which further encourage clustering. Clustering, therefore, is the natural outcome of economic forces. A good example is provided by the semiconductor industry. Together, American and Asian firms supply most of the world’s needs. The industry is capital intensive, research and development costs are high, the manufacturing process is highly complex, but transportation costs are minimal. Technology interdependencies encourage colocation with suppliers, whereas cost and learning curve effects point to scale efficiencies. Clustering, therefore, is mutually advantageous.

Only when transportation costs are prohibitive or scale economies are difficult to realize—that is, when there are disincentives to clustering—do more decentralized patterns of industry location define the natural order. The appliance industry illustrates this. Companies such as GE and Whirlpool have globalized their operations in many respects, but the fundamental economics of the industry make clustering unattractive. The production of certain value-added components, such as compressors or electronic parts, can be concentrated to some extent, but the bulky nature of the product and high transportation costs make further concentration economically unattractive. What is more, advances in flexible manufacturing techniques are reducing the minimum scale needed for efficient production. This allows producers to more finely tailor their product offerings to local tastes and preferences, further thwarting the globalization of the industry.

Thus, classical economic theory tells us why clustering occurs. However, it does not fully explain why *particular* regions attract certain global industries. Porter addressed this issue using a framework he calls a “national diamond.”Porter (1990). It has six components: *factor conditions, home-country demand, related and supporting industries, competitiveness of the home industry, public policy,* and *chance.*

Factor Conditions

The explanation why *particular* regions attract *particular* industries begins with the degree to which a country or region’s endowments match the characteristics and requirements of an industry. Such factor conditions include natural (climate, minerals) as well as created (skill levels, capital, infrastructure) endowments. But to the extent that such factors are mobile, or can be imitated by other countries or regions, factor conditions alone do not fully explain regional dominance. In fact, the opposite is true. When a particular industry is highly profitable and barriers to entry are low, the forces of imitation and diffusion cause such an industry to spread across international borders. (Oster (1994)). The Japanese compete in a number of industries that originated in the United States; Korean firms imitate Japanese strategies; and Central European nations are conquering industries that were founded in Western Europe. Industries that depend on such mobile factors as capital are particularly susceptible.

Home-Country Demand

Porter’s second factor is the nature and size of the demand in the home country. Large home markets act as a stimulus for industry development. And when a large home market develops before it takes hold elsewhere in the world, experienced firms have ample incentives to look for business abroad when saturation at home begins to set in. The motorcycle industry in Japan, for example, used its scale advantage to create a global presence following an early start at home. (Oster (1994)). Porter found that it is not just the *location* of early demand but its *composition* that matters. A product’s fundamental or core design nearly always reflects home-market needs. As such, the nature of the home-market needs and the sophistication of the home-market buyer are important determinants of the potential of the industry to stake out a future global position. It was helpful to the U.S. semiconductor industry, for example, that the government was an early, sophisticated, and relatively cost-insensitive buyer of chips. These conditions encouraged the industry to develop new technologies and provided early opportunities to manufacture on a substantial scale.

Related and Supporting Industries

The presence of related and supporting industries is the third element of Porter's framework. This is similar to our earlier observation about clustering. For example, Hollywood is more than just a cluster of moviemakers—it encompasses a host of suppliers and service providers, and it has shaped the labor market in the Los Angeles area.

Competitiveness of the Home Industry

Firm strategies, the structure, and the rivalry in the home industry define the fourth element of the "national diamond" model. In essence, this element summarizes the "five forces" competitive framework described earlier. The more vigorous the domestic competition is, the more successful firms are likely to compete on a global scale. There is plenty of evidence for this assertion. The fierce rivalry that exists among German pharmaceutical companies has made them a formidable force in the global market. And the intense battle for domestic market share has strengthened the competitive position of Japanese automobile manufacturers abroad.

Public Policy and Chance

The two final components of Porter's model are public policy and chance. There can be no doubt that government policy can—through infrastructure, incentives, subsidies, or temporary protection—nurture global industries. Whether such policies are always effective is less clear. Picking "winners" in the global marketplace has never been the strong suit of governments. The chance element allows for the influence of random events such as where and when fundamental scientific breakthroughs occur, the presence of entrepreneurial initiative, and sheer luck. For example, the early U.S. domination of the photography industry is as much attributable to the fact that George Eastman (of Eastman Kodak) and Edwin Land (of Polaroid) were born here than to any other factor.

5.4: Globalization and Industry Structure

Yoffie suggests 5 propositions that help explain how the structure of an industry can evolve depending on, among other factors, the dynamics that shape competition in the industry and the role governments play in stimulating or obstructing the globalization process. (Yoffie (1993), chaps. 1 and 10. The reader is encouraged to consult this excellent book for further details).

Proposition 1 is that when industries are relatively fragmented and competitive, national environments (factors of production, domestic market and domestic demand, and so forth) will largely shape the international advantage of domestically headquartered firms and the patterns of trade. A correlate to this proposition is that in emerging industries, country advantages also play a dominant role in determining global competitive advantage.

In other words, in fragmented industries relative cost is a key determinant of global success, and since countries differ in terms of their factor costs, as long as entry barriers remain low, production will gravitate to the lowest cost, highest efficiency manufacturing location. Another way of saying this is that the presence of multinational firms, by itself, should not influence the pattern of international trade in globally competitive, fragmented industries; other things being equal, country factors determine the location of production and the direction of exports. Oligopolistic global industry structures define a very different strategic context, as the next proposition illustrates.

Proposition 2 stipulates that if an industry becomes globally concentrated with high barriers to entry, then location, activity concentration, export, and other strategic decisions by multinational companies are determined to a greater extent by the nature of the global oligopolistic rivalry. Thus, while in concentrated industries country characteristics remain important, the dynamics of the global, oligopolistic competitive climate become the principal drivers of global strategy. This is intuitive. In global oligopolies, more so than in fragmented market structures, the success of one firm is directly affected by that of a few, immediate competitors. Entry into the industry is often restricted in some way—by factors such as economies of scale or scope, high levels of capital investment, and the like, or by restrictions imposed by governments. Furthermore, in many global oligopolies, participating firms earn above-average returns, which may make the difference in cost between producing locally and exporting a less critical determinant of strategy. Opportunities to cross-subsidize businesses and geographies further reduce the importance of geography in production or export decisions. As a consequence, the moves and countermoves of direct, global competitors heavily influence company strategies. For example, it is quite common for companies to enter some other firm's home market, not just because that market is likely to generate additional profits but mainly to weaken its global competitive position. This line of reasoning directly leads to a third proposition, which relates organizational and strategic attributes of global competitors to global strategic choice.

Proposition 3 suggests that in global oligopolies, specific firm characteristics—the structure of ownership, strategies employed, and organizational factors, to name a few—directly affect strategic posture, the pattern of trade, and, sometimes, the competitiveness of nations. In global oligopolies with a relatively small number of competitors, issues such as *who* owns the resources necessary for creating value and *who* sets the global priorities take on a greater strategic significance. Executives from different cultures approach strategy differently—state-owned enterprises are often more motivated by public policy considerations, employment, and other nonprofit concerns. These differences can have a direct impact on the relative attractiveness of global strategy options. The influence of governments in global markets is captured further in the fourth proposition.

Proposition 4 suggests that extensive government intervention in global oligopolistic industries can alter the relative balance between firms of different countries—even in fragmented industries, it can alter the direction of trade and affect major corporate trade decisions. The degree and influence of government intervention varies from industry to industry. Whereas in fragmented industries the influence of governments is naturally somewhat limited by market conditions, government intervention can have a pronounced influence in industries with significant economies of scale effects or other market imperfections. For example, governments can protect "infant" industries with such characteristics. While a case can be made for the temporary protection of strategically important industries, in reality, such protection is rarely temporary. This can create a global strategic environment in which anticipating and capitalizing on the actions of governments become the driving forces of global strategy.

Proposition 5 suggests that in industries where firms make long-term commitments, corporate adjustments and patterns of trade tend to be "sticky." This fifth and final proposition addresses the issue of corporate inertia. Although the global competitive climate changes every day, choices made by multinational companies and governments tend to have an enduring impact on the industry environment. This proposition has at least two implications. First, the study of how industries evolve globally and what decisions different competitors made and how they made them is relevant to understanding what drives strategy in a particular global context. Second, the commitments already made by industry participants and governments may spell opportunity or impose constraints for years to come.

These 5 propositions define 2 important dimensions for classifying globalizing industries according to the nature of the strategic challenge they represent: *the degree of global concentration and the extent to which governments intervene.* In industries with a relatively low degree of concentration and little government intervention, the classical economic laws of *comparative advantage* are the primary drivers of international competition. Here, factor costs are a primary determinant of global competitiveness. It would seem natural, therefore, to focus on a global strategy aimed at minimizing costs. But this can be extremely difficult in a fast-changing world. Comparative country costs change continuously. In cars, semiconductors, and computers, among other industries, the comparative (cost) advantage has shifted a number of times since World War II from the United States to Japan to East Asia to Southeast Asia. What is more, there is good reason to believe it will shift again, perhaps to Africa or Latin America. And, with new technological breakthroughs, Western nations may once again become the low-cost production centers. So what should companies do? While companies should definitely take advantage of opportunities to minimize costs, especially in their initial investments, Yoffie suggests that long-term global strategic choices should emphasize *commitments to countries that are likely to act as the best platforms over time for a broad array of activities*. (Yoffie (1993), 432).

In globally concentrated industries where the role of governments is limited, characterized by *oligopolistic competition*, company strategies are often heavily influenced by the moves and countermoves of direct competitors. Strategies such as making significant investments in competitors' markets, regardless of their short- or medium-run profitability—which would not work in highly competitive markets—can only be explained in terms of a strategic posture aimed at maintaining a long-term global competitive balance between the various participants. Caterpillar invested heavily in Japan while Komatsu and European construction equipment manufacturing moved into the United States at a time when such moves offered limited immediate returns. In this kind of competitive environment, the potential for overglobalization—the globalization of different aspects of strategy well in advance of proven benefits—exists as the relatively small number of competitors and high barriers to entry encourage "follow-the-leader" competitive behavior. On the other hand, not responding directly to major competitors can be equally dangerous. Komatsu's challenge to Caterpillar, in part, was made possible because, early on, Caterpillar focused its strategy on keeping John Deere, International Harvester, and Dresser Industries at bay rather than on beating Komatsu. This suggests a number of strategic implications. First, while imitation cannot be the sole basis for developing strategy, in oligopolies, it may be necessary, at times, to match a competitor in order to reduce the risk of competitive disadvantage. A related implication is that in global oligopolies, companies cannot allow their competitors to have uncontested home markets in which profit sanctuaries can be used to subsidize global competitive moves. This explains Kodak's extraordinary efforts to pry open the Japanese market—it knew Fuji would be at a considerable advantage if it remained dominant in Japan. Finally, the use of alliances can make such global moves more affordable, flexible, and effective. Alliances can be powerful vehicles for rapidly entering new countries, acquiring new technologies, or otherwise supporting a global strategy at a relatively low cost. (Yoffie (1993), 433, 434).

Dealing effectively with governments is a prerequisite for global success in oligopolistic industries such as telecommunications, where extensive government intervention creates a global competitive climate known as regulated competition. Here, nonmarket dimensions of global strategy may well be as important as market dimensions. Political involvement may be necessary to create, preserve, or enhance global competitive advantage since government regulations—whether in infant or established industries—are critical to success. As a consequence, strategy in global, regulated industries should be focused as much on shaping the global competitive environment as on capitalizing on the opportunities it offers.

Political competition, characteristic of fragmented industries with significant government intervention, also calls for a judicious mix of market and nonmarket-based strategic thinking. In contrast to regulated competition, in which government policy has a direct impact on individual companies, however, government intervention in political competition often pits one country or region of the world against another. This encourages a whole range of cooperative strategies between similarly affected players and strategic action at the country-industry level.

Finally, it is worth remembering that patterns of competition are not static. Industries evolve continuously, sometimes dramatically. Similarly, the focus of government action in different industries can change as national priorities change and the global competitive environment evolves.

5.5: Points to Remember

1. Industries and companies tend to globalize in stages, and at each stage, there are different opportunities for, and challenges associated with, creating value.
2. Simple characterizations such as "the electronics industry is global" are not particularly useful. A better question is *how* global an industry is or is likely to become; *industry globalization is a matter of degree*.
3. A distinction must be made between *industry globalization, global competition*, and the degree to which a *company has globalized* its operations. Porter explains industry clustering using a framework he calls a "national diamond." It has six components: *factor conditions, home country demand, related and supporting industries, competitiveness of the home industry, public policy,* and *chance*.
4. Yip identifies four sets of "industry globalization drivers"—underlying conditions in each industry that create the potential for that industry to become more global and, as a consequence, for the potential viability of a global approach to strategy. These drivers are *market drivers, cost drivers, competitive drivers,* and *government drivers*.
5. Yoffie offers five propositions that help explain how the structure of an industry can evolve depending on, among other factors, the dynamics that shape competition in the industry and the role governments play in stimulating or obstructing the globalization process. These propositions define two important dimensions for classifying globalizing industries according to the nature of the strategic challenge they represent: *the degree of global concentration* and *the extent to which governments intervene*.

5.6: Ghemawat's "AAA" Global Strategy Framework

Ghemawat so-called AAA framework offers three generic approaches to global value creation. Adaptation strategies seek to increase revenues and market share by tailoring one or more components of a company's business model to suit local requirements or preferences. *Aggregation* strategies focus on achieving economies of scale or scope by creating regional or global efficiencies; they typically involve standardizing a significant portion of the value proposition and grouping together development and production processes. *Arbitrage* is about exploiting economic or other differences between national or regional markets, usually by locating separate parts of the supply chain in different places.

Adaptation

Adaptation—creating global value by changing one or more elements of a company's offer to meet local requirements or preferences—is probably the most widely used global strategy. The reason for this will be readily apparent: some degree of adaptation is essential or unavoidable for virtually all products in all parts of the world. The taste of Coca-Cola in Europe is different from that in the United States, reflecting differences in water quality and the kind and amount of sugar added. The packaging of construction adhesive in the United States informs customers how many square feet it will cover; the same package in Europe must do so in square meters. Even commodities such as cement are not immune: its pricing in different geographies reflects local energy and transportation costs and what percentage is bought in bulk.

Ghemawat subdivides adaptation strategies into five categories: *variation*, *focus*, *externalization*, *design*, and *innovation* (Figure 5.6.1 "AAA Strategies and Their Variants").

Variation strategies not only involve making changes in *products and services* but also making adjustments to *policies*, *business positioning*, and even *expectations for success*. The *product* dimension will be obvious: Whirlpool, for example, offers smaller washers and dryers in Europe than in the United States, reflecting the space constraints prevalent in many European homes. The need to consider adapting *policies* is less obvious. An example is Google's dilemma in China to conform to local censorship rules. Changing a company's overall *positioning* in a country goes well beyond changing products or even policies. Initially, Coke did little more than "skim the cream" off big emerging markets such as India and China. To boost volume and market share, it had to reposition itself to a "lower margin–higher volume" strategy that involved lowering price points, reducing costs, and expanding distribution. Changing *expectations* for, say, the rate of return on investment in a country, while a company is trying to create a presence is also a prevalent form of variation.

Adaptation	Aggregation	Arbitrage
Variation		*Performance Enhancement*
Focus: Reduce Need for Adaptation	*Economies of Scale*	
Externalization: Reduce Burden of Adaptation		*Cost Reduction*
Design: Reduce Cost of Adaptation	*Economies of Scope*	
Innovation: Improve on Exixting Adaptation		*Risk Reduction*

Figure 5.6.1: AAA Strategies and Their Variants

A second type of adaptation strategies uses a focus on particular *products*, *geographies*, *vertical stages* of the value chain, or *market segments* as a way of reducing the impact of differences across regions. A *product* focus takes advantage of the fact that wide differences can exist *within* broad product categories in the degree of variation required to compete effectively in local markets. Ghemawat cites the example of television programs: action films need far less adaptation than local newscasts. Restriction of *geographic* scope can permit a focus on countries where relatively little adaptation of the domestic value proposition is required. A *vertical* focus strategy involves limiting a company's direct involvement to specific steps in the supply chain while outsourcing others. Finally, a *segment* focus involves targeting a more limited customer base. Rather than adapting a product or service, a company using this strategy chooses to accept the reality that without modification, their products will appeal to a smaller market segment or different distributor network from those in the domestic market. Many luxury good manufacturers use this approach.

Whereas focus strategies overcome regional differences by narrowing scope, externalization strategies transfer—through *strategic alliances, franchising, user adaptation*, or *networking*—responsibility for specific parts of a company's business model to partner companies to accommodate local requirements, lower cost, or reduce risk. For example, Eli Lilly extensively uses *strategic alliances* abroad for drug development and testing. McDonald's growth strategy abroad uses *franchising* as well as company-owned stores. And software companies heavily depend on both *user adaptation and networking* for the development of applications for their basic software platforms.

A fourth type of adaptation focuses on design to reduce the cost of, rather than the need for, variation. Manufacturing costs can often be achieved by introducing design *flexibility* so as to overcome supply differences. Introducing standard production *platforms* and *modularity* in components also helps to reduce cost. A good example of a company focused on design is Tata Motors, which has successfully introduced a car in India that is affordable to a significant number of citizens.

A fifth approach to adaptation is innovation, which, given its crosscutting effects, can be characterized as improving the effectiveness of adaptation efforts. For instance, IKEA's flat-pack design, which has reduced the impact of geographic distance by cutting transportation costs, has helped that retailer expand into 3 dozen countries.

Minicase: McDonald's McAloo Tikki (Mucha and Scheffler (2007, April 30))

When Ray Kroc opened his first McDonald's in Des Plaines, Illinois, he could hardly have envisioned the golden arches rising 5 decades later in one of the oldest commercial streets in the world. But McDonald's began dreaming of India in 1991, a year after opening its first restaurant in China. The attraction was obvious: 1.1 billion people, with 300 million destined for middle-class status.

But how do you sell hamburgers in a land where cows are sacred and 1 in 5 people are vegetarian? And how do you serve a largely poor consumer market that stretches from the Himalayas to the shores of the Indian Ocean? McDonald's executives in Oak Brook struggled for years with these questions before finding the road to success.

McDonald's has made big gains since the debut of its first two restaurants in India, in Delhi and Mumbai, in October 1996. Since then, the fast-food chain has grown to more than 160 outlets. The Indian market represents a small fraction of McDonald's $24 billion in annual revenues. But it is not insignificant because the company is increasingly focused on high-growth markets. "The decision to go in wasn't complicated," James Skinner, McDonald's chief executive officer, once said. "The complicated part was deciding what to sell."

At first, McDonald's path into India was fraught with missteps. First, there was the nonbeef burger made with mutton. But the science was off: mutton is 5% fat (beef is 25% fat), making it rubbery and dry. Then there was the french fry debacle. McDonald's started off using potatoes grown in India, but the local variety had too much water content, making the fries soggy. Chicken kabob burgers? Sounds like a winner except that they were skewered by consumers. Salad sandwiches were another flop: Indians prefer cooked foods.

If that was not enough, in May 2001, the company was picketed by protesters after reports surfaced in the United States that the chain's fries were injected with beef extracts to boost flavor—a serious infraction for vegetarians. McDonald's executives in India denied the charges, claiming their fries were different from those sold in America.

But the company persevered, learned, and succeeded. It figured out what Indians wanted to eat and what they would pay for it. It built, from scratch, a mammoth supply chain—from farms to factories—in a country where elephants, goats, and trucks share the same roads. To deal with India's massive geography, the company divided the country into two regions: the north and east, and the south and west. Then it formed 50-50 joint ventures with two well-connected Indian entrepreneurs: Vikram Bakshi, who made his fortune in real estate, runs the northern region; and Amit Jatia, an entrepreneur who comes from a family of successful industrialists, manages the south.

Even though neither had any restaurant experience, this joint-venture management structure gave the company what it needed: local faces at the top. The two entrepreneurs also brought money: before the first restaurant opened, the partners invested $10 million into building a workable supply chain, establishing distribution centers, procuring refrigerated trucks, and finding production facilities with adequate hygiene. They also invested $15 million in Vista Processed Foods, a food processing plant outside Mumbai. In addition, Mr. Jatia, Mr. Bakshi, and 38 staff members spent an entire year in the Indonesian capital of Jakarta studying how McDonald's operated in another Asian country.

Next, the Indian executives embarked on basic-menu research and development (R&D). After awhile, they hit on a veggie burger with a name Indians could understand: the McAloo Tikki (an "aloo tikki" is a cheap potato cake locals buy from roadside vendors).

The lesson in the McDonald's India case: local input matters. Today, 70% of the menu is designed to suit Indians: the Paneer Salsa Wrap, the Chicken Maharaja Mac, the Veg McCurry Pan. The McAloo, by far the best-selling product, also is being shipped to McDonald's in the Middle East, where potato dishes are popular. And in India, it does double duty: it not only appeals to the masses; it is also a hit with the country's 200 million vegetarians.

Another lesson learned from the McDonald's case: vegetarian items should not come into contact with nonvegetarian products or ingredients. Walk into any Indian McDonald's and you will find half of the employees wearing green aprons and the other half in red. Those in green handle vegetarian orders. The red-clad ones serve nonvegetarians. It is a separation that extends throughout the restaurant and its supply chain. Each restaurant's grills, refrigerators, and storage areas are designated as "veg" or "non-veg." At the Vista Processed Foods plant, at every turn, managers stressed the "non-veg" side was in one part of the facility, and the "vegetarian only" section was in another.

Today, after many missteps, one can truly imagine the ghost of Ray Kroc asking Indians one of the greatest questions of all time—the one that translates into so many cultures: "You want fries with that?" Yes, Ray, they do.

Aggregation

Aggregation is about creating *economies of scale* or *scope* as a way of dealing with differences (see Figure 5.6.1 "AAA Strategies and Their Variants"). The objective is to exploit similarities among geographies rather than adapting to differences but stopping short of complete standardization, which would destroy concurrent adaptation approaches. The key is to identify ways of introducing economies of scale and scope into the global business model without compromising local responsiveness.

Adopting a *regional* approach to globalizing the business model—as Toyota has so effectively done—is probably the most widely used aggregation strategy. As discussed in the previous chapter, *regionalization* or *semiglobalization* applies to many aspects of globalization, from investment and communication patterns to trade. And even when companies do have a significant presence in more than one region, competitive interactions are often regionally focused.

Examples of different *geographic* aggregation approaches are not hard to find. Xerox centralized its purchasing, first regionally, later globally, to create a substantial cost advantage. Dutch electronics giant Philips created a global competitive advantage for its Norelco shaver product line by centralizing global production in a few strategically located plants. And the increased use of global (corporate) branding over product branding is a powerful example of creating economies of scale and scope. As these examples show, geographic aggregation strategies have potential application to every major business model component.

Geographic aggregation is not the only avenue for generating economies of scale or scope. The other, nongeographic dimensions of the CAGE framework introduced in Chapter 1—*cultural, administrative, geographic,* and *economic*—also lend themselves to aggregation strategies. Major book publishers, for example, publish their best sellers in but a few languages, counting on the fact that readers are willing to accept a book in their second language (*cultural* aggregation). Pharmaceutical companies seeking to market new drugs in Europe must satisfy the regulatory requirements of a few selected countries to qualify for a license to distribute throughout the EU (*administrative* aggregation). As for *economic* aggregation, the most obvious examples are provided by companies that distinguish between developed and emerging markets and, at the extreme, focus on just one or the other.

Minicase: Globalization at Whirlpool Corporation

The history of globalization at the Whirlpool Corporation—a leading company in the $100-billion global home-appliance industry—illustrates the multitude of challenges associated with globalizing a business model. Whirlpool manufactures appliances across all major categories—including fabric care, cooking, refrigeration, dishwashing, countertop appliances, garage organization, and water filtration—and has a market presence in every major country in the world. It markets some of the world's most recognized appliance brands, including Whirlpool, Maytag, KitchenAid, Jenn-Air, Amana, Bauknecht, Brastemp, and Consul. Of these, the Whirlpool brand is the world's top-rated global appliance brand and ranks among the world's most valuable brands. In 2008, Whirlpool realized annual sales of approximately $19 billion, had 70,000 employees, and maintained 67 manufacturing and technology research centers around the world. (www.whirlpoolcorp.com/about/history.aspx)

> In the late 1980s, Whirlpool Corporation set out on a course of growth that would eventually transform the company into the leading global manufacturer of major home appliances, with operations based in every region of the world. At the time, Dave Whitwam, Whirlpool's chairman and CEO, had recognized the need to look for growth beyond the mature and highly competitive U.S. market. Under Mr. Whitwam's leadership, Whirlpool began a series of acquisitions that would give the company the scale and resources to participate in global markets. In the process, Whirlpool would establish new relationships with millions of customers in countries and cultures far removed from the U.S. market and the company's roots in rural Benton Harbor, Michigan.
>
> Whirlpool's global initiative focused on establishing or expanding its presence in North America, Latin America, Europe, and Asia. In 1989, Whirlpool acquired the appliance business of Philips Electronics N.V., which immediately gave the company a solid European operations base. In the western hemisphere, Whirlpool expanded its longtime involvement in the Latin America market and established a presence in Mexico as an appliance joint-venture partner. By the mid-1990s, Whirlpool had strengthened its position in Latin America and Europe and was building a solid manufacturing and marketing base in Asia.
>
> In 2006, Whirlpool acquired Maytag Corporation, resulting in an aligned organization able to offer more to consumers in the increasingly competitive global marketplace. The transaction created additional economies of scale. At the same time, it expanded Whirlpool's portfolio of innovative, high-quality branded products and services to consumers.
>
> Executives knew that the company's new scale, or global platform, that emerged from the acquisitions offered a significant competitive advantage, but only if the individual operations and resources were working in concert with each other. In other words, the challenge is not in buying the individual businesses—the real challenge is to effectively integrate all the businesses together in a meaningful way that creates the leverage and competitive advantage.
>
> Some of the advantages were easily identified. By linking the regional organizations through Whirlpool's common systems and global processes, the company could speed product development, make purchasing increasingly more efficient and cost-effective, and improve manufacturing utilization through the use of common platforms and cross-regional exports.
>
> Whirlpool successfully refocused a number of its key functions to its global approach. Procurement was the first function to go global, followed by technology and product development. The two functions shared much in common and have already led to significant savings from efficiencies. More important, the global focus has helped reduce the number of regional manufacturing platforms worldwide. The work of these two functions, combined with the company's manufacturing footprints in each region, has led to the development of truly global platforms—products that share common parts and technologies but offer unique and innovative features and designs that appeal to regional consumer preferences.
>
> Global branding was next. Today, Whirlpool's portfolio ranges from global brands to regional and country-specific brands of appliances. In North America, key brands include Whirlpool, KitchenAid, Roper by Whirlpool Corporation, and Estate. Acquired with the company's 2002 purchase of Vitromatic S.A., brands Acros and Supermatic are leading names in Mexico's domestic market. In addition, Whirlpool is a major supplier for the Sears, Roebuck and Co. Kenmore brand. In Europe, the company's key brands are Whirlpool and Bauknecht. Polar, the latest addition to Europe's portfolio, is the leading brand in Poland. In Latin America, the brands include Brastemp and Consul. Whirlpool's Latin American operations include Embraco, the world's leading compressor manufacturer. In Asia, Whirlpool is the company's primary brand and the top-rated refrigerator and washer manufacturer in India.

Arbitrage

A third generic strategy for creating a global advantage is arbitrage (see Figure 3.1). Arbitrage is a way of exploiting differences, rather than adapting to them or bridging them, and defines the original global strategy: buy low in one market and sell high in another. Outsourcing and offshoring are modern day equivalents. Wal-Mart saves billions of dollars a year by buying goods from China. Less visible but equally important absolute economies are created by greater differentiation with customers and partners, improved corporate bargaining power with suppliers or local authorities, reduced supply chain and other market and nonmarket risks, and through the local creation and sharing of knowledge.

Since arbitrage focuses on exploiting differences between regions, the CAGE framework described in Chapter 1 is of particular relevance and helps define a set of substrategies for this generic approach to global value creation.

Favorable effects related to country or place of origin have long supplied a basis for cultural arbitrage. For example, an association with French culture has long been an international success factor for fashion items, perfumes, wines, and foods. Similarly, fast-food products and drive-through restaurants are mainly associated with U.S. culture. Another example of cultural arbitrage—real or perceived—is provided by Benihana of Tokyo, the "Japanese steakhouse." Although heavily American—the company has only one outlet in Japan out of more than 100 worldwide—it serves up a theatrical version of teppanyaki cooking that the company describes as "Japanese" and "eatertainment."

Legal, institutional, and political differences between countries or regions create opportunities for administrative arbitrage. Ghemawat cites the actions taken by Rupert Murdoch's News Corporation in the 1990s. By placing its U.S. acquisitions into holding companies in the Cayman Islands, the company could deduct interest payments on the debt used to finance the deals against the profits generated by its newspaper operations in Britain. Through this and other similar actions, it successfully lowered its tax liabilities to an average rate of less than 10%, rather than the statutory 30% to 36% of the three main countries in which it operated: Britain, the United States, and Australia. By comparison, major competitors such as Disney were paying close to the official rates. (Ghemawat (2007a), chap. 6).

With steep drops in transportation and communication costs in the last 25 years, the scope for geographic arbitrage—the leveraging of geographic differences—has been diminished but not fully eliminated. Consider what is happening in medicine, for example. It is quite common today for doctors in the United States to take X-rays during the day, send them electronically to radiologists in India for interpretation overnight, and for the report to be available the next morning in the United States. In fact, reduced transportation costs sometimes create new opportunities for geographic arbitrage. Every day, for instance, at the international flower market in Aalsmeer, the Netherlands, more than 20 million flowers and 2 million plants are auctioned off and flown to customers in the United States.

As Ghemawat notes, in a sense, all arbitrage strategies that add value are "economic." Here, the term economic arbitrage is used to describe strategies that do not directly exploit *cultural, administrative*, or *geographic differences*. Rather, they are focused on leveraging differences in the costs of labor and capital, as well as variations in more industry-specific inputs (such as knowledge) or in the availability of complementary products. (Ghemawat (2007a), chap. 6).

Exploiting differences in labor costs—through outsourcing and offshoring—is probably the most common form of economic arbitrage. This strategy is widely used in labor-intensive (garments) as well as high-technology (flat-screen TV) industries. Economic arbitrage is not limited to leveraging differences in labor costs alone, however. Capital cost differentials can be an equally rich source of opportunity.

Minicase: Indian Companies Investing in Latin America? To Serve U.S. Customers? (Dickerson (2007, June 9))

Indian investment in Latin America is relatively small but growing quickly. Indian firms have invested about $7 billion in the region over the last decade, according to figures released by the Latin American division of India's Ministry of External Affairs in New Delhi. The report projects that this amount will easily double in the next few years.

As India has become a magnet for foreign investment, Indian companies themselves are looking abroad for opportunities, motivated by declining global trade barriers and fierce competition at home. Their current focus is on Latin America, where hyperinflation and currency devaluation no longer dominate headlines.

Like China, India is trying to lock up supplies of energy and minerals to feed its rapidly growing economy. Indian firms have stakes in oil and natural gas ventures in Colombia, Venezuela, and Cuba. In 2006, Bolivia signed a deal with New Delhi-based Jindal Steel and Power, Ltd., which plans to invest $2.3 billion to extract iron ore and to build a steel mill in that South American nation.

At the same time, Indian information technology companies are setting up outsourcing facilities to be closer to their customers in the West. Tata Consultancy Services is the leader, employing 5,000 tech workers in more than a dozen Latin American countries.

Indian manufacturing firms, accustomed to catering to low-income consumers at home, are finding Latin America a natural market. Mumbai-based Tata Motors, Ltd., has formed a joint venture with Italy's Fiat to produce small pickup trucks in Argentina. Generic drug makers, such as Dr. Reddy's, are offering low-cost alternatives in a region where U.S. and European multinationals have long dominated.

The Indian government has carefully positioned India as a partner, rather than a rival out to steal the region's resources and jobs, a common worry about China. Mexico has been particularly hard-hit by China's rise. The Asian nation's export of textiles, shoes, electronics, and other consumer goods has cost Mexico tens of thousands of manufacturing jobs, displaced it as the second-largest trading partner with the United States, and flooded its domestic market with imported merchandise. In 2006, Mexico’s trade deficit with China was a record $22.7 billion, but China has invested less than $100 million in the country since 1994, according to the Bank of Mexico.

Mexico’s trading relationship with India, albeit small, is much more balanced. Mexico’s trade deficit with India was just under half a billion dollars in 2006, and Indian companies have invested $1.6 billion here since 1994—or about 17 times more than China—according to Mexico’s central bank.

Some of that investment is in basic industries and traditional *maquiladora* factories making goods for export. For example, Mexico’s biggest steel plant is owned by ArcelorMittal. Indian pharmaceutical companies, too, are finding Latin America to be attractive for expansion. Firms including Ranbaxy Laboratories, Ltd., Aurobindo Pharma, Ltd., and Cadila Pharmaceuticals, Ltd., have sales or manufacturing operations in the region.

5.7: Which “A” Strategy Should a Company Use?

A company’s financial statements can be a useful guide for signaling which of the “A” strategies will have the greatest potential to create global value. Firms that heavily rely on branding and that do a lot of advertising, such as food companies, often need to engage in considerable adaptation to local markets. Those that do a lot of R&D—think pharmaceutical firms—may want to aggregate to improve economies of scale, since many R&D outlays are fixed costs. For firms whose operations are labor intensive, such as apparel manufacturers, arbitrage will be of particular concern because labor costs vary greatly from country to country.

Which “A” strategy a company emphasizes also depends on its globalization history. Companies that start on the path of globalization on the supply side of their business model, that is, that seek to lower cost or to access new knowledge, first typically focus on aggregation and arbitrage approaches to creating global value, whereas companies that start their globalization history by taking their value propositions to foreign markets are immediately faced with adaptation challenges. Regardless of their starting point, most companies will need to consider all “A” strategies at different points in their global evolution, sequentially or, sometimes, simultaneously.

Nestlé’s globalization path, for example, started with the company making small, related acquisitions outside its domestic market, and the company therefore had early exposure to adaptation challenges. For most of their history, IBM also pursued an adaptation strategy, serving overseas markets by setting up a mini-IBM in each target country. Every one of these companies operated a largely local business model that allowed it to adapt to local differences as necessary. Inevitably, in the 1980s and 1990s, dissatisfaction with the extent to which country-by-country adaptation curtailed opportunities to gain international scale economies led to the overlay of a regional structure on the mini-IBMs. IBM aggregated the countries into regions in order to improve coordination and thus generate more scale economies at the regional and global levels. More recently, however, IBM has also begun to exploit differences across countries (arbitrage). For example, it has increased its work force in India while reducing its headcount in the United States.

Procter & Gamble’s (P&G) early history parallels that of IBM, with the establishment of mini-P&Gs in local markets, but it has evolved differently. Today, the company’s global business units now sell through market development organizations that are aggregated up to the regional level. P&G has successfully evolved into a company that uses all three “A” strategies in a coordinated manner. It adapts its value proposition to important markets but ultimately competes—through global branding, R&D, and sourcing—on the basis of aggregation. Arbitrage, while important—mostly through outsourcing activities that are invisible to the final consumer—is less important to P&G’s global competitive advantage because of its relentless customer focus.

5.8: From A to AA to AAA

Although most companies will focus on just one "A" at any given time, leading-edge companies—such as General Electric (GE), P&G, IBM, and Nestlé, to name a few—have embarked on implementing two, or even all three of the "A"s. Doing so presents special challenges because there are inherent tensions between all three foci. As a result, the pursuit of "AA" strategies, or even an "AAA" approach, requires considerable organizational and managerial flexibility.This discussion draws on Ghemawat (2007b), Chapter 7.

Pursuing Adaptation and Aggregation

P&G started out with a focus on adaptation. Attempts to superimpose aggregation across Europe first proved difficult and, in particular, led to the installation of a matrix structure throughout the 1980s, but the matrix proved unwieldy. So, in 1999, the then CEO, Durk Jager, announced another reorganization whereby global business units (GBUs) retained ultimate profit responsibility but were complemented by geographic market development organizations (MDOs) that actually managed the sales force as a shared resource across GBUs. The result was disastrous. Conflicts arose everywhere, especially at the key GBU-MDO interfaces. The upshot: Jager departed after less than a year in office.

Under his successor, A. G. Lafley, P&G has enjoyed much more success, with an approach that strikes a better balance between adaptation and aggregation and that makes allowances for differences across general business units and markets. For example, the pharmaceuticals division, with distinct distribution channels, has been left out of the MDO structure. Another example: in emerging markets, where market development challenges are huge, profit responsibility continues to rest with country managers.

Aggregation and Arbitrage

VIZIO, founded in 2002 with only $600,000 in capital by entrepreneur William Wang to create high quality, flat panel televisions at affordable prices, has surpassed established industry giants Sony Corporation and Samsung Electronics Company to become the top flat-panel high definition television (HDTV) brand sold in North America. To get there, VIZIO developed a business model that effectively combines elements of aggregation and arbitrage strategies. VIZIO's contract manufacturing model is based on aggressive procurement sourcing, supply-chain management, economies of scale in distribution.

While a typical flat-screen television includes thousands of parts, the bulk of the costs and ultimate performance are a function of two key components: the panel and the chipset. Together, these two main parts account for about 94% of the costs. VIZIO's business model therefore focuses on optimizing the cost structure for these component parts. The vast majority of VIZIO's panels and chipsets are supplied by a handful of partners. Amtran provides about 80% of VIZIO's procurement and assembly work, with the remaining 20% performed by other ODMs, including Foxconn and TPV Technology.

One of the cornerstones of VIZIO's strategy is the decision to sell through wholesale clubs and discount retailers. Initially, William Wang was able to leverage his relationships at Costco from his years of selling computer monitors. VIZIO's early focus on wholesale stores also fit with the company's value position and pricing strategy. By selling through wholesale clubs and discount stores, VIZIO was able to keeps its prices low. For VIZIO, there is a two-way benefit: the prices of its TVs are comparatively lower than those from major manufacturers at electronics stores, and major manufacturers cannot participate as fully as they would like to at places like Costco.

VIZIO has strong relationships with its retail partners and is honored to offer them only the most compelling and competitively priced consumer electronics products. VIZIO products are available at valued partners including Wal-Mart, Costco, Sam's Club, BJ's Wholesale Club, Sears, Dell, and Target stores nationwide along with authorized online partners. VIZIO has won numerous awards including a number-one ranking in the Inc. 500 for "Top Companies in Computers and Electronics," *Good Housekeeping's* "Best Big-Screens," *CNET's* "Top 10 Holiday Gifts," and *PC World's* "Best Buy," among others. http://www.vizio.com/

Arbitrage and Adaptation

An example of a strategy that simultaneously emphasizes arbitrage and adaptation is investing heavily in a local presence in a key market to the point where a company can pass itself off as a "local" firm or "insider." A good example is provided by Citibank in China. The company, part of Citigroup, has had an intermittent presence in China since the beginning of the 20th century. A little more than 100 years later, in 2007, it was one of the first foreign banks to incorporate locally in China. The decision to incorporate locally was motivated by the desire to increase Citibank's status as an "insider"; with local incorporation, the Chinese government allowed it to extend its reach, expand its product offerings, and become more closely engaged with its local customers in the country.

China's decision in 2001 to become a member of the World Trade Organization (WTO) was a major factor in Citibank's decision to make a greater commitment to the Chinese market. Prior to China' joining the WTO, the banking environment in China was fairly restrictive. Banks such as Citibank could only give loans to foreign multinationals and their joint-venture partners in local currency, and money for domestic Chinese companies could only be raised in offshore markets. These restrictions made it difficult for foreign banks to gain a foothold in the Chinese business community.

Once China agreed to abide by WTO trading rules, however, banks such as Citibank had significantly greater opportunities: they would be able to provide local currency loans to blue-chip Chinese companies and would be free to raise funds for them in debt and equity markets within China. Other segments targeted by Citibank included retail credit cards and home mortgages. These were Citibank's traditional areas of expertise globally, and a huge potential demand for these products was apparent.

Significant challenges remained, however. Competing through organic growth with China's vast network of low-cost domestic banks would be slow and difficult. Instead, in the next few years, it forged a number of strategic alliances designed to give it critical mass in key segments. The first consisted of taking a 5% stake in China's ninth-largest bank, SPDB, a move that allowed Citibank to launch a dual-currency credit card that could be used to pay in *renminbi* in China and in foreign currencies abroad. In the following years, Citibank steadily increased its stake to the maximum 20% allowed under Chinese law and significantly expanded its product portfolio.

In June 2007, Citibank joined forces with Sino-U.S. MetLife Insurance Company, Ltd., to launch an investment unit-linked insurance product. In July of 2008, the company announced the launch of its first debit card. Simultaneously, it signed a deal with China's only national bankcard association, which allowed Citibank's debit cardholders to enjoy access to the association's vast network in China. The card would provide Chinese customers with access to over 140,000 ATMs within China and 380,000 ATMs in 45 countries overseas. Customers could also use their debit cards with over 1 million merchants within China and in 27 other countries. Today, Citibank is one of the top foreign banks operating in China, with a diverse range of products, eight corporate and investment bank branches, and 25 consumer bank outlets.Citibank's Co-Operative Strategy in China (2009).

Developing an AAA Strategy

There are serious constraints on the ability of any one company to use all three "A"s simultaneously with great effectiveness. Such attempts stretch a firm's managerial bandwidth, force a company to operate with multiple corporate cultures, and can present competitors with opportunities to undercut a company's overall competitiveness. Thus, to even contemplate an "AAA" strategy, a company must be operating in an environment in which the tensions among adaptation, aggregation, and arbitrage are weak or can be overridden by large-scale economies or structural advantages, or in which competitors are otherwise constrained. Ghemawat cites the case of GE Healthcare (GEH). The diagnostic imaging industry has been growing rapidly and has concentrated globally in the hands of three large firms, which together command an estimated 75% of revenues in the business worldwide: GEH, with 30%; Siemens Medical Solutions (SMS), with 25%; and Philips Medical Systems (PMS), with 20%. This high degree of concentration is probably related to the fact that the industry ranks in the 90th percentile in terms of R&D intensity.

These statistics suggest that the aggregation-related challenge of building global scale has proven particularly important in the industry in recent years. GEH, the largest of the three firms, has consistently been the most profitable, reflecting its success at aggregation through (a) economies of scale (e.g., GEH has higher total R&D spending than its competitors, but its R&D-to-sales ratio is lower), (b) acquisition prowess (GEH has made nearly 100 acquisitions under Jeffrey Immelt before he became GE's CEO), and (c) economies of scope the company strives to integrate its biochemistry skills with its traditional base of physics and engineering skills; it finances equipment purchases through GE Capital).

GEH has even more clearly outpaced its competitors through arbitrage. It has recently become a global product company by rapidly migrating to low-cost production bases. By 2005, GEH was reportedly more than halfway to its goals of purchasing 50% of its materials directly from low-cost countries and locating 60% of its manufacturing in such countries.

In terms of adaptation, GEH has invested heavily in country-focused marketing organizations. It also has increased customer appeal with its emphasis on providing services as well as equipment—for example, by training radiologists and providing consulting advice on postimage processing. Such customer intimacy obviously has to be tailored by country. And, recently, GEH has cautiously engaged in some "in China, for China" manufacture of stripped-down, cheaper equipment, aimed at increasing penetration there.

5.9: Pitfalls and Lessons in Applying the AAA Framework

There are several factors that companies should consider in applying the AAA framework. Most companies would be wise to *focus on one or two of the "A"s*—while it is possible to make progress on all three "A"s, especially for a firm that is coming from behind, companies (or, more often to the point, businesses or divisions) usually have to focus on one or, at most, two "A"s in trying to build competitive advantage. Companies should also *make sure the new elements of a strategy are a good fit organizationally*. If a strategy does embody substantially new elements, companies should pay particular attention to how well they work with other things the organization is doing. IBM has grown its staff in India much faster than other international competitors (such as Accenture) that have begun to emphasize India-based arbitrage. But quickly molding this work force into an efficient organization with high delivery standards and a sense of connection to the parent company is a critical challenge: failure in this regard might even be fatal to the arbitrage initiative. Companies should also employ multiple integration mechanisms. Pursuit of more than one of the "A"s requires creativity and breadth in thinking about integration mechanisms. Companies should also *think about externalizing integration*. Not all the integration that is required to add value across borders needs to occur within a single organization. IBM and other firms have shown that some externalization can be achieved in a number of ways: joint ventures in advanced semiconductor research, development, and manufacturing; links to, and support of, Linux and other efforts at open innovation; (some) outsourcing of hardware to contract manufacturers and services to business partners; IBM's relationship with Lenovo in personal computers; and customer relationships governed by memoranda of understanding rather than detailed contracts. Finally, companies should *know when not to integrate*. Some integration is always a good idea, but that is not to say that more integration is always better.

5.10: Points to Remember

1. There are three generic strategies for creating value in a global context: *adaptation*, *aggregation*, and *arbitrage*.
2. *Adaptation* strategies seek to increase revenues and market share by tailoring one or more components of a company's business model to suit local requirements or preferences. *Aggregation* strategies focus on achieving economies of scale or scope by creating regional or global efficiencies. These strategies typically involve standardizing a significant portion of the value proposition and grouping together development and production processes. *Arbitrage* is about exploiting economic or other differences between national or regional markets, usually by locating separate parts of the supply chain in different places.
3. Adaptation strategies can be subdivided into five categories: *variation*, *focus*, *externalization*, *design*, and *innovation*.
4. Aggregation strategies revolve around generating *economies of scale or scope*. The other nongeographic dimensions of the CAGE framework introduced in Chapter 1—*cultural*, *administrative*, *geographic*, and *economic*—also lend themselves to aggregation strategies.
5. Since arbitrage focuses on exploiting differences between regions, the CAGE framework also defines a set of substrategies for this generic approach to global value creation.
6. A company's financial statements can be a useful guide for signaling which of the "A" strategies will have the greatest potential to create global value.
7. Although most companies will focus on just one "A" at any given time, leading-edge companies such as GE, P&G, IBM, and Nestlé, to name a few, have embarked on implementing two, or even all three, of the "A"s.
8. There are serious constraints on the ability of any one company to simultaneously use all three "A"s with great effectiveness. Such attempts stretch a firm's managerial bandwidth, force a company to operate with multiple corporate cultures, and can present competitors with opportunities to undercut a company's overall competitiveness.
9. Most companies would be wise to (a) focus on one or two of the "A"s, (b) make sure the new elements of a strategy are a good fit organizationally, (c) employ multiple integration mechanisms, (d) think about externalizing integration, and (e) know when not to integrate.

SECTION OVERVIEW

5.11: Global Strategy as Business Model Change

5.12: Chapter Introduction

Every company has a core domestic strategy, although it may not always be explicitly articulated. This strategy most likely evolved over time as the company rose to prominence in its domestic market and reflects key choices about what value it provides to whom and how, and at what price and cost. At any point in time, these choices are reflected in the company's primary business model, a conceptual framework that summarizes how a company creates, delivers, and extracts value. A *business model* is therefore simply a description of how a company does business. As shown in Figure 5.12.1 "Components of a Business Model", it describes who its customers are, how it reaches them and relates to them (*market participation*); what a company offers its customers (*the value proposition*); with what resources, activities, and partners it creates its offerings (*value chain infrastructure*); and, finally, how it organizes and manages its operations (*global management model*).

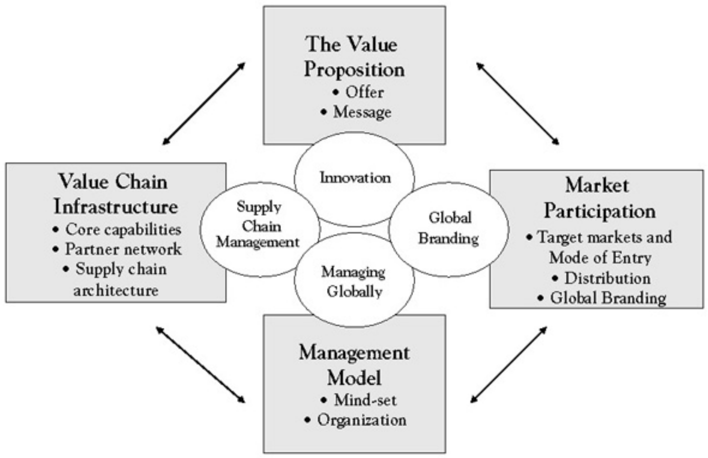


Figure 5.12.1: Components of a Business Model

5.13: Components of a Business Model

A company's value proposition composes the core of its business model; it includes everything it offers its customers in a specific market or segment. This comprises not only the company's bundles of products and services but also how the company differentiates itself from its competitors. A value proposition therefore consists of the full range of tangible and intangible benefits a company provides to its customers (stakeholders).

The market participation dimension of a business model has three components. It describes what specific *markets or segments* a company chooses to serve, domestically or abroad; what methods of distribution it uses to reach its customers; and how it promotes and advertises its value proposition to its target customers.

The value chain infrastructure dimension of the business model deals with such questions as, what key *internal resources and capabilities* has the company created to support the chosen value proposition and target markets; what *partner network* has it assembled to support the business model; and how are these activities organized into an overall, coherent value creation and delivery model?

The global management submodel summarizes a company's choices about a suitable global organizational structure and management policies. Global organization and management style are closely linked. In companies that are organized primarily around global product divisions, management is often highly centralized. In contrast, companies operating with a more geographic organizational structure are usually managed on a more decentralized basis.

It used to be that each industry was characterized by a single dominant business model. In such a landscape, competitive advantage was won mainly through better execution, more efficient processes, lean organizations, and product innovation. While execution and product innovation obviously still matter, they are no longer sufficient today.

Companies are now operating in industries that are characterized by multiple and coexisting business models. Competitive advantage is increasingly achieved through focused and innovative business models. Consider the airline, music, telecommunications, or banking industries. In each one, there are different business models competing against each other. In the airline industry, for example, there are the traditional flag carriers, the low-cost airlines, the business-class-only airlines, and the fractional private-jet-ownership companies. Each business model embodies a different approach to achieving a competitive advantage.

Southwest Airlines' business model, for example, can be described as offering customers an alternative to traveling by car, bus, or train by giving them a no-frills flight service, enhanced through complementary activities. Southwest's business model differs from those of other major U.S. airlines along several dimensions. It is about more than low fares, point-to-point connections, and the use of a standardized fleet of aircraft. A key differentiating factor is the way Southwest treats its employees—putting them first with profit-sharing and empowerment programs. Another is the fun experience Southwest creates on board and in the terminal, with jokes, quizzes, and the relaxed behavior of the cabin crew and ground staff. Yet another is the legendary care and attention Southwest puts into its customer service. Not surprisingly, Southwest's demonstrably successful business model has spawned numerous imitators around the world, including Ryanair, EasyJet, JetBlue, and Air Arabia.

Apple provides an example of why it is useful to focus on a company's overall business model rather than individual components such as products, markets, or suppliers. While it is tempting to think of the iPod as a successful product, it is, in fact, much more. Less visible than redefining the size, look, and functionality of an MP3 player, Apple's real innovation was creating a digital rights management system that could satisfy the intellectual property concerns of the music industry while simultaneously creating a legal music download service that would satisfy consumers. Thus, Apple's real breakthrough was not good product design, it was the creation of a revolutionary business model—one that allowed people to find and legally download high-quality music files extremely easily but that would not allow the pirating of entire albums. Put differently, the iPod was the front-end of a very smart and highly differentiated platform that worked for both the music industry and the consumer. That platform, the iTunes Music Store—which now also offers digital music videos, television shows, iPod games, and feature-length movies—is at the very heart of Apple's strategic move into consumer electronics, allowing more recent Apple products like the iPhone and Apple TV to sync with PCs as easily as the iPod. In fact, iTunes is the trojan horse with which Apple plans to capture a significant share of the home entertainment market.

Describing a company's business strategy in terms of its business model allows explicit consideration of the logic or architecture of each component and its relationship to others as a set of designed *choices* that can be changed. Thus, thinking holistically about every component of the business model—and systematically challenging orthodoxies within these components—significantly extends the scope for innovation and improves the chances of building a sustainable competitive advantage

5.14: Global Strategy as Business Model Change

When a company decides to expand into foreign markets, it must take its business model apart and consider the impact of global expansion on every single component of the model. For example, with respect to its value proposition, a company must decide whether or not to modify its company's core strategy as it moves into new markets. This decision is intimately linked to a choice of what markets or regions to enter and why. Once decisions have been made about the *what* (the value proposition) and *where* (market coverage) of global expansion, choices need to be made about the *how*—whether or not to adapt products and services to local needs and preferences or standardize them for global competitive advantage; whether or not to adopt a uniform market positioning worldwide; which value-adding activities to keep in-house, which to outsource, and which to relocate to other parts of the world—and so on. Finally, decisions need to be made about how to organize and manage these efforts on a global basis. Together, these decisions define a company's global strategic focus on a continuum from a truly global orientation to a more local one. *Crafting a* global strategy *therefore is about deciding how a company should change or adapt its core (domestic) business model to achieve a competitive advantage as the firm globalizes its operations.*

Linking Pankaj Ghemawat's *generic strategy framework* for creating a global competitive advantage, introduced in the Chapter 3, with the above *business model* concept and the full array of *globalization decisions* a company faces when it evaluates its global options, defines the global strategy formulation (conceptual) framework shown in Figure 5.14.1 "Global Strategy: A Conceptual Framework". Generic value creation options need to be evaluated for each business model component to address a range of globalization decisions.

Part 2 of this book is organized using this framework, with chapters devoted to the globalization of the different parts of the business model or the skills needed to do so. Before we embark on this journey, the balance of this chapter is devoted to introducing the concept of *value disciplines*—generic strategic foci for creating value for customers and the key in defining a company's value proposition—and its implications for the other components of the business model.

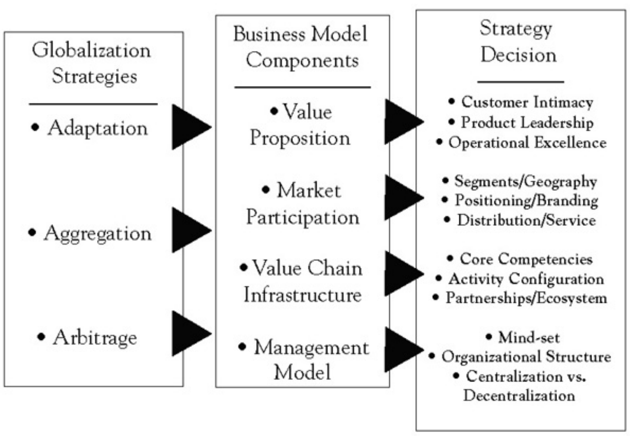


Figure 5.14.1: A Conceptual Framework

Minicase: Microsoft in China (Kirkpatrick (2007, July 17))

Consider the challenges Microsoft faced in going to China. Today, Bill Gates is a local hero. On a recent visit he met with four members of the Politburo in a single day; most executives would count themselves lucky to talk with one of China's top leaders. Last spring, President Hu Jintao toured the Microsoft campus in Redmond, Washington, and was treated to a dinner at Gates's home.

It has not always been this way. Microsoft stumbled for years after entering China in 1992 and lost money there for over a decade. It finally became apparent that almost none of the success factors that drove the company's performance in the United States and Europe applied to China. To succeed there, Microsoft had to become the "un-Microsoft," pricing at rock bottom instead of charging hundreds of dollars for its Windows operating system and Microsoft Office applications; abandoning the public-policy strategy it used elsewhere of protecting its intellectual property at all costs; and closely partnering with the government instead of fighting it, as in the United States—a decision that has opened the company to criticism from human rights groups.

The story begins 15 years ago, when Microsoft sent a couple of sales managers into China from Taiwan. Their mission was to sell software at the same prices the company charged elsewhere. It did not work. The problem was not brand acceptance—everyone was using Windows. But no one was paying. Counterfeit copies could be bought on the street for a few dollars. Market share simply did not translate into revenue.

Microsoft fought bitterly to protect its intellectual property. It sued other companies for illegally using its software but lost regularly in court. Country managers came and went—five in one 5-year period. Two of them later wrote books criticizing the company. One, Juliet Wu, whose *Up Against the Wind* became a local best seller, wrote that Microsoft heartlessly sought sales by any means, that its antipiracy policy was needlessly heavy-handed, and that her own efforts to help bosses in Redmond understand China had been rebuffed.

To add insult to injury, Beijing's city government started installing free open-source Linux operating systems on workers' PCs. (The Chinese Academy of Sciences promoted a version called Red Flag Linux.) Meanwhile, security officials were troubled that government and military operations depended on Microsoft software made in the United States.

In 1999, Gates sent a senior executive, who headed the company's public-policy efforts, to figure out why Microsoft was so hated. After extensive investigation, the executive concluded that Microsoft's business model in China was wrong: the company had assigned executives that were too junior, selling was overemphasized, and the company's business practices did not recognize the importance of collaborating with the government.

In response, Gates sent 25 of Microsoft's 100 vice presidents on a weeklong "China Immersion Tour." The company hired former Secretary of State Henry Kissinger for advice and to open doors. And it told leaders that Microsoft wanted to help China develop its own software industry, an urgent government priority. The company even commissioned a McKinsey study for Chinese officials in 2001 that, among other things, recommended improving the protection of intellectual property.

The company also initiated talks with Chinese security officials to convince them that Microsoft's software was not a secret tool of the U.S. government. As a result, in 2003, the company offered China and 59 other countries the right to look at the fundamental source code for its Windows operating system and to substitute certain portions with their own software—something Microsoft had never allowed in the past. Now when China uses Windows in sensitive applications—such as in the president's office and in its missile systems—it can install its own cryptography.

The opening of a research center in Beijing in 1998 proved to be a real turning point. Created because Gates was impressed with the quality of the country's computer scientists, the laboratory helped Microsoft revamp its image. It began accumulating an impressive record of academic publications, helped lure back smart émigré scientists, and contributed key components to globally released products like the Vista operating system. The lab soon became, according to local polls, the most desirable place in the country for computer scientists to work.

Microsoft executives had also concluded that China's weak intellectual property enforcement laws meant its usual pricing strategies were doomed to fail. Arguing that while it was terrible that people in China pirated so much software, Gates decided that if they were going to pirate anybody's software, he would certainly prefer it be Microsoft's.

In hindsight, it is clear that tolerating piracy turned out to be Microsoft's best long-term strategy, and that it is the reason Windows is used on an estimated 90% of China's almost 200 million PCs. Competing with Linux is easier when there is piracy than when there is not: you can get the real thing, and you get it at the same price. In China's back alleys, Linux often costs more than Windows because it requires more disks. And Microsoft's own prices have dropped so low, it now sells a $3 package of Windows and Office to students.

In 2003, Microsoft took a quantum leap forward in China by hiring Tim Chen, who had been running Motorola's China subsidiary. Chen arrived with entrée to the corridors of power and a practiced understanding of how a Western company could succeed in China. He kept up the blitz of initiatives. Microsoft made Shanghai a global center to respond to customer e-mails. It began extensive training programs for teachers and software entrepreneurs. And it began to work with the ministry of education to finance 100 model computer classrooms in rural areas.

These actions served to change the perception that Microsoft had mainly come to promote antipiracy and to sue people and demonstrated that it had a long-term vision. In the following years, Microsoft invested substantially in China and even invited officials to help decide in which local software and outsourcing companies it should invest. By doing so, it successfully leveraged the synergy that existed between the need of the Chinese economy to have local software capability and the company's need for an ecosystem of companies using its technology and platform. At the same time, the Chinese government started thinking more like Microsoft: it required central, provincial, and local governments to begin using legal software. The city of Beijing now pays for software its employees had previously pirated.

In another boost for Microsoft, last year, the government required local PC manufacturers to load legal software on their computers. Lenovo, the market leader, had been shipping as few as 10% of its PCs that way, and even U.S. PC makers in China were selling many machines "naked." Another mandate requires gradual legalization of the millions of computers in state-owned enterprises. As a consequence, the number of new machines shipped with legal software nationwide has risen from about 20% to more than 50% in recent years.

5.15: Value Disciplines and Business Models

A business model—and a company's principal value proposition in particular—is shaped by the firm's underlying value creation strategy or value discipline, a term coined by Michael Treacy and Fred Wiersema to describe different ways companies can differentiate itself from competitors.This section is based on Treacy and Wiersema (1993). A **value discipline** is more than just a benefit statement—it is a statement of strategic focus and provides a context for a company to set its corporate vision and objectives, to target its most profitable customers, and to focus and align its activities.

In contrast to more traditional market segmentation strategies, which group customers by geography, product mix, or demographics, value disciplines segment customers according to the full range of benefits that are most valuable to them. Specifically, Treacy and Wiersema identify three generic value disciplines: *operational excellence*, *customer intimacy,* and *product leadership.*

A strategy of operational excellence is defined by a relentless focus on providing customers with reliable products or services at competitive prices and delivered with minimal difficulty or inconvenience. Dell Inc., for instance, is a master of operational excellence. Dell has shown buyers of electronics that they do not have to sacrifice quality or state-of-the-art technology in order to buy PCs, printers, or other products easily and inexpensively. By selling to customers directly, building to order rather than to inventory, and creating a disciplined, extremely low-cost culture, Dell has been able to undercut its competitors in price yet provide high-quality products and service. Other leaders in operational excellence include Wal-Mart, Jet Blue, ING bank, and Federal Express.

Companies pursuing operational excellence are relentless in seeking ways to minimize overhead costs, to eliminate intermediate production steps, to reduce transaction and other "friction" costs, and to optimize business processes across functional and organizational boundaries. They focus on delivering their products or services to customers at competitive prices and with minimal inconvenience. Because they build their entire businesses around these goals, these organizations do not look or operate like other companies pursuing other value disciplines.

An operationally excellent company proactively designs its entire business model for its targeted customer segments, paying particular attention to speed, efficiency, and cost. This includes critically reevaluating business processes, reassessing the complete supply chain, and reaching out to suppliers, distributors, and customers to create a larger, more integrated approach to meeting customer needs.

Achieving market leadership through operational excellence requires the development of a business model that pervades the entire organization. Thus, becoming operationally excellent is a challenge not just for the manufacturing department but for the entire company. And while operationally excellent companies are focused on cost and efficiency, they are not necessarily the lowest cost producer or supplier. The notion that an operationally excellent company is fixated on costs and cost cutting, has a rigid command and control organization, and is focused on plant and internal efficiencies is a limited view that seriously misstates the intent and goals of operational excellence.

Minicase: Air Arabia Leads the World in Operational Excellence (www.airarabia.com)

In April of 2009, Air Arabia, the first and largest low-cost carrier (LCC) in the Middle East and North Africa, announced that it was recognized by Airbus, one of the world's leading aircraft manufacturers, for achieving the highest operational utilization in the world. This is the fourth consecutive year that Air Arabia maintained the lead among all global airlines operating Airbus A320 aircraft. According to the latest reports from Airbus, Air Arabia achieved the highest aircraft utilization in 2008, with 99.8% operational reliability.

Operational excellence and service reliability are integral to Air Arabia's success. In selecting Air Arabia for its operational excellence rankings, Airbus conducted a detailed technical analysis of all carriers in the segment. Air Arabia recorded the highest indicators for operational reliability and aircraft utilization reflecting the carrier's extremely high maintenance and technical standards.

Currently, Air Arabia has a fleet of 16 Airbus A320 aircraft and has already placed an order of 44 additional Airbus A320s. By the end of 2009, Air Arabia expected to add two more aircraft and increase its fleet size to 18.

Air Arabia (PJSC), listed on the Dubai Financial Market, is the Middle East and North Africa's leading low-cost carrier. Air Arabia commenced operations in October 2003 and currently operates a fleet of 16 new Airbus A320 aircraft, currently serving

44 destinations across the Middle East, North Africa, South Asia, and Central Asia through its main hub in Sharjah, United Arab Emirates.

Air Arabia is modeled after leading American and European low-cost airlines, and its business model is customized to accommodate local preferences. Its main focus is to make air travel more convenient through Internet bookings and through offering the lowest fares in the market along with the highest levels of safety and service standards.

A focus on customer intimacy, the second value discipline, means segmenting and targeting markets precisely and then tailoring offerings to exactly match the demands of those niches. Companies that excel in customer intimacy combine detailed customer knowledge with operational flexibility so they can respond quickly to almost any need, from customizing a product to fulfilling special requests. As a consequence, these companies engender tremendous customer loyalty. Nordstrom, the department store, for example, is better than any other company in its market of customer service and getting the customer precisely the product or information he or she wants.

While companies pursuing operational excellence concentrate on the operational side of their business models, those pursuing a strategy of customer intimacy continually tailor and shape products and services to fit an increasingly fine definition of the customer. This can be expensive, but customer-intimate companies are willing to take a long-term perspective and invest to build lasting customer loyalty. They typically look at the customer's lifetime value to the company, not the value of any single transaction. This is why employees in these companies will do almost anything—with little regard for initial cost—to make sure that each customer gets exactly what he or she really wants. Nordstrom is a good example of such a company. A few years ago, Home Depot was known for its customer intimacy; more recently, however, it has strayed from this strategic focus.

Customer-intimate companies understand the difference between profit or loss on a single transaction and profit over the lifetime of their relationship with a single customer. Most companies know, for instance, that not all customers require the same level of service or will generate the same revenues. Profitability, then, depends in part on maintaining a system that can identify, quickly and accurately, which customers require what level of service and how much revenue they are likely to generate. Sophisticated companies now routinely use a telephone-computer system capable of recognizing individual customers by their telephone numbers when they call. Such systems allow differential levels of service for different customer groups. Clients with large accounts and frequent transactions are routed to their own senior account representative; those who typically place only an occasional order are referred to a more junior employee or a call center. In either case, the customer's file appears on the representative's screen before the phone is answered. What is more, such a system allows the company to direct specific value-added services or products to specific groups of clients.

Some years ago, Kraft USA decided to strengthen its focus on customer intimacy and created the capacity to tailor its advertising, merchandising, and operations in a single store, or in several stores within a supermarket chain, to the needs of those stores' particular customers. To do so, it had to develop new information systems and analytical capabilities and educate its sales force to create multiple, so-called micromerchandising programs for a chain that carries its products. In other words, Kraft first had to change itself: it had to create the organization, build the information systems, and educate and motivate the people required to pursue a strategy of customer intimacy.

Like most companies that pursue customer intimacy, Kraft decentralized its marketing operations in order to empower the people actually dealing with the customer. Today, Kraft salespeople are trained and rewarded to work with individual store managers and regional managers to create customized promotional programs. To do so, the company gives them the data they need to make recommendations to store managers and to shape promotional programs such as consumer purchases by store, category, and product and their response to past price and other promotions. At corporate headquarters, Kraft trade marketing teams sort and integrate information from multiple sources to supply the sales force with a menu of programs, products, value-added ideas, and selling tools. For instance, the trade marketing team sorted all shoppers into six distinct groups, with names such as "full-margin shoppers," "planners and dine-outs," and "commodity shoppers."

Minicase: Customer Intimacy at the Four Seasons (Martin (2007))

Isadore Sharp, one of four children of Polish parents who immigrated to Toronto before his birth in 1931, opened his first hotel —the Four Seasons Motor Hotel—in 1961 with 125 affordable rooms in a rather seedy area outside the core of downtown Toronto.

At that time, a would-be hotelier had two choices. He could build a small motel with fewer than 200 rooms and simple amenities at relatively low cost. The alternative was a large downtown hotel catering to business travelers. Such hotels usually had at least 750 guest rooms and extensive amenities, including conference facilities, multiple restaurants, and banquet rooms. Each type of hotel had its advantages as well as distinct drawbacks. For all its comfort and intimacy, the small motel was not an option for the business traveler who needed a well-appointed meeting room or state-of-the-art communications facilities. Large hotels produced a big enough pool of revenues to fund the features the market demanded but tended to be cold and impersonal.

But after opening his fourth hotel, Sharp decided to experiment and combine the best of the small hotel with the best of the large hotel. He envisioned a medium-sized hotel, big enough to afford an extensive array of amenities but small enough to maintain a sense of intimacy and personalized service. Sharp reasoned that if the Four Seasons offered distinctly better service than its competitors, it could charge a substantial premium, boosting revenue per room to the point where it could offer top-of-the-line amenities. Before he could ask guests to pay a superpremium room rate, though, Sharp understood that he would have to offer them an entirely different kind of service.

Luxury, at that time, was chiefly defined in terms of architecture and décor. Sharp decided to redefine luxury as service—a support system to fill in for the one left at home and the office. Four Seasons became the first to offer shampoo in the shower; 24-hour room service; bathrobes; cleaning and pressing; a two-line phone in every guest room; a big, well-lighted desk; and 24-hour secretarial services. Defying the traditional approach in the industry, which was to set a relatively fixed standard of physical and service quality across the entire chain, Sharp made sure each city's Four Seasons reflected the local color and culture.

To free up capital and focus its senior management on providing service rather than managing real estate and financing, Four Seasons also became the first big hotel company to manage, rather than own, the hotel facilities that bore its name.

Redefining the way it treated its own employees also helped sharpen Four Seasons' customer focus. Rather than treating its employees as disposable, Four Seasons distinguished itself by hiring more for attitude than experience, by establishing career paths and promotion from within, and by paying as much attention to employee concerns as guest complaints. It pushed responsibility down and encouraged self-discipline by setting high performance standards and holding people accountable, adhering to the company's credo, "generating trust." Significantly, Four Seasons has no separate customer service department. Each employee at the Four Seasons is not just a member of the customer service department but is in charge of it.

Today, with 73 hotels in 31 countries, and with 25 properties under development, Four Seasons is considerably larger than the next biggest luxury player. Condé Nast Traveler ranks 18 Four Seasons hotels in its global "Top 100" list, more than 3 times the next most-cited chain. A Four Seasons signifies that a city has become a global destination.

Finally, product leadership, the third discipline, means offering customers leading-edge products and services that consistently enhance the customer's use or application of the product, thereby making rivals' goods obsolete. Companies that pursue product leadership are innovation-driven, and they constantly raise the bar for competitors by offering more value and better solutions. Product leaders work with three basic principles. First, they focus on creativity; constant innovation is the key to their success. They look for new ideas inside as well as outside the company, have an "experimentation is good" mind-set, and reward risk taking. Second, they know that in order to be successful, they must be fast in capitalizing on new ideas; they know how to commercialize new ideas quickly. To do so, all their business and management processes have to be engineered for speed. Third, product leaders must relentlessly pursue new solutions to the problems that their own latest product or service has just solved. In other words, if anyone is going to render their technology obsolete, they prefer to do it themselves.

Examples of companies that use product leadership as a cornerstone of their strategies include BMW, Intel, Apple, and Nike. These companies have created and maintain a culture that encourages employees to bring ideas into the company and, just as important, they listen to and consider these ideas, however unconventional and regardless of the source. In addition, product leaders continually scan the landscape for new product or service possibilities; where others see glitches in their marketing plans or threats to their product lines, companies that focus on product leadership see opportunity and rush to capitalize on it.

Product leaders avoid bureaucracy at all costs because it slows commercialization of their ideas. Managers make decisions quickly since, in a product leadership company, it is often better to make a wrong decision than to make a late or not at all. That is why these companies are prepared to decide today, then implement tomorrow. Moreover, they continually look for new ways—such as concurrent engineering—to shorten their cycle times. Japanese companies, for example, succeed in automobile innovation because they use concurrent development processes to reduce time to market. They do not have to aim better than competitors to score more hits on the target because they can take more shots from a closer distance.

Product leaders are their own fiercest competitors. They continually cross a frontier, then break more new ground. They have to be adept at rendering obsolete the products and services that they have created because they realize that if they do not develop a successor, another company will. Apple and other innovators are willing to take the long view of profitability, recognizing that whether they extract the full profit potential from an existing product or service is less important to the company's future than maintaining its product leadership edge and momentum. These companies are never blinded by their own successes.

Finally, product leaders also possess the infrastructure and management systems needed to manage risk well. For example, each time Apple ventures into an untapped area, it risks millions of dollars as well as its reputation. It takes that chance, though, in part because its hybrid structure allows it to combine the economies of scale and resource advantages of a multibillion-dollar corporation with the cultural characteristics of a startup company.

Figure 5.15.1 depicts strategic focus in terms of the three value disciplines discussed here and summarizes how each responds to a particular set of competitive drivers and customer needs.

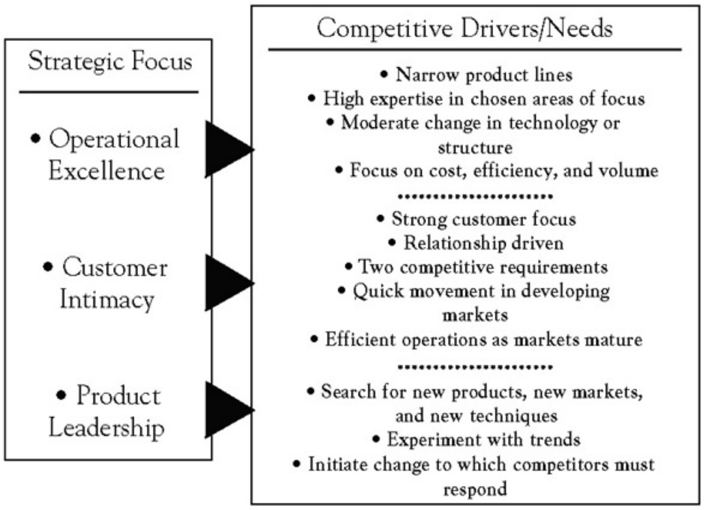


Figure 5.15.1: Choosing a Value Proposition: Value Disciplines

Minicase: How Apple Maintains Product Leadership (Morrison (2009, August 10)).

How does Apple consistently redefine each market it enters by creating products that leapfrog the competition? First, it takes *clarity of purpose and resolve:* it may take years to cultivate new skills and build the right new product. Second, a significant *investment in infrastructure is required:* for example, Apple supports a dedicated innovation team. Third, consistently redefining markets requires *strategic clarity:* innovating effectively means creating your own opportunities in a crowded marketplace to avoid both mediocrity and commoditization. Fourth, *patience is essential*: creativity does not always follow the clock. False starts and the occasional flop are part of the process and must not only be tolerated but be sources of learning. Fifth, *strong leadership is a prerequisite*: innovation does not happen by committee. Visionaries with effective management skills are hard to find, but they are a critical ingredient for success.

Clarity of Purpose and Resolve

Apple's company motto, "Think Different," provides a hint at how Apple maintains focus and its introspective, self-contained operating style that is capable of confounding competitors and shaking up entire industries. Internally, Apple barely acknowledges competition. It is the company's ability to think differently about itself that keeps Apple at the head of the pack. Current and past employees tell stories about products that have undergone costly overhauls just to improve one simple detail. Other products are canceled entirely because they do not fit in or do not perform up to par. Apple's culture has codified a habit that is good for any company to have but is especially valuable for firms that make physical things: stop, step back from your product, and take a closer look. Without worrying about how much work you have already put into it, is it really as good as it could be? Apple constantly asks that question.

Infrastructure Investment

From the outside, Apple's offices look like those of just about any large modern American corporation. Having outgrown its headquarters campus in Cupertino, California, Apple now has employees in other buildings scattered across the town and around the world. Size and sprawl are formidable challenges that most companies do not manage very well, either by splintering into disorganized, undisciplined communities or by locking employees into tight, stifling bureaucracies. Apple tends toward the latter, but it does so in a unique way that generally (but not always) plays to its advantage. At its worst, Apple's culture is characterized by paranoia: employees are notoriously secretive and continuously fear being fired or sued for speaking to anyone outside the company. This obsession with secrecy does give Apple an element of surprise in the marketplace. But this comes at a high cost. Apple's corporate culture came under scrutiny recently after an employee of a foreign supplier—reportedly under suspicion for leaking the prototype of a new iPhone—committed suicide in Shenzhen, China. Beyond the secrecy, which affects everyone, Apple's approach is hardly one-size-fits-all. Rank-and-file employees are often given clear-cut directives and close supervision. Proven talent gets a freer hand, regardless of job title.

Strategic Clarity

Over time, Apple has built a seasoned management team to support bold new product initiatives. The team's guiding principles include the following:

1. *Ignore fads.* Apple held off building a cheap miniature laptop to respond to the "netbook" fad because these devices do not offer good margins. Instead, it released the ultrathin, ultraexpensive Air, a product more in line with its own style.
2. *Do not back down from fights you can win.* Apple is a tough partner and a ruthless enemy. In 2007, Apple pulled NBC's television programs from the iTunes Store after the network tried to double the prices consumers pay to download shows. NBC backed down within days, and, ever since, giant media conglomerates have been hesitant to face off with Apple over pricing.
3. *Flatten sprawling hierarchies.* Companies with extended chains of authority tend to plod when it is time to act. Most of the decisions at Apple come from its chief executive officer, Steve Jobs, and his immediate deputies.
4. *Pay less attention to market research and competitors.* Most firms develop their products based on information obtained from consumer focus groups and imitation of successful products from other companies. Apple does neither, as the iPod and iPhone clearly demonstrate.
5. *Empower your most valuable employees to do amazing work.* Apple takes meticulous care of a specific group of employees known as the "creatives." Its segmented, stratified organizational structure—which protects and coddles its most valuable, productive employees—is one of the company's most formidable assets. One example is Apple's Industrial Design Group (IDG), the team that gives Apple products their distinctive, glossy look. Tucked away within Apple's main campus, the IDG is a world unto itself. It is also sealed behind unmarked, restricted-access doors. Within the IDG, employees operate free from outside distractions and interference. But despite their favored status, Apple's creatives still have no more insight into the company's overall operations than an army private has into the Pentagon. At Apple, new products are often seen in their complete form by only a small group of top executives. This, too, works as a strength for Apple: instead of a sprawling bureaucracy that new products have to be pushed through, Apple's top echelon is a small, tightly knit group that has a hand in almost every important decision the company makes.

Patience

Apple's corporate culture is different because the company dances to a rhythm of its own making. Although its rising stock has become a vital part of many portfolios, Apple cancels, releases, and updates products at its own speed, seemingly irrespective of market conditions or competitive pressure. Apple does not telegraph its moves, either: the iPod and iPhone, both iconic products, each began as rumors that Apple seemed determined to quash.

Strong Leadership

New adherents to the cult of Steve Jobs may be surprised to hear this: the most iconic Apple laptop, the original PowerBook, was released in 1991 after Jobs had been absent for 6 years. Jobs was not responsible for this enduring innovation. So does that mean Steve Jobs is irrelevant? Or is Jobs—and his maniacal focus on building insanely great products—a necessary ingredient of Apple's success? It is said that great leaders are made by their circumstances and that their great deeds actually reflect the participation of thousands, or even millions, of people. In the case of Apple, there would be no Mac, no iPod, and no iPhone without the efforts of thousands of engineers and vast numbers of consumers who were looking for products that better served their needs. That said, Jobs is an imposing figure, and if he was "made" by his circumstances, that process took many years. Remember that the first edition of Steve Jobs—the young inventor who, at 21, created Apple Computer—was not the visionary we know today. Instead, after 9 years at Apple's helm, the young Steve Jobs was ousted because of his aggressive, take-no-prisoners personality, which created a poisonous, unproductive atmosphere when it pervaded the company.

Today's Steve Jobs seems to have learned how to focus that aggressive, take-no-prisoners personality more shrewdly and to great effect. While he is still an essential part of Apple's success, the company has also institutionalized many of Jobs' values to such an extent that Apple is now far less dependent on him. Tim Cook, for example, functioned effectively as acting CEO when Jobs was on sick leave recently. But questions remain. So long as the overwhelming personality of Jobs is present, can anyone really grow into that position? Only when Jobs permanently steps back from his role will we really be able to determine how well Apple has learned the lessons he has taught.

5.16: Choosing a Value Discipline or Selecting a Target Market?

Choosing a value discipline and selecting a particular set of customers to serve are two sides of the same coin. Customers seeking operational excellence define value on the basis of price, convenience, and quality, with price the dominant factor. They are less particular about what they buy than they are about getting it at the lowest possible price and with the least possible hassle. They are unwilling to sacrifice low price or high convenience to acquire a product with a particular label or to obtain a premium service. Whether they are consumers or industrial buyers, they want high quality goods and services, but, even more, they want to get them cheaply or easily or both. These customers like to shop for retail goods at discount and membership warehouse stores, and they are comfortable buying directly from manufacturers. When they buy a car, they seek basic transportation, and when they buy or sell stocks, they use discount brokers.

Consumers seeking customer intimacy are far more concerned with obtaining precisely what they want or need. The specific features and benefits of the product or the way the service is delivered are far more important to them than any reasonable price premium or purchase inconvenience they might incur. Chain stores—whether in the food, book, or music business—that customize their inventories to match regional or even neighborhood tastes serve this category of customer. Other retailers and catalogers attract this customer type by offering the largest imaginable range of products. They typically do not carry just one version of a product or a single brand but many versions or multiple brands.

Finally, customers attuned to product leadership crave new, different, and unusual products. As clothing buyers, they are primarily interested in fashion and trends. In an industrial context, they are buyers who value state-of-the-art products or components because their own customers demand the latest technology from them. If they are service companies, they want suppliers that help them seize breakthrough opportunities in their own markets. They also like to be the first to adopt new technologies, whether BlackBerrys, new cell phones, or large flat-screen TVs.

5.17: Market Leadership and Value Disciplines

The research by Treacy and Wiersema revealed that companies that push the boundaries of one value discipline while meeting industry standards in the other two often gain a significant lead—one that competitors have difficulty overcoming.Treacy and Wiersema (1993). A key reason is that value-discipline leaders do not just tailor their products and services to their customers' preferences but align *their entire business model* to serve a chosen value discipline. This makes it much harder for competitors to copy them, thus providing them with a more enduring competitive advantage.

Companies in different industries that pursue the same value discipline share many characteristics. The business models of Federal Express, Southwest Airlines, and Wal-Mart, for example, are notably similar because they all pursue operational excellence. Someone working at FedEx, therefore, would likely be very comfortable at Wal-Mart, and vice versa. Similarly, the systems, structures, and cultures of product leaders such as Apple in electronics, Johnson & Johnson in health care and pharmaceuticals, and Nike in sport shoes have a great deal in common. But across disciplines, the similarities end. Employees from Wal-Mart do not fit well with the value propositions, management styles, and cultures at Nike or Nordstrom.

When a company decides to go global and is faced with the challenge of adapting its business model to the needs of a foreign market, a key question is how easily the underlying value discipline "travels" or whether the company has to embrace a different strategic focus to succeed. Adapting a business model within a particular value discipline at which the company excels is decidedly easier than creating a new business model based on another value discipline that the company has not previously focused on, as the following minicase attests to.

Minicase: Dell in Asia: Adapt or Change? (Chai (2008, October 27))

From direct sales to retail and staid designs to sexy, Dell is speeding up its reinvention drive in Asia, with the region now earmarked as its bellwether for computer sales worldwide. The company considers countries such as China still "underdeveloped" information technology (IT) markets that offer ample opportunity for growth. To tap into this sales potential, the company is shedding some of the attributes that have defined its modus operandi in the past two decades. Dell has traditionally designed its business around selling to larger corporations, but it is diversifying to leverage Asia's exploding PC user base.

First, the pioneer of direct selling by phone and over the Internet has struck retail agreements across the region, including tie-ups with electronics mega stores such as Gome in China and Courts in Singapore and a partnership with Tata Croma in India. The channel push is crucial to the company's attempt to catch up in the cutthroat regional consumer and small and midsized business markets where Hewlett-Packard (HP) and Lenovo have long had a retail presence.

Second, to create a following, the company is supplementing its retail push with a radical shift in product design that now focuses on form as opposed to the functional and low-cost attributes that Dell has typically emphasized. For example, the firm is selling selected Dell laptops with an unusual color palette of blue, pink, and red. Soon, the company will even allow customers to print their own photos and pictures onto its notebooks. Beyond hardware and aesthetic components, Dell also allows consumers to personalize the content of their PCs, including the preloading of popular movies on selected products.

And third, while Dell previously relied on Asian companies primarily for manufacturing, it is increasingly using the region for higher-value activities such as product design. Four out of five of its new global design centers are based in the region. Its Singapore facility focuses on the company's imaging portfolio of monitors, televisions, and printers; its Bangalore counterpart is responsible for software development and enterprise solutions; the company's Taiwan design centre focuses on laptop and server development; and its China unit concentrates on developing desktop systems and PC-related services.

5.18: Points to Remember

1. Every company has a *core domestic strategy*, although it may not always be explicitly articulated.
2. A *business model* is therefore simply a description of how a company does business. It describes who its customers are and how it reaches them and relates to them (*market participation*); what a company offers its customers (*the value proposition*); with what resources, activities, and partners it creates its offerings (*value chain infrastructure*); and, finally, how it organizes its operations (*implementation model*).
3. Competitive advantage is increasingly achieved through focused and innovative business models.
4. Crafting a global strategy is about deciding how a company should change or adapt its core (domestic) business model to achieve a competitive advantage as the firm globalizes its operations.
5. A business model is shaped by a company's underlying value creation strategy or *value discipline*. A value discipline is a statement of strategic focus and provides a context for a company to set its corporate vision and objectives, to target its most profitable customers, and to focus and align its activities.
6. Three generic value disciplines are *operational excellence*, *customer intimacy*, and *product leadership*. A strategy of *operational excellence* is defined by a relentless focus on providing customers with reliable products or services at competitive prices and delivered with minimal difficulty or inconvenience. A focus on *customer intimacy*, the second value discipline, means segmenting and targeting markets precisely and then tailoring offerings to match exactly the demands of those niches. And *product leadership*, the third discipline, means offering customers leading-edge products and services that consistently enhance the customer's use or application of the product, thereby making rivals' goods obsolete.
7. Choosing a value discipline and selecting a particular set of customers to serve are two sides of the same coin.
8. Companies that push the boundaries of one value discipline while meeting industry standards in the other two often gain a significant lead—one that competitors have difficulty overcoming.

SECTION OVERVIEW

5.19: Target Markets and Modes of Entry

Market participation decisions—selecting global target markets, entry modes, and how to communicate with customers all over the world—are intimately related to decisions about how much to adapt the company's basic value proposition. The choice of customers to serve in a particular country or region and with a particular culture determines how and how much a company must adapt its basic value proposition. Conversely, the extent of a company's capabilities to tailor its offerings around the globe limits or broadens its options to successfully enter new markets or cultures. In this chapter, we look at the first two of these decisions: selecting target markets around the world and deciding how best to enter them. In Chapter 6, we introduce a framework for analyzing choices about adapting a company's basic value proposition. In Chapter 7, we take up global branding, one of a company's primary vehicles for communicating with customers all over the world (Figure 5.1.1 "Market Participation").

5.20: Target Market Selection

Few companies can afford to enter all markets open to them. Even the world's largest companies such as General Electric or Nestlé must exercise strategic discipline in choosing the markets they serve. They must also decide when to enter them and weigh the relative advantages of a direct or indirect presence in different regions of the world. Small and midsized companies are often constrained to an indirect presence; for them, the key to gaining a global competitive advantage is often creating a worldwide resource network through alliances with suppliers, customers, and, sometimes, competitors. What is a good strategy for one company, however, might have little chance of succeeding for another.

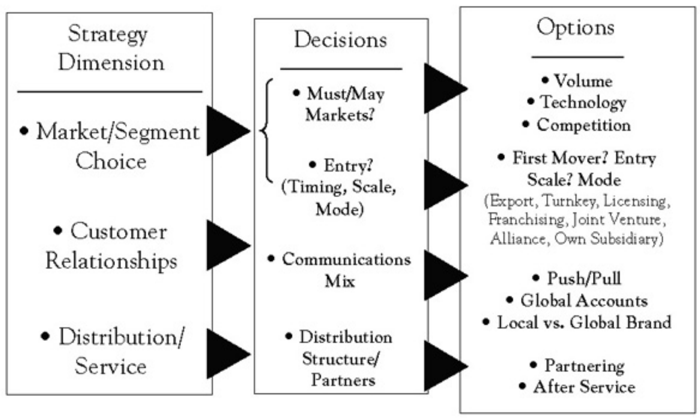


Figure 5.20.1: Market Participation

The track record shows that picking the most attractive foreign markets, determining the best time to enter them, and selecting the right partners and level of investment has proven difficult for many companies, especially when it involves large emerging markets such as China. For example, it is now generally recognized that Western carmakers entered China far too early and overinvested, believing a "first-mover advantage" would produce superior returns. Reality was very different. Most companies lost large amounts of money, had trouble working with local partners, and saw their technological advantage erode due to "leakage." None achieved the sales volume needed to justify their investment.

Even highly successful global companies often first sustain substantial losses on their overseas ventures, and occasionally have to trim back their foreign operations or even abandon entire countries or regions in the face of ill-timed strategic moves or fast-changing competitive circumstances. Not all of Wal-Mart's global moves have been successful, for example—a continuing source of frustration to investors. In 1999, the company spent $10.8 billion to buy British grocery chain Asda. Not only was Asda healthy and profitable, but it was already positioned as "Wal-Mart lite." Today, Asda is lagging well behind its number-one rival, Tesco. Even though Wal-Mart's UK operations are profitable, sales growth has been down in recent years, and Asda has missed profit targets for several quarters running and is in danger of slipping further in the UK market.

This result comes on top of Wal-Mart's costly exit from the German market. In 2005, it sold its 85 stores there to rival Metro at a loss of $1 billion. Eight years after buying into the highly competitive German market, Wal-Mart executives, accustomed to using Wal-Mart's massive market muscle to squeeze suppliers, admitted they had been unable to attain the economies of scale it needed in Germany to beat rivals' prices, prompting an early and expensive exit.

What makes global market selection and entry so difficult? Research shows there is a pervasive the-grass-is-always-greener effect that infects global strategic decision making in many, especially globally inexperienced, companies and causes them to overestimate the attractiveness of foreign markets. (Ghemawat (2001)). As noted in Chapter 1, "distance," broadly defined, unless well-understood and compensated for, can be a major impediment to global success: cultural differences can lead companies to overestimate the appeal of their products or the strength of their brands; administrative differences can slow expansion plans, reduce the ability to attract the right talent, and increase the cost of doing business; geographic distance impacts the effectiveness of communication and coordination; and economic distance directly influences revenues and costs.

A related issue is that developing a global presence takes time and requires substantial resources. Ideally, the pace of international expansion is dictated by customer demand. Sometimes it is necessary, however, to expand ahead of direct opportunity in order to secure a long-term competitive advantage. But as many companies that entered China in anticipation of its membership in the World Trade Organization have learned, early commitment to even the most promising long-term market makes earning a satisfactory return on invested capital difficult. As a result, an increasing number of firms, particularly smaller and midsized ones, favor global expansion strategies that minimize direct investment. Strategic alliances have made vertical or horizontal integration less important to profitability and shareholder value in many industries. Alliances boost contribution to fixed cost while expanding a company's global reach. At the same time, they can be powerful windows on technology and greatly expand opportunities to create the core competencies needed to effectively compete on a worldwide basis.

Finally, a complicating factor is that a global evaluation of market opportunities requires a multidimensional perspective. In many industries, we can distinguish between "must" markets—markets in which a company must compete in order to realize its global ambitions—and "nice-to-be-in" markets—markets in which participation is desirable but not critical. "Must" markets include those that are critical from a *volume* perspective, markets that define *technological leadership*, and markets in which key *competitive* battles are played out. In the cell phone industry, for example, Motorola looks to Europe as a primary competitive battleground, but it derives much of its technology from Japan and sales volume from the United States.

5.21: Measuring Market Attractiveness

Four key factors in selecting global markets are (a) a *market's size and growth rate*, (b) a particular country or region's *institutional contexts*, (c) a region's competitive environment, and (d) a market's *cultural, administrative, geographic*, and *economic distance* from other markets the company serves.

Market Size and Growth Rate

There is no shortage of country information for making market portfolio decisions. A wealth of country-level economic and demographic data are available from a variety of sources including governments, multinational organizations such as the United Nations or the World Bank, and consulting firms specializing in economic intelligence or risk assessment. However, while valuable from an overall investment perspective, such data often reveal little about the prospects for selling products or services in foreign markets to local partners and end users or about the challenges associated with overcoming other elements of distance. Yet many companies still use this information as their primary guide to market assessment simply because country market statistics are readily available, whereas real product market information is often difficult and costly to obtain.

What is more, a country or regional approach to market selection may not always be the best. Even though Theodore Levitt's vision of a global market for uniform products and services has not come to pass, and global strategies exclusively focused on the "economics of simplicity" and the selling of standardized products all over the world rarely pay off, research increasingly supports an alternative "global segmentation" approach to the issue of market selection, especially for branded products. In particular, surveys show that a growing number of consumers, especially in emerging markets, base their consumption decisions on attributes beyond direct product benefits, such as their perception of the global brands behind the offerings.

Specifically, research by John Quelch and others suggests that consumers increasingly evaluate global brands in "cultural" terms and factor three global brand attributes into their purchase decisions: (a) what a global brand signals about quality, (b) what a brand symbolizes in terms of cultural ideals, and (c) what a brand signals about a company's commitment to corporate social responsibility. This creates opportunities for global companies with the right values and the savvy to exploit them to define and develop target markets across geographical boundaries and create strategies for "global segments" of consumers. Specifically, consumers who perceive global brands in the same way appear to fall into one of four groups:

1. *Global citizens* rely on the global success of a company as a signal of quality and innovation. At the same time, they worry whether a company behaves responsibly on issues like consumer health, the environment, and worker rights.
2. *Global dreamers* are less discerning about, but more ardent in their admiration of, transnational companies. They view global brands as quality products and readily buy into the myths they portray. They also are less concerned with companies' social responsibilities than global citizens.
3. *Antiglobals* are skeptical that global companies deliver higher-quality goods. They particularly dislike brands that preach American values and often do not trust global companies to behave responsibly. Given a choice, they prefer to avoid doing business with global firms.
4. *Global agnostics* do not base purchase decisions on a brand's global attributes. Instead, they judge a global product by the same criteria they use for local brands.Quelch (2003, August); Holt, Quelch, and Taylor (2004, September).

Companies that use a "global segment" approach to market selection, such as Coca-Cola, Sony, or Microsoft, to name a few, therefore must manage two dimensions for their brands. They must strive for superiority on basics like the brand's price, performance, features, and imagery, and, at the same time, they must learn to manage brands' global characteristics, which often separate winners from losers. A good example is provided by Samsung, the South Korean electronics maker. In the late 1990s, Samsung launched a global advertising campaign that showed the South Korean giant excelling, time after time, in engineering, design, and aesthetics. By doing so, Samsung convinced consumers that it successfully competed directly with technology leaders across the world, such as Nokia and Sony. As a result, Samsung was able to change the perception that it was a down-market brand, and it became known as a global provider of leading-edge technologies. This brand strategy, in turn, allowed Samsung to use a global segmentation approach to making market selection and entry decisions.

Institutional Contexts (Khanna, Palepu, and Sinha (2005)).

Khanna and others developed a five-dimensional framework to map a particular country or region's institutional contexts. Specifically, they suggest careful analysis of a country's (a) *political and social systems*, (b) *openness*, (c) *product markets*, (d) *labor markets*, and (e) *capital markets*.

A country's political system affects its product, labor, and capital markets. In socialist societies like China, for instance, workers cannot form independent trade unions in the labor market, which affects wage levels. A country's social environment is also important. In South Africa, for example, the government's support for the transfer of assets to the historically disenfranchised native African community has affected the development of the capital market.

The more open a country's economy, the more likely it is that global intermediaries can freely operate there, which helps multinationals function more effectively. From a strategic perspective, however, openness can be a double-edged sword: a government that allows local companies to access the global capital market neutralizes one of the key advantages of foreign companies.

Even though developing countries have opened up their markets and grown rapidly during the past decade, multinational companies struggle to get reliable information about consumers. Market research and advertising are often less sophisticated and, because there are no well-developed consumer courts and advocacy groups in these countries, people can feel they are at the mercy of big companies.

Recruiting local managers and other skilled workers in developing countries can be difficult. The quality of local credentials can be hard to verify, there are relatively few search firms and recruiting agencies, and the high-quality firms that do exist focus on top-level searches, so companies scramble to identify middle-level managers, engineers, or floor supervisors.

Capital and financial markets in developing countries often lack sophistication. Reliable intermediaries like credit-rating agencies, investment analysts, merchant bankers, or venture capital firms may not exist, and multinationals cannot count on raising debt or equity capital locally to finance their operations.

Emerging economies present unique challenges. Capital markets are often relatively inefficient and dependable sources of information, scarce while the cost of capital is high and venture capital is virtually nonexistent. Because of a lack of high-quality educational institutions, labor markets may lack well-trained people requiring companies to fill the void. Because of an underdeveloped communications infrastructure, building a brand name can be difficult just when good brands are highly valued because of lower product quality of the alternatives. Finally, nurturing strong relationships with government officials often is necessary to succeed. Even then, contracts may not be well enforced by the legal system.

Competitive Environment

The number, size, and quality of competitive firms in a particular target market compose a second set of factors that affect a company's ability to successfully enter and compete profitably. While country-level economic and demographic data are widely available for most regions of the world, competitive data are much harder to come by, especially when the principal players are subsidiaries of multinational corporations. As a consequence, competitive analysis in foreign countries, especially in emerging markets, is difficult and costly to perform and its findings do not always provide the level of insight needed to make good decisions. Nevertheless, a comprehensive competitive analysis provides a useful framework for developing strategies for growth and for analyzing current and future primary competitors and their strengths and weaknesses.

Minicase: Which BRIC Countries? A Key Challenge for Carmakers (Haddock and Jullens (2009)).

Today, automobile manufacturers face a critical challenge: deciding which BRIC countries (Brazil, Russia, India, and China) to bet on. In each, as per capita income rises, so will per capita car ownership—not in a straight line but in classic "S-curve" fashion. Rates of vehicle ownership stay low during the first phases of economic growth, but as the GDP or purchasing power of a country reaches a level of sustained broad prosperity, and as urbanization reshapes the work patterns of a country, vehicle sales take off. But that is about where the similarities end. Each of the four BRIC nations has a completely different set of market and industry dynamics that make decision choices about which countries to target, including making difficult decisions about which markets to avoid, extremely difficult.

For one thing, vehicle manufacturing is a high-profile industry that generates enormous revenue, employs millions of people, and is often a proxy for a nation's manufacturing prowess and economic influence. Governments are extensively involved in regulating or influencing virtually every aspect of the product and the way the industry operates—including setting emissions and safety standards, licensing distributors, and setting tariffs and rules about how much manufacturing must take place locally. This reality makes the job of understanding each market and appreciating the differences more vital. For example, a summary overview of the BRIC nations reveals the differences among these markets and the operating complexities in all of them.

Brazil, with Russia, is one of the smaller BRIC countries, with 188 million people (by comparison, China and India each have more than 1 billion, Russia has 142 million). Yet car usage is already relatively high: 104 cars in use per 1,000 people, nearly 10 times the rate of usage in India, according to the *Economist* Intelligence Unit. Because of this, growth projections for Brazil are relatively low—more in line with developed nations than with the other BRIC countries. Projections made by the industry research firm Global Insight show that sales will grow just 2% until 2013, underperforming even the U.S. market's projected growth rate.

On the plus side, Brazil is socioeconomically stable, with increasing wealth and a maturing finance system that is helping to propel growth among rural, first-time buyers who prefer compact cars. Few domestic brands exist, as the market is dominated by GM, Ford, Fiat, and Volkswagen. Prompted by generous government incentives, high import taxes, and exchange rate risks, foreign automakers have invested significantly in Brazil, which has thus become an unrivaled production hub for the rest of South America. Brazilian consumers live in a country with large rural areas and very rough terrain; they demand fairly large, SUV-like cars, made with economical small engines and flex-fuel power trains friendly to the country's biofuel industry. When a Latin American family buys its first automobile, chances are it was made in Brazil.

Russia, even though it is the smallest of the BRIC countries in population, has the highest auto adoption of the four: 213 cars in use per 1,000 people. (Western Europe, by comparison, has 518, according to the *Economist Intelligence Unit*.) Yet Global Insight expects future sales growth to average 6.5% from 2008 to 2013, far outpacing Brazil (2%), Western Europe (1.2%), and Japan and Korea (0.2%).

Given Russia's proximity to Europe, consumer preferences there are more akin to those of the developed markets than to those of China or India, and expensive, status-enhancing European models remain popular, although European safety features, interior components, and electronics are often stripped out to reduce costs. For vehicle manufacturers, the attractions of the Russian market include an absence of both local partnership requirements and significant local competitors. But there is high political risk. So far, the Russian government has permitted foreign carmakers to operate relatively freely, but the Kremlin's history of meddling in private enterprise and undercutting private ownership worries some executives. These concerns were heightened in November 2008, when Russia implemented tariffs against car imports in hopes of avoiding layoffs that might spark labor unrest among the country's 1.5 million car industry workers.

India has 1.1 billion people, but its level of car adoption is still low, with only 11 cars in use per 1,000 people. The upside is higher potential growth: among the BRIC countries, India is expected to have the fastest-growing auto sales, almost 15% per year until 2013, according to Global Insight. Sales of subcompact cars are strong, even during the global recession. The popularity of these small cars combines with India's energy shortages and the country's chronic pollution to provide foreign carmakers with an ideal opportunity to further develop electric power-train technologies there.

Until the early 1990s, foreign automobile manufacturers were mostly shut out of India. That has changed radically. Today, foreign automakers are welcomed and the government promotes foreign ownership and local manufacturing with tax breaks and strong intellectual property protection. And because foreign companies were shut out for a long period of time, India has capable manufacturers and suppliers for foreign vehicle manufacturers to partner with. Local competition is strong but is thus far concentrated among three players: Maruti Suzuki India, Ltd., Tata, and the Hyundai Corporation, which is well established in India.

China is almost as large as the other three combined in total auto sales and production. Its overall auto usage is just 18 cars per 1,000 households, but annual sales growth until 2013 is expected to be almost 10%. Its size and growth potential make China a dominant force in the industry going forward; new models and technologies developed there will almost certainly become available elsewhere.

But the Chinese government plays a central role in shaping the auto industry. Current ownership policies mandate that foreign vehicle manufacturers enter into 50-50 joint ventures with local automakers, and poor intellectual property rights enforcement puts the design and engineering innovations of foreign car companies at constant risk. At the same time, to cope with energy shortages and rampant pollution, the Chinese government is strongly encouraging research and development on alternative power trains, including electric cars and gasoline-electric hybrids. As a result, Chinese car companies may develop significant power-train capabilities ahead of their competitors.

Like their Indian counterparts, Chinese car companies have outpaced global automakers in developing cars specifically for emerging markets. A few Western companies, like Volkswagen AG, which has sold its Santana models in China through a joint venture (Shanghai Volkswagen Automotive Company) since 1985, are competitive. Some Chinese carmakers, like BYD

Company, aspire to become global leaders in the industry. But many suffer from a talent shortage and inexperience in managing across borders. This may prompt them to acquire all or part of distressed Western automobile companies in the near future or to hire skilled auto executives from established companies and their suppliers.

In short, each of the four BRIC nations has a completely different set of market and industry dynamics. And the same is true for the other developing nations. Meanwhile, the number of autos in use in the developing world is projected to expand almost six-fold by 2018.

Cultural, Administrative, Geographic, and Economic Distance

Explicitly considering the four dimensions of *distance* introduced in Chapter 1 can dramatically change a company's assessment of the relative attractiveness of foreign markets. In his book *The Mirage of Global Markets*, David Arnold describes the experience of Mary Kay Cosmetics (MKC) in entering Asian markets. MKC is a direct marketing company that distributes its products through independent "beauty consultants" who buy and resell cosmetics and toiletries to contacts either individually or at social gatherings. When considering market expansion in Asia, the company had to choose: enter Japan or China first? Country-level data showed Japan to be the most attractive option by far: it had the highest per capita level of spending on cosmetics and toiletries of any country in the world, disposable income was high, it already had a thriving direct marketing industry, and it had a high proportion of women who did not participate in the work force. MKC learned, however, after participating in both markets, that the market opportunity in China was far greater, mainly because of economic and cultural distance: Chinese women were far more motivated than their Japanese counterparts to boost their income by becoming beauty consultants. Thus, the entrepreneurial opportunity represented by what MKC describes as "the career" (i.e., becoming a beauty consultant) was a far better predictor of the true sales potential than high-level data on incomes and expenditures. As a result of this experience, MKC now employs an additional business-specific indicator of market potential within its market assessment framework: the average wage for a female secretary in a country.Arnold (2004), p. 34.

MKC's experience underscores the importance of analyzing distance. It also highlights the fact that different product markets have different success factors: some are brand-sensitive while pricing or intensive distribution are key to success in others. Country-level economic or demographic data do not provide much help in analyzing such issues; only locally gathered marketing intelligence can provide true indications of a market's potential size and growth rate and its key success factors.

Minicase: Tata Making Inroads Into China (Chow (2008, April 28)).

Not content with just India, Mumbai-based Tata Group, the maker of the $2,500 Nano small car, is developing a small car for China. The platform is being designed and developed by a joint Indian and Chinese team based in China. The alliance won a new project for the complete design and development of a vehicle platform for a leading original equipment manufacturer for a small car for the China's domestic market. The team is integrating components in automotive modules to radically improve manufacturability and bring down total cost.

Meanwhile, in 2009, Nanjing Tata AutoComp Systems began supplying automotive interior products to Shanghai General Motors and Changan Ford Automobile Company Products, including plastic vents, outlet parts, and cabin air-ventilation grilles. In the same year, Nanjing Tata began supplying General Motors Corporation in Europe. Eventually, the plant will supply global automakers in North America and Europe as well as emerging markets such as China.

Nanjing Auto is a wholly owned subsidiary of Tata AutoComp Systems, which is the automotive part manufacturing arm of India's Tata Motors. The company has 30 manufacturing facilities, mainly in India, and production capabilities in automotive plastics and engineering. It also has 15 joint ventures with Tier 1 supplier companies, mainly in India.

The company has almost completed construction of the 280,000-square-foot Nanjing plant at a cost of approximately $15 million. The first phase included capacity to make parts for air vents, handles, cupholders, ashtrays, glove boxes, and floor consoles. When completed, the plant will have double the current capacity and will also produce instrument panels, door panels, and larger parts. The plant is operated by local Chinese employees; only a few managers are Indian.

In its bid to become a $1 billion global automotive supplier by 2008, Tata AutoComp had to expand into China. Total passenger car sales in India in 2007 were slightly more than 1.4 million units; in China, the number was more than 5.2 million units, according to data from Automotive Resources Asia, a division of J.D. Power and Associates. Tata Motors sold 221,256 passenger cars in India in 2007. In the same year, Shanghai General Motors sold 495,405 cars. "We see huge potential in

> China. To us, China is not just a manufacturing base, but a window to the global market. Our investments are keeping this promising future in mind,'" says the Tata AutoComp's chief executive officer.

5.22: Entry Strategies - Modes of Entry

What is the best way to enter a new market? Should a company first establish an export base or license its products to gain experience in a newly targeted country or region? Or does the potential associated with first-mover status justify a bolder move such as entering an alliance, making an acquisition, or even starting a new subsidiary? Many companies move from exporting to licensing to a higher investment strategy, in effect treating these choices as a learning curve. Each has distinct advantages and disadvantages.

Exporting is the marketing and direct sale of domestically produced goods in another country. Exporting is a traditional and well-established method of reaching foreign markets. Since it does not require that the goods be produced in the target country, no investment in foreign production facilities is required. Most of the costs associated with exporting take the form of marketing expenses.

While relatively low risk, exporting entails substantial costs and limited control. Exporters typically have little control over the marketing and distribution of their products, face high transportation charges and possible tariffs, and must pay distributors for a variety of services. What is more, exporting does not give a company firsthand experience in staking out a competitive position abroad, and it makes it difficult to customize products and services to local tastes and preferences.

Licensing essentially permits a company in the target country to use the property of the licensor. Such property is usually intangible, such as trademarks, patents, and production techniques. The licensee pays a fee in exchange for the rights to use the intangible property and possibly for technical assistance as well.

Because little investment on the part of the licensor is required, licensing has the potential to provide a very large return on investment. However, because the licensee produces and markets the product, potential returns from manufacturing and marketing activities may be lost. Thus, licensing reduces cost and involves limited risk. However, it does not mitigate the substantial disadvantages associated with operating from a distance. As a rule, licensing strategies inhibit control and produce only moderate returns.

Strategic alliances and joint ventures have become increasingly popular in recent years. They allow companies to share the risks and resources required to enter international markets. And although returns also may have to be shared, they give a company a degree of flexibility not afforded by going it alone through direct investment.

There are several motivations for companies to consider a partnership as they expand globally, including (a) facilitating market entry, (b) risk and reward sharing, (c) technology sharing, (d) joint product development, and (e) conforming to government regulations. Other benefits include political connections and distribution channel access that may depend on relationships.

Such alliances often are favorable when (a) the partners’ strategic goals converge while their competitive goals diverge; (b) the partners’ size, market power, and resources are small compared to the industry leaders; and (c) partners are able to learn from one another while limiting access to their own proprietary skills.

The key issues to consider in a joint venture are ownership, control, length of agreement, pricing, technology transfer, local firm capabilities and resources, and government intentions. Potential problems include (a) conflict over asymmetric new investments, (b) mistrust over proprietary knowledge, (c) performance ambiguity, that is, how to “split the pie,” (d) lack of parent firm support, (e) cultural clashes, and (f) if, how, and when to terminate the relationship.

Ultimately, most companies will aim at building their own presence through company-owned facilities in important international markets. Acquisitions or greenfield start-ups represent this ultimate commitment. *Acquisition* is faster, but starting a new, wholly owned subsidiary might be the preferred option if no suitable acquisition candidates can be found.

Also known as foreign direct investment (FDI), acquisitions and greenfield start-ups involve the direct ownership of facilities in the target country and, therefore, the transfer of resources including capital, technology, and personnel. Direct ownership provides a high degree of control in the operations and the ability to better know the consumers and competitive environment. However, it requires a high level of resources and a high degree of commitment.

Minicase: Cola-Cola and Illycaffé (www/thecocacolacompany.com/; http://www.illy.com/)

In March 2008, the Coca-Cola company and Illycaffé Spa finalized a joint venture and launched a premium ready-to-drink espresso-based coffee beverage. The joint venture, Ilko Coffee International, was created to bring three ready-to-drink coffee products—Caffè, an Italian chilled espresso-based coffee; Cappuccino, an intense espresso, blended with milk and dark cacao;

and Latte Macchiato, a smooth espresso, swirled with milk—to consumers in 10 European countries. The products will be available in stylish, premium cans (150 ml for Caffè and 200 ml for the milk variants). All three offerings will be available in 10 European Coca-Cola Hellenic markets including Austria, Croatia, Greece, and Ukraine. Additional countries in Europe, Asia, North America, Eurasia, and the Pacific were slated for expansion into 2009.

The Coca-Cola Company is the world's largest beverage company. Along with Coca-Cola, recognized as the world's most valuable brand, the company markets four of the world's top five nonalcoholic sparkling brands, including Diet Coke, Fanta, Sprite, and a wide range of other beverages, including diet and light beverages, waters, juices and juice drinks, teas, coffees, and energy and sports drinks. Through the world's largest beverage distribution system, consumers in more than 200 countries enjoy the company's beverages at a rate of 1.5 billion servings each day.

Based in Trieste, Italy, Illycaffé produces and markets a unique blend of espresso coffee under a single brand leader in quality. Over 6 million cups of Illy espresso coffee are enjoyed every day. Illy is sold in over 140 countries around the world and is available in more than 50,000 of the best restaurants and coffee bars. Illy buys green coffee directly from the growers of the highest quality Arabica through partnerships based on the mutual creation of value. The Trieste-based company fosters long-term collaborations with the world's best coffee growers—in Brazil, Central America, India, and Africa—providing know-how and technology and offering above-market prices.

5.23: Entry Strategies - Timing

In addition to selecting the right mode of entry, the timing of entry is critical. Just as many companies have overestimated market potential abroad and underestimated the time and effort needed to create a real market presence, so have they justified their overseas' expansion on the grounds of an urgent need to participate in the market early. Arguing that there existed a limited window of opportunity in which to act, which would reward only those players bold enough to move early, many companies made sizable commitments to foreign markets even though their own financial projections showed they would not be profitable for years to come. This dogmatic belief in the concept of a first-mover advantage (sometimes referred to as "pioneer advantage") became one of the most widely established theories of business. It holds that the first entrant in a new market enjoys a unique advantage that later competitors cannot overcome (i.e., that the competitive advantage so obtained is structural and therefore sustainable).

Some companies have found this to be true. Procter & Gamble (P&G), for example, has always trailed rivals such as Unilever in certain large markets, including India and some Latin American countries, and the most obvious explanation is that its European rivals were participating in these countries long before P&G entered. Given that history, it is understandable that P&G erred on the side of urgency in reacting to the opening of large markets such as Russia and China. For many other companies, however, the concept of pioneer advantage was little more than an article of faith and was applied indiscriminately and with disastrous results to country-market entry, to product-market entry, and, in particular, to the "new economy" opportunities created by the Internet.

The "get in early" philosophy of pioneer advantage remains popular. And while there are clear examples of its successful application—the advantages gained by European companies from being early in "colonial" markets provide some evidence of pioneer advantage—first-mover advantage is overrated as a strategic principle. In fact, in many instances, there are disadvantages to being first. First, if there is no real first-mover advantage, being first often results in poor business performance, as the large number of companies that rushed into Russia and China attests to. Second, pioneers may not always be able to recoup their investment in marketing required to "kick start" the new market. When that happens, a "fast follower" can benefit from the market development funded by the pioneer and leapfrog into earlier profitability.For a more detailed discussion, see Tellis, Golder, and Christensen (2001).

This ability of later entrants to free-ride on the pioneer's market development investment is the most common source of first-mover disadvantage and suggests two critical conditions necessary for real first-mover advantage to exist. First, there must be a scarce resource in the market that the first entrant can acquire. Second, the first mover must be able to lock up that scarce resource in such a way that it creates a barrier to entry for potential competitors. A good example is provided by markets in which it is necessary for foreign firms to obtain a government permit or license to sell their products. In such cases, the license, and perhaps government approval, more generally, may be a scarce resource that will not be granted to all comers. The second condition is also necessary for first-mover advantage to develop. Many companies believed that brand preference created by being first constituted a valid source of first-mover advantage, only to find that, in most cases, consumers consider the alternatives available at the time of their first purchase, not which came first.

Minicase: Starbucks' Global Expansion (Starbucks: A Global Work-in-Process (2006); http://www.starbucks.com)

Starbucks' decision to expand abroad came after an extended period of exclusive focus on the North American market. From its founding in 1971, it grew to almost 700 stores by 1995, all within the United States and Vancouver, Canada. It was not until the next decade that Starbucks made its first entry into international markets. By 2006, Starbucks operated approximately 11,000 stores, with 70% in the United States and 30% in international markets, and international revenue had grown to almost 20% of Starbucks' total revenue. Starbucks offered the same basic coffee menu internationally as it did in the United States; however, the range of food products and other items, such as coffee mugs stocked, varied somewhat according to local customs and tastes.

Along with many other companies that pursue global expansion, Starbucks continually faces questions about where and how to further increase its global presence. Should the emphasis be on growth in existing countries or on increasing the number of countries in which it has a presence? How important is the fact that international markets so far have proven less profitable than the U.S. and Canadian markets?

Starbucks in Japan. Interestingly, Starbucks' first foreign move (i.e., outside the United States and Canada) was a joint venture in Japan. At the time, Japan had the second largest economy in the world and was consistently among the top five coffee importers in the world.

The decision to use a joint venture to enter Japan followed intense internal debate. Concerns among senior executives centered on Starbucks' lack of local knowledge, and questions were raised about the company's ability to attract the local talent necessary to grow the Japanese business quickly enough. Starbucks was acutely aware that there were significant differences between doing business in Japan and in the United States and that it might not have enough experience to be successful on its own.

Among other factors, operating costs were predicted to be double those of North America, and Starbucks would have to pay to ship coffee to Japan from its roasting facility in Kent, Washington (near Seattle). In addition, retail space in Tokyo was 2 to 3 times as expensive as in Seattle. Just finding rental space in such a populous city might prove to be a tremendous challenge. Starbucks concluded it needed to form an alliance with a local group that had experience with complex operations and real estate.

Starbucks executives worried that a licensing deal would not be the right solution. Specifically, they were concerned about possible loss of control and insufficient knowledge transfer to learn from the experience. A joint venture was thought to be a better answer, and, after a long search, Starbucks approached Sazaby, Inc., operators of upscale retail and restaurant chains, whose president had approached Starbucks years earlier about the potential of opening Starbucks stores in Japan. Similarity in values, culture, and community-development goals between Starbucks and Sazaby were important considerations in concluding the 50-50 deal. The two companies were equally represented on the board of directors of the newly created Starbucks Coffee Japan. Starbucks was the sole decision-making power in matters relating to brand, product line advertising, and corporate communications, while decisions regarding real-estate operational issues and human resources were handled by Sazaby. Despite strong local competition, the venture was successful from the start. By fiscal year 2000, Starbucks Coffee Japan became profitable more than 2 years ahead of plan.

Starbucks in the United Kingdom. Unlike its expansion into Asia and (later) the Middle East, Starbucks chose to enter the United Kingdom through acquisition rather than partnerships. Speed was a major factor in Starbucks' decision to enter the fast-growing UK market by acquisition. In addition, the culture, language, legal environment, management practices, and labor economics in the United Kingdom were considered sufficiently similar to those that Starbucks' management already knew. This meant that a 100%-owned UK subsidiary could be successfully established from the outset. In May 1998, Starbucks acquired the Seattle Coffee Company, which had a presence in the United Kingdom for some time. This fast-growing chain was modeled on its own style of operations and, at the time of the purchase, had 56 retail units. The Seattle Coffee Company was an attractive acquisition target because of its focus: relatively small market capitalization and established retail units. By 2005, Starbucks had 469 stores in the United Kingdom, which made it the third largest country, after the United States and Japan, to serve Starbucks coffee.

Licensing in China. In a number of developing markets, including China, Starbucks chose to enter into minority share licensing agreements with high-quality, experienced local partners in order to minimize market-entry risks. Under these agreements, the local partners absorbed the capital costs (real estate, store construction) of bringing the Starbucks brand abroad. This eliminated the need for substantial general and administrative expenses by Starbucks and enabled it to establish a presence in foreign markets much more quickly than it would have if it had to invest its own capital and absorb start-up losses.

Risk was also a major consideration when Starbucks looked to enter China. While offering high-volume opportunities in an untapped coffee market, the prevailing culture and politics in China potentially posed significant problems. In April 2000, Beijing city authorities ordered Kentucky Fried Chicken to close its store near the Forbidden City when its lease expired in 2002. Similarly, under pressure from local authorities, McDonald's removed its golden arches from outlets near Tiananmen Square. These incidents demonstrated China's ambiguous attitude toward a growing Western economic and cultural influence.

Another major concern with starting operations in China was recruiting the right staff. Uniformity of customer experience and coffee quality was the key driver behind the Starbucks brand; failure to recruit the staff to ensure these key criteria not only would mean failure for the Chinese retail outlets but also could harm the company's image globally.

Although these factors made licensing an attractive entry model, with growing experience in the Chinese market, Starbucks is steadily reducing its reliance on the licensing model and switching to its core company-operated business model to increase control and reap greater rewards.

Starbucks' globalization history shows that while it was a "first mover" in the United States, it was forced to push harder in international markets to compete with existing players. In Japan, Starbucks was initially a huge success and became profitable 2 years earlier than anticipated. However, just 2 years after Starbucks Japan had become profitable, the company announced a loss of $3.9 million in Japan, its second largest market at the time, reflecting a major increase in local competition. Additional international challenges were a result of Starbucks' chosen entry mode. Although joint ventures provided Starbucks with local knowledge about the market and a low-risk entry into unproven territory, joint ventures did not always reap the rewards that the partners had anticipated. One key factor was that it was often difficult for Starbucks to control the costs in a joint venture, resulting in lower profitability.

5.24: Points to Remember

1. Selecting global target markets, entry modes, and deciding how much to adapt the company's basic value proposition are intimately related. The choice of customers to serve in a particular country or region with a particular culture determines how and how much a company must adapt its basic value proposition. Conversely, the extent of a company's capabilities in tailoring its offerings around the globe limits or broadens its options to successfully enter new markets or cultures.
2. Few companies can afford to enter all markets open to them. The track record shows that picking the most attractive foreign markets, determining the best time to enter them, and selecting the right partners and level of investment has proven difficult for many companies, especially when it involves large emerging markets such as China.
3. Research shows there is a pervasive the-grass-is-always-greener effect that infects global strategic decision making in many, especially globally inexperienced, companies and causes them to overestimate the attractiveness of foreign markets.
4. Four key factors in selecting global markets are (a) a market's size and growth rate, (b) a particular country or region's institutional contexts, (c) a region's competitive environment, and (d) a market's cultural, administrative, geographic, and economic distance from other markets the company serves.
5. There is a wide menu of options regarding market entry, from conservative strategies such as first establishing an export base or licensing products to gain experience in a newly targeted country to more aggressive options such as entering an alliance, making an acquisition, or even starting a new subsidiary.
6. Selecting the right timing of entry is equally critical. And just as many companies have overestimated market potential abroad, and underestimated the time and effort needed to create a real market presence, so have they justified their overseas' expansion on the grounds of an urgent need to participate in the market early.

SECTION OVERVIEW

5.25: Global Supply-Chain Management

In today's global competitive environment, individual companies no longer compete as autonomous entities but as supply-chain networks. Instead of brand versus brand or company versus company, it is increasingly suppliers-brand-company versus suppliers-brand-company. In this new competitive world, the success of a single business increasingly depends on management's ability to integrate the company's intricate network of business relationships. Supply-chain management (SCM) offers the opportunity to capture the synergy of intra- and intercompany integration and management. SCM deals with total business-process excellence and represents a new way of managing business and relationships with other members of the supply chain.

Top-performing supply chains have three distinct qualities. (Lee (2004, October)). First, they are *agile* enough to readily react to sudden changes in demand or supply. Second, they *adapt* over time as market structures and environmental conditions change. And, third, they *align* the interests of all members of the supply-chain network in order to optimize performance. These characteristics—agility, adaptability, and alignment—are possible only when partners promote knowledge-flow between supply-chain nodes. In other words, the flow of knowledge is what enables a supply chain to come together in a way that creates a true value chain for all stakeholders. Knowledge-flow creates value by making the supply chain more transparent and by giving everyone a better look at customer needs and value propositions. Broad knowledge about customers and the overall market, as opposed to just information from order points, can provide other benefits, including a better understanding of market trends, resulting in better planning and product development. (Myers and Cheung (2008, July)).

5.26: Supply Chains - From Push to Pull

A supply chain refers to the flow of physical goods and associated information from the source to the consumer. Key supply-chain activities include production planning, purchasing, materials management, distribution, customer service, and sales forecasting. These processes are critical to the success manufacturers, wholesalers, or service providers alike.

Electronic commerce and the Internet have fundamentally changed the nature of supply chains and have redefined how consumers learn about, select, purchase, and use products and services. The result has been the emergence of new business-to-business supply chains that are consumer-focused rather than product-focused. They also provide customized products and services.

In the traditional supply-chain model, raw material suppliers define one end of the supply chain. They were connected to manufacturers and distributors, which, in turn, were connected to a retailer and the end customer. Although the customer is the source of the profits, they were only part of the equation in this "*push*" model. The order and promotion process, which involves customers, retailers, distributors, and manufacturers, occurred through time-consuming paperwork. By the time customers' needs were filtered through the agendas of all the members of the supply chain, the production cycle ended up serving suppliers every bit as much as customers.

Driven by e-commerce's capabilities to empower clients, most companies have moved from the traditional "push" business model, where manufacturers, suppliers, distributors, and marketers have most of the power, to a customer-driven "pull" model. This new business model is less product-centric and more directly focused on the individual consumer. As a result, the new model also indicates a shift in the balance of power from suppliers to customers.

Whereas in the old "push" model, many members of the supply chain remained relatively isolated from end users, the new "pull" model has each participant scrambling to establish direct electronic connections to the end customer. The result is that electronic supply-chain connectivity gives end customers the opportunity to become better informed through the ability to research and give direction to suppliers. The net result is that customers now have a direct voice in the functioning of the supply chain, and companies can better serve customer needs, carry less inventory, and send products to market more quickly.

Minicase: Zara's Global Business Model (Capell, Kamenev, and Saminather, N.(2006, September 4)).

Inditex, the parent company of cheap, chic-fashion chain Zara, has transformed itself into Europe's leading apparel retailer over the past 10 years and has racked up impressive results in Asia and the United States. Since 2000, Inditex has more than quintupled its sales and profits as it has tripled the number of stores of its eight brands. (Zara is the biggest, accounting for two-thirds of total revenues.) More recently, Inditex increased its year-on-year net sales by 6% in the first nine months of its 2009 fiscal year to 7,759 million euros. Net income grew to 831 million euros. The retailer launched 266 new stores in the first nine months, bringing the group's total number of stores to 4,530 by the end of October 2009.

Key highlights for the period included openings in Asian markets, with 90 new establishments inaugurated by October 31, 2009. These store openings reflect the strategic importance of Asian markets for the group and underscore a year of robust growth in China, Japan, and South Korea. High points of store launches so far this year include flagship locations in Japan and Mainland China.

In Japan, Zara now has a total of 50 stores, including a second flagship location in Tokyo's Shibuya district, which is a must-see global fashion destination. Prior to this opening, Zara had already welcomed shoppers at another upscale store in Shibuya. Zara thus enhances its excellent retail presence in Tokyo's four key shopping areas: the two aforementioned flagship stores in Shibuya, two each in Ginza and Shinjuku, and one in Harajuku.

Meanwhile, in Beijing, the group celebrated the opening of a flagship location in one of the Chinese capital's busiest shopping hubs. The store, which opened its doors on the pedestrian Wangfujing Street, brings the group's number of stores in China to more than 60. The company's firm commitment to expansion in the Chinese fashion market is reflected in its decision to locate shops not only in Beijing and Shanghai but also in emerging cities such as Harbin, Dalian, Qingdao, Changchun, and Kunming.

To get where it is today, Zara has turned globalization on its head, distributing all of its merchandise, regardless of origin, from Spain. With more outlets in Asia and the United States, replenishing stores twice a week—as Zara does now—will become increasingly complex and expensive. The strain is already starting to show. Costs are climbing and growth in same-store sales is slowing: at outlets open for 2 years or more, revenues were up by 5% last year, compared with a 9% increase in 2004. So far, the company has managed to offset that problem by charging more for its goods as it gets farther from headquarters. For instance, Zara's prices in the United States are some 65% higher than in Spain, brokerage Lehman Brothers, Inc., estimates.

Zara has succeeded by breaking every rule in retailing. For most clothing stores, running out of best-selling items is a disaster, but Zara encourages occasional shortages to give its products an air of exclusivity. With new merchandise arriving at stores twice a week, the company trains its customers to shop and shop often. And forget about setting trends—Zara prefers to follow them. Its aim is to give customers plenty of variety at a price they can afford. Zara made 30,000 different items last year, about triple what the Gap did.

Zara does not collaborate with big-name designers and or use multimillion-dollar advertising campaigns. Instead, it uses its spacious, minimalist outlets—more Gucci than Target—and catwalk-inspired clothing to build its brand. Their advertising is their stores. To get shoppers' attention, Zara is located on some of the world's priciest streets: New York's Fifth Avenue, Tokyo's Ginza, Rome's Via Condotti, and the Champs-Elysees in Paris.

Keeping those locations flush with an ever-changing supply of new clothing means striking the right balance between flexibility and cost. So while rivals outsource to Asia, Zara makes its most fashionable items—half of all its merchandise—at a dozen company-owned factories in Spain. Clothes with a longer shelf life, such as basic T-shirts, are outsourced to low-cost suppliers, mainly in Asia and Turkey.

The tight control makes Zara more fleet-footed than its competitors. While rivals push their suppliers to churn out goods in bulk, Zara intentionally leaves extra capacity in the system. That results in fewer fashion mistakes, which means Zara sells more at full price, and when it discounts, it does not have to go as deep. The chain books 85% of the full ticket price for its merchandise, while the industry average is 60%.

Zara's nerve center is an 11,000-square-foot hall at its headquarters in Arteixo, a town of 25,000 in Galicia. That is where hundreds of twenty-something designers, buyers, and production planners work in tightly synchronized teams. It is there that the company does all of its design and distribution and half of its production. The concentrated activity enables it to move a dress, blouse, or coat from drawing board to shop floor in just 2 weeks, less than a quarter of the industry average.

Consider how Zara managed to latch onto one of hottest trends in just 4 weeks in 2006. The process started when trend-spotters spread the word back to headquarters: white eyelet—cotton with tiny holes in it—was set to become white-hot. A quick telephone survey of Zara store managers confirmed that the fabric could be a winner, so in-house designers got down to work. They zapped patterns electronically to Zara's factory across the street, and the fabric was cut. Local subcontractors stitched white-eyelet v-neck belted dresses and finished them in less than a week. The $129 dresses were inspected, tagged, and transported through a tunnel under the street to a distribution center. From there, they were quickly dispatched to Zara stores from New York to Tokyo, where they were flying off the racks just 2 days later.

5.27: Supply-Chain Management

Supply-chain management (SCM) has three principal components: (a) creating the *supply-chain network structure*, (b) developing *supply-chain business processes*, and (c) *managing the supply-chain activities*. (Lambert and Cooper (2000, January)).

The *supply-chain network structure* consists of the member firms and the links between these firms. Primary *members* of a supply chain include all autonomous companies or strategic business units that carry out value-adding activities in the business processes designed to produce a specific output for a particular customer or market. Supporting members are companies that simply provide resources, knowledge, utilities, or assets for the primary members of the supply chain. For example, supporting companies include those that lease trucks to a manufacturer, banks that lend money to a retailer, or companies that supply production equipment, print marketing brochures, or provide administrative assistance.

Supply chains have three *structural dimensions:* horizontal, vertical, and the horizontal position of the focal company within the end points of the supply chain. The first dimension, horizontal structure, refers to the number of tiers across the supply chain. The supply chain may be long, with numerous tiers, or short, with few tiers. As an example, the network structure for bulk cement is relatively short. Raw materials are taken from the ground, combined with other materials, moved a short distance, and used to construct buildings. The second dimension, vertical structure, refers to the number of suppliers or customers represented within each tier. A company can have a narrow vertical structure, with few companies at each tier level, or a wide vertical structure with many suppliers or customers at each tier level. The third structural dimension is the company's horizontal position within the supply chain. A company can be positioned at or near the initial source of supply, be at or near to the ultimate customer, or be somewhere between these end points of the supply chain.

Business processes are the activities that produce a specific output of value to the customer. The management function integrates the business processes across the supply chain. Traditionally, in many companies, upstream and downstream portions of the supply chain were not effectively integrated. Today, competitive advantage increasingly depends on integrating eight key supply-chain processes—customer relationship management, customer service management, demand management, order fulfillment, manufacturing flow management, procurement, product development and commercialization, and managing returns—into an effective value delivery network.Lambert , Guinipero, and Ridenhower (1998).

Regarding the supply-chain management function itself, in some companies, management emphasizes a functional structure, others a process structure, and yet others a combined structure of processes and functions. The number of business processes that it is critical or beneficial to integrate and manage between companies will likely vary. In some cases, it may be appropriate to link just one key process, and, in other cases, it may be appropriate to link multiple or all the key business processes. However, in each specific case, it is important that executives thoroughly analyze and discuss which key business processes to integrate and manage. With the shift from the traditional "push" to the modern "pull" model, supply-chain management has changed—the integration of e-commerce has produced (a) greater cost efficiency, (b) distribution flexibility, (c) better customer service, and (d) the ability to track and monitor shipments.

5.28: CSR and Sweatshops

Source: Weronika, (CC-BY 2.0, 2013) Figure 9.1 A relative of one of the workers in a clothing factory at Rana Plaza, Bangladesh, holds up the picture of his missing family member, presumed dead.

The Importance of Sweatshops

On April 24, 2013, at Rana Plaza on the outskirts of Dhaka, Bangladesh, a building containing apparel factories collapsed, trapping and killing over 1,100 employees. It was not only the worst industrial disaster in the history of the garment industry, it was also the world's most fatal industrial building collapse. News reports soon emerged that the factory owners had ignored ominous warning signs, such as visible cracks in the wall, and had illegally added several stories to the top of the building, creating a weight the building could not bear. Many of the factories operating in the building were producing apparel for well-known Western brands, such as Walmart, Joe Fresh, and Mango.

Rescue workers struggled for over a week to reach trapped survivors, while hospitals tended to the over 2,500 workers who had escaped, many with severe injuries. Survivors told heart-rending tales of having lost mothers and sisters who had worked in the same factories. The deaths of so many innocent workers created a firestorm of controversy in Bangladesh and around the world. Accusations and recriminations were leveled at corporations and government officials. A period of intense and profound soul-searching ensued for the global fashion companies that made substantial use of outsourced factory labor in Bangladesh. Within a few months, two major initiatives were announced, one American and one European, to increase safety and accountability in Bangladeshi factories.

In this chapter, we will explore the complex issues underlying the outsourcing of manufacturing and its relationship to sweatshops and child labor. While the horrific example of Rana Plaza might lead one to assume that sweatshops are always a bad thing, a closer examination reveals the limitations of a simplistic view. In fact, Bangladesh relies heavily on outsourced apparel manufacturing for the well-being of its citizens. Clothing factories employ over 3 million Bangladeshi citizens and the country obtains nearly 80% of its export earnings from the apparel sector.[1] An outright ban on outsourced manufacturing would leave many poor Bangladeshis without a job. Although such jobs may not seem desirable from the perspective of citizens of industrialized countries, in developing countries these kinds of factories often pay more than the average salary.

In this chapter's debate section, we will ask ourselves what is the proper attitude of a major global brand toward manufacturing in a country like Bangladesh, which has suffered from a spate of manufacturing disasters in recent years. The company we will consider is Disney, which is known for producing toys, clothes, and movies aimed at children. Disney has been accused of producing goods in sweatshop factories that employ child labor. Obviously, Disney cannot afford to become known as a company that is unconcerned with the rights of children. What should they do? In order to discuss this issue, we first need to come to a more sophisticated understanding of sweatshops and their benefits and disadvantages.

Understanding Sweatshops: History and Definitions

The term *sweatshop* refers to a factory that is guilty of some sort of labor abuse or violation, such as unsafe working conditions, employment of children, mandatory overtime, payment of less than the minimum wage, unsafe working conditions, abusive discipline, sexual harassment, or violation of labor laws and regulations. The US Government Accounting Office has chosen to define a sweatshop as any manufacturing facility that is guilty of two or more of the above types of labor abuses.[2] However, it is important to understand that the term *sweatshop* is not just a legally defined term but a word that has entered the general lexicon and is used broadly.

Historically, the term was first used in association with the manufacture of articles of clothing and apparel. Shortly after the beginning of the industrial revolution, which began in the United Kingdom at the end of eighteenth century and the beginning of the nineteenth, a rise in living standards led to a much greater consumer demand for clothing. Although the raw materials of clothing—fabric, yarn, buttons, and thread—could be produced efficiently in large, mechanized factories, the same was not the case for the final garment itself. To the present day, it has remained difficult to mechanize the sewing process involved in making clothing: The manual dexterity of a human being has always been needed in addition to a simple sewing machine. Consequently, the manufacturing of clothing has remained labor intensive relative to other industries.

Another particularity of the apparel industry is that it is difficult to predict demand for articles of fashion. In any given year, some styles and colors will be wildly successful, while others will prove unpopular and need to be sold at a discount (hence the ubiquitous nature of discount sales of clothing). Given high labor costs and unpredictable demand, garment manufacturers turned to a system built on outsourcing production to middlemen who would then parcel out production to a number of small workshops. The middlemen were tasked with making sure that production deadlines were met, so they put pressure on the workshops and became known as *sweat-ers*, meaning that they made the workshops and their employees sweat. In time, these high-pressure workshops became known as sweatshops.

By the 1830s, the abuse of workers in sweatshops had become a topic of social concern, and the United Kingdom passed its first Factory Act, which was then amended some 7 times by 1878.[3] In 1844, Friedrich Engels, who would attain fame as Karl Marx's intellectual partner and one of the founders of Marxism, wrote a critique entitled *The Condition of the Working Class in England*. As industrial production developed in the United States, sweatshops also became a major American political issue. Many of the Abolitionists who became famous for their staunch opposition to American slavery also fought against sweatshops, considering them a form of human oppression akin to slavery. By the 1890s, a number of groups sprung up to try to alleviate and control sweatshop conditions.

Origins of the Anti-Sweatshop Movement: The Triangle Shirtwaist Factory Fire

By the first years of the twentieth century, New York City had become a center for apparel manufacturing and, consequently, for sweatshops as well. Tens of thousands of immigrant workers toiled in the sweatshops of an area that is still referred to as the Garment District, the heart of which lies along Seventh Avenue in midtown Manhattan.

By 1900, a number of local unions allied to form the International Ladies Garment Workers Union (ILGWU), the first major attempt to unionize sweatshop labor in the United States. In 1909, approximately 20% of the workforce of the Triangle Shirtwaist Factory walked out in the first major strike in the garment sector.[4] As the strike wore on and the owners of the Triangle Shirtwaist Factory learned of attempts to unionize the remaining workers, the owners locked out the entire staff. At a series of public meetings at which female workers spoke movingly of their deplorable working conditions, a mass walkout ensued, in which 20,000 out of 32,000 total shirtwaist workers walked off the job, giving this action the name of the "Uprising of the 20,000." While a few shops accepted unions and most agreed to improve conditions, the Triangle Shirtwaist Factory did not accept a union. Shortly afterwards, in 1910, 60,000 workers walked off the job in an action that became known as the "Great Revolt." The dispute was mediated by legendary jurist Louis Brandeis, who later became known as one of the Supreme Court's greatest justices.[5]

Despite the central role of the Triangle Shirtwaist Company in these actions, and despite the promises of improvement made pursuant to Brandeis's mediation, it soon became clear that not enough had yet been accomplished. On March 25, 1911, a fire broke out in the Triangle Shirtwaist Company factory located next to Washington Square Park.[6] With several of the main exits locked to prevent employees from stealing, only one exit was available and it was soon blocked by flames. Many workers succumbed to the heat and smoke while others, trapped by the growing fire, stepped out onto an eighth floor ledge, and when the heat became unbearable, jumped off. Dozens of young women fell to their deaths on the pavement below, creating a horrific image that would transform the entire industry. It was the worst industrial accident in the history of the United States.

In the wake of the Triangle Shirtwaist Fire, a number of reforms were promptly undertaken in New York, with over sixty laws dealing with fire safety and labor rights passed by the state legislature in the first two years after the fire. These reforms were echoed and amplified throughout the United States and around the world in the decades that followed. In 1919, the International Labour Organization was created to protect worker rights.[7] In 1937, the United States passed an important national statute on union and labor rights, the National Labor Relations Act.[8] Despite these and other reforms, however, sweatshops stubbornly refused to disappear. In 1994, the US Government Accounting Office noted that thousands of sweatshops continued to operate in the United States.[9] Rather than disappearing, the sweatshop problem would follow the international path of globalization and spread around the world.

Modern Sweatshop Scandals: Kathie Lee Gifford, Nike, Saipan, and Bangladesh

Globalization is a term that refers to the growing interconnection of the world's economies. The globalization trend greatly picked up speed after international moves to lower import tariffs were instituted by the General Agreement on Trade and Tariffs (GATT) in 1947 and even more so after the GATT system was institutionalized in the World Trade Organization (WTO) in 1995. At the corporate level, one manifestation of globalization is foreign outsourcing, the practice of moving manufacturing operations to low-cost countries. Fashion and apparel companies were among the first to take advantage of the benefits of outsourcing. Throughout the period from 1970 to the present, employment in American apparel factories dropped sharply as companies moved production to countries like Indonesia, Vietnam, China, Mexico, and the Dominican Republic.

The outsourcing movement was accompanied by increasing reports of sweatshop abuses. As a result, a number of nongovernmental organizations (NGOs) became involved in anti-sweatshop activities. One of these was an American organization called the National Labor Committee, headed by labor activist Charles Kernaghan. Kernaghan was devoted to ferreting out instances of sweatshop abuse in foreign factories producing for American brands, and then publicizing the abuses in an effort to shame the companies into changing their practices. Not surprisingly, both the factories and their American clients were quite reluctant to share information with Mr. Kernaghan. He therefore developed a number of sleuthing tactics; for example, he would surreptitiously trail the garbage trucks that picked up the factory's waste, following the truck to the local dumpsite. Later, displaying remarkable commitment to his job, he would sneak in and rummage through the waste, looking for discarded office files. When he found the factory's production records, often minutely described in spec sheets, he was able to determine who the client was and how much the client was paying for the labor cost included in assembling a particular garment. Another technique employed by Kernaghan was to find the local food stands where workers would go for lunch or coffee. There he would seek to engage the workers in conversation about the factory. This technique had to be employed with great discretion because, if a factory owner or foreman heard that a worker was collaborating with Kernaghan, there was a great likelihood the worker would be punished or fired.

After several years of watching his reports go ignored by the mainstream media, Kernaghan finally broke a story in 1993 that would transform the public image of American outsourcing. Kernaghan discovered that a fashion line produced for Walmart under the label of a prominent American television personality, Kathie Lee Gifford, was manufactured in Guatemala in a factory that used child labor and engaged in a number of worker abuses. Although Kernaghan expected that this report would receive little coverage, he was unwittingly helped by Gifford herself, who went on the air during her popular morning show, *Live with Regis and Kathie Lee*, to tearfully deny the allegations. In the United States as in many other countries, any incident involving a media celebrity becomes fodder for the popular press. Kernaghan found himself at the center of a news storm. As Kernaghan and Gifford exchanged accusations and denials, the issue of sweatshop abuses came to the fore. Gifford eventually promised publicly to ensure that employment of children would cease and worker rights would be respected, and the controversy abated. Kernaghan has stated that, in the end, Gifford changed nothing of substance.

Throughout the 1990s, a number of other sweatshop-related abuses came to light in factories used by American brands. Several of these involved the island of Saipan, a small American protectorate in the Pacific. A number of factory owners discovered that since Saipan is technically American territory, clothing produced in Saipan could enter the United States duty-free and carry the label "Made in America." Since Saipan is much closer to Vietnam and the Philippines than to the United States, a number of these factories recruited Vietnamese and Filipino natives as factory workers. Upon their arrival in Saipan, however, some of these workers were exposed to flagrant human rights abuses and, in the worst of cases, outright slavery. In one notorious case, workers were literally imprisoned in the factory and forced to work without pay. Eventually, these abuses were revealed and US prosecutors filed charges against factory owners, some of whom were sentenced to substantial prison sentences.

In the early 1990s, one of America's most prominent footwear brands, Nike, also came under attack as reports emerged from Indonesia and Vietnam of worker abuse. In Vietnam, a young female factory employee was working on basketball shoes when her machine exploded and sent a bolt through her heart. The American cartoonist Garry Trudeau began featuring a series of strips satirizing Nike's sweatshop factories in his popular newspaper cartoon Doonesbury. At first, Nike refused to accept responsibility, pointing out that Nike had never manufactured its own footwear and apparel. Nike's contracts with its sourcing factories required the factories to obey labor regulations and, in Nike's view, this meant that any abuses were the factories' responsibility. However, by 1998, the continuing negative publicity obliged Nike to reverse course by instituting a strict code of conduct for its factories.

Through the efforts of a crusading Secretary of Labor Robert Reich, the Clinton administration sought to leverage the power of the bully pulpit available to the US presidency. In 1995, the Clinton administration announced the formation of the Apparel Industry Partnership, a government–industry collaboration aimed at reducing instances of sweatshop abuse. Companies who were able to establish that they had produced their items in sweatshop-free environments would be allowed to add a special label in their clothes: "No Sweat." It seems this approach was ill-advised, as no companies ever made use of it, perhaps because many people would be disconcerted to find a reference to sweat in their garments.

In 1998, America's college students created *US Students Against Sweatshops* (USAS), which has proven to be an influential public interest group. USAS's initial goal was to convince American universities to eliminate sweatshops from the sourcing of college apparel, such as the sweatshirts and T-shirts bearing university logos that are commonly sold in campus stores and bookshops. Around the same time, a group of large American brands announced the creation of the Fair Labor Association (FLA), a group that set standards for certifying American brands as sweatshop-free if they submitted themselves to a regime of regular inspections. The FLA was viewed with suspicion by many antisweatshop activists and NGOs, in part because the FLA did not accept membership from unions, and also because it was felt that FLA's principal approach, to reward corporations with certification for a few years of minimal inspections, was insufficient to truly eliminate sweatshop abuses. As a result, union groups and the USAS led the way in creating a rival group, the Worker Rights Consortium (WRC), which took a different approach. The WRC investigated reports of abuse and published its findings.

In light of continued scrutiny from groups like the WRC, the USAS, the National Labor Committee, and other international groups such as the Clean Clothes Campaign, most large apparel brands developed and publicized their own internal codes of conduct for suppliers. Such codes of conduct were contractually imposed on all suppliers and required that factories comply with all local labor laws, refrain from employing children, and maintain safety programs. In addition, most brands began to require that factories make themselves available for inspections to make sure that they were complying with the standards set forth in the codes of conduct. A number of inspection companies sprang up to service the needs of the corporations and groups of young inspectors soon scanned the globe, moving from factory to factory, checking them for fire violations, reviewing records to make sure that rules on overtime were respected, and so forth.

Despite all these efforts, reports of violations continued to be heard. The American consumer seemed to have wearied of the sweatshop issue to some extent, and companies like Walmart and Nike, which had often been accused of sweatshop abuses, saw their sales and stock valuations continue to rise. Many companies began to focus more on environmentalism and anti–global warming issues, and a number of brands began to require that their supply factories obtain some sort of environmental certification, such as the Bluesign certification that was established in Germany under the auspices of SGS, the world's largest inspection company. Then, in 2012 and 2013, a horrific series of accidents—eerily reminiscent of the Triangle Shirtwaist fire that had occurred a century before—reminded the world's consumers that the sweatshop issue was still with us.

In 2012, a fire broke out at an apparel factory in Pakistan, killing some 270 Pakistani workers. Among the western companies sourcing from that factory were the UK retailer Tesco and the German apparel brand Kix. Kix's offer of compensation to the victim's families of $2,000 per fatality was viewed by many Pakistanis as insulting. Then, just a few months later, at the Tazreen Fashions factory in Dhaka, Bangladesh, another 112 factory workers perished in a fire. Again, it was discovered that well-known western brands such as Walmart, Disney, and the Gap has sourced products from the factory. The world's attention was squarely focused on Pakistan and Bangladesh when the building collapse at Rana Plaza in Bangladesh became the worst industrial catastrophe in the history of apparel manufacturing.

The Other Side of the Story: In Praise of Sweatshops

In light of the above history, it might seem startling that many experts appear to accept the existence of sweatshops as something positive. Economist Jeffrey Sachs, who is perhaps the world's foremost expert on the eradication of poverty (he was the creator of the United Nation's Millennium Project to cut global poverty in half) was quoted in 1997 as saying, "The problem with sweatshops is not that there are too many, but that there are not enough."[10] What did he mean by that?

In general, economists are less disturbed by sweatshop abuses than are labor activists, but most economists would deny that this is because they are heartless or unconcerned with human rights. Rather, they concede that sweatshop abuses are both common and reprehensible, but they also believe that the benefits to the local economy from international outsourcing more than outweigh the harm. According to this point of view, sweatshops are part of the industrialization process and are an inevitable by-product of economic development. Factories in poor countries are able to attract foreign customers because local labor is cheap. As factories proliferate and employment rises, factories must begin to compete for better workers. Wages therefore increase, and factory conditions improve. With a broader tax base and greater economic growth, local governments are able to invest in the infrastructure for further development, building roads, hospitals, and schools.

Some international research studies appear to confirm the economists' point of view. One study revealed that, in most countries where the presence of sweatshops had been reported, apparel factory workers actually earned more than the average national wage.[11] A number of countries have passed through a manufacturing phase in which sweatshop conditions were more prevalent on their way to full industrialization and a diversified economy. Examples include the United States, Japan, and Korea. Most recently, China appears to be following a similar path, though it is still in a transition phase and reports of sweatshop abuses are still common.

Case Study: Disney in Bangladesh

The Walt Disney Corporation is one of the world's largest entertainment conglomerates, known for its theme parks, such as Disneyland and Disneyworld; its long history of producing blockbuster animated movies from *Fantasia* and *Snow White* to *The Lion King* and *Tangled*; and its sale of licensed apparel and toys featuring famous characters from the Disney movies. Given that an important segment of Disney's target market is children, the company is especially exposed to negative publicity related to certain sweatshop abuses, in particular, the use of child labor.

After the 2011 Tazreen Fashions factory fire in Bangladesh, Disney management became concerned about the company's public relations exposure due to its sourcing operations in Bangladesh. Although Disney's apparel manufacturing was far from negligible, it still represented a very small percentage of Disney's total earnings, which came predominantly from its television, film, and theme park divisions. One commonality to the Disney-branded products was that they all relied on Disney's image as a wholesome provider of family fare. If Disney were to become tagged with accusations similar to those leveled at Kathie Lee Gifford—namely that it was the beneficiary of child labor in sweatshop conditions—the consequences could be quite devastating for Disney's public image. What would Disney do if high-school students started nagging their parents to abandon Disney vacations or to stop renting Disney movies?

Therefore, in early 2013, Disney decided to pull its manufacturing operations out of Bangladesh. That Disney departed from Bangladesh shortly before the Rana Plaza building collapse was misinterpreted by many as having been caused by the collapse, whereas Disney had actually made its decision well before the collapse. Despite this, many representatives of antisweatshop NGOs and workers' rights groups condemned Disney's decision as an abdication of responsibility. In the view of such critics, Disney should have stayed behind to help remedy the problem.

Topic for Debate: Should Disney Return?

In this chapter's debate section, we ask, would it more ethical for Disney to stay in Bangladesh and use its considerable reputation to help lobby for improved worker conditions at Bangladesh apparel factories?

We will assume for the purposes of this debate that the Disney Board of Directors has been pressured to reconsider its position. Two directors are preparing their presentations for an upcoming board meeting at which the issue will once again be discussed. One of the directors, whom we will call Mr. Jones, is one of the founders of an international NGO dedicated to worker rights. He was invited onto the board specifically because of his ability to speak to issues of human rights compliance in outsourcing factories. It is Mr. Jones's opinion that Disney should resume operations in Bangladesh.

On the other side is a director we will call Mr. Smith, who is one of the principal shareholders of the Disney Corporation. Mr. Smith is very concerned that a return to Bangladesh would expose Disney to major financial risk, because another factory catastrophe coming after Disney's return could lead to Disney's name being tarnished. You will be asked to help one of these directors prepare their presentation at the Board meeting.

Affirmative

Disney should resume manufacturing in Bangladesh.

Possible Arguments

- Disney has sufficient prestige to help lobby for improved human rights compliance in Bangladesh.
- Disney's departure may only encourage Disney's suppliers and related parties to leave Bangladesh as well, thereby diminishing employment in Bangladesh and harming the local workers through unemployment.
- By helping support the efforts of other foreign companies sourcing in Bangladesh, Disney will learn state-of-the-art methods for working with governments and community groups to help improve worker safety, which can only serve Disney positively in the other countries where Disney

sources its apparel products.

Negative

Disney should not resume manufacturing in Bangladesh.

Possible Arguments

- Disney markets products to children and families; any reports of child labor or the deaths of teenage workers in factories could be devastating to Disney's image.
- Disney should reward—with its factory contracts—those countries that are doing a good job in providing a safe working environment for its employees, free of sweatshop labor.
- Disney's departure should help create an incentive for Bangladeshi authorities to improve conditions in their factories. If no foreign buyers leave, it is too easy for them to become complacent and do little to change the status quo.

Readings

9.1 Address the Real Challenges

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9.2 Disney's Decision Was Appropriate

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9.4 Responsibility Is Local, Not Global

Bhagwati, Jagdish. "Responsibility for Sweatshops is Local, Not Global". *New York Times*. July 11, 2014. http://www.nytimes.com/roomfordebate/2013/05/02/when-does-corporate-responsibility-mean-abandoning-ship/responsibility-for-sweatshops-is-local-not-global.

Synthesis Questions

1. When you buy clothing do you check the inside label to see where the item was manufactured? Would it matter to you to discover that an item was manufactured in Bangladesh?
2. If you found an article of clothing that had a label stating that it was manufactured in the United States, would this make it more attractive to you? What if the item was 20% or 30% more expensive, would that keep you from buying it?
3. What is the best way to make sure the workers in factories are treated fairly? Can you come up with one detailed proposal?

Endnotes

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5. Tony Michels, "Uprising of 20,000 (1909)." in Jewish Women: A Comprehensive Historical Encyclopedia, Jewish Women's Archive, March, 20 2009, http://jwa.org/encyclopedia/article/uprising-of-20000-1909.

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7. Savitri Goonesekere, "A Rights-Based Approach to Realizing Gender Equality," UN Women, accessed May 5, 2014, http://www.un.org/womenwatch/daw/news/savitri.htm.

8. National Labor Relations Act, 29 U.S.C. §§ 151-169 (1935).

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5.29: Supply-Chain Agility and Resiliency

The best companies create supply chains that can respond to sudden and unexpected changes in markets. Agility—the ability to respond *quickly* and *cost-effectively* to unexpected change—is critical because in most industries, both demand and supply fluctuate more rapidly and widely than they used to. In fact, the best companies use agile supply chains to differentiate themselves from rivals. For instance, Zara has become Europe's most profitable apparel brands by building agility into every link of their supply chains. At one end of the product pipeline, Zara has created an agile design process. As soon as designers spot possible trends, they create sketches and order fabrics. That gives them a head start over competitors because fabric suppliers require the longest lead times. However, the company approves designs and initiates manufacturing only after it gets feedback from its stores. This allows Zara to make products that meet consumer tastes and reduces the number of items they must sell at a discount. At the other end of supply chain, the company has created a superefficient distribution system. In part because of these decisions, Zara has grown at more than 20% annually since the late 1990s, and its double-digit net profit margins are the envy of the industry.

Agility and resiliency have become more critical in recent years because sudden shocks to supply chains have become more frequent. The terrorist attack in New York in 2001, the dockworkers' strike in California in 2002, and the SARS epidemic in Asia in 2003, for instance, disrupted many companies' supply chains.

Agility and resiliency help supply chains recover more quickly from such sudden setbacks. When, in September 1999, an earthquake hit Taiwan, shipments of computer components to the United States were delayed by weeks and, in some cases, by months. Most computer manufacturers, such as Compaq, Apple, and Gateway, could not deliver products to customers on time and incurred losses. One exception was Dell. The company changed the prices of PC configurations overnight to steer consumer demand away from hardware built with components that were not available to machines that did not require those parts. Dell could do this because it had contingency plans in place. Not surprisingly, Dell gained market share in the earthquake's aftermath. (Lee (2004, October)).

Supply-chain agility and resilience no longer imply merely the ability to manage risk. It now assumes that the ability to manage risk means being better positioned than competitors to deal with—and even gain advantage from—disruptions. Key to increasing agility and resilience is building *flexibility* into the supply-chain structure, processes, and management. (Sheffi (2005, October)).

5.30: Fair Trade

Source: Lisette Cheresson, (CC-BY, 2013) Figure 8.1 Coffee is the world's second-most traded commodity, behind petroleum. Because coffee grows best on hillsides, harvesting can be labor-intensive – it takes a lot of work to get ripe coffee beans from the bush to your cup. Fair Trade's goal is to make life better for those involved in that process.

Fair Trade: Conscious Consumerism Comes to Coffee

The concept of *fair trade* arose in the mid-twentieth century as a means of providing farmers and farm workers around the world with employment benefits similar to those found in developed nations. At its broadest level, fair trade can be seen as an initiative of the developed world to reward principled production in the developing world. More specifically, fair trade operates primarily as a certification system under which qualified producers (who follow certain environmental and labor standards) are guaranteed a minimum price for their production. This price guarantee is intended to augment and stabilize the revenues of producers in developing countries, so that they can invest in social welfare infrastructure and environmentally friendly farming methods. It is worth noting at the outset that there are some slight variations in the way this concept is spelled or presented. The generic term for this entire field is "fair trade," but we also commonly it spelled as "Fairtrade" or presented with capital letters as "Fair Trade." These latter two versions are actually trademarks that are owned by fair trade organizations, which certify that a participating company has met certain standards.

When people discuss fair trade, the conversation usually begins with coffee, which remains by far the most economically significant product category covered by fair trade. Although fair trade has expanded to include other agricultural and manufactured products, such as bananas, tea, honey, sugar, rice, cacao, organic cotton, textiles, and handicrafts, any attempt to evaluate the success or failure of the fair trade movement must begin with an examination of its role in the coffee industry. With corporate coffee giants like Starbucks vaunting their sales of fair trade coffee, most consumers have become aware of the movement, although few are able to precisely define the mandatory standards that must be satisfied in order for a product to be called fair trade. Now, fair trade coffee is as ubiquitous on supermarket shelves as food deemed certifiably organic—but compared to the organic label, the fair trade certification process is more complex and subject to different interpretations from different certifying bodies.

In this chapter, you will be asked to consider whether a New York–based specialty coffee chain should make the transition to selling exclusively fair trade coffee and tea products. The chain's CEO is aware that fair trade is generally well viewed by consumers, but she has also read some disturbing articles in the press about inconsistencies and even corruption in the fair trade sector. Should she ignore what she has read? Making the switch will increase costs to her consumers, whose cup of coffee will have to go up in price by twenty-five to fifty cents—but on the positive side she will be able to claim that her business is socially responsible and sustainable. Does a coffee shop chain that aspires to the highest level of social responsibility have an obligation to engage in fair trade, even if the existing fair trade system is not perfect? In order to discuss this issue, we need to arrive at a deeper understanding of what fair trade means.

The Origins of Fair Trade

As with many other progressive social programs, the fair trade concept can be traced back to the personal initiatives of a few dedicated reformers with a social conscience. In 1946, Edna Ruth Byler, an American businesswoman, had the idea of importing needlecrafts from impoverished Puerto Rican communities and paying their creators a fair wage for their work. Byler's efforts became the foundation for Ten Thousand Villages, the first North American nonprofit organization devoted to connecting handicraft manufacturers in developing countries with developed-world commodity buyers. Today, Ten Thousand Villages maintains long-term relationships with artisans in 38 countries that provide stable opportunities for income.[1]

Byler's efforts constituted a precursor of fair trade, but the first organizations to utilize the fair trade designation in its modern sense were European. The first fair trade organization in Europe was in the United Kingdom, an offshoot of Oxfam UK, which during the 1950s had sold crafts made by Chinese refugees. By 1964, this had developed into the fair trade Organization, and in 1967, the Netherlands initiated its own cooperative, fair trade Original. Following a concept similar to that of the Ten Thousand Villages storefronts in the United States, the Dutch opened a fair trade World Shop in 1969. World Shops became the first retail distribution network of fair trade products and the first European World Shops conference was held in 1984.[2]

Guatemalan-grown fair trade coffee was introduced in the Netherlands in 1973. In 1988, the first fair trade coffee brand, Max Havelaar, hit the market. Within a year, Max Havelaar commanded a 3-percent share of all coffee sales in the Netherlands. By the late 1980s, there were several national fair trade cooperatives operating in Europe under different umbrella organizations, some of which spanned the jurisdiction of several countries. One of these was the Network of European World Shops (NEWS!), which was formed in 1994 and soon represented roughly 3,000 different shops across the continent.

Fair trade quickly outgrew its European origins. In 1989, the first global fair trade network was initiated, the International Fair Trade Association (IFAT). Five years later, the first network of fair trade organizations was founded in North America, called the Fair Trade Federation. In 1997, Fair Trade Labeling Organizations International (FLO) was founded with the intention of creating a unified worldwide certification scheme. There are currently 23 members of FLO around the world. Founded in 1998, TransFair USA (which changed its name to Fairtrade USA in 2010) was an early FLO member and became the leading third-party certifier of fair trade goods sold in the United States. TransFair got its start in California, importing the production of Nicaraguan coffee farmers.

In 1998, four European Fair Trade organizations banded together to form an international coalition to promote and more clearly define fair trade practices around the world. Calling their coalition FINE, these organizations set forth one of the most commonly used definitions of fair trade:

> A trading partnership, based on dialogue, transparency, and respect, that seeks greater equity in international trade. It contributes to sustainable development by offering better trading conditions to, and securing the rights of, disadvantaged producers and workers —especially in the South. [3]

Fair trade, in the view of its supporters, is quite different from free trade, the defining international economic strategy of the twentieth century. The primary goal of free trade is to increase the economic growth of both developed and developing nations. The massive and continuing expansion of global free trade has been driven by consumers and manufacturers in developed nations. Fair trade, on the other hand, is intended to serve the interests of workers in developing nations. Fair trade is meant to empower manufacturers and farmers in developing nations by providing them with privileged access to socially conscious consumers in the developed world.[4]

Fair Trade in Action: The Key Players

Most socially conscious consumers who are aware of fair trade simply assume that it signals that an item is somehow a "good product," either for environmental reasons or because workers involved in production are well paid. However, as we shall see, the system is more complicated than one might expect, and a well-informed consumer or business needs to go deeper to have a sufficient basis for evaluating fair trade and deciding whether or not to participate in it.

One of the reasons for the complexity of the fair trade system is that there is no universal fair trade authority. There are several important international organizations that serve a coordinating function, but none of these has the power to impose standards on all players in the field. In fact, there are many different kinds of fair trade organizations: international nonprofit organizations, regional nonprofit organizations, local nonprofit organizations that certify fair trade brands, local nonprofit organizations that certify fair trade farming and exporting cooperatives, and finally, both nonprofit and for-profit inspection organizations that visit the farming cooperatives to determine whether they meet the criteria to be certified as fair trade. Let us describe a few of the most important organizations.

Most fair trade certifiers and umbrella organizations are now members of the *World Fair Trade Organization* (WFTO; formerly IFAT). The WFTO serves as a global network and clearinghouse, serving the interests of over 370 independent organizations in more than 70 countries.[5] *Fairtrade International* (FLO) is an international organization, based in Bonn, Germany, that promotes the most widely used certification system for products designated as fair trade or "Fairtrade." Note that FLO deliberately distinguishes itself by using a special way of spelling the term with no space between the words. One reason for this approach is that FLO has registered "Fairtrade" as a trademark, which it then licenses only to those organizations that meet its standards. The Fairtrade trademark has become the world's leading way of designating that a product qualifies as fair trade. Note, however, that other organizations may still prefer to certify a product as fair trade.

FLO-CERT is a private, for-profit company that carries out certification audits for national organizations that wish to authorize local brands and vendors to use the Fairtrade label.[6] *Fair Trade USA* is America's largest fair trade organization; notably, it does not use the Fairtrade trademark, as it resigned from FLO in 2011 out of disagreement with several aspects of the FLO system. In particular, Fair Trade USA objected to the fact that FLO certification is inconsistent with regard to who can be considered a certified producer: With coffee products, certification is limited to cooperatives made up of independent farms, while with other products, like bananas and tea, workers on large farms can also receive certification. Consequently, Fair Trade USA has developed its own certification system that does not use the Fairtrade label, but rather designates products and producers with its own trademark: "Fair Trade Certified."

The above-described organizations are just a few of the literally hundreds of nonprofit and for-profit organizations operating in the fair trade sector. Next, let us describe how the process works in bringing fair trade products to your kitchen.

How It Works: From Farm to Supermarket

There are two different types of fair trade certification: *organizational recognition* and *producer certification*.

Organizational Recognition

To become a fair trade vendor or brand and obtain the right to use one of the authorized trademarks or labels, importers and vendors are certified by national fair trade organizations. Such brands are recognized as trading only products from authorized suppliers who, in turn, buy from farms that pay their workers a fair wage and follow sustainable practices. When you see a product in a supermarket or store that is labeled fair trade, it indicates that the brand has sought and obtained certification from a national Fair Trade organization.

Producer Certification

Producers, in fair trade terms, usually refer to cooperatives of independent farms; however, in the case of particular products, the farms and farm workers themselves may be certified. Producers gain Fair Trade or Fairtrade certification from independent certification organizations. FLO-CERT, which provides Fairtrade certification for farmers in more than 70 countries, is the largest certifying organization in the world. [7]

Now let us look more closely at the different operators in the fair trade supply chain, working backward from your local retailer all the way to the farm workers at the other end.

Retailers

Any local retailer, whether it is a supermarket, boutique, or coffee shop, can sell Fair Trade or Fairtrade products. As noted above, the brands and products themselves must be authorized to use one of the recognized labels or trademarks, but any store or shop that buys legitimate products at wholesale is free to resell them to consumers any way it pleases. Note, in particular, that the local retailer is under no obligation to sell the products at any given price or to return any of its revenues or profits directly to producers in the exporting country. What this means in practice is that, some retailers, aware that a small percentage of affluent consumers is desirous of socially responsible products, will simply charge a very high premium for the fair trade products. The profits generated by such high prices are purely for the retailer alone. Thus, a consumer who pays a high price for a fair trade product, under the impression that this premium will go directly to the producers or farm workers, is somewhat misguided. Indeed, as we will see, some portion of these high prices is *indirectly* returned to the farmers, but in most cases, the amount is less than consumers would expect.

Vendors, Brands, and Importers

Companies that wish to market their products as fair trade and feature a certification label or trademark (such as "Fairtrade" or "Fair Trade Certified") on their packaging must conform to the standards of one of the national certification authorities. Essentially, this means they must buy their product from a certified importer or directly from one of the certified exporting cooperatives. Fair trade importers must pay a minimum price of $1.20/pound for Arabica beans or $1.05 for Robusta beans. This minimum price guarantee is one of the essential features of the fair trade concept.

Exporting Cooperatives

In the coffee sector, there are more than 300 exporting cooperatives in over 20 coffee-exporting nations. Cooperatives are certified by an international certification authority, which in most cases means FLO-CERT. Cooperatives buy their coffee from small, independent farms that adhere to fair trade principles, meaning that workers are paid fairly and that environmental standards are followed. Fair trade coffee is not required to be fully organic, though growers may use organic farming methods if they wish; however, limits are placed on the use of pesticides and herbicides.

The cooperative has the responsibility of visiting the individual farms to make sure that they are complying with standards. The trouble is, according to some farmers, that cooperatives do not always enforce international fair trade standards. Allegedly, the crops from farmers who bribe fair trade cooperatives to be lax with their inspections are mixed in with those from farmers that are truly committed to fair trade practices.

The cooperative consolidates its purchases and sells the bulk coffee to certified importers in developing nations. It is the cooperative that is guaranteed the minimum price maintained by the fair trade system. Note that most cooperatives are unable to sell all of their coffee as fair trade due to insufficient demand, so roughly half to two-thirds of their coffee is sold without a special label. Cooperatives are required to use their profits to engage in social projects, such as building schools or athletic fields for farm workers.

Farmers

In order to sell their coffee to fair trade exporting cooperatives, farmers must agree to limit their use of child labor, GMOs, herbicides, and pesticides. Farmers are not guaranteed a minimum price for their coffee.

Fair Trade Social Projects

Most fair trade organizations, including Fair Trade USA and FLO, promote social and economic development projects in the farmers' communities. One of the principal elements of the fair trade concept is the requirement that a portion of each cooperative's earnings must be invested locally in projects to benefit the farmers, e.g., building schools, hiring teachers, funding for women's empowerment groups, and/or investment in healthcare. Farmers are taught how to lobby large international organizations and demand fair prices for their labor, and children are encouraged—sometimes required—to go to school rather than to work. Fair Trade USA requires that all its farmers have access to doctors and affordable medical treatment in case of illness or injury. Projects are also funded to help protect the environment, for example, through clean water initiatives, training on ways to reduce pesticides and herbicides, education about crop cycling, and funding for reforestation.

One problem with fair trade social projects is that their effects are extremely difficult to quantify. As of 2013, no universal metric had yet been developed to measure the impact that fair trade projects actually have on the developing world. Moreover, it has been alleged that many cooperatives devote all of their profits (if they make any) to social projects, leaving them unable to pay higher cash prices to their farmers. The farmers are thus left with social projects of arguable utility rather than the higher cash prices for their crops that many of them might have preferred. Thus fair trade organizations have come under fire for allegedly making promises they cannot keep.

Fair Trade and the Global Coffee Market

The rise of the fair trade coffee market provides an interesting case study on the interplay between international politics and the global economy. Although coffee is the world's second-most traded commodity, after petroleum, the global coffee market has been subject to periodic boom and bust periods; when prices are low, living conditions become abject for the world's millions of coffee farm workers.[8] In response to this problem, the first International Coffee Agreement was signed in 1962 to impose export quotas and set international prices for coffee as a means of protecting the world's coffee farmers from rollercoaster market swings in coffee prices.[9] By 1989, however, the arrival of new coffee-producing nations on the market, compounded with a change in consumer tastes favoring Arabica coffees, led to the demise of the quota system; this in turn led to a global collapse in prices as farmers were faced with a worldwide coffee glut. The devastating impact on the livelihood of farmers across the developing world was one of the driving motivations behind the creation of the first fair trade cooperatives and marketing organizations, such as Holland's Max Havelaar, which were intended to provide stable prices so that farmers would be less vulnerable to volatile world markets.

By 2002, however, the *Wall Street Journal* reported that an oversupply of coffee beans had once again driven coffee prices to an all-time low, pushing many farmers out of business.[10] This second collapse of world coffee prices was estimated to affect 125 million people internationally, and most farmers were again at the mercy of a volatile market, without recourse. In areas where coffee is grown, few other legal crops are as profitable. The collapse of the global coffee market was relatively painless for consumers: The price of coffee declined disproportionately in developed-world supermarkets. And yet, in the midst of this market turbulence, there is some evidence that farmers that had signed on with fair trade cooperatives enjoyed a relatively stable price for their goods throughout the market collapse.[11]

Fair trade had grown from humble origins to the point where it could be claimed that it was having a major impact on global coffee production. By 2009, fair trade coffee had become a $1.8 billion market.[12]

Coffee Social Responsibility: The Starbucks Example

As America's largest coffee importer, Starbucks was lobbied early on to sell fair trade coffee. In 1999, Starbucks began working with FLO and TransFair USA to buy and sell Fairtrade certified products and launched the first official sales of certified coffee in 2000.[13] Thereafter, Starbucks established the Coffee and Farmer Equity (CAFE) Practices buying guidelines to delineate a specific set of rules and regulations pertaining to ethically sourced coffee, with the goal of eventually ensuring that all of Starbucks's imported coffee would qualify as ethically sourced (though relatively little of that would be Fair Trade certified). The four main areas on which the CAFE guidelines focused were economic accountability, social responsibility, product quality, and economic leadership. An independent body, Scientific Certifications Systems, oversees the evaluation of CAFE products.

In 2009, Starbucks announced that, with cooperation from FLO and TransFair USA, it would promote a $20 million loan program to support small-scale farmers in the developing world.[14] Labeled the Small Farmer Sustainability Initiative (SFSI), the program was designed to promote responsible trading practices throughout the coffee industry. Also in 2009, Starbucks became the largest purchaser of Fair Trade certified coffee in the world, purchasing 40 million pounds of Fair Trade certified crops from vendors on three continents. By 2012, ninety-three percent of the coffee that Starbucks sold worldwide was ethically sourced (according to Starbucks)—ninety percent of which was certified through CAFE practices. The company has announced that its goal is to ensure that one hundred percent of its coffee products are ethically sourced by 2015.

One goal of the SFSI program was to streamline the process of small-scale farmers applying to become a part of the fair trade program. Starbucks and FLO-CERT developed a single-audit system so that farmers applying for Fairtrade certification and Farmer Equity Practices verification could become Starbucks vendors in one step. The streamlined process was intended to eliminate fifteen to thirty percent of the cost of auditing expenses for coffee farmers in the developing world.

Although Starbucks has acquired a reputation for a strong commitment to CSR, having appeared on the list of *Ethisphere Magazine*'s most ethical international companies for four consecutive years, critics have pointed out that Starbucks's promotion of their CAFE program has misled American consumers. Many Starbucks customers have come to believe that all of Starbucks's coffee is fair trade, while it actually only accounts for about 6% of Starbucks's coffee sales.

Good Coffee, Bad Coffee? Evaluating Criticisms of Fair Trade

Fair trade coffee is often held up as one of the great success stories of responsible consumerism. Supporters of the fair trade movement argue that it promotes a more direct trade system, fosters long-term economic improvement in developing nations, provides living wages, strengthens labor protection for artisans and farmers in impoverished communities, and provides access to otherwise unreachable global markets.

Critics of fair trade argue that it constrains the beneficial flexibility of the free market and that most of the social projects promoted by fair trade are such small-scale endeavors that they are not sufficiently influential. Rather than supporting and protecting the interest of small-scale farmers, critics contend that fair trade does little more than play on "developed-world guilt." Critics argue that staying in the fair trade system raises costs for farmers who sometimes experience a decrease in profits due to a decrease in yield, and who also must adhere to labor rules that require them to hire workers rather than employing their own children or offering "work for trade" within their community. Some researchers have found that fair trade labeling cooperatives are able to turn a profit while farmers, originally enticed by the promise of a higher per-pound price, fail to see any significant benefits. In any event, there is no evidence that farmers on average are receiving higher income due to selling to fair trade cooperatives.

There are a number of reports and investigations that indicate that fair trade inspections are unreliable. Some of these criticisms have come from former insiders, such as Christian Jacquiau and Paola Ghillani, formerly associated with Fairtrade Labelling Organizations. [15] In 2006, a *Financial Times* investigation of fair trade in Peru revealed that out of ten mills that claimed to sell fair trade coffee, all ten had sold uncertified coffee as certified. It also found that workers on fair trade farms were often paid beneath the minimum wage, in violation of fair trade standards.

Ironically, many of these criticisms began surfacing just as fair trade was starting to achieve widespread acceptance from consumers and retailers. In many cases, it appears that retailers believe they can increase profits if they jump on the fair trade bandwagon. Arguably, though, such retailers have a tendency to exaggerate the benefits of fair trade. Whole Foods, for example, has boasted that five percent of the money from coffee sales goes to growers. Investigation revealed, however, that the five percent figure merely reflected the price that Whole Foods paid its coffee unit. In Europe, supermarket giant Tesco was reportedly charging upwards of an additional $3.46 for its fair trade coffee, while the farmers of that coffee only received 44 cents of that premium.

Regardless of its real impact on producers and farmers in developing countries, the fair trade movement is already beginning to change the ways that consumers in rich countries think about shopping and consuming. In 2006, Media, Pennsylvania, became the first US town to become fair trade certified by successfully converting a critical percentage of all goods it purchases to those certified by third-party certification schemes.[16] By 2013, approximately thirty-two other US towns had followed suit. In Europe, this process is much further advanced, with hundreds of towns and municipalities having received certification. The success of fair trade certification has spawned a number of similar certifications, of which the best known is the Rainforest Alliance, which certifies food products as grown in a sustainable fashion.

Regardless of the ongoing controversy about its legitimacy, it appears that fair trade certification is here to stay.

Topic for Debate: Should a Specialty Coffee Chain Sell Only Fair Trade Coffee?

In the fictional case that is the topic for this chapter's debate, a small specialty coffee chain, known as World Coffee, Inc., is considering switching over to a 100% fair trade brew for its coffee and tea products.

World Coffee is a chain of eleven stores in the greater New York metropolitan area, with five in Manhattan, three in Brooklyn, two in Long Island, and one in Hoboken, New Jersey. The founder, Wendy Mueller, opened her first store in the trendy Tribeca neighborhood of Manhattan in 2004 and quickly attracted a devoted following due to its use of extremely high-quality coffee, which was complemented with a 100% organic product line—organic milk and cream for the coffee and tea, organic sugar and honey as sweeteners, and pastries and baked goods made from 100% organic ingredients. Building on its initial success, the chain quickly expanded to its current size and each of its store operations is highly profitable. Wendy has a full-time executive staff of four people and the stores employ an additional ten store managers and fifty to sixty part-time employees.

A potential franchise partner from San Francisco, Blake Morton, has approached Wendy and is proposing opening an additional twenty to thirty stores in the western United States, especially in California, Oregon, and Washington.

However, her potential partner has proposed a significant change to World Coffee's operations: They would switch over to 100% fair trade coffee and tea.

Wendy is concerned because she is aware that there has been a lot of criticism of fair trade as a system that promises more than it delivers. She is also concerned that the supply is more limited and that she will have to choose lower quality coffees. Additionally, she feels that it would be hard to source all her coffee from Fair Trade providers unless she raises her coffee prices by twenty-five to fifty cents per cup, and she was already worried that they were too high to begin with.

Despite this, Blake Morton is a vocal supporter of fair trade and is convinced that a 100% fair trade concept will help distinguish her from competitors and drive business to the store.

Wendy proposes that she and Blake research the topic and present their arguments to a jury composed of five people whom Wendy considers as New York's top experts in running and expanding socially responsible businesses. Blake agrees to Wendy's list and they both begin to prepare their arguments.

You will be assigned either to the team supporting Wendy's position or the team supporting Blake's position.

The debate positions may be formulated as follows:

Affirmative

World Coffee should move to 100% fair trade.

Possible Arguments

- Customers are attracted to the fair trade concept.
- Despite the increased cost to consumers and reports that fair trade is not always as transparent as it should be, every little bit helps. If we wait for a perfect system, we will never help poor farmers.
- Fair trade raises awareness that it is possible to help citizens in developing countries.
- Fair trade products are more sustainable than conventional products.
- Fair trade helps put an end to unjust and unsustainable practices in global trade.
- If the coffee shop does a good job of promoting why their prices have increased and gives consumers a reason to pay more, they will.

Negative

World Trade should not adopt a 100% fair trade policy.

Possible Arguments

- Fair trade is not all that it is cracked up to be: It is a marketing gimmick aimed at socially conscious consumers.
- It would be more ethical to buy directly from known farmers, regardless of certification.
- Fair trade coffee is not necessarily organic.
- Our employees and other stakeholders are our first concern, and if we charge too much for coffee, we will find ourselves out of business.
- We can still make fair trade coffee available to customers who want it, but we do not have to offer it exclusively.
- If fair trade improves its certification procedures, we can increase our support later.
- Because fair trade may benefit retailers more than suppliers, it actually adds to the problem by creating a false sense of philanthropy.

Readings

8.1 Benefits of Fairtrade

"Benefits of Fairtrade." Fairtrade International, accessed Nov. 25, 2014. www.fairtrade.net/benefits-of-fairtrade.html

For producers, Fairtrade is unique in offering four important benefits:

1. **Stable prices:** For most products there is a Fairtrade Minimum Price that aims to cover the costs of sustainable production—even when world market prices fall.
2. **A Fairtrade Premium:** The Premium helps producers to improve the quality of their lives. It is paid on top of the agreed Fairtrade price, and producers decide democratically how to use it. Typically they invest it in education, healthcare, farm improvements, or processing facilities to increase income.
3. **Partnership:** Producers are involved in decisions that affect their future. Fairtrade certified producers jointly own and manage Fairtrade International. Through Fairtrade International's Board, its Committees, and consultation processes, producers can influence prices, premiums, standards, and overall strategy.
4. **Empowerment of farmers and workers:** This is a goal of Fairtrade. Small farmer groups must have a democratic structure and transparent administration in order to be certified. Workers must be allowed to have representatives on a committee that decides on the use of the Fairtrade Premium. Both groups are supported by Fairtrade International to develop their capacity in this area.

With Fairtrade, Everyone Wins

Consumers

Shoppers can buy products in line with their values and principles. They can choose from an ever-growing range of great products. By buying into Fairtrade, consumers support producers who are struggling to improve their lives.

Traders/Companies

Since its launch in 2002, the Fairtrade mark has become the most widely recognised social and development label in the world. Fairtrade offers companies a credible way to ensure that their trade has a positive impact for the people at the end of the chain.

Environment

Fairtrade rewards and encourages farming and production practices that are environmentally sustainable. Producers are also encouraged to strive toward organic certification. Producers must:

- Protect the environment in which they work and live. This includes areas of natural water, virgin forest, and other important land areas and dealing with problems of erosion and waste management.
- Develop, implement, and monitor an operations plan on their farming and techniques. This needs to reflect a balance between protecting the environment and good business results.
- Follow national and international standards for the handling of chemicals. There is a list of chemicals that they must not use.
- Not, intentionally, use products that include genetically modified organisms (GMO).
- Work out and monitor what affect their activities are having on the environment. Then they must make a plan of how they can lessen the impacts and keep checking that this plan is carried out.

8.2 "Fair Trade in Bloom"

Downie, Andrew. "Fair Trade in Bloom." *New York Times*. October 2, 2007. http://www.nytimes.com/2007/10/02/business/worldbusiness/02trade.html.

8.3 "Voting with Your Trolley": Can You Really Change the World Just by Buying Certain Foods?

"Food Politics: Voting with Your Trolley." *The Economist: Special Report*. December 7, 2006. http://www.economist.com/node/8380592.

8.4 "The Problem with Fair Trade Coffee"

Haight, Colleen. "The Problem with Fair Trade Coffee." *Stanford Social Innovation Review*. Summer 2011. http://www.ssireview.org/articles/entry/the_problem_with_fair_trade_coffee.

…As the name implies, Fair Trade has sought not only to protect farmers but also to correct the legacy of the colonial mercantilist system… To its credit, Fair Trade USA has played a significant role in getting American consumers to pay more attention to the economic plight of poor coffee growers. Although Fair Trade coffee still accounts for only a small fraction of overall coffee sales, the market for Fair Trade coffee has grown markedly over the last decade, and purchases of Fair Trade coffee have helped improve the lives of many small growers.

Despite these achievements, the system by which Fair Trade USA hopes to achieve its ends is seriously flawed… Among the concerns are that the premiums paid by consumers are not going directly to farmers, the quality of Fair Trade coffee is uneven, and the model is technologically outdated…

The primary way by which FLO and Fair Trade USA attempt to alleviate poverty and jump-start economic development among coffee growers is a mechanism called a price floor, a limit on how low a price can be charged for a product. As of March 2011, FLO fixed a price floor of $1.40 per pound of green coffee beans…

It is these requirements and pricing structure that create a quality problem for Fair Trade coffee… A simple example illustrates this point. A farmer has two bags of coffee to sell and there is a Fair Trade buyer for only one bag. The farmer knows bag A would be worth $1.70 per pound on the open market because the quality is high and bag B would be worth only $1.20 because the quality is lower. Which should he sell as Fair Trade coffee for the guaranteed price of $1.40? …To maximize his income, therefore, he will choose to sell his lower quality coffee as Fair Trade coffee…

…Membership in a cooperative is a requirement of Fair Trade regulations… Premiums are retained by the cooperative and do not pass directly to farmers. Instead, the farmers vote on how the premium is to be spent for their collective use. They may decide to use it to upgrade the milling equipment of a cooperative, improve irrigation, or provide some community benefit, such as medical or educational facilities.

Fair Trade USA is a nonprofit, but an unusually sustainable one. It gets most of its revenues from service fees from retailers. For every pound of Fair Trade coffee sold in the United States, retailers must pay 10 cents to Fair Trade USA. That 10 cents helps the organization promote its brand, which has led some in the coffee business to say that Fair Trade USA is primarily a marketing organization…

Another challenge for FLO is the issue of transparency in business dealings… Records kept by cooperatives have shown that premiums paid for Fair Trade coffee are often used not for schools or organic farming but to build nicer facilities for cooperatives or to pay for extra office staff…

FLO also provides incentives for some farmers to remain in the coffee business even though the market signals that they will not be successful. If a coffee farmer's cost of production is higher than he is able to obtain for his product, he will go out of business. By offering a higher price, Fair Trade keeps him in a business for which his land may not be suitable.

Synthesis Questions

1. After studying this chapter, are you more likely or less likely to buy fair trade coffee?
2. Is there another way of achieving the objectives of improving the lives of developing-country farmers and producers than the Fair Trade approach? Describe at least one option.
3. Why do consumers buy Fair Trade products? List a few reasons and analyze each of them.

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5.31: Creating Supply-Chain Alignment

Leading companies take care to align the interests of all the firms in their supply chain with their own. This is important, because every supply-chain partner firm—whether a supplier, an assembler, a distributor, or a retailer—will focus on its own interests. If any company's interests differ from those of the other organizations in the supply chain, its actions will not maximize the chain's performance.

One way companies align their partners' interests with their own is by redefining the terms of their relationships so that firms share risks, costs, and rewards equitably. Another involves the use of intermediaries, for example, when financial institutions buy components from suppliers at hubs and resell them to manufacturers. Everyone benefits because the intermediaries' financing costs are lower than the vendors' costs. Although such an arrangement requires trust and commitment on the part of suppliers, financial intermediaries, and manufacturers, it is a powerful way to align the interests of companies in supply chains.

A prerequisite to creating alignment is the availability of information so that all the companies in a supply chain have equal access to forecasts, sales data, and plans. Next, partner roles and responsibilities must be carefully defined so that there is no scope for conflict. Finally, companies must align incentives so that when companies try to maximize returns, they also maximize the supply chain's performance.

Minicase: Nestlé Pieces Together Its Global Supply Chain (Steinert-Threlkeld (2006, January)).

A few years ago, Nestlé, the world's largest food company, set out to standardize how it operates around the world. It launched GLOBE (Global Business Excellence), a comprehensive program aimed at implementing a single set of procurement, distribution, and sales management systems. The logic behind the $2.4-billion project was impeccable: implementing a standardized approach to demand forecasting and purchasing would save millions and was critical to Nestlé's operating efficiency in 200 countries around the world.

Nestlé's goal was simple: to replace its 14 different SAP enterprise-planning systems—in place in different countries—with a common set of processes, in factory and in administration, backed by a single way of formatting and storing data and a single set of information systems for all of Nestlé's businesses.

For Nestlé, this was not an everyday project. When it built a factory to make coffee, infant formula, water, or noodles, it would spend $30 to $40 million; committing billions in up-front capital to a backroom initiative was unheard of, or, as someone noted, "Nestlé makes chocolate chips, not electronic ones."

The GLOBE project also stood as the largest-ever deployment of mySAP.com. But whether the software got rolled out to 230,000 Nestlé employees or 200 was not the point. The point was to make Nestlé the first company to operate in hundreds of countries in the same manner as if it operated in one. And that had not been achieved by any company—not even the British East India Company at the peak of its tea-trading power—in the history of global trade.

Consider the complexities. Nestlé was the world's largest food company, with almost $70 billion in annual sales. By comparison, the largest food company based in the United States, Kraft Foods, was less than half that size. Nestlé's biggest Europe-based competitor, Unilever, had about $54 billion in sales. In addition, Nestlé grew to its huge size by selling lots of small-ticket items—Kit Kat, now the world's largest-selling candy bar; Buitoni spaghetti; Maggi packet soups; Lactogen dried milk for infants; and Perrier sparkling water.

The company operated in some 200 nations, including places that were not yet members of the United Nations. It ran 511 factories and employed 247,000 executives, managers, staff, and production workers worldwide.

What is more, for Nestlé, nothing was simple. The closest product to a global brand it had was Nescafé; more than 100 billion cups were consumed each year. But there were more than 200 formulations, made to suit local tastes. All told, the company produced 127,000 different types and sizes of products. Keeping control of its thousands of supply chains, scores of methods of predicting demand, and its uncountable variety of ways of invoicing customers and collecting payments was becoming evermore difficult and eating into the company's bottom line.

The three baseline edicts for project GLOBE were: harmonize processes, standardize data, and standardize systems. This included how sales commitments were made, factory production schedules established, bills to customers created, management reports pulled together, and financial results reported. Gone would be local customs, except where legal requirements and exceptional circumstances mandated an alternative manner of, say, finding a way to pay the suppliers of perishable products like dairy or produce in a week rather than 30 days. And when was this all to be done? In just 3 and a half years. The original GLOBE timeline, announced by Nestlé's executive board, called for 70% of the company's $50 billion business to operate under the new unified processes by the end of 2003.

Mission impossible? The good news was that in one part of the world, Asia, market managers had shown they could work together and create a common system for doing business with their customers. They had used a set of applications from a Chicago supplier, SSA Global, that allowed manufacturers operating worldwide to manage the flow of goods into their factories, the factories themselves, and the delivery of goods to customers while making sure the operations met all local and regional legal reporting requirements. The system was adopted in Indonesia, Malaysia, the Philippines, Thailand, even South Africa, and was dubbed the "Business Excellence Common Application."

But this project was orders of magnitude more involved and more complex. Instead of just a few countries, it would affect 200 of them. Change would have to come in big, not small, steps. Using benchmarks they could glean from competitors such as Unilever and Danone, and assistance from PricewaterhouseCoopers consultants and SAP's own deployment experts, the executives in charge of the GLOBE project soon came to a conclusion they had largely expected going in: this project would take more people, more money, and more time than the board had anticipated. Instead of measuring workers in the hundreds, and Swiss francs in the hundreds of millions, as originally expected, the team projected that 3,500 people would be involved in GLOBE at its peak. The new cost estimate was 3 billion Swiss francs, about $2.4 billion. And the deadline was pushed back as well. The new target: putting the "majority of the company's key markets" onto the GLOBE system by the end of 2005, not 2003.

To lead this massive undertaking, GLOBE's project manager chose a group of business managers, not technology managers, from all of Nestlé's key functions—manufacturing, finance, marketing, and human resources—and from all across the world—Europe, Asia, the Americas, Africa, and Australia.

These were people who knew how things actually worked or should work. They knew how the company estimated the demand for each of its products, how supplies were kept in the pipeline, even mundane things like how to generate an invoice, the best way to process an order, how to maintain a copier or other office equipment, and how to classify all the various retail outlets, from stores to vending machines, that could take its candy bars and noodles. The system would allow managers to manage it all from the web.

The process for the team of 400 executives started with finding, and then documenting, the four or five best ways of doing a particular task, such as generating an invoice. Then, the GLOBE team brought in experts with specific abilities, such as controlling financial operations, and used them as "challengers." They helped eliminate weaknesses, leaving the best practices standing.

At the end of that first year, the project teams had built up the basic catalog of practices that would become what they would consider the "greatest asset of GLOBE": its "Best Practices Library." This was an online repository of step-by-step guides to the 1,000 financial, manufacturing, and other processes that applied across all Nestlé businesses. Grouped into 45 "solution sets," like demand planning or closing out financial reports, the practices could now be made available online throughout the company, updated as necessary, and commented on at any time.

It was not always possible to choose one best practice. Perhaps the hardest process to document was "generating demand." With so many thousands of products, hundreds of countries, and local tastes to deal with, there were "many different ways of going to market," many of which were quite valid. This made it hard to create a single software template that would serve all market managers.

So GLOBE executives had to practice a bit more tolerance on that score. The final GLOBE template included a half-dozen or so different ways of taking products to market around the world. But no such tolerance was shown for financial reporting. The 400 executives were determined to come up with a rigorous step-by-step process that would not change.

Experts were brought in along the way to challenge each process. But in the end, one standard would, in this case, have to stand. Financial terms would be consistent. The scheme for recording dates and amounts would be the same. The timing of inputting data would be uniform; only the output could change. In Thailand, there would have to be a deviation so that invoices could be printed out in Thai characters so that they could be legal and readable. In the Philippines, dates would have to follow months, as in the United States. Most of the rest of the world would follow the European practice of the day preceding the month.

Progress was slow, however. Nestlé managers had always conducted their businesses as they saw fit. As a consequence, even standardizing on behind-the-scenes practices, like how to record information for creating bills to customers met, with resistance. As country managers saw it, decision making was being taken out of local markets and being centralized. Beyond that, someone had to pay the bill for the project itself. That would be the countries, too.

By the fall of 2005, almost 25% of Nestlé was running on the GLOBE templates. And GLOBE's project manager was confident that 80% of the company would operate on the new standardized processes by the end of 2006. The greatest challenge was getting managers and workers to understand that their jobs would change—in practical ways. In many instances, workers would be entering data on raw materials as they came into or through a factory. Keeping track of that would be a new responsibility. Doing it on a computer would be a wholly new experience. And figuring out what was happening on the screen could be a challenge. Minutia? Maybe. Considerable change? Definitely.

But the templates got installed and business went on—in Switzerland, Malaysia-Singapore, and the Andean region. In each successive rollout, the managers of a given market had 9 months or more to document their processes and methodically adjust them to the templated practices. In 2003, Thailand, Indonesia, and Poland went live. In 2004, Canada, the Philippines, and the Purina pet food business in the United Kingdom joined the network. But, by then, the system was bumping up against some technical limits. In particular, the mySAP system was not built for the unusual circumstances of the Canadian food retailing market. Food manufacturers have lots of local and regional grocery chains to sell to, and promotional campaigns are rife. MySAP was not built to track the huge amount of trade promotions engaged in by Nestlé's Canadian market managers: there were too many customers, too many products, and too many *data points*.

In India, changing over in mid-2005 was complicated by the fact that not only was Nestlé overhauling all of its business processes, but it also did not know what some of the key financial processes would have to be. At the same time it was converting to the GLOBE system, India was changing its tax structure in all 29 states and six territories. Each would get to choose whether, and how, to implement a fee on the production and sale of products, known as a value-added tax. Meeting the scheduled go-live date proved difficult.

And all over the world, managers learned that the smallest problem in standardized systems means that product can get stopped in its tracks. In Indochina, for instance, pallets get loaded with 48 cases of liquids or powders, and are then moved out. If a worker fails to manually check that the right cases have been loaded on a particular pallet, all dispatching stops are held up until the pallet is checked.

These setbacks notwithstanding, GLOBE taught Nestlé how to operate as a truly global company. For example, managers from the water businesses initially rejected the idea of collecting, managing, and disseminating data in the same way as their counterparts in chocolate and coffee. Some managers figured that if they were able to produce all the water or all the chocolate they needed for their market locally, that should be enough. But the idea was to get Nestlé's vast empire to think, order, and execute as one rather than as a collection of disparate companies. This meant that a particular manufacturing plant in a particular manager's region might be asked to produce double or triple the amount of coffee it had in the past. Or it might mean that a particular plant would be closed.

So, while the company did away with data centers for individual countries, each one does now have a data manager. The task is to make sure that the information that goes into GLOBE's data centers is accurate and complete. That means that country managers can concentrate more on what really matters: serving customers.

5.32: Making Supply Chains Adaptable

Global companies must be able to adapt their supply networks when markets or strategies change. The best companies tailor their supply chains to the nature of the markets they serve. They often end up with more than one supply chain, which can be expensive, but, in return, they secure the best manufacturing and distribution capabilities for each offering. Cisco, for example, uses contract manufacturers in low-cost countries such as China for standard, high-volume networking products. For its broad line of midvalue items, the company uses vendors in low-cost countries to build core products, but it customizes those products itself in major markets such as the United States and Europe. And for highly customized, low-volume products, Cisco uses vendors close to main markets, such as Mexico for the United States and Eastern European countries for Europe. Despite the fact that it uses three different supply chains at the same time, the company is careful not to become less agile. Because it uses flexible designs and standardized processes, Cisco can switch the manufacture of products from one supply network to another, when necessary. (Sheffi (2005, October)).

Companies that compete primarily on the basis of operational excellence typically focus on creating supply chains that deliver goods and services to consumers as quickly and inexpensively as possible. They invest in state-of-the art technologies and employ metrics and reward systems aimed at boosting supply-chain performance.

For companies competing on the basis of customer intimacy or product leadership, a focus on efficiency is not enough—agility is a key factor. Customer-intimate companies must be able to add and delete products and services as customer needs change; product leadership companies must be able to adapt their supply chains to changes in technology and to capitalize on new ideas.

All companies must align their supply-chain infrastructure and management with their underlying value proposition to achieve a sustainable competitive advantage. That is, they must align the interests of all the firms in the supply network so that companies optimize the chain's performance when they maximize their interests.

Minicase: Nikon, With the Help of UPS, Focuses on Supply-Chain Innovation (www.ups-scs.co/solutions/case...s/cs_nikon.pdf)

To support the launch of its new digital cameras, Nikon, with the help of UPS Supply Chain Solutions, reengineered its distribution network to keep retailers well supplied. Nikon knew that customer service capabilities needed to be completely up to speed from the start and that distributors and retailers would require up-to-the-minute information about product availability. While the company had previously handled new product distribution in-house, this time Nikon realized that burdening its existing infrastructure with a new, demanding, high-profile product line could impact customer service performance adversely. So Nikon applied its well-known talent for innovation to creating an entirely new distribution strategy, and it took the rare step of outsourcing distribution of an entire consumer-electronics product line. With UPS Supply Chain Solutions on board, Nikon was able to quickly execute a synchronized supply-chain strategy that moves products to retail stores throughout the United States, Latin America, and the Caribbean, and allows Nikon to stay focused on the business of developing and marketing precision optics.

Starting at Nikon's manufacturing centers in Korea, Japan, and Indonesia, UPS Supply Chain Solutions now manages air and ocean freight and related customs brokerage. Nikon's freight is directed to Louisville, Kentucky, which not only serves as the all-points connection for UPS's global operations but is also home to the UPS Supply Chain Solutions Logistics Center main campus. Here, merchandise can be either "kitted" with accessories such as batteries and chargers or repackaged to in-store display specifications. Finally, the packages are distributed to literally thousands of retailers across the United States or shipped for export to Latin American or Caribbean retail outlets and distributors, using any of UPS's worldwide transportation services to provide the final delivery.

With the UPS Supply Chain Solutions system in place, the process calibrates the movement of goods and information by providing SKU-level visibility within complex distribution and information technology (IT) systems. UPS also provides Nikon advance shipment notifications throughout the U.S., Caribbean, and Latin American markets. The result: a "snap shot" of the supply chain that rivals the performance of a Nikon camera.

Nikon has already seen the results of its innovation in both digital technology and product distribution. The consumer digital-camera sector is one of Nikon's fastest-growing product lines. In addition, supply-chain performance and customer service have measurably improved. Products leaving Nikon manufacturing facilities in Asia can now be on a retailer's shelf in as few as 2 days. While products are en route, Nikon also has the ability to keep retailers informed of delivery times and to adjust them as needed so that no retailer needs to miss sales opportunities due to lack of product availability.

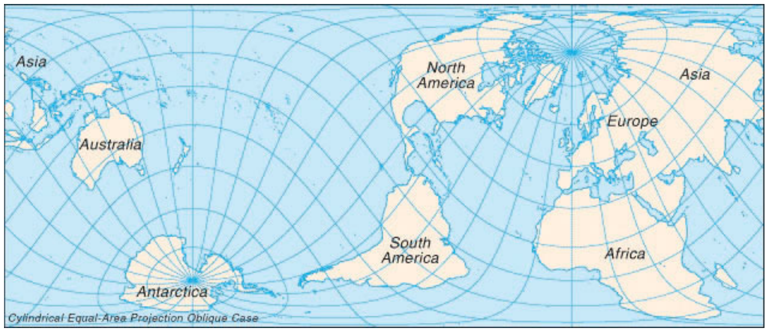
5.33: Points to Remember

1. In today's global competitive environment, individual companies no longer compete as autonomous entities but as supply-chain networks. Instead of brand versus brand or company versus company, then network is increasingly suppliers-brand-company versus suppliers-brand-company.
2. Top-performing supply chains have three distinct qualities. First, they are *agile* enough to react readily to sudden changes in demand or supply. Second, they *adapt* over time as market structures and environmental conditions change. And third, they *align* the interests of all members of the supply-chain network in order to optimize performance.
3. Driven by e-commerce's capabilities to empower clients, most companies have moved from the traditional "*push*" business model—where manufacturers, suppliers, distributors, and marketers have most of the power—to a customer-driven "*pull*" model.
4. Supply-chain management (SCM) has three principal components: (a) creating the *supply-chain network structure*, (b) developing *supply-chain business processes*, and (c) *managing the supply-chain activities*. The *supply-chain network structure* consists of the member firms and the links between these firms. Business processes are the activities that produce a specific output of value to the customer. The *management function* integrates the business processes across the supply chain.
5. The best companies create supply chains that can respond to sudden and unexpected changes in markets. Agility—the ability to respond *quickly* and *cost-effectively* to unexpected change—is critical because in most industries, both demand and supply fluctuate more rapidly and widely than they used to. Key to increasing agility and resilience is building *flexibility* into the supply-chain structure, processes, and management.
6. Global companies must be able to adapt their supply networks when markets or strategies change. Companies that compete primarily on the basis of operational effectiveness typically focus on creating supply chains that deliver goods and services to consumers as quickly and inexpensively as possible. They invest in state-of-the-art technologies and employ metrics and reward systems aimed at boosting supply-chain performance. For companies competing on the basis of customer intimacy or product leadership, a focus on efficiency is not enough; agility is a key factor. Customer-intimate companies must be able to add and delete products and services as customer needs change; product leadership companies must be able to adapt their supply chains to changes in technology and to capitalize on new ideas.
7. Leading companies take care to align the interests of all the firms in their supply chain with their own. This is important because every supply-chain partner firm—whether a supplier, an assembler, a distributor, or a retailer—will focus on its own interests. If any company's interests differ from those of the other organizations in the supply chain, its actions will not maximize the chain's performance.

5.34: International Expansion and Global Market Opportunity Assessment

5.35: Chapter Introduction

International Expansion and Global Market Opportunity Assessment



WHAT'S IN IT FOR ME?

1. What are the inputs into global strategic move choices?
2. What are the components of PESTEL analysis and the factors that favor globalization?
3. What are the traditional entry modes for international expansion?
4. How can you use the CAGE model of market assessment?
5. What is the importance of and inputs into scenario analysis?

This chapter pulls together all the information about choosing to expand internationally and possible ways to make that choice. Section 8.1 shows that choosing to expand internationally is rarely black and white. A wide variety of internationalization moves are available after choosing to expand. Moreover, some flatteners make global moves easier, while some make them more difficult. Indeed, even importing and outsourcing can be considered stealth, or at least early, steps in internationalization, because they involve doing business across borders. In Section 8.1, you will learn the rationale for international expansion and the planning and due diligence it requires.

This chapter also features a richness of analytical frameworks. In Section 8.2, you will learn about PESTEL, the framework for analyzing the political, economic, sociocultural, technological, environmental, and legal aspects of different international markets. Section 8.3 describes the strategies available to you when entering a new market. Section 8.4 will demonstrate how globalization and the CAGE (cultural, administrative, geographic, and economic) framework address questions related to the *flattening* of markets and how the dimensions they help you assess are essentially *flatteners*. Finally, in Section 8.5, you will learn about scenario analysis, which will prepare you to begin an analysis of which international markets might present the greatest opportunities, as well as suggest possible landmines that you could encounter when exploiting them.

Opening Case: The Invisible Global Retailer and Its Reentry into US Markets

Which corporation owns 123 companies, operates in twenty-seven countries, and has been in the mobile-phone business for over a decade? If you don't know, you're not alone. Many people haven't heard of the Otto Group, the German retailing giant that's second only to Amazon in e-commerce and first in the global mail-order business. The reason you've likely never heard of the Otto Group is because the firm stays in the background while giving its brands the spotlight. This strategy has worked over the company's almost eighty-year history, and Otto continues to apply it to new moves, such as its social media site, Two for Fashion. "They are talking about fashion, not about Otto, unless it suits," explained Andreas Frenkler, the company's division manager of new media and e-commerce, about the site's launch in 2008.Lydia Dishman, "How the Biggest Online Retailer You've Never Heard of Will Take the U.S. Market," *BNET*, April 16, 2010, accessed August 20, 2010, www.bnet.com/blog/publishing-style/how-the-biggest-online-retailer-you-8217ve-never-heard-of-will-take-the-us-market/248. The site is now one of the top fashion blogs in Germany and is an integral part of the retailer's marketing strategy.

Leading through Passion, Vision, and Strategy

Today, the Otto Group consists of a large number of companies that operate in the major economic zones of the world. The Otto Group's lines of business include financial services, multichannel retail, and other services. The financial services segment covers an international portfolio of commercial services along the value chain of retail companies, such as information-, collection-, and receivable-management services. The multichannel retail segment covers the Otto Group's worldwide range of retail offerings;

goods are marketed across three distribution channels—catalogs, e-commerce, and over-the-counter (OTC) retail. The third segment combines the Otto Group's logistics, travel, and other service providers as well as sourcing companies. Logistics service providers and sourcing companies support both the Otto Group's multichannel retail activities and non-Group clients. Travel service providers offer customers travel offerings across all sales channels. Unique to the Otto Group is the combination of travel agencies, direct marketing, and Internet sites. The combined revenue of these three ventures is growing rapidly, even during the global economic downturn. The travel service revenues for 2010 were 10 billion euros, or about $12 billion."Otto Group: Private Company Information," *BusinessWeek*, accessed February 7, 2011, http://investing.businessweek.com/businessweek/research/stocks/private/snapshot.asp?privcapId=61882597.

Even though it operates in a variety of market segments, business ideas, and distribution channels—not to mention its regional diversity—the Otto Group sees itself as a community built on shared values. Otto's passion for success is based on four levels of performance, which together represent the true strength of the Otto Group: "Passion for our customers, passion for innovation, passion for sustainability, and passion for integrated networking." Each one of these performance levels is an integral element of the Otto Group's guiding principle and self-image."Accelerating toward New Goals," Otto Group, accessed August 20, 2010, www.ottogroup.com/en/die-otto-group/daten-und-fakten/segmente.php.

Future growth is guided by the Otto Group's Vision 2020 strategy, which is based on achieving a strong presence in all key markets of the three largest regions—Europe, North America, and Asia. In doing so, the Otto Group relies on innovative concepts in the multichannel business, on current trends in e-commerce, on OTC retail, and on developments in mobile commerce. In keeping with that vision, its focus for near-term expansion is on expanding the Group's strong position in Russia and increasing market share in other economic areas, such as the Chinese and Brazilian markets. Investment options in core European markets are continually being reviewed to strengthen the multichannel strategy. As a global operating group, Otto aims to have a presence in all major markets and will continue to expand OTC retailing.

In 2010, for instance, the Otto Group continued to develop its activities in the growth markets of Central and Eastern Europe. Through takeovers and the acquisition of further shares in various distance-selling concepts, including Quelle Russia, the Otto Group has continued to build on its market leadership in Russian mail order. A further major goal for the future is to expand OTC retail within the multichannel retail segment, making it one of the pillars of Otto alongside its e-commerce and catalog businesses. The foundations of value-oriented corporate management are reflected in the uncompromising customer orientation evident in business activities with both end consumers and corporate clients.

The strategy envisages targeted investments that provide the Otto Group with "Best in Class" business models. Otto not only draws on an excellent range of customer services as the basis for its success in its core business of multichannel retailing but also offers an array of retail-related services for its corporate clients. In the future, the company is looking to expand these services, moving beyond its core business. The buying organization of the Otto Group has been repositioned under the name Otto International and is now a firm fixture in the world's key sourcing markets. Otto International's corporate clients stand to benefit directly from the market power of the Otto Group while providing the volumes to make their own contribution to its growth.

The US Market Reentry Initiative

Germany remains the Otto Group's most-important regional sales market, followed by France, the rest of Europe, North America, and Asia. In the United States, Otto set up a greenfield division called Otto International and quietly launched Field & Stream 1871, a brand of outdoor clothing, outerwear, footwear, and accessories, in 2010. The products are available only on the Field & Stream e-commerce site. As always, the Otto name is almost nowhere on the site, being visible only on the site's privacy policy page.

Industry experts thought it surprising that Otto launched the clothing line because it had previously left the US market after its acquisition of Eddie Bauer's parent company, Spiegel, failed in 2009.

Still, the Otto Group has received much acclaim for its innovations in the retail arena. For example, according to a Microsoft case study, Otto was the first company (1) to use telephone ordering, (2) to produce a CD-ROM version of its catalog in the 1990s (to deal with slow dial-up connections), and (3) to build one of the largest collections of online merchandise, at www.otto.de."Microsoft Case Studies," Microsoft, accessed August 20, 2010, http://www.microsoft.com/casestudies/Case_Study_Detail.aspx?CaseStudyID=200504; and "Otto Group: OTTO," accessed February 7, 2011, www.ottogroup.com/otto.html?&L=0. So the Otto Group may have other innovations planned for Field & Stream. But the US fashion market is saturated with competitors. As *WWD* reported, Otto may do better to focus on growing its own retail brands and utilizing its impressive in-house manufacturing and logistics divisions, which are now Otto's fastest-growing segment.Thomas Brenner, “Otto Group: A German Giant Tiptoes Back to the U.S.,” *WWD*, April 14, 2010, accessed February 7, 2011, http://www.wwd.com/wwd-publications/wwd/2010-04-14?id=3036440&date=today&module=tn/today#/article/retail-news/otto-group-a-german-giant-tiptoes-back-to-the-u-s--3036500?navSection=issues &navId=3036440. Otto could use these divisions to build other retail operations—while keeping a low profile, of course.

Opening Case Exercises

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. How do non-German markets figure into the Otto Group’s strategy?
2. What do you think the firm has had to do to plan for this level of international expansion?
3. Which country-entry modes does the firm appear to prefer? Does it vary these modes?
4. After the Otto Group failed in its first effort to enter the US market with Spiegel, why would it try again?
5. How does this latest effort to enter the US market differ from its prior attempt?

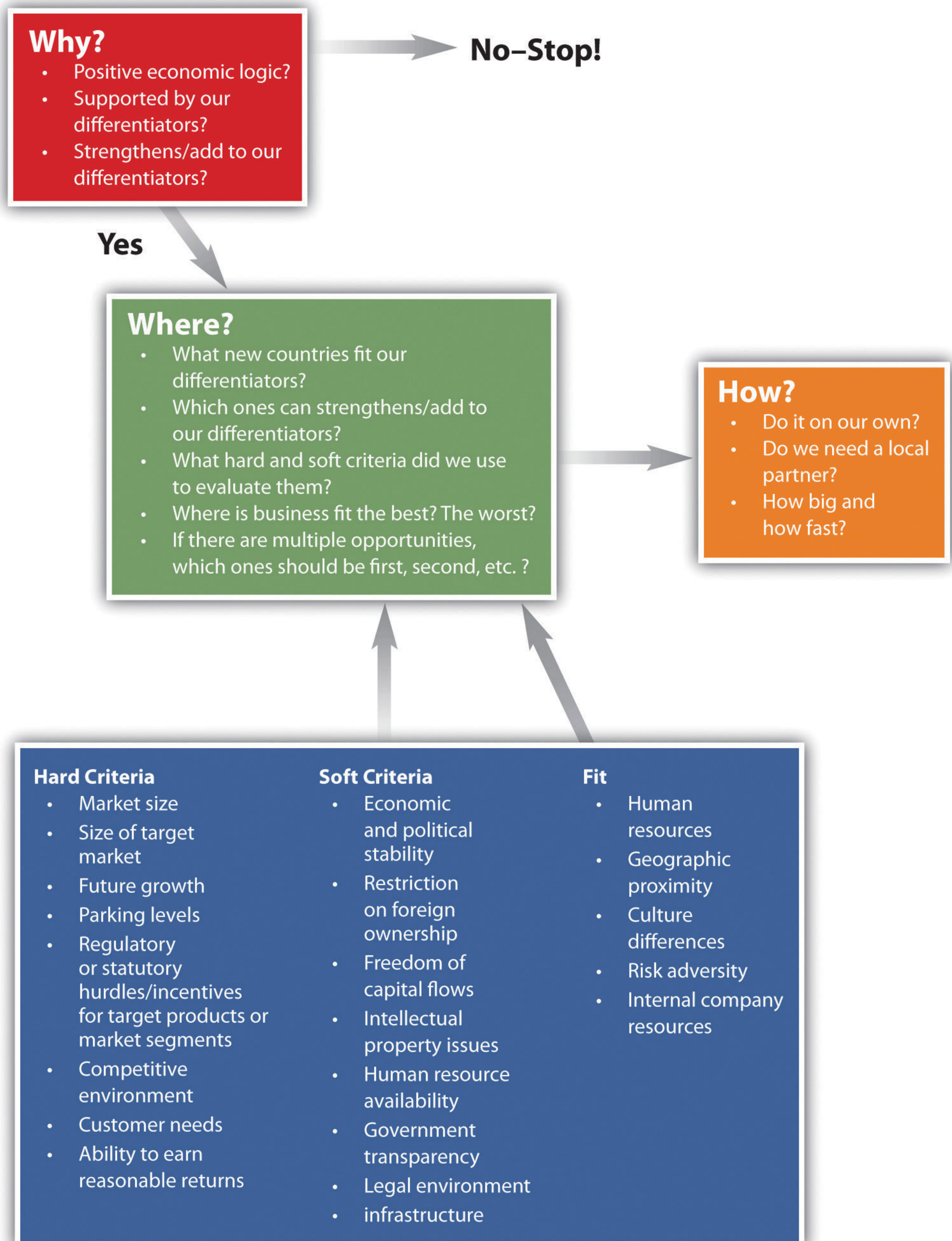
5.36: Global Strategic Choices

Learning Objectives

1. Learn about the *rationale and motivations for* international expansion.
2. Understand the importance of international due diligence.
3. Recognize the role of regional differences, consumer preferences, and industry dynamics.

The *Why*, *Where*, and *How* of International Expansion

The allure of global markets can be mesmerizing. Companies that operate in highly competitive or nearly saturated markets at home, for instance, are drawn to look overseas for expansion. But overseas expansion is not a decision to be made lightly, and managers must ask themselves whether the expansion will create real value for shareholders. Companies can easily underestimate the costs of entering new markets if they are not familiar with the new regions and the business practices common within the new regions. For some companies, a misstep in a foreign market can put their entire operations in jeopardy, as happened to French retailer Carrefour after their failed entry into Chile, which you'll see later in this section. In this section, as summarized in the following figure, you will learn about the rationale for international expansion and then how to analyze and evaluate markets for international expansion.



Why?
Positive economic logic?
Supported by our differentiators?
Strengthens/add to our differentiators?
No–Stop!
Yes
Where?
What new countries fit our differentiators?
Which ones can strengthens/add to our differentiators?
What hard and soft criteria did we use to evaluate them?
Where is business fit the best? The worst?
If there are multiple opportunities, which ones should be first, second, etc. ?
How?
Do it on our own?
Do we need a local partner?
How big and how fast?
Hard Criteria
Market size
Size of target market
Future growth
Parking levels
Regulatory or statutory hurdles/incentives for target products or market segments
Competitive environment
Customer needs
Ability to earn reasonable returns
Soft Criteria
Economic and political stability
Restriction on foreign ownership
Freedom of capital flows
Intellectual property issues
Human resource availability
Government transparency
Legal environment
infrastructure
Fit
Human resources
Geographic proximity
Culture differences
Risk adversity
Internal company resources

Rationale for International Expansion

Companies embark on an expansion strategy for one or more of the following reasons:

- To improve the cost-effectiveness of their operations
- To expand into new markets for new customers
- To follow global customers

For example, US chemical firm DuPont, Brazilian aerospace conglomerate Embraer, and Finnish mobile-phone maker Nokia are all investing in China to gain new customers. Schneider Logistics, in contrast, initially entered a new market, Germany, not to get new customers but to retain existing customers who needed a third-party logistics firm in Germany. Thus, Schneider followed its customers to Germany. Other companies, like microprocessor maker Intel, are building manufacturing facilities in China to take advantage of the less costly and increasingly sophisticated production capabilities. For example, Intel built a semiconductor manufacturing plant in Dalian, China, for $2.5 billion, whereas a similar state-of-the-art microprocessor plant in the United States can cost $5 billion.“2011 Global R&D Funding Forecast,” *R&D Magazine*, December 2010, accessed January 2, 2011, http://www.rdmag.com/tags/publications/global-r-and-d-funding-forecast. Intel has also built plants in Chengdu and Shanghai, China, and in other Asian countries (Vietnam and Malaysia) to take advantage of lower costs.

Planning for International Expansion

As companies look for growth in new areas of the world, they typically prioritize which countries to enter. Because many markets look appealing due to their market size or low-cost production, it is important for firms to prioritize which countries to enter first and to evaluate each country’s relative merits. For example, some markets may be smaller in size, but their strategic complexity is lower, which may make them easier to enter and easier from an operations point of view. Sometimes there are even substantial regional differences within a given country, so careful investigation, research, and planning are important to do before entry.

International Market Due Diligence

International market due diligence involves analyzing foreign markets for their potential size, accessibility, cost of operations, and buyer needs and practices to aid the company in deciding whether to invest in entering that market. Market due diligence relies on using not just published research on the markets but also interviews with potential customers and industry experts. A systematic analysis needs to be done, using tools like PESTEL and CAGE, which will be described in Section 8.2 and Section 8.4, respectively. In this section, we begin with an overview.

Evaluating whether to enter a new market is like peeling an onion—there are many layers. For example, when evaluating whether to enter China, the advantage most people see immediately is its large market size. Further analysis shows that the majority of people in that market can’t afford US products, however. But even deeper analysis shows that while many Chinese are poor, the number of people who can afford consumer products is increasing.Art Kleiner, “Getting China Right,” *Strategy and Business*, March 22, 2010, accessed January 23, 2011, www.strategy-business.com/article/00026?pg=al.

Regional Differences

The next part of due diligence is to understand the regional differences within the country and to not view the country as a monolith. For example, although companies are dazzled by China’s large market size, deeper analysis shows that 70 percent of the population lives in rural areas. This presents distribution challenges given China’s vast distances. In addition, consumers in different regions speak different dialects and have different tastes in food. Finally, the purchasing power of consumers varies in the different cities. City dwellers in Shanghai and Tianjin can afford higher prices than villagers in a western province.

Let’s look at a specific example. To achieve the dual goals of reducing operations costs and being closer to a new market of customers, for instance, numerous high-tech companies identify Malaysia as an attractive country to enter. Malaysia is a relatively inexpensive country and the population’s English skills are good, which makes it attractive both for finding local labor and for selling products. But even in a small country like Malaysia, there are regional differences. Companies may be tempted to set up operations in the capital city, Kuala Lumpur, but doing a thorough due diligence reveals that the costs in Kuala Lumpur are rising rapidly. If current trends continue, Kuala Lumpur will be as expensive as London in five years. Therefore, firms seeking primarily a lower-cost advantage would do better to locate to another city in Malaysia, such as Penang, which has many of the same advantages as Kuala Lumpur but does not have its rising costs.Ajay Chamania, Heral Mehta, and Vikas Sehgal, “Five Factors for Finding the Right Site,” *Strategy and Business*, November 23, 2010, accessed May 17, 2011, www.strategy-business.com/article/10403?gko=e029a.

Understanding Local Consumers

Entering a market means understanding the local consumers and what they look for when making a purchase decision. In some markets, price is an important issue. In other markets, such as Japan, consumers pay more attention to details—such as the quality of products and the design and presentation of the product or retail surroundings—than they do to price. The Japanese demand for perfect products means that firms entering Japan might have to spend a lot on quality management. Moreover, real-estate costs are high in Japan, as are freight costs such as fuel and highway charges. In addition, space is limited at retail stores and stockyards, which means that stores can't hold much inventory, making replenishment of products a challenge. Therefore, when entering a new market, it's vital for firms to perform full, detailed market research in order to understand the market conditions and take measures to account for them.

How to Learn the Needs of a New Foreign Market

The best way for a company to learn the needs of a new foreign market is to deploy people to immerse themselves in that market. Larger companies, like Intel, employ ethnographers and sociologists to spend months in emerging markets, living in local communities and seeking to understand the latent, unarticulated needs of local consumers. For example, Dr. Genevieve Bell, one of Intel's anthropologists, traveled extensively across China, observing people in their homes to find out how they use technology and what they want from it. Intel then used her insights to shape its pricing strategies and its partnership plans for the Chinese consumer market.Navi Radjou, "R&D 2.0: Fewer Engineers, More Anthropologists," *Harvard Business Review* (blog), June 10, 2009, accessed January 2, 2011, http://blogs.hbr.org/radjou/2009/06/rd-20-fewer-engineers-more-ant.html.

Differentiation and Capability

When entering a new market, companies also need to think critically about how their products and services will be different from what competitors are already offering in the market so that the new offering provides customers value. Companies trying to penetrate a new market must be sure to have some proof that they can deliver to the new market; this proof could be evidence that they have spoken with potential customers and are connected to the market."How We Do It: Strategic Tests from Four Senior Executives," *McKinsey Quarterly*, January 2011, accessed January 22, 2011, www.mckinseyquarterly.com/PDFDownload.aspx?ar=2712&srid=27. Related to firm capability, another factor for firms to consider when evaluting which country to enter is that of "corporate fit." **Corporate fit** is the degree to which the company's existing practices, resources and capabilties fit the new market. For example, a company accustomed to operating within a detailed, unbiased legal environment would not find a good corporate fit in China because of the current vagaries of Chinese contract law.Carol Wingard, "Ensuring Value Creation through International Expansion," *L.E.K. Consulting Executive Insights* 5, no. 3, accessed January 15, 2011, http://www.lek.com/sites/default/files/Volume_V_Issue_3.pdf. Whereas a low corporate fit doesn't preclude expanding into that country, it does signal that additional resources or caution may be necessary. Two typical dimensions of corporate fit are human resources practices and the firm's risk tolerance.

Did You Know?

Over the years 2005–09, the number of Global 500 companies headquartered in BRIC countries (Brazil, Russia, India, and China) increased significantly. China grew from 8 headquarters to 43, India doubled from 5 to 10, Brazil rose from 5 to 9, and Russia went from 4 to 6. The United States still leads with 181 company headquarters, but it's down from 219 in 2005.Jeanne Meister and Karie Willyerd, *The 2020 Workplace* (New York: HarperBusiness, 2010), 22, citing "FT500 2009," *Financial Times*, accessed November 27, 2009, http://www.ft.com/reports/ft500-2009.

Industry Dynamics

In some cases, the decision to enter a new market will depend on the specific circumstances of the industry in which the company operates. For example, companies that help build infrastructure need to enter countries where the government or large companies have a lot of capital, because infrastructure projects are so expensive. The president of Spanish infrastructure company Fomento de Construcciones y Contratas said, "We focus on those countries where there is more money and there is a gap in the infrastructure," such as China, Singapore, the United States, and Algeria."Practical Advice for Companies Betting on a Strategy of Globalization," *Knowledge@Wharton*, January 12, 2011, accessed February 5, 2011, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2541.

Political stability, legal security, and the "rule of law"—the presence of and adherence to laws related to business contracts, for example—are important considerations prior to market entry regardless of which industry a company is in. Fomento de

Construcciones y Contratas learned this the hard way and ended up leaving some countries it had entered. The company's president, Baldomero Falcones, explained, "When you decide whether or not to invest, one factor to take into account is the rule of law. Our ethical code was considered hard to understand in some countries, so we decided to leave during the early stages of the investment.""Practical Advice for Companies Betting on a Strategy of Globalization," *Knowledge@Wharton*, January 12, 2011, accessed February 5, 2011, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2541.

Ethics in Action

Companies based in China are entering Australia and Africa, primarily to gain access to raw materials. Trade between China and Africa grew an average of 30 percent in the decade up to 2010, reaching $115 billion that year.Paul Redfern, "Africa: Trade between China and Continent at U.S.$115 Billion a Year," *Daily Nation*, February 11, 2011, accessed February 14, 2011, allafrica.com/stories/201102140779.html. Chinese companies operate in Zambia (mining coal), the Democratic Republic of the Congo (mining cobalt), and Angola (drilling for oil). To get countries to agree to the deals, China had to agree to build new infrastructure, such as roads, railways, hospitals, and schools. Some economists, such as Dambisa Moyo, who wrote *Dead Aid: Why Aid Is Not Working and How There Is a Better Way for Africa*, believe that the way to help developing countries like those in Africa is not through aid but through trade. Moyo argues that long-term charity is degrading. She advocates business investments and setting up enterprises that employ local workers. Ecobank CEO Arnold Ekpe (whose bank employs 11,000 people in twenty-six African states) says the Chinese look at Africa differently than the West does: "[The Chinese] are not setting out to do good," he says. "They are setting out to do business. It's actually much less demeaning."Alex Perry, "Africa, Business Destination," *Time*, March 12, 2009, accessed February 14, 2011, www.time.com/time/specials/packages/article/0,28804,1884779_1884782_1884769,00.html#ixzz1DwbdOXvs. Deborah Brautigam, associate professor at the American University's International Development Program, agrees. In her book, *The Dragon's Gift: The Real Story of China in Africa*, she says, "The Chinese understand something very fundamental about state building: new states need to build buildings and dignity, not simply strive to end poverty."Steve Bloomfield, "China in Africa: Give and Take," *Emerging Markets*, May 27, 2010, accessed February 14, 2011, http://www.emergingmarkets.org/Article/2580082/CHINA-IN-AFRICA-Give-and-take.html.

Steps and Missteps in International Expansion

Let's look at an example of the steps—as well as the missteps—in international expansion. American retailers entered the Chilean market in the mid- to late 1990s. They chose Chile as the market to enter because of the country's strong economy, the advanced level of the Chilean retail sector, and the free trade agreements signed by Chile. From that standpoint, their due diligence was accurate, but it didn't go far enough, as we'll see.

Retailer JCPenney entered Chile in 1995, opening two stores. French retailer Carrefour also entered Chile, in 1998. Neither company entered through an alliance with a local retailer. Both companies were forced to close their Chilean operations due to the losses they were incurring. Analysis by the Aldolfo Ibáñez University in Chile explained the reasons behind the failures: the managers of these companies were not able to connect with the local market, nor did they understand the variables that affected their businesses in Chile."The Globalization of Chilean Retailing," *Knowledge@Wharton*, December 12, 2007, accessed January 5, 2011, www.wharton.universia.net/index.cfm?fa=viewfeature&id=1450&language=english. Specifically, the Chilean retailing market was advanced, but it was also very competitive. The new entrants (JCPenney and Carrefour) didn't realize that the existing major local retailers had their own banks and offered banking services at their retail stores, which was a major reason for their profitability. The outsiders assumed that profitability in this sector was based solely on retail sales. They missed the importance of the bank ties. Another typical mistake that companies make is to assume that a new market has no competition just because the company's traditional competitors aren't in that market.

Now let's continue with the example and watch native Chilean retailers enter a market new to them: Peru.

The Chilean retailers were successful in their own markets but wanted to expand beyond their borders in order to get new customers in new markets. The Chilean retailers chose to enter Peru, which had the same language.

The Peruvian retailing market was not advanced, and it did not offer credit to customers. The Chileans entered the market through partnership with local Peruvian firms, and they introduced the concept of credit cards, which was an innovation in the poorly developed Peruvian market. Entering through a domestic partner helped the Chileans because it eliminated hostility and made the investment process easier. Offering the innovation of credit cards made the Chilean retailers distinctive and offered an advantage over the local offerings."The Globalization of Chilean Retailing," *Knowledge@Wharton*, December 12, 2007, accessed January 5, 2011, www.wharton.universia.net/index.cfm?fa=viewfeature&id=1450&language=english.

KEY TAKEAWAYS

- Companies embark on an expansion strategy for one or more of the following reasons: (1) to improve the cost-effectiveness of their operations, (2) to expand into new markets for new customers, and (3) to follow global customers.
- Planning for international expansion involves doing a thorough due diligence on the potential markets into which the country is considering expanding. This includes understanding the regional differences within markets, the needs of local customers, and the firm's own capabilities in relation to the dynamics of the industry.
- Common mistakes that firms make when entering a new market include not doing thorough research prior to entry, not understanding the competition, and not offering a truly targeted value proposition for buyers in the new market.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What are some of the common motivators for companies embarking on international expansion?
2. Why is international market due diligence important?
3. What are some ways in which a company can learn about the needs of local buyers in a new international market?
4. Discuss the meaning of "corporate fit" in relation to international market expansion.
5. Name two common mistakes firms make when expanding internationally

5.37: PESTEL, Globalization, and Importing

Learning Objectives

1. Know the components of PESTEL analysis.
2. Recognize how PESTEL is related to the dimensions of globalization.
3. Understand why importing might be a stealth form of international entry.

Know the Components of PESTEL Analysis

PESTEL analysis is an important and widely used tool that helps show the big picture of a firm's external environment, particularly as related to foreign markets. PESTEL is an acronym for the political, economic, sociocultural, technological, environmental, and legal contexts in which a firm operates. A PESTEL analysis helps managers gain a better understanding of the opportunities and threats they face; consequently, the analysis aids in building a better vision of the future business landscape and how the firm might compete profitably. This useful tool analyzes for market growth or decline and, therefore, the position, potential, and direction for a business. When a firm is considering entry into new markets, these factors are of considerable importance. Moreover, PESTEL analysis provides insight into the status of key market *flatteners*, both in terms of their present state and future trends.

Firms need to understand the macroenvironment to ensure that their strategy is aligned with the powerful forces of change affecting their business landscape. When firms exploit a change in the environment—rather than simply survive or oppose the change—they are more likely to be successful. A solid understanding of PESTEL also helps managers avoid strategies that may be doomed to fail given the circumstances of the environment. JCPenney's failed entry into Chile is a case in point.

Finally, understanding PESTEL is critical prior to entry into a new country or region. The fact that a strategy is congruent with PESTEL in the home environment gives no assurance that it will also align in other countries. For example, when Lands' End, the online clothier, sought to expand its operations into Germany, it ran into local laws prohibiting it from offering unconditional guarantees on its products. In the United States, Lands' End had built a reputation for quality on its no-questions-asked money-back guarantee. However, this was considered illegal under Germany's regulations governing incentive offers and price discounts. The political skirmish between Lands' End and the German government finally ended when the regulations banning unconditional guarantees were abolished. While the restrictive regulations didn't put Lands' End out of business in Germany, they did inhibit its growth there until the laws were abolished.

There are three steps in the PESTEL analysis. First, consider the relevance of each of the PESTEL factors to your context. Next, identify and categorize the information that applies to these factors. Finally, analyze the data and draw conclusions. Common mistakes in this analysis include stopping at the second step or assuming that the initial analysis and conclusions are correct without testing the assumptions and investigating alternative scenarios.

The framework for PESTEL analysis is presented below. It's composed of six sections—one for each of the PESTEL headings.Mason Carpenter, Talya Bauer, and Berrin Erdogan, *Principles of Management* (Nyack, NY: Unnamed Publisher, 2009), accessed January 5, 2011, www.gone.2012books.lardbucket.org/printed-book/127834. The framework includes sample questions or prompts, the answers to which can help determine the nature of opportunities and threats in the macroenvironment. These questions are examples of the types of issues that can arise in a PESTEL analysis.

PESTEL Analysis

1. Political
   - How stable is the political environment in the prospective country?
   - What are the local taxation policies? How do these affect your business?
   - Is the government involved in trading agreements, such as the European Union (EU), the North American Free Trade Agreement (NAFTA), or the Association of Southeast Asian Nations (ASEAN)?
   - What are the country's foreign-trade regulations?
   - What are the country's social-welfare policies?
2. Economic
   - What are the current and forecast interest rates?

- What is the current level of inflation in the prospective country? What is it forecast to be? How does this affect the possible growth of your market?
- What are local employment levels per capita, and how are they changing?
- What are the long-term prospects for the country's economy, gross domestic product (GDP) per capita, and other economic factors?
- What are the current exchange rates between critical markets, and how will they affect production and distribution of your goods?

3. Sociocultural
    - What are the local lifestyle trends?
    - What are the country's current demographics, and how are they changing?
    - What is the level and distribution of education and income?
    - What are the dominant local religions, and what influence do they have on consumer attitudes and opinions?
    - What is the level of consumerism, and what are the popular attitudes toward it?
    - What pending legislation could affect corporate social policies (e.g., domestic-partner benefits or maternity and paternity leave)?
    - What are the attitudes toward work and leisure?
4. Technological
    - To what level do the local government and industry fund research, and are those levels changing?
    - What is the local government's and industry's level of interest and focus on technology?
    - How mature is the technology?
    - What is the status of intellectual property issues in the local environment?
    - Are potentially disruptive technologies in adjacent industries creeping in at the edges of the focal industry?
5. Environmental
    - What are the local environmental issues?
    - Are there any pending ecological or environmental issues relevant to your industry?
    - How do the activities of international activist groups (e.g., Greenpeace, Earth First!, and People for the Ethical Treatment of Animals [PETA]) affect your business?
    - Are there environmental-protection laws?
    - What are the regulations regarding waste disposal and energy consumption?
6. Legal
    - What are the local government's regulations regarding monopolies and private property?
    - Does intellectual property have legal protections?
    - Are there relevant consumer laws?
    - What is the status of employment, health and safety, and product safety laws?

Political Factors

The political environment can have a significant influence on businesses. In addition, political factors affect consumer confidence and consumer and business spending. For instance, how stable is the political environment? This is particularly important for companies entering new markets. Government policies on regulation and taxation can vary from state to state and across national boundaries. Political considerations also encompass trade treaties, such as NAFTA, ASEAN, and EU. Such treaties tend to favor trade among the member countries but impose penalties or less favorable trade terms on nonmembers.

Economic Factors

Managers also need to consider macroeconomic factors that will have near-term and long-term effects on the success of their strategy. Inflation rates, interest rates, tariffs, the growth of the local and foreign national economies, and exchange rates are critical. Unemployment, availability of critical labor, and the local cost of labor also have a strong bearing on strategy, particularly as related to the location of disparate business functions and facilities.

Sociocultural Factors

The social and cultural influences on business vary from country to country. Depending on the type of business, factors such as the local languages, the dominant religions, the cultural views toward leisure time, and the age and lifespan demographics may be critical. Local sociocultural characteristics also include attitudes toward consumerism, environmentalism, and the roles of men and women in society. For example, Coca-Cola and PepsiCo have grown in international markets due to the increasing level of consumerism outside the United States.

Making assumptions about local norms derived from experiences in your home market is a common cause for early failure when entering new markets. However, even home-market norms can change over time, often caused by shifting demographics due to immigration or aging populations.

Technological Factors

The critical role of technology is discussed in more detail later in this section. For now, suffice it to say that technological factors have a major bearing on the threats and opportunities firms encounter. For example, new technology may make it possible for products and services to be made more cheaply and to a better standard of quality. New technology may also provide the opportunity for more innovative products and services, such as online stock trading and remote working. Such changes have the potential to change the face of the business landscape.

Environmental Factors

The environment has long been a factor in firm strategy, primarily from the standpoint of access to raw materials. Increasingly, this factor is best viewed as both a direct and indirect cost for the firm.

Environmental factors are also evaluated on the footprint left by a firm on its respective surroundings. For consumer-product companies like PepsiCo, for instance, this can encompass the waste-management and organic-farming practices used in the countries where raw materials are obtained. Similarly, in consumer markets, it may refer to the degree to which packaging is biodegradable or recyclable.

Legal Factors

Finally, legal factors reflect the laws and regulations relevant to the region and the organization. Legal factors can include whether the rule of law is well established, how easily or quickly laws and regulations may change, and what the costs of regulatory compliance are. For example, Coca-Cola's market share in Europe is greater than 50 percent; as a result, regulators have asked that the company give shelf space in its coolers to competitive products in order to provide greater consumer choice."EU Curbs Coca-Cola Market Dominance," *Food & Beverage Reporter*, August 2005, accessed February 18, 2011, www.developtechnology.co.za/index.php?option=com_content&task=view&id=18464&Itemid=101.

Many of the PESTEL factors are interrelated. For instance, the legal environment is often related to the political environment, where laws and regulations can only change when they're consistent with the political will.

PESTEL and Globalization

Over the past decade, new markets have been opened to foreign competitors, whole industries have been deregulated, and state-run enterprises have been privatized. So, globalization has become a fact of life in almost every industry.George S. Yip, "Global Strategy in a World of Nations," *Sloan Management Review* 31, no. 1 (1989): 29–40. This entails much more than companies simply exporting products to another country. Some industries that aren't normally considered global do, in fact, have strictly domestic players. But these companies often compete alongside firms with operations in multiple countries; in many cases, both sets of firms are doing equally well. In contrast, in a truly global industry, the core product is standardized, the marketing approach is relatively uniform, and competitive strategies are integrated in different international markets.Michael E. Porter, *Competition in Global Industries* (Boston: Harvard Business School Press, 1986); George S. Yip, "Global Strategy in a World of Nations," *Sloan Management Review* 31, no. 1 (1989): 29–40. In these industries, competitive advantage clearly belongs to the firms that can compete globally.

A number of factors reveal whether an industry has globalized or is in the process of globalizing. The sidebar below groups globalization factors into four categories: *markets*, *costs*, *governments*, and *competition*. These dimensions correspond well to Thomas Friedman's flatteners (as described in his book *The World Is Flat*), though they are not exhaustive.Thomas L. Friedman, *The World Is Flat* (New York: Farrar, Straus and Giroux, 2005).

Factors Favoring Industry Globalization

1. Markets
   - Homogeneous customer needs
   - Global customer needs
   - Global channels
   - Transferable marketing approaches
2. Costs
   - Large-scale and large-scope economies
   - Learning and experience
   - Sourcing efficiencies
   - Favorable logistics
   - Arbitrage opportunities
   - High research-and-development (R&D) costs
3. Governments
   - Favorable trade policies
   - Common technological standards
   - Common manufacturing and marketing regulations
4. Competition
   - Interdependent countries
   - Global competitorsAdapted from Michael E. Porter, *Competition in Global Industries* (Boston: Harvard Business School Press, 1986); George S. Yip, “Global Strategy in a World of Nations,” *Sloan Management Review* 31, no. 1 (1989): 29–40.

Markets

The more similar markets in different regions are, the greater the pressure for an industry to globalize. Coca-Cola and PepsiCo, for example, are fairly uniform around the world because the demand for soft drinks is largely the same in every country. The airframe-manufacturing industry, dominated by Boeing and Airbus, also has a highly uniform market for its products; airlines all over the world have the same needs when it comes to large commercial jets.

Costs

In both of these industries, costs favor globalization. Coca-Cola and PepsiCo realize economies of scope and scale because they make such huge investments in marketing and promotion. Since they’re promoting coherent images and brands, they can leverage their marketing dollars around the world. Similarly, Boeing and Airbus can invest millions in new-product R&D only because the global market for their products is so large.

Governments and Competition

Obviously, favorable trade policies encourage the globalization of markets and industries. Governments, however, can also play a critical role in globalization by determining and regulating technological standards. Railroad gauge—the distance between the two steel tracks—would seem to favor a simple technological standard. In Spain, however, the gauge is wider than in France. Why? Because back in the 1850s, when Spain and neighboring France were hostile to one another, the Spanish government decided that making Spanish railways incompatible with French railways would hinder any French invasion.

These are a few key drivers of industry change. However, there are particular implications of technological and business-model breakthroughs for both the pace and extent of industry change. The *rate* of change may vary significantly from one industry to the next; for instance, the computing industry changes much faster than the steel industry. Nevertheless, change in both fields has prompted complete reconfigurations of industry structure and the competitive positions of various players. The idea that all industries change over time and that business environments are in a constant state of flux is relatively intuitive. As a strategic decision maker, you need to ask yourself this question: how accurately does current industry structure (which is relatively easy to identify) predict future industry conditions?

Importing as a Stealth Form of Internationalization

Ironically, the drivers of globalization have also given rise to a greater level of imports. Globalization in this sense is a very strong flattener. **Importing** involves the sale of products or services in one country that are sourced in another country. In many ways, importing is a stealth form of internationalization. Firms often claim that they have no international operations and yet—directly or indirectly—base their production or services on inputs obtained from outside their home country. Firms that engage in importing must learn about customs requirements, informed compliance with customs regulations, entry of goods, invoices, classification and value, determination and assessment of duty, special requirements, fraud, marketing, trade finance and insurance, and foreign trade zones. Importing can take many forms—from the sourcing of components, machinery, and raw materials to the purchase of finished goods for domestic resale and the outsourcing of production or services to nondomestic providers.

Outsourcing occurs when a company contracts with a third party to do some work on its behalf. The outsourcer may do the work within the same country or may take the work to another country (i.e., offshoring). **Offshoring** occurs when you take a function out of your country of residence to be performed in another country, generally at a lower cost. **International outsourcing**, or outsourcing work to a nondomestic third party, has become very visible in business and corporate strategy in recent years. But it's not a new phenomenon; for decades, Nike has been designing shoes and other apparel that are manufactured abroad. Similarly, Pacific Cycle doesn't make a single Schwinn or Mongoose bicycle in the United States but instead imports them entirely from manufacturers in Taiwan and China. It may seem as if international outsourcing is new because businesses are now more often outsourcing services, components, and raw materials from countries with developing economies (e.g., China, Brazil, and India).

In addition to factors of production, information technologies (IT)—such as telecommunications and the widespread diffusion of the Internet—have provided the impetus for outsourcing services. Business-process outsourcing (BPO) is the delegation of one or more IT-intensive business processes to an external provider that in turn owns, administers, and manages the selected process on the basis of defined and measurable performance criteria. The firms in service and IT-intensive industries—insurance, banking, pharmaceuticals, telecommunications, automotive, and airlines—are among the early adopters of BPO. Of these, insurance and banking are able to generate the bulk of the savings, purely because of the large proportion of processes that they can outsource (i.e., the processing of claims and loans and providing service through call centers). Among those countries housing BPO operations, India experienced the most dramatic growth in services where language skills and education were important. Research firm Gartner anticipates that the BPO market in India will reach $1.8 billion by 2013."Indian BPO Market to Grow 25 percent in 2010," *Times of India*, March 29, 2010, accessed February 17, 2011, http://timesofindia.indiatimes.com/business/india-business/Indian-BPO-market-to-grow-25-in-2010/articleshow/5739043.cms.

Generally, foreign outsourcing locations tend to be defined by how automated a production process or service can be made and the transportation costs involved. When transportation costs and automation are both high, then the knowledge worker component of the location calculation becomes less important. You can see how you might employ the CAGE framework to evaluate potential outsourcing locations. In some cases, though, firms invest in both plant equipment and the training and development of the local workforce. This becomes important when the broader labor force needs to have a higher level of education to operate complex plant machinery or because a firm's specific technologies also have a cultural component. Brazil is one case in point; Ford, BMW, Daimler, and Cargill have all made significant investments in the educational infrastructure of this significant, emerging economy.Spencer E. Ante, "IBM Bets on Brazilian Innovation," *BusinessWeek*, August 17, 2009, accessed February 18, 2011, http://www.businessweek.com/technology/content/aug2009/tc20090817_998497.htm; "Cargill Annual Report 2006," Cargill website, accessed October 27, 2010, www.cargill.com.br/wcm/groups/public/@csf/@brazil/documents/document/br-2006-annual-rpt.pdf; "Ford to Raise Brazil Investments by $281 Million," *Reuters*, April 8, 2010, accessed February 18, 2011, www.reuters.com/article/2010/04/08/ford-brazil-idUSN0821323920100408; "Cargill Investing $210 Million in Brazilian Plant," *Forbes*, February 2, 2011, accessed February 18, 2011, www.forbes.com/feeds/ap/2011/02/02/business-food-retailers-amp-wholesalers-us-cargill-brazil_8289031.htm.

KEY TAKEAWAYS

- A PESTEL analysis examines a target market's political, economic, social, technological, environmental, and legal dimensions in terms of both its current state and possible trends.
- An understanding of the dimensions of PESTEL helps you better grasp the dimensions on which a target market or industry may be more global or local.
- Importing is a stealth form of international entry, because the factors that favor globalization can also lead to a higher level of imports, and inputs can be sourced from anywhere they have either the lowest cost, highest quality, or some combination of these characteristics.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What are the components of PESTEL analysis?
2. What are the four dimensions of pressures favoring globalization?
3. How are the PESTEL and globalization dimensions related to the flatteners (in the context that Thomas Friedman talks about them in his book *The World Is Flat*)?
4. Why might importing be considered a stealth form of internationalization or an internationalization entry mode?
5. What is the difference between outsourcing and offshoring?

5.38: International-Expansion Entry Modes

Learning Objectives

1. Describe the five common international-expansion entry modes.
2. Know the advantages and disadvantages of each entry mode.
3. Understand the dynamics among the choice of different entry modes.

The Five Common International-Expansion Entry Modes

In this section, we will explore the traditional international-expansion entry modes. Beyond importing, international expansion is achieved through exporting, licensing arrangements, partnering and **strategic alliances**, acquisitions, and establishing new, wholly owned subsidiaries, also known as **greenfield ventures**. These modes of entering international markets and their characteristics are shown in Table 8.1.Shaker A. Zahra, R. Duane Ireland, and Michael A. Hitt, "International Expansion by New Venture Firms: International Diversity, Mode of Market Entry, Technological Learning, and Performance," *Academy of Management Journal* 43, no. 5 (October 2000): 925–50. Each mode of market entry has advantages and disadvantages. Firms need to evaluate their options to choose the entry mode that best suits their strategy and goals.

Table 8.1 International-Expansion Entry Modes

Type of Entry	Advantages	Disadvantages
Exporting	Fast entry, low risk	Low control, low local knowledge, potential negative environmental impact of transportation
Licensing and Franchising	Fast entry, low cost, low risk	Less control, licensee may become a competitor, legal and regulatory environment (IP and contract law) must be sound
Partnering and Strategic Alliance	Shared costs reduce investment needed, reduced risk, seen as local entity	Higher cost than exporting, licensing, or franchising; integration problems between two corporate cultures
Acquisition	Fast entry; known, established operations	High cost, integration issues with home office
Greenfield Venture (Launch of a new, wholly owned subsidiary)	Gain local market knowledge; can be seen as insider who employs locals; maximum control	High cost, high risk due to unknowns, slow entry due to setup time

Exporting

Exporting is a typically the easiest way to enter an international market, and therefore most firms begin their international expansion using this model of entry. Exporting is the sale of products and services in foreign countries that are sourced from the home country. The advantage of this mode of entry is that firms avoid the expense of establishing operations in the new country. Firms must, however, have a way to distribute and market their products in the new country, which they typically do through contractual agreements with a local company or distributor. When exporting, the firm must give thought to labeling, packaging, and pricing the offering appropriately for the market. In terms of marketing and promotion, the firm will need to let potential buyers know of its offerings, be it through advertising, trade shows, or a local sales force.

Amusing Anecdotes

One common factor in exporting is the need to translate something about a product or service into the language of the target country. This requirement may be driven by local regulations or by the company's wish to market the product or service in a locally friendly fashion. While this may seem to be a simple task, it's often a source of embarrassment for the company and humor for competitors. David Ricks's book on international business blunders relates the following anecdote for US companies doing business in the neighboring French-speaking Canadian province of Quebec. A company boasted of *lait frais usage*, which translates to "used fresh milk," when it meant to brag of *lait frais employé*, or "fresh milk used." The "terrific" pens sold by another company were instead promoted as *terrifiantes*, or terrifying. In another example, a company intending to say that its appliance could use "any kind of electrical current," actually stated that the appliance "wore out any kind of liquid." And imagine how one company felt when its product to "reduce heartburn" was advertised as one that reduced "the warmth of heart"!David A. Ricks, *Blunders in International Business* (Hoboken, NJ: Wiley-Blackwell, 1999), 101.

Among the disadvantages of exporting are the costs of transporting goods to the country, which can be high and can have a negative impact on the environment. In addition, some countries impose tariffs on incoming goods, which will impact the firm's profits. In addition, firms that market and distribute products through a contractual agreement have less control over those operations and, naturally, must pay their distribution partner a fee for those services.

Ethics in Action

Companies are starting to consider the environmental impact of where they locate their manufacturing facilities. For example, Olam International, a cashew producer, originally shipped nuts grown in Africa to Asia for processing. Now, however, Olam has opened processing plants in Tanzania, Mozambique, and Nigeria. These locations are close to where the nuts are grown. The result? Olam has lowered its processing and shipping costs by 25 percent while greatly reducing carbon emissions.Michael E. Porter and Mark R. Kramer, "The Big Idea: Creating Shared Value," *Harvard Business Review*, January–February 2011, accessed January 23, 2011, http://hbr.org/2011/01/the-big-idea-creating-shared-value/ar/pr.

Likewise, when Walmart enters a new market, it seeks to source produce for its food sections from local farms that are near its warehouses. Walmart has learned that the savings it gets from lower transportation costs and the benefit of being able to restock in smaller quantities more than offset the lower prices it was getting from industrial farms located farther away. This practice is also a win-win for locals, who have the opportunity to sell to Walmart, which can increase their profits and let them grow and hire more people and pay better wages. This, in turn, helps all the businesses in the local community.Michael E. Porter and Mark R. Kramer, "The Big Idea: Creating Shared Value," *Harvard Business Review*, January–February 2011, accessed January 23, 2011, http://hbr.org/2011/01/the-big-idea-creating-shared-value/ar/pr.

Firms export mostly to countries that are close to their facilities because of the lower transportation costs and the often greater similarity between geographic neighbors. For example, Mexico accounts for 40 percent of the goods exported from Texas.Andrew J. Cassey, "Analyzing the Export Flow from Texas to Mexico," *StaffPAPERS: Federal Reserve Bank of Dallas*, No. 11, October 2010, accessed February 14, 2011, www.dallasfed.org/research/staff/2010/staff1003.pdf. The Internet has also made exporting easier. Even small firms can access critical information about foreign markets, examine a target market, research the competition, and create lists of potential customers. Even applying for export and import licenses is becoming easier as more governments use the Internet to facilitate these processes.

Because the cost of exporting is lower than that of the other entry modes, entrepreneurs and small businesses are most likely to use exporting as a way to get their products into markets around the globe. Even with exporting, firms still face the challenges of currency exchange rates. While larger firms have specialists that manage the exchange rates, small businesses rarely have this expertise. One factor that has helped reduce the number of currencies that firms must deal with was the formation of the European Union (EU) and the move to a single currency, the euro, for the first time. As of 2011, seventeen of the twenty-seven EU members use the euro, giving businesses access to 331 million people with that single currency."The Euro," European Commission, accessed February 11, 2011, http://ec.europa.eu/euro/index_en.html.

Licensing and Franchising

Licensing and franchising are two specialized modes of entry that are discussed in more detail in Chapter 9. The intellectual property aspects of licensing new technology or patents is discussed in Chapter 13.

Partnerships and Strategic Alliances

Another way to enter a new market is through a strategic alliance with a local partner. A strategic alliance involves a contractual agreement between two or more enterprises stipulating that the involved parties will cooperate in a certain way for a certain time to achieve a common purpose. To determine if the alliance approach is suitable for the firm, the firm must decide what value the partner could bring to the venture in terms of both tangible and intangible aspects. The advantages of partnering with a local firm are that the local firm likely understands the local culture, market, and ways of doing business better than an outside firm. Partners are especially valuable if they have a recognized, reputable brand name in the country or have existing relationships with customers that the firm might want to access. For example, Cisco formed a strategic alliance with Fujitsu to develop routers for Japan. In the alliance, Cisco decided to co-brand with the Fujitsu name so that it could leverage Fujitsu's reputation in Japan for IT equipment and solutions while still retaining the Cisco name to benefit from Cisco's global reputation for switches and routers.Steve Steinhilber, *Strategic Alliances* (Cambridge, MA: Harvard Business School Press, 2008), 113. Similarly, Xerox launched signed strategic alliances to grow sales in emerging markets such as Central and Eastern Europe, India, and Brazil. "ASAP Releases Winners of 2010 Alliance Excellence Awards," Association for Strategic Alliance Professionals, September 2, 2010, accessed February 12, 2011, newslife.us/technology/mobile/ASAP-Releases-Winners-of-2010-Alliance-Excellence-Awards.

Strategic alliances are also advantageous for small entrepreneurial firms that may be too small to make the needed investments to enter the new market themselves. In addition, some countries require foreign-owned companies to partner with a local firm if they want to enter the market. For example, in Saudi Arabia, non-Saudi companies looking to do business in the country are required by law to have a Saudi partner. This requirement is common in many Middle Eastern countries. Even without this type of regulation, a local partner often helps foreign firms bridge the differences that otherwise make doing business locally impossible. Walmart, for example, failed several times over nearly a decade to effectively grow its business in Mexico, until it found a strong domestic partner with similar business values.

The disadvantages of partnering, on the other hand, are lack of direct control and the possibility that the partner's goals differ from the firm's goals. David Ricks, who has written a book on blunders in international business, describes the case of a US company eager to enter the Indian market: "It quickly negotiated terms and completed arrangements with its local partners. Certain required documents, however, such as the industrial license, foreign collaboration agreements, capital issues permit, import licenses for machinery and equipment, etc., were slow in being issued. Trying to expedite governmental approval of these items, the US firm agreed to accept a lower royalty fee than originally stipulated. Despite all of this extra effort, the project was not greatly expedited, and the lower royalty fee reduced the firm's profit by approximately half a million dollars over the life of the agreement."David A. Ricks, *Blunders in International Business* (Hoboken, NJ: Wiley-Blackwell, 1999), 101. Failing to consider the values or reliability of a potential partner can be costly, if not disastrous.

To avoid these missteps, Cisco created one globally integrated team to oversee its alliances in emerging markets. Having a dedicated team allows Cisco to invest in training the managers how to manage the complex relationships involved in alliances. The team follows a consistent model, using and sharing best practices for the benefit of all its alliances.Steve Steinhilber, *Strategic Alliances* (Cambridge, MA: Harvard Business School Press, 2008), 125.

Joint ventures are discussed in depth in Chapter 9.

Did You Know?

Partnerships in emerging markets can be used for social good as well. For example, pharmaceutical company Novartis crafted multiple partnerships with suppliers and manufacturers to develop, test, and produce antimalaria medicine on a nonprofit basis. The partners included several Chinese suppliers and manufacturing partners as well as a farm in Kenya that grows the medication's key raw ingredient. To date, the partnership, called the Novartis Malaria Initiative, has saved an estimated 750,000 lives through the delivery of 300 million doses of the medication."ASAP Releases Winners of 2010 Alliance Excellence Awards," Association for Strategic Alliance Professionals, September 2, 2010, accessed September 20, 2010, newslife.us/technology/mobile/ASAP-Releases-Winners-of-2010-Alliance-Excellence-Awards.

Acquisitions

An **acquisition** is a transaction in which a firm gains control of another firm by purchasing its stock, exchanging the stock for its own, or, in the case of a private firm, paying the owners a purchase price. In our increasingly flat world, cross-border acquisitions have risen dramatically. In recent years, cross-border acquisitions have made up over 60 percent of all acquisitions completed worldwide. Acquisitions are appealing because they give the company quick, established access to a new market. However, they are expensive, which in the past had put them out of reach as a strategy for companies in the undeveloped world to pursue. What has changed over the years is the strength of different currencies. The higher interest rates in developing nations has strengthened their currencies relative to the dollar or euro. If the acquiring firm is in a country with a strong currency, the acquisition is comparatively cheaper to make. As Wharton professor Lawrence G. Hrebiniak explains, "Mergers fail because people pay too much of a premium. If your currency is strong, you can get a bargain.""Playing on a Global Stage: Asian Firms See a New Strategy in Acquisitions Abroad and at Home," *Knowledge@Wharton*, April 28, 2010, accessed January 15, 2011, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2473.

When deciding whether to pursue an acquisition strategy, firms examine the laws in the target country. China has many restrictions on foreign ownership, for example, but even a developed-world country like the United States has laws addressing acquisitions. For example, you must be an American citizen to own a TV station in the United States. Likewise, a foreign firm is not allowed to own more than 25 percent of a US airline."Playing on a Global Stage: Asian Firms See a New Strategy in Acquisitions Abroad and at Home," *Knowledge@Wharton*, April 28, 2010, accessed January 15, 2011, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2473.

Acquisition is a good entry strategy to choose when scale is needed, which is particularly the case in certain industries (e.g., wireless telecommunications). Acquisition is also a good strategy when an industry is consolidating. Nonetheless, acquisitions are risky. Many studies have shown that between 40 percent and 60 percent of all acquisitions fail to increase the market value of the acquired company by more than the amount invested."Playing on a Global Stage: Asian Firms See a New Strategy in Acquisitions Abroad and at Home," *Knowledge@Wharton*, April 28, 2010, accessed January 15, 2011, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2473. Additional risks of acquisitions are discussed in Chapter 9.

New, Wholly Owned Subsidiary

The proess of establishing of a new, wholly owned subsidiary (also called a greenfield venture) is often complex and potentially costly, but it affords the firm maximum control and has the most potential to provide above-average returns. The costs and risks are high given the costs of establishing a new business operation in a new country. The firm may have to acquire the knowledge and expertise of the existing market by hiring either host-country nationals—possibly from competitive firms—or costly consultants. An advantage is that the firm retains control of all its operations. Wholly owned subsidiaries are discussed further in Chapter 9.

Entrepreneurship and Strategy

The Chinese have a "Why not me?" attitude. As Edward Tse, author of *The China Strategy: Harnessing the Power of the World's Fastest-Growing Economy*, explains, this means that "in all corners of China, there will be people asking, 'If Li Ka-shing [the chairman of Cheung Kong Holdings] can be so wealthy, if Bill Gates or Warren Buffett can be so successful, why not me?' This cuts across China's demographic profiles: from people in big cities to people in smaller cities or rural areas, from older to younger people. There is a huge dynamism among them."Art Kleiner, "Getting China Right," *Strategy and Business*, March 22, 2010, accessed January 23, 2011, www.strategy-business.com/article/00026?pg=al. Tse sees entrepreneurial China as "entrepreneurial people at the grassroots level who are very independent-minded. They're very quick on their feet. They're prone to fearless experimentation: imitating other companies here and there, trying new ideas, and then, if they fail, rapidly adapting and moving on." As a result, he sees China becoming not only a very large consumer market but also a strong innovator. Therefore, he advises US firms to enter China sooner rather than later so that they can take advantage of the opportunities there. Tse says, "Companies are coming to realize that they need to integrate more and more of their value chains into China and India. They need to be close to these markets, because of their size. They need the ability to understand the needs of their customers in emerging markets, and turn them into product and service offerings quickly."Art Kleiner, "Getting China Right," *Strategy and Business*, March 22, 2010, accessed January 23, 2011, www.strategy-business.com/article/00026?pg=al.

KEY TAKEAWAYS

- The five most common modes of international-market entry are exporting, licensing, partnering, acquisition, and greenfield venturing.
- Each of these entry vehicles has its own particular set of advantages and disadvantages. By choosing to export, a company can avoid the substantial costs of establishing its own operations in the new country, but it must find a way to market and distribute its goods in that country. By choosing to license or franchise its offerings, a firm lowers its financial risks but also gives up control over the manufacturing and marketing of its products in the new country. Partnerships and strategic alliances reduce the amount of investment that a company needs to make because the costs are shared with the partner. Partnerships are also helpful to make the new entrant appear to be more local because it enters the market with a local partner. But the overall costs of partnerships and alliances are higher than exporting, licensing, or franchising, and there is a potential for integration problems between the corporate cultures of the partners. Acquisitions enable fast entry and less risk from the standpoint that the operations are established and known, but they can be expensive and may result in integration issues of the acquired firm to the home office. Greenfield ventures give the firm the best opportunity to retain full control of operations, gain local market knowledge, and be seen as an insider that employs locals. The disadvantages of greenfield ventures are the slow time to enter the market because the firm must set up operations and the high costs of establishing operations from scratch.

- Which entry mode a firm chooses also depends on the firm's size, financial strength, and the economic and regulatory conditions of the target country. A small firm will likely begin with an export strategy. Large firms or firms with deep pockets might begin with an acquisition to gain quick access or to achieve economies of scale. If the target country has sound rule of law and strong adherence to business contracts, licensing, franchising, or partnerships may be middle-of-the-road approaches that are neither riskier nor more expensive than the other options.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What are five common international entry modes?
2. What are the advantages of exporting?
3. What is the difference between a strategic alliance and an acquisition?
4. What would influence a firm's choice of the five entry modes?
5. What is the possible relationship among the different entry modes?

5.39: CAGE Analysis

Learning Objectives

1. Understand the inputs into CAGE analysis.
2. Know the reasons why CAGE analysis emphasizes distance.
3. See how CAGE analysis can help you identify institutional voids.

The Inputs into CAGE Analysis

Pankaj "Megawatt" Ghemawat is an international strategy guru who developed the **CAGE framework** to offer businesses a way to evaluate countries in terms of the "distance" between them.Pankaj Ghemawat, "Distance Still Matters," *Harvard Business Review* 79, no. 8 (September 2001): 1–11. In this case, distance is defined broadly to include not only the physical geographic distance between countries but also the cultural, administrative (currencies, trade agreements), and economic differences between them. As summarized in Table 8.2, the CAGE (cultural, administrative, geographic, and economic) framework offers a broader view of distance and provides another way of thinking about location and the opportunities and concomitant risks associated with global arbitrage.Pankaj Ghemawat, "The Forgotten Strategy," *Harvard Business Review* 81, no. 11 (September 2003).

Table 8.2 The CAGE Framework

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 networks	Absence of shared monetary or political association	Lack of a common border	Differences in costs and quality of the following: • Natural resources • Financial resources • 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			

Cultural Distance	Administrative Distance	Geographic Distance	Economic Distance
Products have high-linguistic content (TV).	Government involvement is high in industries that are • producers of staple goods (electricity), • producers of other "entitlements" (drugs), • large employers (farming), • large suppliers to government (mass transportation), • national champions (aerospace), • vital to national security (telecommunications), • exploiters of natural resources (oil, mining), and • subject to high-sunk costs (infrastructure).	Products have a low value-of-weight or bulk ratio (cement).	Nature of demand varies with income level (cars).
Products affect cultural or national identity of consumers (foods).		Products are fragile or perishable (glass or fruit).	Economies of standardization or scale are important (mobile phones).
Product features vary in terms of size (cars), standards (electrical appliances), or packaging.		Communications and connectivity are important (financial services).	Labor and other factor cost differences are salient (garments).
Products carry country-specific quality associations (wines).		Local supervision and operational requirements are high (many services).	Distribution or business systems are different (insurance).
			Companies need to be responsive and agile (home appliances).

Source: Recreated from Pankaj Ghemawat, "Distance Still Matters," *Harvard Business Review* 79, no. 8 (September 2001), accessed February 15, 2011, sabanet.unisabana.edu.co/postgrados/finanzas_negocios/Homologacion/negociosint/Distance%20still%20matters.pdf.

To apply the CAGE framework, identify locations that offer low raw material costs, access to markets or consumers, or other key decision criteria. You might, for instance, determine that you're interested in markets with strong consumer buying power, so you would use per capita income as your first sorting criterion. As a result, you would likely end up with some type of ranking. Ghemawat provides an example for the fast-food industry, where he shows that on the basis of per capita income, countries like Germany and Japan would be the most attractive markets for the expansion of a North American fast-food company. However, when he adjusts this analysis for distance using the CAGE framework, he shows that Mexico ranks as the second most attractive market for international expansion, far ahead of Germany and Japan.Pankaj Ghemawat, "Distance Still Matters," *Harvard Business Review* 79, no. 8 (September 2001): 1–11. Recall though, that any international expansion strategy still needs to be supported by the specific resources and capabilities possessed by the firm, regardless of the picture presented by the CAGE analysis. To understand the usefulness of the CAGE framework, consider Dell and its efforts to compete effectively in China. The vehicles it used to enter China were just as important in its strategy as its choice of geographic arena. For Dell's corporate clients in China, the CAGE framework would likely have revealed relatively little distance on all four dimensions—even geographic—given the fact that many personal-computer components have been sourced from China. However, for the consumer segment, the distance was rather great, particularly on the dimensions of culture, administration, and economics. For example, Chinese consumers didn't buy over the Internet, which is the primary way Dell sells its products in the United States. One possible outcome could have been for Dell to avoid the Chinese consumer market altogether. However, Dell opted to choose a strategic alliance with distributors whose knowledge base and capabilities allowed Dell to better bridge the CAGE-framework distances. Thus the CAGE framework can be used to address the question of where (which arena) and how (by which entry vehicle) to expand internationally.

CAGE Analysis and Institutional Voids

While you can apply CAGE to consider some first-order distances (e.g., physical distance between a company's home market and the new foreign market) or cultural differences (e.g., the differences between home-market and foreign-market customer preferences), you can also apply it to identify institutional differences. Institutional differences include differences in political systems and in financial markets. The greater the distance, the harder it will be to operate in that country. Emerging markets in particular can have greater differences because these countries lack many of the specialized intermediaries that make institutions like financial markets work. Table 8.3 lists examples of specialized intermediaries for different institutions. If an institution lacks these specialized intermediaries, there is an **institutional void**. An institutional void refers to the absence of key specialized intermediaries found in the markets of finance, managerial talent, and products, which otherwise reduce transaction costs.

Table 8.3 Specialized Intermediaries within a Country or Other Geographic Arena

Institution	Specialized Intermediary
Financial markets	• Venture-capital firms • Private equity providers • Mutual funds • Banks • Auditors • Transparent corporate governance
Markets for managerial talent	• Management institute or business schools • Certification agencies • Headhunting firms • Relocation agencies
Markets for products	• Certification agencies • Consumer reports • Regulatory authorities (e.g., the Food and Drug Administration) • Extrajudicial dispute resolution services
All markets	• Legal and judiciary (for property rights protection and enforcement)

Three Strategies for Handling Institutional Voids

When a firm detects an institutional void, it has three choices for how to proceed in regard to the potential target market: (1) adapt its business model, (2) change the institutional context, or (3) stay away.

For example, when McDonald's tried to enter the Russian market, it found an institutional void: a lack of local suppliers to provide the food products it needs. Rather than abandoning market entry, McDonald's decided to adapt its business model. Instead of outsourcing supply-chain operations like it does in the United States, McDonald's worked with a joint-venture partner to fill the voids. It imported cattle from Holland and russet potatoes from the United States, brought in agricultural specialists from Canada and Europe to improve Russian farmers' management practices, and lent money to farmers so that they could invest in better seeds and equipment. As a result of establishing its own supply-chain and management systems, McDonald's controlled 80 percent of the Russian fast-food market by 2010. The process, however, took fifteen years and $250 million in investments."McDonald's in Russia: Accept or Attempt to Change Market Context?," *Economic Times of India*, April 30, 2010, accessed February 17, 2011, http://economictimes.indiatimes.com/features/corporate-dossier/McDonalds-in-Russia-Accept-or-attempt-to-change-market-context/articleshow/5874306.cms; Tarun Khanna and Krishna G. Palepu, *Winning in Emerging Markets: A Road Map for Strategy* (Cambridge, MA: Harvard Business School Press, 2010).

An example of the second approach to dealing with an institutional void—changing the institutional context—is that used by the "Big Four" audit firms (i.e., Ernst & Young, KPMG, Deloitte Touche Tohmatsu, and PricewaterhouseCoopers) when they entered

Brazil. At the time, Brazil had a fledgling audit services market. When the four firms set up branches in Brazil, they raised financial reporting and auditing standards across the country, thus bringing a dramatic improvement to the local market.Tarun Khanna, Krishna G. Palepu, and Jayant Sinha, “Strategies That Fit Emerging Markets,” *Harvard Business Review* 83, no. 6 (June 2005): 2–16.

Finally, the firm can choose the strategy of staying away from a market with institutional voids. For example, The Home Depot’s value proposition (i.e., low prices, great service, and good quality) requires institutions like reliable transportation networks (to minimize inventory costs) and the practice of employee stock ownership (which motivates workers to provide great service). The Home Depot has decided to avoid countries with weak logistics systems and poorly developed capital markets because the company would not be able to attain the low cost–great service combination that is its hallmark.Tarun Khanna, Krishna G. Palepu, and Jayant Sinha, “Strategies That Fit Emerging Markets,” *Harvard Business Review* 83, no. 6 (June 2005): 2–16.

Ethics in Action

Nestlé’s Nespresso division is one of the company’s fastest-growing divisions. The division makes a single-cup espresso machine along with single-serving capsules of coffees from around the world. Nestlé is headquartered in Switzerland, but the coffee it needs to buy is primarily grown in rural Africa and Latin America. Nespresso set up local facilities in these regions that measure the quality of the coffee. Nespresso also helps local farmers improve the quality of their coffee, and then it pays more for coffee beans that are of higher quality. Nespresso has gone even further by advising farmers on farming practices that improve the yield of beans farmers get per hectare. The results have proven beneficial to all parties: farmers earn more money, Nespresso gets getter quality beans, and the negative environmental impact of the farms has diminished.Michael E. Porter and Mark R. Kramer, “The Big Idea: Creating Shared Value,” *Harvard Business Review*, January–February 2011, accessed January 23, 2011, http://hbr.org/2011/01/the-big-idea-creating-shared-value/ar/pr.

KEY TAKEAWAYS

- CAGE analysis asks you to compare a possible target market to a company’s home market on the dimensions of culture, administration, geography, and economy.
- CAGE analysis yields insights in the key differences between home and target markets and allows companies to assess the desirability of that market.
- CAGE analysis can help you identify institutional voids, which might otherwise frustrate internationalization efforts. Institutional differences are important to the extent that the absence of specialized intermediaries can raise transaction costs just as their presence can reduce them.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Explain what distance is in relation to the CAGE framework.
2. What are the key elements in CAGE analysis?
3. What is an institutional void?
4. How might CAGE analysis help you identify institutional voids?
5. What are three possible choices firms have when they’re considering entering a foreign market with large institutional voids?

5.40: Scenario Planning and Analysis

Learning Objectives

1. Understand the history and role of scenario planning and analysis.
2. Know the six steps of scenario planning and analysis.
3. Be able to map scenarios in a two-by-two matrix.

The History and Role of Scenario Planning and Analysis

Strategic leaders use the information revealed by the application of PESTEL analysis, global dimensions, and CAGE analysis to uncover what the traditional SWOT framework calls *opportunities* and *threats*. A **SWOT (strengths, weaknesses, opportunities, and threats)** assessment is a strategic-management tool that helps you take stock of an organization's internal characteristics, or its strengths and weaknesses, such that any action plan builds on what it does well while overcoming or working around weaknesses; the SWOT assessment also helps a company assess external environmental conditions, or opportunities and threats, that favor or threaten an organization's strategy. In particular, you can use it to evaluate the implications of your industry analysis, both for your focal firm specifically and for the industry in general. However, a SWOT assessment works best with one situation or scenario and provides little direction when you're uncertain about potential changes to critical features of the scenario. Scenario planning can help in these cases.

Scenario Planning

Scenario planning helps leaders develop a detailed, internally consistent picture of a range of plausible outcomes as an industry evolves over time. You can also incorporate the results of scenario planning into your strategy formulation and implementation. Understanding the PESTEL conditions—as well as the level, pace, and drivers of industry globalization and the CAGE framework—will probably equip you with some insight into the outcomes of certain scenarios. The purpose of scenario planning, however, is to provide a bigger picture—one in which you can see specific trends and uncertainties. Developed in the 1950s at the global petroleum giant Shell, the technique is now regarded as a valuable tool for integrating changes and uncertainties in the external context into overall strategy.Paul J. H. Schoemaker, "When and How to Use Scenario Planning: A Heuristic Approach with Illustration," *Journal of Forecasting* 10, no. 6 (November 1991): 549–64; Paul J. H. Schoemaker and Cornelius A. J. M. van der Heijden, "Integrating Scenarios into Strategic Planning at Royal Dutch/Shell," *Planning Review* 20, no. 3 (1992): 41–46; Paul J. H. Schoemaker, "Multiple Scenario Development: Its Conceptual and Behavioral Foundation," *Strategic Management Journal* 14, no. 3 (March 1993): 193–213. Since September 11, 2001, the use of scenario planning has increased in businesses. Analysis of Bain & Company's *Management Tools and Trends Survey* shows that in the post-9/11 period, approximately 70 percent of 8,500 global executives reported that their firms used scenarios, in contrast to a usage rate of less than 50 percent in most of the 1990s.Darrell Rigby and Barbara Bilodeau, "A Growing Focus on Preparedness," *Harvard Business Review* 85 (July–August 2007). In addition, scenarios ranked fifteenth in satisfaction levels among the twenty-five management tools that Bain examined in 1993, while it ranked eighth in 2006.Darrell Rigby and Barbara Bilodeau, "A Growing Focus on Preparedness," *Harvard Business Review* 85 (July–August 2007): 21–22.

Unlike forecasts, scenarios are not straight-line, one-factor projections from present to future. Rather, they are complex, dynamic, interactive stories told from a future perspective. To develop useful scenarios, executives need a rich understanding of their industry along with broad knowledge of the diverse PESTEL and global conditions that are most likely to affect them. The six basic steps in scenario planning are detailed below.

Six Basic Steps of Scenario Planning

- **Step 1.** Choose the target issue, scope and time frame that the scenario will explore. The scope will depend on your level of analysis (i.e., industry, subindustry, or strategic group), the stage of planning, and the nature and degree of uncertainty and the rate of change. Generally, four scenarios are developed and summarized in a grid. The four scenarios reflect the extremes of possible worlds. To fully capture critical possibilities and contingencies, it may be desirable to develop a series of scenario sets.
- **Step 2.** Brainstorm a set of key drivers and decision factors that influence the scenario. This could include social unrest, shifts in power, regulatory change, market or competitive change, and technology or infrastructure change. Other significant changes in external contexts, like natural disasters, might also be considered.

- **Step 3.** Define the two dimensions of greatest uncertainty. (For an example, see Table 8.4.) These two dimensions form the axes of the scenario framework. These axes should represent two dimensions that provide the greatest uncertainty for the industry. For instance, the example on the global credit-union industry identifies changes in the playing field and technology as the two greatest areas of uncertainty up through the year 2005.
- **Step 4.** Detail the four quadrants of the scenarios with stories. Describe how the four worlds would look in each scenario. It's often useful to develop a catchy name for each world as a way to further develop its distinctive character. One of the worlds will likely represent a slightly future version of the status quo, while the others will be significant departures from it. As shown in the credit-union scenarios, *Chameleon* describes a world in which both the competitive playing field and technology undergo radical change, while *Wallet Wars* is an environment of intense competition but milder technological change. In contrast, in *Technocracy*, the radical changes are in technology, whereas in *Credit Union Power*, credit unions encounter only minor changes on either front.Adapted from "Scenarios for Credit Unions 2010: An Executive Report," Credit Union Executives Society, 2004, accessed May 10, 2011, www.dsicu.com/pdfs/2010_Scenarios.pdf.
- **Step 5.** Identify indicators that could signal which scenario is unfolding. These can either be trigger points that signal the change is taking place or milestones that mean the change is more likely. An indicator may be a large industry supplier like Microsoft picking up a particular but little-known technological standard.
- **Step 6.** Assess the strategic implications of each scenario. Microscenarios may be developed to highlight and address business-unit-specific or industry-segment-specific issues. Consider needed variations in strategies, key success factors, and the development of a flexible, robust strategy that might work across several scenarios.

The process of developing scenarios and then conducting business according to the information that the scenarios reveal makes it easier to identify and challenge questionable assumptions. It also exposes areas of vulnerability (e.g., in a country, an industry, or a company), underscores the interplay of environmental factors and the impact of change, allows for robust planning and contingency preparation, and makes it possible to test and compare strategic options. Scenarios also help firms focus their attention on the trends and uncertainties that are likely to have the greatest potential impact on their future.

Once you've determined your target issue, scope, and time frame, you can draw up a list of driving forces that is as complete as possible and is organized into relevant categories (e.g., science-technology, political-economic, regulatory, consumer-social, or industry-market). As you proceed, be sure to identify *key* driving forces—the ones with the greatest potential to affect the industry, subindustry, or strategic group in which you're interested.

Trends and Uncertainties

Among the driving forces for change, be sure to distinguish between *trends* and *uncertainties*. **Trends** are forces for change whose direction—and sometimes timing—can be predicted. For example, experts can be reasonably confident in projecting the number of consumers in North America, Europe, and Japan who will be over sixty-five years old in the year 2020 because those people are alive now. If your firm targets these consumers, then the impact of this population growth will be significant to you; you may view it as a key trend. For other trends, you may know the direction but not the pace. China and India, for example, are experiencing a trend of economic growth, and many foreign investments depend on the course of infrastructure development and consumer-spending power in this enormous market. Unfortunately, the future pace of these changes is uncertain.

Did You Know?

In his book *Africa Rising*, Vijay Mahajan documents how trends surrounding the 900 million African consumers may offer businesses more opportunities than they're currently taking advantage of:

Many tourists come to Africa every year to see the big game there—the elephants, lions, and rhinos. But I came for a different type of big game. I was seeking out the successful enterprises that are identifying and capitalizing on the market opportunities, and seeking lessons from those that are not so successful, too. In Nairobi, Maserame Mouyeme of The Coca-Cola Company told me how important it is 'to walk the market.' Then, in Harare, I first heard the term 'consumer safari' in a meeting with Unilever executives. This is what they call their initiatives to spend a day with consumers in their homes to understand how they use products. Years after I started on this journey, I now had a term to describe the quest I was on. I was on a consumer safari. The market landscape that is Africa is every bit as marvelous and surprising as its geographic landscape. It presents as big an opportunity as China and India.Vijay Mahajan, *Africa Rising: How 900 Million African Consumers Offer More Than You Think* (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), xii.

In contrast, **uncertainties**—forces for change whose direction and pace are largely unknown—are more important for your scenario. European consumers, for example, tend to distrust the biotechnology industry, and given the number of competing forces at work—industries, academia, consumer groups, regulators, and so on—it is difficult to predict whether the consumers will be more or less receptive to biotechnology products in the future. Labeling regulations, for instance, may be either strengthened or relaxed in response to changing consumer opinion.

You might also want to consider the possibility of significant disruptions—that is, steep changes that have an important and unalterable impact on the business environment. A major disaster—such as the September 11 terrorist attacks—can spur regulatory and other legal reforms with major and lasting impact on certain technologies and competitive practices. Table 8.4 provides sample scenarios created for the credit-union industry, providing an idea of how you would do this if asked to apply scenario analysis to another industry setting. As you can see, identifying the entry of new competitors and the impact of technology are the two primary sources of uncertainty about the future.

Table 8.4 Developing Scenarios for the Global Credit-Union Industry

CHANGES IN THE PLAYING FIELD			
TECHNOLOGICAL CHANGE		**Minor**	**Major**
		Gradual	**Credit Union Power:** Both technology and the playing field have changed at a moderate pace, making this the most stable scenario. Even with moderate change in these areas, however, the changing basis of competition, new business models, human resources challenges, and industry dynamics are different enough to pose significant challenges for many financial-services companies.
		Radical	**Technocracy:** The wide-scale adoption of the Internet by US consumers has led to massive technological innovation for financial-services companies, increasing the range of distribution channels as well as the products, services, and geographic scope of financial-services organizations. Regulations and other changes in the playing field, however, have been slow to follow.
Note: After considering a PESTEL analysis, experts in the credit-union industry would identify the two most significant macroeconomic factors as (1) regulatory factors affecting both the types of businesses that credit unions can compete in and the entry of new players and consolidation of existing ones, and (2) technological factors, or the speed with which new technologies related to banking are both developed and adopted by consumers. These two dimensions define the major areas of uncertainty facing credit union executives in the next decade. Considering those dimensions and following the six basic steps in scenario planning, you might then develop the following four scenarios.			

Source: Adapted from “Scenarios for Credit Unions 2010: An Executive Report,” Credit Union Executives Society, 2004, accessed May 10, 2011, www.dsicu.com/pdfs/2010_Scenarios.pdf.

KEY TAKEAWAYS

- Scenario planning was developed in the 1950s by Shell as a tool for integrating changes and uncertainties in the external context into overall strategy. Today it ranks among the top ten management tools in the world in terms of usage. Scenarios are complex, dynamic, interactive stories told from a future perspective. To develop useful scenarios, you need a rich understanding of your industry along with broad knowledge of the diverse PESTEL and global conditions that are most likely to affect them.
- The six steps in formulating a scenario plan are the following: (1) choose the target issue, scope, and time frame that the scenario will explore; (2) brainstorm a set of key drivers and decision factors that influence the scenario; (3) define the two dimensions of greatest uncertainty; (4) detail the four quadrants of the scenarios with stories about that future; (5) identify indicators that could signal which scenario is unfolding; and (6) assess the strategic implications of each scenario.
- Considering the distillation of issues and drivers, select two dimensions of change that will serve as the two dimensions of your scenario-planning matrix. You must be able to describe the dimensions as high and low at each extreme.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What is scenario planning and analysis?
2. What is the history of scenario planning and analysis?
3. What is the advantage of scenario planning and analysis over SWOT analysis?
4. What are the six steps involved in scenario planning and analysis?
5. What is the difference between uncertainties and trends in scenario planning and analysis?

5.41: End-of-Chapter Questions and Exercises

These exercises are designed to ensure that the knowledge you gain from this book about international business meets the learning standards set out by the international Association to Advance Collegiate Schools of Business (AACSB International).Association to Advance Collegiate Schools of Business website, accessed January 26, 2010, http://www.aacsb.edu. AACSB is the premier accrediting agency of collegiate business schools and accounting programs worldwide. It expects that you will gain knowledge in the areas of communication, ethical reasoning, analytical skills, use of information technology, multiculturalism and diversity, and reflective thinking.

EXPERIENTIAL EXERCISES

(AACSB: Communication, Use of Information Technology, Analytical Skills)

1. Identify a local company whose products or services you really admire. Conduct an assessment of why, where, and how this company might expand internationally. In class, talk through the pros and cons of what you've recommended.
2. Using the same company from the first exercise, undertake PESTEL, globalization, and scenario analyses of the new international target market. What are the implications of your analyses for the recommendations you compiled? What resources did you draw on and what key questions remain unanswered?
3. Kohl's Corporation is a very large and successful US retailer. It has no physical or Internet retail outlets outside the United States. What opportunities might this company have for global expansion? What modes should it explore? Should Kohl's stay "local"?

Ethical Dilemmas

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. Entry into new markets, regardless of entry mode, typically requires extensive relationship building. In some countries, such relationship building includes the exchange of gifts. At the same time, many companies are bound by laws, regulations, or business associations that prohibit bribery. Bribery is an offer or the receipt of any gift, loan, fee, reward, or other advantage to or from any person as an inducement to do something that is dishonest or illegal.Hossein Askari, Scheherazade Sabina Rehman, and Noora Arfaa, *Corruption and Its Manifestation in the Persian Gulf* (Northampton, MA: Edward Elgar Publishing, 2010), 9. Review the most recent International Chamber of Commerce Commission report on corruption, "ICC Rules of Conduct and Recommendations for Combating Extortion and Bribery" (available at www.iccwbo.org/policy/anticorruption/id870/index.html). It discusses what the implications of these rules might be for gifts.
2. For each of the entry modes identified in this chapter, develop a list of the key areas of ethical lapses. Draft a policy statement that a firm can use to manage and prevent these lapses.
3. Using the Internet or your library, conduct a search on the topics of "infant formula" or "disposable diapers" and "emerging economies." What are some of the ethical issues that are raised when discussing the export of these products to emerging markets?

SECTION OVERVIEW

5.42: Strategy and International Business

5.43: Chapter Introduction

Strategy and International Business

WHAT'S IN IT FOR ME?

1. What are the basics of business and corporate strategy?
2. What is the range of generic strategies?
3. How do generic strategies become international strategies?
4. What are the five facets of good strategies?
5. What is the significance of the P-O-L-C (planning-organizing-leading-controlling) framework?

This chapter takes you deeper into the subjects of strategy and management in international business and within the context of a flattening world. As a business student, you will likely take a full course in strategic management, so you should view this chapter as simply an introduction to the field. You will learn about strategy—specifically, the strategy formulation framework known as the strategy diamond. This will help you better understand how international markets—whether for customers or factors of production—can be an integral part of a firm's strategy. Because you know that the world is not flat, in the sense that Thomas Friedman describes, it is important that an international strategy be adjusted to adapt, overcome, or exploit differences across countries and regions. Finally, Section 10.5 provides an introduction to managing international businesses through a brief overview of the P-O-L-C (planning-organizing-leading-controlling) framework.

Source: "Business Opportunities," Splash Corporation, accessed June 3, 2011, www.splashb2b.com/business.aspx.

Opening Case: Making a Splash with Splash Corporation

The tale of husband and wife Rolando and Rosalinda Hortaleza is well known in the Philippines. As the story goes, the couple launched a backyard business in 1985 to supplement their entry-level salaries as doctors at a government hospital. From this humble beginning, the Splash Group of Companies was born.

Beyond the Backyard

Like many entrepreneurs, the Hortalezas sought a big success. In 1987, they spotted an opportunity in hair spray, because "big hair" was the fad in the Philippines at that time. So the couple created a company that offered a high-quality, low-price alternative to imported hair spray.Tyrone Solee, "Hortaleza Success Story," *Millionaire Acts* (blog), February 15, 2009, accessed June 3, 2010, http://www.millionaireacts.com/808/hortaleza-success-story.html. The gambit proved successful, and the Hortalezas earned their first million Philippine pesos in sales that year. Over the years, the company name changed several times, reflecting its growth and evolving strategy. What began as Hortaleza Cosmetics in 1986 became Splash Cosmetics in 1987, Splash Manufacturing Corporation in 1991, and finally Splash Corporation in 2001."Splash Corporation, Making Waves in the Global Beauty and Personal Care Industry," Splash Corporation, accessed November 10, 2010, www.splash.com.ph/NewsAndEvents.aspx?ID=8. Today, Splash Corporation sells more skin-care products than international giants like Johnson and Unilever and local brands. With sales of 90 billion pesos (nearly $2 billion), Splash Corporation is the number one maker of skin-care products in the Philippines and is sixth in the international market, being the only Filipino-owned company to hold a position among global companies and brands.Tyrone Solee, "Hortaleza Success Story," *Millionaire Acts* (blog), February 15, 2009, accessed December 27, 2010, http://www.millionaireacts.com/808/hortaleza-success-story.html. In twenty years, the small business that the Hortalezas started has posted 5 billion Philippine pesos in sales, putting it among the country's 300 largest corporations.

Splash Corporation exports and markets Splash products to almost twenty countries around the world. In Indonesia, unlike the rest of the company's market destinations, Splash entered into a joint venture with an Indonesian company, Parit Padang. By itself, Parit Padang is one of the largest pharmaceutical and health-care distribution companies in Indonesia. The joint venture, called Splash Indonesia PT, began operating in 2000, importing Splash soap and skin-care products every month from Manila. The venture now produces some of its products locally in Indonesia, employing a staff of 40 there in its factory. Splash Indonesia PT has even developed a new product for the local market, the SkinWhite Whitening Bath Soap. This product blends innovative ingredients and technology from the Philippines with a fine Indonesian noodle soap, creating a whitening body soap of a seemingly better quality than other local soaps.

Splash recently launched the Splash Nutraceutical Corporation. The term *nutraceutical* was coined in the 1990s by Dr. Stephen DeFelice, founder of the US-based Foundation for Innovation in Medicine. DeFelice defined the word as any substance that is a food or part of a food and provides medical or health benefits, including the prevention and treatment of disease. In essence, nutraceuticals are "a food (or part of a food) that provides medical or health benefits, including the prevention and/or treatment of a disease."Vicki Brower, "Nutraceuticals: Poised for a Healthy Slice of the Healthcare Market?," *Nature Biotechnology* 16, no. 8 (1998): 728–731, quoted in Ekta K. Kalra, "Nutraceutical—Definition and Introduction," *AAPS PharmSci* 5, no. 2 (2003), accessed November 9, 2010, www.aapsj.org/view.asp?art=ps050325#ref1.

The nutraceuticals market is growing rapidly worldwide, especially in such developed countries where disposable incomes are higher and the challenges of diet-disease links, aging populations, and rising health care costs are more pronounced. Nutraceuticals currently address health concerns like cardiovascular disease, osteoporosis, high blood pressure, diabetes, and gastrointestinal disorders. Worldwide sales of nutraceutical products have grown exponentially and are currently estimated at $80 billion.

The establishment of Splash Nutraceuticals completes the company's mission of becoming a total-wellness company. Fondly called "Doc" by Splash employees (while his wife is the "Doctora"), Dr. Rolando Hortaleza considers nutraceuticals a natural extension of the company's personal care line of products. He defines the term *wellness* as "beauty inside and out—if you feel good about yourself, you then become more productive." He estimates the market potential of nutraceuticals to be in the billions of pesos.

The Values, Mission, and Vision behind Splash

Corporate Cause: We shall uplift the pride and economic well-being of the societies we serve.

Mission: Splash is a world-class company that is committed to making accessible, innovative, high-quality and value personal care products for everyone.

Vision: We are a marketing company in the beauty, personal and health care industries where we shall be known for strong brand management of pioneering, high-quality and innovative products derived from extensive research to improve the well-being of our consumers. We shall do this through:

Leading edge trade and consumer marketing systems.

Pursuit of excellence in all other business systems.

We shall be generous in sharing the rewards with our employees, business partners, stockholders and our community for the realization of our corporate cause."Corporate Cause/Vision/Mission," Splash Corporation, accessed November 9, 2010, www.splash.com.ph/our_company.aspx?id=2.

Opening Case Exercises

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. Describe Splash Corporation's corporate strategy and business strategy.
2. Use the strategy diamond tool (see Section 10.4) to summarize Splash Corporation's strategy.

5.44: Business and Corporate Strategy

> **Learning Objectives**
>
> 1. Understand the difference between strategy formulation and strategy implementation.
> 2. Comprehend the relationships among business, corporate, and international strategy.
> 3. Know the inputs into a SWOT analysis.

What Is Strategy?

A strategy is the central, integrated, externally oriented concept of how a firm will achieve its objectives. **Strategy formulation** (or simply *strategizing*) is the process of deciding what to do; **strategy implementation** is the process of performing all the activities necessary to do what has been planned. Neither can succeed without the other; the two processes are interdependent from the standpoint that implementation should provide information that is used to periodically modify the strategy. However, it's important to distinguish between the two because, typically, different people are involved in each process. In general, the leaders of the organization formulate strategy, while everyone is responsible for strategy implementation.

Figure 10.1 Corporate and Business Strategy

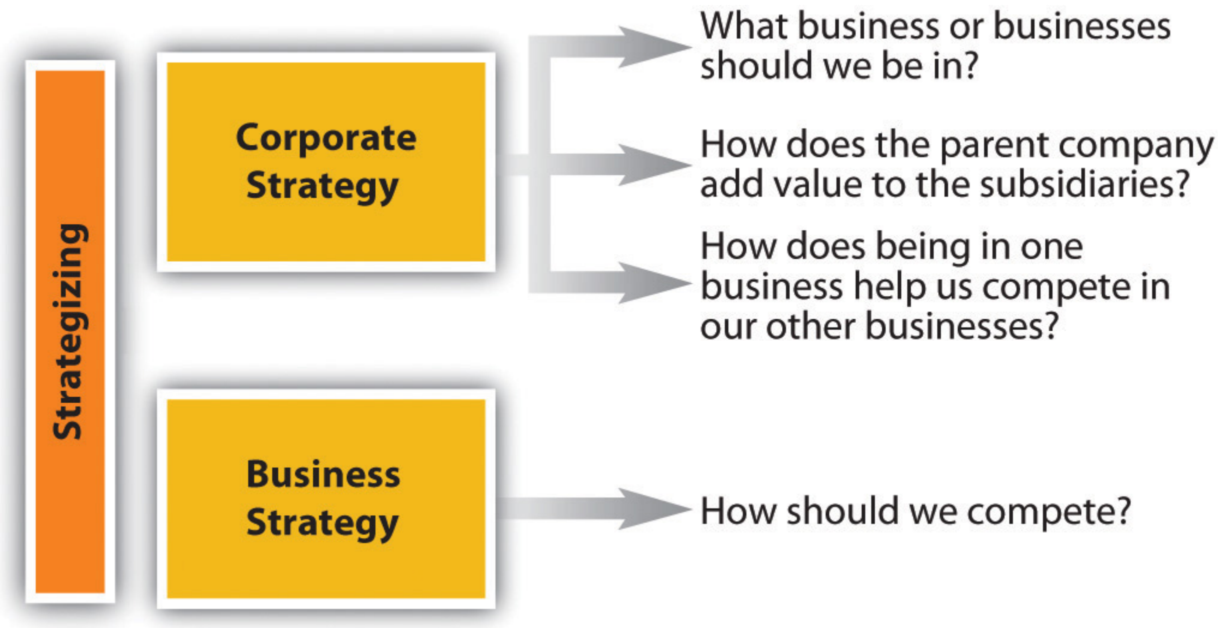


Figure 10.1 summarizes the distinction between business and corporate strategy. The general distinction is that business strategy addresses *how we should compete*, while corporate strategy is concerned with *in which businesses we should compete*. Specifically, **business strategy** refers to the ways in which a firm plans to achieve its objectives within a particular business. In other words, one of Splash Corporation's business strategies would address its objectives within the nutraceuticals business. This strategy may focus on such things as how it competes against multinationals, including Unilever and Procter & Gamble. Similarly, Walmart managers are engaged in business strategy when they decide how to compete with Sears for consumer dollars.

Corporate strategy addresses issues related to three fundamental questions:

1. **In what businesses will we compete?** The Hortalezas, for instance, say that they are in the wellness business; but from the opening case, you can see that they're talking about specific niche markets related to wellness.
2. **How can we, as a corporate parent, add value to our various lines of business (often called subsidiaries)?** For example, Splash's senior management might be able to orchestrate synergies and learning by using new products coming out of the Splash Research Institute. It can also glean market intelligence through health and beauty care retail outlets. Market intelligence can give Splash information on which brands are selling well, and some of those brands might be good targets for Splash to

acquire, such as it did with the Hygienix brand line. Hygienix is a brand line of antibacterial skin-care products. Corporate strategy deals with finding ways to create value by having two or more owned businesses cooperate and share resources.

3. **How can diversifying our business or entering a new industry, help us compete in our other industries?** The Hortalezas' experience with the HBC retailers can provide valuable insights into which new products to develop through the Splash Research Institute; in addition, Splash can sell more of its own products through HBC outlets.

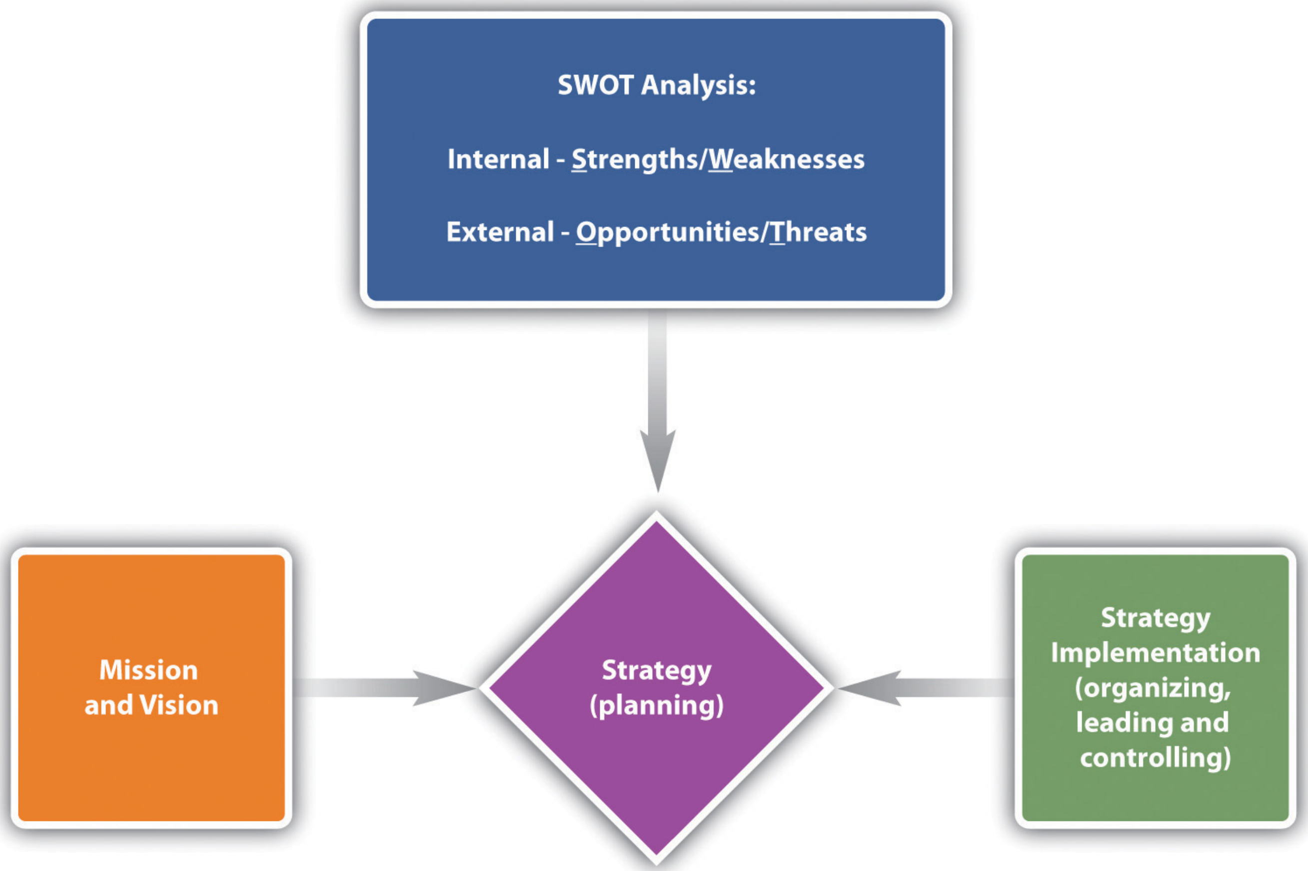
International strategy is specialized in the sense that corporate strategy guides the choice of which markets, including different countries, a firm competes in. The different types of international strategy are reviewed in Section 10.3. Even when a firm doesn't sell products or services outside its home country, its international strategy can include importing, international outsourcing, or offshoring. **Importing** involves the sale of products or services in one country that are sourced in another country. Penzeys Spices, for instance, sells herbs and spices that it buys from all over the world, yet it has retail outlets in only twenty-three states. However, such activity is not limited to small companies like Penzeys. Kohl's Corporation, one of the largest discount retailers in the country, has stores exclusively in the United States but most of its products are sourced overseas. In **outsourcing**, the company delegates an entire process (e.g., accounts payable) to the outsource vendor. The vendor takes control of the operation and runs the operation as it sees fit. The company pays the outsource vendor for the end result; how the vendor achieves those end results is up to the vendor. The outsourcer may do the work within the same country or may take it to another country (also known as offshoring). In **offshoring**, the company takes a function out of its home country and places the function in another country, generally at a lower cost. **International outsourcing** refers to work that is contracted to a nondomestic third party.

The Strategizing Process

From where does strategy originate? Strategy formulation typically comes from the top managers or owners of an organization, while the responsibility for strategy implementation resides with all organizational members. This entire set of activities is called the strategizing process, as summarized in Figure 10.2.

As you can see with the opening case on Splash Corporation, the strategizing process starts with an organization's mission and vision. A **mission statement** is the organization's statement of purpose and describes who the company is and what it does. Customers, employees, and investors are the stakeholders most often emphasized, but others like government or communities (i.e., in the form of social or environmental impact) can also be impacted.Mason Carpenter, Talya Bauer, and Berrin Erdogan, *Principles of Management* (Nyack, NY: Unnamed Publisher, 2009), accessed January 5, 2011, www.gone.2012books.lardbucket.org/printed-book/127834. Mission statements are often longer than vision statements. Sometimes mission statements include a summation of the firm's values. **Organizational values** are those shared principles, standards, and goals.

Figure 10.2



Source: M. Carpenter, 2010

A **vision statement**, in contrast, is a future-oriented declaration of the organization's purpose. In many ways, the mission statement lays out the organization's "purpose for being," and the vision statement then says, "on the basis of that purpose, this is what we want to become." The strategy should flow directly from the vision, since the strategy is intended to achieve the vision and satisfy the organization's mission. Along with some form of internal and organizational analysis using **SWOT** (or the firm's strengths, weaknesses, opportunities, and threats), a strategy is formulated into a strategic plan. This plan should allow for the achievement of the mission and vision. Taking SWOT analysis into consideration, the firm's management then determines how the strategy will be implemented in regard to organization, leadership, and controls. Strategic planning, together with organizing, leading, and controlling, is sometimes referred to by the acronym **P-O-L-C**. This is the framework managers use to understand and communicate the relationship between strategy formulation and strategy implementation.

Did You Know?

Research suggests that companies from different countries approach strategy from different perspectives of social responsibility. Central to the distinctiveness of the Indian business model is the sense of mission, a social goal for the business that goes beyond making money and helps employees see a purpose in their work. Every company we [the researchers] saw articulated a clear social mission for their business. ITC, a leading conglomerate, echoed the views of the companies we interviewed with this statement, describing the company's purpose: "Envisioning a larger societal purpose has always been a hallmark of ITC. The company sees no conflict between the twin goals of shareholder value enhancement and societal value creation." Contrast this Indian model, where a company's business goal is seen as bettering society, with the US model, where we try to motivate employees around the corporate goal of making shareholders rich. The US approach is at a sizable disadvantage, because it is difficult for most people to see making money for shareholders as a goal that is personally meaningful. While it is possible to tie pay to shareholder value, it is extremely expensive to pay the average employee enough in share-based incentives to get him or her to focus on shareholder value.Peter Cappelli, Harbir Singh, Jitendra Singh, and Michael Useem, "The India Way: Lessons for the U.S.," *Academy of Management Perspectives* 24, no. 2 (2010): 6–24.

The Fundamentals of SWOT Analysis

SWOT analysis was developed by Ken Andrews in the early 1970s.Kenneth R. Andrews, *The Concept of Corporate Strategy* (Homewood, IL: Richard D. Irwin, 1971). It is the assessment of a company's strengths and weaknesses—the S and W—which occur as part of organizational analysis; this organizational analysis of S and W is an audit of a company's internal workings. Conversely, examining the opportunities and threats is a part of environmental analysis—the company must look outside the organization to determine the opportunities and threats, over which it has less control. When conducting a SWOT analysis, a firm asks four basic questions about itself and its environment:

1. What can we do?
2. What do we want to do?
3. What might we do?
4. What do others expect us to do?

Strengths and Weaknesses

A good starting point for strategizing is an assessment of what an organization does well and what it does less well.Mason Carpenter, Talya Bauer, and Berrin Erdogan, *Principles of Management* (Nyack, NY: Unnamed Publisher, 2009), accessed January 5, 2011, www.gone.2012books.lardbucket.org/printed-book/127834. The general idea is that good strategies take advantage of *strengths* and minimize the disadvantages posed by any *weaknesses*. Michael Jordan, for instance, is an excellent all-around athlete; he excels in baseball and golf, but his athletic skills show best in basketball. As with Jordan's athleticism, when you can identify certain strengths that set an organization apart from actual and potential competitors, that strength is considered a source of competitive advantage. The hardest but most important thing for an organization to do is to develop its competitive advantage into a **sustainable competitive advantage**—that is, using the organization's strengths in way a that can't be easily duplicated by other firms or made less valuable by changes in the external environment.

Opportunities and Threats

After considering what you just learned about competitive advantage and sustainable competitive advantage, it's easy to see why the external environment is a critical input into strategy. *Opportunities* assess the external attractive factors that represent the reason for a business to exist and prosper. What opportunities exist in the market or the environment from which the organization can benefit? *Threats* include factors beyond your control that could place the strategy or even the business itself at risk. Threats are also external—managers typically have no control over them, but it can be beneficial to have contingency plans in place to address them.

In summary, SWOT analysis helps you identify strategic alternatives that address the following questions:

- **Strengths and opportunities (SO).** How can you use your strengths to take advantage of the opportunities?
- **Strengths and threats (ST).** How can you take advantage of your strengths to avoid real and potential threats?
- **Weaknesses and opportunities (WO).** How can you use your opportunities to overcome the weaknesses you are experiencing?
- **Weaknesses and threats (WT).** How can you minimize your weaknesses and avoid threats?Heinz Weihrich, "The TOWS Matrix—A Tool for Situational Analysis," *Long Range Planning* 15, no. 2 (April 1982): 52–64.

KEY TAKEAWAYS

- Strategy formulation is coming up with the plan, and strategy implementation is making the plan happen.
- There are different forms of strategy. Business strategy refers to how a firm competes, while corporate strategy answers questions concerning the businesses with which the organization should compete. International strategy is a key feature of many corporate strategies. In some cases, international strategy takes the form of outsourcing or offshoring.
- An overview of the strategizing process involves a SWOT (strengths, weaknesses, opportunities, threats) analysis and the development of the organization's mission and vision.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What is the difference between strategy formulation and strategy implementation?
2. What are the different levels of strategy?
3. To what level of strategy do outsourcing, offshoring, and international strategy belong?

5.45: Generic Strategies

> **Learning Objectives**
>
> 1. Know the three business-level strategies.
> 2. Understand the difference between the three dimensions of corporate strategy.
> 3. Comprehend the importance of economies of scale and economies of scope in corporate strategy.

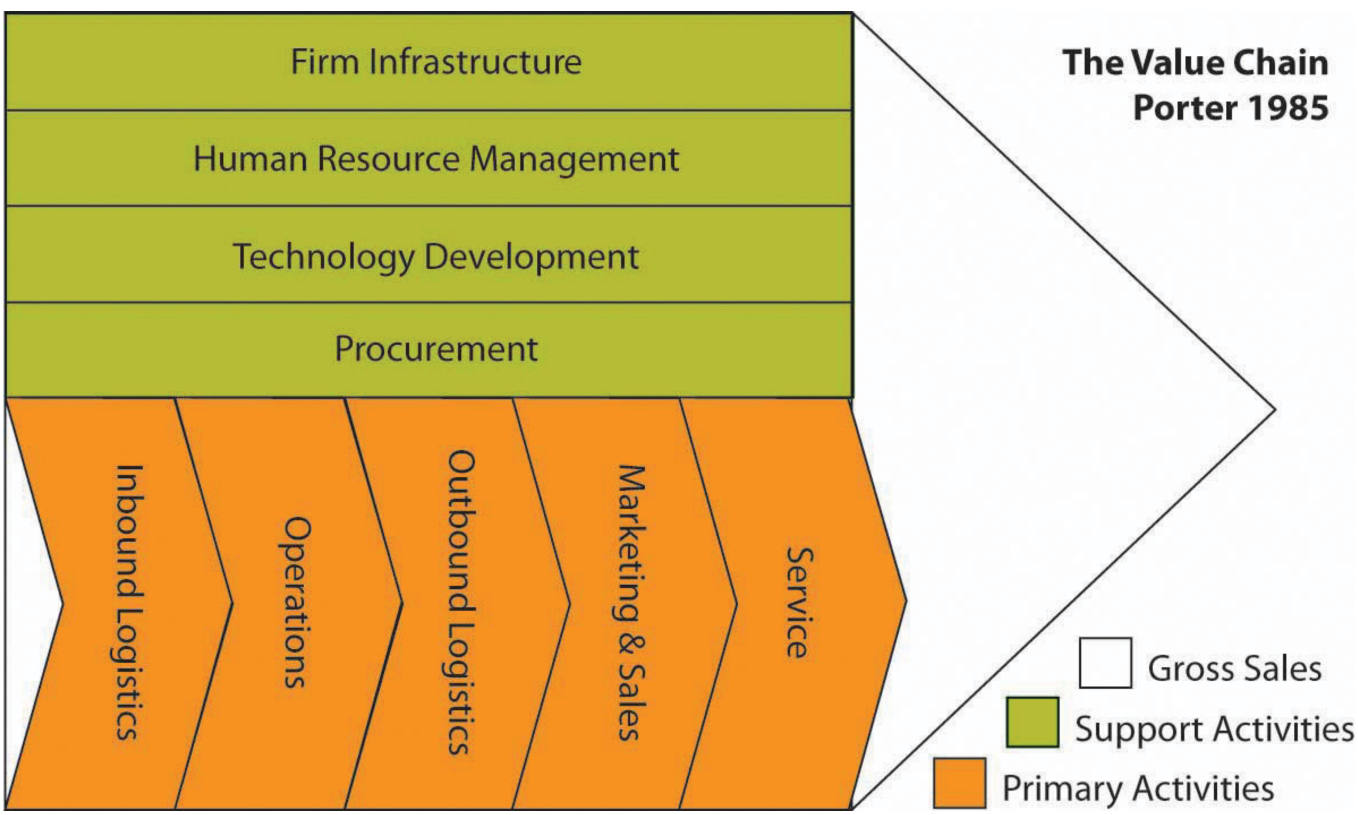
Types of Business-Level Strategies

Business-level strategies are intended to create differences between a firm's position and those of its rivals. To position itself against its rivals, a firm must decide whether to *perform activities differently* or *perform different activities*.Michael E. Porter, "What Is Strategy?," *Harvard Business Review* 74, no. 6 (November–December 1996): 61–78. A firm's business-level strategy is a deliberate choice in regard to how it will perform the value chain's primary and support activities in ways that create unique value.

Collectively, these primary and support activities make up a firm's **value chain**, as summarized in Figure 10.3. For example, successful Internet shoe purveyor Zappos has key value-chain activities of purchasing, logistics, inventory, and customer service. Successful use of a chosen strategy results only when the firm integrates its primary and support activities to provide the unique value it intends to deliver. The Zappos strategy is to emphasize customer service, so it invests more in the people and systems related to customer service than do its competitors.

Value is delivered to customers when the firm is able to use competitive advantages resulting from the integration of activities. Superior fit of an organization's functional activities, such as production, marketing, accounting, and so on, forms an activity system—with Zappos, it exhibits superior fit among the value-chain activities of purchasing, logistics, and customer service. In turn, an effective activity system helps the firm establish and exploit its strategic position. As a result of Zappos's activity system, the company is the leading Internet shoe retailer in North America and has been acquired by Amazon to further build Amazon's clothing and accessories business position.

Figure 10.3 The Value Chain



Source: Adapted from Michael Porter, Competitive Advantage (New York: Free Press, 1985). Exhibit is Creative Commons licensed at http://en.Wikipedia.org/wiki/Image:ValueChain.PNG.

Favorable positioning is important to develop and sustain competitive advantages.Edward H. Bowman and Constance E. Helfat, "Does Corporate Strategy Matter?," *Strategic Management Journal* 22, no. 1 (January 2001): 1–4; Bill McEvily and Akbar Zaheer, "Bridging Ties: A Source of Firm Heterogeneity in Competitive Capabilities," *Strategic Management Journal* 20, no. 12 (December 1999): 1133–56. Improperly positioned firms encounter competitive difficulties and can fail to sustain competitive advantages. For example, Sears made ineffective responses to competitors such as Walmart, leaving it in a weak competitive position for years. These ineffective responses resulted from the company's inability to implement appropriate strategies to take advantage of external opportunities and internal competencies and to respond to external threats. Two researchers have described this situation: "Once a towering force in retailing, Sears spent 10 sad years vacillating between an emphasis on hard goods and soft goods, venturing in and out of ill-chosen businesses, failing to differentiate itself in any of them, and never building a compelling economic logic."Donald C. Hambrick and James W. Fredrickson, "Are You Sure You Have a Strategy?," *Academy of Management Executive* 19, no. 4 (2005): 52. Firms choose from among three generic business-level strategies to establish and defend their desired strategic position against rivals: (1) *cost leadership*, (2) *differentiation*, and (3) *integrated cost leadership and differentiation*. Each business-level strategy helps the firm establish and exploit a competitive advantage within a particular scope.

When deciding on a strategy to pursue, firms have a choice of two potential types of competitive advantage: (1) lower cost than competitors or (2) better quality (through a differentiated product or service) for which the form can charge a premium price. Competitive advantage is therefore achieved within some scope. **Scope** includes the geographic markets the company serves as well as the product and customer segments in which it competes. Companies seek to gain competitive advantage by implementing a cost leadership strategy or a differential strategy.

As you read about each of these business-level strategies, it's important to remember that none is better than the others. Rather, how effective each strategy depends on each firm's specific circumstances—namely, the conditions of the firm's external environment as well as the firm's internal strengths, capabilities, resources, and core competencies.

Cost-Leadership Strategy

Choosing to pursue a **cost-leadership strategy** means that the firm seeks to make its products or provide its services at the lowest cost possible relative to its competitors while maintaining a quality that is acceptable to consumers. Firms achieve cost leadership by building large-scale operations that help them reduce the cost of each unit by eliminating extra features in their products or services, by reducing their marketing costs, by finding low-cost sources or materials or labor, and so forth. Walmart is one of the most cited examples of a global firm pursuing an effective cost-leadership strategy.

One of the primary sets of activities that firms perform is the set of activities around supply-chain management and logistics. Supply-chain management encompasses both inbound and outbound logistics. Inbound logistics include identifying, purchasing, and handling all the raw materials or inputs that go into making a company's products. For example, one of Stonyfield Farm's inputs is organic milk that goes into its organic yogurts. Walmart buys finished products as its inputs, but it must warehouse these inputs and allocate them to its specific retail stores. In outbound logistics, companies transport products to their customer. When pursuing a low-cost strategy, companies can examine logistics activities—sourcing, procurement, materials handling, warehousing, inventory control, transportation—for ways to reduce costs. These activities are particularly fruitful for lowering costs because they often account for a large portion of the firm's expenditures. For example, Marks & Spencer, a British retailer, overhauled its supply chain and stopped its previous practice of buying supplies in one hemisphere and shipping them to another. This will save the company over $250 million dollars over five years—and will greatly reduce carbon emissions.Michael E. Porter and Mark R. Kramer, "The Big Idea: Creating Shared Value," *Harvard Business Review*, January 2011, accessed January 14, 2011, http://hbr.org/2011/01/the-big-idea-creating-shared-value/ar/pr.

Differentiation Strategy

Differentiation stems from creating unique value to the customer through advanced technology, high-quality ingredients or components, product features, superior delivery time, and the like.Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), 150. Companies can differentiate their products by emphasizing products' unique features, by coming out with frequent and useful innovations or product upgrades, and by providing impeccable customer service. For example, the construction equipment manufacturer Caterpillar has excelled for years on the durability of its tractors; its worldwide parts availability, which results in quick repairs; and its dealer network.

When pursuing the differentiation strategy, firms examine all activities to identify ways to create higher value for the customer, such as by making the product easier to use, by offering training on the product, or by bundling the product with a service. For example, the Henry Ford West Bloomfield Hospital in West Bloomfield, Michigan, has distinguished itself from other hospitals by being more like a hotel than a hospital. The hospital has only private rooms, all overlooking a pond and landscaped gardens. The hospital is situated on 160 acres of woodlands and wetlands and has twenty-four-hour room service, Wi-Fi, and a café offering healthful foods. "From the get-go, I said that the food in the hospital would be the finest in the country," says Gerard van Grinsven, president and CEO of the hospital.Gerard van Grinsven, "Healthy Living, the Ritz Way" (booklet, BIF-6 Collaborative Innovation Summit, Providence, RI, September 15–16, 2010), 60–61. The setting and food are so exquisite that not only has the café become a destination café, but some couples have even held their weddings there.Gerard van Grinsven, "Healthy Living, the Ritz Way" (presentation, BIF-6 Collaborative Innovation Summit, Providence, RI, September 15–16, 2010).

Integrated Cost-Leadership/Differentiation Strategy

An **integrated cost-leadership and differentiation strategy** is a combination of the cost leadership and the differentiation strategies. Firms that can achieve this combination often perform better than companies that pursue either strategy separately.Gregory G. Dess, Anil Gupta, Jean-François Hennart, and Charles W. L. Hill, "Conducting and Integrating Strategy Research at the International, Corporate, and Business Levels: Issues and Directions," *Journal of Management* 21, no. 3 (Fall 1995): 377. To succeed with this strategy, firms invest in the activities that create the unique value but look for ways to reduce cost in nonvalue activities.

Types of Corporate Strategy

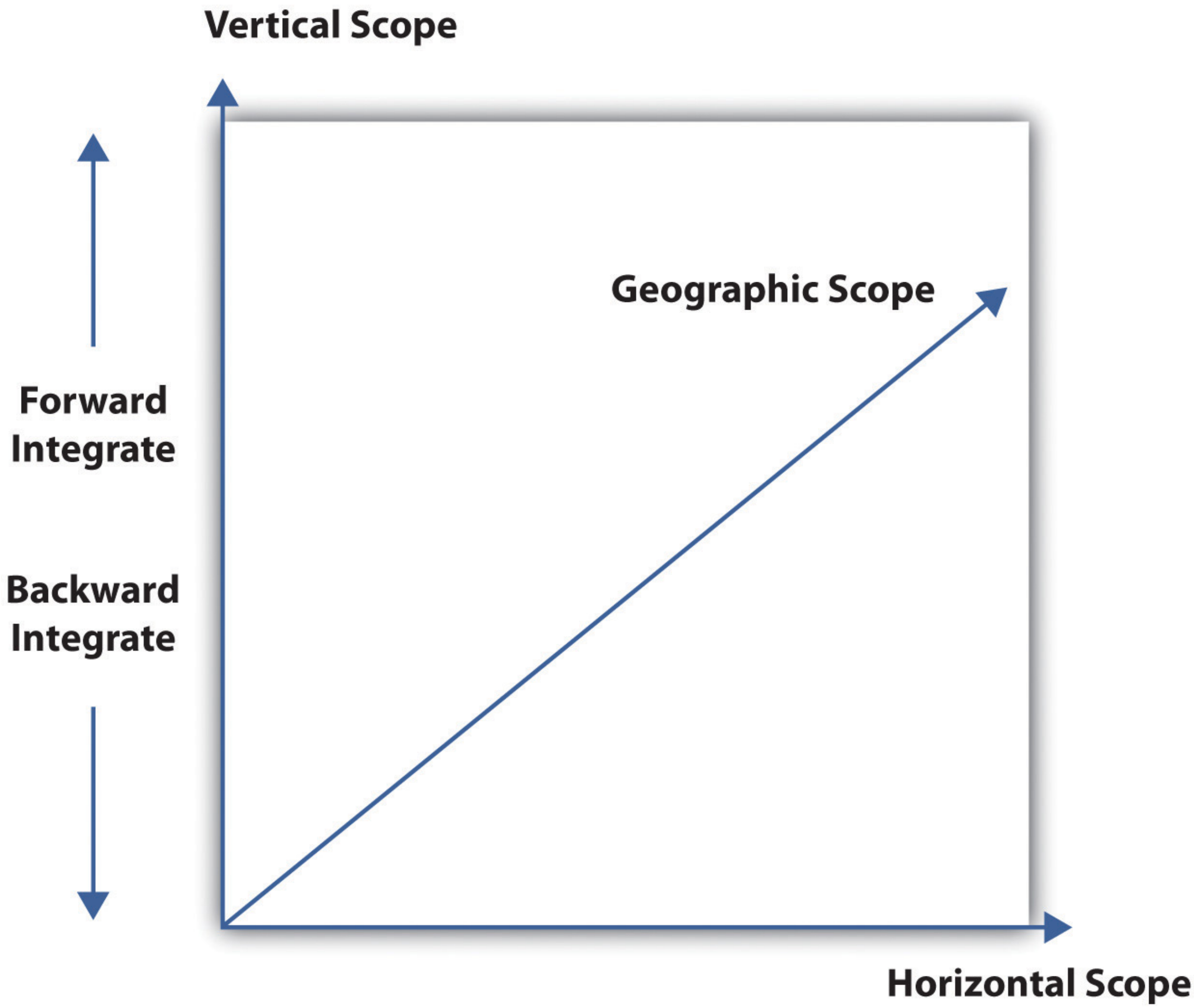
Remember, business strategy is related to questions about how a firm competes; corporate strategy is related to questions about what businesses to compete in and how these choices work together as a system. Nonprofits and governments have similar decision-making situations, although the element of competition isn't always present. A firm that is making choices about the scope of its operations has several options. Figure 10.4 summarizes how all organizations can expand (or contract) along any of three areas: (1) *vertical*, (2) *horizontal*, and (3) *geographic*.

Vertical Scope

Vertical scope refers to all the activities, from the gathering of raw materials to the sale of the finished product, that a business goes through to make a product. Sometimes a firm expands vertically out of economic necessity. Perhaps it must protect its supply of a critical input, or perhaps firms in the industry that supply certain inputs are reluctant to invest sufficiently to satisfy the unique or heavy needs of a single buyer. Beyond such reasons as these—which are defensive—firms expand vertically to take advantage of growth or profit opportunities. Vertical expansion in scope is often a logical growth option because a company is familiar with the arena.

Sometimes a firm can create value by moving into suppliers' or buyers' value chains. In some cases, a firm can bundle complementary products. If, for instance, you were to buy a new home, you'd go through a series of steps in making your purchase decision. Now, most homebuilders concentrate on a fairly narrow aspect of the homebuilding value chain. Some, however, have found it profitable to expand vertically into the home-financing business by offering mortgage brokerage services. Pulte Homes Inc., one of the largest homebuilders in the United States, set up a wholly owned subsidiary, Pulte Mortgage LLC, to help buyers get financing for new homes. This service simplifies the home-buying process for many of Pulte's customers and allows Pulte to reap profits in the home-financing industry. Automakers and car dealers have expanded into financing for similar reasons.

Figure 10.4



Source: M. Carpenter, 2010

Horizontal Scope

Whereas as vertical scope reflects a firm's level of investment in upstream or downstream activities, **horizontal scope** refers to the number of similar businesses or business activities at the same level of the value chain. A firm increases its horizontal scope in one of two ways:

1. By moving from an industry market segment into another, related segment
2. By moving from one industry into another (the strategy typically called *diversification*)

Examples of horizontal scope include when an oil company adds refineries; an automaker starts a new line of vehicles; or a media company owns radio and television stations, newspapers, books, and magazines. The degree to which horizontal expansion is desirable depends on the degree to which the new industry is related to a firm's home industry. Industries can be related in a number of different ways. They may, for example, rely on similar types of human capital, engage in similar value-chain activities, or share customers with similar needs. Obviously, the more factors present, the greater the degree of relatedness. When, for instance, Coca-Cola and PepsiCo expanded into the bottled water business, they were able to take advantage of the skill sets that they'd already developed in bottling and distribution. Moreover, because bottled water and soft drinks are substitutes for one another, both appeal to customers with similar demands.

On the other hand, when PepsiCo expanded into snack foods, it was clearly moving into a business with a lesser degree of relatedness. For one thing, although the distribution channels for both businesses are similar (both sell products through grocery stores, convenience stores, delis, and so forth), the technology for producing the products is fundamentally different. In addition, although the two industries sell complementary products—they're often sold at the same time to the same customers—they aren't substitutes.

Economies of Scale, Economies of Scope, Synergies, and Market Power

Why is increased horizontal scope attractive? Primarily because it offers opportunities in four areas:

1. To exploit economies of scale, such as by selling more of the same product in the same geographic market
2. To exploit possible economies of scope by sharing resources common to different products
3. To enhance revenue through synergies—achieved by selling more, but different, products to the same customers
4. To increase market power—achieved by being relatively bigger than suppliers

Economies of scale, in microeconomics, are the cost advantages that a business obtains through expanding in size, which is one reason why companies grow large in certain industries. Economies of scale are also used to justify free-trade policies, because some economies of scale may require a larger market than is possible within a particular country. For example, it wouldn't be efficient for a small country like Switzerland to have its own automaker, if that automaker could only sell to its local market. That automaker may be profitable, however, if it exports cars to international markets in addition to selling to selling them in the domestic market.

Economies of scope are similar in concept to economies of scale. Whereas economies of scale derive primarily from efficiencies gained from marketing or the supply side, such as increasing the scale of production of a single product type, economies of scope refer to efficiencies gained from demand-side changes, such as increasing the scope of marketing and distribution. Economies of scope gained from marketing and distribution are one reason why some companies market products as a bundle or under a brand family. Because segments in closely related industries often use similar assets and resources, a firm can frequently achieve cost savings by sharing them among businesses in different segments. The fast-food industry, for instance, has many segments—burgers, fried chicken, tacos, pizza, and so forth. Yum! Brands, which operates KFC, Pizza Hut, Taco Bell, A&W Restaurants, and Long John Silver's, has embarked on what the company calls a "multibrand" store strategy. Rather than house all of its fast food in separate outlets, Yum! achieves economies of scope across its portfolio by bundling two outlets in a single facility. The strategy works in part because customer purchase decisions in horizontally related industries are often made simultaneously. In other words, two people walking into a bundled fast-food outlet may desire different things to eat, but both want fast food, and both are going to eat at the same time. In addition, the inherent product and demand differences across breakfast, lunch, dinner, and snacks allows for multiple food franchises to share a resource that would otherwise be largely unused during off-peak hours.

Geographic Scope

A firm increases **geographic scope** by moving into new geographic areas without entirely altering its business model. In its early growth period, for instance, a company may simply move into new locations in the same country. For example, the US fast-food chain Sonic will only open new outlets in states that are adjacent to states where it already has stores.

More often, however, increased *geographic scope* has come to mean *internationalization*—entering new markets in other parts of the world. For this reason, international strategy is discussed in depth in the next section. For a domestic firm whose operations are confined to its home country, the whole globe is a potential area of expansion. Remember, however, that just as different industries can exhibit different degrees of relatedness, so, too, can different geographic markets—even those within the same industry. We can assess relatedness among different national markets by examining a number of factors, including laws, customs, cultures, consumer preferences, distances from home markets, common borders, language, socioeconomic development, and many others.

Economies of Scale, Economies of Scope, or Reduction in Costs

Geographic expansion can be motivated by economies of scale or economies of scope. Research and development (R&D), for example, represents a significant, relatively fixed cost for firms in many industries. When firms move into new regions of a country or global arenas, they often find that they can amortize their R&D costs over a larger market. For instance, the marginal cost for a pharmaceutical firm to enter a new geographic market is lower than the marginal costs of R&D and running clinical trials, which are required when a company wants to bring a new drug into the US market. Once the costs of development and entry are covered, entering new geographic markets brings in new revenues. Because the fixed costs have been amortized over the new, larger market, the average cost for all the firm's customers goes down. It should come as no surprise, then, that industries with relatively high R&D expenditures, such as pharmaceuticals and computer-related products, are among the most thoroughly globalized industries. Finally, changes in geographic scope can lower costs when operations are moved to lower cost supply markets.

KEY TAKEAWAYS

- There are three different business-level strategies: (1) cost leadership, (2) differentiation, and (3) integrated cost leadership and differentiation.
- All three of these business-level strategies involve choices related to differentiation and cost leadership. Corporate strategy can unfold in terms of vertical integration (or disintegration), horizontal integration (or disintegration), or geographic diversification.
- Choices made with respect to these three aspects of diversification have financial implications in the form of economies of scale or scope. Geographic expansion into new countries can affect profitability through economies of scale, economies of scope, or reduction in costs resulting from less costly inputs.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. On what two dimensions are all business strategies based?
2. What are the three dimensions of corporate strategy and how are they different?
3. What are the three ways in which geographic diversification can positively affect financial performance?

5.46: The Five Elements of Strategy

> **Learning Objectives**
>
> 1. Know the five elements of strategy through the strategy diamond.
> 2. Understand the interrelationship among the elements in the strategy diamond.
> 3. Recognize how the strategy diamond helps you develop and articulate international strategy.

Good strategy formulation means refining the elements of the strategy. First of all, don't confuse part of a strategy for a strategy itself. Being a low-cost provider or first mover in a market may be part of a strategy or the underlying logic of a particular strategy, but it's not a complete strategy. It's also important not to confuse your mission or vision with a strategy, even though the former are essential to the development and execution of good strategies.

As noted earlier, a strategy is an integrated and externally oriented concept of how a firm will achieve its objectives—how it will compete against its rivals. A strategy consists of an integrated set of choices. These choices relate to five elements managers must consider when making decisions: (1) *arenas*, (2) *differentiators*, (3) *vehicles*, (4) *staging and pacing*, and (5) *economic logic*. This group of elements, which are central to the strategic management process outlined in Figure 10.6, makes up the **strategy diamond**. Most strategic plans focus on one or two such elements, often leaving large gaps in the overall strategy. Only when you have answers to questions about each of these five elements can you determine whether your strategy is an integrated whole; you'll also have a better idea of the areas in which your strategy needs to be revised or overhauled. As the strategy diamond figure shows, a good strategy considers the five key elements in order to arrive at specific answers to five questions:

1. **Arenas.** Where will we be active?
2. **Differentiators.** How will we get there?
3. **Vehicles.** How will we win in the marketplace?
4. **Staging.** What will be our speed and sequence of moves?
5. **Economic logic.** How will we obtain our returns?

Let's take a closer look at each of these elements.

Figure 10.6 The Strategy Diamond

Source: Adapted from Donald C. Hambrick and James W. Fredrickson, "Are You Sure You Have a Strategy?," Academy of Management Executive 19, no. 4 (2005): 51–62.

Arenas

Arenas are areas in which a firm will be active. Decisions about a firm's arenas may encompass its products, services, distribution channels, market segments, geographic areas, technologies, and even stages of the value-creation process. Unlike vision statements, which tend to be fairly general, the identification of arenas must be very specific. It clearly tells managers what the firm should and should not do. In addition, because firms can contract with outside parties for everything from employees to manufacturing services, the choice of arenas can be fairly narrowly defined for some firms.

For example, as the largest US bicycle distributor, Pacific Cycle owns the Schwinn, Mongoose, and GT brands and sells its bikes through big-box retail outlets and independent dealers, as well as through independent agents in foreign markets. In addition to these arena choices, Pacific Cycle has entirely outsourced the production of its products to Asian manufacturers. This is important in the sense that the strategy diamond also helps the firm be precise in regard to which activities it will engage itself and which ones it will outsource and where. As you know, Asia happens to be a low-cost source of high-quality manufactured goods. In outsourcing shoes and apparel lines, Nike follows a similar strategy in terms of arenas. One key difference, however, is that Nike, through its Nike Town retail outlets, has also chosen a direct retail presence in addition to its use of traditional retail-distribution channels.

The arenas facet of the strategy diamond helps you answer questions about business strategy—that is, it helps you determine which particular industry or geographic segments are the firm's prime competitive arenas. The arenas facet also allows you to summarize corporate strategy—that is, it allows you to summarize which group of industry and geographic segments the firm competes in.

Differentiators

Differentiators are features and attributes of a company's product or service that help it beat its competitors in the marketplace. Firms can be successful in the marketplace along a number of common dimensions, including image, customization, technical superiority, price, quality, and reliability. Japanese automakers Toyota and Honda have done very well by providing effective combinations of differentiators. They sell both inexpensive cars and high-end cars with high-quality features, and many consumers find the value that they provide hard to match. However, even though the best strategies often combine differentiators, history has shown that firms often perform poorly when they try to be all things to all consumers. It's difficult to imagine, for instance, a single product that boasts both state-of-the-art technology and the lowest price on the market. Part of the problem is perceptual—consumers often associate low quality with low prices. Part of it is practical—leading-edge technologies cost money to develop and command higher prices because of their uniqueness or quality.

There are two critical factors in selecting differentiators:

1. Decisions must be made early. Key differentiators rarely materialize without significant up-front decisions, and without valuable differentiators firms tend to lose marketplace battles.
2. Identifying and executing successful differentiators mean making tough choices—trade-offs. Managers who can't make tough decisions about trade-offs often end up trying to satisfy too broad a spectrum of customer needs; as a result, they execute poorly on most dimensions.

Audi is an example of a company that has aligned these two factors successfully. Several years ago, Audi management realized that its cars were perceived as low-quality but high-priced German automobiles—obviously a poor competitive position. The firm decided that it had to move one way or another—up market or down market. It had to do one of two things: (1) lower its costs so that its pricing was consistent with customers' perceptions of product quality or (2) improve quality sufficiently to justify premium pricing. Given limited resources, the firm couldn't go in both directions; that is, it couldn't produce cars in both the low-price and high-quality strata. Audi made a decision to invest heavily in quality programs and in refining its marketing efforts. Ten years later, the quality of Audi cars has increased significantly, and customer perception has moved them much closer to the level of BMW and Mercedes-Benz. Audi has reaped the benefits of premium pricing and improved profitability, but the decisions behind the strategic up-market move entailed significant trade-offs.

Differentiators are what drive potential customers to choose one firm's offerings over those of competitors. The earlier and more consistent the firm is at driving these differentiators, the greater the likelihood that customers will recognize them.

Vehicles

Vehicles are the means for participating in targeted arenas. For instance, a firm that wants to go international can do so in different ways. In a recent drive to enter certain international markets (e.g., Argentina), Walmart has opened new stores and grown organically—meaning that it developed all the stores internally as opposed to acquiring stores already based in the countries it wanted to enter. Elsewhere (namely, in England and Germany), Walmart has purchased existing retailers and is in the process of transferring its unique way of doing business to the acquired companies. Likewise, a firm that requires a new technology could develop it through investments in research and development (R&D). Or it could opt to form an alliance with a competitor or a supplier that already possesses the technology, accelerating the integration of the missing piece into its set of resources and capabilities. Finally, it could simply buy another firm that owns the technology. In this case, the possible vehicles for entering a new arena include acquisitions, alliances, and organic investment and growth.

Staging and Pacing

Staging and pacing refer to the timing and speed, or pace, of strategic moves. Staging choices typically reflect available resources, including cash, human capital, and knowledge. At what point, for example, should Walmart have added international markets to its strategy? Perhaps if the company had pursued global opportunities earlier, it would have been able to develop a better sense of foreign market conditions and even spread the cost of entry over a longer period of time. However, by delaying its international moves, the company was able to focus on dominating the US market, which is—after all—the largest retail market in the world. Despite mixed results overseas, Walmart is the undisputed leader in global retailing and has recently increased its emphasis on international markets as the basis for future growth.

Staging decisions should be driven by several factors—resources, urgency, credibility, and the need for early wins. Because few firms have the resources to do everything they'd like to do immediately, they usually have to match opportunities with available resources. In addition, not all opportunities to enter new arenas are permanent; some have only brief windows. In such cases, early wins and the credibility of certain key stakeholders may be necessary to implement a strategy.

Economic Logic

Economic logic refers to how the firm will earn a profit—that is, how the firm will generate positive returns over and above its cost of capital. Economic logic is the "fulcrum" for profit creation. Earning normal profits, of course, requires a firm to meet all fixed, variable, and financing costs. Achieving desired returns over the firm's cost of capital is a tall order for any organization. In analyzing a firm's economic logic, think of both costs and revenues. Sometimes economic logic resides primarily on the cost side of the equation. Irish airline Ryanair, for example, can fly passengers for significantly lower costs per passenger mile than any major competitor. At other times, economic logic may rest on the firm's ability to increase the customer's willingness to pay premium prices for products (in other words, prices that significantly exceed the costs of providing enhanced products).

When the five elements of strategy are aligned and mutually reinforcing, the firm is generally in a position to perform well. High performance levels, however, ultimately mean that a strategy is also being executed well. This leads to strategy implementation.

The Five Elements and International Strategy

As you learn to apply the strategy diamond to issues about international business, you will probably work through three related questions:

1. Do we need to expand outside our home country?
2. If so, where should we expand?
3. Finally, how should we do that?

Answering the first question requires an understanding of the international strategy's economic logic and how the strategy is supported by the current differentiators. Answering the second question includes identifying specific regions and countries and the criteria that might be used to prioritize potential markets. Finally, the answer to the third question involves whether the organization should enter the new international market on its own, with a partner, or through acquisition.

Considering the responses to these questions, you'll then have a new strategy diamond that addresses the following:

- **Arenas.** The specific geographic markets and the channels and value-chain activities in those markets.
- **Differentiators.** How being international differentiates the organization from competitors, makes products or services more attractive to future customers, and strengthens the effectiveness of the differentiators in the chosen arenas.
- **Vehicles.** The preference to use organic investment and growth, alliances, or acquisitions as expansion vehicles.
- **Staging and pacing.** When you start expanding, how quickly you expand and the sequence of your expansion efforts.
- **Economic logic.** How your international strategy contributes to the overall economic logic of your business and corporate strategies.

KEY TAKEAWAYS

- The strategy diamond lets you summarize the characteristics of a firm's business and corporate strategy in terms of five facets—arenas, differentiators, vehicles, staging and pacing, and economic logic.
- All five facets are interrelated. When the five elements of strategy are aligned and mutually reinforcing, the firm is generally in a position to perform well.
- The strategy diamond helps you develop international strategy, using three related questions:
    1. Do we need to expand outside our home country?
    2. If so, where should we expand?
    3. How should we expand?

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What are the five facets of the strategy diamond?
2. How does the strategy diamond capture a firm's business strategy?
3. How does the strategy diamond capture a firm's corporate strategy?
4. What are some of the strategy-diamond issues a good international strategy must address?

5.47: International Strategy

Learning Objectives

1. Know the trade-offs being made in terms of local responsiveness and global efficiency in regard to international strategies.
2. Distinguish among multidomestic, global, and transnational strategies.
3. Understand how the local environment can impact a firm's international strategy.

At the corporate level, firms choose to use one of three international strategies: multidomestic, global, or transnational (transnational is a combination of multidomestic and global). These three strategies reflect trade-offs between local responsiveness and global efficiency For firms to gain a competitive advantage, they have to devise strategies that take best advantage of the firm's core compentencies and that are difficult for competitors to copy.

Multidomestic Strategy

Multidomestic strategy maximizes local responsiveness by giving decentralizing decision-making authority to local business units in each country so that they can create products and services optimized to their local markets. A multidomestic strategy would be appropriate, for instance, where Thomas Friedman's flat-world thesis is not applicable. A multidomestic strategy focuses on competition within each country and maximizes local responsiveness. It assumes that the markets differ and, therefore, are segmented by country boundaries. In other words, consumer needs and desires, industry conditions (e.g., the number and type of competitors), political and legal structures, and social norms vary by country. Using a multidomestic strategy, the firm can customize its products to meet the specific preferences and needs of local customers. As a result, the firm can compete more effectively in each local market and increase its local market share.

The disadvantage of a multidomestic strategy, however, is that the firm faces more uncertainty because of the tailored strategies in different countries. In addition, because the firm is pursuing different strategies in different locations, it cannot take advantage of economies of scale that could help decrease costs for the firm overall. The multidomestic strategy has been more commonly used by European multinational firms because of the variety of cultures and markets found in Europe.

As mentioned earlier, Yum! Brands has a strong incentive to compete internationally with its restaurant concepts (i.e., KFC, Pizza Hut, Taco Bell, A&W Restaurants, and Long John Silver's). Yum! pursues a multidomestic strategy by trying to localize as much as possible. The firm doesn't open restaurants using only the US model. Wherever the company has locations, it consistently adapts to local tastes and negotiates well when cultural and political climates change: "In Japan, for instance, KFC sells tempura crispy strips. In northern England, KFC stresses gravy and potatoes, while in Thailand, it offers fresh rice with soy or sweet chili sauce. In Holland, the company makes a potato-and-onion croquette. In France, it sells pastries alongside chicken. And in China, the chicken gets spicier the farther inland you travel. More and more, if it's only an American brand without a regional appeal, it's going to be difficult to market."Brian O'Keefe, "What Do KFC and Pizza Hut Conjure Up Abroad?," *Fortune*, November 26, 2001, 102–10. Recognizing this constraint, Yum! introduces its products in those foreign markets that are the shortest "taste" distance from its traditional home markets.Pankaj Ghemawat, "Distance Still Matters," *Harvard Business Review* 79, no. 8 (2001): 147. So, it sticks to high-population areas in which American culture has some appeal as well.

Global Strategy

In contrast to a multidomestic strategy, a **global strategy** is centralized and controlled by the home office and seeks to maximize global efficiency Under this strategy, products are much more likely to be standardized rather than tailored to local markets. One way to think about global strategies is that if the world is flat, you can sell the same products and services in the same way in every country on the planet. The strategic business units operating in each country are assumed to be interdependent, and the home office attempts to achieve integration across these businesses. Therefore, a global strategy emphasizes economies of scale and offers greater opportunities to utilize innovations developed at the corporate level or in one country in other markets.

Although pursuing a global strategy decreases risk for the firm, the firm may not be able to gain as high a market share in local markets because the global strategy isn't as responsive to local markets. Another disadvantage of the global strategy is that it is difficult to manage because of the need to coordinate strategies and operating decisions across country borders. Consequently, achieving efficient operations with a global strategy requires the sharing of resources as well as coordination and cooperation across country boundaries, which in turn require centralization and headquartered control. Whether the world is flat or flattening can often depend on the industry. In most cases, the world isn't flat, but in a few industries the market characteristics are fairly common. The cement and concrete industry is an example of an industry where the flatteners have taken effect. CEMEX, a Mexico-based cement and building materials company founded in 1906, pursued an international business strategy that led to its growth and position as one of the top building materials companies in the world today.“Strategically Positioned,” CEMEX, accessed January 1, 2011, www.cemex.com/tc/tc_gl.asp. CEMEX acquired companies to grow rapidly, took advantage of economies of scale, and used the Internet to lower its cost structure. Perhaps most crucial to its international expansion success was foreseeing the shifts in distribution technologies that would bring previously disparate regional markets closer together.Daniel F. Spulber, *Global Competitive Strategy* (Cambridge, UK: Cambridge University Press, 2007), 217–18.

In 2009, CEMEX CEO Lorenzo H. Zambrano wrote a message to stakeholders regarding sustainable development:

In 2009, as we coped with the worst crisis to hit the global economy, our industry, and our company in 75 years, we took important and decisive steps to strengthen not only our business model, but also our commitment to sustainable development. As a result, we are a stronger company, well positioned to take advantage of the recovery of the global economy. That is testimony to the quality of our employees, to our company’s core values of collaboration, integrity, and leadership, and to the disciplined execution of sound strategies.

We made several difficult decisions during the year to adjust to a rapidly evolving and extraordinarily challenging market environment. For example, we sold assets, most notably our Australian operations, and reorganized our business to improve efficiency and productivity. Together, these measures brought about an unfortunate, but necessary, reduction in our workforce. However, these steps enabled us to weather the crisis and will position our company for long-term success.

Even as the economic crisis unfolded, we deepened our commitment to our stakeholders. We continued our efforts to ensure the safety of our employees, and many of our country operations recorded solid improvements in their safety performance. However, despite our ongoing efforts, I am deeply saddened to report that 33 people—including employees, contractors, and third parties—died in incidents related to our operations during 2009. This is tragic and unacceptable. We are working harder than ever to identify and address the root causes of all fatalities and serious injuries in order to prevent their recurrence. For example, we are expanding and strengthening our efforts in key areas such as safety training for drivers and contractors. Above all, we remain committed to our global long-term goal of zero incidents.

On the environmental front, we continued to reduce our carbon footprint by improving the energy efficiency of our operations and expanding our use of alternative fuels. As a result, in 2009 we increased our use of alternative fuels to 16.4 percent, exceeding our target for 2015 ahead of time. In addition, Eurus, the wind farm project developed by ACCIONA Energía, became fully operational during the year and can supply 25 percent of our plants’ electricity needs in Mexico.

Finally, we engaged the communities in which we operate through open and ongoing dialogue, social initiatives, and volunteer efforts. We continued to find ways to promote access to housing and community infrastructure. For example, we launched our most successful low-income housing solution, Patrimonio Hoy, in the Dominican Republic.

As a global company, we are deeply aware of our responsibility to address complex sustainability challenges. We are committed to further reducing our impact on the environment and recognize that we have many opportunities to improve. We reconfirm our commitment to address climate change and to the development of a low-carbon economy.

We actively engage with our global panel of sustainability experts, who provide important and valuable advice. On a personal note, I thank them for their feedback and for continuously challenging us to make further progress.

We present our 2009 sustainable development report within the framework of our overall sustainability website to better communicate our sustainability performance. We have provided an executive summary that highlights our performance on our key sustainability issues. We hope that you find the report engaging, transparent, and comprehensive, and we welcome your feedback.

Sincerely, Lorenzo H. Zambrano

CEMEX Chairman of the Board and Chief Executive OfficerLorenzo H. Zambrano, “Addressing Complex Sustainability Challenges,” CEMEX, accessed June 7, 2010, www.cemex.com/su/Su_oc_me.aspx.

Transnational Strategy

Transnational strategy seeks to combine the best of multidomestic strategy and a global strategy to get both global efficiency and local responsiveness. For many industries, given the differences across markets and the similarties being fostered by the flatteners, this form of strategy is highly desirable and appropriate. The difficulty is that combining the multidomestic and global strategies is hard to do because it requires fulfililng the dual goals of flexibility and coordination. Firms must balance opposing local and global goals. On the positive side, firms that effectively implement a transnational strategy often outperform competitors who use either the multidomestic or global corporate-level strategies.John Child and Yanni Yan, “National and Transnational Effects in International Business: Indications from Sino-Foreign Joint Ventures,” *Management International Review* 41, no. 1 (January 2001): 53–75.

The Ford Motor Company and BMW are examples of firms pursuing a transnational strategy. Ford, for example, is focusing on the “world car,” building one core car that will be sold globally. This strategy lowers Ford’s development costs, because rather than developing different cars for different countries or regions, Ford will sell the same car to all markets. The world car strategy, however, poses a major hurdle: how to design a car that appeals to consumers in many different countries. To tackle the issue, Ford took a page from BMW, which uses the concept of “fashion forward” when designing its 3 Series cars for multiple markets. The secret, according to Verena Kloos, president of BMW’s DesignworksUSA studio in California, is to “show consumers what the next big thing is, not reflect what they think now.” As James D. Farley, Ford’s global marketing chief, sees it, the global appeal of the 3 Series rests on trust and aspiration. People worldwide see the same design, which builds trust through ubiquity and familiarity and leads them to aspire to own the car themselves.David Kiley, “Can Ford’s ‘World Car’ Bet Pay Off?,” *BusinessWeek*, accessed June 7, 2010, http://www.businessweek.com/magazine/content/09_24/b4135058974279.htm?campaign_id=rss_innovate.

International Strategy and the Local Environment

Sometimes, firms expanding into new geographic markets find that they must adapt certain components of their strategies to accommodate local environments. In the United States, for instance, Dell is famous for the business model that allows it to skip middlemen and go directly to suppliers and customers. In its early years, Dell experimented with a brick-and-mortar retail strategy but quickly retrenched. As it expanded into international markets, however, Dell has found that it has to suspend its direct model, at least temporarily. Why? Basically because it needs local intermediaries to help develop both a base of business and acceptable levels of customer awareness and sophistication. Such has been the case first in India and then in China, which constitute huge markets for Dell.

Figure 10.5 Dell’s Local Operations in Xiamen, China

Courtesy of Dell, Inc.

While Dell provides a good example of adaptation, most global firms tend to approach corporate strategy from the perspective of their domestic market constraint, which can be problematic. Microsoft is a case in point. The United States and the European Union (EU) have very different traditions and models of competition, which in turn means that strategies must vary across these important markets. Had you not been aware of these differences, you might think that Microsoft followed an ideal resource-based corporate strategy in its diversification into Europe. It bundled its Windows operating system with the Internet Explorer browser and other software to increase the company's perceived value and, therefore, customers' willingness to pay. It also used its extensive experience with home-computer software, operating systems, and applications to better penetrate the server market for software and operating systems, where customers are primarily businesses. Finally, Microsoft tried to lock out competitors by including its Windows Media Player as a standard feature in both its server and home PC operating systems.

The EU, however, has made these Microsoft tactics illegal: the bundling strategy "deters innovation and reduces consumer choice in any technologies which Microsoft could conceivably take an interest in and tie with Windows in the future.""EU Lowers Boom on Microsoft," *Wired*, March 24, 2004, accessed November 10, 2010, http://www.wired.com/techbiz/media/news/2004/03/62789. The EU signaled its disapproval by imposing a fine of over $600 million and giving Microsoft ninety days to release versions of its Windows operating systems for home PCs and servers without the Windows Media Player and to begin providing rivals access to the details of the code underlying its proprietary server systems, used primarily in business settings. This is not the first time such differences in regulatory environments have been ignored or underestimated by global firms. Just a few years earlier, the European Commission's ruling dealt a fatal blow to the all-but-done merger between Honeywell and General Electric (GE), citing that the merger would reduce competition in the aerospace industry.Yusaf Akbar, "Grabbing Victory from the Jaws of Defeat: Can the GE-Honeywell Merger Force International Competition Policy Cooperation?," *World Competition* 25, no. 4 (2002): 26–31.

KEY TAKEAWAYS

- Multidomestic strategy maximizes local responsiveness by giving decentralizing decision-making authority to local business units in each country so that they can create products and services optimized to their local markets. This strategy allows firms to compete more effectively in the local market and increase their share in that market. The disadvantage of a multidomestic strategy, however, is that the firm faces more uncertainty because of the tailored strategies in different countries. In addition, because the firm is pursuing different strategies in different locations, it cannot take advantage of economies of scale that could help decrease costs for the firm overall.
- A global strategy is centralized and controlled by the home office and seeks to maximize global efficiency. Under this strategy, products are much more likely to be standardized rather than tailored to local markets. Although pursuing a global strategy decreases risk for the firm, the firm may not be able to gain as high a market share in local markets because the global strategy isn't as responsive to local markets.
- A transnational strategy offers the advantages of both the multidomestic strategy (efficiency) and global strategy (responsiveness to local conditions) but has the disadvantage that it is difficult to simultaneously execute the dual goals of flexibility and coordination.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. When should a firm choose the global strategy rather than a multidomestic strategy?
2. How might a given country's regulatory environment impact a firm's international strategy?
3. How do the international strategies affect the trade-offs managers must make between local responsiveness and global efficiency?

5.48: Managing the International Business with the P-O-L-C Framework

> **Learning Objectives**
>
> 1. Know the dimensions of the P-O-L-C framework.
> 2. Recognize the general inputs into each P-O-L-C dimension.

A manager's primary challenge is to solve problems creatively. In order to help managers respond to the challenge of creative problem solving, principles of management have long been categorized into the four major functions of planning, organizing, leading, and controlling, or the P-O-L-C framework.Mason Carpenter, Talya Bauer, and Berrin Erdogan, *Principles of Management* (Nyack, NY: Unnamed Publisher, 2009), accessed January 5, 2011, www.gone.2012books.lardbucket.org/printed-book/127834. These four functions are actually highly integrated when carried out in the day-to-day realities of running an organization. So, don't get caught up in trying to closely analyze and understand a complete, clear rationale for the categorization of the skills and practices that comprise the P-O-L-C framework.

It's important to note that this framework is not without criticism. Specifically, these criticisms stem from this observation: while P-O-L-C functions might be ideal, they don't accurately depict the day-to-day actions of actual managers.Henry Mintzberg, *The Nature of Managerial Work* (New York: Harper & Row, 1973). The typical day in the life of a manager at any level can be fragmented and hectic, with the constant threat of having priorities dictated by the law of the trivial many and important few (i.e., the 80-20 rule). However, the general conclusion seems to be that the P-O-L-C framework of management still provides a very useful way of classifying the activities managers engage in as they attempt to achieve organizational goals.David Lamond, "A Matter of Style: Reconciling Henri and Henry," *Management Decision* 42, no. 2 (2004): 330–56.

Planning

You have already been exposed to the essentials of planning in your introduction to strategy and strategic management. "Planning is the function of management that involves setting objectives and determining a course of action for achieving these objectives."Reference for Business, "Management Functions," *Encyclopedia of Business*, 2nd ed., accessed August 2, 2008, http://www.referenceforbusiness.com/management/Log-Mar/Management-Functions.html. In this section, planning reflects the notion of strategizing. To plan well, managers must be aware of the external conditions facing their organizations (recall the O and T in the discussion of SWOT in Section 10.1). Managers must also be good decision makers to set a course for achieving organizational objectives. In international business, planning is particularly complex given all the countries and variables involved.

There are five steps in the planning process. First, the process begins with SWOT analysis, which means that planners must be aware of the critical factors facing their organization in terms of economic conditions, their competitors, and their customers.

Second, planners establish organizational objectives. Organizational objectives are statements of what needs to be achieved and when. Third, planners identify multiple ways of achieving those objectives, with an eye toward choosing the best path to reach each objective. Fourth, planners must formulate the necessary steps and ensure effective implementation of plans. Finally, planners must constantly monitor the progress of their plans and evaluate the success of those plans, making adjustments as necessary. Let's look at the three primary types of plans and planning—strategic, tactical, and operational.

Strategic Planning

Strategic planning is the most long-range planning, typically looking three years or more into the future. During strategic planning, an organization's top managment analyzes competitive opportunities and threats as well as the strengths and weaknesses of the organization, getting input from across the organization. Then the managers set a plan for how best to position the organization to compete effectively in the environment. Strategic planning is generally conducted across the enterprise and includes setting objectives that reflect the organization's mission.

Tactical Planning

Tactical planning, in contrast to strategic planning, has a shorter time horizon, typically one to three years, and specifies fairly concrete ways to implement the strategic plan. Tactical planning is often done by middle-level managers.

Operational Planning

Operational planning takes the organization-wide or subunit goals and specifies concrete action steps to achieve the strategic and tactical plans. Operational planning is short-range planning (less than a year).

Organizing

Organizing is a management function that develops an organizational structure and coordinates human resources within that structure to achieve organizational objectives. Typically, organizational structure is represented by an organizational chart that graphs the lines of who reports to whom and shows a hierarchical chain of command. In recent years, however, social network analysis has become increasingly popular as a means of identifying who in the organization people consider to be "expert" and turn to when they need help.Olivier Serrat, "Social Network Analysis," *Knowledge Solutions* 28 (February 2009), accessed January 3, 2011, www.adb.org/Documents/Information/Knowledge-Solutions/Social-Network-Analysis.pdf. The advantage of mapping this type of informal network is that it shows who is a valuable, well-connected expert, even if that person is not a de facto "boss." Decisions made about the structure of an organization are generally referred to as **organizational design** decisions.

Organizing takes place at both the level of the organization and at the level of the job. Organizing at the level of the enterprise or organization involves deciding how best to divide or cluster jobs into departments to effectively allocate and coordinate effort. There are many different ways to departmentalize, such as organizing by a job function, by products, by geographical regions, or by type of customer. Larger organizations often use several methods of departmentalization. When the business crosses borders, the organization must choose a structure that complements its strategy. This often relates to whether there is a separate international division or if each country operates autonomously (and to what degree).

Organizing at the job level means designing individual jobs within the organization. Decisions must be made about the duties and responsibilities associated with each job, as well as the manner in which the duties should be carried out. Decisions made about the nature of jobs within the organization are generally called **job design** decisions.

Job design involves organizing jobs so that each position makes productive use of an individual's talents. In the past, job design meant narrowing a job's tasks so that the individual could be more proficient at those tasks. But further research showed that too narrow a job function leads to boredom and concomitant job dissatisfaction.

As a result, organizations now try to balance specialization (and the efficiency it brings) with variety and opportunity for autonomy. Human resource specialists use principles such as empowerment, job enrichment, and teamwork when designing jobs. For instance, HUI Manufacturing, a custom sheet-metal fabricator, has done away with traditional departments in order to focus outward on customers rather than internally on departments. As a result, HUI listens and responds to customers. Using small-team "huddles" and company-wide meetings, HUI employees work together to understand their customers and how HUI might service them best."Your Teams: Overview," HUI Manufacturing, accessed November 9, 2010, www.huimfg.com/abouthui-yourteams.aspx. While some employees remain specialists, employees are paid more to develop multiple skill sets—thus a metalworker may also be proficient in design and accounting. As a result, HUI's workforce is highly diverse in terms of individual capabilities.

Leading

Leading involves influencing and inspiring others to take action. Managers who lead well inspire their employees to be enthusiastic about working to achieve organizational goals and objectives.

Managers can become effective leaders by understanding their employees' individual values, personalities, and attitudes. For example, studies of motivation and motivational theory help managers understand how workers can be energized to put forth productive effort. Studies of communication, likewise, provide direction as to how managers can effectively and persuasively communicate. Finally, studies of leadership and leadership style provide information on topics such as how a manager can be a good leader and what leadership styles are most appropriate and effective in certain situations. When an organization's operations cross borders, managers have to make additional choices related to the employment of local workers versus relocating workers from the home country, as well as the degree and frequency with which employees rotate through positions and countries.

Controlling

The controlling function requires monitoring performance so that it meets the performance standards established by the organization. Controlling consists of three steps—setting performance standards based on the company's objectives, measuring and comparing actual performance against standards, and taking corrective action when necessary. For example, a performance standard can be that a technical support staffer will resolve three customer problems per hour. If staffers are consistently only able to resolve three problems per hour, it may mean that the standard was set too high. Setting performance standards is a delicate balance: managers want the task to be attainable but not too easy. If the standard is set at five problem resolutions per hour and half of the staffers achieve that goal, then they can be recognized for their achievement, while the staffers unable to meet that performance level can be coached, or other measures can be taken to minimize the low performance.

Performance standards can be measured in various ways, such as through financial statements, sales reports, production results, customer satisfaction, and formal performance appraisals. Managers at all levels engage in the function of controlling to some degree.

Don't let the term *control* confuse you into thinking that it means manipulation. Rather, the controlling function is intended to ensure that work is proceeding according to plan. Indeed, effective control requires having plans and objectives and establishing which position will be responsible for correcting deviations that occur.

Effective controls provide valuable feedback mechanisms. For international companies, such feedback includes the methods for transferring knowledge and advantages out of home or foreign countries into the business operations of other countries. Such learning, while a key advantage of global firms, is easier said than done. Even the best firms have found cross-border learning difficult. For example, when Toyota vehicles in the United Kingdom experienced problems with their braking and acceleration systems, these design issues were not communicated to the company's US operations until the same difficulties had reached crisis proportions in the United States.

In summary, the P-O-L-C functions of planning, organizing, leading, and controlling are widely considered to be the best means of describing the manager's job. Managers perform these essential functions despite tremendous changes in their environment and the tools they use to perform their roles.

KEY TAKEAWAYS

- The principles of management can be distilled down to four critical functions. These functions are planning, organizing, leading, and controlling.
- Strategy is a starting point in the P-O-L-C framework, but it also incorporates many additional activities that allow the strategy to be executed well. This framework provides useful guidance into what the ideal job of a manager should look like in both domestic and international business contexts.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What are the management functions in the P-O-L-C framework?
2. Are there any criticisms of this framework?
3. What function does planning serve?
4. What function does organizing serve?
5. What function does leading serve?
6. What function does controlling serve?

5.49: End-of-Chapter Questions and Exercises

These exercises are designed to ensure that the knowledge you gain from this book about international business meets the learning standards set out by the international Association to Advance Collegiate Schools of Business (AACSB International).Association to Advance Collegiate Schools of Business website, accessed January 26, 2010, http://www.aacsb.edu. AACSB is the premier accrediting agency of collegiate business schools and accounting programs worldwide. It expects that you will gain knowledge in the areas of communication, ethical reasoning, analytical skills, use of information technology, multiculturalism and diversity, and reflective thinking.

EXPERIENTIAL EXERCISES

(AACSB: Communication, Use of Information Technology, Analytical Skills)

1. One of the reasons that firms expand across borders is to expand the impact and value created by their strong brands. Pick a local company and develop a vision for how it can expand its brand globally. What seem to be the opportunities and barriers to doing this? Review the short YouTube video on global branding by Sanjay Sood, a UCLA professor, and see how you might qualify your recommendations. The video is at http://www.youtube.com/watch?v=X26WHNRhqPk.
2. Visit the corporate websites of Splash Corporation, CEMEX, Procter & Gamble, and 3M. How does it appear that these firms have organized their global business operations? What are their similarities and differences, and what might explain those similarities and differences? How might you characterize their business, corporate, and international strategies?
3. Outsourcing and offshoring are important parts of international strategy, yet they also have a clear ethical dimension. View the trailer for *Outsourced: The Movie* at http://www.youtube.com/watch?v=LImhTTFu4b8 and the opening sample video clips (starting with "Todd's First Training") at www.outsourcedthemovie.com/Clips/ms_educlips.html. What stereotypes do the videos highlight? What does it appear Todd is learning from this experience?

Ethical Dilemmas

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. What are the ethical implications of outsourcing or offshoring business activities?
2. You have been hired by Procter & Gamble (P&G) to work in their cosmetics product development group. P&G is aiming to grow its business by identifying new products where demand is growing quickly in emerging markets. Through a Filipino classmate from your college days, you learn about the skin-lightening product market and how rapidly it is growing in emerging markets. What are some of the ethical considerations you might want to take into account as you evaluate this market and make recommendations to your colleagues at P&G?
3. You are a quality-control manager for Toyota Motor Corporation in the United Kingdom. Over the past six months, you have forwarded information to Toyota's headquarters in Japan about possible brake problems but have seen no action taken. In your heart you believe that the company is just being careful to confirm what the problems actually are and is not intentionally covering up the problem. This morning you read a piece in *USA Today* about Toyota vehicles in the United States experiencing similar problems. What action do you take?

CHAPTER OVERVIEW

6: International Business Functions

SECTION OVERVIEW

6.1: Exporting, Importing, and Global Sourcing

6.2: Corporations and their Social Responsibility

Understanding Corporations and CSR

The subject of this book is *corporate social responsibility* (CSR), a broad term that refers generally to the ethical role of the corporation in society. Before we define CSR more precisely and before we explore in depth a number of case studies that illustrate aspects of the ethical role of corporations, we first need to understand exactly what corporations are, why they exist, and why they have become so powerful.

Today, the global role of corporations rivals that of national or local governments. In 2000, it was reported that, of the 100 largest economic organizations in the world, 51 were corporations and 49 were countries.[1] General Motors, Walmart, Exxon, and Daimler Chrysler all ranked higher than the nations of Poland, Norway, Finland and Thailand (in terms of economic size, comparing corporate revenues with national gross domestic product, or GDP). This trend has continued, and for the past decade, 40 to 50 of the world's 100 largest economic organizations have been corporations, with the rest being national economies. In 2012, Walmart was the twenty-fifth largest economic organization in the world, putting it ahead of 157 countries.[2]

For corporate employees, as for citizens living in communities dominated by large corporations, the corporation is arguably the most important form of social organization. For people such as corporate executives and shareholders, whose lives depend directly on corporations, it is not surprising that company politics often are considered more relevant than national or local politics. Corporations are also a major part of the daily lives of the world's citizens and consumers. For devoted fans of iconic brands like Nike, Apple, Mercedes, or Louis Vuitton, the corporation can occupy a psychological niche very much like that of a member of the family. Indeed, if many teenagers today were forced to choose between an iPhone and a memorable night out celebrating their parents' anniversary, the parents would likely celebrate alone. Similarly, those parents might also be loath to part with their cherished products. Dad would not easily say goodbye to his Chevrolet Corvette or Bose stereo, and Mom might not be easily persuaded to part with her Yamaha piano or Rossignol skis.

At the opposite extreme, for citizens who have been harmed physically or financially by corporations—like the Louisiana or Alaska residents whose beaches were fouled by massive oil spills, or the thousands of small investors who found their life savings wiped out by the Ponzi schemes of Bernie Madoff's investment company—the corporation can seem as dangerous as an invading army, or as destructive as an earthquake.

Despite their vast social role, corporations remain poorly understood by the world's citizens. While school children everywhere are expected to study the structure and history of their nation's government, they are not similarly taught to appreciate the functions, motivations, and inner workings of corporations. Let us begin with a brief review of the nature of corporations.

BP oil rig explosion, photo by United States Coast Guard (2010, public domain). Figure 1.1 The 2010 explosion of a British Petroleum (BP) oil rig off the coast of Louisiana, the cause of the worst environmental disaster in U.S. history.

Why Do Corporations Exist?

There were no corporations in ancient Egypt, Greece, or Rome; or in imperial China or Japan; or among the precolonial kingdoms of the Zulu or Ashanti. The Aztecs and Incas had no corporations, nor did the Sioux, Cherokee, or Navajo. It is true that in some classical and traditional societies there were certain forms of communal and religious organizations that anticipated the organizational capacities of corporations, but strictly speaking, they were not corporations.

Corporations are a relatively modern social innovation, with the first great corporations dating from about 1600. Since then, the growth of corporations has been phenomenal. What explains it? Why has the corporate structure been so successful, profitable, and powerful? Here are a few of the distinguishing characteristics of corporations.

Corporations are Creatures of Law

The first point to make about corporations is that they are not informal organizations or assemblies. In order to exist at all, corporations must be authorized by state or national laws. In their daily operations, corporations are regulated by a specific set of laws. Every country has laws that stipulate how corporations can be created; how they must be managed; how they are taxed; how their ownership can be bought, sold, or transferred; and how they must treat their employees. Consequently, most large corporations have large legal and government affairs departments. Since the laws and rules that may constrain corporations are written and enforced by the government, most corporations consider it of vital importance to seek influence over governmental regulators and lawmakers. In most countries, the very largest corporations have privileged access to top decision makers. The extent and reach of corporate influence over governments is one of the most controversial aspects of corporate existence.

Corporations Raise Capital for Major Undertakings

The first great benefit of corporations is that they provide an organized vehicle for pooling cash and capital from a large number of investors so that they can undertake major enterprises. Thus, one great stimulus to the growth of corporations was the rapid growth of international trade between 1400 and 1700 CE. In that era, sending a large vessel across the oceans was a major financial and logistical undertaking, which was also extremely risky; ships were often lost in storms. These early commercial ventures required such large capital investments that, at first, funding them was only within the reach of royalty. American schoolchildren are taught that the legendary explorer Christopher Columbus needed the royal patronage of Queen Isabella of Spain to support the voyages that led to the “discovery” of the New World. However, as new ocean trading routes were established and the vast potential for profits from trading spices became known, the first modern corporations were formed: the English East India Company, chartered in 1600, and its archrival, the Dutch East India Company, chartered in 1602. These companies are considered the world’s first multinational corporations, and they possessed most of the hallmarks of corporate structure that we see today.

Corporations and Other Business Structures

Not all businesses or companies are public corporations. For example, in the US, it is legal to operate a business in your own name (this is called a *sole proprietorship*) or with partners (a *partnership*). Corporations also come in a bewildering array of forms. Thus, in the US, we have *C corporations*, *S corporations*, *benefit corporations* (also *B corporations*), and *limited liability companies* (LLCs). In the UK, the term *company* is preferred to corporation, and we will notice that the names of most large UK companies followed by the designation *plc* or *PLC* (public limited company), as in Rolls-Royce plc, while smaller companies often have the designation *Ltd* (private limited company). In France, large companies are usually designated *SA* (société anonyme), while smaller ones may be known as *SARL* (sociétéà responsabilité limité). In Germany, large companies are designated *AG* (Aktiengesellschaft), while smaller ones are known as *GmbH* (Gesellschaft mit beschränkter Haftung). In Japan, the corresponding terms are *KK* (kabushiki kaisha) and *YK* (yūgen kaisha).

All of these terms define two basic aspects of corporations: 1) their limited liability (which applies to all corporations), and 2) their status as a *public* or *private* company. Public companies are allowed to sell their shares on public stock markets and tend to be the larger type of company.

The Importance of Limited Liability

Why aren’t all businesses sole proprietorships or partnerships, instead of corporations? The answer is found in the concept of *liability*, which refers to the risk of loss for debts incurred by the business, or for damages caused by the business.

If you start a business as a sole proprietor or via a partnership, you (and/or your partners) are *personally liable* for any debts or damage that can be attributed to the particular business. Let us say that you have $1 million in assets and your good friend has $2 million in assets. Together, you agree to invest $250,000 each in a pizza delivery business (the business will start with $500,000 worth of capital). Unfortunately, in the first month of operation, one of your drivers negligently causes a car accident and severely injures a family driving in another car. The family sues you for their injuries and they obtain a court judgment ordering you to pay $3 million in compensation. Even though you had intended to invest only $250,000 in the business, now your entire fortune and that of your friend are likely to be wiped out in satisfying that court judgment. The same sort of result could arise if your business ran up $3 million in debt that it was unable to pay back. Thus, the founder of a sole proprietorship exposes his/her entire personal assets to the risk that the assets will be seized to satisfy liabilities incurred by the business.

The result can be quite different for a corporation. One of the principal advantages of a corporation, from an investor's point of view, is that the corporation provides a legal a "shield" from liability. A shareholder of a corporation only risks the stock that the shareholder owns. The shareholder's personal assets are not in jeopardy. When a corporation suffers an adverse legal judgment and does not have sufficient funds to satisfy the judgment, the corporation simply goes bankrupt. The party or parties who have been injured cannot sue the owners—the shareholders—of the corporation because the corporation acts as a shield from liability.

Why does society allow the shareholders of a corporation to retreat behind the corporate shield, while we do not allow the same for owners of a so-called mom-and-pop business in the form of a sole proprietorship? The main purpose of the liability-shield is to encourage investment in corporations. People are more willing to invest in a corporation (by acquiring stock) because they need not fear that their personal assets can be seized to satisfy the business's debts or liabilities. The underlying implication is that corporations and corporate investment provide important benefits for society, which explains why governments have been willing to adopt laws that protect and encourage corporate ownership. As many U.S. states learned in the nineteenth century, it can make sound economic sense to attract large corporations because they often become major employers and taxpayers. Corporations may enhance the ability of the local economy to compete with foreign economies that are supported by the productivity of their own corporations.

In many instances the ability of corporations to retreat behind the corporate shield has been controversial. For example, several major airlines (notably American Airlines) have been accused of choosing to declare bankruptcy over finding a way to pay high wages to their pilots and cabin personnel.[3] The airlines were attacked by labor unions as having used the bankruptcy as a tactic to avoid meeting the union's demands for fair wages. Such corporations are able to benefit from an option provided by US bankruptcy law, known as *Chapter 11 reorganization*, which allows them to enter bankruptcy temporarily. The courts appoint a trustee to run the corporation, and the trustee is empowered to take any actions necessary to reduce the corporation's debts, including revoking labor agreements with employees. Such corporations can later "emerge" from bankruptcy with fewer employees or with employees earning lower salaries.

Corporations Permit Wealth Creation and Speculation in Stocks

While all corporations possess limited liability, not all of them are permitted to raise money in the stock market or have their shares traded in stock markets. Here, we find the important distinction between *public corporations*, which may have their shares traded on stock markets, and *private corporations*, which may not have their shares traded on stock markets.

As a rule, large corporations and multinational corporations choose to do business as public corporations because big companies have such enormous capital needs that they may best raise funds by placing stock for sale in public stock markets. However, this is not always the case; there are some very large corporations that choose to remain private, which means that they raise money directly from investors rather than from making stock available on stock markets.

On the whole, ownership of a corporate interest in the form of stocks is more freely and easily transferable than ownership of an interest in a sole proprietorship or partnership. If you want to sell a mom-and-pop store, you generally have to sell the whole business; you cannot sell a small portion when you need to raise money.

If you are one of the members of a partnership and you want to sell your share, you will generally have to get prior approval from the other partners; needing to do so may discourage possible investors because they may not want to go to the trouble of seeking approval from your partners. However, if you inherit a thousand shares of stock in Apple from your wealthy aunt (which, in 2013, would have had an approximate value of $420,000), and you find that you need extra money, you can sell one hundred shares (or about $42,000 worth). Such a transaction is easy because there are lots of investors eager to own Apple shares and you do not need anyone's approval. This ease of transferability also encourages people to invest in stock instead of in other businesses, because it is so easy to sell corporate stock as needed.

When a corporation grows and/or becomes more profitable, the shareholders benefit financially in two ways. First, the corporation will often distribute a portion of its profits to the shareholders in the form of *dividends*, a certain annual payment per share of stock. Second, if a corporation is growing rapidly and is expected to be very profitable in the future, more investors will want to own its stock and the price of that stock will increase. Thus, ownership of stock is an investment vehicle that provides many advantages over other types of investments. For one thing, you can own stock without having to personally take part in the management of the company. In addition, you can sell all or part of your ownership when you need the funds. Finally, if the corporation is very successful, it will not only pay a steady revenue stream—through dividends—but your shares will become more valuable over time.

The advantages of stock ownership as an investment vehicle explains the growth of the world's great stock exchanges, such as the New York Stock Exchange or the Hong Kong Stock Exchange. Stock exchanges are like enormous flea markets for stock, because you can either buy or sell stock there. Unlike the goods available in ordinary markets, though, the price of stocks fluctuates constantly, literally minute by minute. A stock that was worth $10 last year may now be worth as much as $1000 or as little as $0.10. Thus, stock markets are also somewhat like casinos or lotteries, because they allow investors to speculate on the future.

Speculation has its pros and cons. The potential for wealth creation through stock ownership has spawned an important industry that employs hundreds of thousands of people and generates vast profits: financial services. Stock brokerages, investment banks, and trading houses have arisen to provide expert guidance and services to investors.

American colleges and universities have developed a highly collaborative and perhaps even symbiotic relationship with the financial services industry. For one thing, since there are many jobs and professional occupations in financial services, virtually all universities offer courses and majors in finance or financial economics, and many also have graduate business schools that prepare students for careers in the financial services industry.

Perhaps equally importantly, most colleges and universities depend on private and charitable donations to help defray the cost of running the institution and, consequently, to keep tuition rates and fees lower (although many students will find it hard to imagine how tuition could be any higher). When wealthy individuals and corporations make donations or charitable contributions to colleges and universities, they often do so by giving corporate stock. Even when they make a cash donation, the university may find that it is most financially convenient to use that cash to acquire corporate stock. As a result, the largest universities have amassed vast holdings of corporate stock, among other investments. The financial resources of a university are often held in the form of a special trust known as an *endowment*. Universities prefer not to sell off parts of the endowment but rather seek to cover costs by using the interest and dividends generated by the endowment.

At times, the corporate holdings of universities have become quite controversial. For example, in the 1970s and 1980s, a growing student movement called on universities to *divest* (to sell all their stock) in any corporations that did business with the racist apartheid regime that controlled South Africa at that time. Many commentators believe that it was this pressure on corporations that led to the fall of the apartheid regime and the election of South Africa's first black president, Nelson Mandela.

Corporations Can Have Perpetual Existence

It is possible but rare for family-owned businesses to remain sole proprietorships for several generations; more commonly, they eventually become corporations, or they are sold or transferred to a new business operator. Very often, a small business is sold when the founder dies, because the founder's children or heirs either do not want to work in the family business or are not as gifted in that business as was the founder. Even in successful, family-owned businesses where a child or relative of the founder inherits the business, it still happens that after a generation or two, no further family members are qualified (or wish) to join the business, and the business must be sold.

However, corporations are structured from the outset to have a potentially perpetual existence, because corporations do business through their officers and executives rather than through their owners. Although it is possible for owners to have dual roles as shareholders and as executives, it is not necessary. One common scenario is for the founder of the corporation to act as its chief executive officer (CEO) until such time as the corporation becomes so large and successful that the shareholders prefer to transfer management responsibility to an executive with specific professional experience in running a large corporation.

Disadvantages of the Corporate Form

Separation of Ownership and Management Functions

One potential disadvantage of the corporate form (from the point of view of its founders) is that, as the corporation grows, the original founders may lose control and even be pushed out of the corporation by newcomers. This happened to Steve Jobs, the legendary cofounder of Apple, who was pushed out of his leadership role in 1985 by Apple's board of directors, only to return in the mid-1990s and retake his role as CEO. More recently, in 2013, George Zimmer, the founder of the apparel retailer Men's Wearhouse, was terminated as chairman of the board by his own board of directors. This situation can arise because, as a company grows, the founders may be tempted to part with some portion of their equity by selling stock to new investors. Corporations are ultimately controlled by the board of directors, who are voted into office by the shareholders. If a founder allows his or her share of corporate stock to drop beneath 50%, then the founder will no longer be able to elect a majority of the board of directors, and may become subject to termination as an officer by the board. The board of directors is thus a sort of committee that controls the fate of the corporation, and it does this principally by choosing a CEO and supervising the CEO's performance.

Dual Taxation

Although the tremendous growth in the number and size of corporations, and their ever-increasing social role, is due in part to their advantages as an investment vehicle, there are some financial disadvantages worth mentioning. One of the most important is so-called dual taxation, which refers to the practice in most countries of taxing corporate profits twice: once when the corporation declares a certain amount of profit, and again when the corporation distributes dividends to shareholders. The complexity of corporate tax regulations is such that even small corporations must frequently employ specialized accountants and attorneys to handle their tax returns.

Quarterly Financial Reporting for Publicly Traded Corporations

Another disadvantage applies only to publicly traded corporations. Although all corporations are subject to a number of government regulations, the highest degree of regulation applies to public corporations, which raise capital by selling stock in stock markets. Large corporations are often willing to submit to these burdensome regulations because there are strong benefits to being traded on a stock exchange, the most important of which is the ability to raise a great deal of initial funding when the stock is first made available for trade. This first public sale of stock is known in the US an *initial public offering* or *IPO*. In two famous recent examples, Google raised $1.67 billion with its IPO in 2004, and Facebook raised $18 billion with its IPO in 2012.

Source: Toms Shoes, photo by Vivianna Love (CC BY 2.0, 2009) Figure 1.2 A well-worn pair of Toms Shoes;
Toms gives away free shoes to a poor child for every pair it sells.

Despite the allure of additional financing, a company that is traded on a stock market must make a great deal of financial information publicly available, usually on a quarterly basis, four times per year. This obligation can be quite onerous because it requires the corporation to employ a number of internal accountants as well as outside auditors. In addition, the information that is publicly revealed can be of strategic value to the corporation's competitors. Moreover, the need to make frequent quarterly reports on the company's ongoing profitability can have a negative impact on corporate strategy, because executives may become fixated on short-term goals while neglecting long-term goals. In light of these disadvantages, it is not surprising that some public corporations decide to take their shares off the stock markets in a process that is known as *going private*, which is the opposite of an IPO. Other corporations simply avoid going public in the first place. Thus, there are also some very large corporations, such as the multi–billion-dollar engineering firm Bechtel, which prefer to remain private even though they could raise investment capital with an IPO. Such companies prefer to raise capital by other means to avoid the requirements of quarterly earnings reports and therefore not revealing financial information to competitors.

Corporate Social Responsibility

In this book, we will make continual reference to the concept of corporate social responsibility, but it is important to realize that CSR is an evolving concept that can be analyzed from multiple perspectives. The term *CSR* may be used quite differently depending on whether a given speaker is looking at it from the point of view of a corporation, a government, a charity sponsored by the corporation, a citizen employed by the corporation, a citizen who has been harmed by the corporation, or an activist group protesting abuses of corporate power. Let us review key concepts and terms related to CSR, starting with CSR itself.

CSR: Definition

We define CSR simply and broadly as the ethical role of the corporation in society. Corporations themselves often use this term in a narrower, and less neutral, form. When corporations have a director of CSR or a committee in charge of CSR, or when they mention CSR prominently in their mission statements, they are invariably using the term to mean "corporate actions and policies that have a positive impact on society." Corporations refer most frequently to CSR when they speak of civic organizations they support, or to corporate environmental or social policies.

One related term here is corporate "compliance." Not only are large corporations subjected to a host of governmental regulations, many of which have social objectives (such as avoidance of discrimination, corruption, or environmental damage), but many corporations also have set up internal guidelines. In order to make sure that a corporation respects or complies with all these laws, regulations, and norms, both internal and external, corporations increasingly employ "compliance" officers or executives. For example, large fashion and apparel companies frequently place a specific executive in charge of "human rights compliance," to ensure that its clothing was manufactured in safe factories that respect labor laws and do not employ children.

Corporate Philanthropy

Corporate philanthropy refers to a corporation's gifts to charitable organizations. There is an implication that the corporation's donations have no strings attached, which is probably quite rare. At a minimum, most corporations expect that their donations will be publicly attributed to the corporation, thus generating positive public relations. When corporations make large cash gifts to universities or museums, they are usually rewarded with a plaque, or with a building or library named after the donor. Such attributions burnish the corporation's public image, and in such cases we are not dealing with true corporate philanthropy, strictly speaking, but something more in the nature of marketing or public relations.

Stakeholder Capitalism

Stakeholder capitalism refers to a conception of the corporation as a body that owes a duty not only to its *shareholders* (the predominant American view) but also to all of its *stakeholders*, defined as all those parties who have a stake in the performance and output of the corporation. Stakeholders include the company's employees, unions, suppliers, customers, local and national governments, and communities that may be affected by corporate activities such as construction, manufacturing, and pollution. Stakeholder capitalism is a concept that was largely developed in Europe and reflects the widespread European attitude toward corporate governance, which accepts a great degree of government and social oversight of the corporation. The American approach is often described, in contrast, as *laissez-faire* (meaning "leave alone"), in that corporations are granted more freedom of operation than in Europe. One example of a stakeholder approach is in the German practice known as *codetermination*, in which corporations are required to provide a seat on the corporation's board of directors for a union representative. This is intended to oblige the corporation to be more cognizant of worker needs and demands, and to ensure that corporate strategies are not concealed from workers.

Cause-Related Marketing

Cause-related marketing (CRM) refers to a corporation's associating the sales of its products to a program of donations or support for a charitable or civic organization. An example is provided by the famous Red campaign, in which corporations such as Gap pledged to contribute profits from the sale of certain red-colored products to a program for African development and alleviation of AIDS-related social problems. The basic idea of cause-related marketing is that the corporation markets its brand at the same time that it promotes awareness of the given social problem or civic organization that addresses the social problem. Another well-known example is the pink ribbon symbol that promotes breast-cancer awareness and is used prominently in the marketing of special lines of products by many corporations, such as Estée Lauder, Avon, New Balance and Self Magazine. In addition to marketing products with the pink-ribbon symbol, Estee Lauder has made support for breast cancer awareness one of the defining features of its corporate philanthropy. Thus, Estee Lauder also frequently refers to such charitable contributions, currently on the order of $150 million, in its corporate communications and public relations documents.[4]

Sponsorship

Sponsorship refers to a corporation's financial support for sports, art, entertainment, and educational endeavors in a way that prominently attributes the support to the particular corporation. Sponsorship can be considered a form of marketing communications because it seeks to raise awareness and appreciation of the corporation in a given target audience. Arguably, of course, sponsorship benefits society, because society appreciates sports, art, and entertainment. However, in the case of sponsorship, as opposed to philanthropy, the sponsors expect a clear return. Indeed, many corporations carefully analyze the benefits of their sponsorship activities in the same way they measure the impact of their marketing and advertising.

Many prominent global sponsors are companies that find it difficult to advertise through other channels. For example, Philip Morris, the world's largest tobacco company and owner of the Marlboro brand, which finds its global advertising restricted due to a number of bans and limits on tobacco advertising, has invested heavily in sponsorship. Philip Morris has long been the number one sponsor of Formula 1 race car competitions, and it is impossible for a spectator to watch one of these races without observing, consciously or otherwise, huge billboards and banners featuring the famous red-and-white Marlboro logo. Similarly, since alcohol advertising is also increasingly scrutinized, it is not surprising that Budweiser has followed a similar tactic and become the principal sponsor of NASCAR racing. Pharmaceuticals have also become an area subjected to tight advertising and marketing controls; therefore, Pfizer, the world's largest pharmaceutical company, engages in scores of sponsorship activities, notably in its support for the Paralympics, an Olympic-style competition for physically-handicapped athletes.

Sustainability

Sustainability has become such an important concept that it is frequently confused with CSR. Indeed, for some companies it seems that CSR is sustainability. This is perhaps not surprising, given the growing media attention on issues related to sustainability.

Sustainability is a concept derived from environmentalism; it originally referred to the ability of a society or company to continue to operate without compromising the planet's environmental condition in the future. In other words, a sustainable corporation is one that can sustain its current activities without adding to the world's environmental problems. Sustainability is therefore a very challenging goal, and many environmentalists maintain that no corporation today operates sustainably, since all use energy (leading to the gradual depletion of fossil fuels while emitting greenhouse gases) and all produce waste products like garbage and industrial chemicals. Whether or not true sustainability will be attainable anytime in the near future, the development and promotion of sustainability strategies has become virtually an obsession of most large corporations today, as their websites will attest in their inevitable reference to the corporation's sincere commitment to sustainability and responsible environmental practices. No corporation or corporate executive today will be heard to say that they do not really care about the environment. However, if we observe their actions rather than their words, we may have cause for doubt.

We will explore specific cases related to sustainability in later chapters. For now, let us just note that CSR, strictly speaking, is broader than environmental sustainability because it also refers to a corporation's ethical relationship to its employees, shareholders, suppliers, competitors, customers, and local and foreign governments.

More recently, many people have been using the term *sustainability* also to refer to social and political sustainability, which brings the concept closer to that of CSR.

Greenwashing

Greenwashing refers to corporations that exaggerate or misstate the impact of their environmental actions. By the early 1990s a great number of consumer products were being promoted as "environmentally friendly," "eco-friendly," or "green," when in fact there was little or nothing to justify the claims. In 1991, an American Marketing Association study revealed that 58% of environmental ads contained at least one deceptive claim. As a result, many advertising regulatory bodies around the world adopted specific advertising codes to regulate the honesty and accuracy of environmental claims in advertising. For example, in the UK, a producer of a recycling bin advertised that it helped buyers "save the rainforests" by encouraging recycling of plastic and paper products. The advertisement was found to be misleading because most paper products sold in the UK were not made from wood in tropical rainforests, but from wood harvested on northern European tree farms.

In Norway, car manufacturers and dealers are prohibited from claiming that their cars are green, eco-friendly, etc., because in the view of the Norwegian Consumer Ombudsman, it is impossible for cars to be beneficial for the environment; the best they can do is reduce the environmental damage they cause.[5]

Greenwashing is not only a corporate practice but a political one as well, as politicians everywhere promise to undertake actions to improve the environment. Thus, the administration of former US President George W. Bush was widely criticized for promoting legislation under the name of the "Clear Skies Initiative," when in fact the purpose of the legislation was to weaken antipollution measures.[6]

Social Entrepreneurship and Social Enterprise

Social entrepreneurship and social enterprise refer to the use of business organizations and techniques to attain laudable social goals. As we will discuss further in Chapter 6, Blake Mycoskie decided to create TOMS Shoes largely as a reaction to his travels in Argentina, which had exposed him to terrible poverty that left many school-age children without shoes. An important part of the corporate mission of TOMS Shoes lies in its pledge to give away a free pair of shoes for every pair purchased by a customer. TOMS Shoes' model has been imitated by many others, including the popular online eyewear brand, Warby Parker.

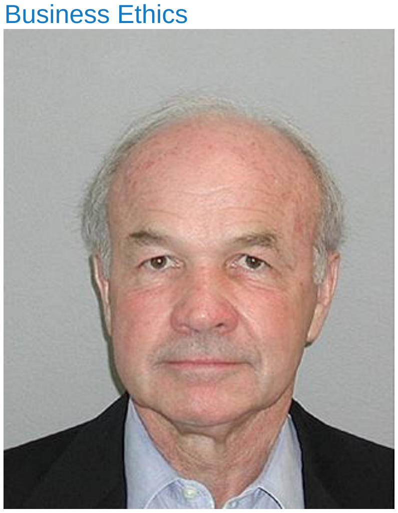
The difference between social entrepreneurship and CSR is that, with social entrepreneurship, the positive social impact is built into the mission of the company from its founding. Other examples of social entrepreneurship include The Body Shop, Ben & Jerry's ice cream, and Newman's Own. The Body Shop was founded by noted activist Anita Roddick who insisted that all products be derived from ingredients which were natural, organic, and responsibly sourced. Her employment policies famously allowed every employee to take off one day a month from work to engage in social or community projects. Similarly, Ben & Jerry's was founded to promote the use of organic, locally-produced food. The company's founders insisted on a policy that executives earn no more than seven times the salary of factory line-workers (although this policy was eventually relaxed when it became difficult to recruit a competent CEO at those wages). Ben & Jerry's engaged in a number of high-profile political activities in which they encouraged their employees to participate, such as protesting the building of the Seabrook nuclear power plant in Vermont. Newman's Own was founded by film actor Paul Newman and his friend A. E. Hotchner with the goal of selling wholesome products and giving away 100% of the profits to charitable ventures. To date, Newman's Own has given away over $200 million.

Social Marketing

Social marketing refers to the use of business marketing techniques in the pursuit of social goals. Often, governments and nonprofit organizations make use of social marketing to make their points more forcefully and effectively to a wide audience. Classic examples are the extremely powerful TV commercials warning of the dangers of unsafe driving or of failing to use seatbelts. Cinematic techniques are employed to portray dramatic, arresting images of crumpled cars and bodies, children and mothers crying. The source of social marketing advertisements is usually a local government or nonprofit organization.

Social marketing is usually used to try to convince citizens to drive more safely, eat better, report child and domestic abuse, and avoid various forms of criminality and drug use. As with ordinary advertising, social marketing can seem overdone or maudlin, and some social marketing ads have been mocked or considered silly. For example, former First Lady Nancy Reagan participated in a social marketing campaign that urged young people to "Just Say No" to drugs, an approach which was ridiculed as simplistic by many. Noted radical activist Abbie Hoffman said that telling drug users to "just say no" to drugs was like telling manic-depressives to "just cheer up." Despite that, drug use in America declined over the time period that the campaign was in progress, though there is no evidence that any part of this decline was due to the campaign.

Business Ethics



Source: United States Marshals Service, 2004, public domain
Figure 1.3 The mug shot of former Enron top executive Ken Lay. Lay was eventually convicted on 10 counts of fraud; while awaiting sentencing of up to 100 years in prison he died of a heart attack in 2006.

Business ethics is an academic discipline closely related to CSR, but one that tends to use the tools of philosophy to formally analyze the ethical role of individuals and corporations. Although the terms are quite similar, there are differences of nuance. For example, although academics who study business ethics tend to focus on corporations, the term itself could also apply to the ethical dilemmas of sole proprietors or of individuals involved in commercial situations, such as a private party trying to sell a used car that he knows has a hidden mechanical flaw. While the term *CSR* tends to be used by corporations and social entrepreneurs in a way that assumes a positive connotation, *business ethics* is used in a more neutral and even critical fashion, as one might expect, given the perspective of writers who are not beholden to corporations. Indeed, when the media uses the term *business ethics*, it is often in a negative sense, to draw attention to instances of deception or fraud on the part of corporations or executives.[7]

White-Collar Crime

White-collar crime refers to fraudulent or financially-oriented criminal activities by high-status professionals or businesspeople. The term *white-collar crime* was coined by sociologist Edwin Sutherland, who defined it as a "crime committed by a person of respectability and high social status in the course of his occupation" in a 1939 speech entitled "The White Collar Criminal." Although the term applies to financial fraud committed by individuals who are not associated with corporations, there is a strong linkage to corporations in actual practice because corporate executives are often well-placed to commit crimes of fraud and corruption. However, a distinction should be drawn between white-collar crime and corporate crime, which refers to crimes for which the corporation itself is responsible. In many cases, such as in violations of US laws against bribing foreign government officials, it may be unclear whether the matter is better classified as white-collar crime or corporate crime. In the law, it may depend on whether the corporation's senior executives were aware of and supported the acts of criminality.

While there is a popular perception that punishments for wealthy white-collar criminals are less severe than for poor and middle-class criminals, the situation appears to have changed in light of the severe penalties for white-collar crime mandated by the 2002 Sarbanes–Oxley Act, which was adopted by the US Congress in the wake of the notorious Enron scandal. As a result, former Enron CEO Jeffrey Skilling, the architect of Enron's frauds, was sentenced to 24 years in prison. Bernie Ebbers, former CEO of WorldCom, was convicted of fraudulent misstating of billions of dollars of WorldCom earnings, resulting in a sentence of 25 years. More recently, Bernie Madoff, whose vast Ponzi scheme defrauded investors of up to $65 billion, was sentenced in 2009 to 150 years in prison for his crimes, effectively a life sentence without possibility of parole.

Topic for Debate: Regulation of Corporations

It is one of the basic premises of this book that we do not want you merely to read and assimilate the material. We want you to engage it personally in an effort to develop and refine your own opinions. Therefore, each chapter will feature a topic for debate (more detailed rules and suggestions for debate will be set forth in the next chapter). Most chapters will feature an in-depth case study based on a real-life business situation, or a fictionalized account of a real business situation or social controversy. In this chapter we will use what we will call a "mini-case study"—a sort of thought experiment, based on a simple set of facts as follows:

Mini-Case Study: The Case of the Undecided Voter

Your close friend, Jane Goodie, is a college student who has registered to vote in her first election. Jane's father has been a lifelong Republican voter and Jane's mother a lifelong Democrat. As Jane grew up, she often listened to her parents debating politics at the dinner table. More than once, Jane found herself disconcerted and discouraged by the appearance of biased thinking on the part of one or both of her parents; they rarely seemed to agree or listen to each other in their political debates. Sometimes, Jane even wondered to herself, "Why do they vote at all, since their votes obviously just cancel each other out?" However, since her parents have strongly urged her to vote as soon as she is old enough, and since they have also urged to make up her own mind about which candidate to choose, she is looking forward to expressing her own views at the ballot box. But first she must make up her mind.

Since this is not a presidential election year, the most important office up for election is that of Senator. Both senatorial candidates are very impressive and illustrious people: One is a graduate of Harvard Law School, the other of Yale Law School. The Democratic, or "liberal," candidate pursued an impressive career as an environmental lawyer before being elected to a position as mayor of one of the leading cities in your state. The Republican, or "conservative," candidate enjoyed an impressive career as an advisor to a number of successful start-up companies before also being elected to a position as a mayor of one of the leading cities in your state.

Both candidates appear to be exceptionally bright, eloquent, and dedicated to public service. In this particular campaign, they both espouse very similar views on foreign policy and social policy. In fact, the main difference between the candidates comes down to one thing: their attitude toward government regulation of business, and of large corporations in particular. The Democratic candidate, citing recent examples of fraud, pollution, and layoffs at major corporations, is calling for tighter regulation of corporations. The Republican candidate, citing the importance of the business sector as a major taxpayer and creator of jobs, calls for a loosening and reduction of government regulation of business.

Your friend does not know who to vote for, but believes that she should decide on the basis of the single issue on which the candidates differ: the regulation of business. Your friend asks for your advice.

You are therefore asked to develop the strongest reasons for supporting one of the following two possible responses:

Affirmative Position

Jane should vote for the Democratic candidate.

Possible Arguments:

- It is better to maintain tight regulation of businesses and corporations, given their propensity to cause or contribute to social harms.
- Corporations are able to lobby governments to shield themselves from regulation.
- Corporations are able to attain more power and influence than citizens.

Negative Position

Jane should vote for the Republican candidate.

Possible Arguments:

- It is better to liberate businesses and corporations from onerous and expensive government regulation.
- Corporations are major employers and job-creators.
- Corporations can undertake enormous projects beyond the scope of small business or individuals.
- Corporations stimulate research and innovation.

Readings

The readings below are meant only to stimulate your thinking about possible perspectives to take on corporations. Please supplement them with your own research.

1.1 The Corporation as a "Psychopathic" Creature

Bakan, Joel. "Business as Usual," in The Corporation: The Pathological Pursuit of Profit and Power, 28-59. New York: Simon and Schuster, 2004.

Bakan, Joel. "The Externalizing Machine," in The Corporation: The Pathological Pursuit of Profit and Power, 60-84. New York: Simon and Schuster, 2004.

Business leaders today say their companies care about more than profit or loss, that they feel responsible to society as a whole, not just to their shareholders. Corporate social responsibility is their new creed, a self-conscious corrective to earlier greed-inspired visions of the corporation. Despite this shift, the corporation itself has not changed. It remains, as it was at the time of its origins as a modern business institution in the middle of the nineteenth century, a legally designated "person" designed to valorize self-interest and invalidate moral concern. Most people would find its "personality" abhorrent, even psychopathic, in a human being, yet curiously we accept it in society's most powerful institution. The troubles on Wall Street today, beginning with Enron's spectacular crash, can be blamed in part on the corporation's flawed institutional character, but the company was not unique for having that character. Indeed, all publicly traded corporations have it, even the most respected and socially acceptable….

As a psychopathic creature, the corporation can neither recognize nor act upon moral reasons to refrain from harming others. Nothing in its legal makeup limits what it can do to others in pursuit of its selfish ends, and it is compelled to cause harm when the benefits of doing so outweigh the costs. Only pragmatic concern for its own interests and the laws of the land constrain the corporation's predatory instincts, and often that is not enough to stop it from destroying lives, damaging communities, and endangering the planet as a whole…. Far less exceptional in the world of the corporation are the routine and regular harms caused to others—workers, consumers, communities, the environment—by corporation's psychopathic tendencies. These tend to be viewed as inevitable and acceptable consequences of corporate activity—"externalities" in the coolly technical jargon of economics.

“An externality,” says economist Milton Friedman, “is the effect of a transaction…on a third party who has not consented to or played any role in the carrying out of that transaction.” All the bad things that happen to people and the environment as a result of corporations’ relentless and legally compelled pursuit of self-interest are thus neatly categorized by economists as externalities—literally, other people’s problems.

1.2 “EPA Costs US Economy $353 Billion per Year”

Young, Ryan. “EPA costs US economy $353 billion per year.” The Daily Caller. Last modified December 27, 2012. http://dailycaller.com/2012/12/27/epa-costs-us-economy-353-billion-per-year/ .

Transparency is the lifeblood of democracy. Washington needs more of it, especially in the all-too-opaque world of regulation. The Environmental Protection Agency (EPA), for example, is the most expensive federal regulatory agency. Its annual budget is fairly modest in Beltway terms, at a little less than $11 billion, but that’s not where the vast majority of its costs come from. Complying with EPA regulations costs the US economy $353 billion per year—more than 30 times its budget—according to the best available estimate. By way of comparison, that is more than the entire 2011 national GDPs of Denmark ($332 billion) and Thailand ($345 billion)…

In the last edition of the Unified Agenda, the fall 2011 edition, the EPA had 318 rules at various stages of the regulatory process. Nobody outside the agency knows how many rules it currently has in the pipeline. All in all, 4,995 EPA rules appeared in the Winter Unified Agenda from 1999–2011. Over the same period, 7,161 EPA final rules were published in the *Federal Register*. That means more than 2,000 final rules, which have the force of law, came into effect without first appearing in the Unified Agenda. This could indicate an important transparency problem.

That’s just the EPA’s *annual* flow of regulations. The agency has existed for more than 40 years. How many total rules does it currently have in effect? Again, the answer doesn’t come from the agency. Earlier this year, the Mercatus Center’s Omar Al-Ubaydli and Patrick A. McLaughlin ran text searches through the entire *Code of Federal Regulations* (CFR) for terms such as “shall,” “must,” “prohibited,” and the like. The CFR Title covering environmental protection alone contains at least 88,852 specific regulatory restrictions. The number could be as high as 154,350….

Justice Louis Brandeis correctly believed that sunshine is the best disinfectant. With high regulatory costs contributing to a stagnant economic recovery, it is well past time to shine more light on regulatory agencies. Annual agency report cards would make a good start.

1.3 Press Release from the US Consumer Product Safety Commission

Consumer Product Safety Commission. “Port Surveillance News: CPSC Investigators Find, Stop Nearly 650,000 Unsafe Products at the Start of Fiscal Year 2012.” News Release. April 5, 2012. https://www.cpsc.gov/en/Newsroom/News-Releases/2012/Port-Surveillance-News-CPSC-Investigators-Find-Stop-Nearly-650000-Unsafe-Products-at-the-Start-of-Fiscal-Year-2012/.

Investigators Stop Nearly 650,000 Unsafe Products

Investigators with the US Consumer Product Safety Commission (CPSC) prevented more than half a million violative and hazardous imported products from reaching the hands of consumers in the first quarter of fiscal year 2012.

Working with US Customs and Border Protection (CBP) agents, CPSC port investigators successfully identified consumer products that were in violation of US safety rules or found to be unsafe. CPSC and CBP teamed up to screen more than 2,900 imported shipments at ports of entry into the United States. As applicable, these screenings involved use and abuse testing or the use of an X-ray fluorescence (XRF) analyzer. Their efforts prevented more than 647,000 units of about 240 different non-complying products from reaching consumers, between October 1, 2011 and December 31, 2011.

Topping the list of products stopped were children’s products containing levels of lead exceeding the federal limits, toys and other articles with small parts that present a choking hazard for children younger than 3 years old, and toys and child-care articles with banned phthalates.

In addition to violative toys and other children’s products, items stopped at import included defective and dangerous hair dryers, lamps, and holiday lights.

“We mean business when it comes to enforcing some of the toughest requirements for children’s products in the world. If an imported product fails to comply with our safety rules, then we work to stop it from coming into the United States,” said Chairman Inez Tenenbaum. “Safer products at the ports means safer products in your home.”

During fiscal year 2011, CPSC inspected more than 9,900 product shipments at the ports nationwide and stopped almost 4.5 million units of violative or hazardous consumer products from entering the stores and homes of US consumers.

CPSC has been screening products at ports since it began operating in 1973. In 2008, the agency intensified its efforts with the creation of an import surveillance division.

1.4 "Costs of Air Pollution in the U.S."

Taylor, Timothy. "Costs of Air Pollution in the U.S.," *Conversable Economist* (blog), November 7, 2011, http://conversableeconomist.blogspot.com/2011/11/costs-of-air-pollution-in-us.html.

What costs does air pollution impose on the U.S. economy? Nicholas Z. Muller, Robert Mendelsohn, and William Nordhaus tackle that question in the August 2011 issue of the *American Economic Review*. Total "gross external damages" the six "criterion" air pollutants in 2002—sulfur dioxide, nitrogen oxides, volatile organic compounds, ammonia, fine particulate matter, and coarse particulate matter—was $182 billion.

Since GDP was about $10.5 trillion in 2002, the cost of air pollution was a bit under 2% of the total. The effects included in the model calculations are adverse consequences for human health, decreased timber and agriculture yields, reduced visibility, accelerated depreciation of materials, and reductions in recreation services.

The sectors with the biggest air pollution costs measured in terms of "gross external damages" (GED) (counting the same six pollutants but again not counting carbon emissions) are utilities, agriculture/forestry, transportation, and manufacturing.

If one looks at the ratio of gross economic damages to value-added in the sector, agriculture/forestry and utilities lead the way by far with ratios above one-third. Manufacturing has fairly high gross external damages, but the GED/VA ratio for the sector as a whole is only 0.01.

To me, a lesson that emerges from these calculations is that the costs of air pollution and of burning fossil fuels are very high, both in absolute terms and compared to the value-added of certain industries, even without taking carbon emissions into account. Environmentalists who are discouraged by their inability to persuade more people of the risks of climate change might have more luck in reducing carbon emissions if they deemphasized that topic—and instead focused on the costs of these old-fashioned pollutants.

1.5 "Over-Regulated America"

"Over-regulated America: The home of laissez-faire is being suffocated by excessive and badly written regulation." The Economist. Last modified February 8, 2012. http://www.economist.com/node/21547789 .

Synthesis Questions

The most productive discussions and debates are those that open our eyes to different perspectives and different ways of thinking. While we may not change our initial opinions, we may emerge with an enhanced understanding of the perspectives of others, or of the complexity of a particular issue.

So we suggest that at the end of each chapter you answer a few questions in a way that allows you to "synthesize" your discussions and readings—by bringing together the strongest parts of each side of the argument—so as to arrive at a deeper, more nuanced understanding of the issues involved.

Clearly, the ethical role of corporations is a vast, complex topic and allows for a great diversity of opinions. Here are three initial synthesis questions for further reflection:

Synthesis Questions

1. Are corporations on the whole good for society?
2. Do you personally like or distrust corporations? Why?
3. How should society regulate corporations?

Endnotes

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2. Vincett Trivett, “25 US Mega Corporations: Where They Rank If They Were Countries,” *Business Insider*, June 27, 2011, accessed December 6, 2014, http://www.businessinsider.com/25-corporations-bigger-tan-countries-2011-6?op=1.

3. Steven Pearlstein, “Two Can Play the Airline Bankruptcy Game,” *Washington Post*, 28 April 2012, accessed November 28, 2014, www.washingtonpost.com/business/steven-pearlstein-two-can-play-the-airline-bankruptcy-game/2012/04/27/gIQAJ239nT_story.html.

4. “The Estee Lauder Companies Breast Cancer Awareness Campaign,” accessed November 28, 2014, bcacampaign.com/.

5. “Norway Outlaws ‘Green’ Cars,” *TerraPass*, September 11, 2007, accessed December 6, 2014, terrapass.com/politics/norway-outlaws/.

6. US Senator Patrick Leahy, “The Greenwashing of the Bush Anti-Environmental Record on the President’s Earth Day Visits to Maine and Florida,” (statement on the Senate floor, Washington, DC, April 26, 2004).

7. See Sebastian Bailey, “Business Leaders Beware: Ethical Drift Makes Standards Slip,” *Forbes*, May 15, 2013, accessed December 6, 2014, http://www.forbes.com/sites/sebastianbailey/2013/05/15/business-leaders-beware-ethical-drift-makes-standards-slip/.

6.3: What is Importing and Exporting?

Learning Objectives

1. Understand what importing and exporting are.
2. Learn why companies export.
3. Explain the main contractual and investment entry modes.

What Do We Mean by Exporting and Importing?

The history of importing and exporting dates back to the Roman Empire, when European and Asian traders imported and exported goods across the vast lands of Eurasia. Trading along the **Silk Road** flourished during the thirteenth and fourteenth centuries.Jack Goldstone, *Why Europe? The Rise of the West in World History 1500–1850* (New York: McGraw-Hill, 2008). Caravans laden with imports from China and India came over the desert to Constantinople and Alexandria. From there, Italian ships transported the goods to European ports.J. O. Swahn, *The Lore of Spices* (Gothenburg, Sweden: Nordbok, 1991), 15–17.

For centuries, importing and exporting has often involved intermediaries, due in part to the long distances traveled and different native languages spoken. The spice trade of the 1400s was no exception. Spices were very much in demand because Europeans had no refrigeration, which meant they had to preserve meat using large amounts of salt or risk eating half-rotten flesh. Spices disguised the otherwise poor flavor of the meat. Europeans also used spices as medicines. The European demand for spices gave rise to the spice trade.Antony Wild, *The East India Company: Trade and Conquest from 1600* (Guilford, CT: Lyons Press, 2000). The trouble was that spices were difficult to obtain because they grew in jungles half a world away from Europe. The overland journey to the spice-rich lands was arduous and involved many middlemen along the way. Each middleman charged a fee and thus raised the price of the spice at each point. By the end of the journey, the price of the spice was inflated 1,000 percent.Jack Turner, *Spice: The History of a Temptation* (Westminster, MD: Alfred A. Knopf, 2004), 5.

As explained in Chapter 8, **exporting** is defined as the sale of products and services in foreign countries that are sourced or made in the home country. Importing is the flipside of exporting. **Importing** refers to buying goods and services from foreign sources and bringing them back into the home country. Importing is also known as global sourcing, which will be examined in depth in Section 9.4.

An Entrepreneur's Import Success Story

Selena Cuffe started her wine import company, Heritage Link Brands, in 2005. Importing wine isn't new, but Cuffe did it with a twist: she focused on importing wine produced by black South Africans. Cuffe got the idea after attending a wine festival in Soweto, where she saw more than five hundred wines from eighty-six producers showcased.Selena Cuffe's bio, African-American Chamber of Greater Cincinnati / Greater Kentucky, accessed September 4, 2010, african-americanchamber.com/view-user-profile/selena-cuffe.html. Cuffe did some market research and learned of the $3 billion wine industry in Africa. She also saw a gap in the existing market related to wine produced by indigenous African vintners and decided to fill it. She started her company with $70,000, financed through her savings and credit cards. (In Section 9.5, you'll learn about other sources of financing available to entrepreneurs and small businesses as well as to larger enterprises.) In the first year, sales were only $100,000 but then jumped to $1 million in the second year, when Cuffe sold to more than one thousand restaurants, retailers, and grocery stores.South African Chamber of Commerce in America, "Heritage Link Brands, Connecting U.S. Palates to African Wines," profile, May 4, 2010, accessed September 4, 2010, www.sacca.biz/?m=5&idkey=637. Even better, American Airlines began carrying Cuffe's imported wines on flights, thus providing a steady flow of business amid the more uncertain restaurant market.American Airlines, "Serving Up Wines That Invest in Our Communities," American Airlines Corporate Responsibility page, accessed September 4, 2010, www.aa.com/i18n/aboutUs/corporateResponsibility/caseLibrary/supporting-our-communities.jsp. Cuffe has attributed her success to passion as well as to patience for meeting the multiple regulations required when running an import business.Maritza Manresa, *How to Open and Operate a Financially Successful Import Export Business* (Ocala, FL: Atlantic Publishing, 2010), 101. (You'll learn more about these regulations in Section 9.4).

Exporting is an effective entry strategy for companies that are just beginning to enter a new foreign market. It's a low-cost, low-risk option compared to the other strategies. These same reasons make exporting a good strategy for small and midsize companies that can't or won't make significant financial investment in the international market.

Companies can sell into a foreign country either through a local distributor or through their own salespeople. Many government export-trade offices can help a company find a local distributor. Increasingly, the Internet has provided a more efficient way for foreign companies to find local distributors and enter into commercial transactions.

Distributors are export intermediaries who represent the company in the foreign market. Often, distributors represent many companies, acting as the "face" of the company in that country, selling products, providing customer service, and receiving payments. In many cases, the distributors take title to the goods and then resell them. Companies use distributors because distributors know the local market and are a cost-effective way to enter that market.

However, using distributors to help with export can have its own challenges. For example, some companies find that if they have a dedicated salesperson who travels frequently to the country, they're likely to get more sales than by relying solely on the distributor. Often, that's because distributors sell multiple products and sometimes even competing ones. Making sure that the distributor favors one firm's product over another product can be hard to monitor. In countries like China, some companies find that —culturally—Chinese consumers may be more likely to buy a product from a foreign company than from a local distributor, particularly in the case of a complicated, high-tech product. Simply put, the Chinese are more likely to trust that the overseas salesperson knows their product better.

Why Do Companies Export?

Companies export because it's the easiest way to participate in global trade, it's a less costly investment than the other entry strategies, and it's much easier to simply stop exporting than it is to extricate oneself from the other entry modes. An export partner in the form of either a distributor or an export management company can facilitate this process. An **export management company (EMC)** is an independent company that performs the duties that a firm's own export department would execute. The EMC handles the necessary documentation, finds buyers for the export, and takes title of the goods for direct export. In return, the EMC charges a fee or commission for its services. Because an EMC performs all the functions that a firm's export department would, the firm doesn't have to develop these internal capabilities. Most of all, exporting gives a company quick access to new markets.

Benefits of Exporting: Vitrac

Egyptian company Vitrac was founded by Mounir Fakhry Abdel Nour to take advantage of Egypt's surplus fruit products. At its inception, Vitrac sourced local fruit, made it into jam, and exported it worldwide. Vitrac has acquired money, market, and manufacturing advantages from exporting:Japan External Trade Organization, "Big in Japan," case study, accessed August 27, 2010, www.jetro.go.jp/en/reports/.

- **Market.** The company has access to a new market, which has brought added revenues.
- **Money.** Not only has Vitrac earned more revenue, but it has also gained access to foreign currency, which benefits companies located in certain regions of the world, such as in Vitrac's home country of Egypt.
- **Manufacturing.** The cost to manufacture a given unit decreased because Vitrac has been able to manufacture at higher volumes and buy source materials in higher volumes, thus benefitting from volume discounts.

Risks of Exporting

There are risks in relying on the export option. If you merely export to a country, the distributor or buyer might switch to or at least threaten to switch to a cheaper supplier in order to get a better price. Or someone might start making the product locally and take the market from you. Also, local buyers sometimes believe that a company which only exports to them isn't very committed to providing long-term service and support once a sale is complete. Thus, they may prefer to buy from someone who's producing directly within the country. At this point, many companies begin to reconsider having a local presence, which moves them toward one of the other entry options.

Ethics in Action

Different Countries, Different Food and Drug Rules

Particular products, especially foods and drugs, are often subject to local laws regarding safety, purity, packaging, labeling, and so on. Companies that want to make a product that can be sold in multiple countries will have to comply with the highest common denominator of all the laws of all the target markets. Complying with the highest standard could increase the overall cost of the product. As a result, some companies opt to stay out of markets where compliance with the regulation would be more costly. Is it ethical to be selling a product in one country that another country deems substandard?

Specialized Entry Modes: Contractual

Exporting is a easy way to enter an international market. In addition to exporting, companies can choose to pursue more specialized modes of entry—namely, contracutal modes or investment modes. Contractual modes involve the use of contracts rather than investment. Let's look at the two main contractual entry modes, licensing and franchsing.

Licensing

Licensing is defined as the granting of permission by the licenser to the licensee to use intellectual property rights, such as trademarks, patents, brand names, or technology, under defined conditions. The possibility of licensing makes for a flatter world, because it creates a legal vehicle for taking a product or service delivered in one country and providing a nearly identical version of that product or service in another country. Under a licensing agreement, the multinational firm grants rights on its intangible property to a foreign company for a specified period of time. The licenser is normally paid a royalty on each unit produced and sold. Although the multinational firm usually has no ownership interests, it often provides ongoing support and advice. Most companies consider this market-entry option of licensing to be a low-risk option because there's typically no up-front investment.

For a multinational firm, the advantage of licensing is that the company's products will be manufactured and made available for sale in the foreign country (or countries) where the product or service is licensed. The multinational firm doesn't have to expend its own resources to manufacture, market, or distribute the goods. This low cost, of course, is coupled with lower potential returns, because the revenues are shared between the parties.

Franchising

Similar to a licensing agreement, under a **franchising** agreement, the multinational firm grants rights on its intangible property, like technology or a brand name, to a foreign company for a specified period of time and receives a royalty in return. The difference is that the franchiser provides a bundle of services and products to the franchisee. For example, McDonald's expands overseas through franchises. Each franchise pays McDonald's a franchisee fee and a percentage of its sales and is required to purchase certain products from the franchiser. In return, the franchisee gets access to all of McDonald's products, systems, services, and management expertise.

Specialized Entry Modes: Investment

Beyond contractual relationships, firms can also enter a foreign market through one of two investment strategies: a joint venture or a wholly owned subsidiary.

Joint Ventures

An **equity joint venture** is a contractual, strategic partnership between two or more separate business entities to pursue a business opportunity together. The partners in an equity joint venture each contribute capital and resources in exchange for an equity stake and share in any resulting profits. (In a nonentity joint venture, there is no contribution of capital to form a new entity.)

To see how an equity joint venture works, let's return to the example of Egyptian company, Vitrac. Mounir Fakhry Abdel Nour founded his jam company to take advantage of Egypt's surplus fruit products. Abdel Nour initially approached the French jam company, Vitrac, to enter into a joint venture with his newly founded company, VitracEgypt. Abdel Nour supplied the fruit and the markets, while his French partner supplied the technology and know-how for producing jams.

In addition to exporting to Australia, the United States, and the Middle East, Vitrac began exporting to Japan. Sales results from Japan indicated a high demand for blueberry jam. To meet this demand—in an interesting twist, given Vitrac's origin—Vitrac had to import blueberries from Canada. Vitrac thus was importing blueberries from Canada, manufacturing the jam in Egypt, and exporting it to Japan.Japan External Trade Organization, "Big in Japan," case study, accessed August 27, 2010, www.jetro.go.jp/en/reports/.

Using French Vitrac's manufacturing know-how, Abdel Nour had found a new supply and the opportunity to enter new markets with it, thus expanding his partner's reach. The partnership fit was good. The two companies' joint venture continued for three years, until the French company sold its shares to Abdel Nour, making Vitrac a 100 percent owned and operated Egyptian company. Abdel Nour's company reached $22 million in sales and was the Egyptian jam-market leader before being bought by a larger Swiss company, Hero."Egypt/Switzerland: Hero Acquires Egyptian Jam Market Leader," *Just-Food*, October 8, 2002, accessed September 5, 2010, www.just-food.com/news/hero-acquires-egyptian-jam-market-leader_id69297.aspx.

Risks of Joint Ventures

Equity joint ventures pose both opportunities and challenges for the companies involved. First and foremost is the challenge of finding the right partner—not just in terms of business focus but also in terms of compatible cultural perspectives and management practices.

Second, the local partner may gain the know-how to produce its own competitive product or service to rival the multinational firm. This is what's currently happening in China. To manufacture cars in China, non-Chinese companies must set up joint ventures with Chinese automakers and share technology with them. Once the contract ends, however, the local company may take the knowledge it gained from the joint venture to compete with its former partner. For example, Shanghai Automotive Industry (Group) Corporation, which worked with General Motors (GM) to build Chevrolets, has plans to increase sales of its own vehicles tenfold to 300,000 in five years and to compete directly with its former partner.Ian Rowley, "Chinese Carmakers Are Gaining at Home," *BusinessWeek*, June 8, 2009, 30–31.

Did You Know?

In the past, joint ventures were the only relationship foreign companies could form with Chinese companies. In fact, prior to 1986, foreign companies could not wholly own a local subsidiary. The Chinese government began to allow equity joint ventures in 1979, which marked the beginning of the Open Door Policy, an economic liberalization initiative. The Chinese government strongly encouraged equity joint ventures as a way to gain access to the technology, capital, equipment, and know-how of foreign companies. The risk to the foreign company was that if the venture soured, the Chinese company could end up keeping all of these assets. Often, Chinese companies only contributed things like land or tax concessions that foreign companies couldn't keep if the venture ended. As of 2010, equity joint ventures between a Chinese company and a foreign partner require a minimum equity investment by the foreign partner of at least 33 to 70 percent of the equity, but there's no minimum investment set for the Chinese partner.Atma Global Knowledge Media, "Entry Models into the Chinese Market," CultureQuest 2003.

Wholly Owned Subsidiaries

Firms may want to have a direct operating presence in the foreign country, completely under their control. To achieve this, the company can establish a new, wholly owned subsidiary (i.e., a greenfield venture) from scratch, or it can purchase an existing company in that country. Some companies purchase their resellers or early partners (as VitracEgypt did when it bought out the shares that its partner, Vitrac, owned in the equity joint venture). Other companies may purchase a local supplier for direct control of the supply. This is known as vertical integration.

Establishing or purchasing a wholly owned subsidiary requires the highest commitment on the part of the international firm, because the firm must assume all of the risk—financial, currency, economic, and political.

Did You Know?

McDonald's has a plant in Italy that supplies all the buns for McDonald's restaurants in Italy, Greece, and Malta. International sales has accounted for as much as 60 percent of McDonald's annual revenue.Annual revenue in 2008 was $23.5 billion, of which 60 percent was international. See Suzanne Kapner, "Making Dough," *Fortune*, August 17, 2009, 14.

Cautions When Purchasing an Existing Foreign Enterprise

As we've seen, some companies opt to purchase an existing company in the foreign country outright as a way to get into a foreign market quickly. When making an acquisition, due diligence is important—not only on the financial side but also on the side of the country's culture and business practices. The annual disposable income in Russia, for example, exceeds that of all the other BRIC countries (i.e., Brazil, India, and China). For many major companies, Russia is too big and too rich to ignore as a market. However, Russia also has a reputation for corruption and red tape that even its highest-ranking officials admit. Presidential economic advisor Arkady Dvorkovich (whose office in the Kremlin was once occupied by Soviet leader Leonid Brezhnev), for example, advises, "Investors should choose wisely" which regions of Russia they locate their business in, warning that some areas are more corrupt than others.Carol Matlack, "The Peril and Promise of Investing in Russia," *BusinessWeek*, October 5, 2009, 48–51. Corruption makes the world less flat precisely because it undermines the viability of legal vehicles, such as licensing, which otherwise lead to a flatter world.

The culture of corruption is even embedded into some Russian company structures. In the 1990s, laws inadvertently encouraged Russian firms to establish legal headquarters in offshore tax havens, like Cyprus. A **tax haven** is a country that has very advantageous (low) corporate income taxes.

Businesses registered in these offshore tax havens to avoid certain Russian taxes. Even though companies could obtain a refund on these taxes from the Russian government, "the procedure is so complicated you never actually get a refund," said Andrey Pozdnyakov, cofounder of Siberian-based Elecard.Carol Matlack, "The Peril and Promise of Investing in Russia," *BusinessWeek*, October 5, 2009, 48–51.

This offshore registration, unfortunately, is a danger sign to potential investors like Intel. "We can't invest in companies that have even a slight shadow," said Intel's Moscow-based regional director Dmitry Konash about the complex structure predicament.Carol Matlack, "The Peril and Promise of Investing in Russia," *BusinessWeek*, October 5, 2009, 48–51.

Did You Know?

Some foreign companies believe that owning their own operations in China is an easier option than having to deal with a Chinese partner. For example, many foreign companies still fear that their Chinese partners will learn too much from them and become competitors. However, in most cases, the Chinese partner knows the local culture—both that of the customers and workers—and is better equipped to deal with Chinese bureaucracy and regulations. In addition, even wholly owned subsidiaries can't be totally independent of Chinese firms, on whom they might have to rely for raw materials and shipping as well as maintenance of government contracts and distribution channels.

Collaborations offer different kinds of opportunities and challenges than self-handling Chinese operations. For most companies, the local nuances of the Chinese market make some form of collaboration desirable. The companies that opt to self-handle their Chinese operations tend to be very large and/or have a proprietary technology base, such as high-tech or aerospace companies—for example, Boeing or Microsoft. Even then, these companies tend to hire senior Chinese managers and consultants to facilitate their market entry and then help manage their expansion. Nevertheless, navigating the local Chinese bureaucracy is tough, even for the most-experienced companies.

Let's take a deeper look at one company's entry path and its wholly owned subsidiary in China. Embraer is the largest aircraft maker in Brazil and one of the largest in the world. Embraer chose to enter China as its first foreign market, using the joint-venture entry mode. In 2003, Embraer and the Aviation Industry Corporation of China jointly started the Harbin Embraer Aircraft Industry. A year later, Harbin Embraer began manufacturing aircraft.

In 2010, Embraer announced the opening of its first subsidiary in China. The subsidiary, called Embraer China Aircraft Technical Services Co. Ltd., will provide logistics and spare-parts sales, as well as consulting services regarding technical issues and flight operations, for Embraer aircraft in China (both for existing aircraft and those on order). Embraer will invest $18 million into the subsidiary with a goal of strengthening its local customer support, given the steady growth of its business in China.

Guan Dongyuan, president of Embraer China and CEO of the subsidiary, said the establishment of Embraer China Aircraft Technical Services demonstrates the company's "long-term commitment and confidence in the growing Chinese aviation market."United Press International, "Brazil's Embraer Expands Aircraft Business into China," July 7, 2010, accessed August 27, 2010, http://www.upi.com/Business_News/2010/07/07/Brazils-Embraer-expands-aircraft-business-into-China/UPI-10511278532701.

Building Long-Term Relationships

Developing a good relationship with regulators in target countries helps with the long-term entry strategy. Building these relationships may include keeping people in the countries long enough to form good ties, since a deal negotiated with one person may fall apart if that person returns too quickly to headquarters.

Did You Know?

One of the most important cultural factors in China is *guanxi* (pronounced *guan shi*), which is loosely defined as a connection based on reciprocity. Even when just meeting a new company or potential partner, it's best to have an introduction from a common business partner, vendor, or supplier—someone the Chinese will respect. China is a relationship-based society. Relationships extend well beyond the personal side and can drive business as well. With guanxi, a person invests with relationships much like one would invest with capital. In a sense, it's akin to the Western phrase "You owe me one."

Guanxi can potentially be beneficial or harmful. At its best, it can help foster strong, harmonious relationships with corporate and government contacts. At its worst, it can encourage bribery and corruption. Whatever the case, companies without guanxi won't accomplish much in the Chinese market. Many companies address this need by entering into the Chinese market in a collaborative arrangement with a local Chinese company. This entry option has also been a useful way to circumvent regulations governing bribery and corruption, but it can raise ethical questions, particularly for American and Western companies that have a different cultural perspective on gift giving and bribery.

Conclusion

In summary, when deciding which mode of entry to choose, companies should ask themselves two key questions:

1. How much of our resources are we willing to commit? The fewer the resources (i.e., money, time, and expertise) the company wants (or can afford) to devote, the better it is for the company to enter the foreign market on a contractual basis—through licensing, franchising, management contracts, or turnkey projects.
2. How much control do we wish to retain? The more control a company wants, the better off it is establishing or buying a wholly owned subsidiary or, at least, entering via a joint venture with carefully delineated responsibilities and accountabilities between the partner companies.

Regardless of which entry strategy a company chooses, several factors are always important.

- **Cultural and linguistic differences.** These affect all relationships and interactions inside the company, with customers, and with the government. Understanding the local business culture is critical to success.
- **Quality and training of local contacts and/or employees.** Evaluating skill sets and then determining if the local staff is qualified is a key factor for success.
- **Political and economic issues.** Policy can change frequently, and companies need to determine what level of investment they're willing to make, what's required to make this investment, and how much of their earnings they can repatriate.
- **Experience of the partner company.** Assessing the experience of the partner company in the market—with the product and in dealing with foreign companies—is essential in selecting the right local partner.

Companies seeking to enter a foreign market need to do the following:

- Research the foreign market thoroughly and learn about the country and its culture.
- Understand the unique business and regulatory relationships that impact their industry.
- Use the Internet to identify and communicate with appropriate foreign trade corporations in the country or with their own government's embassy in that country. Each embassy has its own trade and commercial desk. For example, the US Embassy has a foreign commercial desk with officers who assist US companies on how best to enter the local market. These resources are best for smaller companies. Larger companies, with more money and resources, usually hire top consultants to do this for them. They're also able to have a dedicated team assigned to the foreign country that can travel the country frequently for the later-stage entry strategies that involve investment.

Once a company has decided to enter the foreign market, it needs to spend some time learning about the local business culture and how to operate within it.

KEY TAKEAWAYS

- Exporting is the sale of products and services in foreign countries that are sourced or made in the home country. Importing refers to buying goods and services from foreign sources and bringing them back into the home country.
- Companies export because it's the easiest way to participate in global trade, it's a less costly investment than the other entry strategies, and it's much easier to simply stop exporting than it is to extricate oneself from the other entry modes. The benefits of exporting include access to new markets and revenues as well as lower manufacturing costs due to higher manufacturing volumes.
- Contractual forms of entry (i.e., licensing and franchising) have lower up-front costs than investment modes do. It's also easier for the company to extricate itself from the situation if the results aren't favorable. On the other hand, investment modes (joint ventures and wholly owned subsidiaries) may bring the company higher returns and a deeper knowledge of the country.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What are the risks and benefits associated with exporting?
2. Name two contractual modes of entry into a foreign country. Which do you think is better and why?
3. Why would a company choose to use a contractual mode of entry rather than an investment mode?
4. What are the advantages to a company using a joint venture rather than buying or creating its own wholly owned subsidiary when entering a new international market?

6.4: Global Sourcing and Its Role in Business

Learning Objectives

1. Identify what global sourcing is.
2. Learn what comprises the best practices in global sourcing.
3. Recognize the difference between outsourcing and global sourcing.

What Is Global Sourcing?

Global sourcing refers to buying the raw materials, components, or services from companies outside the home country. In a flat world, raw materials are sourced from wherever they can be obtained for the cheapest price (including transportation costs) and the highest comparable quality.

Recall the discussion of the spice trade in Section 9.1. Europeans sourced spices from China and India. The long overland trade routes required many payments to intermediaries and local rulers, raising prices of spices 1,000 percent by the end of the journey. Such a markup naturally spurred Europeans to look for other trade routes and sources of spices. The desire for spices and gold is what ultimately led Christopher Columbus to secure funding for his voyage across the Atlantic Ocean. Even before that, Portuguese ships were sailing down the coast of Africa. In the 1480s, Portuguese ships were returning to Europe laden with African melegueta pepper. This pepper was inferior to the Far Eastern varieties, but it was much cheaper. By 1500, pepper prices dropped by 25 percent due to the new sources of supply.Edwin S. Hunt and James M. Murray, *A History of Business in Medieval Europe, 1200–1550* (Cambridge, UK: Cambridge University Press, 1999), 229.

Today, the pattern of global sourcing continues as a way to obtain commodities and raw materials. But sourcing now is much more expanded; it includes the sourcing of components, of complete manufactured products, and of services as well.

There are many companies that export to a country while sourcing from that same country. For example, Apple sells iPods and iPads to China, and it also manufactures and sources components in China.

Best Practices in Global Sourcing

Given the challenges of global sourcing, large companies often have a staff devoted to overseeing the company's overseas sourcing process and suppliers, managing the relationships, and handling legal, tax and administrative issues.

Judging Quality from Afar: ISO 9000 Certification

How can companies know that the products or services they're sourcing from a foreign country are of good quality? The mark of good quality around the world is ISO 9000 certification. In 1987, the International Organization of Standardization (ISO) developed uniform standards for quality guidelines. Prior to December 2000, three ISO standards were used: ISO 9001, ISO 9002, and ISO 9003. These standards were collectively referred to as ISO 9000. In 2000, the standards were merged into a revised ISO 9001 standard named ISO 9001:2000. In 2008, a new revision was issued, ISO 9001:2008. The standards are voluntary, but companies can demonstrate their compliance with the standard by passing certification. (Companies that had achieved ISO 9001:2000 certification were required to be recertified to meet ISO 9001:2008 standards.) The certification is a mark that the company's products and services have met quality standards and that the company has quality management processes in place. Companies of any size can get certified. To ensure high-quality products, some companies require that their suppliers be certified before they will source products or services from them. ISO 9001:2008 certification is a "seal of quality" that is trusted around the world.

In addition to quality standards, ISO also developed ISO 14000 standards, which focus on the environment. Specifically, ISO 14000 certification shows that the company works to minimize any harmful effects it may have on the environment.

Over the years, companies have learned to manage for quality and consistency.

- Companies can use unannounced inspections to verify that their suppliers meet quality-assurance standards (although this is costly when suppliers are far away).
- For consistency, to avoid disruption in getting goods, Walmart makes sure that no supplier does more than 25 percent of their business with Walmart.

- Companies can evaluate supplier performance. Cost isn't everything. Many companies use scorecards to evaluate suppliers from whom they source components. Cost is part of the scorecard, of course, but often it represents only part of the evaluation, not all of it. Instead, companies look at issues such as supply continuity, as well as whether the relationship is based on openness and trust.

Trends in Sourcing: Considering Carbon Costs

One of the rising concerns about global sourcing is that of the carbon footprint of goods traveling long distances. A **carbon footprint** is a measure of the impact that activities like transportation and manufacturing have on the environment, especially on climate change. (The "footprint" is the impact, and "carbon" is shorthand for all the different greenhouse gases that contribute to global warming.Mike Berners-Lee and Duncan Clark, "What Is a Carbon Footprint?," *Green Living Blog*, *Guardian*, June 4, 2010, accessed September 12, 2010, http://www.guardian.co.uk/environment/blog/2010/jun/04/carbon-footprint-definition.) Everyone's daily activities, such as using electricity or driving, have a carbon footprint because of the greenhouse gases produced by burning fossil fuels for electricity, heating, transportation, and so on. The higher the carbon footprint, the worse the activity is for the environment.

In global sourcing, although transporting goods by air and truck has a high carbon footprint due to the fossil fuels burned, ocean transport doesn't. Also, the carbon-footprint measure doesn't just focus on distance; it looks at all the fossil fuels used in the manufacture of an item. For example, when one looks at the total picture of how much energy is required to make a product, the carbon footprint of transportation may be less than the carbon footprint of the manufacturing process. Some regions have natural advantages. For example, it is more environmentally friendly to smelt aluminum in Iceland than locally because of the tremendous amount of electricity required for smelting. Iceland has abundant geothermal energy, which has no carbon footprint compared to generating electricity by burning coal. It's better for the environment to smelt the aluminum in Iceland and then ship it elsewhere.

Similarly, it is more environmentally sound for people in the United Kingdom to buy virgin wood from Sweden than to buy recycled paper made in the United Kingdom. Why? Sweden uses nuclear energy to make paper, which has a much lower carbon footprint than electricity in the United Kingdom, which is generated by burning coal. Even though the paper is recycled, the electricity costs of recycling make it more harmful to the environment.

Perhaps one of the most-effective changes companies can make to help the environment is to work collaboratively with their trading partners. For example, an agreement between potato-chip manufacturers and potato suppliers eliminated wasted resources. Specifically, the physics of frying potato chips requires boiling off the water in the potato, which consumes a large amount of energy. Although boiling off the water would seem to be a requirement in the cooking process, UK-based Carbon Trust discovered a man-made practice that increased these costs. Potato-chip manufacturers buy potatoes by weight. Potato suppliers, to get the most for their potatoes, soak the potatoes in water to boost their weight, thus adding unnecessary water that has to be boiled off. By changing the contracts so that suppliers are paid more for less-soggy potatoes, suppliers had an incentive to use less water, chip makers needed to expend less energy to boil off less water, and the environment benefited from less water and energy waste. These changes had a much more beneficial impact on the environment than would have been gained by a change in transportation.MIT Center for Transportation and Logistics and Council of Supply Chain Management Professionals, "Achieving the Energy-Efficient Supply Chain" (symposium, Royal Sonesta Hotel, Cambridge, MA, April 30, 2007).

Outsourcing versus Global Sourcing

In **outsourcing**, the company delegates an entire process (e.g., accounts payable) to an outsource vendor. The vendor takes control of the operation and runs the operation as it sees fit. The company pays the outsource vendor for the end result; how the vendor achieves those end results is up to the vendor.

Companies outsource for numerous reasons. There are many advantages to outsourcing:

- Reducing costs by moving labor to a lower-cost country
- Speeding up the pace of innovation by hiring engineers in a developing market at much lower cost
- Funding development projects that would otherwise be unaffordable
- Liberating expensive home-country-based engineers and salespeople from routines tasks, so that they can focus on higher value-added work or interacting with customers
- Putting a standard business practice out to bid, in order to lower costs and let the company respond with flexibility. If a new method of performing the function becomes advantageous, the company can change vendors to take advantage of the new development, without incurring the delays of hiring and training new employees on the process.

Pharmaceutical company Eli Lilly and Company uses outsourcing to bring down the cost of developing a new drug, which stands at $1.1 billion. Lilly hopes to bring down the cost to $800 million through outsourcing. The company is outsourcing the heart of the research effort—drug development—to contract research organizations (CROs).Jonathan D. Rockoff, "Lilly Taps Contractors to Revive Pipeline," *Wall Street Journal*, January 5, 2010, accessed September 7, 2010, http://online.wsj.com/article/SB10001424052748704247504574604503922019082.html. It does 20 percent of its chemistry work in China, for one-quarter the US cost. Lilly hopes to reduce the cost of clinical trials as well, by expanding those efforts to BRIC countries (i.e., Brazil, Russia, India, and China).Paul McDougall, "Drug Company Eli Lilly Outsources Clinical Data to India," *InformationWeek*, November 20, 2006, accessed September 7, 2010, www.informationweek.com/news/global-cio/outsourcing/showArticle.jhtml?articleID=194500067; Patricia Van Arnum, "Outsourcing Clinical Trial Development and Materials," *Pharmaceutical Technology* 6, no. 34 (June 2, 2010): 44–46.

The Hidden Costs of Outsourcing

Although outsourcing's costs savings, such as labor costs, are easy to see, some of the hidden costs aren't as visible. For example, high-tech products that spend months traveling by ocean face product obsolescence, deterioration, spoilage, taxes, loss due to damage or theft, and increased administrative and business travel costs. Threats of terrorism, religious strife, changing governments, and failing economies are further issues of concern. Stanley Furniture, a US maker of home furnishings, decided to bring its offshore production back home after product recalls from cribs made in Slovenia, transportation costs, and intellectual property issues outweighed the advantages of cheap goods and labor.Sarah Kabourek, "Back in the USA," *Fortune*, September 28, 2009, 30. All of these hidden costs add up to a world that is less than flat.

Manufacturing outsourcing is also called contract manufacturing. The move to **contract manufacturing** means that companies like IBM have less control over manufacturing than they did when they owned the factories. Contract-manufacturing companies such as Celestica are making IBM products alongside Hewlett-Packard (HP) and Dell products. Celestica's own financial considerations influence whether it gives preference to IBM, HP, or Dell if there is a rush on manufacturing. The contract manufacturer's best efforts will go to whichever client negotiated the best terms and highest price; this makes companies more vulnerable to variability.

Quanta Computer, based in Taiwan, is the largest notebook-computer contract manufacturer in the world. Quanta makes laptops for Sony, Dell, and HP, among others. In June 2010, Quanta shipped 4.8 million laptops, a laptop-shipment record.Carter Sprunger, "Quanta Computer Breaks Laptop Shipment Record in June," *Notebooks*, July 9, 2010, accessed October 28, 2010, http://notebooks.com/2010/07/09/quanta-computer-breaks-laptop-shipment-record-in-june. For consumer electronics, outsourcing has become the dominant way of doing business.

Managing Outsourced Services

If a company outsources a service, how does it guarantee the quality of that service? One way is through service-level agreements. **Service-level agreements (SLAs)** contractually specify the service levels that the outsourcer must meet when performing the service. SLAs are one way that companies ensure quality and performance when outsourcing services. SLAs typically include the following components:

- Scope of services
  - Frequency of service
  - Quality expected
  - Timing required
- Cost of service
- Communications
  - Dispute-resolution procedures
  - Reporting and governance
  - Key contacts
- Performance-improvement objectives

Johns Hopkins Enterprise's SLA for Accounts Receivable

Johns Hopkins Enterprise expects the following service levels for accounts receivable:

- Contact the customer after forty-five days if the open invoice is greater than $10,000.
- Contact the customer after sixty days if the open invoice is between $3,000 and $10,000.

- Contact the customer after ninety days if the open invoice is less than $3,000.
- Contact the department within two days if the customer claims the invoice will not be paid due to performance. At this point, it is the department's responsibility to resolve and the invoice will be closed as uncollectible. Once the disagreement with the customer is resolved, a new invoice will be issued.
- All issues that the A/R Service Center can fix will be completed within three business days. Follow-up calls will be made within five business days."Accounts Receivable Shared Service Center Service Level Agreement," Johns Hopkins Enterprise, last updated July 1, 2009, accessed November 23, 2010, ssc.jhmi.edu/accountsreceivable/inter_entity.html.

Entrepreneurial Opportunities from Outsourcing

Crimson Consulting Group is a California-based firm that performs global market research on everything from routers to software for clients including Cisco Systems, HP, and Microsoft. Crimson has only fourteen full-time employees, which would be too few to handle these market research inquiries. But Crimson outsources some of the market research to Evalueserve in India and some to independent experts in China, the Czech Republic, and South Africa. "This allows a small firm like us to compete with McKinsey and Bain on a very global basis with very low costs," said Crimson CEO Glenn Gow.Pete Engardio with Michael Arndt and Dean Foust, "The Future of Outsourcing," *BusinessWeek*, January 30, 2006, accessed November 18, 2010, http://www.businessweek.com/magazine/content/06_05/b3969401.htm.

For example, imagine a company that has an idea for a new medical device, but lacks market research into the opportunity. The company could outsource its market research to a firm like Evalueserve. For a relatively small fee, the outsourced firm could, within a day, assemble a team of Indian patent attorneys, engineers, and business analysts, start mining global databases, and call dozens of US experts and wholesalers to provide an independent market-research report.

KEY TAKEAWAYS

- Global sourcing refers to buying the raw materials, components, complete products, or services from companies located outside the home country.
- Information technology and communications have enabled the outsourcing of business processes, enabling those processes to be performed in different countries around the world.
- Best practices in global sourcing include the following components:
  - Using ISO 9001:2008 certification to help ensure the quality of products regardless of where they are produced
  - Considering not just the quality of products but also the environmental practices of the company providing the products, through ISO 14000 certification
  - Using service-level agreements to ensure the quality of services
- Entrepreneurs benefit from outsourcing because they can acquire services as needed, without having to build those capabilities internally.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Why do companies source globally?
2. What are some ways in which to ensure quality from unknown suppliers?
3. When and how would you use a service-level agreement?
4. Is contract manufacturing the same as outsourcing?
5. Explain the advantages and disadvantages of outsourcing.

6.5: Managing Export and Import

Learning Objectives

1. Learn the main players in export and import.
2. Recognize the role of intermediaries.
3. Identify some of the documents needed for export and import transactions.

Who Are the Main Actors in Export and Import?

The size of exports in the world grew from less than $100 million after World War II to well over $11 trillion today. Export and import is big business, but it isn't just for big businesses. Most of the participants are small and midsize businesses, making this an exciting opportunity for entrepreneurs.

Importing and exporting require much **documentation** (i.e., filing official forms) to satisfy the regulations of countries. The value of the documentation is that it enables trade between entities who don't know each other. The parties are able to trust each other because the documentation provides a common framework and process to ensure that each party will do what they say in the import/export transaction.

The main parties involved in export and import transactions are the exporter, the importer, and the carrier. The **exporter** is the person or entity sending or transporting the goods out of the country. The **importer** is the person or entity buying or transporting goods from another country into the importer's home country. The **carrier** is the entity handling the physical transportation of the goods. Well-known carriers across the world are United Parcel Service (UPS), FedEx, and DHL.

Customs administration offices in both the home country and the country to which the item is being exported are involved in the transaction. In the United States, the US Customs Service became the US Bureau of Customs and Border Protection (CBP) after the terrorist attacks on September 11, 2001. The mandate now isn't simply to move goods through customs quickly and efficiently to facilitate international trade; it also ensures that the items coming into the United States are validated and safe as well. Robert Bonner took the position as commissioner of the Customs Service on September 10, 2001. On his second day on the job at 10:05 a.m. EDT, he had to close all the airports, seaports, and border ports of entry. The priority mission of the Customs Service became security—preventing terrorists and terrorist weapons from entering the country. On the third day, however, the trade and business implications of shutting down the borders became visible. Border crossings that used to take ten to twenty minutes were taking ten to twelve hours. Automobile plants in Detroit, using just-in-time delivery of parts for cars, began to shut down on September 14 due to a lack of incoming supplies and parts. Businesses were going to have a difficult time operating if the borders were closed. Thus, the twin goals of the newly created CBP became security as well as trade facilitation. As Bonner explained, "In the past, the United States had no way to detect weapons coming into our borders. We had built a global trading system that was fast and efficient, but that had no security measures."Robert Bonner, "Supply Chain Security: Government-Industry Partnership" (presentation at the Resilient and Secure Supply Chain symposium, MIT, Cambridge, MA, September 29, 2005).

Mary Murphy-Hoye, a senior principal engineer at Intel, put it simply: "Our things move in big containers, and the US Department of Homeland Security is worried about them. Security means knowing what is it, where is it, where has it been, and has anyone messed with it."Mary Murphy Hoye, "Future Capabilities in the Supply Chain" (presentation at the MIT Center for Transportation and Logistics conference, MIT, Cambridge, MA, May 8, 2007).

After September 11, the twin goals of safety and facilitation were met through three interrelated initiatives:

1. The twenty-four-hour rule, requiring advanced information prior to loading
2. An automated targeting system to evaluate all inbound freight
3. Sophisticated detection technology for scanning high-risk containers

Cooperation for Security

The World Customs Organization (WCO) created a framework that calls for cooperation between the customs administrations of different countries. Under the WCO Framework of Standards to Secure and Facilitate Global Trade, if a customs administration in one country identifies problems in cargo from another country, that customs administration could ask the exporting country to do an inspection before goods are shipped. Businesses across the world benefit (in terms of speed and cost) if there is one common set of security standards globally, and the WCO is working toward that goal.World Customs Organization, "WCO Presents Draft

Framework of Standards at Consultative Session in Hong Kong, China," news release, March 25, 2005, accessed September 7, 2010, www.wcoomd.org/press/default.aspx?lid=1&id=78.

Role of Intermediaries

In addition to the main players described above, intermediaries can get involved at the discretion of the importer or exporter. Entrepreneurs and small and midsize businesses, in particular, make use of these intermediaries, rather than expending their resources to build these capabilities in-house.

A **freight forwarder** typically prepares the documentation, suggests shipping methods, navigates trade regulations, and assists with details like packing and labeling. At the foreign port, the freight forwarder arranges to have the exported goods clear customs and be shipped to the buyer. The process ends with the freight forwarder sending the documentation to the seller, buyer, or intermediary, such as a bank.

As you learned in Chapter 14, Section 14.1, an export management company (EMC) is an independent company that performs the duties a firm's export department would execute. The EMC handles the necessary documentation, finds buyers for the export, and takes title of the goods for direct export. In return, the EMC charges a fee or a commission for its services.

Banks perform the vital role of finance transactions. The role of banks will be examined in Chapter 14, Section 14.5.

What's Needed for Import and Export Transactions?

Various forms of documentation are required for import and export transactions.

The **bill of lading** is the contract between the exporter and the carrier (e.g., UPS or FedEx), authorizing the carrier to transport the goods to the buyer's destination. The bill of lading acts as proof that the shipment was made and that the goods have been received.

A **commercial or customs invoice** is the bill for the goods shipped from the exporter to the importer or buyer. Exporters send invoices to receive payment, and governments use these invoices to determine the value of the goods for customs-valuation purposes.

Did You Know?

IBM does business with 160 countries. Daily, it sends 2,500 customs declarations and ships 5.5 million pounds of products worth $68 million.Theo Fletcher, "Global Collaboration for Security" (presentation at the Resilient and Secure Supply Chain symposium, MIT, Cambridge, MA, September 29, 2005).

The **export declaration** is given to customs and port authorities. The declaration provides the contact information for both the exporter and the importer (i.e., buyer) as well as a description of the items being shipped, which the CPB uses to verify and control the export. The government also uses the information to compile statistics about exports from the country.

Humorous Anecdote

Customs regulations in some countries—particularly emerging-market countries—may impede or complicate international trade. A study of the speed and efficiency of items getting through customs in different countries found that it can take anywhere from three to twenty-one days to clear incoming goods. This variation causes problems because companies can't plan on a steady flow of goods across the border. Some countries have customs idiosyncrasies. In Brazil, for example, no goods move within the country on soccer game days and documents that are not signed in blue ink will incur delays for their accompanying goods."Supply Chain Strategies in Emerging Markets" (roundtable discussion at the MIT Center for Transportation and Logistics, MIT, Cambridge, MA, March 7, 2007).

The **certificate of origin**, as its name implies, declares the country from which the product originates. These certificates are required for import duties. These import duties are lower for countries that are designated as a "most favored nation."

Certificate of Origin as Marketing Tool

Not all governments or industries require certificates of origin to be produced, but some companies are seeing that a certificate of origin can be used for competitive advantage. For example, Eosta, an importer of organic fruit, puts a three-digit number on each piece of fruit. At the website http://www.natureandmore.com, customers can type in that number and get a profile of the farmer who grew the fruit, getting a glimpse into that farmer's operations. For example, Fazenda Tamanduá, a farm in Brazil, grows mangoes using a variety that needs less water to grow and a drip-irrigation system that optimizes water use. This database gives customers a way to learn about growers and provides a way for growers and others to share what they learn.Daniel Goleman, *Ecological Intelligence* (New York: Crown Business, 2009), 191. Providing this type of certification to customers differentiates Eosta products and makes them more attractive to sustainability-minded consumers.

Although not required, **insurance certificates** show the amount of coverage on the goods and identify the merchandise. Some contracts or invoices may require proof of insurance in order to receive payment.

Some governments require the purchase of a **license** (i.e., permission to export) for goods due to national security or product scarcity. Interestingly, licenses for import and export date back to the 1500s at least, when Japan required a system of licenses to combat the smuggling of goods taking place.Maritza Manresa, *How to Open and Operate a Financially Successful Import Export Business* (Ocala, FL: Atlantic Publishing, 2010), 20.

Impact of Trade Agreements

Trade agreements impact the particulars of doing business. For example, the North American Free Trade Agreement (NAFTA) makes Mexico different from other Latin American countries due to the ease of movement of goods between that country and the United States. Changes in agreements can affect the competitiveness of different countries. When China joined the World Trade Organization (WTO), the rapid elimination of tariffs and quotas on textiles harmed US makers.

The **letter of credit** is a legal document issued by a bank at the importer's (or buyer's) request. The importer promises to pay a specified amount of money when the bank receives documents about the shipment. Simply put, the letter of credit is like a loan against collateral (in this case, the goods being shipped) in which the funds are placed in an escrow account held by the bank. Letters of credit are trusted forms of payment in international trade because the bank promises to make the payment on behalf of the importer (i.e., buyer) and the bank is a trusted entity. Given that the letter of credit is like a loan, getting one issued from the bank requires proof of the importer's (or buyer's) ability to pay the amount of the loan.

Chapter 14, Section 14.5 is devoted to the broad topic of the payment and financing associated with import and export transactions.

KEY TAKEAWAYS

- There are several main parties involved in export and import transactions:
  - The exporter, who is the person or entity sending or transporting the goods out of the country
  - The importer, who is the person or entity buying or transporting goods from another country into the importer's home country
  - The carrier, which is the entity handling the physical transportation of the goods
  - The customs-administration offices from both the home country and the foreign country
- Intermediaries, such as freight forwarders and export management companies (EMC), provide companies with expert services so that the firms don't have to build those capabilities in-house. You could argue that such intermediaries make the world flatter, while the regulations and institutions that they help the firm deal with actually make the world less flat. Freight forwarders specialize in identifying the best shipping methods, understanding trade regulations, and arranging to have exported goods clear customs. EMCs handle the necessary documentation, find buyers for the export, and take title of the goods for direct export.
- Essential documents for importing and exporting include the bill of lading, which is the contract between the exporter and the carrier; the export declaration, which the customs office uses to verify and control the export; and the letter of credit, which is the legal document in which the importer promises to pay a specified amount of money to the exporter when the bank receives proper documentation about the shipment.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Name the four main players in export and import transactions.
2. What role do intermediaries play in export and import transactions?
3. Explain the purpose of a letter of credit.
4. What is the difference between the export declaration and the commercial or customs invoice? How are they related?

6.6: What Options Do Companies Have for Export and Import Financing?

Learning Objectives

1. Understand how companies receive or pay for goods and services.
2. Learn the basics of export financing.
3. Discover the role of organizations like OPIC, JETRO, and EX-IM Bank.

How Companies Receive or Pay for Goods and Services

You've already learned about two of the three documents required for getting paid in export/import transactions. The *letter of credit* is a contract between banks that stipulates that the bank of the importer will pay the bank of the exporter upon getting the proper documentation about the merchandise. Because importers and exporters rarely know each other, the letter of credit between two banks ensures that each party will do what it says it will do. The *bill of lading*, which is issued by the carrier transporting the merchandise, proves that the exporter has given the carrier the merchandise and that the carrier owns title to the merchandise until paid by the importer. Both the letter of credit and the bill of lading can function as collateral against loans. The final document, the **draft (or bill of exchange)** is the document by which the exporter tells the importer to pay a specified amount at a specified time. It is a written order for a certain amount of money to be transferred on a certain date from the person who owes the money or agrees to make the payment. The draft is the way in which an exporter initiates the request for payment.

There are two types of drafts. The **sight draft** is paid on receipt of the draft (when it is "seen") and the **time draft** is payable at a later time, typically 30, 60, 90, or 120 days in the future as specified by the time draft.

Giving the importer 120 days to pay the draft is very attractive for the importer because it allows time for the importer to sell the goods before having to pay for them. This helps the importer's cash flow. Importers will prefer to give business to an exporter who offers these attractive payment terms, which is why exporters offer them. However, waiting 120 days to get paid could cause cash-flow problems for the exporter. To avoid this problem, the exporter may choose to factor the contract. In **factoring**, the exporter sells the draft at a discount to an intermediary (often a bank) that will pay the exporter immediately and then collect the full amount from the importer at the specified later date. For example, the factor (bank) pays the exporter 93 percent of the value of the draft now. The factor now owns the draft and collects the full amount owed 120 days later from the importer. The factor earns roughly a 7 percent return in 120 days (but bears the risk that the importer defaults on the payment or takes longer to pay). Factor rates are typically 5 to 8 percent of the total amount of the draft.

Of course, it's possible for the exporter to ask for **cash in advance** from the importer or buyer, but this is a risky agreement for the buyer to make. As a result, importers prefer to do business with exporters who do not require cash in advance.

An **open account**, in direct contrast to cash in advance, is an arrangement in which the exporter ships the goods and then bills the importer. This type of agreement is most risky for the exporter, so exporters avoid it when possible or offer it only to their own subsidiaries or to entities with whom they have long-term relationships.

Basics of Export Financing

Financing against collateral is called **secured financing**, and it's the most common method of raising new money. Banks will advance funds against payment obligations, shipment documents, or storage documents.

There are several common sources of financing:

- A loan from a commercial bank
- A loan from an intermediary, such as an export management company that provides short-term financing
- A loan from a supplier, for which the buyer can make a down payment and ask to make further payments incrementally
- A loan from the corporate parent
- Governmental or other organizational financing

Did You Know?

Banks like HSBC provide trade finance and related services, including a highly automated trade-processing network of Internet trade services, export document-preparation system, and electronic documentary-credit advising. Some of these banks also provide specialized financing services, such as factoring.

Some companies have mechanisms for providing credit to their business customers. For example, package delivery company United Parcel Service (UPS) also owns warehouses to which its customers can ship their products. Because UPS can see and track the inventory that its business customers send using this service, it can lend those companies money based on their warehouse inventory and goods-in-transit. Simply put, UPS information systems know that a company's goods are on their way or in the warehouse, so UPS can lend money based on that knowledge.

Success Tips for Entrepreneurs

Entrepreneurs and small businesses can look to the US Small Business Administration (SBA) for help with their import or export businesses. Although the SBA itself doesn't loan money, it does guarantee loans and offers good loan programs for small businesses. Let's look at two programs in particular. The SBA's Export Express loan program is the most flexible program available to small businesses. The funds that small businesses obtain through this program can be used to pay for any activity that will increase exports, be it helping the exporter fund the purchase of the export items, take part in trade shows, obtain letters of credit, or translate marketing materials that it will use to sell the goods in overseas markets. Small businesses can get loans or lines of credit of up to $250,000. Obtaining a loan requires going to a bank or other lender and asking if they are an SBA Export Express lender. If so, the small business can apply for the loan with that lender and then send the application to the SBA for final approval. The SBA will review the application to make sure that the funds will be used to enter new export markets (or to expand the company's current market) and that the company has been in business for at least one year.US Small Business Administration, "Finance Start-Up," accessed September 5, 2010, www.sba.gov/smallbusinessplanner/start/financestartup/SERV_EXPORT.html.

A second loan program, the SBA's Export Working Capital Program (EWCP), provides loans for businesses that can generate export sales but don't have the working capital to purchase inventory or to stay in business during the long payment cycles. The maximum loan amount or line of credit for the EWCP is $2 million. More information on these loan programs is available at the SBA's international trade website: http://www.sba.gov/international.

Another useful tip for entrepreneurs is to use the Automated Export System (AES) to file the necessary documentation required for exporting. The AES is available to companies of all sizes but is of particular value to entrepreneurs and small businesses that might otherwise have to fill out all this documentation themselves. By filing the documents electronically, entrepreneurs get immediate feedback if there are any errors in their paperwork and can make the corrections right away. This can save days of costly delays. The AES lets entrepreneurs and businesses submit all the export information required by all the agencies involved in the export process. The process begins by filing the export document. If all the necessary information has been provided, the entrepreneur or business gets a confirmation message with approval. If there have been errors, the error message explains the omission or erroneous information so that it can be corrected. For more information, see www.aesdirect.gov.

Finally, entrepreneurs can accept payments in many ways, including checks, credit cards, or services like PayPal.

The Role of Organizations in Providing Financing

Countries often have government-supported organizations that help businesses with import and export activities to and from their country. These services are, for the most part, free and include providing information, contacts, and even financing options.

The **Japan External Trade Organization (JETRO)** was originally established in the 1950s to help the war-torn Japanese economy by promoting export of Japanese products to other countries. By the 1980s, Japan had massive export surpluses and began to feel the need to promote imports. So JETRO's mission reversed; its focus became to assist foreign companies to export their products into Japan. JETRO now offers such free services as

- market-entry information,
- business partner matching,
- expert business consulting (through bilingual business consultants who're experts in various industries), and
- access to a global network of executives and advisors.

On the financing side, JETRO offers subsidies to potential companies, free offices for up to four months while the foreign firm researches the Japanese market, and exhibition space when the company is ready to display their products to prospective Japanese importers."Open a Japan Office / Invest in Japan," Japan External Trade Organization, accessed November 22, 2010, www.jetro.org/index.php?option=com_content&task=view&id=652.

The current goal of JETRO is to help Japan attract foreign direct investment (FDI) as part of its economic restructuring plan. FDI refers to an investment in or the acquisition of foreign assets with the intent to control and manage them. Companies can make an

FDI in several ways, including purchasing the assets of a foreign company; investing in the company or in new property, plant or equipment; or participating in a joint venture with a foreign company, which typically involves an investment of capital or know-how.

The **Overseas Private Investment Corporation (OPIC)** was established as an agency of the US government in 1971. OPIC helps US businesses invest overseas, particularly in developing countries. As its website states, "OPIC Financing provides medium- to long-term funding through direct loans and loan guaranties to eligible investment projects in developing countries.""Financing," Overseas Private Investment Corporation, accessed November 22, 2010, www.opic.gov/financing. It also provides exporters' insurance. The most useful tool of OPIC is that it can "provide financing in countries where conventional financial institutions often are reluctant or unable to lend on such a basis.""Financing," Overseas Private Investment Corporation, accessed November 22, 2010, www.opic.gov/financing.

The **Export-Import Bank of the United States (Ex-Im Bank)** helps exporters who have found a buyer, yet the buyer is unable to get financing for the purchase in their own country. Ex-Im Bank can provide credit support (i.e., loans, guarantees, and insurance for small businesses) that covers up to 85 percent of the transaction's export value.

Unlike JETRO, OPIC, and Ex-Im Bank, the Private Export Funding Corporation (PEFCO) is a private-sector organization. PEFCO was formed in 1970 "to assist in financing U.S. exports by supplementing the financing available from commercial banks and other lenders.""Overview," Private Export Funding Corporation, accessed November 22, 2010, http://pefco.com/about/overview.html. PEFCO provides medium- to long-term loans if they are secured against nonpayment under an appropriate guarantee or insurance policy issued by Ex-Im Bank or for certain small-business export loans under a guarantee issued by the SBA.

Did You Know?

The Development Bank of Japan (DBJ) has loan programs for foreign-affiliated companies investing in Japan. According to Masaaki Kaji of DBJ, the loans are offered at low fixed interest rates for five- to fifteen-year terms.Katherine Hyde, "JETRO Symposium on Business Alliances/Investment in Japan: Market Brainstorms," *Japan Society*, November 1, 2005, accessed August 29, 2010, www.japansociety.org/jetro_symposium_on_business_alliancesinvestment_in_japan_market_. During the twenty-year history of the program, the three hundred companies that have received financial aid have generated $850 billion dollars in income for the Japanese economy. DBJ also works with regional Japanese banks to provide merger and acquisition advice to small and midsize companies. One of DBJ's most famous projects provided financing and strategic advice for the joint venture established between Starbucks and Sazaby Japan.Katherine Hyde, "JETRO Symposium on Business Alliances/Investment in Japan: Market Brainstorms," *Japan Society*, November 1, 2005, accessed August 29, 2010, www.japansociety.org/jetro_symposium_on_business_alliancesinvestment_in_japan_market_.

KEY TAKEAWAYS

- The main financial documents import/export companies use in order to get paid are the letter of credit (which states that the bank will pay the exporter upon getting the proper documentation about the merchandise), the bill of lading (which proves that the exporter has given the carrier the merchandise and that the carrier owns title to the merchandise until paid by the importer), and the draft, or bill of exchange (which tells the importer to pay a specified amount at a specified time).
- Companies can obtain funding via loans from several sources: a commercial bank, an intermediary, a supplier, their corporate parent, or a governmental or other organization.
- The role of organizations like OPIC, JETRO, and Ex-Im Bank is to provide financing, market information, and trade assistance. These organizations are often country specific (e.g., JETRO, which focuses on Japan) or specific to a category of countries (e.g., OPIC, which factors loans to developing countries).

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. If you were an exporter, would you ever give your buyer three months to pay an invoice? Why or why not?
2. Describe how the SBA can help entrepreneurs and small businesses in their export ventures.
3. Explain the difference between a letter of credit and a draft.

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SECTION OVERVIEW

6.7: E-Business and E-Commerce

6.8: Chapter Introduction

Vermont Teddy Bear Company

Figure 6.8.1: Used *with permission from Vermont Teddy Bear.*

In 1980, John Sortino got the idea for making teddy bears. He was playing with his young son, Graham, and noticed that none of Graham's 38 stuffed animals was made in the United States. This inspired John to make a teddy bear for Graham—named Bearcho. John then went on to make others, falling in love with the idea of making them by hand. Bearcho was soon followed by Buffy, Bearazar, and Fuzzy Wuzzy, all made in his wife's sewing room. By 1983, John was selling his bears from a gift cart at an open-air market in Burlington, Vermont. The sale of his first bear took 4 days, and it took 1 year to sell 200 bears."The Vermont Teddy Bear Story," *Vermont Teddy Bear Company*, accessed March 24, 2012, www.vermontteddybear.com/Static/Our-Story.aspx; "Vermont Teddy Bear Company," *Score.org*, accessed March 24, 2012, www.score.org/success-stories/vermont-teddy-bear-company. Today, the Vermont Teddy Bear Company produces about 300,000 bears a year.

The Vermont Teddy Bear Company has tapped into America's long-standing love affair with teddy bears by creating a wide variety of customized teddy bears and shipping them to customers via the well-recognized Bear-Gram, "…a customized bear placed in a colorful box with an air hole and game printed on the inside, and enclosed with a personalized greeting and candy treat.""The Vermont Teddy Bear Story," *Vermont Teddy Bear Company*, accessed March 24, 2012, www.vermontteddybear.com/Static/Our-Story.aspx. The company has experienced many changes, including John's departure in 1995 to pursue other interests and the addition of Pajamagram and Calyx Flowers as additional unique brands, but the Vermont Teddy Bear Company remains a household name and a Vermont icon.

Jay Bruns, vice president of branding, talks about the importance of knowing how to present the product so the company can grow further. Right now, a Vermont Teddy Bear is a unique gift item that promises quality for life, but the dynamics of gifting have changed. Same day or overnight delivery is not special anymore, so a Vermont Teddy Bear must offer something more than convenience. It needs to be a "go-to" gift of choice rather than an emergency or "last-minute" gift. This requires presenting the product as fresh and special.Telephone interview with Jay Bruns, vice president of branding, Vermont Teddy Bear Company, March 9, 2012. E-commerce is an integral part of Vermont Teddy Bear's marketing strategy, with online sales accounting for more than one-half of its total sales. The company saw the growth in online buying and launched its website in October 1996 in an effort to reach the online consumer base. Elisabeth Robert, the CEO at the time, saw the potential synergy between radio and the Internet and used the power of the company's radio advertising "…to direct customers to the company's website where they could actually see the bears they were ordering."Portland Helmich, "Not Your Average Bear," *Business People Vermont*, 2002, accessed March 24, 2012, www.vermontguides.com/2002/2-feb/teddybear.htm.

Victor Castro, director of e-commerce, describes the company's e-commerce strategy as direct marketing with a focus on easy ordering and the customer being able to interact with the brand. Convenience has become even more convenient, and the Vermont Teddy Bear Company makes things simple. As the consumer becomes more proficient online, it will be necessary to communicate properly what the Vermont Teddy Bear gift is all about (i.e., the experience of owning the bear). Castro says that the company has been very successful at that. However, the company's e-commerce strategy must evolve with changes in the online customer. Telephone interview with Victor Castro, director of e-commerce, Vermont Teddy Bear Company, March 9, 2012.

To learn more about the Bear-Gram, go to www.vermontteddybear.com/Static/Bear-Grams.aspx. To take the online factory tour, go to www.vermontteddybear.com/Static/tour-welcomestation.aspx.

Video Clip 6.8.1:

PBS Curiosity Quest—Vermont Teddy Bear

A tour of the Vermont Teddy Bear factory.

6.9: E-Business and E-Commerce - The Difference

Learning Objectives

1. Define e-business and e-commerce and explain the difference between them.
2. Understand that there are several different types of e-commerce and that a business can be engaged in more than one type at the same time.
3. Explain what a business model is and why the model that is selected is so important.

As stated in "Foundations for Small Business", e-business and e-commerce are terms that are often used interchangeably. But e-business and e-commerce are not the same. This section will elaborate on the differences between the two and some of the foundational knowledge that is critical to understanding and using e-commerce in particular.

E-Business

"Foundations for Small Business" talked about e-business in terms of using the Internet and online technologies to create operational efficiencies, thereby increasing customer value. Kelly Wright, "E-Commerce vs. E-Business," *Poole College of Management*, November 27, 2002, accessed October 10, 2011, scm.ncsu.edu/scm-articles/article/e-commerce-vs.-e-business. It is important that small businesses understand the nature of e-business and how it can facilitate operations as well as growth—if growth is desired. It has been said on other occasions, and it will continue to be said, that not all small businesses look for growth, choosing instead to happily remain small. For the small businesses that do want to grow, however, e-business can help them do it.

E-Business Components

E-business involves several major components: Terri C. Albert and William B. Sanders, *e-Business Marketing* (Upper Saddle River, NJ: Prentice-Hall, 2003), 2–4; and Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 4. business intelligence (BI), customer relationship management (CRM), supply chain management (SCM), enterprise resource planning (ERP), e-commerce, conducting electronic transactions within the firm, collaboration, and online activities among businesses.

Figure 6.9.1: Components of E-Business

Business intelligence is about the activities that a small business may undertake to collect, store, access, and analyze information about its market or competition to help with decision making. When conducted online, BI is efficient and quick, helping companies to identify noteworthy trends and make better decisions faster. BI has been described as "the crystal ball of the 21st century."Lena

L. West, “Business Intelligence: The Crystal Ball of Champions,” *Small Business Computing.com*, April 11, 2006, accessed October 10, 2011, www.smallbusinesscomputing.com/biztools/article.php/3598131/Business -Intelligence-The-Crystal-Ball-of-Champions.htm.

As defined in Chapter 2, **customer relationship management (CRM)** refers to “…a customer service approach that focuses on building long-term and sustainable customer relationships that add value for the customer and the company.”Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 759. It is a company-wide strategy that brings together information from all data sources within an organization (and sometimes from external data sources) to give one holistic view of each customer in real time. The goal is to reduce costs and increase profitability while providing customer satisfaction.“What Is CRM?,” cestinationCRM.com, February 19, 2010, accessed October 10, 2011, www.destinationcrm.com/Articles/CRM-News/Daily-News/What-Is-CRM-46033.aspx. CRM applications are available for even the smallest businesses.

Every small business has a supply chain, the network of vendors that provide the raw components that are needed to make a product or deliver a service. The management of this network is known as **supply chain management (SCM)**. SCM is about efficiently and effectively improving the way that a company finds those raw components and then delivers the product or the service to the customer. Thomas Wailgum and Ben Worthen, “Supply Chain Management Definition and Solutions,” *CIO*, November 20, 2008, accessed October 10, 2011, www.cio.com/article/40940/Supply_Chain_Management_Definition_and_Solutions. SCM applications are now available for small businesses. More details about SCM are presented in Chapter 12.

Enterprise resource planning (ERP), as mentioned in Chapter 1, is about integrating all departments and functions across a company (sales, marketing, human resources, finance, accounting, production, engineering, etc.) into a single computer system that can serve the particular needs of each department. The objective is to provide information quickly and efficiently to those who need it. Small businesses have many vendor choices for ERP systems. There are more than thirty vendors in the field, and they are looking to small and midsize businesses as their primary growth market. Mary O. Foley, “ERP for Small Business: The Time is Ripe,” *Inc.*, October 1, 2007, accessed October 10, 2011, technology.inc.com/2007/10/01/erp-for-small-business -the-time-is-ripe. More details about ERP are provided in Chapter 12.

E-commerce, as defined in Chapter 1, is the marketing, selling, and buying of goods and services online. It generates revenue, which e-business does not. E-commerce is typically associated with e-marketing, discussed in Chapter 8, but most of this chapter is dedicated to the operational, nonmarketing dimensions of e-commerce.

Conducting electronic transactions within a firm can occur through an **intranet**, e-mail, and instant messaging. An intranet is a private network within a business that is used for information sharing, processing, and communication. The goal is to “streamline the workplace and allow easy information exchange within an organization.”Dachary Carey, “What Is Intranet Technology Used For?,” *Life123*, accessed October 10, 2011, www.life123.com/technology/internet/intranet/what-is-intranet.shtml.

Collaboration can occur internally or externally, and it often involves business partners. The goal is to help teams or business partners communicate with each other more effectively and efficiently, manage projects and shared materials, save companies the costs of travel, and reduce travel-related productivity losses. Gerry Blackwell, “Altogether Now: Comparing Collaboration Software,” *Small Business Computing.com*, January 28, 2008, accessed October 10, 2011, www.smallbusinesscomputing.com/buyersguide/article.php/10729_3724501 /Altogether-Now-Comparing-Collaboration-Software.htm. E-mail, instant messaging, newsgroups, bulletin boards, discussion boards, virtual team rooms, online meetings, and **wikis** are common means of collaboration. A wiki is a web page that can be viewed and modified by anybody with a web browser and access to the Internet unless it is password protected.“7 Things You Should Know about Wikis,” *Educause Learning Initiative*, July 2005, accessed October 10, 2011, net.educause.edu/ir/library/pdf/ELI7004.pdf. The most well-known wiki is *Wikipedia*.

Online activities between businesses focus on information sharing and communication via e-mail, online meetings, instant messaging, and **extranets**. An extranet is the part of an intranet that is made available to business partners, vendors, or others outside a company. It allows a business “to share documents, calendars, and project information with distributed employees, partners, and customers” and “it enables 24/7 private, secure access to collaborative tools with just an Internet connection.” “Communicate Quickly and Efficiently Through Intranets, Extranets and Portals,” *Gozapit Interactive*, 2009, accessed October 10, 2011, www.gozapit.com/intranet-extranet.htm. They make communication easier, eliminate redundant processes, reduce paperwork, increase productivity, provide immediate updates and information, and provide quick response times to problems and questions.“Communicate Quickly and Efficiently Through Intranets, Extranets and Portals,” *Gozapit Interactive*, 2009, accessed

October 10, 2011, www.gozapit.com/intranet-extranet.htm. The result is money and time saved for employees, the company, vendors, and your customers. Commercial transactions typically do not take place on extranets.

As integral as e-business may be to many small businesses, however, there will be small businesses that choose not to go the e-business route. Small businesses that are nonemployers and/or are very small operations that choose to stay that way—for example, local delis, gift shops, restaurants, dry cleaners, and ice cream shops can be and are successful without having to make a commitment to e-business. Therefore, a small business can choose to incorporate all, some, or none of the e-business components. Given the ways in which the Internet continues to transform small businesses, however, it would be virtually impossible for a small business to operate totally outside the realm of e-business.

E-Commerce

The moment that an exchange of value occurs, e-business becomes e-commerce. Elias M Awad, *Electronic Commerce: From Vision to Fulfillment* (Upper Saddle River, NJ: Pearson Education, 2005), 4. E-commerce is the revenue generator for businesses that choose to use the Internet to sell their goods and services. Some small businesses rely on the Internet to grow and survive. As stated in Chapter 1, many small businesses also look to e-commerce for their own business needs, such as computers and office technology, capital equipment and supplies, office furnishings, inventory for online sale, or other business-related goods."E-commerce: Small Businesses Become Virtual Giants on the Internet," accessed October 10, 2011, www.score.org/system/files/become_a_virtual_giant.pdf. This is not surprising considering the pervasiveness of the Internet for business transactions of all shapes and sizes.

Types of E-Commerce

Every Internet business is either **pure-play** or **brick-and-click**. A pure-play business, such as Amazon and Zappos, has an online presence only and uses the capabilities of the Internet to create a new business. Brick-and-click businesses, such as Barnes and Noble and Vermont Country Store, combine a physical presence with an online presence. These businesses use the Internet to supplement their existing businesses. Sandeep Krishnamurthy, *E-Commerce Management: Text and Cases* (Mason, OH: South-Western, 2003), 73.

There are several different types of e-commerce. A common classification system is with respect to the nature of transactions or the relationships among participants. Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 8. There are seven major types of e-commerce:

1. **Business-to-business (B2B)** e-commerce, where businesses focus on selling to other businesses or organizations, is the largest form of e-commerce. Kenneth C. Laudon and Carol G. Traver, *E-commerce: Business, Technology, Society* (Upper Saddle River, NJ: Prentice Hall, 2007), 58; Turban et al., 2008, 8. Cisco, Staples, and Spiceworks (information technology [IT] and IT networks for the small- and medium-sized business) are all B2B companies.
2. **Business-to-consumer (B2C)** is the earliest form of e-commerce, but it is second in size to B2B. It refers to retail sales between businesses and individual consumers. Consumers gather information; purchase physical goods, such as books and clothing; purchase information goods, such as electronic material or digitized content, such as software; and, for information goods, receive products over an electronic network. Zorayda Ruth Andam, "e-Commerce and e-Business," *Asia and Pacific Training Centre for Information and Communication Technology for Development*, May 2003, accessed June 21, 2012, www.unapcict.org/ecohub/resou...ad/attachment1.
3. **Consumer-to-consumer (C2C)** e-commerce is where consumers sell products and personal services to each other with the help of an **online market maker** to provide catalog, search engine, and transaction-clearing capabilities so that products can be easily displayed, discovered, and paid for. The most well-known C2C business is eBay, but there are many other online market makers as well. Craigslist is an extremely popular small e-commerce business for placing classified ads.
4. **Business-to-government (B2G)** e-commerce can generally be defined as transactions with the government. The Internet is used for procurement, filing taxes, licensing procedures, business registrations, and other government-related operations. This is an insignificant segment of e-commerce in terms of volume, but it is growing.
5. **Consumer-to-business (C2B)** e-commerce is between private individuals who use the Internet to sell products or services to organizations and individuals who seek sellers to bid on products or services.Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 8.Elance is an example of C2B where a consumer posts a project with a set budget deadline and within hours companies and/or individuals review the consumer's requirements and bid on the project. The consumer reviews the bids and selects the company or individual that will complete the project. Elance empowers consumers around the world by providing the meeting ground and platform for such

transactions.“Ecommerce Definition and Types of Ecommerce,” *DigitSmith*, accessed October 10, 2011, www.digitsmith.com/ecommerce-definition.html. Priceline.com is a well-known example of C2B e-commerce.

6. **Mobile commerce (m-commerce)** refers to the purchase of goods and services through wireless technology, such as cell phones, and handheld devices, such as Blackberries and iPhones. Japan has the lead in m-commerce, but it is expected to grow rapidly in the United States over the next several years. eMarketer predicts mobile content revenues will grow to more than $3.53 billion in 2014, a compound annual growth rate of nearly 20 percent for the period 2009–2014, with the fastest growth coming from mobile music.“Mobile Content Soars Thanks to Device and Network Advances,” *eMarketer*, August 31, 2010, accessed October 10, 2011, www.emarketer.com/Articles/Print.aspx?1007899.
7. **Peer-to-peer (P2P)** technology makes it possible for Internet users to share files and computer resources directly without having to go through a central web server. P2P began with Napster offering free music downloads via a file-sharing system.*Free Encyclopedia of Ecommerce*, “Peer-to-Peer Technology (P(2P),” accessed June 1, 2012, ecommerce.hostip.info/pages/8...ology-P2P.html. Tamago launched the world’s first P2P commerce system in 2005, which allowed people to sell every type of digital media directly from their computers to customers all over the world. People who publish videos, photos, music, e-books, and so forth can earn royalties, while buyers earn commissions for distributing media to others.“Tamago Launches First Peer-to-Peer eCommerce System,” *PR Leap*, October 15, 2006, accessed October 10, 2011, www.prleap.com/pr/51931.

Figure 6.9.2: How P2P E-Commerce Works at Tamago.com *Source: “Peer to Peer Profit,” www.tamago.us (accessed October 10, 2011).*

Although these types of e-commerce have been discussed individually, there are many instances in which one company engages in multiple types. Office Depot and Staples are brick-and-click businesses that engage in B2B, B2C, and perhaps B2G e-commerce. Carbonite and Gourmet Gift Baskets are both pure-play small businesses that engage in B2C and B2B e-commerce.

E-Commerce Business Models

The decision to engage in e-commerce is an important one. The advantages are clear: lower business costs; 24/7 accessibility anywhere; the potential for stronger customer service; the ability to introduce a niche product; the ability to reach global markets on a more equalized basis with larger firms, making mass customization possible; and greater customer loyalty. But the risks are there as well. Internet problems, website problems, security and privacy breaches, intellectual property theft, legal liability, product and/or service failure, customer deceit, and customer dissatisfaction are but a few of the risks. Therefore, the choice of an e-commerce business model must be made carefully. Each model will have different implications in terms of business planning and strategy.

An **e-commerce business model** is the method that a business uses to generate revenue online. “The business model spells out how a company makes money by specifying where it is positioned in the value chain. Some models are quite simple. A company produces a good or service and sells it to customers. If all goes well, the revenues from sales exceed the cost of operation and the company realizes a profit. Other models can be more intricately woven.”Michael Rappa, “Business Models on the Web,” *DigitalEnterprise.org*, January 17, 2010, accessed October 10, 2011, digitalenterprise.org/models/models.html. Another way to look at a business model is that it "reflects management's hypothesis about what customers want, how they want it, and how the enterprise can organize to best meet those needs, get paid for doing so, and make a profit."David J. Teece, "Business Models, Business Strategy and Innovation," *Long Range Planning* 43, no. 2–3 (2010): 172–94. There are many models to choose from, and new models will continue to emerge as technology evolves and businesses look for new and creative ways to generate revenue. Some of the many e-commerce business models are as follows:For additional discussions of business models, see Michael Rappa, "Business Models on the Web," *DigitalEnterprise.org*, January 17, 2010, accessed October 10, 2011, digitalenterprise.org/models/models.html; and Robert D. Atkinson et al., "The Internet Economy 25 Years After .Com: Transforming Commerce & Life," *Information Technology & Innovation Foundation*, March 2010, accessed October 10, 2011, www.itif.org/files/2010-25-years.pdf.

- The **virtual merchant model** is used by online retailers that operate over the Internet only. FreshDirect is a small business that offers fresh food and brand-name groceries for home delivery in New York. Amazon is another example of a virtual merchant.
- The **brokerage model** brings buyers and sellers together and facilitates transactions. Supply Chain Connect is a small business that helps "companies optimize their purchasing and sales purchasing and sales processes through the use of e-commerce across a broad range of products including chemicals, plastics, wire and cable, and manufactured goods." "About Supply Chain Connect," *Supply Chain Connect*, accessed October 10, 2011, www.supplychainconnect.com.
- The **incentive marketing model** is a "customer loyalty program that provides incentives to customers such as redeemable points or coupons for making purchases from associated retailers."Michael Rappa, "Business Models on the Web," *DigitalEnterprise.org*, January 17, 2010, accessed October 10, 2011, digitalenterprise.org/models/models.html. Cool Savings, a small business that uses this model, wants to be its customers' free resource for valuable coupons, discounts, and special offers from their favorite brands and stores.

Because the business model will be at the center of the business plan, the model must be designed carefully. If a successful model is to be built, the model should effectively address the eight key elements listed in Table 6.9.1:. Although value proposition and the revenue model may be the most important and easily identifiable aspects of a company's business model, the other six elements are equally important. Kenneth C. Laudon and Carol G. Traver, *E-Commerce: Business, Technology, Society* (Upper Saddle River, NJ: Prentice Hall, 2007), 58; Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 8.

Table 6.9.1: Key Elements of a Business Model

Components	Key Questions
Value proposition	Why should the customer buy from you?
Revenue model	How will you earn your money?
Market opportunity	What market space do you intend to serve, and what is its size?
Competitive environment	Who else occupies your intended market space?
Competitive advantage	What special advantages does your firm bring to the market space?
Market strategy	How do you plan to promote your products or services to attract your target audience?
Organizational development	What types of organizational structures within the firm are necessary to carry out the business plan?
Management team	What kinds of experiences and background are important for the company's leaders to have?

Source: Kenneth C. Laudon and Carol G. Traver, *E-commerce: Business, Technology, Society* (Upper Saddle River, NJ: Prentice Hall, 2007), 59.

E-Commerce Trends

For businesses already engaged in e-commerce and for those that are thinking about it, being aware of the latest e-commerce trends is important because they could have a long-term influence on the future of a company's market. This influence, in turn, could mean life or death for your e-commerce operations. Several general e-commerce trends can be identified, and they are relevant to all e-commerce operations.

- E-commerce will continue to grab more market share. Heather Green, "US Ecommerce Growth to Pick Up in 2010, But Hit Mature Stride," *Bloomberg BusinessWeek*, February 2, 2009, accessed October 10, 2011, www.BusinessWeek.com/the_thread/blogspotting/archives/2009/02/us__ecommerce_gr.html.
- It is expected that, in some way, the web will influence 53 percent of all purchases made in 2014. Geoffrey A. Fowler, "E-Commerce Growth Slows, But Still Out-Paces Retail," *Wall Street Journal*, March 8, 2010, accessed October 10, 2011, blogs.wsj.com/digits/2010/03/08/e-commerce-growth-slows-but-still-out-paces-retail.
- The lines between online and offline commerce will become less defined. If somebody buys from a mobile device in your store, is that a web sale or a store sale? Retailers need to think of some new ways that they can take the web's influence into account. Geoffrey A. Fowler, "E-Commerce Growth Slows, But Still Out-Paces Retail," *Wall Street Journal*, March 8, 2010, accessed October 10, 2011, blogs.wsj.com/digits/2010/03/08/e-commerce-growth-slows-but-still-out-paces-retail.
- B2B e-commerce will continue to significantly outpace B2C e-commerce, representing more than 85 percent of all e-commerce.
- M-commerce is the fastest growing segment of visitors to e-commerce websites. If a business does not allow customers to both browse its catalog and conduct transactions on a mobile device, customers will seek out other brands that offer such experience. Frank Gruber, "Exploring the Latest E-Commerce Industry Trends," *Tech Cocktail*, June 3, 2010, accessed October 10, 2011, techcocktail.com/exploring-the-latest-e -commerce-industry-trends-2010-06.
- Many businesses have increased their social marketing initiatives through a combination of Facebook pages, Twitter tweets, YouTube fan videos, and blogs. Any business that sells its products or services online without having a social strategy will suffer."Recap of Ecommerce Trends from the Internet Retailer 2010 Conference," *Tealeaf*, June 22, 2010, accessed October 10, 2011, tealeaf.typepad.com/blog/2010/06/recap-of-ecommerce-trends.html.

The following e-commerce trends specifically apply to small businesses:

- The Internet will continue to create opportunities for small businesses. It is now possible to buy a wide range of specialized products and services that are not available elsewhere. The Internet has provided a lifeline for many small producers and has allowed entrepreneurs to enter retailing without having to invest heavily in physical outlets."E-Commerce Industry," *QFinance*, accessed October 10, 2011, www.qfinance.com/sector-profiles/e-commerce. Small businesses can easily enter the e-commerce arena as pure-play businesses. Take Socrata, an online service that makes it easy to share data—anything from crime statistics to football schedules. This small start-up business discovered that federal agencies were the site's biggest users. "It became clear that a really good place for our technology was helping government organizations share data in the interest of transparency."John Tozzi, "Gov 2.0: The Next Internet Boom," *Bloomberg BusinessWeek*, May 27, 2010, accessed October 10, 2011, www.BusinessWeek.com/smallbiz/content/may2010/sb20100526_721134.htm.
- Broadband and wireless networks will be everywhere. Small businesses will need to factor in the effect of the broadband revolution on their businesses. Steve King et al., "INTUIT Future of Small Business Report: Technology Trends and Small Business," *Intuit*, June 2007, accessed October 10, 2011, http-download.intuit.com/http.intuit/CMO/intuit/futureofsmallbusiness/SR-1037B__intuit_tech_trends.pdf. Consider the case of the small, ten-person shop in Seattle that engraves plaques and trophies. Today, 60 percent of its business is conducted online, with customers who live outside the Seattle area. Secretary of Commerce Gary Locke, "Remarks at Organization for Economic Cooperation and Development (OECD) Conference," December 9, 2009, accessed October 10, 2011, www.commerce.gov/news/secretary-speeches/2009/12/09/remarks -organization-economic-cooperation-and-development-oecd-conference.html.
- The Internet will continue to be a platform that provides small businesses with a wide range of new tools, services, and capabilities. Small businesses will find new ways to use the Internet, contributing to the blurred distinctions between the physical and the virtual worlds. Steve King et al., "INTUIT Future of Small Business Report: Technology Trends and Small Business," *Intuit*, June 2007, accessed October 10, 2011, http-download.intuit.com/http.intuit/CMO/intuit/futureofsmallbusiness/SR-1037B__intuit__tech_trends.pdf.
- Small business relationships will become increasingly virtual as online social networks expand.Steve King et al., "INTUIT Future of Small Business Report: Technology Trends and Small Business," *Intuit*, June 2007, accessed October 10, 2011, http-download.intuit.com/http.intuit/CMO/intuit/futureofsmallbusiness/SR-1037B__intuit_tech_trends.pdf. Many small businesses are promoting their presence on Facebook and Twitter. Westbrook Lobster and Arisco Farms are both small businesses in Connecticut that have an online social presence. Naked Pizza in New Orleans has a presence on Twitter that has proven to be a

boon to its business.Abbey Klaasen, “Twitter Proves Its Worth as a Killer App for Local Businesses,” *Advertising Age*, May 18, 2009, accessed October 10, 2011, adage.com/article/digital/twitter-proves-worth-a-killer-app-local-businesses/136662.

Video Clip 6.9.1:

Naked Pizza on Twitter

Naked Pizza can now be followed on Twitter.

Is E-Commerce for All Small Businesses?

Despite the popularity and pervasiveness of e-commerce, not all small businesses may be interested in pursuing e-commerce as a part of their businesses. Many small businesses survive without an online presence. However, business analysts have agreed for a long time “that for any company larger than a local mom and pop store, e-commerce is now a business requirement.”Beverly Kracher and Cynthia L. Corritore, “Is There a Special E-Commerce Ethics?,” *Business Ethics Quarterly* 14, no. 1 (2004): 71–94.

KEY TAKEAWAYS

- E-business and e-commerce are not synonymous terms. E-commerce generates revenue. E-business does not.
- E-business and/or e-commerce may not be of interest to all small businesses. However, using technology well is proving to be one of the most prominent drivers of business success.
- E-business consists of several major components, one of which is e-commerce.
- Every Internet business is either pure-play (an Internet presence only) or brick-and-click (having both a physical and an online presence).
- The seven major types of e-commerce are B2B, B2C, C2C, B2G, C2B, m-commerce, and P2P.
- An e-commerce business model is the method that a business uses to generate revenue online. Some models are very simple; others are more complicated. New business models are being introduced all the time.
- E-commerce will continue to grab more market share, and the line between online and offline commerce will become less defined.

EXERCISES

1. In the Frank’s All-American BarBeQue case in Chapter 2, the son, Robert Rainsford, wants to bring his expertise to improving the operations of the business. What other elements of digital technology, e-business, and e-commerce could be used to improve operations?
2. Joan Watson is the owner of Joan’s Gourmet Baskets, a small brick-and-mortar business that specializes in gourmet gift and picnic baskets. Joan has been keeping up with the fancy food and gourmet food trends (being a great fan of the Fancy Food Show that is held several times a year), and she thinks she should tap into this sector by creating an online business that will complement her physical business. This would make her baskets available to a wider market. She is proud of the quality of her products and the customer loyalty that she has earned through her hard work and hopes she will be able to be just as successful in the e-commerce environment.

   Joan knows that she needs more information before proceeding further. She has asked you to prepare a report that answers the following questions: How will her physical business compare to her online business; that is, where will things be the same, and where will they be different? What business model should she use? What are the special challenges and obstacles she will face as she moves from traditional commerce to e-commerce? What is Web 2.0 all about and does she need to be concerned about it? She expects that you will do additional gourmet foods research to support your ideas.

6.10: E-Commerce Operations

Learning Objectives

1. Explain the issues associated with whether a small business should buy or build its website.
2. Explain some of the legal issues that are relevant to e-commerce.
3. Discuss the need for an ethical website, particularly in terms of security, privacy, and trust.
4. Explain why order fulfillment is such an important part of successful e-commerce.

There are multiple parts to the creation of an e-commerce website: the infrastructure (the nuts and bolts building of the site), the e-marketing side (the design and creation of a web presence, which is discussed in Chapter 7), and the operational side. The operational side is the focus of this section.

The Website: Buy or Build?

Unless a small business owner is technologically savvy or employs someone who is, building the company's website in-house from the ground up is not a particularly good idea. An effective website presence requires a good looking, professionally designed website. There are several approaches to having someone else build that website. Two are described here.

- **Full-service web developers** provide design, programming, support, hosting, search engine optimization, and more. Any combination of the services can be selected. Having the developer perform all the services would be the most expensive alternative. **Hosting** is the housing, serving, and maintaining of the files for one or more websites."What Is Hosting (Web Site Hosting, Web Hosting, and Webhosting)?," accessed October 21, 2011, searchsoa.techtarget.com/definition/hosting.**Search engine optimization** refers to the strategies intended to position a website at the top of search engines such as Google, Yahoo!, and Bing.Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 758.
- A much lower-priced option is to select one of the many companies online that can help you to design your website. Typically these sites provide a choice of website design templates that can be easily edited; design services that are available if none of the templates meet your needs; hosting; **domain name selection** (your business address or name on the Internet, e.g., gone.2012books.lardbucket.org) and **domain name registration** (registering your domain name with a domain name registrar and paying a fee that must be renewed annually); Christopher Heng, "How to Register Your Own Domain Name," *Thesitewizard.com*, 2010, accessed October 10, 2011, www.thesitewizard.com/archive/registerdomain.shtml. and **search engine placement** (submitting your website to specific search engines of your choice). Intuit.com and Webs.com are two companies that offer these and other services. The lowest level of services are often free.

Video Clip 6.10.1

Domain Name Dollar Store

A humorous look at getting a URL for your website at a rock bottom price.

The ultimate cost for a website will be a function of its size, complexity, and the level of design. No two projects will cost the same. Part of the process of building a website, however, should be conducting some research and talking with website designers. The Internet offers a variety of sources on how to determine how much a website should cost. WebpageFX.com offers a historical perspective on website costs, a cost calculator to find out how much a web project would cost, and examples of specific web design and website development projects with cost figures.“How Much Should a Web Site Cost?,” 2010, accessed October 10, 2011, www.webpagefx.com/How-much-should-web-site-cost.html.

Consider the following two scenarios:

- “A small business needs a website for their business so they have a presence on the Internet. The site is simple—about 5 pages with information about the business, the services they provide, and a form that can be submitted and the information received via email. The budget isn’t available for creating a graphic ‘look,’ and existing images will be used. A smaller, less experienced designer may take on a project like this for a few hundred dollars. A medium sized firm might quote $3000 to $4000 depending on variables. A larger firm would probably not take a project this small.”“How Much Does a Website Cost?,” *Planetlink.com*, accessed October 10, 2011, www.planetlink.com/articles/how_much_does_website_cost.html.
- “A mail order company wants to get into online sales. They currently have no website. They have a narrow mix of about 200 products with a broad target market; it’s also time to update their image. Depending on a wide range of variables, a project like this could start at about $7000 and go into six figures.”“How Much Does a Website Cost?,” *Planetlink.com*, accessed October 10, 2011, www.planetlink.com/articles/how_much_does_website_cost.html.

There is no easy answer to the question of how much a website will cost. “A simple answer is that it will cost whatever a business is willing to spend—anywhere from free to millions of dollars.”“How Much Does a Website Cost?,” *Planetlink.com*, accessed October 10, 2011, www.planetlink.com/articles/how_much_does_website_cost.html. A better way to address cost is to answer the following questions:“How Much Does a Website Cost?,” *Planetlink.com*, accessed October 10, 2011, www.planetlink.com/articles/how_much_does_website_cost.html.

- What are your needs, goals, and expectations?
- What are the needs and expectations of your visitors, customers, and clients?
- Is your business already established with its unique brand or identity?
- What is required in terms of the skills, experiences, and level of design?
- Do you want to hire a high-profile design shop, a medium-sized design studio, a small company, or a student?
- What can you afford to budget for your project?

Legal

There is nothing easy about the law. It is complex under the best of circumstances, but it is necessary to protect the rights and privileges of people and businesses. Companies that choose to engage in e-commerce must be aware of the legal environment because "a lack of awareness…can lead to missteps as well as missed opportunities…."Kathleen Mykytn and Peter P. Mykytn, "The Importance of the Law for E-Commerce Strategies," *Information Systems Management* 22, no. 2 (2005): 50–56. A summary of important legal issues for e-commerce is in Table \(\PageIndex{1}\. However, the focus here is on three areas: electronic transactions, intellectual property, and jurisdiction.

Table \(\PageIndex{1}\: Important Legal Issues for E-Commerce

Issue	Description
Jurisdiction	The ability to sue in other states or countries.
Electronic transactions	All transactions that take place online.
Liability	The use of multiple networks and trading partners makes documenting responsibility difficult. How can liability for errors, malfunctions, or fraudulent use of data be determined?
Identity fraud	The Identity, Theft, and Assumption Deterrence Act of 1998 makes identity fraud a federal felony carrying a three- to twenty-five-year prison sentence.
Defamation	Is the Internet service provider liable for material published on the Internet because of services it provides or supports? (Usually not.) Who else is liable for defamation? What if the publisher is in another country?
Intellectual property law	Protects creations of the human mind.
Digital signatures	Digital signatures are recognized as legal in the United States and some but not all other countries.
Regulation of consumer	The United States allows the compilation and sale of customer databases. The European Union does not.
Time and place	An electronic document signed in Japan on January 5 may have the date January 4 in Los Angeles. Which date is considered legal if a dispute arises?
Electronic contracts	If all the elements to establish a contract are present, an electronic contract is valid and enforceable.
Taxation	Taxation of sales transactions by states is on hold in the United States and some but not all other countries. Expect this issue to be revived because the potential for increased revenue to the states is significant.

Source: Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 795.

Electronic transactions are the many kinds of transactions that take place online, including contractual dealings, buying and selling of goods and services, information exchange, financial transactions (credit card payments; payor services, such as PayPal; and money transfers), and communications. When developing a website, the small business owner must ensure that all online business transactions will be secure, particularly those involving money. This discussion must take place with whomever is developing your website.

Intellectual property is "a creation of the mind, such as inventions, literary and artistic works, and symbols, names, images, and designs, used in commerce."Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 774. Music, photos, videos, digital news, and artwork are forms of intellectual property that can be transmitted over the Internet. All small business owners need to be concerned about the theft of intellectual property. They are afforded multiple protections, which are summarized in Table \(\PageIndex{2}\.

Table \(\PageIndex{2}\ Intellectual Property Protections

Law	Protection Provided by the Law
Intellectual property law	Protects creations of the human mind
Patent law	Protects inventions and discoveries
Copyright law	Protects original works of authorship, such as music and literary works and computer programs
Trademark law	Protects brand names and other symbols that indicate source of goods and services
Trade secret law	Protects confidential business information
Law of licensing	Enables owners of patents, trademarks, copyrights, and trade secrets to share them with others on a mutually agreed-on basis
Law of unfair competition dealing with counterfeiting and piracy	Protects against those who try to take a free ride on the efforts and achievements of creative people

Source: Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 779.

It is important to protect intellectual property because businesses will not realize the full benefits of their inventions and would be inclined to focus less on research and development. Additionally, without intellectual property protections, "exporters face unfair competition abroad, non-exporters face counterfeit imports at home, and all businesses face legal, health and safety risks from the threat of counterfeit goods entering their supply chains." "Why Protect Intellectual Property?," *StopFakes.gov*, accessed June 1, 2012, origin.www.stopfakes.gov/lear...-protect-my-ip. Unfortunately, US small businesses are at a disadvantage because"Why Protect Intellectual Property?," *StopFakes.gov*, accessed June 1, 2012, origin.www.stopfakes.gov/lear...-protect-my-ip.

- They may lack the knowledge, expertise, or resources necessary to prevent the theft of their ideas and products.
- Many small businesses do not have personnel and operators overseas, so they do not have the necessary eyes and ears needed to be vigilant. The theft of their ideas and products often goes undetected.
- Small businesses generally do not have the kinds of access and resources that are likely available to larger companies (e.g., specialized legal counsel).

Because of the complexities of intellectual property protections, this area requires the services of an attorney, preferably one experienced and knowledgeable in cyberlaw.

Jurisdiction refers to the right and power that a court has to interpret and apply the law in a particular geographic location.Peter LaSorsa, "Selling Products Online: What Legal Jurisdiction," *Practical eCommerce*, November 5, 2008, accessed October 10, 2011, www.practicalecommerce.com/articles/860-Selling-Products-Online-What-Legal -Jurisdiction-Applies-. "A court must have jurisdiction over the litigants and the claims before it entertains a lawsuit. In the context of Internet commerce, this issue erupts when a dispute arises between businesses from different states [or countries]."Elias M. Awad, *Electronic Commerce: From Vision to Fulfillment* (Upper Saddle River, NJ: Prentice-Hall, 2005), 387. Many small businesses will be selling products online in other states and in other countries, so it is important to understand the jurisdictions that might be applicable to any online transaction. "In many cases, laws from the customer's state are the ones that will apply in the event a problem arises. This is equally true regarding the laws of other countries."Peter LaSorsa, "Selling Products Online: What Legal Jurisdiction," *Practical eCommerce*, November 5, 2008, accessed October 10, 2011, www.practicalecommerce.com/articles/860-Selling-Products-Online-What-Legal -Jurisdiction-Applies-. From the perspective of any business, but particularly a small business, it would be much easier from both a time and a money perspective to have an issue litigated in the home state of a business. Although there are no guarantees, these steps can be taken to increase the chances of a dispute being settled in the home state of a business: Peter LaSorsa, "Selling Products Online: What Legal Jurisdiction," *Practical eCommerce*, November 5, 2008, accessed October 10, 2011, www.practicalecommerce.com/articles/860-Selling-Products-Online-What-Legal -Jurisdiction-Applies-.

1. If using a contract with another party, make sure the contract says that any dispute must be filed in your home state and that both parties to the contract agree to jurisdiction in that state.
2. When a customer is purchasing an item on the website of a business, one of the terms and conditions of the transaction should be that the customer agree to jurisdiction in the home state of that business. This can be done with a check box next to the statement. Make the customer check it off before completing the purchase.
3. A less effective way is to include a disclaimer on the website that any transaction will convey jurisdiction to the home state of a business, and any dispute must be heard by a court of competent jurisdiction in the home state of the business.

All these steps should also be considered when selling to other countries. However, the laws in other countries will undoubtedly introduce complications into protecting the US-based business. Take the example of Yahoo! and the sale of Nazi memorabilia on one of its auction websites. A French court ruled that such sales breached French law against the display of Nazi items. Yahoo! took steps to remove and ban all such hate paraphernalia from its auction sites, but it continued to fight jurisdiction of the French ruling in American courts.Kathleen Mykytn and Peter Mykytn, "The Importance of the Law For E-Commerce Strategies," *Information Systems Management* 22, no. 2 (2005): 50–56. It would be very easy for a small business to inadvertently find itself in a similar situation. That is why a business needs to be careful when selling outside its home country. Be familiar with foreign laws. This is not an easy task because the minute a business website goes live, the business goes global. The laws of the world suddenly become relevant.

Ethical Issues

It is known that "ethical factors do play a significant role in e-consumers' purchasing decisions."Avshalom M. Adam, Avshalom Aderet, and Arik Sadeh, "Do Ethics Matter to E-Consumers?," *Journal of Internet Commerce* 6, no. 2 (2007): 19–34. Therefore, ethical factors should be of major concern in e-commerce and, accordingly, in the information and protections offered by an e-commerce website.

It has been observed that the "Internet represents a new environment for unethical behavior," and "ethical transgressions are more likely to happen in e-transactions as compared to face-to-face transactions."Sergio Roman, "The Ethics of Online Retailing: A Scale Development and Validation from the Consumer's Perspective," *Journal of Business Ethics*, 72 (2007): 131–48. To a large extent, this is due to the absence of physical and interpersonal cues that are present in traditional retailing or business settings. The implication is that e-commerce operations should focus more specifically and explicitly on the ethics messages that are being conveyed by the website. Thus the focus of this ethics discussion is on three major components of e-commerce ethics: security, privacy, and trust.

Security and Privacy

Website security (the protection of a company, its suppliers, its customers, and its employees from criminal activity) is a critical consideration for any small business engaged in e-commerce. The Internet is a global playground for criminals. It is less risky to steal online because "the potential for anonymity on the Internet cloaks many criminals in legitimate-looking identities, allowing them to place fraudulent orders with online merchants, steal information by intercepting e-mail,…shut down e-commerce sites by using software viruses," Kenneth C. Laudon and Carol G. Traver, *E-commerce: Business, Technology, Society* (Upper Saddle River, NJ: Prentice Hall, 2007), 248. and steal financial information and money. This new type of crime is referred to as cybercrime, and it is a serious threat to e-commerce.

Cybercrime refers to any criminal activity that is done using computers and the Internet,"Cybercrime," *TechTerms.com*, accessed October 10, 2011, www.techterms.com/definition/cybercrime. and it includes a wide range of offenses. Downloading illegal music, stealing from online bank accounts, stealing credit card numbers and personal information, stealing identities, posting confidential business information on the Internet, and creating and distributing viruses on other computers are only some of the thousands of crimes that are considered cybercrimes."Cybercrime," *TechTerms.com*, accessed October 10, 2011, www.techterms.com/definition/cybercrime. Cybercrimes can take place anytime and anyplace. It has cost American companies a median loss of $3.8 million a year, and data protection and information technology (IT) practitioners from 45 US organizations from various sectors reported that, across their companies, 50 successful attacks were experienced over a four-week period.Alejandro Martinez-Cabrera, "Cybercrime Costs Firms $3.8 Million Yearly," *Computer Crime Research Center*, August 3, 2010, accessed October 10, 2011, www.crime-research.org/news/03.08.2010/3807.

Video Clip **6.10.2**

The Business of Cybercrime

Cybercrime today.

Video Clip **6.10.3**

The State of Cybercrime

Do not be fooled. Cybercrime is on the rise.

Video Clip **6.10.4**

Cybercrime Trailer

New cybercrime threats.

Cybercrime is more profitable than the illegal drug trade (more than $100 billion globally per year). Every three seconds an identity is stolen, and without security, an unprotected PC can become infected within four minutes of connecting to the Internet.“What Is Cybercrime?,” *Symantec*, accessed October 10, 2011, us.norton.com/cybercrime/definition.jsp; and “Cyber Crime ‘More Profitable Than Drugs’,” *9News*, June 9, 2009, accessed October 10, 2011, news.smh.com.au/breaking-news-national/cyber-crime-more-profitable-than-drugs-20090609-c1qm.html. A Microsoft security intelligence report maintains that cybercrime is fast maturing as a profession, with cybercriminals becoming more sophisticated and packaging online threats that can be sold to others.Rudolph Muller, “Cybercrime Getting More Sophisticated,” *Mybroadband*, June 24, 2010, accessed October 10, 2011, mybroadband.co.za/news/internet/13279-Cybercrime-getting-more-sophisticated.html.

Examples of Cybercrimes“Computer Crime & Intellectual Property Section,” US Department of Justice, accessed October 10, 2011, www.cybercrime.gov.

The Computer Crime & Intellectual Property Section of the US Department of Justice keeps a running list of press releases related to cybercrimes. Here are three examples.

1. A Miami man pled guilty to one count of conspiracy to traffic in and possess unauthorized credit card numbers with intent to defraud, and one count of trafficking in unauthorized credit card numbers.
2. A Rhode Island man pleaded guilty to Internet sales of unregistered, unlabeled pesticides for cats and dogs while infringing on the trademark of two well-known national brand names, “Frontline” and “Frontline Plus.” The man made more than 3,500 sales through eBay.
3. A Canadian man was sentenced to 33 years in prison for selling counterfeit cancer drugs using the Internet.

Cybercrime hurts the bottom line of any business, but small and medium-sized businesses are the new cybercrime target. “Hackers and computer criminals…are taking a new aim—directly at small and midsize businesses…Smaller businesses offer a much more attractive target than larger enterprises that have steeled themselves with years of security spending and compliance efforts.”Tim Wilson, “Small Business: The New Black in Cybercrime Targets,” *Dark Reading*, March 19, 2009, accessed October 10, 2011, www.darkreading.com/security/perimeter-security/215901301/small-business-the-new-black-in-cybercrime -targets.html. Small businesses are potentially very lucrative targets for several reasons:

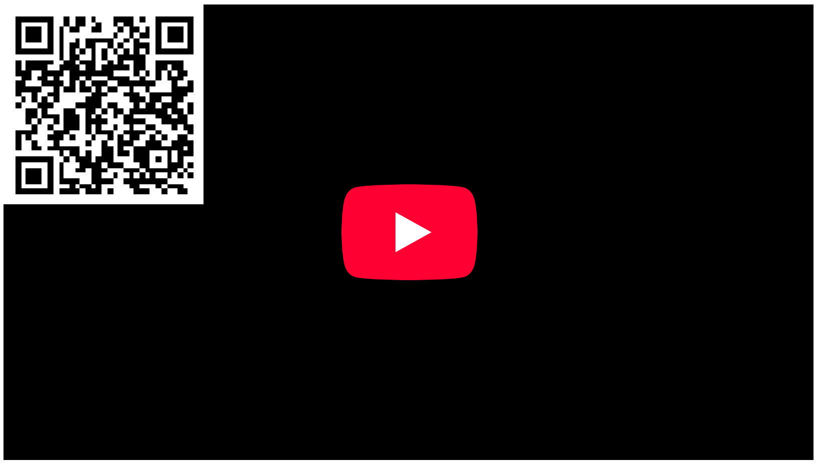
- Nearly one fifth of small businesses do not use antivirus software.
- Two thirds of small businesses do not have a security plan in place.
- Sixty percent of small businesses do not use encryption on their wireless links.
- Only about 60 percent of mom-and-pop shops have met the credit card industry’s data security standards for protecting credit card data. Compliance at the smallest businesses is even worse.
- Two thirds of small and medium-sized businesses believe that large companies are the main target for cybercrime,…yet 85 percent of the fraud seen in business occurs in small and medium-sized businesses.Tim Wilson, “Small Business: The New

Black in Cybercrime Targets," *Dark Reading*, March 19, 2009, accessed October 10, 2011, www.darkreading.com/security/perimeter-security/215901301/small-business-the-new-black-in-cybercrime -targets.html.

The cybercriminal is looking to steal and disrupt. Securing a website should be a top priority for any company—small, medium, or large—that uses the Internet to conduct its business.

Video Clip 6.10.5

How SSL Security Works on E-Commerce Websites



How Amazon.com grew so fast by incorporating SSL security.

Given the state of cybercrime, assuring the security and the **privacy** of e-consumers (the protection of the personal information of customers on the Internet) are necessary to build and maintain confidence in the e-market, particularly because the risk of privacy invasion and security flaws is significant.Avshalom M. Adam, Avshalom Aderet, and Arik Sadeh, "Do Ethics Matter to E-Consumers?," *Journal of Internet Commerce* 6, no.2 (2007): 19–34. Further, such assurances have been found to have a significant impact on the willingness to purchase.Naresh K. Malhotra, Sung S. Kim, and James Agarwal, "Internet Users' Information Privacy Concerns (IUIPC): The Construct, the Scale and a Causal Model," *Information Systems Research* 15, no. 4 (2004): 289–304, as cited in Avshalom M. Adam, Avshalom Aderet, and Arik Sadeh, "Do Ethics Matter to E-Consumers?," *Journal of Internet Commerce* 6, no.2 (2007): 19–34.

E-customers voice their privacy concerns in different ways. Here are some examples:Sergio Roman, "The Ethics of Online Retailing: A Scale Development and Validation from the Consumer's Perspective," *Journal of Business Ethics*, 72 (2007): 131–48.

- "I don't like websites that ask you for personal information that is not necessary for the purchase to be made."
- "All privacy notices contain the same information, and besides, how do I know that the website actually follows the privacy policy."
- "I'm not comfortable at all with the idea of the online retailer having my personal information and selling it to other companies for marketing purposes."

The scope of failure in protecting customers' personal information can be potentially devastating because of the global reach of the Internet; the effect can easily reach millions of people.Beverly Kracher and Cynthia L. Corritore, "Is There a Special E-Commerce Ethics?," *Business Ethics Quarterly* 14, no. 1 (2004): 71–94. Heartland is a payment processor responsible for handling about 100 million credit card transactions every month. They disclosed in June 2009 that thieves had used malicious software in its network in 2008 to steal an unknown number of credit card numbers.Eric Larkin, "Massive Theft of Credit Card Numbers Reported," *PCWorld*, January 20, 2009, accessed October 10, 2011, www.pcworld.com/article/158003/massive _theft_of_credit_card_numbers_reported.html.

Fortunately, the theft of credit card and other personal information originating from websites accounted for only about 11 percent of the identity theft or fraud that affected 11 million Americans in 2009."Javelin Study Finds Identity Fraud Reached New High in 2008, but Consumers Are Fighting Back," *Javelin Strategy and Research*, February 10, 2010, accessed October 10, 2011, www.javelinstrategy.com/news/831/92/Javelin-Study-Finds-Identity-Fraud -Reached-New-High-but-Consumers-are-Fighting-Back/d,pressRoomDetail. This is why the act of providing credit card information on a website for a purchase is still considered by some people to be so risky that they refuse to conduct any Internet transactions. This has obvious implications for any small company that hopes to do business online.

Fortunately, there is a very straightforward way to provide the security and privacy that online customers seek: the use of **Secure Sockets Layer (SSL)**, a security protocol that is used by web browsers and web servers to help users protect their data during transfer."FAQ: SSL Basics," *VeriSign Authentication Services*, 2011, accessed October 10, 2011, www.verisign.com/ssl/ssl-information-center/ssl-basics. Companies like VeriSign offer SSL protection certificates, and the placement of its icon on a website can offer security and privacy assurances to online customers. The inclusion of SSL protection should be discussed with your website designer.

Trust

Trust is about believing—believing that someone will do what they say and that they will not intentionally do something to hurt you. Trust is an important part of all business relationships. Without trust, all e-commerce would come to a halt. "Trust is central to establishing successful e-commerce ventures and to ensure the continued success of this business paradigm into the future."Albert J. Marcella, *Establishing Trust in Virtual Markets* (Altamonte Springs, FL: The Institute of Internal Auditors, 1999), as cited in Beverly Kracher and Corritore, "Is There A Special E-Commerce Ethics?," *Business Ethics Quarterly* 14, no. 1 (2004): 71–94. Trust will improve competitiveness, reduce the costs of doing business, build loyalty, and increase the effectiveness of websites. In short, trust can be an important source of competitive advantage. Trust is essential.

In the physical world, trust is much easier to develop. Physical cues from spaces and buildings, face-to-face voice and body language, and salesperson effectiveness can translate easily into trust relationships. In the online world, however, trust develops as a result of the complex interaction of multiple factors that have design implications for the website. Here are some examples of trust: Avshalom Adam, Avshalom Aderet, and Arik Sadeh, "Do Ethics Matter to E-Consumers?," *Journal of Internet Commerce* 6, no. 2 (2007): 19–34; Andrea Everard and Dennis F. Galletta, "How Presentation Flaws Affect Perceived Site Quality, Trust, and Intention to Purchase from an Online Store," *Journal of Management Information Systems* 22, no. 3 (2005–6): 55–95; William Hampton-Sosa and Marios Koufaris, "The Effect of Web Site Perceptions on Initial Trust in the Owner Company," *International Journal of Electronic Commerce* 10, no. 1 (2005): 55–81; Beverly Kracher and Cynthia L. Corritore, "Is There a Special E-Commerce Ethics?," *Business Ethics Quarterly* 14, no. 1 (2004): 71–94; and Sergio Roman, "The Ethics of Online Retailing: A Scale Development and Validation from the Consumers' Perspective," *Journal of Business Ethics* 72 (2007): 131–48.

- The customer observes the seller to be honest, fair, responsible, and benevolent.
- The customer expects that the company behind the website will not engage in opportunistic behavior.
- The customer is confident about the site's security and privacy protection (security and privacy having been shown to be an important determinant of a customer's willingness to buy online).
- The customer perceives the company's website as appealing (linked to layout, typography, font size, and color choices)—the belief being that an appealing website reflects a company has the capabilities and resources to fulfill its promises.
- The customer experiences a site that is easy to use (i.e., easy to navigate, easy to search, easy to gather information) and has relevant content, interactivity, site consistency, and site reliability.
- The customer perceives presentation flaws (e.g., poor style, incompleteness, language errors, conflicting colors, delay, and confusing terminology) as indicators of a low-quality, untrustworthy website.

Another element of trust is **order fulfillment**. Order fulfillment is all about meeting expectations, and some argue that this is the most important element of trust.Terry Newholm et al., "Multi-Story Trust and Online Retailer Strategies," *International Review of Retail, Distribution and Consumer Research*, 14, no. 4 (2004): 437–56. Delays in the delivery of a product, the delivery of the wrong product, and the hassles of returning merchandise are stresses that can contribute to a less-than-satisfactory Internet buying experience. Such experiences contribute to a lack of trust. In contrast, satisfied consumers express themselves this way:Sergio Roman, "The Ethics of Online Retailing: A Scale Development and Validation from the Consumers' Perspective," *Journal of Business Ethics* 72 (2007): 131–48.

- "Products at this site are a bit pricey, but it is worth purchasing from this site since you get what you order and within the promised delivery time."
- "I keep purchasing from this site because they always have the items I want in stock."

Buying some products online, such as clothing, furniture, and toys, does not offer buyers the opportunity to touch and feel the product before buying. As a result, order fulfillment becomes even more important to customer satisfaction.

Linked closely to order fulfillment is **product reliability**. Product reliability refers to “the accurate display and description of a product so that what customers receive is what they thought they ordered.”Sergio Roman, “The Ethics of Online Retailing: A Scale Development and Validation from the Consumers’ Perspective,” *Journal of Business Ethics* 72 (2007): 131–48. Online retailers should provide a complete and realistic description of the product and its benefits—with high-quality pictures and perhaps even demonstration videos if possible, appropriate, and affordable—along with product availability and likely ship dates. Customers should be notified by e-mail of order acceptance, and the anticipated delivery date with phone and e-mail contacts for any needed assistance.

Video Link **6.10.6**

Inflatable Fruitcake, the "Perfect" Christmas Gift?

We've all seen this on TV.

What all this says is that website owners must proceed carefully to create their online presence in a way that will inspire trust. “If consumers trust online merchants and have confidence in the reliability and integrity of merchants, they will likely feel more at ease making purchases and disclosing sensitive information online. Therefore, the success of online merchants and the future of e-commerce may depend heavily on online trust.”Ye Diana Wang and Henry H. Emurian, “Trust in E-Commerce: Consideration of Interface Design Factors,” *Journal of Electronic Commerce in Organizations* 3, no. 4 (2005): 42–60.

Payment Options

Nowhere are security, privacy, and trust more necessary than at the point of payment. Without this transaction, there is no e-commerce, so it is imperative that small businesses selling online take the necessary steps to reduce customer concerns about shopping online. A recent survey found that retailers operating online may have lost more than $44 billion dollars over a one-year period as a result of transaction problems on their websites; in addition, 27 percent of online shoppers would turn to an offline or online competitor if they encountered an online transaction issue.“Tealeaf Survey Reveals That Online Retailers Potentially Lost More Than $44 Billion Due to Transaction Problems on Their Sites,” *Tealeaf*, September 27, 2010, accessed October 10, 2011, www.tealeaf.com/news/news-releases/2010/Tealeaf-Survey -Reveals-Online-Retailers-Potentially-Lost.php. More specifically, online shoppers who encountered a transaction problem would react as follows:“Tealeaf Survey Reveals That Online Retailers Potentially Lost More Than $44 Billion Due to Transaction Problems on Their Sites,” *Tealeaf*, September 27, 2010, accessed October 10, 2011, www.tealeaf.com/news/news-releases/2010/Tealeaf-Survey -Reveals-Online-Retailers-Potentially-Lost.php.

- Sixty-six percent would contact customer service, including
  - Fifty-three percent calling customer service; and
  - Thirty-six percent e-mailing or logging a web complaint with customer service.
- Thirty-two percent would abandon the transaction entirely, including

- Twenty-seven percent turning to an online or offline competitor.

To make matters even worse, the potential for lost revenue when customers have a negative online shopping experience is amplified by the rising use of social media like Facebook and Twitter; the voicing of displeasure on social networks can significantly damage a company's reputation."Tealeaf Survey Reveals That Online Retailers Potentially Lost More Than $44 Billion Due to Transaction Problems on Their Sites," *Tealeaf*, September 27, 2010, accessed October 10, 2011, www.tealeaf.com/news/news-releases/2010/Tealeaf-Survey -Reveals-Online-Retailers-Potentially-Lost.php. The message is clear. Online transactions must run smoothly.

But there is another important issue: the number of payment options that are offered to the customer. Research shows that the more payment options customers have, the more likely they will complete their purchase.Delilah Obie, "Choosing a Vendor to Process Your Online Transactions," *SCORE*, accessed October 10, 2011, www.score.org/resources/online-transactions-vendor; "How to Increase Sales with Online Payment Options," March 22, 2010, accessed October 10, 2011, www.openforum.com/idea-hub/topics/money/article/how-to -increase-sales-with-online-payment-options-thursday-bram; "More Payment Options Can Mean More Business," *MivaCentral*, 2009, accessed October 10, 2011, mivacentral.com/articles/payment.mv; T. Brandon, "Multiple Payment Processing Options Increase Sales," *eZine Articles*, October 21, 2007, accessed October 10, 2011, ezinearticles.com/?Multiple-Payment-Processing-Options-Increase-Sales&id= 793303; and Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008).

- Merchants offering multiple payment methods have lower cart abandonment rates.
- If you can afford it and maintain your profit margin, offering multiple payment options is a means to increase your sales by increasing customer confidence and convenience.
- North American online businesses with four or more options for payment see an average **sales conversion rate** of 72 percent. The sales conversion rate is the percentage of site visitors that make a purchase.
- Each new payment option added at the point of checkout results in a sales increase of 5–20 percent.

Customers shopping online expect convenience and a variety of payment options. Credit cards are by far the most popular means for making an online payment, with one survey indicating that 70 percent of online consumers used this payment method."Online Retail Payments Forecast 2010–2014: Alternative Payments Growth Strong but Credit Card Projected for Comeback," *Javelin Strategy and Research*, February 2010, accessed October 10, 2011, www.javelinstrategy.com/research/Brochure-171. Any small business that does not have its website set up to accept credit cards will lose 60–80 percent of its potential orders. Further, offering a credit card option will increase the number of orders, and those orders will be substantially larger because credit cards enable impulse buying, reassure customers of your legitimacy, and simplify your billing.Delilah Obie, "Choosing a Vendor to Process Your Online Transactions," *SCORE*, accessed October 10, 2011, www.score.org/resources/online-transactions-vendor.

Consistent with credit cards being the online payment method of choice, it has been reported that 99 percent of online businesses offer a general purpose credit card, which include Visa, MasterCard, American Express, and Discover."More Payment Options Can Mean More Business," *MivaCentral*, 2009, accessed October 10, 2011, mivacentral.com/articles/payment.mv. However, debit cards are growing in popularity ahead of other payment alternatives.

Table \(\PageIndex{3}\) Payment Options Consumers Used to Make Online Purchases in 2009

Payment Option	% Used
Major credit card usable anywhere	70
Major debit card usable anywhere	55
Online payment service, such as PayPal or Google Checkout	51
Gift card good only at a specific merchant	41
Store-branded credit card good only at the merchant that issued the card	27
Prepaid card or payroll card usable anywhere	17
Online credit service such as BillMeLater	17
Store-branded debit card good only at merchant that issued the card	16

The implications of this for small business are that credit cards should be the first payment method that should be set up for online sales. Additional payment methods should be added as quickly as the budget allows because it is clear that more payment options translate into a greater likelihood of purchase. However, the choice of alternative payment methods should be in keeping with the growth strategy of the business. It may be that offering one method of payment provides a satisfactory level of sales, thereby eliminating the need for additional methods for sales growth.

KEY TAKEAWAYS

- It is important to protect intellectual property.
- Ethics influence consumer purchases.
- Small businesses are the new target for cybercrime. As a result, small businesses must pay attention to their website security because it will protect the business and influence customer trust.

EXERCISES

1. Find three small business websites. Analyze each website in terms of its trustworthiness. Discuss why you would or would not trust each site. Be specific.
2. Discuss whether you think an unintelligible privacy policy is ethical. Be specific in your arguments.

6.11: E-Commerce Technology

Learning Objectives

1. Explain what an e-commerce platform is.
2. Discuss the importance of a CRM solution to a small business.
3. Explain m-commerce and why small businesses should consider incorporating it into their e-commerce strategy.
4. Explain the significance of Web 2.0 to a small business.

As discussed in Chapter 1, digital technology has put small business on a more equal footing with its larger competitors. Although it is certainly true that a commitment to technology is not for every small business, it is also true that technology is transforming small business in important ways: (1) businesses are easier to find online than ever before; (2) communicating with customers is shifting to e-mail marketing and social media; (3) e-mail and mobile phones are improving productivity; (4) collaboration among employees who are working in multiple venues is easier; (5) outsourcing is easier; and (6) more companies are shifting their attention to how they can sell products and services online. Using technology well is proving to be one of the most prominent drivers of business success. Ross Dawson, "Six Ways Technology Is Transforming Small Business," *Ross Dawson Blog*, November 18, 2009, accessed October 10, 2011, rossdawsonblog.com/weblog/archives/2009/11/six_ways_techno.html.

Technology specifically related to e-commerce is a large umbrella. E-commerce platforms, customer relationship management (CRM), going mobile, and Web 2.0 will be discussed in this section.

E-Commerce Platforms

An **e-commerce platform** is the software that makes it possible for a business to sell online. In general, the core e-commerce platform should support basic requirements such as custom styling, **search engine optimization**, credit card processing, promotions, catalog management, analytics, product browsing, checkout, and order management. Additionally, e-commerce platforms should provide self-service content management systems (CMS), support multiple languages, and support multiple stores."Ecommerce Integration," *Treehouse Logic*, May 20, 2010, accessed October 10, 2011, blog.treehouselogic.com/2010/05/20/ecommerce-integration. These requirements may vary slightly depending on which type of e-commerce is being conducted. **Analytics** refer to the tools that can track the different ways people use your website and then make sense of the data. Justin Whitney, "What Is Web Analytics?," *AllBusiness.com*, 2010, accessed October 10, 2011, www.allbusiness.com/marketing-advertising/marketing-advertising/11382028 -1.html. Analytics will be discussed in further detail in Chapter 8.

The **all-in-one e-commerce platform solution** has become more popular with online merchants. This solution provides everything: the core e-commerce platform plus hosting, accounting, analytics, and marketing tools such as e-mail management. Because all the tools are integrated, they work together.James Macguire, "Starting Your Own E-Business, Pt 2: Choosing a Platform," *ecommerce-guide.com*, September 26, 2005, accessed October 10, 2011, www.ecommerce-guide.com/solutions/building/article.php/3551461. It has also been reported that e-commerce platforms are now enabling online retailers to better reach consumers through mobile devices and social media sites."E-commerce Platforms Offer Retailers New Social and Mobile Features, *Internet Retailer*, April 22, 2010, accessed October 10, 2011, www.internetretailer.com/ECTR/article.asp?id=34549. This is great news for the small business that wants to tap into these growing markets.

The list of e-commerce software providers is always growing, but there are many products that are tailored specifically for small to medium-sized businesses. Some of the names that come up frequently for small business are BigCommerce, Magento, Affinity Internet, ProStores (for the smaller merchant), and Miva Merchant. However, this list is not exhaustive, and new products enter the marketplace all the time.

Customer Relationship Management

Customer relationship management, as mentioned in Chapter 2, refers to "a customer service approach that focuses on building long-term and sustainable customer relationships that add value for the customer and the company."Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 75. Some small businesses may wonder whether they really need the added complexity of a small business CRM solution. The answer will depend to a large extent on the size of the business and its growth objectives. However, it has been observed that there is no small business out there that, “sometimes in spite of themselves, didn’t benefit from implementing a…CRM or its watered down equivalent—a simpler Contact Management software solution.”Perry Norgarb, “Does Your Small Business Even Need a CRM Software Solution?,” *SmallBizCRM*, accessed October 10, 2011, www.smallbizcrm.com/does-your -small-business-need-a-software-solution.html. Recent studies have revealed that CRM applications account for the following: Peter Norgarb, “So Where Do You Start? How Do You Start?,” 2010, www.smallbizcrm.com.

- Revenue increases of up to 41 percent per salesperson
- Decreased sales cycles of over 24 percent
- Lead conversion rate improvements of over 300 percent
- Customer retention improvements of 27 percent
- Decreased sales and marketing costs of 23 percent
- Improved profit margins of over 2 percent

It has also been noted that companies can boost their profits by almost 100 percent by retaining just 5 percent of their customers. Peter Norgarb, “So Where Do You Start? How Do You Start?,” 2010, www.smallbizcrm.com. What does this mean for the small business that chooses to go with a CRM solution? As long as the solution is well implemented and actually used, there should be an immediate payoff and productivity improvement throughout the company. Additionally, choosing to engage in e-commerce makes the selection of a CRM solution even more important because the quality of customer relationships is so important to online success.

Although there was a time when CRM solutions were not feasible for small business, they are available today for even the smallest businesses. These CRM solutions are priced and designed with the small business in mind.

Going Mobile

As defined earlier in this chapter, **mobile e-commerce (m-commerce)** refers to the purchase of goods and services through wireless technology, such as cell phones and handheld devices. It consists of two primary components: “…the ability to use a wireless phone or other mobile device to conduct financial transactions and exchange payments over the Internet…and the ability to deliver information that can facilitate a transaction—from making it easy for your business to be ‘found’ via a mobile Web browser to creating mobile marketing campaigns such as text promotions and loyalty programs.”Laurie McCabe, “Mobile Commerce: Coming to Ecommerce Sites Near You,” *ecommerce-guide.com*, September 14, 2010, accessed October 10, 2011, www.ecommerce-guide.com/news/trends/article.php/3903526/Mobile-Commerce -Coming-to-Ecommerce-Sites-Near-You.htm. It is predicted that in 2015 m-commerce revenues will make up 8.5 percent of all US e-commerce revenue and 20 percent of global e-commerce revenue. In the United States, that will represent only one half of 1 percent of all retail revenues.Ian Mansfield, “US Mobile Ecommerce Revenues Set to Rise to $23.8bn in 2015, *Cellular-News*, April 14, 2010, accessed October 10, 2011, www.cellular-news.com/story/42841.php. However, even though m-commerce is lagging behind other mobile uses, wireless devices and m-commerce are expected to create another revolution in e-commerce. The most important thing that online retailers can do is to “…take action soon because the mobile environment is adapting much more quickly than the web.”Brendan Gibbons, “To Tap Mobile Buyers, First Determine Their Needs,” *Practical eCommerce*, March 16, 2010, accessed October 10, 2011, www.practicalecommerce.com/articles/1732-To-Tap-Mobile-Buyers-First-Determine -Their-Needs.

Small businesses need to sort out the hype from what’s real. What’s real are the facts and the trends. Jim Jansen, “Online Product Research: 58% of Americans Have Researched a Product or Service Online,” September 29, 2010, accessed October 10, 2011, pewinternet.org/Reports/2010/...-Research.aspx; “Majority of Online Retailers Plan to Have Mobile Ecommerce Websites by 2011,” *Deluxe for Business*, August 20, 2010, accessed October 10, 2011, deluxesmallbizblog.com/web-de...bsites-by-2011; Laurie McCabe, “Mobile Commerce: Coming to Ecommerce Sites Near You,” *ecommerce-guide.com*, September 14, 2010, accessed October 10, 2011, www.ecommerce-guide.com/news/trends/article.php/3903526/Mobile-Commerce -Coming-to-Ecommerce-Sites-Near-You.htm; Ian Mansfield, “Mobile Internet Devices Expected to Surpass One Billion by 2013,” *Cellular-News*, December 9, 2009, accessed October 10, 2011, www.cellular-news.com/story/40997.php; John Lawson, “75% of Online Retailers Are Ramping Up Mobile Strategies,” *ColderICE*, accessed June 1, 2012, colderice.com/75-of-online-re...le-strategies/; Aaron Smith, “Mobile Access 2010,” *Pew Internet & American Life Project*, July 7, 2010, accessed October 10, 2011, www.pewinternet.org/Reports/2010/Mobile-Access-2010.aspx; and Ian Mansfield, “US Mobile Ecommerce Revenues Set to Rise to $23.8bn in 2015, *Cellular-News*, April 14, 2010, accessed October 10, 2011, www.cellular-news.com/story/42841.php.

1. From the second quarter 2009 through the second quarter 2010, Amazon’s customers around the world used mobile devices to buy more than $1 billion in products. This is a trend that any small business with an e-commerce website should watch closely.

2. Mobile devices connected to the Internet are reshaping the way people are going about their personal and professional lives.
3. One of the fastest growth areas in e-commerce will be using mobile devices to make online purchases.
4. Close to 80 percent of organizations plan to have mobile websites by the end of 2011. Online retailers without an m-commerce strategy will be in the minority.
5. Handheld devices are increasingly being used to research products, compare prices, and buy online while shopping.
6. A central driver to m-commerce growth is **smartphone** ownership and the corresponding mobile Internet use.
7. Nearly 58 percent of Americans have researched a product or a service online.
8. Among cell phone owners, 11 percent purchased a product or a service using their phones.

Video Clip **6.11.1**

Mobile E-Commerce Capabilities

Gene Alvarez, Gartner Group, discusses m-commerce.

Major retailers have been able to easily offer remote access to customers who want to make purchases using mobile devices (e.g., Target and Nordstrom). Software is now available for small businesses to offer some of the same bells and whistles, giving their online customers the ability to shop via smartphones.Stuart J. Johnston, “Small Business Ecommerce Trends: Shop by Smartphone,” *Small Business Computing.com*, September 7, 2010, accessed October 10, 2011, www.smallbusinesscomputing.com/news/article.php/3902136/Small-Business -Ecommerce-Trends-Shop-by-Smartphone.html.

Mobile e-commerce may not be for all small businesses, but a small business owner who is already in e-commerce or has plans to do so should give it consideration. Multichannel shoppers tend to purchase more, so small companies need to think of ways to “effectively engage customers by delivering consistent, rich experiences across all channels, including mobile, to maintain and fuel double-digit ecommerce industry growth rates.”“Majority of Online Retailers Plan to Have Mobile Ecommerce Websites by 2011,” *Deluxe for Business*, August 20, 2010, accessed October 10, 2011, deluxesmallbizblog.com/web-design/search-marketing/majority-of-online-retailers -plan-to-have-mobile-ecommerce-websites-by-2011. Online customers are ready and increasingly interested in using mobile devices to make purchases.

Web 2.0

There is no agreement about an exact definition of **Web 2.0** but, in general, it refers to websites that are more interactive, engaging, and interesting than before. A Web 2.0 site is one where visitors can engage with you, your business, and your site by doing things like the following:Steve Strauss, “Maximizing Your Web Presence Is Key to Building Your Small Business,” *USA Today*, April 11, 2010, accessed October 10, 2011, www.usatoday.com/money/smallbusiness/columnist/strauss/2010-04-11-building-web-presence_N.htm.

- Posting comments on your blog or your articles or chatting in a forum
- Retweeting your content, sharing it on Facebook, or Digging it

- Watching a video, listening to a podcast, or participating in a webinar
- Taking a quiz or responding to a poll

Web 2.0 is about having a conversation with your customers. This is very different from **Web 1.0**, where websites were static and all you could do was read. Web 2.0 sites are collaborative and interactive. The small business that creates a site that engages and interacts with people, that makes people want to stick around, will be giving people more of a chance to create a connection with the business.Steve Strauss, "Maximizing Your Web Presence Is Key to Building Your Small Business," *USA Today*, April 11, 2010, accessed October 10, 2011, www.usatoday.com/money/smallbusiness/columnist/strauss/2010-04-11-building-web-presence_N.htm. These closer ties will increase customer awareness and consideration of the company's products and services, improve customer satisfaction, increase the chances of loyalty, increase the chances for sales, and add to the bottom line. There will also be significant benefits realized between the small business and its suppliers and partners: lowering the costs of communication and doing business.

A much smaller percentage of small businesses have adopted elements of Web 2.0 as compared to large enterprises and midsize companies.Heather Claney, "Small Businesses Apparently Slow to Adopt Web 2.0 Philosophies," *IT Knowledge Exchange*, June 29, 2008, accessed October 10, 2011, itknowledgeexchange.techtarget.com/channel-marker/small-businesses-apparently -slow-to-adopt-web-20-philosophies. However, many small businesses are using Web 2.0 in a variety of positive ways.Anita Campbell, "Real Life Examples of Business Owners Using Social Media," *Small Business Trends*, July 3, 2008, accessed October 10, 2011, smallbiztrends.com/2008/07/real-life-examples-of-business-owners-using-social-media.html.

- One business owner operated a Facebook group, attracted interest in the business, and developed loyalty through the group.
- Another business routinely put press releases online and attested to their value at getting the company's website found in search engines.
- The owner of a product company reported good results with videos that were loaded on YouTube and on the company's website. The video attracted people to the site and also engaged existing visitors on the site.
- A small real-estate company has a Facebook page, a blog, and a property value calculator that allows homeowners to calculate an approximation of their home's value without having to speak with a realtor. The information is then sent via e-mail.

As Web 2.0 keeps evolving, the value and opportunities it will bring to small businesses will continue to grow. "The increased flow of two-way information between business and customer, the increase in information distribution through blogs and wikis, and the increased participation of customers in product improvement and even design will continue. By adopting Web 2.0 technologies and tools, small businesses can improve market share, profit, and reputation, now and in the future."Sang-Heui Lee, David DeWester, and So Ra Park, "Web 2.0 and Opportunities for Small Businesses," *Service Business* 2, no. 4 (2008): 335–45.

Video Clip **6.11.2**

Web 2.0

Evolution of website technology to Web 2.0.

KEY TAKEAWAYS

- E-commerce platforms make it possible for businesses to sell online. The all-in-one platform solution has become more popular with online merchants. There are many platforms that are tailored specifically for small and medium-sized businesses.
- Small businesses should think about CRM. CRM solutions are now available for even the smallest of businesses.
- Even though m-commerce is lagging behind other mobile uses, wireless devices and m-commerce are expected to create another revolution in e-commerce.
- Web 2.0 is important. It is about having a conversation with your customers. Small businesses need to learn about it and strongly consider incorporating it into their e-commerce strategies.
- Web 2.0 keeps evolving, so the value and opportunities it will bring to small businesses will continue to grow.

EXERCISES

1. Select three small business websites. Identify the features that are examples of Web 2.0.
2. Find three CRM solutions (software products) online that are geared to small businesses. Compare the features. If you owned a small business, which one would you choose? Why?

6.12: The Three Threads

Learning Objectives

1. Explain how e-business and e-commerce contribute to customer value.
2. Explain how e-business and e-commerce can benefit a company's cash flow.
3. Explain why e-business and e-commerce are becoming increasingly necessary for small business survival.

Customer Value Implications

E-business in general and e-commerce in particular can both contribute to increased customer value. In the case of e-business, moving operations to digital technology can improve productivity, reduce or eliminate duplicative processes, streamline supply chain management and enterprise resource planning, improve customer and vendor relationships, improve business intelligence, increase and improve internal collaboration while doing the same with external business partners. In all instances, the customer, the vendor, and the business partner should realize increased value from doing business with the company in terms of greater efficiency, speed of information flows and transactions, and overall satisfaction.

In the case of e-commerce, customer value is provided via convenience, a greater selection of products, the ability to easily compare prices and services, 24/7 availability, privacy protection, multiple payment options, and reliable order fulfillment processes. Web 2.0, in particular, presents "consumers with a whole array of options in searching for value products and services and finding exactly what they need and want with minimum efforts, in line with the current customer desire for personalization, individual approach and empowerment."Efthymios Constantinides and Stefan J. Fountain, "Web 2.0: Conceptual Foundations and Marketing Issues," *Journal of Direct, Data and Digital Marketing Practice* 9, no. 3 (2008): 231–44.

Cash-Flow Implications

The cash flow of a small business should benefit from all the sources of value just mentioned because they should result in lower operating costs, improved customer relationships, and higher sales. In particular, cash flow should increase as a result of the following:

- Prepaid purchases by business-to-business (B2B) customers. This may apply to other e-commerce customers as well.
- Multiple payment options. The greater the number of options, the higher the number of sales and the higher the average order size.
- Lower costs of sales as a result of the reduced need for telephone, travel expenses, and live salespeople.
- Eliminating many steps in business processes and cutting out the middlemen. Tamir Dotan, "How Can eBusiness Improve Customer Satisfaction? Case Studies in the Financial Service Industry," *University of Amsterdam*, accessed October 10, 2011, www.tamirdotan.com/e-business%20Article.html.
- Saving money on employees and salaries because of **customer outsourcing** (i.e., anything that the customer does individually, things like searching for product or service information, entering his or her billing information, and signing up for an e-mail confirmation. These are things that customer service representatives do not have to do.Dave Roos, "Advantages of E-commerce," *How Stuff Works*, 2010, accessed October 10, 2011, communication.howstuffworks.com/advantages-e-commerce.htm.
- Increased sales as a result of selling niche products. "It turns out that most small businesses (and start-ups) have relatively niche-y products…The Internet disproportionately favors small businesses since it enables them to position their niche goods to people *shopping for* that particular niche good."Brian Halligan, "Four Ways the Internet Is Transforming Small Business," *HubSpot Blog*, October 2, 2006, accessed October 10, 2011, blog.hubspot.com/blog/tabid/6307/bid/50/Four-Ways-the-Internet-Is-Transforming-Small-Business.aspx.

This is not an exhaustive list. However, it is illustrative of the many ways in which e-business and e-commerce can impact the cash flow of a small business in a favorable way.

Digital Technology and E-Environment Implications

Although not all small businesses may choose to go the route of digital technology and the e-environment (e-business and e-commerce), it has been advised on many fronts that small businesses seriously consider creative ways in which to incorporate them all into their operations. Digital technology is difficult to avoid, whether it be computers, **smartphones**, or iPads (see the story of

Lloyd's Construction in Chapter 1). Even on a small scale, digital technology can help improve business processes and keep costs down.

The importance of e-business and e-commerce to small business has been the focus of this chapter. Realistically, neither can be avoided by small businesses that want to grow. E-commerce in particular has opened up the world to small business. Websites have "created a flattening effect in the sense that small businesses and large businesses [are] suddenly on a level playing field…The web [allows] small companies to have the same reach as a large firm. A small company's web site [can] be viewed a million times just as easily as a large firm's web site, and that information [is] available worldwide, 24 hours a day. Small businesses [can] now have some of the same abilities as large companies to reach customers with rich content of information about their products nationally or internationally."Sang-Heui Lee, David DeWester, and So Ra Park, "Web 2.0 and Opportunities for Small Businesses," *Service Business* 2, no. 4 (2008): 335–45. The small business that wants to grow will ignore e-business and e-commerce at its peril.

KEY TAKEAWAYS

- E-business and e-commerce both contribute to increased customer value.
- The cash flow of a small business should benefit from the customer value offered by e-business and e-commerce.
- Even though some small businesses may choose not to go the route of digital technology, e-business, or e-commerce, it has been suggested that small businesses seriously consider creative ways in which to incorporate them into all operations.

EXERCISES

1. Select three small businesses that engage in e-commerce. Interview the owners and ask them to describe (1) how e-commerce has added customer value and (2) the positive and negative impacts on cash flow.
2. Locate at least one small business that is a nonemployer (i.e., consists of only the owner). Interview the owner about the role that digital technology plays in the business and what his or her plans are, if any, to increase its incorporation. Find out if the business has a website. If it does, are there plans to engage in e-commerce? If the business does not have a website, find out why not and whether there are any plans to create one.

Disaster Watch

I've Been Hacked!

Not discouraged by the bad economy, Marnie McCormick opened "The Country Store" in the local shopping center. McCormick had done her homework. She originally leased the store front for a temporary stint, selling a line of unique handcrafted products and locally made foods while asking people what sort of products they wished were available in the area. In this way, she was able to build the kind of store that was needed, using the existing demand to decide what kinds of products she would offer.

McCormick had a myriad of concerns at start-up—inventory, suppliers, marketing, outfitting the store, and administrative systems. What she did not know was that someone had hacked into her computer system. From somewhere unknown, the hard drive of her computer in the store had been hacked. The hackers had downloaded a key-logging program (a virus that makes it possible for the hacker to record all your keystrokes, gaining access to passwords and other sensitive information). The hackers were able to see everything that she typed into the computer: e-mails, communications with vendors and customers, passwords—everything. The hackers only had to wait until she logged into her online bank account before they had all the information they needed for the payoff. She soon discovered that someone had been in her bank account, transferring money at will. The hackers had changed the password. The system crashed immediately.

As soon as she had opened the doors to her new store, McCormick had to close them. What should she do to get her store up and running again? How can she prevent this from happening in the future? Jake Lynch, "Hackers Set Sights on Small Businesses, Households," *Issaquah Reporter*, August 19, 2010, accessed October 10, 2011, www.pnwlocalnews.com/east_king/iss/news/101077494.html.

6.13: Countertrade

Learning Objectives

1. Understand what countertrade is.
2. Recognize why companies engage in countertrade.
3. Know two structures of countertrade.

What Is Countertrade?

Some countries limit the profits (currency) a company can take out of a country. As a result, many companies resort to **countertrade,** where companies trade goods and services for other goods and services; actual monies are involved only to a lesser degree, if at all. You can imagine that limitations on transferring profits would make the world less flat; so too would the absence of countertrade opportunities in situations where currency transfer limitations are in place. Countertrade is also a resourceful way for exporters to sell their products and services to foreign companies or countries that would be unable to pay for them using hard currency alone.

All kinds of companies, from food and beverage company PepsiCo to power and automation technologies giant the ABB Group, engage in countertrade. When PepsiCo wanted to enter the Indian market, the government stipulated that part of PepsiCo's local profits had to be used to purchase tomatoes. This requirement worked for PepsiCo, which also owned Pizza Hut and could export the tomatoes for overseas consumption.

This is one example of countertrade, specifically counterpurchase. By establishing this requirement, the Indian government was able to help a local agricultural industry, thereby mitigating criticism of letting a foreign beverage company into the country.

Another example in which companies exchanged goods and services rather than paying hard currency is Bharat Heavy Electricals Limited (BHEL), the largest power generation equipment manufacturer in India. BHEL wanted to secure additional overseas orders. To accomplish this, BHEL looked for countertrade opportunities with other state-owned firms. The company entered into a joint effort with an Indian, state-owned mineral-trading company, MMTC Ltd., to import palm oil worth $1 billion from Malaysia, in return for setting up a hydropower project in that nation. Malaysia is the second-largest producer of palm oil in the world. Because India imports an average of 8 million tons of edible oil every year but consumes 15 million tons, importing edible oil is valuable.Utpal Bhaskar and Asit Ranjan, "Bhel Looking at Counter-Trade Deals to Secure Overseas Orders," *Live Mint*, May 11, 2010, accessed November 18, 2010, http://www.livemint.com/2010/05/11224356/Bhel-looking-at-countertrade.html.

Why Do Companies Engage in Countertrade?

One reason that companies engage in this practice is that some governments mandate countertrade on very large-scale (over $1 million) deals or if the deal is in a certain industry. For example, South Korea mandates countertrade for government telecommunications procurement over $1 million. When governments impose counterpurchase obligations, firms have no choice but to engage in countertrade if they wish to sell goods into that country.

Countertrade also can mitigate the risk of price movements or currency-exchange-rate fluctuations. Because both sides of a countertrade deal in real goods, not financial instruments, countertrade can solve the inflation risk involved in foreign currency procurement. In effect, countertrade can be a better mechanism than financial instruments as a way to hedge against inflation or currency fluctuations.Sang-Rim Choi and Adrian E. Tschoegl, "Currency Risks, Government Procurement and Counter-Trade: A Note," *Applied Financial Economics* 13, no. 12 (December 2003): 885–89.

Finally, countertrade offers a way for companies to repatriate profits. As you'll see in Chapter 15, some governments restrict how much currency can flow out of their country. (Governments do this to preserve foreign exchange reserves.) Countertrade offers a way for companies to get profits back to the home country via goods rather than money.

Structures in Countertrade

The very first trading—thousands of years ago—was based on barter. **Barter** is simply the direct exchange of one good for another, with no money involved. Thus, barter predates even the invention of money.

Does barter still take place today? Yes—and not just among two local businesses exchanging something like a haircut for a therapeutic massage. Thanks to new innovations and the Internet, barter is taking place across international borders. For example, consider the Bartercard. Established in 1991, Bartercard functions like a credit card, but instead of funding the card through cash in a bank account, a company funds the card with its own goods and services. No cash is needed. Over 75,000 trading members in thirteen countries are using the Bartercard, doing $1.3 billion in cashless transactions annually.Bartercard website, accessed November 23, 2010, bci.bartercard.com.

In a **counterpurchase** structure, the seller receives cash contingent on the seller buying local products or services in the amount of (or a percentage of) the cash. Simply put, counterpurchase occurs when the seller receives cash but contractually agrees to buy local products or services with that cash.

Disadvantages of Countertrade

Countertrade has a tarnished image due to its associations with command economies during the Cold War, when the goods received were often useless or of poor quality but were forced upon companies by command-economy government regulations. New research is showing that countertrade transactions have legitimate economic rationales, but the risk of receiving inferior goods continues.Peter W. Liesch and Dawn Birch, "Research on Business-to-Business Barter in Australia," in *Getting Better at Sensemaking*, ed. Arch G. Woodside, Advances in Business Marketing and Purchasing, vol. 9 (Bingley, UK: Emerald Group Publishing, 2001), 353–84. Most countertrade structures, except for barter, make sense only for very large firms that can take a product like palm oil and—in turn—trade it in a useful way. That's why BHEL partnered with MMTC on the Malaysia countertrade deal—because MMTC specializes in bulk commodities. Similarly, PepsiCo was able to make use of the tomatoes it was required to counterpurchase because it also operates a pizza business.

KEY TAKEAWAYS

- Countertrade refers to companies that trade goods and services for other goods and services; actual monies are involved only to a lesser degree, if at all. Although countertrade had a tainted reputation during the Cold War days, it's a useful way for exporters to trade with developing countries that may not be able to pay for the goods in hard currency.
- Companies engage in countertrade for three main reasons: (1) to satisfy a foreign-government mandate, (2) to hedge against price and currency fluctuations, and (3) to repatriate profits from countries that limit the amount of currency that can be taken out of the country.
- Barter is a structure of countertrade that has been around for thousands of years and continues today. Counterpurchase is a countertrade structure that involves the seller receiving cash contingent on the seller buying local products or services in the amount of (or a percentage of) the cash.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What are some of the disadvantages of countertrade?
2. Describe an example of how counterpurchasing works.
3. Does barter still make sense in the modern world? Who might engage in barter? What advantages might they gain?

SECTION OVERVIEW

6.14: Understanding the Roles of Finance and Accounting in Global Competitive Advantage

6.3.7: End-of-Chapter Questions and Exercises

These exercises are designed to ensure that the knowledge you gain from this book about international business meets the learning standards set out by the international Association to Advance Collegiate Schools of Business (AACSB International).Association to Advance Collegiate Schools of Business website, accessed January 26, 2010, www.aacsb.edu. AACSB is the premier accrediting agency of collegiate business schools and accounting programs worldwide. It expects that you will gain knowledge in the areas of communication, ethical reasoning, analytical skills, use of information technology, multiculturalism and diversity, and reflective thinking.

EXPERIENTIAL EXERCISES

(AACSB: Communication, Use of Information Technology, Analytical Skills)

1. You've been tasked with obtaining financing for your subsidiary in Brazil. Of all the sources of financing you've learned about in this chapter, which sources of financing would you explore? Would you consider equity financing in the Brazilian stock exchange? What factors would you research before making this financing decision?
2. Go to http://www.oanda.com to check the current value of the US dollar relative to the euro. Compare this exchange rate to the exchange rate one year ago. Imagine that you are an executive in a multinational firm that will be manufacturing components at a Chinese subsidiary and selling those components to a US subsidiary that will assemble the components into finished goods and then sell them to a Portuguese subsidiary to sell to European markets. What actions would you take to mitigate currency risk?
3. You are the treasury operations manager for a multinational company. You've been tasked with recommending a cash-investment strategy that will maximize a return on the cash and maintain the liquidity needed for emergencies. Using what you've learned about centralized depositories, multilateral netting, fronting loans, tax havens, and transnational investment, what recommendations would you make?

Ethical Dilemmas

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. Coca-Cola operates thirty-nine bottling plants in China."Coca-Cola on the Yangtze: A Corporate Campaign for Clean Water in China," *Knowledge@Wharton*, August 18, 2010, accessed August 25, 2010, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2568. China is an important market for Coca-Cola. The company's sales in volume grew 19 percent in China in 2009 while declining 1 percent in the United States. Coca-Cola also hopes to expand its business into the juice, dairy, and ready-to-drink markets. It had offered $2.3 billion to buy Chinese company China Huiyuan Juice to get a strong (20 percent) share in China's juice market. Chinese regulators, however, rejected the deal. In 2004, Coca-Cola was forced to shut down one of its bottling plants in south India after community organizers blamed it for causing water shortages there. (A year earlier PepsiCo's plant in the same state also lost its operating license for similar reasons.) Coca-Cola is now partnered with the World Wildlife Fund (WWF) to improve the water quality of the Yangtze River, which is the longest river in Asia and supplies 35 percent of China's water but is now the most threatened river in the world due to pollution. Coca-Cola is working with rural farmers, for example, to reduce runoff from animal waste into the river by turning it into biogas for cooking and heating instead. The company has pledged $24 million over seven years to support fresh-water programs globally. It's also striving to be "water neutral" by making its "waste" water pure enough for agricultural irrigation and completely offsetting the amount of water it uses in its soft-drink products by funding clean-water projects and watershed preservation efforts around the world. What do you think of these moves by Coca-Cola? On the one hand, as the world's largest beverage company, its water-neutral plan could make a big difference, and its clout brings attention to the world water issue. On the other hand, bringing attention to the issue could put the spotlight on the company itself, which uses 2.5 liters of water to make a liter of Coke. In fact, when looking across the whole supply chain, 200 liters of water go into making a single liter of Coke (due to water-intensive sugar cane crops). However, looked at from an entire-chain perspective, it takes 140 liters of water to make a cup of coffee and 800 to 1,000 gallons of water to get a single gallon of milk.Peter M. Senge, *The Necessary Revolution* (New York: Doubleday, 2008), 77–92. If you were a Chinese consumer, would you be more likely to buy Coca-Cola products given the company's efforts to clean up the Yangtze River? If you were an executive at Coca-Cola, what actions or programs would you recommend or support?
2. As you learned in Section 15.5, transfer pricing is legal, and firms can manipulate transfer prices to avoid taxes. The practice, however, violates the spirit of the law in some countries. Should firms engage in this practice? On the other hand, by not taking advantage of these opportunities, would firms be shortchanging their investors?

6.15: Chapter Introduction

Understanding the Roles of Finance and Accounting in Global Competitive Advantage

WHAT'S IN IT FOR ME?

1. What are the role of accounting in business and the impact of international standards?
2. What are the nature of currency risk and the methods of currency translation?
3. What are the sources of financing available to firms?
4. What are capital budgeting and the factors that influence international investment decisions?
5. What are global money management methods that reduce corporate transaction costs and taxes?

In this chapter, you'll learn the principles and techniques of global finance and accounting. In the opening case study, you'll see the increased role that governments are playing in the business finance arena. In a flat world, access to capital (i.e., part of the finance function) is uniform across countries, as are accounting standards. However, access to capital varies significantly across countries and between small and large firms. Accounting standards also vary, though these differences are decreasing.

In Section 15.1, you'll get a glimpse into why countries developed different accounting rules in the past and how new international accounting standards have emerged to create smoother capital markets functioning in our increasingly global world.

In Section 15.2, you'll learn the importance of consolidated financial statements, and the challenges they present in currency translation. You'll also explore two techniques of currency translation and two ways to mitigate the risks of currency exposure.

In Section 15.3, you'll learn the sources of financing available to international firms and see how firms like L'Occitane, IBM, Hewlett-Packard, Kimberly-Clark, SAP, and McDonald's are making financing and investment decisions.

In Section 15.4, you'll see the factors underlying political risk and economic volatility and learn three ways that multinational firms are structuring their financial organizations to deal with those risks. You'll also find out how religion can impact the financial laws of some countries.

Finally, in Section 15.5, you'll delve into global money management and how firms like Colgate move money across borders to minimize costs and taxes, while gaining maximum returns on their capital.

Opening Case: Bucyrus and Ex-Im Bank

Among the many changes taking place in the international business landscape, numerous leading management consultants predict that government will play an increasingly active role. Governments will no longer simply be an external regulator but will be a direct participant in particular strategic choices and actions. The *new normal*, in terms of government involvement in business, is one in which government's hand in strategy and strategy execution will be highly visible and significant. Part of this governmental activism is a result of the growing scale and reach of global firms. For instance, even before the global financial meltdown in 2009, McKinsey & Company consultancy noted the following:

As businesses expand their global reach, and as the economic demands on the environment intensify, the level of societal suspicion about big business is likely to increase. The tenets of current global business ideology—for example, shareholder value, free trade, intellectual-property rights, and profit repatriation—are not understood, let alone accepted, in many parts of the world. Scandals and environmental mishaps seem as inevitable as the likelihood that these incidents will be subsequently blown out of proportion, thereby fueling resentment and creating a political and regulatory backlash. This trend is not just of the past 5 years but of the past 250 years. The increasing pace and extent of global business, and the emergence of truly giant global corporations, will exacerbate the pressures over the next 10 years.Ian Davis and Elizabeth Stephenson, "Ten Trends to Watch in 2006," *McKinsey Quarterly*, January 2006, accessed July 24, 2010, www.mckinseyquarterly.com/Ten_trends_to_watch_in_2006_1734.

Unfortunately for big (and small) business, the apparent systematic risk, managerial excesses, and imprudence that led to the global financial meltdown in 2008 and 2009 have only exacerbated the interest of government in business matters. Let's look at the example of Bucyrus International for how to survive and thrive in this new normal of governmental activism.Compiled based on reports in Rick Barrett, "Bucyrus Chief Dug Deep for Support," *Milwaukee (WI) Journal Sentinel*, July 3, 2010, accessed July 23, 2010, http://www.jsonline.com/business/97745649.html; James R. Hagerty, "U.S. Ex-Im Bank Reconsiders India Coal Project," *Wall Street Journal*, June 30, 2010, accessed July 23, 2010, http://online.wsj.com/article/SB10001424052748704334604575338791530127472.html?mod=WSJ_hps_LEFT_WhatsNews; Rich Rovito, "Bucyrus' Sullivan Wants Vote, and Sleep," *Milwaukee (WI) Business Journal*, July 6, 2010, accessed July 23, 2010, http://milwaukee.bizjournals.com/milwaukee/blog/2010/07/bucyrus_sullivan_wants_vote_and_some_sleep.html?t=printable; Rick Barrett, "Export-Import Bank May Reconsider Bucyrus Decision," *Milwaukee (WI) Journal Sentinel*, June 28, 2010, accessed July 23, 2010, http://www.jsonline.com/business/97319564.html.

Meet Bucyrus

Bucyrus caters to those who *mine* their own business.Bucyrus website, accessed July 23, 2010, www.bucyrus.com. To be precise, the company designs and manufactures surface and subsurface mining equipment and aftermarket replacement parts, as well as servicing its equipment. Its mining products are used for unearthing coal, gold, iron ore, oil sands, and other raw materials. The company sells products to customers worldwide, from large companies to small ones to quasi-governmental agencies operating largely in South America, Australia, Canada, China, India, South Africa, and the United States. Even though Bucyrus is a US-based company, international sales account for more than 70 percent of its revenues.

Bucyrus in Emerging Markets

Like many successful multinationals, much of Bucyrus's new work takes place in emerging markets where the growth and need is greatest. For instance, Bucyrus struck a deal in which its mining shovels would be used to dig coal to fire a giant, new power plant being built by Reliance Industries in India. Reliance, with nearly 25,000 employees, is India's largest private-sector conglomerate, with business interests in energy, retailing, chemicals, textiles, and communications."10 Years Highlight: Financial Highlights," Reliance Industries Limited, accessed July 23, 2010, www.ril.com/html/investor/10_yearshighlight.html.

Although Bucyrus and Reliance had agreed on the deal, the involvement of the Export-Import Bank of the United States (Ex-Im Bank) as a loan guarantor complicated things. Ex-Im Bank is the principal government agency responsible for aiding the export of American goods and services—thereby creating and sustaining US jobs—through a variety of loan, guarantee, and insurance programs. Although supporting US exports is its primary mission, the bank was sued by Friends of the Earth, Greenpeace and four American cities that brought a global warming lawsuit against the bank as well as the Overseas Private Investment Corporation (OPIC), contending that the agencies provided financial assistance to projects without first evaluating the projects' global warming impacts.Friends of the Earth, "Landmark Global Warming Lawsuit Settled," press release, February 6, 2009, accessed December 12, 2010, action.foe.org/t/6545/pressRelease.jsp?press_release_KEY=486. The lawsuit took seven years to resolve, but in the end the courts ruled that Ex-Im Bank and OPIC must consider the environmental effect of the projects they fund."Settlement Agreement: Export-Import Bank of the United States," Friends of the Earth, February 6, 2009, accessed December 12, 2010, www.foe.org/pdf/Ex-Im_Settlement.pdf; "Victory!," *ClimateLawsuit.org*, accessed December 12, 2010, www.foe.org/climate/climatelawsuit/index.htm.

In reviewing Bucyrus's loan-guarantee application, Ex-Im Bank expressed concerns about the project's environmental impact.Bob Hague, "Ex-Im Bank Moves Forward on Bucyrus Deal," *Wisconsin Radio Network*, July 14, 2010, accessed December 12, 2010, http://www.wrn.com/2010/07/ex-im-bank-moves-forward-on-bucyrus-deal. In the end, the bank rejected the application. It stated that the coal-fired power plant that would be fed by the mine conflicted with the Obama administration's environmental goals.Mark Drajem, "Reliance Power's India Plan Rejected by U.S. Export-Import Bank," *BusinessWeek*, June 26, 2010, accessed December 12, 2010, http://www.businessweek.com/news/2010-06-26/reliance-power-s-india-plan-rejected-by-u-s-export-import-bank.html. The guarantees would have backed loans that Reliance would have used to purchase mining equipment from Bucyrus. If the bank's rejection of the financing stood, Reliance could turn to another country, most likely China, for financing and equipment.James R. Hagerty and Amol Sharma, "Employment, Environment at Odds," *Wall Street Journal*, June 28, 2010, accessed December 12, 2010, http://online.wsj.com/article/SB10001424052748704846004575332810145193160.html. The bank's ruling was not appealable, but within hours of hearing about it, Bucyrus CEO Tim Sullivan launched an intense campaign aimed at getting Ex-Im Bank to reverse course before the Indian project's equipment orders went to Chinese companies. Sullivan argued that the rejection could result in a loss of $600 million in equipment sales for Bucyrus and up to 1,000 US jobs could be at stake.Patrick McIlheran, "Reprieve for Bucyrus in Era of Mojo," *Milwaukee (WI) Journal Sentinel*, June 30, 2010, accessed December 12, 2010, http://www.jsonline.com/news/opinion/97521434.html.

Preparation + Reaching Out to Stakeholders…and a Little Luck

Sullivan fumed at the bank's rejection of his loan application. He had recently gone out on a limb and made the bold move of convincing his board of directors to spend $250 million to expand and refurbish Bucyrus's South Milwaukee operations, while the company's competitors were moving work to China.Rick Barrett, "Bucyrus Chief Dug Deep for Support," *Milwaukee (WI) Journal Sentinel*, July 3, 2010, accessed July 23, 2010, http://www.jsonline.com/business/97745649.html. Instead of accepting defeat with the bank's decision, he went on the attack. Sullivan notified elected officials, many of whom were engaged in reelection campaigns. Given the prevailing tough US economic atmosphere, the officials would likely back an initiative that would retain or increase US jobs. Sullivan also called business and labor union leaders and enlisted support from Bucyrus's hundreds of suppliers. The president of the United Steelworkers of America, Leo Gerard, appealed to the public to participate in a letter-writing campaign to protest Ex-Im Bank's refusal to finance mining equipment that would be made by union members. "At a time when we are losing good-paying jobs, and at a time when President Obama wants to double US exports, how can the Export-Import Bank deny a loan that would create and protect jobs at Bucyrus International? It was a dumb decision," Gerard told the *Journal Sentinel*.Rick Barrett, "Obama Visit to Racine Wednesday May Be Pushing Review," *Milwaukee (WI) Journal Sentinel*, June 28, 2010, http://www.jsonline.com/business/97319564.html accessed November 28, 2010.

As Sullivan rallied potential supporters, luck played its role: President Barack Obama was planning for a town hall meeting in Racine, Wisconsin, just a few miles from Bucyrus's headquarters. Even better, the town hall meeting topic was the economy. A local business association took out full-page advertisements in the local newspapers asking the president to help reverse the bank's decision and save US jobs. Sullivan was astute in pushing the right political hot buttons, but getting Obama's attention would have been much harder had he not been coming to Racine.

All-Night Negotiations and a Surprise Reversal of the Ex-Im Bank Decision

It is important to remember that Bucyrus is not a coal miner but instead a supplier to that industry, so Ex-Im Bank's complaint was really with Bucyrus's customer, Reliance. After all-night negotiations, still prior to President Obama's visit to Wisconsin, Reliance and Ex-Im Bank remained in disagreement. The bank's primary mission is to support US exports,Carter Wood, "Ex-Im Bank: Starting to Get Things Right, Slowly," *Shop Floor*, July 15, 2010, accessed December 12, 2010, shopfloor.org/tag/export-import-bank. but it still wanted Reliance to commit to buying US equipment for renewable energy projects as a condition of its approving the loan guarantees.Rick Barrett, "Reversal Revives Bucyrus' Big Deal," *Milwaukee (WI) Journal Sentinel*, June 30, 2010, accessed December 12, 2010, http://www.jsonline.com/business/97484379.html. Reliance, however, stated that making such a promise would violate World Trade Organization rules. The impasse was finally settled when Reliance agreed to pursue renewable energy projects in addition to the coal-fired power plant.Rick Barrett, "Reversal Revives Bucyrus' Big Deal," *Milwaukee (WI) Journal Sentinel*, June 30, 2010, accessed December 12, 2010, http://www.jsonline.com/business/97484379.html. In an Export-Import Bank news release, Ex-Im Bank chairman and president Fred P. Hochberg said, "We are pleased that Reliance is making this commitment to renewable energy, which allows us to sustain U.S. jobs and promote both conventional and renewable energy exports."Export-Import Bank of the United States, "Ex-Im Bank Approves Preliminary Review of Export Financing Application for India's Sasan Power Plant," press release, July 14, 2010, accessed December 12, 2010, www.exim.gov/pressrelease.cfm/D25FB2CF-D13D-A3B0-A324873AFCC72DC7. Renewable energy sources only account for about 12 percent of India's power,Prashant Bawankule, "Renewable Energy Sources: What Will Work for India?," *Chilli Breeze*, November 2010, accessed December 12, 2010, www.chillibreeze.com/articles_various/Renewable-Energy.asp. while 50 percent comes from coal-fired plants and the rest from oil and gas.Prashant Bawankule, "Renewable Energy Sources: What Will Work for India?," *Chilli Breeze*, November 2010, accessed December 12, 2010, www.chillibreeze.com/articles_various/Renewable-Energy.asp. Therefore, progress on alternative energy sources in India was seen as a victory (or at least a face-saving reason) for Ex-Im Bank's reversing its original decision.

A few of hours before Obama landed in Wisconsin, therefore, Ex-Im Bank announced it would reconsider its rejection of the loan guarantees and would review the application again, taking "into account Reliance's expressed commitment to invest in the renewable energy sector" in its review.Mark Drajem, "U.S. Export-Import Bank Reconsiders India Coal Financing Deal," *BusinessWeek*, July 1, 2010, accessed December 12, 2010, http://www.businessweek.com/news/2010-07-01/u-s-export-import-bank-reconsiders-india-coal-financing-deal.html. In a letter to Reliance chairman Anil Ambani, Hochberg asked Reliance to consider building renewable-energy power plants capable of producing at least 250 megawatts of power, which would be among the largest renewable projects built in India to date.Fred P. Hochberg, letter to Anil Ambani, Chairman, Reliance ADAG, June 30, 2010, accessed December 12, 2010, media.journalinteractive.com/documents/EI-bank-ltr_062010.pdf. The letter did not, however, make the loan guarantees contingent on a fixed amount of renewable energy nor did it impose a deadline for those projects.Rick Barrett, "Reversal Revives Bucyrus' Big Deal," *Milwaukee (WI) Journal Sentinel*, June 30, 2010, accessed December 12, 2010, http://www.jsonline.com/business/97484379.html.

Nonetheless, Reliance's agreement to support renewable energy projects was the key factor in the bank's reversed decision. "If we can encourage India to move faster toward renewable energy as part of this project, and to increase opportunities for U.S. exporters, and to finalize the deal with Bucyrus and save jobs, that's a big victory for everyone," an Ex-Im Bank official said.Rick Barrett, “Reversal Revives Bucyrus’ Big Deal,” *Milwaukee (WI) Journal Sentinel*, June 30, 2010, accessed December 12, 2010, http://www.jsonline.com/business/97484379.html.

Although experts agree that Obama’s involvement was vital to the bank’s reverse decision, many think Bucyrus would have prevailed in the long run anyway, because the bank’s decision would not prevent the plant from being built but merely result in the equipment contract going to a foreign competitor.

Experts said Bucyrus’s reaction to the bank’s initial decision could be a great example of how a company should behave when a deal is threatened by a government agency.Rick Barrett, “Bucyrus Chief Dug Deep for Support,” *Milwaukee (WI) Journal Sentinel*, July 3, 2010, accessed July 23, 2010, http://www.jsonline.com/business/97745649.html. Sullivan may have been lucky with Obama’s pending visit to Racine, but he also had courage and knew how to seize the moment, enlisting the help of business leaders, union officials, and elected officials alike. “If you are going to be aggressive, the way Bucyrus was in this case, then you had better have the facts on your side,” said University of Wisconsin–Madison professor Mason Carpenter. Bucyrus took risks and expended much political capital. “The stakes were big here,” Carpenter said. “To me, this was a case of how to respond to a crisis in our new, more political world.”Rick Barrett, “Bucyrus Chief Dug Deep for Support,” *Milwaukee (WI) Journal Sentinel*, July 3, 2010, accessed July 23, 2010, http://www.jsonline.com/business/97745649.html.

Opening Case Exercises

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. How was the deal between Bucyrus and Reliance threatened by a government agency?
2. What do you think of how Bucyrus’s CEO handled the situation?
3. Do you think governmental agencies will become more involved in business matters? Why or why not?

6.16: International Accounting Standards

Learning Objectives

1. Learn the value of accounting in international business.
2. Describe the role of accounting standards.
3. Recognize the difficulties caused by countries using different accounting standards.

The Role of Accounting in International Business

The purpose of accounting is to communicate the organization's financial position to company managers, investors, banks, and the government. **Accounting standards** provide a system of rules and principles that prescribe the format and content of financial statements. Through this consistent reporting, a firm's managers and investors can assess the financial health of the firm. Accounting standards cover topics such as how to account for inventories, depreciation, research and development costs, income taxes, investments, intangible assets, and employee benefits. Investors and banks use these financial statements to determine whether to invest in or loan capital to the firm, while governments use the statements to ensure that the companies are paying their fair share of taxes.

As countries developed different cultures, languages, and social and economic traditions, they developed different accounting practices as well. In an increasingly globalized world, however, these differences are not optimal for the smooth functioning of international business.

The Emergence of New International Accounting Standards

The International Accounting Standards Board (IASB) is the major entity proposing international standards of accounting. Originally formed in 1973 as the International Accounting Standards Committee (IASC) and renamed the International Accounting Standards Board in 2001, the IASB is an independent agency that develops accounting standards known as **international financial reporting standards (IFRS)**.“History,” International Accounting Standards Board, accessed November 26, 2010, www.ifrs.org/Home.htm.

The IASB is composed of fifteen representatives from professional accounting firms from many countries.“About the IFRS Foundation and the IASB,” IFRS Foundation, accessed November 25, 2010, www.ifrs.org/The+organisation/IASCF+and+IASB.htm. These board members formulate the international reporting standards. For a standard to be approved, 75 percent of the board members must agree. Often, getting agreement is difficult given the social, economic, legal, and cultural differences among countries. As a result, most IASB statements provide two acceptable alternatives. Two alternatives aren't as solid or straightforward as one, but it's better than having a dozen different options.

Adherence to the IASB's standards is voluntary, but many countries have mandated use of IFRS. For example, all companies listed on EU stock exchanges are required to use IFRS.European Commission, “Report to the European Securities Committee and to the European Parliament,” April 6, 2010, accessed November 26, 2010, eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=com:2010:0292:fin:en:html. The same is true for all companies listed on South Africa's Johannesburg Stock Exchange and Turkey's Istanbul Stock Exchange. In all, over one hundred nations have adopted or permitted companies to use the IASB's standards to report their financial results.Neil Baker, “IFAC Calls for Crucial Reporting Roadmap,” *Compliance Week*, July 27, 2009, accessed November 26, 2010, www.complianceweek.com/blog/glimpses/2009/07/27/ifac-calls-for-reporting-roadmap.

The United States doesn't mandate using the IFRS. Instead, the United States has the Financial Accounting Standards Board (FASB), which issues standards known as **generally accepted accounting principles (GAAP)**. The US currently mandates following GAAP. However, the FASB and IASB are working on harmonizing the accounting standards; many IASB standards are similar to FASB ones. The United States is moving toward adopting the IFRS but hasn't committed to a specific time frame.Marie Leone, “Harvey Goldschmid Named IASB Trustee,” *CFO*, December 11, 2009, accessed November 26, 2010, www.cfo.com/printable/article.cfm/14461503.

The primary reason for adopting one standard internationally is that if different accounting standards are used, it's difficult for investors or lenders to compare the financial health of two companies. In addition, if a single international standard is used, multinational firms won't have to prepare different reports for the different countries in which they operate.

Accounting standards can be complex; and this makes modification of standards difficult. In addition, differing practices among various nations add to the complications of a unified accounting format. For example, in the United States and Great Britain, individual investors provide a substantial source of capital to companies, so accounting rules are designed to help individual investors.CIRCA, "International Accounting Norms: Background and Recent Developments in the EU," accessed November 26, 2010, circa.europa.eu/irc/dsis/accstat/info/data/en/accounting%20for%20website.htm. In contrast, the tradition in Switzerland, Germany, and Japan is for companies to rely more on banks for funding. Companies in these countries have a tighter relationship with banks. This means that less information is disclosed to the public. It also results in accounting rules that value assets conservatively to protect a bank's investment. In other countries, the government steps in to make loans or invest in companies whose activities are in the "national interest."

Finally, accounting rules in China follow neither IFRS nor GAAP, which makes it hard for investors to gauge the true value of a company.Doug McIntyre, "Chinese Accounting: Greek to Many," *Forbes*, June 18, 2007, accessed November 26, 2010, http://www.forbes.com/2007/06/18/china-accounting-gaap-pf-education-in_dm_0618investopedia_inl.html. To address this issue, some large Chinese companies report results in both Chinese accounting standards and the IASB's standards. The two accounting standards can show quite different results for the same company, which is why convergence proponents advocate using one global accounting standard.

Characteristics of International Accounting Standards and Their Implications for International Business

On one hand, having to adhere to GAAP rules as well as IFRS rules creates extra labor and paperwork for multinational firms. For example, a US company seeking to raise funds in Germany has to prepare a financial report according to IFRS accounting rules as well as US GAAP rules. Further problems arise when different country accounting rules make the financial statements look different. If the same transaction is accounted for in different ways based on different country accounting rules, the comparability of financial reports is undermined.

In some instances, the differences between US GAAP rules and IFRS are significant. For example, the last-in, first-out (LIFO) accounting method is allowed by GAAP but banned by IFRS. Some firms, such as aluminum company Alcoa, receive a tax benefit from using the LIFO method.Marie Leone, "Unfazed by IFRS," *CFO*, April 30, 2010, accessed August 10, 2010, www.cfo.com/article.cfm/14495043. If IFRS is mandated for all US companies, firms like Alcoa may need to make significant cash-tax payments. This is why US adoption of IFRS is taking time, and why the FASB and IASB are working hard to harmonize the standards.

On the positive side, other companies, like IBM, may gain greater efficiencies and stronger controls from a move to IFRS. For example, converting to IFRS would make it possible for IBM to create a globally shared service center for accounting, rather than having accounting departments in different regions.Marie Leone, "Unfazed by IFRS," *CFO*, April 30, 2010, accessed August 10, 2010, www.cfo.com/article.cfm/14495043.

US adoption of the IASB's global accounting standards would be useful to big multinational companies. Tyco International, for example, is the parent of 1,200 legal entities, 900 of them outside the United States. For Tyco, having to follow only IFRS rules would be positive, because it would enable Tyco to prepare financials on the same basis worldwide and to more freely move accounting staff from country to country and business to business. Nonetheless, given Tyco's massive network of information systems, making the switch would still be "a tremendous amount of work," according to John Davidson, the company's controller and chief accounting officer.David McCann, "IFRS: Jekyll or Hyde?," *CFO*, November 20, 2009, accessed October 28, 2010, www.cfo.com/article.cfm/14456597/c_14457492.

Some smaller public companies, however, would see only costs from a move to IFRS. Davey Tree Expert Company, for example, which only does business in the United States and Canada, sees no benefits. Because the company is unlikely to ever list on any national exchange, the argument that unified standards would allow comparability of financials has no value.David McCann, "IFRS: Jekyll or Hyde?," *CFO*, November 20, 2009, accessed October 28, 2010, www.cfo.com/article.cfm/14456597/c_14457492.

An interim step toward the United States adopting IFRS is to permit US firms that operate globally to file only under IFRS, rather than under both GAAP and IFRS, thereby reducing their financial-statement preparation costs.

KEY TAKEAWAYS

- The purpose of accounting is to communicate an organization's financial position to company managers, investors, banks, and the government. Accounting provides a system of rules and principles that prescribe the format and content of financial statements. Through this consistent reporting, a company's managers and investors can assess the financial health of the firm.

- Historically, countries have followed different accounting standards. If different accounting standards are used, however, it's difficult for investors or lenders to compare two companies or determine their financial condition. US firms and any listed on a US stock exchange must prepare financial statements in accordance with the US Financial Accounting Standards Board (FASB) standards, which are known as generally accepted accounting principles (GAAP). Firms based in the European Union (EU) follow standards adopted by the International Accounting Standards Board (IASB) known as international financial reporting standards (IFRS). Over one hundred nations have adopted or permit companies to use IFRS to report their financial results. The United States is moving toward adopting IFRS but hasn't committed to a time frame. The FASB and IASB are working on harmonizing the two accounting standards.
- The three main advantages of a single set of international accounting standards are (1) an increased comparability between firms, which reduces investor risk and facilitates cross-border financing and investment; (2) a reduction in the cost of preparing consolidated financial statements for multinational firms; and (3) the improved reliability and credibility of financial reports.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What is the purpose of accounting?
2. Why do countries have different accounting standards?
3. What are the advantages of a single set of international accounting standards?
4. Which set of accounting standards does the United States follow?
5. Why are some governments reluctant to follow IFRS?

6.17: Accounting in International Business

Learning Objectives

1. Describe what consolidated financial statements are.
2. Understand the risk of currency fluctuations.
3. Explain two methods that firms use for currency translation.

Financial Statements in International Business

Multinational firms often organize as separate legal entities (i.e., companies) in different countries to gain advantages, such as limiting liability or taking advantage of local corporate tax regulations. Also, many countries mandate that companies that do business in their country set up a separate company in that country. As a result, a multinational company may have numerous foreign subsidiaries, all owned by the parent. A **consolidated financial statement** brings together all the financial statements of a parent and its subsidiaries into a single financial statement. The consolidated financial statement must reconcile all the investment and capital accounts as well as the assets, liabilities, and operating accounts of the firms. Consolidated financial statements demonstrate that firms—although legally separate from the parent and each other—are in fact economically interdependent. Most of the developed nations require consolidated statements so that losses can't be hidden under an unconsolidated subsidiary. The International Accounting Standards Board (IASB) standards mandate the use of consolidated financial statements.

Consolidating financial statements of subsidiaries located in different countries poses problems because of the different currencies used in different countries. Companies must decide on what basis they will translate those different currencies into the home currency of the parent company.

Currency Risk

Currency values fluctuate from day to day relative to each other, which poses a risk for firms that operate internationally. Currency risk is the risk of a change in the exchange rate that will adversely affect the company. Companies face this risk because they typically price their products and services in the local currency of each country in which they operate, to make it easy for local customers to understand the pricing and make the purchase. This practice exposes companies to currency risk. For example, the US dollar fluctuated from 1.501 dollars per euro in October 2009 to 1.19440 in June 2010."Historical Exchange Rates," *OANDA*, accessed October 28, 2010, http://www.oanda.com/currency/historical-rates?date_fmt=us&date=10/26/09&date1=02/25/09&exch=EUR&exch2=EUR&expr=USD&expr2=USD&format=HTML&margin_fixed=0. This means that if a US company were selling a product for 1,000 euros, the company would receive $1,501 dollars for it in October 2009 but only $1,194 for it in June 2010. To preserve profits, the company might raise the euro-denominated price of its products, but the company would risk a drop in sales due to the increased price.

In a simple example, currency fluctuations mean that if a US-based company sold its product in Germany at a 10 percent profit and the currency value of the dollar dropped 10 percent relative to the euro, then the profit would be wiped out.

Companies can mitigate currency risk by engaging in hedging. **Hedging** refers to using financial instruments to reduce adverse price movements by taking an offsetting position. Specifically, a firm can lock in a guaranteed foreign exchange rate through a forward contract. In the **forward contract**, the firm agrees to pay a specific rate at the beginning of the contract for delivery at a future date. Thus, the firm will pay the agreed-on exchange rate regardless of what the current exchange rate is at the date of the final settlement. There are costs associated with using these instruments, such as premium pricing, bank fees, and interest payments. But companies often prefer to protect themselves against a potential larger downside loss, even if they have to pay extra to avoid that bigger loss.

Currency Translation

When multinational companies consolidate their subsidiaries' financial statements, they must translate all the currencies into the currency used by the parent company in its home country. There are two methods which a company can use for currency translation—the current-rate method or the temporal method.

Current-Rate Method

The **current-rate method** is a method of foreign-currency translation in which items in the subsidiaries' financial statements are translated into the currency of the parent corporation at the current exchange rate (i.e., the rate on the date when the statements are prepared). In this case, the current value may be different on the day it's translated than on the date when the assets were originally purchased. Although this difference is only a paper gain or loss, it nonetheless affects the valuation of the firm. This method is the most widely used currency-translation method.

Temporal Method

The **temporal method** is a method of foreign-currency translation that uses exchange rates based on the rate in place when the assets and liabilities were originally acquired or incurred. The temporal method avoids the paper gains or losses problem of the current-rate method. But because subsidiaries purchase assets at different times throughout the year, the multinational firm's balance sheet may not balance if the temporal method is used.

Currency Fluctuations

When the Chinese government announced in 2010 that it would allow its currency, the yuan, to float more freely in relation to other world currencies, US CFOs knew that the change would affect their currency-risk picture. When the yuan was pegged to the dollar (from 2008 to 2010), China's currency had less value, which gave China an advantage in global trade. China's goods were cheaper in world markets. Once the yuan floats more freely, it's expected to appreciate against the dollar.

The yuan's appreciation against the dollar will most likely bring two results. First, it will bring Chinese consumers' purchasing power closer to parity around the world. Second, manufacturing in China will be more expensive than it was in the past, which brings about two results of its own. Foreign firms may move their manufacturing operations out of China (or not open them there in the first place) as they search for the lowest costs elsewhere, and the yuan's value appreciation in the long term means that Chinese products will become more expensive for other countries to buy, which will force China to move from manufacturing lower-margin products like toys and shoes to higher-end businesses. These higher-end areas will bring China into more direct competition with the United States and Europe.Kate O'Sullivan, "Freeing the Yuan," *CFO*, June 23, 2010, accessed October 28, 2010, www.cfo.com/article.cfm/14506658.

Forward Exchange Rate

One way to deal with the problem of currency fluctuations is to use the forward-exchange-rate method. The **forward exchange rate** is the rate at which two parties agree to exchange currency and execute a deal at some specific point in the future, usually 30 days, 60 days, 90 days, or 180 days in the future. The firms agree up front on the rate at which they'll exchange currencies, although the actual delivery of the foreign currency will be at a future specified date. For example, a multinational firm based in Spain might sign a contract with a US bank to buy US dollars for euros 90 days from now at a specified exchange rate. The Spanish corporation would use the forward exchange rate as a way to reduce exchange-rate risk if the value of the euro decreases substantially relative to the US dollar.

If two subsidiaries of the same multinational firm do a currency exchange, then they can use an internal forward rate. The **internal forward rate** is a company-generated forecast of future **spot exchange rates**. The internal forward rate may differ from the forward rate quoted by the foreign exchange market. The advantage of this agreement between the parent and foreign subsidiaries is that if the exchange rate changes, the subsidiary will be not be blamed or credited for the change.

KEY TAKEAWAYS

- Multinational firms often organize as separate legal entities (i.e., companies) in different countries to gain advantages such as limiting liability or taking advantage of local corporate tax regulations. A consolidated financial statement brings together all the financial statements of a parent and its subsidiaries into a single financial statement. Consolidating financial statements of subsidiaries located in different countries poses problems because of the different currencies used in different countries.
- Currency values fluctuate from day to day relative to each other. Companies can mitigate currency risk by engaging in hedging. Hedging refers to using financial instruments to reduce adverse price movements by taking an offsetting position. Specifically, a firm can lock in a guaranteed foreign exchange rate through a forward contract. In a forward contract, a firm agrees to pay a specific rate at the beginning of the contract for delivery at a future date.
- Companies must decide what method they'll use to translate different currencies into the home currency of the parent company. Under the current-rate method of currency translation, items in the subsidiaries' financial statements are translated at the current

exchange rate (i.e., the rate on the date when the statements are prepared) into the currency of the parent corporation. Under the temporal method, firms use the exchange rate based on the rate in place when the assets and liabilities were originally acquired or incurred.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Why do most developed nations require consolidated financial statements?
2. What does currency risk mean?
3. What are some ways that companies can reduce the currency risk they face?
4. Compare the current-rate method of currency translation with the temporal method.
5. Explain the difference between the foreign exchange rate and the internal forward rate.

6.18: Fundamentals of Finance

Learning Objectives

1. Know the various financing options available to international firms.
2. Explain the value of capital budgeting.
3. Understand the role of governments in affecting investment decisions.

Financial Structure and Sources of Financing

As demonstrated in the opening case study, governments, banks, and individuals all play a role in international financing. Businesses get external capital from these sources—capital that lets them build, expand, and grow.

Financial structure refers to the ways in which a multinational firm's assets are financed—from short-term borrowing to long-term debt and equity. Managing a multinational firm's financial structure involves asking: *What is the ideal mix of debt versus equity to finance international operations? Where should these funds be invested?* Multinational firms engage in both **transnational financing** (i.e., seeking capital from a foreign sources) and **transnational investment** (i.e., investing capital in foreign markets).

Sources of financing available to firms include foreign stock exchanges, foreign bond markets, foreign banks, venture-capital firms, and funding from the parent company. Although global equity and debt markets offer firms a new way to get funding—often at lower cost than US markets—they are also complicated by foreign currency and exchange rates.

Equity financing refers to raising capital by selling shares of stock. The **stock market** refers to the organized trading of securities through exchanges. An individual or entity can purchase partial ownership in a corporation, buying shares of stock in the company. The **global equity market** refers to all stock exchanges worldwide where firms can buy and sell stock for financing an investment.

The largest exchanges in the world include the New York Stock Exchange (NYSE) Euronext, the Tokyo Stock Exchange, NASDAQ (National Association of Securities Dealers Automated Quotations) stock exchange, and the London Stock Exchange. The advantage of raising capital in equity markets is that the firm doesn't have to repay the money at a specific time or at a specific interest rate, as it does with bank loans. The disadvantage is that each time a firm offers stock, the firm's management loses some control of the company because shareholders can now vote to approve or disallow management actions.

Debt financing refers to raising capital by borrowing the money and agreeing to repay the entire amount plus agreed-on interest at a specific date in the future. Firms can borrow money from banks or by selling bonds. The advantage of raising money through debt financing is that company management doesn't give up any ownership of the firm.

Firms can also obtain funding via intrafirm loans or trade credits. A **trade credit** lets the customer (in this case, the subsidiary buying the goods or services) defer payment on the good or service for a specified period of time, typically thirty or ninety days. By borrowing capital from a parent, both the subsidiary and the parent eliminate paying transaction costs to an outside entity such as a bank, which would charge fees to make the transaction.

Financing Options Available to Subsidiaries

Subsidiaries can choose between two major ways to finance their operations through external sources: overseas equity markets and overseas debt markets. Let's look at each in turn.

Raising Money in Overseas Equity Markets

Multinational firms choose to raise money in foreign markets for a number of reasons. For example, French luxury beauty products company L'Occitane conducted its initial public offering (IPO) on Hong Kong's stock exchange, rather than on the stock exchange in its home country—the NYSE Euronext in Paris.Peter Bisson, Rik Kirkland, and Elizabeth Stephenson, "The Great Rebalancing," *McKinsey Quarterly*, June 2010, accessed October 28, 2010, www.mckinseyquarterly.com/The_great_rebalancing_2627. L'Occitane made this decision because emerging-market consumers are its fastest-growing segment. Listing on Hong Kong's exchange makes the company more visible in these growing markets and lets locals participate in the growth of the firm by buying shares.

Some multinational firms raise money in both their home-country and overseas stock exchanges. One of the reasons for listing on multiple exchanges is a lower cost of capital as shares become available to global investors who might not otherwise be able to purchase shares due to international investment barriers.

Emerging markets are also opening stock exchanges. For example, the Shanghai and Shenzhen Stock Exchanges in China opened in 1990. In July 2010, the Shanghai Stock Exchange became the sixth-largest stock exchange in the world based on market capitalization.

Figure 15.1 Shanghai Stock Exchange

Courtesy of Jindao Floors Inc.

Public share ownership in China remains complex with three classes of shares: A, B, and H. A-shares are local shares denominated in China's local currency for domestic investors. B-shares are denominated in Hong Kong dollars or US dollars and are generally owned by foreigners. H-shares are for China-incorporated companies traded in Hong Kong. Chinese authorities (the China Securities Regulatory Commission, the People's Bank of China, and the State Administration of Foreign Exchange) closely regulate the Shanghai and Shenzhen Stock Exchanges. Indeed, the Chinese government actively intervenes in its capital markets. For example, it didn't allow any new equity funds to be established in 2007. The government also owns a relatively high number of shares in many listed companies. China's low transparency, poor implementation of securities regulations, and restrictions on hedging and risk-management tools are warning signs to foreign investment-fund executives. At the same time, the government lacks many regulations related to educating or protecting investors. A brokerage firm can allow an investor to buy and sell any amount of any security after the investor answers three questions in the following areas: name, health, and risk tolerance.Matt Anderson, Daniel Curtis, Derek Lin, and Ian Van Reepinghen, "Coming of Age: A Look at China's New Generation of Investors," in The Lauder Institute, *Lauder Global Business Insight Report 2010: First-Hand Perspectives on the Global Economy* (Philadelphia: Wharton, University of Pennsylvania, 2010), 69–73, accessed October 28, 2010, knowledge.wharton.upenn.edu/papers/download/021710_GlobalBiz_2010.pdf.

Raising Money in Overseas Debt Markets

Multinational firms can issue bonds in overseas markets as well as in their home countries. Even China now has an active bond market. Before April 2008, Chinese state-owned enterprises were about the only ones issuing corporate debt in China because corporate bonds were so costly and time-consuming to issue there. Corporate bonds had to be listed on the stock exchange and approved by exchange regulators, making the process subject to political whims. State-owned enterprises raised money in the bond market to finance big infrastructure projects, and the bonds had state guarantees. In 2008, new rules simplified the issuing process, and the Chinese government began letting foreign companies issue yuan-denominated bonds through Hong Kong in 2010. The attraction of the Chinese bond market, according to Chris Zhou, director of debt capital markets at UBS Securities in Beijing, is that "the bond market is a relatively easy and cost-effective way to get money."Frederik Balfour, "In China, A Burst of Corporate Bonds," *BusinessWeek*, July 6, 2009, 25.

McDonald's was the first foreign company to issue yuan-denominated bonds, selling 200 million yuan (or $29 million) of 3 percent notes due in September 2013. As Donald Straszheim, senior managing director and head of China research at the International

Strategy & Investment Group observed, “There are hundreds of global companies wanting to do more business in China, and they will want to be involved in the country’s evolving credit market.”Patricia Kuo and Shelley Smith, “McDonald’s Sets Benchmark for China With Yuan Bond Sale,” *Bloomberg*, August 20, 2010, accessed August 23, 2010, http://www.bloomberg.com/news/2010-08-19/mcdonald-s-yuan-bonds-set-standard-as-china-promotes-debt-credit-markets.html.

According to McDonald’s spokesperson Lisa Howard, issuing bonds in China “gives us access to new funding to support growth in China. We are very confident in the Chinese market and have a strong plan to grow our business in China.”Patricia Kuo and Shelley Smith, “McDonald’s Sets Benchmark for China with Yuan Bond Sale,” *Bloomberg*, August 20, 2010, accessed August 23, 2010, http://www.bloomberg.com/news/2010-08-19/mcdonald-s-yuan-bonds-set-standard-as-china-promotes-debt-credit-markets.html. McDonald’s will use the money it has raised in the bond market to provide working capital for expansion in China, including opening as many as 175 restaurants in 2010, adding to the 1,000 restaurants it already has there.

Innovation and Entrepreneurship

WaterHealth: Financing for Entrepreneurs in Developing Countries

WaterHealth is a company that sells and leases water purification systems for use in developing countries. The company also sells and leases special sanitary water containers that reduce the spread of waterborne diseases from contaminated ladles. WaterHealth developed ultraviolet technology to sanitize water. The technology doesn’t require large-scale operations or equipment, which enables local entrepreneurs in developing countries to use the technology to open their own water shops to sell water to local customers. The result? Consumers gain access to cheaper, cleaner water, while the local economy gains new businesses. WaterHealth’s innovative financing doesn’t require high up-front payments for its technology. Instead, the company collects user fees, allowing the repayment of financing costs over time.WaterHealth International, “Frequently Asked Questions,” accessed August 14, 2010, www.waterhealth.com/.

Investment Decisions

Capital Budgeting

Capital budgeting refers to the process of financing long-term outlays for major projects such as plant expansion, entry into new markets, or research and development. The process of capital budgeting helps a firm decide which major investment projects will be most economically advantageous for the firm by assessing each project’s benefits, costs, and risks. When making capital-investment decisions, firms examine the initial investment that will be required, the cost of capital, and the amount of cash flow or other gains which the project will provide. The **cost of capital** is the rate of return that a company could earn if it chose a different investment of equivalent risk. The cost of capital comes into play because firms have choices in how to put their capital to use; using the capital for one purpose precludes using it for a different purpose.

Some governments court foreign borrowers by offering low-interest loans or by offering lower corporate income tax to attract investment in their countries. For example, Poland created special tax breaks for companies. These tax breaks make the country attractive for firms such as Hewlett-Packard and IBM to locate operations there. Similarly, Singapore’s government has invested heavily in education and training in an effort to attract investment by leading multinational firms. Singapore also offers subsidies to companies locating there. As corporations think about where to invest, build factories, locate offices, and source talent, they explore such opportunities actively.Peter Bisson, Rik Kirkland, and Elizabeth Stephenson, “The Market State,” *McKinsey Quarterly*, June 2010, accessed October 28, 2010, www.mckinseyquarterly.com/The_market_state_2628.

How Government Actions Affect Investment Decisions

Government policy affects foreign investment and innovation. According to Jeffrey Sachs, a leading international economic advisor and Columbia University professor, the near-term prospects for Brazil are bright, and it’s poised to do the best among Latin American countries.

Brazil

For the last fifteen years, Brazil has been investing heavily in education. In particular, Brazil made high school available to all citizens and invested in higher education, science, and technology. The result of these government investments is that not only does Brazil have a more educated workforce, but it has also narrowed off the gap between rich and poor and between ethnically divided segments of Brazilian society. In contrast, countries with deep ethnic and racial inequities aren’t unified societies, which leads to mediocre economic performance. Brazil plans to invest another $22 billion in science and technology innovation in 2010 and seeks corporations to join in additional investments in the country.Jeffrey Sachs, “Economics for a Crowded Planet” (webinar, HSM Global, 2009), accessed October 28, 2010, us.hsmglobal.com/contenidos/hsm-webinars-sachs.html; Jeffrey Sachs, *The End of Poverty: Economic Possibilities for Our Time* (New York: Penguin, 2005).

IBM is one of the companies investing in Brazil. CEO Sam Palmisano met with Brazilian President Luiz Inacio Lula Da Silva to discuss the creation of a “collaboratory” in Brazil. IBM’s collaboratories match IBM researchers with local experts from governments, universities and companies. IBM’s Palmisano praised Brazil’s strategy: “Investments in innovation are critical, especially in a downturn. They can help Brazil and other countries, including the US, realize an economic expansion.” Among the BRIC countries (Brazil, Russia, India, and China), Brazil is seeing the highest growth in business partners that IBM works with, averaging 150 percent year over year, according to Claudia Fan Munce, managing director of IBM Venture Capital Group.Steve Hamm, “Big Blue’s Global Lab,” *BusinessWeek*, August 27, 2009, accessed October 28, 2010, http://www.businessweek.com/magazine/content/09_36/b4145040683083.htm; Spencer E. Ante, “IBM Bets on Brazilian Innovation,” *BusinessWeek*, August 17, 2009, accessed October 28, 2010, http://www.businessweek.com/technology/content/aug2009/tc20090817_998497.htm.

As the above example illustrates, Brazil is attracting foreign business. Companies making foreign investments, however, must be aware of the total financial picture, including the tax environment. Brazil has a very complex tax system. “If it’s not the most complicated tax system in the world, it’s certainly right up there,” said Mark Buthman, finance chief at Kimberly-Clark, the consumer packaged goods giant, which has approximately 3,000 people in its Brazilian operation. “It’s not uncommon to have disagreements with the taxing authorities that you have to work through over time.”Kate O’Sullivan, “Brazil Is Booming (and Maddening),” *CFO*, July 15, 2010, accessed October 28, 2010, www.cfo.com/printable/article.cfm/14508833. What makes doing business in Brazil challenging is that the tax laws have not kept pace with the progress of modern products or services; that is, the categories of taxes do not correspond to modern-day categories of products and services. The lack of parallelism leads to confusion and misinterpretation. To deal with the difficulties, Kimberly-Clark, for example, employs seventy people—most of them native Brazilians—in its finance group in Brazil.

In addition to federal taxes, Brazilian states assess their own taxes as well. Thack Brown, CFO of SAP Latin America, says that any misstep regarding a labor or tax regulation can prove costly. “If you do have an issue, not only can the penalties be large, but you can spend three or four or even 10 years working through the judicial system.”Kate O’Sullivan, “Brazil Is Booming (and Maddening),” *CFO*, July 15, 2010, accessed October 28, 2010, www.cfo.com/printable/article.cfm/14508833. Despite the difficulties, Brown says that compared to China, the Brazilian system is still more structured and capable of dealing with issues.Kate O’Sullivan, “Brazil Is Booming (and Maddening),” *CFO*, July 15, 2010, accessed October 28, 2010, www.cfo.com/printable/article.cfm/14508833.

Indonesia

Indonesia is the third-largest democracy in the world and the largest economy in Southeast Asia. The country recently created an investment coordinating board to attract foreign direct investment into Indonesia. How is Indonesia making itself attractive to foreign investors?

1. It’s touting its young population—half of the population is under thirty years of age, which bodes well for a skilled workforce and growing consumer base.
2. It’s touting its political stability of twelve years after democratization, and monetary stability for the last five to six years.
3. It’s investing in infrastructure. “We are committing $50 billion from a budgetary standpoint for the development of infrastructure as part of a $150 billion five-year program,” said Gita Wirjawan, Indonesia’s chairman of Badan Koordinasi Penanaman Modal (BKPM), the country’s newly created investment coordinating board. “That will produce 20,000 kilometers of new roads and an additional 15,000 megawatts of power generation. That is going to create a much higher degree of connectivity than what we have today.”“Why Gita Wirjawan Wants to Open Indonesia to International Investors,” *Knowledge@Wharton*, July 21, 2010, accessed August 9, 2010, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2553.

Despite these advances, Indonesia still restricts which industries foreign investors can invest in. For example, investors can’t invest in telecommunications towers. Nonetheless, Indonesia has attracted some major investors, such as a large Middle Eastern investor who will build an integrated infrastructure project including a port, a rail track, and new power-generation capability. The total investment will be about $5.2 billion. Indonesia has also convinced the Swiss firm Holcim to expand its cement capabilities in

Indonesia."Why Gita Wirjawan Wants to Open Indonesia to International Investors," *Knowledge@Wharton*, July 21, 2010, accessed August 9, 2010, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2553.

The Role of Government

The role of government in terms of international business and finance includes

- passing laws and setting policies (e.g., regulating stock and bond markets and setting tax codes),
- enforcing laws (laws laxly enforced have little value),
- providing infrastructure (e.g., fast communications infrastructure and reliable electricity are important to the smooth functioning of capital markets), and
- providing capital (e.g., providing or guaranteeing loans, as the US government does through the Export-Import Bank of the United States).Scott Leibs, "A Force to Be Reckoned With," *CFO*, February 1, 2010, accessed August 7, 2010, www.cfo.com/printable/article.cfm/14470883.

KEY TAKEAWAYS

- Multinational firms have a choice in how they finance international operations. Some choose to raise capital through equity markets, issuing stock on domestic or overseas stock exchanges. Others opt for debt financing through banks or bond markets in order to not give up ownership in the firm.
- Capital budgeting is the process by which firms assess the relative merits of different investment choices, weighing the cost of capital and the expected returns of different investment options.
- Governments can play an active role in attracting firms to invest in their countries or enticing foreign borrowers by offering low-interest loans or lower corporate income taxes. When evaluating countries for investment potential, companies consider a government's economic policies (e.g., business environment, trade policy, investment policy, and infrastructure) as well as any cultural issues (e.g., ethnic, religious, and gender inequalities) that may be a barrier.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What sources of financing are available to a company's subsidiaries?
2. What is the advantage of equity financing over debt financing?
3. When might a company choose debt financing?
4. Name two advantages of raising money on a foreign stock exchange.
5. Why is capital budgeting important to a multinational company?

6.19: Financial Management in International Business

Learning Objectives

1. Understand the factors that underlie political risk and volatility.
2. Identify two ways in which the financial organization of a multinational firm can be structured.
3. Recognize how religion can influence financial practices in some countries.

Accounting for Political and Economic Risk

Companies that locate operations in foreign countries face a set of unavoidable risks, chief among which are political and economic risks. Political risks arise from decisions that foreign governments make, including changes in government that result from wars and coups. Economic risks are often paired with political risks but can also arise from international money markets. Both risks are exacerbated by increased volatility and changes in laws.

Increased Volatility

In the 2010 *McKinsey Global Survey* of 1,416 executives from around the world, 63 percent of respondents "expect increased overall volatility to become a permanent feature of the global economy."Renée Dye and Elizabeth Stephenson, "Five Forces Reshaping the Global Economy: McKinsey Global Survey Results," *McKinsey Quarterly*, May 2010, accessed November 23, 2010, www.mckinseyquarterly.com/Five_forces_reshaping_the_global_economy_McKinsey_Global_Survey_results_2581. For example, the most important growing economy in the world, China, is a force that must be reckoned with. The volatility arises because this major economy isn't a developed state with commitment to the rule of law and strong institutions. Rather, it's an emerging market where political insecurities are the ultimate driver, according to Ian Bremmer, president of the Eurasia Group and author of *The End of the Free Market*.Rik Kirkland, "China's State Capitalism and Multinationals: An Interview with the President of Eurasia Group," *McKinsey Quarterly*, May 2010, accessed November 23, 2010, www.mckinseyquarterly.com/Chinas_state_capitalism_and_multinationals_An_interview_with_the_president_of_Eurasia_Group_2583.

To prepare for volatility, multinational companies may want to plan contingencies or at least think through how they might react to events that are currently "unthinkable," such as significant, rapid shifts in currency values (e.g., a 30 percent decline of the dollar versus an emerging-market currency); an exit from the euro by some nations; dramatic, rapid changes in commodity prices (e.g., oil prices spiking to $200 a barrel); or defaults on debt by major nations.Lowell Bryan, "Globalization's Critical Imbalances," *McKinsey Quarterly*, June 2010, accessed October 28, 2010, www.mckinseyquarterly.com/Globalizations_critical_imbalances_2624. These events seem highly improbable now, but, if they come to pass, executives who have thought about how to respond to them will be better positioned to react effectively.

Legal Infrastructure: Challenges of Nascent Laws

Variations in contract law, bankruptcy law, real estate law, intellectual property rights, and liability are just some of the legal issues that companies face when operating or making investments in emerging-market countries. Slow civil judicial processes, corrupt judges, and potential biases against foreigners can affect a company's ability to operate effectively, recover losses, or collect bad debts. For example, General Motors (GM) often uses a contractual structure with suppliers in which GM owns the proprietary tooling used in their supplier's factory. In most countries, if the supplier goes bankrupt, GM can easily take the tooling back. But GM noted that this isn't possible in China due to the nascent state of the country's bankruptcy law, which was created only in 1988.Harjeet S. Bhabra, Tong Liu, and Dogan Tirtiroglu, "Capital Structure Choice in a Nascent Market," *Financial Management*, June 22, 2008, accessed November 25, 2010, www.allbusiness.com/company-activities-management/company-structures-ownership/11673477-1.html. As a result, GM uses contracts to mitigate these risks.

Financial Organizational Structure in International Business

Multinational companies can choose to manage their financial operations centrally or via a decentralized organizational structure.

Centralized Structures

The advantages of a **centralized structure** are that the company can afford to hire and retain specialized staff with deep expertise who can bring savings to the company through centralized cash management and more efficient capital investment. Centralization can improve control and compliance with corporate policies. This structure enables the firm to gain economies of scale for investment and borrowing activities that can reduce transaction costs and provide the firm with the most competitive pricing.

Decentralized Structures

Alternatively, multinational firms may choose a **decentralized financial organization structure** due to variations in language, consumers, cultures, business practices, and government rules, laws, and regulations among different countries. A decentralized structure lets multinational firms exploit local knowledge and business conditions to deal with uncertainty. The downsides of a decentralized approach are higher costs (due to having to hire more employees), some unavoidable duplication of effort, and a diminishment of control.

Communication with Headquarters

If a company uses a decentralized financial structure, it's vital for regional chief financial officers (CFOs) in the different countries to keep regular contact with their superiors at headquarters. Rebecca Norton, vice president of finance, Asia-Pacific, at Business Objects (a unit of SAP), makes it a point to participate in global conference calls as often as possible, in order to "wave the Asia-Pacific flag." She notes that this is necessary to ensure that her overseas colleagues understand the conditions under which the Asian business operates.Don Durfee, "Local Knowledge," *CFO*, November 1, 2008, accessed August 12, 2010, www.cfo.com/printable/article.cfm/12465219. The reason for the frequent communication is to help the home office better understand the opportunities and risks of the foreign country. For example, if headquarters is focused on short-term performance indicators, the head office is more likely to allocate funds to developed markets where returns are quick. But this approach neglects emerging markets, which have more future potential.

According to a 2010 McKinsey study, global economic activity is shifting from developed to developing nations with populations that are young and growing.Renée Dye and Elizabeth Stephenson, "Five Forces Reshaping the Global Economy: McKinsey Global Survey Results," *McKinsey Quarterly*, May 2010, accessed November 23, 2010, www.mckinseyquarterly.com/Five_forces_reshaping_the_global_economy_McKinsey_Global_Survey_results_2581. The growth in the number of consumers in these emerging markets make them not only a focus for rising consumption and production but also major providers of talent, capital, and innovation. This makes it vital for US companies to succeed in these emerging markets. Despite identifying this trend as the most important trend for business in the next five years, only 40 percent of executives are taking action and fully 20 percent are taking no action at all to capture emerging-market growth.Renée Dye and Elizabeth Stephenson, "Five Forces Reshaping the Global Economy: McKinsey Global Survey Results," *McKinsey Quarterly*, May 2010, accessed November 23, 2010, www.mckinseyquarterly.com/Five_forces_reshaping_the_global_economy_McKinsey_Global_Survey_results_2581. This is where communication with headquarters becomes imperative. Regional CFOs must spur actions, such as developing partnerships or joint ventures with local companies, recruiting talent from emerging markets, and developing new business models.

One company taking action is the Luxottica Group, a $6.6 billon eyewear company based in Italy. Although Luxottica sells its products online, it remains solidly committed to brick-and-mortar retail stores and is rapidly expanding its retail presence in China. Describing the role of retail stores, Chris Beer, CEO of Asia Pacific, greater China, and South Africa for Luxoticca, said, "You need to create a connection, create a personal experience, and that's what we've done."Sheila Shayon, "Luxottica Envisions Future of Retail," *Brand Channel*, July 22, 2010, accessed November 26, 2010, www.brandchannel.com/home/post/2010/07/22/Luxottica-Eye-Hub-Retail-Concept.aspx On the finance side, Kevin Zhou, retail CFO for Luxottica, closely follows the regulatory environment in China and actively communicates with headquarters to explain evolving legislation and help them understand local financial issues. "You have to always tell them the truth about what's happening in China, and keep updating them," he says. "Keep explaining, and before long, people at headquarters will really understand what's going on in this market."Don Durfee, "Local Knowledge," *CFO*, November 1, 2008, accessed August 12, 2010, www.cfo.com/printable/article.cfm/12465219.

Hybrid Financial Organization Structures

Finally, multinational companies follow a hybrid of centralized financial operations for some tasks and regional operations for others. Before it was acquired by Hewlett-Packard (HP) in April 2010, network switching and routing solutions company 3Com had centralized specific operations in its North America shared service center (SSC). The North America SSC provided a number of accounting services globally. Although the US-based SSC had a much higher cost of labor than Singapore (where 3Com offshored transaction-based processes), 3Com decided to keep higher-value services in the North America SSC due to 3Com's assessment of the risk and complexity in comparison to the anticipated benefit of moving these from one global center to another.

Some of the tasks retained by the North American SSC were worldwide consolidation, worldwide intercompany accounting, and external reporting.

The following processes have been performed in each region (i.e., Europe, the Middle East, and Africa [EMEA]; North America; Latin America; and Asia-Pacific) due to language and local knowledge issues:

- Regional general ledger
- Regional revenue accounting
- Local field finance accounting
- Regional and local payroll
- Regional and local value-added tax (VAT) and good-and-services tax (GST) compliance and reportingPhil Searle and Fraser Kirk, “Expanding Geographic Scope and Setting Up a Truly Global Process Model,” *Shared Services & Outsourcing Network* 5, no. 9 (January 2004), accessed November 23, 2010, www.ssonetwork.co.uk/topic_detail.aspx?id=194&ekfrm=50.

3Com also assigned local field finance managers to be key shared accounting services team members located in the company’s higher-risk countries to help ensure compliance with local legal, statutory, tax, and reporting requirements and to help with enforcement and communication of corporate policies locally. Their responsibilities include the following:

- Ensuring all statutory and tax (direct and indirect) filings are completed in accordance with local country requirements
- Liaising with local external auditors, tax authorities, and outsource agencies to ensure the proper execution of payroll and employee disbursements
- Communicating and enforcing corporate accounting policies to local employees
- Ensuring appropriate accounting for local accruals by liaising with local marketing and sales teams to determine if services related to outstanding purchase orders have been providedPhil Searle and Fraser Kirk, “Expanding Geographic Scope and Setting Up a Truly Global Process Model,” *Shared Services & Outsourcing Network* 5, no. 9 (January 2004), accessed November 23, 2010, www.ssonetwork.co.uk/topic_detail.aspx?id=194&ekfrm=50.

Did You Know?

What does the job description for a treasury operations manager look like? The tasks of a manager overseeing international-unit financial management include

- managing foreign exchange exposures, hedging, accounting compliance, multilateral netting, and multilateral cash pool;
- driving collection, disbursement, concentration and cash accounting, and domestic debt-portfolio management;
- performing cost review and analysis of monthly cash management;
- assisting the treasurer in bank coordination, agreement negotiations, and renewals;
- modeling financial transaction scenarios for capital budgeting and planning analysis (i.e., debt, equity, and other capital market transactions);
- preparing, reviewing, and maintaining Sarbanes-Oxley controls; and
- delivering and coordinating cash forecasts with bank-funding needs and regulatory capital requirements.

The Impact of Religion: Islamic Finance

Companies operating in countries where Islam is the official religion, such as Malaysia, Saudi Arabia, Kuwait, Bahrain, and Yemen, must adhere to Islamic finance laws. Islamic law prohibits certain financial practices that are common in other countries. For example, Islamic law (called **Sharia**) prohibits charging interest on money. No interest can be charged, including fixed-rate, floating, simple, or compounded interest, at whatever rate. The Sharia also prohibits financial practices like speculation, conventional insurance, and derivatives, because they’re considered gambling in the Islamic tradition. Sharia also prohibits *gharar*, which means “uncertainty” and includes conventional practices like short selling.

To overcome these prohibitions, financial products must be Sharia compliant. There are approved alternatives to interest and speculative investments. For example, instead of lending money and charging interest, banks can lend money and earn profits by charging rentals on the asset leased to the customer. One alternative investment strategy, *musharakah*, allows profit and loss sharing. It’s a partnership wherein profits are shared per an agreed-on ratio and losses are shared in proportion to the capital or investment of each partner. A *mudarabah* is an investment partnership, whereby the investor provides capital to another party or entrepreneur in order to undertake a business or investment activity. While profits are shared on an agreed-on ratio, loss of investment is born only by the investor. The entrepreneurs only lose their share of the expected income.“Introduction to Islamic

Financing," HSBC Amanah, accessed August 14, 2010, www.assetmanagement.hsbc.com/gam/attachments/mena/amanah/islamic_invest.pdf.

These investment arrangements demonstrate the Sharia's risk-sharing philosophy—the lender must share in the borrower's risk. Since fixed, predetermined interest rates guarantee a return to the lender and fall disproportionately on the borrower, they are seen as exploitative, socially unproductive, and economically wasteful. The preferred mode of financing is profit and loss sharing.

Islamic finance law extends to mutual funds, securities firms, insurance companies, and other nonbanks. A growing number of conventional financial institutions, both inside and outside the Islamic world, have in recent years created Islamic subsidiaries or have been offering Islamic "windows" or products in addition to conventional ones.Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh, UK: Edinburgh University Press, 2000).

KEY TAKEAWAYS

- Political and economic risks arise when a country lacks a long history or commitment to the rule of law. Companies can prepare for volatility by thinking through "unthinkable" scenarios and planning how they would respond if such situations occurred.
- Multinational firms can organize their financial operations in a centralized, decentralized, or hybrid organization structure. The advantages of a centralized structure are that the company can afford to hire and retain specialized staff who have deep expertise and can bring savings to the company through centralized cash management and more efficient capital investment. Centralization also enables the firm to gain economies of scale for investment and borrowing activities that will reduce transaction costs and get the firm the most competitive pricing. On the other hand, a decentralized financial organization structure allows the firm to recognize the variations in language, customs, cultures, business practices, rules, laws, and regulations among different countries. A decentralized structure lets multinational firms exploit local knowledge and business conditions to deal with uncertainty.
- It's important for regional CFOs to stay in regular contact with corporate headquarters to alert headquarters to opportunities (or warn them of dangers) in their countries.
- Islamic countries practice Sharia—the prohibition of charging interest on money. There are approved, Sharia-compliant alternatives to interest and speculative investments. For example, instead of lending money and charging interest, banks can lend money and earn profits by charging rentals on the asset leased to the customer. One alternative investment strategy, *musharakah*, allows profit and loss sharing. It's a partnership wherein profits are shared per an agreed-on ratio and losses are shared in proportion to the capital or investment of each partner.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Name two ways that companies can prepare or deal with political risk or volatility in a country.
2. What advantages does a decentralized financial organization structure bring to a multinational firm?
3. What advantages does a centralized financial organization structure bring?
4. Why are frequent communications between a regional CFO and headquarters important?
5. How might religion impact financing operations?

6.20: Global Money Management- Moving Money across Borders

Learning Objectives

1. Understand the role of global money management in a multinational firm.
2. Know how multilateral netting and transfer pricing can be used to minimize transaction costs and taxes for the firm.
3. Appreciate the efficiencies and savings that result from centralized depositories.

Global Money Management and Centralized Depositories

Global money management involves moving money across borders and managing the firm's financial resources in a way that minimizes taxes and transaction fees while maximizing the firm's returns.

A multinational company can make the most of its cash reserves by holding cash balances at a central location, called a **centralized depository**. There are two main advantages of centralized depositories:

1. The company earns a higher interest on higher amounts of cash, because cash from across the company is pooled.
2. Pooling cash reserves reduces the total amount of cash that the company needs to hold, because the amount of cash held on hand as a precautionary measure against the unexpected can be pooled and thus reduced—it's unlikely that all the worst cases will happen simultaneously.

Centralized money management also lets a company trade currencies between its subsidiaries and thereby eliminate intermediaries like banks. This practice saves the firm transaction costs. Centralization also means that the company can buy currencies in larger lot sizes, which gives it a better price.

Two facts are important to keep in mind when using the centralized depository technique for global cash management. First, a government can restrict how much capital can flow out of the country (governments do this to preserve foreign exchange reserves). Second, there are transaction costs associated with moving money across borders, and these costs are incurred each time the money is moved.

Cash Management

Companies need to be aware of differences in local cash practices. For example, business customers in Asia often pay their invoices via bank draft—a common method there, but almost unheard of in the United States. This approach typically means a company gets its cash slowly, creating potential working-capital problems. "If you sell to a customer on 30-day terms and on day 29 they give you a bank draft, that's three months more you'll have to wait," said Brian Kenny, CFO of specialty chemicals materials company W. R. Grace's Asia-Pacific division.Don Durfee, "Local Knowledge," *CFO*, November 1, 2008, accessed August 12, 2010, www.cfo.com/printable/article.cfm/12465219.

Multilateral Netting

Multilateral netting is a technique which companies use to reduce the costs of cross-border payments between subsidiaries. Three or more subsidiaries must participate. (If only two participate, the technique is known as bilateral netting.)

For example, let's say a firm's subsidiary in the Czech Republic owes the Australian subsidiary $4 million, while the Australian subsidiary owes the Czech subsidiary $10 million. Rather than the Czech subsidiary transferring $4 million and the Australian transferring $10 million, the parties agree to one payment in which the Australian subsidiary pays the Czech $6 million. Both payments are thus satisfied. The total funds that flowed between the subsidiaries are reduced from $14 million to $6 million, reducing costs. For example, if the transaction costs (i.e., the foreign exchange commission plus the transfer fees) are 1 percent of the total funds transferred, the transaction costs in this example drop from $140,000 to $60,000. In cases where multiple subsidiaries trade amongst each other, the savings are even more significant. For example, if four subsidiaries each trade with three other subsidiaries, the total number of transactions can be reduced from twelve to three, which reduces transaction costs substantially.

In a real-life example, Colgate-Palmolive operates in 218 countries. Much of its manufacturing operations are centralized rather than being located in numerous countries around the world. As a result, subsidiaries do a lot of business with each other. Colgate headquarters requires that all subsidiaries submit and settle their payments to each other on the same day. By directing all settlements to one day, Colgate maximizes the benefits of multilateral netting and saves on the spread. This reduces the transaction costs as well as the risk of currency fluctuations.Kabir Masson, "'Managing International Financial Risk': A Presentation by Hans L. Pohlschroeder," *Columbia Business School Chazen Web Journal of International Business*, February 24, 2009, accessed November 23, 2010, www1.gsb.columbia.edu/mygsb/faculty/research/pubfiles/3386/Managing%20International%20Financial%20Risk%2Epdf.

Did You Know?

According to a survey of almost five hundred CFOs and controllers from US-based companies, the following are the top concerns regarding international taxes:

- Cost of complying with international taxes (31 percent of respondents)
- Transfer pricing (28 percent)
- Repatriation of offshore earnings (21 percent)
- Risk management in developing countries (14 percent)
- Mergers and acquisitions transactions (5 percent)Marie Leone, "Tax Sticklers, Not Schemers," *CFO*, May 26, 2010, accessed October 28, 2010, www.cfo.com/printable/article.cfm/14501223.

Tax Advantages of Fronting Loans

A **fronting loan** is a loan made between a parent company and its subsidiary through a financial intermediary such as a bank. The advantage of using fronting loans as a way to lend money, rather than the parent lending the money directly to the subsidiary, is that the parent can gain some tax benefits and bypass local laws that restrict the amount of funds that can be transferred abroad. With a fronting loan, the parent deposits the total amount of the loan in the bank. The bank then lends the money to the subsidiary. For the bank, the loan is risk free, because the parent has provided the money to the bank. The bank charges the subsidiary a slightly higher interest rate on the loan than it pays to the parent, thus making a profit.

The tax advantages of fronting loans come into play if the loan is made by a subsidiary located in a tax haven. A **tax haven** is a country that has very advantageous (i.e., low) corporate income taxes. Bermuda is a well-known tax haven. The bank pays interest to the tax-haven subsidiary. The subsidiary doesn't pay taxes on that interest because of the tax-haven laws. At the same time, the interest paid by the subsidiary receiving the loan is tax deductible.

Transfer Pricing

Multinational firms that conduct business among their cross-border subsidiaries can use tax-advantageous transfer pricing. Transfers occur when a company transfers goods or services between its subsidiaries in different countries. For example, a firm might design a product in one country, manufacture it in a second country, assemble it in a third country, and then sell it around the world. Each time the good or service is transferred between subsidiaries, one subsidiary sells it to the other. The question is, what price should be paid? The **transfer price** is the price that one subsidiary (or subunit of the company) charges another subsidiary (or subunit) for a product or service supplied to that subsidiary.

Since the pricing taking place is between entities owned by the same parent firm, there's an opportunity for pricing an item or service at significantly above or below cost in order to gain advantages for the firm overall. For example, transfer pricing can be a way to bring profits back to the home country from countries that restrict the amount of earnings that multinational firms can take out of the country. In this case, the firm may charge its foreign subsidiary a high price, thus extracting more money out of the country. The firm would use a cost-plus markup method for arriving at the transfer price, rather than using market prices.

Although this practice optimizes results for the company as a whole, it may bring morale problems for the subsidiaries whose profits are impacted negatively from such manipulation. In addition, the pricing makes it harder to determine the actual profit which the favored subsidiary would bring to the company *without* such favored treatment. Finally, all the price manipulations need to remain compliant with local regulations. In fact, to combat such potential losses of income tax revenue, more than forty countries have adopted transfer-pricing rules and requirements."Driving Indirect Tax Performance—Managing the Global Reform Challenge," KPMG, April 2010, accessed October 28, 2010, www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Pages/Driving-indirect-tax-performance-Global-reform.aspx.

Generally, compliance with local tax regulations means setting prices such that they satisfy the "arm's length principle." That is, the prices must be consistent with third-party market results. The test of fairness is, "What would an independent company, operating in a competitive market, charge for performing comparable services or selling similar products?"Alfredo (Jay) Urquidi and David

R. Jarczyk, "The Importance of Economics in the Practice of Transfer Pricing," *Transfer Pricing International Journal*, May 26, 2010, accessed November 23, 2010, www.ceterisgroup.com/files/Articles/Urquidi-Jarczyk-Economics_May10.pdf.

Nonetheless, even within these guidelines, multinational firms can adjust prices to shift income from a higher-tax country to a lower-tax one. Governments, of course, are instituting or revising legislation to ensure maximum taxes are collected in their own countries. As a result, multinational firms must monitor compliance with local transfer-pricing regulations.Alfredo (Jay) Urquidi and David R. Jarczyk, "The Importance of Economics in the Practice of Transfer Pricing," *Transfer Pricing International Journal*, May 26, 2010, accessed November 23, 2010, www.ceterisgroup.com/files/Articles/Urquidi-Jarczyk-Economics_May10.pdf.

Indirect Taxes

One way that governments respond to budget shortfalls is by imposing or increasing **indirect taxes** like the value-added tax (VAT) and goods-and-services tax (GST). The reach of these indirect taxes is extending into new areas of the global economy. "The slow economy and falling direct-tax rates are causing many governments worldwide to tighten their existing indirect-tax regimes or introduce new ones," said Frank Sangster, a principal in KPMG's US Indirect Tax practice. "Finance and tax directors must be proactive in considering how their organizations are responding to the global VAT changes, which are already affecting their markets, operations and internal systems.""U.S. Multinationals Expected to Feel Impact of Accelerated Global Move to VAT," *SmartPros*, May 3, 2010, accessed October 28, 2010, accounting.smartpros.com/x69387.xml.

More countries are coming to rely on VAT as a significant and stable source of tax revenue, so these taxes are unlikely to diminish. China and India are considering introducing national VAT systems for the first time, while European Union (EU) countries might be looking at ways to raise more revenue through VAT. International companies can assess and manage the risks and opportunities of new VAT systems by using merging technologies to increase automation of the indirect tax process, deciding whether to insource or outsource new compliance obligations, and using modeling techniques to assess the impact of local VAT changes."U.S. Multinationals Expected to Feel Impact of Accelerated Global Move to VAT," *SmartPros*, May 3, 2010, accessed October 28, 2010, accounting.smartpros.com/x69387.xml; "Driving Indirect Tax Performance—Managing the Global Reform Challenge," KPMG, April 2010, accessed October 28, 2010, www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Pages/Driving-indirect-tax-performance-Global-reform.aspx.

Manufacturing shoes in China for the Chinese market is subject to a 17 percent VAT, for example, but shoes for export aren't subject to this tax. In some cases, it may be cheaper to make the shoes in China, export them to Hong Kong, reimport them into China, and pay import duties instead of VAT. Local import/export regulations can also impact where companies decide to locate specific functions of the supply chain, such as distribution centers or warehouses. In Fujian province, one can import materials one day and export the output the next day. In Guangdong province, in contrast, the local authorities insist on thirty days' notice for reexported materials. The point is that each emerging-market country and even each region in an emerging-market country can have its own interplay of taxes, duties, and regulatory delays that affect how companies design their operations and the margins they're able achieve.

Did You Know?

Colombia and Indirect Taxes

To attract business process outsourcing (BPO) vendors to Colombia, the country eliminated the VAT tax on BPO service exports. This makes it more attractive to locate offshoring services in Colombia. Local governments also created two free-trade zones in Bogotá and Medellín specifically for BPO, providing state-of-the-art infrastructure and services to companies that settle there.Luis Andrade and Andres Cadena, "Colombia's Lesson in Economic Development," *McKinsey Quarterly*, July 2010, accessed August 14, 2010, www.mckinseyquarterly.com/Economic_Studies/Productivity_Performance/Colombias_lesson_in_economic_development_2642.

KEY TAKEAWAYS

- Global money management involves moving money across borders and managing the firm's financial resources in a way that minimizes taxes and transaction fees while maximizing the firm's returns.
- Companies can use multilateral netting as a way to reduce the costs of cross-border payments between subsidiaries. They can also use fronting loans to gain tax advantages.
- The transfer price is the prices at which subsidiaries or affiliates of the same firm sell goods or services to each other. When subsidiaries are located in countries with different tax rates, opportunities exist to move income to a lower-taxing jurisdiction. Firms can manipulate transfer prices to reduce global tax liabilities

- A multinational company can make the most of its cash reserves by holding cash balances at a central location, called a centralized depository, thus earning higher interest and being able to reduce the total amount of cash reserves held on hand. However, the two downsides of centralized depositories are that governments can restrict how much capital flows out of their country and transaction costs are incurred each time money is moved across borders.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. How can local cash practices in a country affect a subsidiary's cash flow?
2. What are some advantages that multinational firms gain from centralized depositories?
3. Explain multilateral netting and how it can reduce transaction costs.
4. Why would a company choose to do a fronting loan?
5. What are the challenges of transfer pricing?

6.21: Corruption in International Business

Source: Stockmonkeys.com, (CC-BY 2.0, 2012) Figure 10.1 A common practice worldwide is for government favors to be sought in exchange for surreptitious payments in cash. Corruption is not merely a problem in developing countries. In recent years, American, German and Italian companies have been implicated in corruption scandals, both domestic and international.

The Problem of Corruption

When a large corporation decides to enter a foreign market, it must usually secure a number of licenses, permits, registrations, or other government approvals. Certain types of business may be even be impossible or illegal unless the corporation is first able to obtain a change or adjustment to the nation's laws or regulations. Since the power to authorize the foreign corporation's activities is vested in the hands of local politicians and officials, and since corporations have access to large financial resources, it should not be surprising that some corporate executives resort to financial incentives to influence foreign officials. While certain financial incentives, such as promises to invest in local infrastructure, may be legitimate, any form of direct payment to the foreign official that is intended to influence that official's public decisions will cross the line into illegal *subornation*, also commonly referred to as *bribery*.

Bribery is one of the archetypal examples of a corporation engaged in unethical behavior. A number of problems can be attributed to business bribery. First, it is obviously illegal—all countries have laws that prohibit the bribery of government officials—so the foreign company engaging in bribery exposes its directors, executives, and employees to grave legal risks. Second, the rules and regulations that are circumvented by bribery often have a legitimate public purpose, so the corporation may be subverting local social interests and/or harming local competitors. Third, the giving of bribes may foment a culture of corruption in the foreign country, which can prove difficult to eradicate. Fourth, in light of laws such as the US Foreign Corrupt Practices Act (FCPA) and the Organization of Economic Cooperation and Development (OECD) Convention on Anti-Bribery (discussed in greater detail below), bribery is illegal not only in the target country, but also in the corporation's home country. Fifth, a corporation that is formally accused or convicted of illicit behavior may suffer a serious public relations backlash.

Despite these considerable disincentives, experts report that worldwide business corruption shows little signs of abating. Transparency International (TI), a leading anticorruption organization based in Berlin, estimates that one in four people worldwide paid a bribe in 2009. It appears that the total number of bribes continues to increase annually. The World Economic Forum calculated the cost of corruption in 2011 at more than five percent of global GDP (US$2.6 trillion) with over $1 trillion paid in bribes each year.[1]

Governments and intergovernmental organizations have redoubled their efforts to combat the perceived increase in international business corruption. Globalization, which accelerated in the final decades of the twentieth century, is often cited by specialists as contributing to the spread of corruption. Corporations and businesses in every nation have become increasingly dependent on global networks of suppliers, partners, customers, and governments. The increased interaction between parties in different countries has multiplied the opportunities for parties to seek advantage from illicit incentives and payoffs. Although outright bribery is clearly unethical and illegal, there is great deal of behavior that falls into a gray zone that can be difficult to analyze according to a single global standard. When does a business gift become a bribe? What level of business entertainment is "right" or "wrong"? Over the past two decades, governments and regulators have sought to clearly define the types of behavior that are considered unethical and illegal.

Another factor that has heightened the sense of urgency among regulators is the magnitude of recent cases of corruption (several of which are described in greater detail below). The cost to shareholders as well as stakeholders and society has proven enormous. Governments and international organizations have ramped up their enforcement of anticorruption laws and sought increasingly severe penalties, sometimes imposing fines amounting to hundreds of millions of dollars. Largely as a result of these efforts, most multinational corporations have developed internal policies to ensure compliance with anticorruption legislation. However, as we will see in the case study featured in this chapter, such compliance also raises complex ethical dilemmas for corporations. It remains difficult to regulate ethical behavior when social and cultural norms vary significantly from country to country. Acts that are considered unethical in one country may represent a traditional way of doing business in another. One legal scholar explains the difference as follows:

A common misconception, held in both Western and developing countries, and even among many researchers on corruption, is to confuse what is corrupt with what is legal. Laws are defined by values, as are ethical norms, but the two are not equivalent.[2]

In this chapter, we will explore the impact, reasonableness, and the effectiveness of anticorruption laws and corporate compliance rules. Finally, we will discuss a case in which the line between corruption and traditional business practices remains difficult to ascertain.

The Scope of the Problem

Recent cases of corruption in international business have attracted considerable media attention. Paying a traffic officer to ignore a minor traffic violation is unremarkable; paying a senior government official a secret bribe of millions of dollars to get a large contract signed is a different matter.

While virtually all multinational companies have adopted anticorruption policies, it is not clear how often these policies are fully implemented and internalized as part of the corporate culture. The emphasis on anticorruption policies is relatively recent and, even in the most responsible organizations, such policies are still works in progress. However, there is some evidence that the implementation is not always as effective as might be hoped.

For example, a study by Control Risks and the *Economist* magazine's Intelligence Unit showed that while most companies acknowledge the need to combat bribery and corruption, many are complacent and unprepared to deal with scandals inside their own organizations.[3] The review of global attitudes on corruption surveyed more than 300 senior lawyers and compliance heads in April 2013. It painted a disturbing picture. The authors concluded that "too many companies still fall short of best practices in their anticorruption compliance programs." Despite ranking anticorruption high on most corporate agendas, the report noted a "danger of complacency" among companies, and as a result, "the risk of a company finding itself in the middle of a corruption-based investigation remains real."[4]

Transparency International's Corruption Perceptions Index (CPI) ranks countries and territories according to their perceived levels of public sector corruption. It is an aggregate indicator that combines different sources of information about corruption, making it possible to compare countries. Perceptions are used because corruption is generally a hidden activity that is difficult to measure. The CPI confirms that corruption remains a problem worldwide and takes place even in the wealthiest countries.[5] Research in 2012 by the Austrian economist Friedrich Schneider placed the annual loss to the German economy alone at €250 billion.[6]

The Dow Jones State of Anti-Corruption Survey in 2011, which surveyed more than 300 companies worldwide, found that more than 55 percent of companies have found cause to reconsider working with certain global business partners due to concerns about possible violation of anticorruption regulations. Additionally, the biannual survey indicated than more than 40 percent of companies believe they have lost business to competitors who won contracts unethically, an increase from only 10 percent in the 2009 study. "Strict liability provisions in legislation like the UK Bribery Act make businesses responsible for the activities of their agents and partners overseas, and this is having a direct impact on the occurrence of new business partnerships between firms," said Rupert de Ruig, managing director of Risk and Compliance, Dow Jones.[7]

Global social costs from corruption include the reluctance of investors to commit to projects in developing economies, inhibited growth of businesses due to syphoning off of revenues for bribes, and diversion of funds from food, medical, and educational aid programs. In addition, it seems likely that corruption hampers the development of executive talent in developing nations, given that frustrated local executives may seek to emigrate to countries where corruption is less prevalent. Consider for example, the long term impact of the necessity of paying a bribe to get running water in a household in rural India.[8] This type of corruption can effectively exclude the poor from access to vital public services. Economist Daniel Kaufmann of the Harvard Institute of International Development cites public sector corruption as the most severe obstacle to development in developing and post-communist countries.[9]

Notable Examples of Corruption

The number and magnitude of recent corruption cases prosecuted by government authorities is disconcerting. Moreover, these widely-publicized cases may represent only the tip of the iceberg: Regulatory bodies focus principally on the bribery of public officials so that other forms of business corruption are under-reported. To date, the ten largest cases successfully tried pursuant to the FCPA are listed below (in order of magnitude of fines):

1. Siemens (Germany): $800 million in 2008
2. KBR/Halliburton (USA): $579 million in 2009
3. BAE (UK): $400 million in 2010
4. Total SA (France): $398 million in 2013
5. Snamprogetti Netherlands BV/ENI SpA (Holland/Italy): $365 million in 2010
6. Technip SA (France): $338 million in 2010
7. JGC Corporation (Japan) $218.8 million in 2011
8. Daimler AG (Germany): $185 million in 2010

9. Alcatel-Lucent (France): $137 million in 2010
10. Magyar Telekom/Deutsche Telekom (Hungary/Germany): $95 million in 2011

There are other recent examples of large-scale corruption in international business.

Walmart in Mexico

According to a report issued by the Mexican Employers Association in 2011, companies operating in Mexico spend more than 10 percent of their revenue on corrupt acts. One of the most well-known cases was the Walmart scandal that was brought to light in September 2005 and resulted in the company's stock value dropping by as much as $4.5 billion. Evidence unearthed by internal and external investigations revealed a widespread use of bribes, alleged to total over $24 million. The bribes were paid to facilitate the construction of Walmart stores throughout Mexico. The country is a huge market for Walmart—one in every five Walmart stores is in Mexico. As of October 2014, the investigation continued, having implicated Walmart management at the most senior levels of complicity or awareness.

GlaxoSmithKline in China

In September 2013, China's Xinhua news agency reported that a police investigation into bribes paid by drug manufacturer GlaxoSmithKline (GSK) indicated that the bribes were organized and paid by GSK China and not by individuals operating on their own prerogative as had been reported by the company initially. Police also alleged that the corporate parent merely went through the motions of an internal audit process, indicating a knowledge and acceptance of the bribery. This very recent case suggests that the Chinese government's widely publicized arrests and convictions for bribery have not yet served as a sufficient deterrent to corrupt practices by foreign corporations.

Alcatel in Costa Rica

In January 2010 Alcatel agreed to pay Costa Rica US $10 million in reparations for social damage caused by Alcatel's payment of US$2.5 million in bribes to get a contract to provide mobile phone services in that country. This case is notable for its application of the concept of *social damage* and the resulting order of compensation to the citizens of Costa Rica.

Anticorruption Laws and Regulations

The first major international anticorruption law was the United States' Foreign Corrupt Practices Act (FCPA), adopted in 1977.[11] The FCPA criminalized bribery of foreign public officials by American business enterprises. Initially, the FCPA was not well received. Few other countries followed suit and US companies complained that the FCPA shut them out of the competition for billions of dollars' worth of overseas business contracts. Slowly, however, the push for concerted anticorruption measures gathered momentum, and intergovernmental institutions such as the OECD, the African Union, and the United Nations eventually adopted anticorruption conventions. Further support for a global anticorruption agenda was provided by the lending institutions such as the World Bank, by NGOs such as Transparency International, and by the rapidly evolving CSR movement. Notable among these efforts was the Communist Party of China's promulgation of a code of ethics to fight the widespread corruption within the Communist Party of China.[12]

The FCPA applies only to bribes paid (or offered) to foreign government officials to obtain or retain business or to develop an unfair competitive advantage. The concepts of *bribe* and *foreign government official* can be interpreted broadly. While companies and executives charged with FCPA violations have often sought to characterize their payments as business "gifts," this has not shielded them from liability when there was evidence that the payments were intended as a means of obtaining illicit objectives. However, where payments have been characterized as "facilitation" or "lubrication" payments, meaning that they merely created an incentive for an official to promptly execute legal actions, such as mandatory customs inspections, the payments have been allowed. In numerous countries, the state owns all or part of commercial enterprises so that a great number of business executives could be classified as foreign government officials.

In 1997, the OECD established legally binding standards for defining bribery in international business transactions. Similar to the FCPA, the OECD Anti-Bribery Convention focuses on the bribery of public officials. Like the FCPA, the OECD also potentially creates the opportunity for companies to circumvent the regulations by hiring consultants or agents (this topic will be the focus of this chapter's case study discussion). Notably excluded from the scope of the OECD Convention is a prohibition against bribing private parties. Despite such loopholes, the OECD Convention was an important step in the right direction. By 2012, forty-three countries had ratified the agreement and begun its implementation.

Corruption and Culture

Prior to the expansion of international trade in the nineteenth and twentieth centuries, most commerce was local and followed traditional norms and ethical standards. With the expansion of international trade, however, businesses began to operate across cultural and linguistic boundaries. Misunderstandings and transgressions, both intended and unintended, became commonplace. To some extent, perceptions of corruption may derive from cultural differences, because behavior that is considered corrupt in one society may represent a normal business practice in another.

One example can be found in the Chinese concept of *guanxi*, which refers to the reciprocal obligations and benefits expected from a network of personal connections. A person with a powerful level of *guanxi* is considered a preferred business partner because such a person can utilize connections to obtain business or government approvals. *Guanxi* can derive from extended family, school friends and alumni, work colleagues, members of common clubs or organizations, and business associates. Chinese businesspeople seek to cultivate an intricate and extensive web of lifelong *guanxi* relationships. The key expectation in *guanxi* networks is reciprocity in the granting of favors; the failure to reciprocate is considered a breach of trust. The greater the favor asked or granted, the greater the favor owed. *Guanxi* thus generates a cycle of favors over time. Among the questionable practices facilitated by *guanxi* are certain types of corrupt favoritism—such as nepotism (favoring family members) and cronyism (favoring friends). In fact, relatively high levels of nepotism or cronyism are accepted and tolerated in many non-Western cultures, not only in China. As applied to business transactions, *guanxi* opens doors and creates opportunities for business relationships and dealings. In itself, *guanxi* is not corrupt. However, strong *guanxi* connections and obligations can serve as an incentive to corruption.

Many traditional business practices around the world are rooted in concepts analogous to *guanxi*, as in the practice of using business gifts or personal connections to speed up transactions both large and small. Russians use the term *blat* to refer to the ability to get things done through personal networks or contacts with people of influence. The Japanese have adapted the English word *connections* to coin a term of their own, *konne*. In Pakistan, the use of personal *sifarish* ("recommendation") refers to the ability to make contact with the right official on the most favorable terms. The French expression for bribe is *pot de vin* ("jug of wine"), which implies friendly relations. In Urdu and Hindi, petty bribes are known as *chai pani* ("tea water"). In West Africa the term is *dash*. The English colloquial term *grease* and the German *schmiergeld* ("grease money") imply a lubrication or easing of resistance to the transaction. In Mozambique, one term for corruption is *cabritismo* or "goatism," which is derived from the saying "a goat eats where it is tethered."

The universality of such terms suggests that various forms of business bribery and graft are prevalent worldwide. However, specific business activities that are considered acceptable in some societies may be considered taboo in others. Thus, the American practice of lobbying legislators and governmental agencies would be considered an illegal form of buying influence in many other countries. In some societies, gift giving to chiefs, elders, or religious leaders is considered not only acceptable and appropriate, but even a mandatory traditional expression of respect and obligation.

A survey conducted by KPMG in the United Kingdom found that while 80 percent of respondents agreed that the UK Anti-Corruption Act was an admirable attempt to address the problem of corruption, 58 percent believed that the Act was impractical and ignored the reality that bribery is an accepted way of doing business in many countries. Other similar studies have revealed widespread international criticism of US anticorruption law as hypocritical in light of the American business practice of offering gifts to potential customers or clients (e.g., trips to conferences, golf outings, tickets to entertainment and sporting events, use of luxury facilities such as spas, condos, and country clubs, etc.).

Case Study: The Chinese Agent

The fictional case subject for this chapter is based on the difficult issue of determining the ethics of employing a well-connected agent. In our case, an American for-profit educational institution, which we will call Cleveland College, is opening a Shanghai campus to offer United States–style college programs in China. There is a ready market in China for "prestigious" US baccalaureate degrees. However, Cleveland College needs to satisfy a lot of red tape to be accredited in China and obtain the necessary licenses for an educational institution in the Shanghai area.

On an exploratory trip to Shanghai, the President of Cleveland College, Mark Rollins, is approached by a prominent businessman, Wang Li, a former member of the Shanghai city government who is familiar with the educational bureaucracy. Wang offers to assist as a public relations agent, but his fee is so hefty ($200,000 per year) that Rollins fears that Wang is going to use much of it to grease palms. Research with local authorities indicates that Wang is well respected and has a high level of *guanxi* with local educational officials. Wang promises to get Cleveland College all the necessary certifications in much faster time than it usually takes, and also promises to prevent bothersome audits and bureaucratic problems. Should Cleveland College sign him on? What FCPA danger would this entail?

Corruption in China

Over the past decade, the Chinese government has joined the global community in decrying corruption and initiating regulations and laws, and publically stating a strong intent to clamp down on corruption. Thus, in a widely publicized 2011 statement by China's Premier, Wen Jiabao, anticorruption actions were emphasized as a "primary task in 2011."[13] This was interpreted as an indication that increased enforcement of anticorruption laws will be a top government priority and that these prohibitions must be taken seriously by foreign corporations operating in China.

A number of recent high-profile cases have illustrated the extent of the Chinese crackdown on corruption. One notorious case was that of the former anticorruption official Huang Songyou, who was sentenced to death for accepting 7.71 billion yuan in bribes. In another case, Wang Huayuan and eight other senior officials of the provincial governments in Guangdong and Zhejiang provinces were convicted of corrupt actions that took place between 1998 and 2009. The former president of the Supreme Court and the former vice president of the state-owned China Development Bank were charged with taking bribes and then convicted to life in prison. In 2011, China sought the repatriation of Lai Changxing from Canada after twelve years there. As former chairman of Yuanhua International Corporation, Changxing was accused of absconding with $7.7 billion dollars. His defense against the repatriation was that he would face torture and execution.

Some observers have questioned the resolve of the Chinese government and have suggested that the small number of corruption prosecutions concluding with extreme punishments may have less to do with ending corruption than with sending a message to those who engage in corruption beyond an acceptable level. Others have suggested that anticorruption prosecutions may be an alternative means of conducting political purges. A more positive but still skeptical interpretation is to view the anticorruption cases as an expression of support for global anticorruption, an encouragement to foreign investors who fear corruption, and a way of appeasing the Chinese citizenry. According to Yan Sun, Associate Professor of Political Science at the City University of New York, it was corruption, rather than democracy as such, that lay at the root of the social dissatisfaction that led to the Tiananmen protest movement of 1989.

Foreign Educational Institutions in China

Accompanying China's meteoric economic development over the last three decades has been a corresponding growth in sophisticated higher education. The number of institutions of higher education in China has doubled in the last ten years. By 2020, China intends to have produced 195 million college graduates. The Chinese government has determined that it must not only increase the number of college graduates, but also make China an education destination for non-Chinese students. Accomplishing these goals will necessitate increased cooperation with Western institutions of higher education

In an interview with University World News in 2013, Michael Gaebel, head of the higher education policy unit at the European University Association (EUA) reported that, just a few years ago, "it was very difficult to convince European vice-chancellors that Asia was not just a provider of fee-paying students. Now no one in Europe can ignore that China has become important globally for research and will continue growing in importance."[14] In 2013, China's vice minister for education announced that China would take efforts to attract more foreign students. By 2020, China hoped to attract some 500,000 international students, making the country the largest Asian destination for international students. Currently about 35,000 foreign students are studying in China.

With 37 million students studying in over 2,400 universities and colleges, China has the largest system of higher education in the world. The rapid growth of demand for colleges and universities in recent years has resulted in a number of problems, including rushed and poor quality construction, high student–lecturer ratio, shortages of qualified faculty, and questionable academic quality, not to mention allegations of corruption.

Corruption in higher education in China has been widely reported, including allegations of widespread plagiarism, selling of degrees, favoritism in admissions, and bribery for grades. A study by Wuhan University Professor Shen Yan showed that ghostwriting academic theses was a one billion–yuan business in 2009, and that 70 percent of the published theses were plagiarized. John Bray, author of "Facing up to Corruption, a Practical Guide,"[15] reports that parents in China often have to pay for a spot in a university for their child.

Compounding these problems is the growing level of unemployment among recent graduates. The *Epoch Times* reported a 7.7 percent employment rate among the seven million graduates in 2014.[16] The decline in the perceived value of Chinese higher education has created an opportunity for foreign universities. There is a perception that a degree from a Western university is more credible and that its graduates are more employable than graduates of Chinese institutions. Carl Fey, Dean of Nottingham University Business School China, discusses the growing number of foreign campuses opening in China. At his school, they spend the first year teaching students English, so they learn to work, study, and speak in English before diving into subject matter. "Your diploma looks exactly the same whether you graduated from Nottingham, UK, or Nottingham, China," Fey said. "That's because the education's actually the same."[17]

The number of foreign universities operating in China is changing rapidly as institutions from Europe, the United States, and other Western countries enter the fray. This course is not without operational hurtles, as was noted when Harvard University pulled out of a high profile and widely published and joint venture with its Chinese counterpart, the prestigious Beijing University. Harvard cited several reasons for ending the relationship, including low enrollment, high operating expenses, and issues within the Chinese language program.

One of the problems faced by Western universities operating in China is that the potential for government censorship places severe limitations on academic freedom. While this is the most notable issue, there are many other challenges, mostly related to cultural differences. The red tape involved in getting the appropriate licenses, accreditations, and building permits from the various governmental agencies involved in local, regional, and centralized government is a daunting task for a foreigner. Most foreign institutions find it more expedient to partner with established Chinese universities than to attempt to open a new university, but even then, there are all the usual issues related to operation of a partnership or joint venture, all complicated by the cultural differences.

Topic for Debate: To Hire, or Not to Hire a "Consultant" Who May Be Bribing Officials on Behalf of the University

Should Cleveland College hire the local Chinese agent, or "public relations" consultant, who requests a sizeable enough retainer that we may reasonably suspect he is making cash donations to obtain the goodwill of local educational institutions?

Affirmative Position

Cleveland College should hire the local Chinese agent/consultant.

Possible Arguments

- Secret cash payments may act as a morally-acceptable "lubricant" to facilitate commercial exchanges.
- Corruption is an inevitable part of the process of opening up new and developing markets.
- Companies that elect to comply with the letter of the law in the strictest sense may be at a severe competitive disadvantage.
- Payment of "fees" to officials can serve as an incentive to development, cutting through unnecessary bureaucracy.
- Corruption as defined in this context is a Western concept and may not be applicable in all countries.
- In many societies, the "gift culture" is a form of appropriate behavior based on long-standing traditions of exchanging favors.

Negative Position

Cleveland College should not hire the local Chinese agent/consultant.

Possible Arguments

- Paying an agent a fee, who then bribes a government official does not necessarily relieve the college of the risk of violating anticorruption laws.
- Paying an agent to bribe a government official sets a precedent that can lead to ongoing demands for bribes.
- If the organization pays a bribe, and they do not get what they paid for, they have no recourse. This is a high-risk form of investment.
- If the college goes down the path of bribing officials for any purpose, using the justification that it is a traditional and acceptable way of conducting business, it implicitly condones a lack of ethics to its employees—the next step would be to sell grades, diplomas or admissions.

Readings

10.1 “Corruption from a Cross-Cultural Perspective”

Hooker, John. “Corruption from a Cross-Cultural Perspective.” Pittsburgh, PA: Carnegie Mellon University. October 2008. ba.gsia.cmu.edu/jnh/corruption08s.pdf.

The world is shrinking, but its cultures remain worlds apart, as do its ethical norms. Bribery, kickbacks, cronyism, and nepotism seem to be more prevalent in some parts of the world, and one wants to know why. Is it because some peoples are less ethical than others? Or is it because they have different ethical systems and regard these behaviors as acceptable?

…The phenomenon of corruption provides a good illustration of these realities. Corruption is best understood as behavior that corrupts: it undermines the cultural system in which it occurs. Because cultures can operate in very different ways, very different kinds of behavior can corrupt. Practices that Westerners consider questionable, such as cronyism and nepotism, may be functional in other cultures. Practices that are routine and acceptable in the West, such as bringing a lawsuit for breach of contract, may be corrupting in a wide range of cultures, Western and non-Western, but for very different reasons.

The West tends to be universalist in its outlook: every society works, or should work, essentially the same way. Its business practices, for example, should be based on a market system that is characterized by transparency and regulated by laws that apply to everyone. A country that fails to conform to this model is seen as underdeveloped or dysfunctional. It follows from this view that that corruption is basically the same in Sweden as in Sudan.

The reality, however, is that different cultures use radically different systems to get things done. Whereas Western cultures are primarily rule-based, most of the world’s cultures are relationship-based. Westerners tend to trust the system, while people …cemented by personal honor, filial duty, friendship, or long-term mutual obligation. Loyalty to cronies is suspect behavior in the West but represents high moral character in much of the world.

…What is corrupt in the West may be acceptable elsewhere. The classic example of the purchasing agent illustrates this point. The Western purchasing agent is expected to award contracts based on the quality of bids and transparently available financial information about the bidders. An agent who favors personal friends is viewed as corrupt, because cronyism subverts this transparency-based system. It creates a conflict of interest: A choice that is good for the agent and his or her cronies may not be good for the company.

In much of the world, however, cronyism is a foundation for trust. A purchasing agent does business with friends because friends can be trusted. He or she may not even ask to see the company financials, since this could insult the other’s honor. It is assumed that cronies will follow through on the deal, not because they fear a lawsuit, but because they do not wish to sacrifice a valuable relationship in an economy where relationships are the key to business. In such a system it is in the company’s interest for the agent to do business with friends, and cronyism may therefore present no conflict of interest.

What is acceptable in the West may be corrupt elsewhere …Even so basic a practice as negotiation, which is routine in the West, can disrupt harmony in Confucian cultures. Westerners tend to organize their affairs around agreements, deals, or contracts, relying on a concept of covenant that traces back to the ancient Middle East. These agreements are hammered out in negotiation, as for example when labor and management sit across the table from each other. This practice is functional and constructive, so long as it proceeds according to rules of fair play and good faith.

Confucian cultures …are based primarily on loyalty and obligation to friends, family or superiors rather than on a system of rules.

10.2 “Facing up to Corruption: A Practical Business Guide”

Bray, John. “Facing up to Corruption: A Practical Business Guide.” London: Control Risks. 2007. www.giaccentre.org/documents/CONTROLRISKS.CORRUPTIONGUIDE.pdf

Direct and Indirect Bribery

Indirect bribery is one of the most sensitive policy issues facing international companies. A typical example would be a case where a company employs a commercial agent to help it win a government contract. The agent is paid by commission based on a percentage of the contract fee; part of that commission is passed on to a government official. The agent’s employers do not know—and do not wish to know—what happened…

The OECD Anti-Bribery Convention explicitly covers payments made “directly or through intermediaries” to secure a business advantage. US and other international legal practice already includes several cases where companies have been prosecuted for paying bribes via agents. Ignorance—wilful or otherwise—is not a defence.

…A broad understanding of corruption includes certain kinds of influence, although the boundary between acceptable and unacceptable forms of influence is often hard to define. A series of cases in the US and other countries have drawn attention to the ethical issues surrounding political lobbying. In principle, political lobbying is legitimate. One of the main roles of industry associations is to lobby government on their members’ behalf. Individual companies, like ordinary citizens, are entitled to seek assistance from their political and diplomatic representatives. Problems arise when such contacts appear secretive, when there is a suspicion of favouritism or when a company’s influence appears to be both disproportionate and against the wider public interest.

In many societies it is common to speed up both larger and smaller transactions through personal connections… The use of personal contacts is both commonplace and useful. However, as with political lobbying, it becomes problematic when the connections lack transparency and when officials break rules on behalf of their business friends, or seek illicit favours in return.

In cases of doubt, the so-called “newspaper test” provides a useful indicator: would a proposed transaction cause you or your company embarrassment when reported in the press? If it would, do not do it.

10.3 “The Cost of Corruption: A Discussion Paper on Corruption, Development and the Poor”

Evans, Bryan R. “The Cost of Corruption: A Discussion Paper on Corruption, Development and the Poor,” (Middlesex, UK: Tearfund, 1999), accessed December 3, 2014, www.tearfund.org/webdocs/Website/Campaigning/Policy%20and%20research/The%20cost%20of%20corruption.pdf.

Far from being a “victimless crime,” corruption infringes the fundamental human right to fair treatment. All persons are entitled to be treated equally, and when one person bribes a public official he acquires a privileged status in relation to others. He becomes an ‘insider’ while others are made “outsiders” (and the more “outside” they are—the very poor, the landless, women, ethnic minorities—the more they will be hurt). Clare Short, the UK Secretary of State for International Development, notes a report in the Indian magazine Outlook to the effect that the bribe for a new water connection was R1,000. This effectively excluded the poor from access to running water, with all the health and time-loss implications that this entails. Corruption is thus profoundly inegalitarian in its effects—it has a “Robin Hood-in-reverse” character. Hugh Bayley MP, introducing a bill to create offences of international bribery and corruption, went so far as to say that “bribery is a direct transfer of money from the poor to the rich.”

…The ramifications spread yet further. Productive foreign investment may be lost. Before the Asian crisis of 1997/98 there were some who argued that corruption was not harmful, it merely greased the wheels of commerce. It was pointed out that some countries which ranked high in surveys of the level of corruption, also excelled in economic growth. The World Development Report notes that the question of predictability (the amount to be paid, the certainty of outcome) throws some light on this apparent paradox. “For a given level of corruption, countries with more predictable corruption have higher investment rates…”

However, the Report went on to state that even in these countries corruption had an adverse impact on economic performance, because the higher transaction costs and increased uncertainty put off potential investors. Time magazine quotes research by Professor Shang-Jin Wei of Harvard School of Government to the effect that the high level of corruption in Mexico compared with Singapore was the equivalent of a 24 per cent increase in the marginal rate of taxation.

A conservationist, Lansen Olsen, in a letter to the Transparency International Newsletter notes that “political corruption is a major feature of the political habitat in which wildlife conservation efforts sink or swim.” When corruption breaches regulations designed to protect the environment, everyone suffers in the long term, as the loss of primary forest leads to soil erosion, local climate change, etc., but it is the poor who have the smallest resources with which to weather environmental degradation.

Corruption can also have ugly and unpredictable consequences for the (Western) briber. As soon as he pays he begins to lose control. If he does not get what he paid for he is in no position to complain. Having broken the law he is vulnerable to blackmail. If he tries to break the corrupt relationship he may face a variety of threats, including the threat of violence.

Synthesis Questions

1. Consider the following hypothetical example: An American college seeks to obtain a good image among Chinese educational regulators and accreditors by inviting a number of them, all expenses paid, to a week-long conference in Hawaii. Is this morally acceptable? Does it constitute a form of bribery? Why or why not?
2. In the past two decades, a number of very large corporations have paid large fines for corrupt behavior. Presumably, the executives who authorized the payments were highly-educated, experienced, professional people. Why do you think they failed to speak up against the corruption?
3. This chapter explores the concept of guanxi. Do you think guanxi is morally wrong, or rather, is an acceptable form of traditional practice that must be allowed to continue? What are the prospects for guanxi in the future?

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6.22: Importance of Leadership in a Global Economy

Over the years, leadership scholars have found in their studies that, when talking about the leadership process, culture matters.Koopman, Hartog, & Konrad (1999). In general, the leadership literature points to the critical need for cross-cultural and global leadership, especially given the pressing need to build networks and relationshipsGoldsmith, Greenberg, Robertson, & Hu-Chan (2003). and to create an appreciation for differences and similarities. Bennis noted that, although leadership competencies have remained the same, it is "our understanding of what it is and how it works and the ways in which people learn to apply it has shifted."Bennis (1985), p. 3.

Leadership theories and models available thus far, while helpful in understanding leadership development, are inadequate paradigms for a full understanding of the changing nature of leadership in the 21st century. Goldsmith et al.Goldsmith et al. (2003), p. 7. argued for new forms of leadership that include thinking globally, appreciating **cultural diversity**, developing technological savvy, building partnerships and alliances, and sharing leadership. Research into **cross-cultural leadership** revealed that understanding national cultures is critical to leadership development and that organizations must accept differing perceptions of leadership.Derr, Roussillon, & Bournois (2002), p. 298.

Leadership theories and programs that operate from a Western-based, **androcentric framework** hinder the shift that is required for understanding leadership on a broader level. Situational leadership theories,Northouse (2007), pp. 15–108. which focus on leadership traits, skills, and styles, are inadequate models in this regard because their basic foundation (understanding the individual as leader) implies a Western-based ideology of leadership that does not exist in many national cultures; therefore, the underlying concepts of this style of leadership do not always translate universally. Other theories, such as **transformational** and **team leadership**, emphasize the collective voice as essential yet neglect the cultural implications for leadership. Even cultures that share similar Western beliefs about organizational structure still operate differently based on their unique cultural contexts.Mutabazi (2002), p. 204.

In a global economy, it is becoming increasingly more important to understand the wants and needs of those we serve, that is, the internal and external stakeholders. Having awareness of this need means that leaders must be able to shape the culture of their organizations to address changing stakeholder needs. Edgar Schein noted that leaders can do this by having a "personal sense that they are the creation of the cultures of the countries, families, occupations, and reference groups, and that culture plays a huge role in the capacities of their organization to form."Schein (2006), p. 259. Culturally intelligent leaders need be strategic in aligning the culture of their organizations with the people who work in them. This **organizational culture** becomes an advantage for leaders, making it easier for them to respond to external environmental factors, which include culture shifts.

Debbe KennedyKennedy (2008), pp. 35–40. proposed the following five qualities that leaders need in order to address and use cultural differences to the advantage of their organization:

- *Leaders must make diversity a priority*.
- *Leaders must get to know people and their differences*.
- *Leaders must enable rich communication*.
- *Leaders must make accountability a core value*.
- *Leaders must be able to establish mutualism as the final arbiter*.

These five characteristics I have seen as important differences between the ways that managers and leaders handle cultural conflicts and situations. Culturally intelligent leaders are those that elevate diversity to the top of organizational planning and view it as a critical factor to innovation and creativity. Innovation in diversity begins with a definition of diversity, which many organizations lack or have poorly articulated. If they do, diversity definitions are focused on race and ethnicity and do not explore the dynamic dimensions implicit in culture. In a 2007 study on diversity in the workplace, the Society of Human Resource Management*Human resource management guide* (n.d.). reported that only 30% of organizations have a shared definition of diversity in the workplace. However, 75% feel that diversity can be used to improve work and relationships. A focus for, and an articulation of, defining diversity and its importance in the work force can open dialogue for organizations.

Having culturally intelligent leaders in organizations matter because they help to develop a curiosity for differences in the workplace in employees. They help to provide access to information and intentionally gather cultural knowledge on a daily basis that will help them and others learn more about differences and the influence of differences in the workplace. Additionally, leaders can foster creativity and curiosity when they set aside some time, on a day-to-day basis, to practice and master their cultural intelligence skills.

When I have seen culturally intelligent leaders in action, they cultivate an environment of trust, which is critical when working with differences in the workplace. Patrick LencioniLencioni (2002). wrote that trust is a critical foundational element in interpersonal relationships. Leaders must be willing to be vulnerable in intercultural interactions, openly admitting what they know and don't know about culture and cultural differences. They must be able to admit that they might not be able to resolve intercultural differences. By demonstrating vulnerability, a leader enables richer communication and creates an inviting space and environment for intercultural dialogue. In this situation, people are more willing to ask for help and to provide one another with constructive feedback; they take risks and learn to appreciate the differences in skills and style that each person brings to the work environment.

For diversity and culture to flourish in organizations, everyone in the workplace must hold each other accountable toward differences. My experiences working with leaders of different sectors, both formal and informal, have shown me that the creation of a mission and vision for diversity can only take an organization so far. Culturally Intelligent leaders create standards of accountability, explaining what is expected of each employee and of themselves in intercultural interactions.

As an example, I was brought in to facilitate a workshop about cultural differences for public sector employees. In this workshop, the city manager and a city council member were present; they wanted to demonstrate to their employees the importance of culture and their commitment to diversity in the city. At the end of the session, they stood up and addressed the participants, reminding them that the workshop they participated in was only one of many to come. Moreover, the city manager and city council member told the employees that they would do whatever it took to ensure that everyone was held accountable for delivering culturally relevant services to the department's clients. In this way, "Putting differences to work is greatly enhanced when personal responsibility is a common thread woven tightly into everyone's fabric."Kennedy (2008).

When everyone is held accountable for their choices and behaviors in an intercultural workplace, there is a higher level of respect and trust among workers. Everyone is encouraged to perform his or her best and to hold themselves to the highest standards in working with each other. Intercultural conflicts still occur, but the responses to these conflicts from individuals are different.

Lee Bolman and Terrence DealBolman & Deal (2008). wrote that organizations are a coalition of individuals and groups with different interests, preferences, and beliefs. The differences among individuals and groups can change, but this usually occurs very slowly. Leaders must be able to identify mutual interests, values, and beliefs in order to create a culture of mutual **interdependence**. Because conflict is unavoidable, and often necessary, it is best for leaders to create a picture of mutual dependence that is both beneficial and progressive for employees.

Leadership matters even more when cultures are intertwined in the workplace. Leadership and culture are like two pieces of rope. On their own, they can be used to bundle objects, connect one thing to another, and even support weight. When threaded and intertwined, they do all of these things but are much stronger and have less chances of being snapped. A rope is firm and strong yet flexible and pliable. Because change is constant, leaders can use their cultural intelligence to steer organizations, and those they lead, toward finding innovative strategies and solutions to intercultural issues.

Like an anthropologist, culturally intelligent leaders explore, discover, and find cultural artifacts in their business environment that are both barriers to, and promoters of, growth. A culturally intelligent leader will accomplish this from an "outsider" perspective while keeping his or her "insider" perspective in line. Ronald HeifetzHeifetz (1994). says that one should take a leap to get a balcony perspective when one has been on the dance floor too long; this enables one to see a bigger picture of what is really going on in the intercultural business workplace. Reminding yourself that what you see is only one perspective of a bigger picture can help you to pay attention to what you did not notice or what you cannot see. Cultural intelligence requires leaders to take a critical role in guiding different values in order to bring them into alignment with the business. However, leaders need not do this alone; in fact, they should invite and encourage members to assist in addressing diversity and then challenge them to be culturally intelligent as well.

SECTION OVERVIEW

6.23: Cultural Intelligence Defined

6.24: What is Cultural Intelligence?

At the core of it, cultural intelligence is your ability to successfully adapt to unfamiliar cultural settings. Peter Earley and Elaine Mosakowski defined cultural intelligence (CI) as the ability to "tease out of a person's or group's behavior those features that would be true of all people and all groups, those peculiar to this person or this group, and those that are neither universal nor idiosyncratic."Earley & Mosakowski (2004), p. 140. Earley et al. wrote that cultural intelligence is not just about learning new cultural situations; it is creating "a new framework for understanding what he or she experiences and sees."Earley, Ang, & Tan (2006), p. 6. Similarly, David Thomas and Kerr Inkson indicated that cultural intelligence is about

being skilled and flexible about understanding a culture, learning more about it from your on-going interactions with it, and gradually reshaping your thinking to be more sympathetic to the culture and your behaviors to be more skilled and appropriate when interacting with others from the culture.Thomas & Inkson, (2003), p. 14.

The idea of cultural intelligence is an immensely useful tool in business. It helps to bring attention to the differences in thought and behaviors due to cultural factors. Consistently practicing cultural intelligence has been known to increase the success of multicultural team performance. Leaders who are culturally intelligent have awareness of how culture contributes to communication and creates shared learning.Darlington (1996), p. 53.

Tuning into Cultural Intelligence

On a business trip to Texas, my colleague, who had never visited the state, was surprised at the amount of "Spanish music" on the radio. Every time she found a music station or station providing information, the speakers and singers spoke in Spanish. She said, "I can't find any music that I can understand," and quickly changed to a local station that played top 40 and pop music.

When I suggested that we should try listening to different music and experience the cultural shift between our state and another, she said, "No way. I can't understand what they're saying!" I replied, "I can't either, but it's a part of the culture here and wouldn't it be interesting to be like one of the locals?" Her response, "That's okay. I'll just stick to what I know."

Cultural intelligence is like tuning into different stations, being able to adapt to one's new environment, and, in this case, to the style of music in this region of the United States. Like my colleague, we all have particular stations that we like. Music that is familiar provides us with comfort. Tuning in to the same stations over and over again breeds familiarity with the songs and the types of programming broadcast by the stations. We even program the stations into our car radio so as to know exactly what buttons to push if we want to hear a specific music genre.

When you are in a different city or state, you begin to lose the signals of your favorite stations. Try as you might, the stations often do not come through. What might you do? You could find another station in that state that offers the same music or information that you like. Upon finding it, you might program it so as to not lose the station. However, what if the radio frequencies you encounter pick up limited stations? Like my colleague, you might turn off the radio or change the station back to one that is familiar. Or, like her, you could bring your own MP3 player with your own music.

Similarly, when you are in unfamiliar cultural settings, you realize that the signals you are receiving are vastly different from your own. You are not familiar with what your new surroundings are communicating to you. Your first reaction is to find something familiar, and you look for cues and signs to help you adjust. However, you cannot always rely on what you know and what you can bring with you. Like my co-worker, bringing equipment, like an MP3 player, does not always guarantee successful integration. After many tries, she found out her MP3 player did not work in the rental car; she opted for turning off the radio altogether. In intercultural interactions, the equipment—that is, our skill sets and our knowledge—may not be enough to cope in a new cultural environment. We need to be able to learn how to turn off or reset ourselves to better adapt to the new situation.

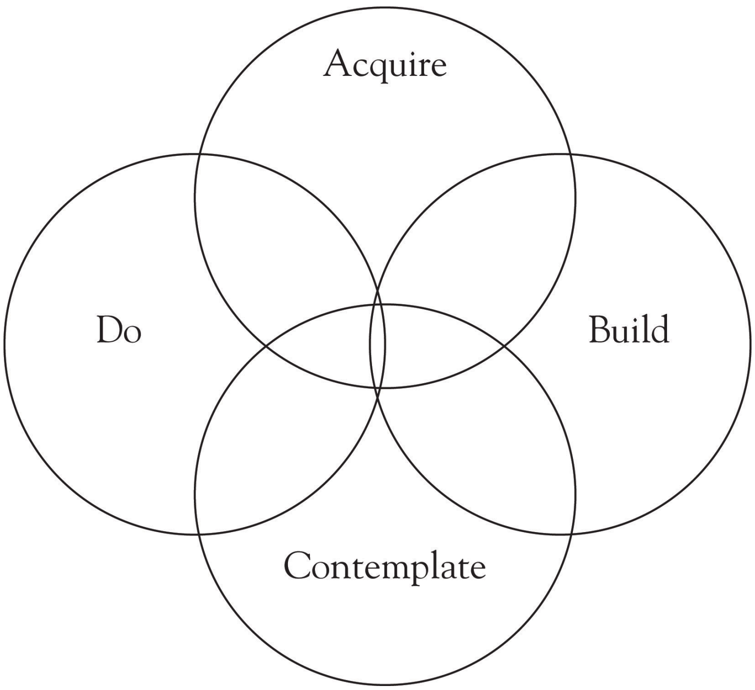
6.25: Cultural Intelligence Model

Cultural intelligence is a framework to help you learn to turn off your "cruise control." Like a computer that has been on too long, is working too hard, or has too many programs running that cause it to freeze, we have to learn to reset our mental programming. Sometimes, resetting it once or twice does not work; you will need to turn it off completely by taking a pause and then returning to it at a later time.

Cultural intelligence emphasizes three areas: metacognition and cognition, motivation, and behavior. Metacognition and cognition represent your ability to think, learn, and strategize. In CI, the principle of motivation refers to your self-efficacy and confidence, your ability to be persistent, and the alignment to your personal values. Behavior, in CI, is about your ability to have a repertoire of skills and your ability to adapt your behavior.

The framework for **cultural intelligence** consists of the following parts: knowledge, strategic thinking, motivation, and behaviors. It may be helpful to think about these as the **ABCs of CI**: **A**cquire, **B**uild, **C**ontemplate, and **D**o.

Figure 3.1 Cultural Intelligence Model



Acquire Knowledge

A fundamental piece of inter- and cross-cultural interactions is the knowledge a leader has when working with cultures unfamiliar and different from his or her own. Knowledge is a central tenet in intercultural training and is included in the cultural intelligence model because it is essential for any person, whether leading or managing, to be attentive to cultural systems. You must know how cultures are created, interpreted, and shared, as well as how cultural interpretations, meaning, and symbols can impact behaviors and attitudes.

You can think about this aspect of the model as *acquire*, because you need to acquire information and knowledge that help you to identify cultural elements at play. The acquisition of knowledge—tapping into what you have stored in your memory—is cognition.

Build Your Strategic Thinking

Once you gain knowledge about the culture, how will you use it? What parts of the knowledge obtained will you use? Will they all fit, given the cultural setting? These questions address the component of cultural intelligence that speaks to your ability, as a leader, to strategize across cultures. It is your ability to *build* awareness of your surrounding through preparation and planning. It is often referred to as "metacognition."

Earley et al. noted, “Figuring out how things operate and what is appropriate in a new culture is detective work using the facts of the case—assemble them, order and organize them, interpret them, act on them.”Earley et al. (2006), p. 27. Strategic thinking is important because it is how you think about, or make sense of, the knowledge and use it in a way that helps you better perform and interact with different cultures. If you are able to understand how you learn the information and how you have processed it, this helps you to make sense of unfamiliar situations. Early and PetersonEarley & Peterson (2004), p. 105. wrote that when there is a focus on metacognition, this component of CI can help people to develop and expand their behavioral repertoires.

Contemplate Your Motivation and Ability to Work with Others

The third element of the cultural intelligence model speaks to your ability to pay attention to your surroundings as well as your responses to unfamiliar situations. It is about reflecting upon your own interests, your drive, and your motivation, as well as your willingness to work through, and with, cultural interactions.

You can think about this component of the model as *contemplate* because it requires you to be present—to take a step back, suspend your judgments and biases, reflect upon your assumptions, and listen carefully. It requires that you be alert and remain aware of your cultural surroundings. As a leader, presence allows you to identify the cultural scripts that are hidden and to recognize when to turn them off.

Adapt and Perform

Richard Carlson said that “everything we do has the potential to influence another human being…the key element here is not to second-guess yourself but rather to become conscious of how your life choices influence those around you.”Carlson (2005), p. 130. Carlson speaks to our level of conscious choice in day-to-day living. When do we choose to adapt to our environments? Because of a choice we made, what did we let go? How has our choice affected our beliefs and values?

These questions address the fourth component of cultural intelligence, which is your adaptability and ability to perform new behaviors based on new cultural surroundings. Are you aware of how others see you and how you come across to them? How do you interpret what others say, and how do you respond? Culturally intelligent leaders are like chameleons in social environments, changing their behaviors to mimic their surroundings.

6.26: What Makes Cultural Intelligence Unique?

Howard GardnerGardner (1983). popularized the idea that intelligence is more than cognitive capacity—that human potential cannot be limited to cognitive intelligence the way it is described and defined in society. You can think about cultural intelligence as another form of intelligence. People with this particular intelligence have the ability to steer their way through unfamiliar cultural interactions; they do this in what seems to others as an effortless manner. This does not mean that culturally intelligent people are more intelligent overall than others; rather, those who are not skilled in this intelligence may need to adopt a different approach toward learning and improving their cultural intelligence.

According to Earley and Peterson, cultural intelligence is a significant improvement over existing approaches because it "provides an integrated approach to training dealing with knowledge and learning, motivation and behavior, and is built upon a unifying psychological model of cultural adaptation rather than the piecemeal and country-specific approach in training."Earley & Peterson (2004), p. 101. David Thomas and Kerr InksonThomas & Inkson (2003). wrote that, compared to emotional and social intelligence, cultural intelligence theory includes the influence of cultural factors and their impact in intercultural interactions.

Emotional intelligence is one's ability and capacity to identify, assess, and manage one's emotions as well as others' emotions. Although extremely important, emotional intelligence "presumes a degree of familiarity within a culture and context that may exist across many cultures for a given individual."Earley & Peterson (2004), p. 105 Similarly, the social cues picked up and used by someone with high **social intelligence**—that is, the ability and capacity to sense one's inner state, feelings, and thoughts in relation to one's social environment, and react appropriately in this environment for social successGoleman (2006), pp. 83–84.—differs from culture to culture.

Earley and Peterson argue that **adaptation** is a requirement when one enters new cultural contexts, and cultural intelligence provides the theoretical background for understanding how one would need to adjust, adapt, or reinvent oneself based on the culture and the situation.Earley & Peterson (2004). Someone with high emotional and social intelligence is not guaranteed to be culturally intelligent, although having those skills can make it easier for them to learn about cultural intelligence. This is illustrated in the following case study.

Martha works as a program director for a large nonprofit that directs volunteer programs. Her co-workers describe her as, "personable, outgoing, empathic, and caring." Whenever there is conflict or unsettled business, she is the "go to person" for helping her colleagues work out their issues. Her ability to be empathetic enables her to understand others' thoughts and feelings as well as their intentions.

When Martha gets upset or frustrated, she "takes a pause" or will back away from the issue or person until she can get a hold of her emotions. If Martha is asked how she manages her emotions, she replies that meditation and exercise help her to regulate how she feels from moment to moment. She's even led agency wide sessions on self-care and exercise.

Volunteers who work for Martha love that she cares about their needs. During workshops and events she introduces volunteers to one another, helping them to learn about and get to know each other. Martha is also very attuned to those around her by listening and observing, which makes her a great program director for volunteers.

Martha's emotional and social intelligences are high, which makes it difficult for Lorraine, Martha's direct supervisor, to understand why Martha has such challenges working with people of cultural groups different than her own. Martha, as her jovial self, is always kind and thoughtful, but sometimes she will say culturally inappropriate things, not aware that she's said them.

One of the volunteers who is Southeast Asian has noted, "I like Martha but it seems like she just doesn't understand me. Like the time I had to cancel my tutoring shift. No one was watching my sister's baby so I had to watch her. I told Martha and she was real nice and understanding, but I feel that she didn't *really* understand that I have an obligation to my family before this volunteer job. I had to explain to her that this is what it's like in my culture, that family comes first. Then, she nodded and understood."

In this case, although Martha is empathic, she does not understand that the volunteer has very specific cultural needs. Her empathy is not viewed as authentic because Martha does not understand, nor does she pick up on, the cultural cues, thus leading the volunteer to feel the way she feels. **Empathy** is a good foundation for intercultural relationships, but awareness of cultural nuances is critical for making the connection.

The following describes other ways in which scholars and practitioners believe cultural intelligence is different from other approaches:

- Cultural intelligence is a growing field that is continuously being researched and tested in many societies. A search on the Internet for the word "cultural intelligence" yields over 2.7 million hits. When searching for academic papers and scholarship, the word yields almost 1.5 million hits. Other intercultural approaches do not yield as much universal appeal as cultural intelligence.
- Cultural intelligence demands that leaders gather more than knowledge of cultural facts. It is awareness of how culture works, of the values and beliefs that ground a person's thinking and motivation, and of exploring behavioral intelligence.
- Cultural intelligence emphasizes a circular path, not a linear one; this means that, over time, one will continue to learn and their cultural intelligence will expand. It is not a step-by-step process that culminates in an "ultimate outcome." Rather, through cultural intelligence, one learns more about him- or herself and his or her ability to interact with different cultures. There is always room for improvement and development in cultural intelligence.
- Cultural intelligence does not speak to specific cultures. Cultural intelligence is a broad approach that looks at developing a set of skills, as well as awareness and knowledge, that help you to adapt and interact with multiple cultures.

6.27: The Labyrinth of Cultural Intelligence

> *We have not even to risk the adventure alone…the labyrinth is thoroughly known. We have only to follow the thread of the hero path…and where we had thought to slay another, we shall slay ourselves. Where we had thought to travel outward, we will come to the center of our existence. And where we had thought to be alone, we will be with all the world.*
>
> *Joseph Campbell, The Power of Myth*

Labyrinths often serve as metaphors for personal journeys into the self and back into the world. In a labyrinth, there is one path to the center, and that same path leads you out. You make the choice to enter the path and start a journey. You make the choice to continue the journey or to end it by retracing your steps to the place you entered.

You can think about your journey into cultural intelligence as entering a labyrinth. It is not a maze; rather, it is journey that brings you to a deeper awareness of yourself and your place in the world. In a labyrinth, you find yourself walking around short curves, long curves, around edges of the circle, getting closer to the center. As you do so, you may feel a variety of emotions and thought: hesitation, confidence, motivation, ease, caution, or reflection. In the labyrinth, we become the observer of these thoughts and emotions. As Carlson noted, “We can simply step back and watch the show. It’s really just like watching a movie on the screen.”Carlson (2005), p. 50.

The labyrinth has long served as a metaphor of change and growth. Walking the labyrinth is a time of exploration and discovery. Careful listening and the willingness to take risks, and to challenge yourself, lead you to a transformation. This transformation encompasses a new, expansive vision of possibilities in your world. It serves as a container for your experiences in life: fun and play, disappointment and sadness, grief and loss, joy and prosperity, success and failure. When you look at the labyrinth as a metaphor for your cultural intelligence journey, you will see that your path is sometimes shared with others, and, at times, it is yours alone.

As Joseph Campbell noted, everyone goes through a psychological transformation that brings them to a more fulfilling life.Campbell (1988). Cultural intelligence is a process and a tool to help you evolve, to help you take the risks required when in unfamiliar cultural interactions. When applied, you will notice that you have gained a new consciousness of your place in the world.

6.28: Summary

- Cultural intelligence is the ability to adapt successfully to unfamiliar cultural settings.
- There are three elements to cultural intelligence: metacognition and cognition, motivation, and behavior.
- Cultural intelligence can be expressed as the ABCs of CI: acquire (knowledge), build (strategic thinking), contemplate (motivation), and do (behavior).
- Cultural intelligence is more comprehensive than emotional and social intelligences.
- People who have high emotional and social intelligences do not necessarily have high cultural intelligence.
- CI is more than knowledge-gathering; it does not speak to one specific culture.
- Your journey into cultural intelligence can be seen as entering a labyrinth. Labyrinths serve as metaphors for personal journeys that lead to transformation and change.
- Practicing and applying cultural intelligence principles enables you to learn more about yourself and your relationship to the world.

SECTION OVERVIEW

6.29: History, Globalization, and Values-Based Leadership

6.30: History, Globalization, and Values-Based Leadership

What's in It for Me?

Reading this chapter will help you do the following:

1. Learn about the history of principles of management.
2. Know the context for contemporary principles of management.
3. Understand key global trends.
4. See how globalization is affecting management principles and practices.
5. Appreciate the importance of value-based leadership (ethics) in management.

The planning-organizing-leading-controlling (P-O-L-C) framework is summarized in the following figure. In this chapter, you'll learn that some principles of management are enduring, but you'll also see that managers need to be continually adapting to changing times. Each facet of the framework—from planning, to organizing, to leading, to controlling—has to be adapted to take advantage of, and to manage in, our changing world. Global trends affect both the style and the substance of management. As the world becomes more global, managers find themselves leading workforces that may be distributed across the country—and the world. Workers are more educated, but more is expected of them.

Planning	Organizing	Leading	Controlling
1. Vision & Mission	1. Organization Design	1. Leadership	1. Systems/Processes
2. Strategizing	2. Culture	2. Decision Making	2. Strategic Human Resources
3. Goals & Objectives	3. Social Networks	3. Communications	
		4. Groups/Teams	
		5. Motivation	

Figure 6.30.1: The P-L-O-C framework

The realm of managers is expanding. As a leader, you'll be a role model in the organization, setting the tone not just for *what* gets done but *how* it gets done. Increasingly, good business practice extends to stewardship, not just of the organization but of the environment and community at large. Ethics and values-based leadership aren't just good ideas—they're vital to attracting talent and retaining loyal customers and business partners.

6.31: Case in Point- Hanna Andersson Corporation Changes for Good

Figure 6.31.1: Jessica Lucia – pajama time – CC BY-NC-ND 2.0.

Born from a desire to bring quality European-style children's clothing to the United States, Hanna Andersson Corporation has sold colorful clothing and accessories since 1983. Husband and wife cofounders, Tom and Gun (pronounced "gōōn") Denhart, started the Portland, Oregon–based company by distributing imported Swedish clothing from their home. Named for Gun's Swedish grandmother, the company now boasts over $100 million in annual sales and employs over 500 people. Growing from an exclusive mail-order catalog business in the early 1980s, today Hanna Andersson also distributes products online, in 29 retail stores nationwide, and through select specialty retailers.

Over the years, Hanna Andersson has shown that it deeply values its employees. The company provides supplemental child-care reimbursement to all employees—even part-time sales associates. Additional employee benefits include part-time and flexible work hours, considerable paid time off, and 8 hours per year of paid time for employees to volunteer in the community. More important, though, employees feel like they are part of the Hanna Andersson family. In fact, in the beginning many of the employees were friends and family members of the Denharts.

It was important to the Denharts that they were involved in the decisions of the company and that those decisions took quality of life issues into account. Gun states, "If you can create balance among your work, your community, your family, and your friends, then you're going to be more satisfied." Examples of this philosophy infusing Hanna Andersson include the establishment of HannaDowns, a clothing recycling program where customers can return used clothing and receive a 20% off coupon for their next purchase. The charitable nature of Hanna Andersson has continued through what is now the HannaHelps program. This program awards grants and donates products to schools and nonprofit groups, helping children in the community and around the world. In addition, under Gun's leadership Hanna Andersson established ongoing donations, 5% of pretax profits, to charities that benefit women and children.

The considerable growth and development the business experienced did not come without its challenges and necessary organizational change. In the 1990s and early 2000s, increased competition from other retailers and the introduction of online commerce posed some challenges for Hanna Andersson. The Denharts found themselves without a solid growth plan for the future. They worried that they might have lost sight of market forces. Change was necessary if Hanna Andersson was to remain viable.

Realizing the need for help and direction, the Denharts promoted from within the company to help initiate change and strategic growth, and in 1995, Phil Iosca took the strategic lead as CEO. Hanna Andersson was then sold to a private equity firm in 2001 and has since changed ownership several times, leading to a new business direction for the company. After selling the business, Gun remained on the Hanna board of directors until 2007. She also served as chair of the Hanna Andersson Children's Foundation from 2001 to 2006. She still partners with the company from time to time on charitable events in the community.

Under Iosca's steady leadership, the company opened several retail stores throughout the country in 2002 and established online commerce. In 2009, Hanna Andersson began distributing merchandise wholesale through retail partners such as Nordstrom and Costco. The implementation of each of these new distribution avenues required a great deal of change within the company. HR Vice President Gretchen Peterson explains, "The growth of the retail business required the greatest shift in our internal processes from both technical systems, to inventory planning and buying to distribution processes to our organizational communication and HR processes (recruitment, compensation, etc.), as well as our marketing communication programs." Tenured employees throughout the company found themselves in unfamiliar territory, unsure of the company's future as the board and owners debated the risks and rewards of retail expansion. Fortunately, the changes were mostly offset by a consistent leadership team. Petersen, who has been with the company since 1994, explains, "From 1995 to 2010, we retained the same CEO (Iosca) and therefore, the face of the company and the management style did not fluctuate greatly."

When Iosca retired in early 2010, chief operating officer Adam Stone took over as CEO. He helped his company weather yet another transition with a calm push for changes within the company. To help understand different points of view at Hanna Andersson, Stone often sat in on inventory and operational planning meetings. Step by step, Stone was able to break down work initiatives so the continuing changes were not so overwhelming to the company and its valued employees. Over time, his and other company leaders' presence has helped employees make better, more strategic decisions. Rather than resisting change, they now feel heard and understood.

The decision to sell wholesale turned out to be a good one, as it has enabled the company to weather the recession's negative effect on retail and online purchases. Accounting for approximately 10% of total sales, the company's wholesale business is expected to boost yearly revenue by 5%. With more conscientious inventory purchases and strategic distribution initiatives, Hanna Andersson has realized a higher sales volume, lower inventory at year-end, and less liquidation. Through it all, company management has done an effective job at interpreting the desired growth goals of its owners while inspiring change within the company. With continued clear communication, direction, and willingness to try new techniques, Hanna Andersson is poised for growth and success in the future while not forgetting to take care of its employees.

Case study based on information from Bollier, D. (1996). *Aiming higher: 25 stories of how companies prosper by combining sound management and social vision* (pp. 23–35). New York: The Business Enterprise Trust; Boulé, M. (2009, July 16). Hanna Andersson employee can't say enough of a thank-you to co-workers who helped her through cancer. *Oregonian*. Retrieved March 4, 2010, from http://www.oregonlive.com/news/oregonian/margie_boule/index.ssf/2009/07/hanna_andersson_employee_cant.html;

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Discussion Questions

1. How has Hanna Andersson applied values-based leadership in terms of the organization's choices related to P-O-L-C?
2. How did company leaders like Iosca, Petersen, and Stone help facilitate change within the company? Did they remain consistent with the values of the founders?
3. What were the reasons for organizational change within Hanna Andersson, both internally and externally?
4. What unique challenges do family-owned and -operated businesses face?
5. How did the mission of Hanna Andersson evolve over time?

6.32: Ancient History- Management Through the 1990s

Learning Objectives

1. Early motivation for development of principles.
2. What problems did these principles solve?
3. What were the limitations of these early views?

Early Management Principles

Early management principles were born of necessity. The most influential of these early principles were set forth by **Henri Fayol** a French mining engineer. In 1888, Fayol became director of a mining company. The company was in difficulty, but Fayol was able to turn it around and make the company profitable again. When he retired, Fayol wrote down what he'd done to save the company. He helped develop an "administrative science" and developed principles that he thought all organizations should follow if they were to run properly.

Fayol's 14 Principles of Management

1. Specialization/Division of Labor

   By specializing in a limited set of activities, workers become more efficient and increase their output.

2. Authority/Responsibility

   Managers must have the authority to issue commands, but with that authority comes the responsibility to ensure that the work gets done.

3. Discipline

   Workers must obey orders if the business is to run smoothly. But good discipline is the result of effective leadership: workers must understand the rules and management should use penalties judiciously if workers violate the rules.

4. Unity of Command

   An employee should receive orders only from one boss to avoid conflicting instructions.

5. Unity of Direction

   Each unit or group has only one boss and follows one plan so that work is coordinated.

6. Subordination of Individual Interest

   The interests of one person should never take precedence over what is best for the company as a whole.

7. Remuneration

   Workers must be fairly paid for their services.

8. Centralization

   Centralization refers to decision making: specifically, whether decisions are centralized (made by management) or decentralized (made by employees). Fayol believed that whether a company should centralize or decentralize its decision making depended on the company's situation and the quality of its workers.

9. Line of Authority

   The line of authority moves from top management down to the lowest ranks. This hierarchy is necessary for unity of command, but communication can also occur laterally if the bosses are kept aware of it. The line should not be overextended or have too many levels.

10. Order

    Orderliness refers both to the environment and materials as well as to the policies and rules. People and materials should be in the right place at the right time.

11. Equity

Fairness (equity), dignity, and respect should pervade the organization. Bosses must treat employees well, with a "combination of kindliness and justice."

12. Stability of Tenure

    Organizations do best when tenure is high (i.e., turnover is low). People need time to learn their jobs, and stability promotes loyalty. High employee turnover is inefficient.

13. Initiative

    Allowing everyone in the organization the right to create plans and carry them out will make them more enthusiastic and will encourage them to work harder.

14. Esprit de Corps

    Harmony and team spirit across the organization builds morale and unity.

Time and Motion

Figure 6.32.1: Coal is mined and moved by heavy machinery. The coal lift shown is 20th century and not modern. In Taylor's time, it was moved by shovel to rail cars or trucks. PublicDomainPictures – CC0 public domain.

Frederick Winslow Taylor, a contemporary of Fayol's, formalized the principles of scientific management in his 1911 book, *The Principles of Scientific Management*. Taylor described how productivity could be greatly improved by applying the scientific method to management; for this reason, the scientific approach is sometimes referred to as Taylorism.

Taylor is most famous for his "time studies," in which he used a stopwatch to time how long it took a worker to perform a task, such as shoveling coal or moving heavy loads. Then he experimented with different ways to do the tasks to save time. Sometimes the improvement came from better tools. For example, Taylor devised the "science of shoveling," in which he conducted time studies to determine how much weight a worker could lift with a shovel without tiring. He determined that 21 pounds was the optimal weight. But since the employer expected each worker to bring his own shovel, and there were different materials to be shoveled on the job, it was hard to ensure that 21-pound optimum. So, Taylor provided workers with the optimal shovel for each density of materials, like coal, dirt, snow, and so on. With these optimal shovels, workers became three or four times more productive, and they were rewarded with pay increases.

Frank Gilbreth and Lillian Moller Gilbreth, his wife (who outlived Frank by 48 years!), were associates of Taylor and were likewise interested in standardization of work to improve productivity (Wikipedia, 2009). They went one better on Taylor's time studies, devising "motion studies" by photographing the individual movements of each worker (they attached lights to workers' hands and photographed their motions at slow speeds). The Gilbreths then carefully analyzed the motions and removed unnecessary ones. These motion studies were preceded by timing each task, so the studies were called "time and motion studies."

Applying time and motion studies to bricklaying, for example, the Gilbreths devised a way for workers to lay bricks that eliminated wasted motion and raised their productivity from 1,000 bricks per day to 2,700 bricks per day. Frank Gilbreth applied the same technique to personal tasks, like coming up with "the best way to get dressed in the morning." He suggested the best way to button the waistcoat, for example, was from bottom up rather than top down. Why? Because then a man could straighten his tie in the same motion, rather than having to raise his hands back up from the bottom of the waistcoat.

Limitations of the Early Views

Fayol, Taylor, and the Gilbreths all addressed productivity improvement and how to run an organization smoothly. But those views presumed that managers were overseeing manual labor tasks. As work began to require less manual labor and more knowledge work, the principles they had developed became less effective. Worse, the principles of Taylorism tended to dehumanize workers.

The writer **Upton Sinclair** who raised awareness of deplorable working conditions in the meatpacking industry in his 1906 book, *The Jungle*, was one of Taylor's vocal critics. Sinclair pointed out the relatively small increase in pay (61%) that workers received compared with their increased productivity (362%). Frederick Taylor answered Sinclair's criticism, saying that workers should not get the full benefit because it was management that devised and taught the workers to produce more. But Taylor's own words compare workers to beasts of burden: The worker is "not an extraordinary man difficult to find; he is merely a man more or less the type of an ox, heavy both mentally and physically" (Sinclair, 1911; Taylor, 1911)

When work was manual, it made sense for a manager to observe workers doing a task and to devise the most efficient motions and tools to do that task. As we moved from a manufacturing society to a service-based one, that kind of analysis had less relevance. Managers can't see inside the head of a software engineer to devise the fastest way to write code. Effective software programming depends on knowledge work, not typing speed.

Likewise, a services-based economy requires interactions between employees and customers. Employees have to be able to improvise, and they have to be motivated and happy if they are to serve the customer in a friendly way. Therefore, new management theories were developed to address the new world of management and overcome the shortcomings of the early views.

Finally, early views of management were heavily oriented toward efficiency, at the expense of attention to the manager-as-leader. That is, a manager basically directs resources to complete predetermined goals or projects. For example, a manager may engage in hiring, training, and scheduling employees to accomplish work in the most efficient and cost-effective manner possible. A manager is considered a failure if he or she is not able to complete the project or goals with efficiency or when the cost becomes too high. However, a leader within a company develops individuals to complete predetermined goals and projects. A leader develops relationships with his or her employees by building communication, by evoking images of success, and by eliciting loyalty. Thus, later views of management evoke notions of leaders and leadership in discussing the challenges and opportunities for modern managers.

Management Ideas of the 1990s

Peter Drucker was the first scholar to write about how to manage knowledge workers, with his earliest work appearing in 1969. Drucker addressed topics like management of professionals, the discipline of entrepreneurship and innovation, and how people make decisions. In 1982, **Tom Peters and Robert Waterman** wrote *In Search of Excellence*, which became an international best seller and ushered a business revolution by changing the way managers viewed their relationships with employees and customers. On the basis of the authors' research focusing on 43 of America's most successful companies in six major industries, the book introduced nine principles of management that are embodied in excellent organizations:

1. Managing Ambiguity and Paradox
   The ability of managers to hold two opposing ideas in mind at the same time and still be able to function effectively.
2. A Bias for Action
   A culture of impatience with lethargy and inertia that otherwise leaves organizations unresponsive.
3. Close to the Customer
   Staying close to the customer to understand and anticipate customer needs and wants.
4. Autonomy and Entrepreneurship
   Actions that foster innovation and nurture customer and product champions.
5. Productivity through People
   Treating rank-and-file employees as a source of quality.
6. Hands-On, Value-Driven
   A management philosophy that guides everyday practice and shows management's commitment.
7. Stick to the Knitting
   Stay with what you do well and the businesses you know best.
8. Simple Form, Lean Staff
   The best companies have very minimal, lean headquarters staff.

9. Simultaneous Loose-Tight Properties (Peters & Waterman, 1982)
   Autonomy in shop-floor activities plus centralized values.

Following up, Peters wrote a *Passion for Excellence*, which placed further emphasis on leadership, innovation, and valuing people. His book *Thriving on Chaos*, published the day of the biggest stock market crash of the time ("Black Monday," October 19, 1987), addressed the uncertainty of the times; and *Liberation Management*, published in 1992, laid out 45 prescriptions for how to lead companies in a rapidly changing world. The book called for empowering people by involving everyone in decision making and eliminating bureaucratic rules and humiliating conditions. Peters urged organizational leaders (i.e., managers) to celebrate and recognize employees for their contributions. His advice to leaders was to "master paradox" (i.e., develop a level of comfort with complexity and ambiguity) and establish direction for the company by developing an inspiring vision and leading by example.

Beginning in the 1970s, **Warren Bennis** pioneered a new theory of leadership that addressed the need for leaders to have vision and to communicate that vision. More than just a manager, an effective leader was defined as someone with the ability to influence and motivate others not only to perform work tasks but also to support the organization's values and meet the organization's goals. Different views of leadership through the ages are shown next.

Views of Leadership Through the Ages

A leader is a dealer in hope. —*Napoleon*

I suppose that leadership at one time meant muscle; but today it means getting along with people.—*Indira Gandhi*

What leaders really do: set direction, align people, and motivate people.—*John Kotter (Kotter, 1990)*.

Key Takeaway

Early management theorists developed principles for managing organizations that suited the times. A century ago, few workers were highly educated; most work was manual, tasks were repetitive, and rates of change were slow. Hierarchy brought unity and control, and principles of management in which managers defined tasks and coordinated workers to move in a unified direction made sense. As the economy moved from manufacturing to services, the need for engaging workers' minds and hearts became more important. Drucker, Peters, and Waterman presented ideas on how managers could achieve excellence in a continually changing business environment, while Bennis encouraged managers to become inspiring leaders who empowered people.

Exercises

1. What goals seem to dominate early management principles?
2. Do you see any commonalities between Fayol's principles of management from 1911 and those of Tom Peters in the 1990s?
3. Are there any jobs today for which time and motion studies would make sense to do? Would any other skills need to be taught as well?
4. What do early management principles leave out?
5. How would you put some of the ideas of the 1990s into practice?
6. What aspects of P-O-L-C would be most likely to change based on what you have learned in this section?

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6.33: Contemporary Principles of Management

Learning Objectives

1. Recognize organizations as social movements.
2. Understand the benefits of social networking.
3. Recognize learning organizations.
4. Understand virtual organizations.

Corporations as Social Movements

Traditionally, we've thought of corporations as organizations that had clear boundaries, formal procedures, and well-defined authority structures. In contrast, social movements are seen as more spontaneous and fluid. The term social movement refers to a type of group action that is focused on specific political or social issues; examples include the civil rights movement, the feminist movement, and the gay rights movement. Leaders of social movements depend on charisma rather than authority to motivate participants to action. Contemporary management theory, however, is showing that the lines between the two are blurring: corporations are becoming more like social movements, and social movements are taking on more permanence. Just as companies are outsourcing specific jobs, so social movements can contract out tasks like lobbying and fundraising.

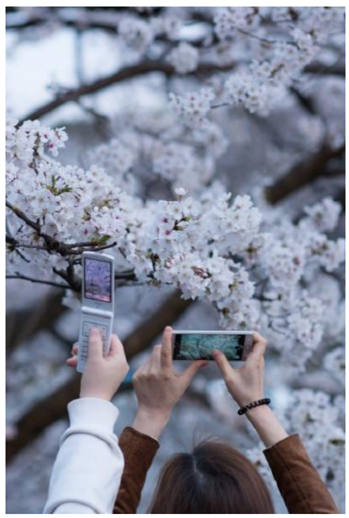

Figure 6.33.1: We are more connected, at least virtually, than ever before. Takashi Hososhima – Traditional cell phone vs Smart phone – CC BY-SA 2.0.

Corporations can implement initiatives that mimic a social movement. Consider how the CEO of one bank described a program he introduced: "The hierarchical management structure will give way to some collective activities that will improve our effectiveness in the marketplace. Decisions won't flow from a management level to people on the line who are expected to implement those decisions.…We're telling everyone, choose a process, figure out what and where the problems are, work together to come up with solutions, and then put your solutions to work (Davis, et. al., 2005)." Thus, more and more leading businesses are harnessing the mechanics of social movements to improve how they will manage their businesses in the future.

Social Networking

Social networking refers to systems that allow members of a specific site to learn about other members' skills, talents, knowledge, or preferences. Companies use these systems internally to help identify experts.

In the world, at large, social networks are groups of individuals who share a common interest or passion. Poker players, dog lovers, and high school alumni are a few examples of social networks in action. In the corporate world, a social network is made up of individuals who share an employer and, potentially, other interests as well. But in the pre-Internet age, managers lacked the tools to recognize or tap the business value of in-house social networks. The company softball team was a social network, sure. But what did that have to do with the bottom line?

Today, social networks are starting points for corporate innovation: potentially limitless arrangements of individuals inspired by opportunities, affinities, or tasks. People feel better and work better when they belong to a group of other people like themselves (Rummler, 2007). This new attitude toward social networks in the workplace has been fueled by the growth of social networking sites like Facebook.

Facebook was started by then-college student Mark Zuckerberg in 2004 as a way of connecting a social network—specifically, university students. Since then, Facebook has changed the way organizations connect as well. Some companies maintain a physical presence on Facebook that allows consumers to chime in about their passions (or lack of them) for corporate offerings, news, and products. Starbucks has adopted this model, asking consumers to help them revive their product lines and image.

As Zuckerberg told the *Wall Street Journal*, “We just want to share information more efficiently (Vara, 2007).” And, in the information age, that’s what social networks do best. Companies are applying the online social networking model of open and closed groups to their corporate intranets, creating secure sites for employees in different locations to collaborate on projects based on common interests, management directives, and incentives. For example, IBM’s pilot virtual world will let Big Blue employees use chat, instant messaging, and voice communication programs while also connecting to user-generated content in the public spaces of Second Life, another large social networking site. IBM also opened a virtual sales center in Second Life and, separately from the Second Life partnership, is building an internal virtual world where work groups can have meetings.

The use of online social networking principles can open the door to outside collaborations. For example, Netflix offered a million-dollar reward to anyone in the company’s social network of interested inventors who could improve the algorithm that matches movie lovers to new titles they might enjoy. Companies like Procter & Gamble and InnoCentive are tapping social networks of scientists to improve their products.

Social networks fueled by passion can help managers retain, motivate, and educate staff. They might even help Facebook’s Mark Zuckerberg with an in-house dilemma as his company grows. According to the *Wall Street Journal*, the world’s most dynamic social networking site has “little management experience.”

Learning Organizations

In a 1993 article, Harvard Business School professor David Garvin defined a learning organization as “an organization skilled at creating, acquiring, and transferring knowledge, and at modifying its behavior to reflect new knowledge and insights (Garvin, 1993).” The five building blocks of learning organizations are

1. *Systematic problem solving*: The company must have a consistent method for solving problems, using data and statistical tools rather than assumptions.
2. *Experimentation*: Experiments are a way to test ideas in small steps. Experiments let companies hunt for and test new knowledge, such as new ways of recycling waste or of structuring an incentive program.
3. *Learning from past experience*: It’s essential for companies to review projects and products to learn what worked and what didn’t. Boeing, for example, systematically gathered hundreds of “lessons learned” from previous airplane models, such as the 737 and 747, which it applied to the 757s and 767s, making those the most successful, error-free launches in Boeing’s history.
4. *Learning from others*: Recognizing that good ideas come from anywhere, not just inside the company, learning organizations network with other companies in a continual search for good ideas to adapt and adopt.
5. *Transferring knowledge*: Sharing knowledge quickly throughout the organization is the way to make everyone a smart, contributing member.

Virtual Organizations

A virtual organization is one in which employees work remotely—sometimes within the same city, but more often across a country and across national borders. The company relies on computer and telecommunications technologies instead of physical presence for communication between employees. E-mail, wikis, Web meetings (i.e., like Webex or GoToMeeting), phone, and Internet relay chat (IRC) are used extensively to keep everyone in touch. Virtual companies present special leadership challenges because it’s essential for leaders to keep people informed of what they are supposed to be doing and what other arms of the organization are doing. Communication in a commons area is preferable to one-on-one communication because it keeps everyone up to speed and promotes learning across the organization.

The Value of Wikis

Wikis provide companies with a number of benefits (Tapscott & Williams, 2006):

With more and more companies outsourcing work to other countries, managers are turning to tools like wikis to structure project work globally. A wiki is a way for many people to collaborate and contribute to an online document or discussion (see "The Value of Wikis"). The document remains available for people to access anytime. The most famous example is Wikipedia. A wikified organization puts information into everyone's hands. Managers don't just talk about empowering workers—the access to information and communication empowers workers directly. People who are passionate about an idea can tap into the network to make the idea happen. Customers, too, can rally around an issue and contribute their opinions.

Many companies that are not solely virtual use the principles of a virtual organization as a way to structure the work of globally distributed teams. VeriFone, one of the largest providers of electronic payment systems worldwide, has development teams working on software projects around the world. In what the company calls a "relay race," developers in Dallas working on a rush project send unfinished work at quitting time to another development center in Laupahoehoe, Hawaii. When the sun sets there, the project is handed off to programmers in Bangalore, India, for further work, and by morning, it's back in Dallas, 16 hours closer to completion. Similarly, midwestern Paper Converting Machine Co. (PCMC) outsourced some design work to Chennai, India. Having U.S. and Indian designers collaborate 24/7 has helped PCMC slash development costs and time, enabling the company to stay in business, according to CEO Robert Chapman. Chapman said, ""We can compete and create great American jobs, but not without offshoring (Engardio, 2006)."

Virtual organizations also pose management challenges. In practical terms, if everyone is empowered to be a decision maker but various people disagree, how can decisions be made? If all workers can work at the times they choose, how can management be sure that workers are doing their work—as opposed to reading Web sites for fun, shopping, or networking with friends—and that they are taking appropriate breaks from work to avoid burnout? There are also challenges related to the virtual environment's dependence on computers and Web security.

Key Takeaway

In today's fast-changing world, organizations are becoming more like social movements, with more fluid boundaries and more participation in leadership across all levels. Social networks within corporations let employees find out about one another and access the people who have the skills, knowledge, or connections to get the job done. Continuous learning is important, not just for individuals but for organizations as a whole, to transfer knowledge and try out new ideas as the pace of change increases. Virtual organizations can speed up cycle time, but they pose new challenges for managers on how to manage remote workers. Communications technologies and the Web let employees work from anywhere—around the corner or around the world—and require special attention to managing communication.

Exercises

1. What commonalities do you see between organizations and social movements?
2. How would you use a social network to solve a work-related task?
3. Why do social networks inspire employees?
4. How do social networks help managers plan, organize, lead, and control?
5. What steps would you take to help your organization become a learning organization?
6. What are the advantages of a virtual organization?
7. What aspects of P-O-L-C would be most likely to change based on what you have learned in this section?

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- Wikis pool the talent of experts as well as everyone from across the company and beyond it—in all time zones and geographic locations.
- Input from unanticipated people brings fresh ideas and unexpected connections.
- Wikis let people contribute to a project any time, giving them flexibility in managing their time.
- It’s easy to see the evolution of an idea, and new people can get up to speed quickly by seeing the history of the project.
- Co-creation of solutions eliminates the need to “sell” those solutions to get buy-in.
- Wikis cut the need for e-mail by 75% and the need for meetings by 50%.

6.34: Global Trends

Learning Objectives

1. What are the top 10 ways that the world is changing?
2. What is the pace of these changes?

As the summary "Top Trends" suggests, we are living in exciting times, and you're at the forefront of it. The world is changing in dramatic ways, and as a manager, you're in the best position to take advantage of these changes. Let's look at 10 major ways in which the world is changing; we'll characterize the first five as challenges and the next five as solutions.

Top Trends

Top 5 Challenge Trends

1. Increasing Concern for the Environment
2. Greater Personalization and Customization
3. Faster Pace of Innovation
4. Increasing Complexity
5. Increasing Competition for Talent

Top 5 Solution Trends

1. Becoming More Connected
2. Becoming More Global
3. Becoming More Mobile
4. Rise of the Creative Class
5. Increasing Collaboration

Top 5 Challenge Trends

Increasing Concern for the Environment

We all seem to believe that the weather has been getting weirder in recent decades, and analysis by the National Oceanic and Atmospheric Administration (NOAA) suggests that there have been more catastrophic weather events in recent years than 10–20 years ago (NCDC, 2008). People are seeing the growing threat of global warming, which is leading to failing crops, rising sea levels, shortages of drinking water, and increasing death tolls from disease outbreaks such as malaria and dengue fever. Currently, 175 nations have signed the Kyoto Protocol on climate change and pledged to begin the long process of reducing greenhouse gas emissions. According to McKinsey's Global Survey of Business Executives, executives across the world believe that business plays a wider role in society and has responsibility to address issues such as environmental concerns beyond just following the letter of the law to minimize pollution. More and more companies now watch the "triple bottom line"—the benchmark of how they benefit, not just (1) profits but also (2) employees and (3) the environment as a whole. Companies realize they have to take bold steps to minimize their carbon footprint, create environmentally friendly products, and manage the company for more than just the next quarter's profits. Managers can't simply "greenwash" (pretend to be green through tiny steps and heavy advertising).

Figure 6.34.1: Wind power is a high-growth business that takes advantage of increasing interest in sustainable energy sources. TumblingRun – Into the Night – CC BY-ND 2.0.

Greater Personalization and Customization

We're no longer happy with cookie-cutter products. Consumers are demanding more say in products and services. One size no longer fits all, and that means tailoring products and services to meet specific customer preferences. And as companies sell their products globally, that tailoring has to meet vastly different needs, cultural sensitivities, and income levels. Even something simple such as Tide laundry detergent can come in hundreds of potential variants in terms of formulations (powders, liquids, tablets), additives (whiteners, softeners, enzymes), fragrances (unscented, mountain fresh, floral), and package sizes (from single-load laundromat sizes to massive family/economy sizes). Customization and the growing numbers of products mean managing more services and more products. For example, for just $4.99 plus shipping, you can create your own Kleenex oval tissue box (Mykleenextissue, 2008)! Managing for mass production won't suffice in the future.

Faster Pace of Innovation

We all want the next new thing, and we want it now. New models, new products, and new variations—companies are speeding new products to market in response to customer demands. The Finland-based mobile phone maker Nokia sells 150 different devices, of which 50–60 are newly introduced each year. The new variations are tailored to local languages, case colors, carriers, add-ons, and content. David Glazer, engineering director at Google, explained how his company adapts to this fast pace: "Google has a high tolerance for chaos and ambiguity. When we started OpenSocial [a universal platform for social-network applications], we didn't know what the outcome was going to be." So Google started running a bunch of experiments. "We set an operational tempo: when in doubt, do something," Glazer said, "If you have two paths and you're not sure which is right, take the fastest path (Fast Company, 2008)."

Increasing Complexity

Because we want more sustainability, more customization, and more innovation, companies face growing complexity. Nokia's 50–60 new phone models a year all have 300–400 components, some of which contain millions or hundreds of millions of transistors. Those components have to arrive at the right manufacturing location (Nokia has 10 worldwide) from whichever country they originated and arrive just in time to be manufactured.

Increasing Competition for Talent

We need people who can solve all these tough problems, and that's a challenge all by itself. According to McKinsey's global survey of trends, business executives think that this trend, among all trends, will have the greatest effect on their companies in the next five years. Jobs are also getting more complex. Consider people who work in warehouses doing shipping and receiving. At Intel, these workers were jokingly called "knuckle-dragging box pushers" and known for using their brawn to move boxes. Now, the field of transportation and shipping has become known as "supply chain management" and employees need brains as well as brawn—they need to know science and advanced math. They're called on to do mathematical models of transportation networks to find the most efficient trucking routes (to minimize environmental impact) and to load the truck for balance (to minimize fuel use) and for speed of unloading at each destination. Intel now acknowledges the skills that supply chain people need. The company created a career ladder leading to "supply chain master" that recognizes employees for developing expertise in supply chain modeling, statistics, risk management, and transportation planning. Overall, demand will grow for new types of talent such as in the green energy industry. At the same time, companies face a shrinking supply of seasoned managers as baby boomers retire in droves. Companies will have to deal with shortages of specific skills.

Top 5 Solution Trends

Becoming More Connected

We can now use the Internet and World Wide Web to connect people with people as never before. By mid-2008, more than 1.4 billion people were online, and that number continues to increase each year as the developing world catches up with the developed world on Internet usage (Internetworldstats, 2000). Through over a 100 million Web sites, we can access information, words, sounds, pictures, and video with an ease previously unimaginable.

Becoming More Global

We can now tap into more global suppliers and global talent. Whatever problem a manager faces, someone in the world probably has the innovative products, the knowledge, or the talent to address the problem. And the Internet gives managers to the tools to help problems find solutions, customers find suppliers, and innovators find markets. The global problems we face will require people to work together to solve them. Ideas need to be shaped and implemented. Moving ideas around the world is a lot less costly and generates less greenhouse gases than moving people and products around the world. Organizations and social movements alike are using social networking to help people find others with the skills and talents to solve pressing problems.

Becoming More Mobile

We can now reach employees, suppliers, and customers wherever they are. By the end of 2008, 60% of the world's population—4 billion people—were using mobile phones (Itu, 2008). And, like Internet use, mobile phone adoption continues to grow. The penetration of mobile phones is changing the way we do business because people are more connected and able to share more information. Two-way, real-time dialogue and collaboration are available to people anytime, anywhere. The low cost of phones compared with computers puts them in the hands of more people around the world, and the increasing sophistication of software and services for the phone expands its use in business settings. Phones are not just a voice communication device—they can send text as well as be a connective device to send data. The fastest mobile phone growth is in developing countries, bringing connectivity to the remotest regions. Fisherman off the coast of southern India can now call around to prospective buyers of their catch before they go ashore, which is increasing their profits by 8% while actually lowering the overall price consumers have to pay for fish by 4% (Corbett, 2008). In South Africa, 85% of small black-owned businesses rely solely on mobile phones. Nokia has 120,000 outlets selling phones in India, where half the population lives in rural areas, not cities.

Rise of the Creative Class

With blogs, Flickr, and YouTube, anyone can post their creative efforts. And with open source and wikis, anyone can contribute ideas and insights. We have ubiquitous opportunities for creativity that are nurturing a new creative class. For example, *OhmyNews*, a popular newspaper, is written by 60,000 contributing "citizen reporters." It has become one of South Korea's most influential news sources, with more than 750,000 unique users a day (Hua, 2007; Schonfeld & Vi-Wyn, 2007). The demand for workers and ability for workers to work from anywhere may lead to an "e-lance economy." Workers may become free agents, working temporarily on one project and then moving to another when that project is done. Mobile connectivity means these new workers can live anywhere in the world and can work from anywhere in their community. For you as a manager, this means managing workers who might be in a cubicle in Columbus, Ohio, an apartment in Amsterdam, or an Internet café in Bangalore.

Increasing Collaboration

These solution trends combine to foster a rise in collaboration across space and time. We can now bring more people together to solve more problems more quickly. To design new products quickly—and make sure they meet consumer needs—companies are now looking beyond their four walls for innovation. Google, for example, identifies itself as an organization that believes in open, decentralized innovation. "Google can't do everything. And we shouldn't," said Andy Rubin, senior director of Mobile Platforms. "That's why we formed the Open Handset Alliance with more than 34 partners (Fast Company, 2009)." While the handset alliance is about open cell phones (i.e., phones that aren't tied to any particular phone company and can be programmed by users just like Apple or Palm's "apps"), collaboration means much more than communications. People can now not just communicate but actually collaborate, building coalitions, projects, and products (Friedman, 2005). Groups self-organize on the Web. For example, the MIT-based Vehicle Design Summit is virtual, so students from around the world can participate. The goal is to make a low-cost, 200-mpg four-seater for the Indian market; in 2008, about 200 students participated in this international open-source project (Fast Company, 2008). A cross section of more trend predictions follows.

Trends, Trends, Trends

It seems that trend-tracking has become somewhat of a business. Glance over these top trends from the editors of *Wired*, *McKinsey Quarterly*, and *USA Today*.

Wired 2008 Business Trends

1. Open Source Tycoons
2. Social Networks Grow Up
3. Green on the Outside

4. Invisible Internet
5. Rise of the Instapreneur
6. Building a Better Banner
7. Invented in China
8. VCs Look for a New Life
9. The Human Touch (Wired, 2008)

Top business trends likely to have the greatest effect on business over the next five years

1. Competition for talent will intensify, become more global.
2. Centers of economic activity will shift globally, regionally.
3. Technological connectivity will increase.
4. Ubiquitous access to information will change economics of knowledge.
5. Demand for natural resources will grow, as will strain on environment.
6. Population in developed economies will age.
7. Consumer landscape will change, expand significantly.
8. Role, behavior of business will come under increasing scrutiny.
9. Organizations will become larger, more complex.
10. New global industry structures will emerge (e.g., private equity, networked)(McKinseyquarterly, 2007)

Countdown of the biggest trends in small business

1. Web 2.0
2. Rise of e-marketing
3. Little is the new big
4. The new consumer
5. Fragmentation
6. The world is getting flatter
7. Personalization
8. Work anywhere, any place
9. Global warming may put you out of business (USAtoday, 2009)

Key Takeaway

Today's world faces many challenges, from the need to protect the natural environment to the rapid pace of innovation and change. Technological connectivity is bringing the world closer together and enabling people to work from anywhere. Demand for talent and low-cost workers gives rise to outsourcing and employees working remotely, whether from home or from remote different countries. At the same time, information is now available to more and more people. This drives demand for personalization. It increases complexity but at the same time gives us the collaboration tools needed to solve tough problems.

Exercises

1. How do you manage innovation if ideas can come from anywhere, including people who aren't your direct employees—or aren't even part of the company?
2. If, according to some trends, you can work anytime and anywhere, how do you decide when to work? When do you stop working?
3. What advantages do you see from a global workforce?
4. What commonalities do you see across the trends presented in "Trends, Trends, Trends"?
5. Which of the trends depend on technology?
6. What aspects of P-O-L-C would be most likely to change based on what you have learned in this section?

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Previous: 3.4 Contemporary Principles of Management

Next: 3.6 Globalization and Principles of Management

6.35: Globalization and Principles of Management

Learning Objectives

1. Why might global trends influence management principles?
2. What is the GLOBE project, and why is it relevant to management?
3. What is a cultural dimension, and how do cultural dimensions affect business dealings and management decisions?

Globalization and Cross-Cultural Lessons

Despite the growing importance of global business, *Fortune* 500 companies have reported a shortage of global managers with the necessary skills (GMAC Global Relocation, 2008; Gregersen, et. al., 1998). Some experts have argued that most U.S. companies are not positioned to implement global strategies due to a lack of global leadership capabilities (Hollenbeck & McCall, 2003)

It's easy to understand the problem: communicating and working with people from different countries can be a challenge—not just because of language issues but also because of different cultural norms. For example, in the United States, we tend to be direct in our communication. If you ask a U.S. manager a question, you'll tend to get a direct answer. In other cultures, particularly in southern Europe and Japan, the answer to a question begins with background and context—not the bottom line—so that the listener will understand how the person arrived at the conclusion. Similarly, in some cultures, it is considered rude to deliver bad news or say "no" to a request—instead, the speaker would give a noncommittal answer like "we'll see" or "we'll try."

Figure 6.35.1: Our places of work are more diverse than ever before. Oregon Department of Transportation – Diversity – CC BY 2.0.

Country-by-country differences are so prevalent that a worldwide team of scholars proposed to create and validate a theory of the relationship between culture and societal, organizational, and leadership effectiveness. Called the GLOBE Project, it included 170 researchers working together for 10 years to collect and analyze data on cultural values and practices and leadership attributes from more than 17,000 managers in 62 societal cultures. In its 2006 report, GLOBE identified the following nine dimensions of culture (Javidan, et. al., 2006).

Performance Orientation

Should you reward people for performance improvement and excellence? In countries like the United States and Singapore, the answer is yes. Organizations in these countries use employee training and development to help people improve their skills and performance. In countries like Russia and Greece, however, family and background count for more than performance.

Uncertainty Avoidance

Life often brings unpredictable events, and with them anxiety. **Uncertainty avoidance** reflects the extent to which members of a society attempt to cope with anxiety by minimizing uncertainty. Should you establish rules, procedures, and social norms to help your employees deal with uncertainty? In countries where uncertainty avoidance is high, like Brazil and Switzerland, the answer is yes. People in such societies want strict rules, laws, and policies to eliminate or control the unexpected. Employees in these countries tend to seek order, consistency, and structure. Countries with low uncertainty avoidance, in contrast, are less rule-oriented. They tolerate a variety of opinions and are open to change and taking risks. Countries with low uncertainty avoidance include Hong Kong and Malaysia.

Assertiveness

How assertive, confrontational, or aggressive should you be in relationships with others? In highly assertive countries like the United States and Austria, competition between individuals and groups is encouraged. Managers may set up incentives that reward the best idea, even it it's contrary to established practices. People in less assertive countries, like Sweden and New Zealand, prefer harmony in relationships and emphasize loyalty and solidarity.

Power Distance

Power distance reflects the extent to which the less powerful members of institutions and organizations expect and accept that power is distributed unequally. Should you distribute decision-making power equally among the group? In high-power-distance countries like Thailand, Brazil, and France, the answer is no. People in these societies expect unequal power distribution and greater stratification, whether that stratification is economic, social, or political. People in positions of authority in these countries expect (and receive) obedience. Decision making is hierarchical with limited participation and communication. Australia, in contrast, has a power distance rating that is much lower than the world average. The Australian view reinforces cooperative interaction across power levels and stresses equality and opportunity for everyone.

Gender Egalitarianism

Should you promote men rather than women? Counties with low gender egalitarianism are male dominated. Men hold positions of power to a much greater extent in low-gender-egalitarianism countries like Egypt and South Korea. Companies operating in more gender-egalitarian countries such as the Nordic countries, Germany, and the Netherlands encourage tolerance for diversity of ideas and roles regardless of gender.

Institutional Collectivism

Institutional collectivism refers to the extent to which people act predominantly as a member of a lifelong group or organization. Should you reward groups rather than individuals? In countries with high institutional collectivism such as Sweden, the answer is yes. Countries with low institutional collectivism, such as in the United States, emphasize individual achievement and rewards.

Humane Orientation

Should you reward people for being fair, altruistic, generous, and kind to others? In countries such as Malaysia, this practice is more prevalent and encouraged than in low-humane-orientation countries such as Germany.

Future Orientation

Will your employees favor activities that involve planning and investing in the future for long-term payoff? Or do they want to see short-term results? **Future orientation** is defined as one's expectations and the degree to which one is thoughtful about the future. It is a multifaceted concept that includes planning, realism, and a sense of control. Companies in countries with high future orientation, such as China and Singapore, will have a longer-term planning horizon, and they will be more systematic about planning. Corporations in countries that are the least future-oriented, such as Argentina and Russia, will be more opportunistic and less systematic. At the same time, they'll be less risk averse.

Global Ventures Gone Awry

When Corning proposed a joint venture with a Mexican glass manufacturer, Vitro, the match seemed made in heaven. But just two years later, the venture was terminated. What happened? Cultural clashes eroded what could have been a lucrative partnership. To start, American managers were continually frustrated with what they perceived to be slow decision making by Mexican managers. Mexico ranks higher on the power distance dimension than the United States—company structures are hierarchical, and decisions are made only by top managers. Loyalty to these managers is a high priority in Mexico, and trying to work around them is a big taboo. Mexicans also have a less urgent approach to time. They see time as more abundant than their U.S. counterparts. As a result, Mexicans thought that Americans wanted to move too fast on decisions, and they perceived American directness in communication as aggressive (Brake, 1996). Additional vignettes on managing across borders are shared next.

Managing Across Borders

Lines on the Map Miss the Real Story

Diversity is deeper than variations between countries. Sometimes those differences appear in different regions of the same country. For example, some parts of Mexico don't use Spanish as the primary language. Wal-Mart's Mexico's Juchitan store, therefore, conducts business in the local Zapotec tongue, encourages female employees to wear traditional Zapotec skirts, and does the morning company cheer in Zapotec.

Talent Abroad

With so much variation across countries, it's no surprise that countries vary in level of talent and the supply of managerial, skilled, and unskilled labor. Companies shouldn't assume that emerging market countries offer inferior labor pools. GM, for instance, found that 50% of its assembly-line workers in India have college degrees—a ratio much higher than in other countries.

Local Solutions by People Who Understand Local Needs

Nokia uses local designers to create country-specific handset models. The models designed in India for Indians are dust resistant and have a built-in flashlight. The models designed in China for the Chinese have a touch screen, stylus, and Chinese character recognition. Local designers are more likely to understand the needs of the local population than headquarters-located designers do.

Strategies in emerging markets conference, held by the MIT Center for Transportation and Logistics (CTL) on March 7, 2007, Cambridge, MA.

Key Takeaway

Because the business environment increasingly depends on collaboration across regional and national borders, a successful global manager needs to be culturally sensitive and have an understanding for how business is done in different cultures. In some countries, loyalty to the group is key. Other countries celebrate mavericks and rule breakers if they can get things done. Knowing how best to communicate with your coworkers and employees—whether to be direct or indirect, whether to follow strict protocol or be more causal, whom to involve in decisions—are all important considerations.

Exercises

1. You've just been made a manager in Sweden, known for its institutional collectivism. What incentives and reward structures would you use to motivate your employees?
2. How would you prepare workers for an overseas assignment?
3. Your company has 12 branches in the United States and will be opening its first branch in Brazil. Your company prides itself on its self-managed teams. Will you keep this policy in the new country? Why or why not?
4. You're a manager in Japan, and you've just discovered that a team leader under your supervision has made a mistake that will result in a quality problem. How will you handle this mistake?
5. You work in Hong Kong for a Swiss-owned firm. The Swiss are known for their high uncertainty avoidance. What differences might you expect to see from your Swiss bosses compared with your Hong Kong employees?
6. What aspects of P-O-L-C would be most likely to change based on what you have learned in this section?

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6.36: Developing Your Values-Based Leadership Skills

Learning Objectives

1. What ethical challenges do managers likely face?
2. Why are ethics relevant to principles of management?
3. What decision-making framework can you use to help integrate ethics into your own principles of management?

Ethical Challenges Managers Face

It's late at night and the office is quiet—except that you've got a nagging voice in your head. Your product is already two weeks behind schedule. You've got to get it out this week or lose the deal. But you've discovered a problem. To correct the problem would mean another 3-week delay—and you know the client won't go for that. It's a small error—it'll probably never become an issue. What do you do?

Managers face these kinds of issues all the time. Ethical dilemmas can arise from a variety of areas, such as:

It's easy to think that people who behave unethically are simply bad apples or have a character flaw. But in fact, it's often the situation or circumstances that create the ethical pressures. A global study of business ethics, published by the American Management Association, found that the main reasons for a lapse of ethics are:

You may have developed your own personal code of ethics, but the social environment of the organization can be a barrier to fulfilling that code if management is behaving unethically. At Enron, vice president Sherron Watkins pointed out the accounting misdeeds, but she didn't take action beyond sending a memo to the company's chairman. Although she was hailed as a hero and whistleblower, she in fact did not disclose the issue to the public. Similarly, auditors at Arthur Andersen saw the questionable practices that Enron was pursuing, but when the auditors reported these facts to management, Arthur Andersen's managers pointed to the $100 million of business they were getting from the Enron account. Those managers put profits ahead of ethics. In the end, both companies were ruined, not to mention the countless employees and shareholders left shattered and financially bankrupt.

Since 2002, when the Sarbanes-Oxley Act was passed, companies have been required to write a code of ethics. The act sought to reform corporate governance practices in large U.S. public companies. The purpose of the rules is to "define a code of ethics as a codification of standards that is reasonably necessary to deter wrongdoing and to promote honest and ethical conduct," including the ethical handling of actual or apparent conflicts of interest, compliance with laws, and accountability to adhere to the code (SEC, 2009). The U.S. financial crisis of late 2008 pointed out that other areas, particularly in the financial services industry, needed stiffer regulations and regulatory scrutiny as well, and those moves will begin to take effect in early 2009. Some companies go a step further and articulate a set of values that drives their code of conduct, as "Procter & Gamble's Values and Code of Ethics" shows.

Procter & Gamble's Values and Code of Ethics

Procter & Gamble Company lives by a set of five values that drive its code of business conduct. These values are:

1. ***Integrity***

We always try to do the right thing.

We are honest and straightforward with each other.

We operate within the letter and spirit of the law.

We uphold the values and principles of P&G in every action and decision.

We are data-based and intellectually honest in advocating proposals, including recognizing risks.

*2. **Passion for Winning***

We are determined to be the best at doing what matters most.

We have a healthy dissatisfaction with the status quo.

We have a compelling desire to improve and to win in the marketplace.

*3. **Leadership***

We are all leaders in our area of responsibility, with a deep commitment to delivering leadership results.

We have a clear vision of where we are going.

We focus our resources to achieve leadership objectives and strategies.

We develop the capability to deliver our strategies and eliminate organizational barriers.

*4. **Trust***

We respect our P&G colleagues, customers and consumers, and treat them as we want to be treated.

We have confidence in each other's capabilities and intentions.

We believe that people work best when there is a foundation of trust.

*5. **Ownership***

We accept personal accountability to meet our business needs, improve our systems, and help others improve their effectiveness.

We all act like owners, treating the Company's assets as our own and behaving with the Company's long-term success in mind (Procter & Gamble, 2009).

Importance of Ethics in Management

Figure 6.36.1: Trust is the cornerstone of ethical leadership. Casa Thomas Jefferson – shaking hands – CC BY-NC-ND 2.0.

Ethical behavior among managers is even more important in organizations because leaders set the moral tone of the organization and serve as role models. Ethical leaders build trust in organizations. If employees see leaders behaving unethically, chances are the employees may be less inclined to behave ethically themselves. Companies may have printed codes of ethics, but the key standard is whether leaders uphold those values and standards. We tend to watch leaders for cues on appropriate actions and behavior that the company expects. Decisions that managers make are an indicator of their ethics. If the company says it cares about the safety of employees but then does not buy enough protective gear for them, it is not behaving in line with its code. Likewise, if managers exhibit unsafe behavior or look the other way when employees act unsafely, their behavior is not aligned with their stated code.

Without integrity, there can be no trust. Leadership is based on trust. Ethics drive effectiveness because employees know they can do the right thing decisively and with confidence. Ethical behavior earns the trust of customers and suppliers as well. It earns the public's good will. Ethical managers and ethical businesses tend to be more trusted and better treated. They suffer less resentment, inefficiency, litigation, and government interference. If top management cuts corners, however, or if they make shady decisions, then no matter how good the code of ethics sounds, people will emulate the questionable behavior, not the code.

As a manager, you can make it clear to employees that you expect them to conduct business in an ethical manner by offering seminars on ethics, having an ethics hotline via which employees can anonymously raise issues, and having an ombudsman office or ethics committee to investigate issues.

Integrating Ethics into Managerial Decision Making

Ethics implies making a choice between decision-making rules. For instance, when choosing between two suppliers, do you choose the cheapest (decision rule 1) or the highest quality (decision rule 2). Ethics also implies deciding on a course of action when no clear decision rule is available. Dilemmas occur when the choices are incompatible and when one course of action seems to better serve your self-interest but appears to violate a moral principle. One way to tackle ethical dilemmas is to follow an ethical decision-making process, like the one described below

Steps in an Ethical Decision-Making Process

If you see unethical behavior in others, confronting it early is better. Early on, you have more of an opportunity to talk with the person in a fact-finding (rather than an accusatory) way. The discussion may nip the problem in the bud and prevent it from escalating. Keeping silent because you want to avoid offending the person may lead to much greater problems later on. As French playwright Jean-Baptiste Moliere wrote, “It’s not only for what we do that we are held responsible, but for what we do not do.”

Key Takeaway

Management involves decision making, and decisions often have an ethical component. Beyond personal ethics or a moral code, managers face making decisions that reflect the company as a whole, affecting its future success and vitality. Ethics doesn’t just mean following the law but acting in accordance with basic values.

Exercises

1. What are the consequences of unethical behavior?
2. If you were writing a code of ethics for your company, what would you include?
3. In times of economic downturn, is ethical behavior a luxury?
4. How would you handle an ethical violation committed by one of your employees?
5. Nobel laureate economist Milton Friedman said that companies should focus on maximizing profits, not social responsibilities or purposes. Do you agree with this view? Why or why not?
6. What aspects of P-O-L-C would be most likely to change based on what you have learned in this section?

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1. Assess the situation: What are you being asked to do? Is it illegal? Is it unethical? Who might be harmed?
2. Identify the stakeholders and consider the situation from their point of view. For example, consider the point of view of the company’s employees, top management, stockholders, customers, suppliers, and community.
3. Consider the alternatives you have available to you and how they affect the stakeholders:
    - consequences
    - duties, rights, and principles
    - implications for personal integrity and character
4. How does the action make you feel about yourself? How would you feel if your actions were reported tomorrow in the *Wall Street Journal* (or your daily newspaper)? How would you explain your actions to your mother or to your 10-year-old child?
5. Make a decision. This might involve going to your boss or to a neutral third party (such as an ombudsman or ethics committee). Know your values and your limits. If the company does nothing to rectify the situation, do you want to continue working for the company?
6. Monitor outcomes. How did the decision work out? How did it turn out for all concerned? If you had it to do over again, what would you do differently (Hartman & DesJardins, 2008)?

6.37: Globalizing the Management Model

Previous chapters focused on the challenges associated with globalizing the first three components of the business model framework—the value proposition, market choices, and the value-chain infrastructure. This chapter looks at globalizing the fourth component—the company's management model—which summarizes its choices about a suitable global organizational structure and decision-making framework.

The judicious globalization of a company's management model is critical to unlocking the potential for global competitive advantage. But globalizing a company's management model can be ruinous if conditions are not right or the process for doing so is flawed. So key questions include when, and to what extent, should a company globalize its decision-making processes and its organizational and control structure; what are some of the key implementation challenges; and how does a company get started?

This chapter is organized in two parts. The first discusses a key "soft" dimension of globalizing a company's management model—creating and embedding a global mind-set—a prerequisite for global success. The second part deals with the "hard" dimensions of creating a global architecture: choosing a suitable *organizational structure* and streamlining *global decision-making* processes.

6.38: Pitfalls in Globalizing a Management Model

Globalizing a company's management model is hard. As firms increase their revenue by expanding into more countries and by extending the lives of existing products by bringing them into emerging markets, costs can often be reduced through global sourcing and better asset utilization. But capitalizing on such profit opportunities is hard because every opportunity for increased globalization has a cost and carries a danger of actually reducing profit. For example, the company's customer focus may blur as excessive standardization makes products appeal to the lowest common denominator, alienating key customer segments and causing market share to fall. Or a wrong globalization move makes innovation slow down and causes price competition to sharpen.

The best executives in a worldwide firm are often country managers who are protective of "their" markets and value delivery networks. Globalization shrinks their power. Some rise to new heights within the organization by taking extra global responsibilities; some leave. Many fight globalization, making it tough for the CEO. Sometimes they win and the CEO loses. Overcoming organizational resistance is therefore key to success.

Minicase: When Global Strategy Goes Wrong (Huggett (2002, April 4)).

In April of 2002, Japan's leading mobile operator, NTT DoCoMo, Inc., announced it would write down the reduced value of its investment in AT&T Wireless Services, Inc., a move expected to contribute to an extraordinary loss of about 1 trillion yen ($7.53 billion) for the fiscal year. And when the full extent of the write-downs of all its recent European, U.S., and Asian investments was realized, the bill for the ambitious globalization strategy pursued by Japan's—and Asia's—most valuable company exceeded $10 billion.

NTT DoCoMo clearly had the cash flow from its domestic business to avoid, by a long way, the high-profile fate of now bankrupt Swissair. However, the two companies' approaches to global strategy provide interesting parallels and lessons for other international players in all industries. NTT DoCoMo and the former Swiss flag carrier enjoyed strong economic success built around a former monopoly and highly protected incumbent positions in their home markets. NTT DoCoMo was the clear leader in the Japanese mobile market, with a 60% market share that drove an annual operating cash flow of more than $10 billion. Swissair's dominant carrier position delivered financial performance that was similarly blue chip.

But a strong domestic market position and excess cash flow do not guarantee success abroad. In fact, without a quite sophisticated understanding of the uniqueness of its domestic situation, a strong domestic position could conceal some of the risks of a global strategy. The first lesson is one of microeconomics: understand what drives superior economic performance in a particular business and do not take domestic success for granted. Both the airline and the telecommunications businesses are highly regulated, technology-driven, and capital-intensive industries with high fixed and very low marginal costs (per airline seat or per mobile-call minute). Rapid changes in regulation and technology are changing some of the rules of the game but not the basic economics of either of these businesses.

In the airline industry, cost advantages are driven by an airline's dominance in airport hubs and on specific routes. The airline with the most flights in and out of a specific airport generates lower unit costs per flight and per passenger than competitors. The airline with the highest market share and flight frequency on a given route typically has lower costs per seat, higher utilization, and superior pricing power. In the mobile industry, the significant fixed-cost components of the business (networks, product development, and brand advertising and promotion) provide unit cost advantages to the national market leader compared with its followers.

The second lesson from NTT DoCoMo and Swissair's experience is to have a clear view of the real economic boundaries of your business—is it a global business or, rather, a multilocal or regional one? Sitting on increasing cash balances, both DoCoMo and Swissair saw a high volume of merger and acquisition activity. They concluded a wave of "globalization" was underway in their industries and that they could not afford to be left out. The result: they developed growth aspirations beyond their national boundaries.

But while regulatory changes allowed increased foreign shareholdings in telecommunications and airlines opened up new international investment opportunities, they have not changed the laws of economics. Despite regulatory changes, the economics of the mobile-phone industry remain primarily national or regional in nature. This implies that it is better to be a market leader in one country than a follower in two countries. Similarly, regulatory changes in traditional, bilateral air-transport agreements have shifted barriers to entry and hence increased competition and reduced pricing power in the airline industry, but they have not changed its fundamental economics. All successful airline mergers have been driven around building or expanding hub or route dominance, not around building sheer, absolute scale in terms of either aircraft or destinations served

When both NTT DoCoMo and Swissair convinced themselves they needed to expand beyond domestic boundaries to survive, the race to fulfill their global aspirations seems to have resulted in a set of investments more focused on the number of flags on a boardroom map rather than on these basic economics driving superior profitability in their industries. The risks of these two aggressive expansion strategies were further compounded by not having control over most of their international investments. This suggests a third lesson: move to management control if you are serious about capturing acquisition synergies.

During the mid to late 1990s, Swissair kept its investment bankers busy with a nonstop string of deals. The company adopted an explicit “hunter strategy,” which led to acquisitions of noncontrolling minority stakes in a string of strategically challenged nonincumbent carriers: German charter carrier LTU, the French airlines AOM-Air Liberte and Air Littoral, and Italy’s Volare Airlines and Air Europe. In addition, Swissair acquired stakes in Polish flag carrier LOT, Belgium’s Sabena, and South African Airways.

Without majority control, there was very limited scope for Swissair management to drive the economic benefits from these airline shareholdings through route consolidation, aircraft fleet rationalization and purchasing benefits. In addition, there was no ability to take corrective action when operational or financial performance deteriorated.

Similarly, in short order, DoCoMo accumulated direct or indirect stakes in nine mobile operators—most for cash—at the peak of the telecom bubble. But this acquisition spree resulted in equity stakes in only two market leaders, and these were in relatively minor geographic markets: KPN Mobile domestically in the Netherlands and Hutchison in Hong Kong. All the others were lesser players. DoCoMo acquired stakes in the No. 3 U.S. player, AT&T Wireless; Taiwan’s No. 4 player, KG Telecom; the United Kingdom’s No. 5 player, Hutchison U.K., and distant followers KPN Orange in Belgium and E-Plus in Germany. Worse still, all these investments were minority stakes and so gave DoCoMo limited ability to exert control over critical strategic and operational issues at these operators.

6.39: The Importance of a Global Mind-Set

A common challenge that many corporations encounter as they move to globalize their operations can be summed up in one word: mind-set. Successful global expansion requires corporate leaders who think proactively, who sense and foresee emerging trends, and who act upon them in a deliberate, timely manner. To accomplish this, they need a global mind-set and an enthusiasm to embrace new challenges, diversity, and a measure of ambiguity. Simply having the right product and technology is not sufficient; it is the caliber of a company's global leadership that that makes the difference.

Herbert Paul defines a mind-set as "a set of deeply held internal mental images and assumptions, which individuals develop through a continuous process of learning from experience" (Paul (2000)). These images exist in the subconscious and determine how an individual perceives a specific situation and his or her reaction to it. In a global context, a global mind-set is "the ability to avoid the simplicity of assuming all cultures are the same, and at the same time, not being paralyzed by the complexity of the differences " (Paul (2000)). Thus, rather than being frustrated and intimidated by cultural differences, an individual with a global mind-set enjoys them and seeks them out because they are fascinated by them and understand they present unique business opportunities.

The concept of a mind-set does not just apply to individuals: it can be logically extended to organizations as the aggregated mind-set of all of its members. Naturally, at the organizational level, mind-set also reflects how its members interact as well as such issues as the distribution of power within the organization. Certain individuals, depending on their position in the organizational hierarchy, will have a stronger impact on the company's mind-set than others. In fact, the personal mind-set of the CEO is sometimes the single most important factor in shaping the organization's mind-set.

A corporate mind-set shapes the perceptions of individual and corporate challenges, opportunities, capabilities, and limitations. It also frames how goals and expectations are set and therefore has a significant impact on what strategies are considered and ultimately selected and how they are implemented. Recognizing the diversity of local markets and seeing them as a source of opportunity and strength, while at the same time pushing for strategic consistency across countries, lies at the heart of global strategy development. To become truly global, therefore, requires a company to develop two key capabilities. First, the company must have the capability to enter any market in the world it wishes to compete in. This requires that the company constantly looks for market opportunities worldwide, processes information on a global basis, and is respected as a real or potential threat by competitors, even in countries or markets it has not yet entered. Second, the company must have the capability to leverage its worldwide resources. Making a switch to a lower cost position by globalizing the supply chain is a good example. Leveraging a company's global know-how is another.

To understand the importance of a corporate mind-set to the development of these capabilities, consider two often quoted corporate mantras: "think global and act local" and its opposite, "think local and act global." The "think global and act local" mind-set is indicative of a global approach in which management operates under the assumption that a powerful brand name with a standard product, package, and advertising concept serves as a platform to conquer global markets. The starting point is a globalization strategy focused on standard products, optimal global sourcing, and the ability to react globally to competitors' moves. While sometimes effective, this approach can discourage diversity, and it puts a lot of emphasis on uniformity. Contrast this with a "think local and act global" mind-set, which is based on the assumption that global expansion is best served by adaptation to local needs and preferences. In this mind-set, diversity is looked upon as a source of opportunity, whereas strategic cohesion plays a secondary role. Such a "bottom-up" approach can offer greater possibilities for revenue generation, particularly for companies wanting to rapidly grow abroad. However, it may require greater investment in infrastructure necessary to serve each market and can produce global strategic inconsistency and inefficiencies.

C. K. Prahalad and Kenneth Lieberthal first exposed the Western (which they refer to as "imperialist") bias that many multinationals have brought to their global strategies, particularly in developing countries. They note that they would perform better—and learn more—if they more effectively tailored their operations to the unique conditions of emerging markets. Arguing that literally hundreds of millions of people in China, India, Indonesia, and Brazil are ready to enter the marketplace, they observe that multinational companies typically target only a tiny segment of affluent buyers in these emerging markets: those who most resemble Westerners. This kind of myopia—thinking of developing countries simply as new places to sell old products—is not only shortsighted and the direct result of a Western "imperialist" mind-set; it causes these companies to miss out on much larger market opportunities further down the socioeconomic pyramid that are often seized by local competitors. (Prahalad and Lieberthal (1998)).

Companies with a genuine global mind-set do not assume that they can be successful by simply exporting their current business models around the globe. Citicorp, for example, knew it could not profitably serve a client in Beijing or Delhi whose net wealth is less than $5,000 with its U.S. business model and attendant cost structure. It therefore had to create a new business model—which meant rethinking every element of its cost structure—to serve average citizens in China and India.

What is more, as we have seen, the innovation required to serve the large tier-two and tier-three segments in emerging markets has the potential to make them more competitive in their traditional markets and therefore in all markets. The same business model that Citicorp developed for emerging markets, for example, was found to have application to inner-city markets in the United States and elsewhere in the developed world.

To become truly global, multinational companies will also increasingly have to look to emerging markets for talent. India is already recognized as a source of technical talent in engineering, sciences, and software, as well as in some aspects of management. High-tech companies recruit in India not only for the Indian market but also for the global market. China, Brazil, and Russia will surely be next. Philips, the Dutch electronics giant, is downsizing in Europe and already employs more Chinese than Dutch workers. Nearly half of the revenues for companies such as Coca-Cola, Procter & Gamble (P&G), Lucent, Boeing, and GE come from Asia, or will in the near future.

As corporate globalization advances, the composition of senior management will also begin to reflect the importance of the BRIC (Brazil, Russia, India, and China) countries and other emerging markets. At present, with a few exceptions, such as Citicorp and Unilever, executive suites are still filled with nationals from the company's home country. As the senior managements for multinationals become more diverse, however, decision-making criteria and processes, attitudes toward ethics, and corporate responsibility, risk taking, and team building all will likely change, reflecting the slow but persistent shift in the center of gravity in many multinational companies toward Asia. This will make the clear articulation of a company's core values and expected behaviors even more important than it is today. It will also increase the need for a single company culture as more and more people from different cultures have to work together.

6.40: Determinants of a Corporate Global Mind-Set

What factors shape a corporation's mind-set? Can they be managed? Given the importance of mind-set to a company's global outlook and prospects, these are important questions. Paul cites four primary factors: (1) *top management's view of the world*; (2) *the company's strategic and administrative heritage;* (3) *the company's dominant organizational dimension*; and (4) *industry-specific forces driving or limiting globalization*. (Paul (2000)).

Top Management's View of the World

The composition of a company's top management and the way it exercises power both have an important influence on the corporate mind-set. The emergence of a visionary leader can be a major catalyst in breaking down existing geographic and competitive boundaries. Good examples are Jack Welch at General Electric or Louis Gerstner at IBM, who both played a dominant role in propelling their companies to positions of global leadership. In contrast, leaders with a parochial, predominantly ethnocentric vision are more likely to concentrate on the home market and not be very interested in international growth.

Administrative Heritage

The second factor is a company's "administrative heritage"—a company's strategic and organizational history, including the configuration of assets the company has acquired over the years, the evolution of its organizational structure, the strategies and management philosophies the company has pursued, its core competencies, and its corporate culture. In most companies, these elements evolve over a number of years and increasingly "define" the organization. As a consequence, changing one or more of these key tangible and intangible elements of a company is an enormous challenge and therefore a constraint on its global strategic options. For example, many traditional multinationals such as Philips and Unilever created freestanding subsidiaries with a high degree of autonomy and limited strategic coordination in many of the countries and markets where they chose to compete. Companies with such a history may encounter greater resistance in introducing a more global mind-set and related strategies than companies such as Coca-Cola, which have predominantly operated with a more centralized approach.

Organizational Structure

The type of *organizational structure* a company has chosen—discussed more fully in the next section—is also a key determinant of a corporate mind-set. In a strongly product-oriented structure, management is more likely to think globally as the entire information infrastructure is geared toward collecting and processing product data on a worldwide basis. Compare this to an organization with a focus on countries, areas, or regions—the mind-set of managers tends to be more local. Here, the information infrastructure is primarily oriented toward local and regional needs. It follows that in a matrix structure based on product as well as geographic dimensions, the mind-set of management is expected to reflect both global and local perspectives.

Industry Forces

Industry factors such as opportunities for economies of scale and scope, global sourcing, and lower transportation and communication costs push companies toward a global efficiency mind-set. Stronger global competition, the need to enter new markets, and the globalization of important customers pull in the same direction. Similarly, the trend toward a more homogeneous demand, particularly for products in fast-moving consumer goods industries, and more uniform technical standards for many industrial products, encourage a more global outlook. Another set of industry drivers, however, works in the opposite direction and calls for strategies with a high degree of local responsiveness. Such drivers include strong local competition in important markets and the existence of cultural differences, making the transfer of globally standardized concepts less attractive. Issues such as protectionism, trade barriers, and volatile exchange rates may also force a national business approach. All these forces work together and help create the conditions that shape the global mind-set of a company.

Creating the Right Global Mind-Set

Thus, to create the right global mind-set, management must understand the different, often opposite, environmental forces that shape it. At the corporate level, managers focusing on global competitive strategies tend to emphasize increased cross-country or cross-region coordination and more centralized, standardized approaches to strategy. Country managers, on the other hand, frequently favor greater autonomy for their local units because they feel they have a better understanding of local market and customer needs. Thus, different groups of managers can be expected to analyze data and facts in a different way and favor different strategic concepts and solutions depending on their individual mind-sets.

In practice, two different scenarios can develop. In the first scenario, one perspective consistently wins at the expense of the other. Under this scenario, the company may be successful for a certain period of time but will most likely run into trouble at a later time because its ability to learn and innovate will be seriously impaired as it opts for "short-sighted" solutions within a given framework. In the second scenario, a deliberate effort is made to maintain a "creative tension" between both perspectives. This scenario recognizes the importance of such a tension to the company's ability to break away from established patterns of thinking and look for completely new solutions. This ability to move beyond the existing paradigm and, in that sense, further develop the mind-set is probably one of the most important success factors for many of the established successful global players. Utilizing creative tension in a constructive manner requires the development of a corporate vision as well as a fair decision-making process. The corporate vision is expected to provide general direction for all managers and employees in terms of where the company wishes to be in the future. Equally important is setting up a generally understood and accepted fair decision process, which must allow for sufficient opportunities to analyze and discuss both global and local perspectives, and their merits, in view of specific strategic situations.

P&G has been particularly innovative in designing its global operations around the tension between local and global concerns. Four pillars—global business units, market development organizations, global business services, and corporate functions—form the heart of P&G's organizational structure. Global business units build major global brands with robust business strategies; market development organizations build local understanding as a foundation for marketing campaigns; global business services provide business technology and services that drive business success; and corporate functions work to maintain our place as a leader of our industries.

6.41: Organization as Strategy

Organizational design should be about developing and implementing corporate strategy. In a global context, the balance between local and central authority for key decisions is one of the most important parameters in a company's organizational design. Companies that have partially or fully globalized their operations have typically migrated to one of four organizational structures: (a) an *international*, (b) a *multidomestic*, (c) a *global*, or (d) a so-called *transnational* structure. Each occupies a well-defined position in the global aggregation or local adaptation matrix first developed by Bartlett and Ghoshal and usefully describes the most salient characteristics of each of these different organizational structures (Figure 6.41.1 "Global Aggregation/Local Adaptation Matrix"). This section draws substantially on Aboy (2009). See, for example, Bartlett and Ghoshal (1987a, 1987b, 1988, 1992, 2000).

The international model characterizes companies that are strongly dependent on their domestic sales and that export opportunistically. International companies typically have a well-developed domestic infrastructure and additional capacity to sell internationally. As their globalization develops further, they are destined to evolving into multidomestic, global, or transnational companies. The international model is fairly unsophisticated, unsustainable if the company further globalizes, and is therefore usually transitory in nature. In the short term, this organizational form may be viable in certain situations where the need for localization and local responsiveness is very low (i.e., the domestic value proposition can be marketed internationally with very minor adaptations) and the economies of aggregation (i.e., global standardization) are also low.

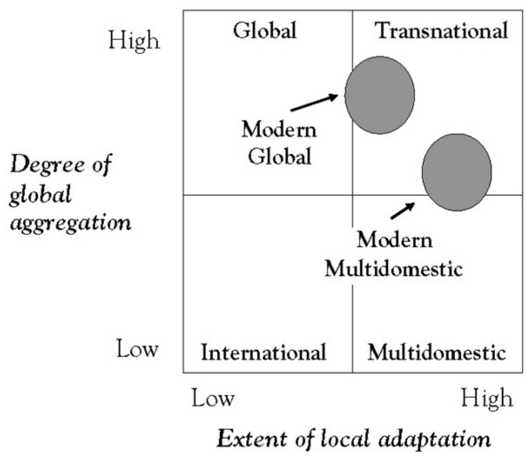


Figure 6.41.1: Global Aggregation/ Local Adaptation Matrix

The multidomestic organizational model describes companies with a portfolio of independent subsidiaries operating in different countries as a decentralized federation of assets and responsibilities under a common corporate name. (Bartlett and Ghoshal (1987a, 1987b)). Companies operating with a multidomestic model typically employ country-specific strategies with little international coordination or knowledge transfer from the center headquarters. Key decisions about strategy, resource allocation, decision making, knowledge generation and transfer, and procurement reside with each country subsidiary, with little value added from the center (headquarters). The pure multidomestic organizational structure is positioned as high on local adaptation and low on global aggregation (integration). Like the international model, the traditional multidomestic organizational structure is not well suited to a global competitive environment in which standardization, global integration, and economies of scale and scope are critical. However, this model is still viable in situations where local responsiveness, local differentiation, and local adaptation are critical, while the opportunities for efficient production, global knowledge transfer, economies of scale, and economies of scope are minimal. As with the international model, the pure multidomestic company often represents a transitory organizational structure. An example of this structure and its limitations is provided by Philips during the last 25 years of the last century. In head-to-head competition with its principal rival, Matsushita, Philips' multidomestic organizational model became a competitive disadvantage against Matsushita's centralized (global) organizational structure.

The traditional global company is the antithesis of the traditional multidomestic company. It describes companies with globally integrated operations designed to take maximum advantage of economies of scale and scope by following a strategy of standardization and efficient production. (See, for example, G. S. Yip (1981, 1982a, 1982b, 1989, 1991a, 1991b, 1994, 1996, 1997); Yip and Madsen (1996)). By globalizing operations and competing in global markets, these companies seek to reduce cost of research and development (R&D), manufacturing, production, procurement, and inventory; improve quality by reducing variance; enhance customer preference through global products and brands; and obtain competitive leverage. Most, if not all, key strategic decisions—about corporate strategy, resource allocation, and knowledge generation and transfer—are made at corporate headquarters. In the global aggregation-local adaptation matrix, the pure global company occupies the position of extreme global aggregation (integration) and low local adaptation (localization). An example of a pure global structure is provided by the aforementioned Japanese company Matsushita in the latter half of the last century. Since a pure global structure also represents an (extreme) ideal, it frequently is also transitory.

The transnational model is used to characterize companies that attempt to simultaneously achieve high global integration and high local responsiveness. It was conceived as a theoretical construct to mitigate the limitations of the pure multidomestic and global structures and occupies the fourth cell in the aggregation-adaptation matrix. This organizational structure focuses on integration, combination, multiplication of resources and capabilities, and managing assets and core competencies as a network of alliances as opposed to relying on functional or geographical division. Its essence, therefore, is matrix management. The ultimate objective is to have access and make effective and efficient use of all the resources the company has at its disposal globally, including both global and local knowledge. As a consequence, it requires management-intensive processes and is extremely hard to implement in its pure form. It is as much a mind-set, idea, or ideal rather than an organization structure found in many global corporations. (Ohmae (2006)).

Given the limitations of each of the above structures in terms of either their global competitiveness or their implementability, many companies have settled on matrix-like organizational structures that are more easily managed than the pure transnational model but that still target the simultaneous pursuit of global integration and local responsiveness. Two of these have been labeled the *modern multidomestic* and *modern global* models of global organization. (Aboy (2009), p. 3).

The modern multidomestic model is an updated version of the traditional (pure) multidomestic model that includes a more significant role for the corporate headquarters. Accordingly, its essence no longer consists of a loose confederation of assets, but rather a matrix structure with a strong culture of operational decentralization, local adaptation, product differentiation, and local responsiveness. The resulting model, with national subsidiaries with significant autonomy, a strong geographical dimension, and empowered country managers allows companies to maintain their local responsiveness and their ability to differentiate and adapt to local environments. At the same time, in the modern multidomestic model, the center is critical to enhancing competitive strength. Whereas the primary role of the subsidiary is to be locally responsive, the role of the center is multidimensional; it must foster global integration by (a) developing global corporate and competitive strategies, and (b) playing a significant role in resource allocation, selection of markets, developing strategic analysis, mergers and acquisitions, decisions regarding R&D and technology matters, eliminating duplication of capital intensive assets, and knowledge transfer. An example of a modern multidomestic company is Nestlé.

The modern global company is rooted in the tradition of the traditional (pure) global form but gives a more significant role in decision making to the country subsidiaries. Headquarters targets a high level of global integration by creating low-cost sourcing opportunities, factor cost efficiencies, opportunities for global scale and scope, product standardization, global technology sharing and information technology (IT) services, global branding, and an overarching global corporate strategy. But unlike the traditional (pure) global model, the modern global structure makes more effective use of the subsidiaries in order to encourage local responsiveness. As traditional global firms evolve into modern global enterprises, they tend to focus more on strategic coordination and integration of core competencies worldwide, and protecting home country control becomes less important. Modern global corporations may disperse R&D, manufacture and production, and marketing around the globe. This helps ensure flexibility in the face of changing factor costs for labor, raw materials, exchange rates, as well as hiring talent worldwide. P&G is an example of a modern global company.

6.42: Realigning and Restructuring for Global Competitive Advantage

Creating the right environment for a global mind-set to develop and realigning and restructuring a company's global operations, at a minimum, requires *(a) a strong commitment by the right top management, (b) a clear statement of vision and a delineation of a well-defined set of global decision-making processes, (c) anticipating and overcoming organizational resistance to change, (d) developing and coordinating networks, (e) a global perspective on employee selection and career planning.*

A strong commitment by the right top management. Shaping a global mind-set starts at the top. The composition of the senior management team and the board of directors should reflect the diversity of markets in which the company wants to compete. In terms of mind-set, a multicultural board can help operating managers by providing a broader perspective and specific knowledge about new trends and changes in the environment. A good example of a company with a truly global top management team is the Adidas Group, the German-based sportswear company. Its executive board consists of two Germans, an American, and a New Zealander; the CEO is German. The company's supervisory board includes German nationals, a Frenchman, and Russians. Adidas is still an exception. Many other companies operating on a global scale still have a long way to go to make the composition of their top management and boards reflects the importance and diversity of their worldwide operations.

A clear statement of vision and a delineation of a well-defined set of global decision-making processes. For decades, it has been general management's primary role to determine corporate strategy and the organization's structure. In many global companies, however, top management's role has changed from its historical focus strategy, structure, and systems to one of developing purpose and vision, processes, and people. This new philosophy reflects the growing importance of developing and nurturing a strong corporate purpose and vision in a diverse, competitive global environment. Under this new model, middle and upper-middle managers are expected to behave more like business leaders and entrepreneurs rather than administrators and controllers. To facilitate this role change, companies must spend more time and effort engaging middle management in developing strategy. This process gives middle and upper-middle managers an opportunity to make a contribution to the (global) corporate agenda and, at the same time, helps create a shared understanding and commitment of how to approach global business issues. Instead of traditional strategic planning in a separate corporate planning department, Nestlé, for example, focuses on a combination of bottom-up and top-down planning approaches involving markets, regions, and strategic product groups. That process ensures that local managers play an important part in decisions to pursue a certain plan and the related vision. In line with this approach, headquarters does not generally force local units to do something they do not believe in. The new philosophy calls for development of the organization less through formal structure and more through effective management processes.

Anticipating and overcoming organizational resistance to change. The globalization of key business processes such as IT, purchasing, product design, and R&D is critical to global competitiveness. Decentralized, siloed local business processes simply are ineffective and unsustainable in today's intense, competitive global environment. In this regard, creating the right "metrics" is important. When all of a company's metrics are focused locally or regionally, locally or regionally inspired behaviors can be expected. Until a consistent set of global metrics is adopted, designed to encourage global behaviors, globalization is unlikely to take hold, much less succeed. Resistance to such global process initiatives runs deep, however. As many companies have learned, country managers will likely invoke everything from the "not invented here" syndrome to respect for local culture and business heritage to defend the status quo.

Developing and coordinating networks. Globalization has also brought greater emphasis on collaboration, not only with units inside the company but also with outside partners such as suppliers and customers. Global managers must now develop and coordinate networks, which give them access to key resources on a worldwide basis. Network building helps to replace nationally held views with a collective global mind-set. Established global companies, such as Unilever or GE, have developed a networking culture in which middle managers from various parts of the organization are constantly put together in working, training, or social situations. They range from staffing multicultural project teams, to sophisticated career path systems encouraging international mobility, to various training courses and internal conferences.

A global perspective on employee selection and career planning. Recruiting from diverse sources worldwide supports the development of a global mind-set. A multicultural top management, as described previously, might improve the company's chances of recruiting and motivating high-potential candidates from various countries. Many companies now hire local managers and put them through intensive training programs. Microsoft, for example, routinely brings foreign talent to the United States for intensive training. P&G runs local courses in a number of countries and then sends trainees to its headquarters in Cincinnati or to large foreign subsidiaries for a significant period of time. After completion of their training, they are expected to take over local management positions.

Similarly, a career path in a global company must provide for recurring local and global assignments. Typically, a high-potential candidate will start in a specific local function, for example, marketing or finance. A successful track record in the chosen functional area provides the candidate with sufficient credibility in the company and, equally important, self-confidence to take on more complex and demanding global tasks, usually as a team member where he or she gets hands-on knowledge of the workings of a global team. With each new assignment, managers should broaden their perspectives and establish informal networks of contact and relationships. Whereas international assignments in the past were primarily demand-driven to transfer know-how and solve specific problems, they are now much more learning-oriented and focus on giving the expatriate the opportunity to understand and benefit from cultural differences as well as to develop long-lasting networks and relationships. Exposure to all major functions, rotation through several businesses, and different postings in various countries are critical in creating a global mind-set, both for the individual manager and for the entire management group. In that sense, global human resource management is probably one of the most powerful medium- and long-term tools for global success.

Minicase: March 31, 2008: Citi Announces New Corporate Organizational Structure (news.primerica.com/public/news/citi-announces-new-corp-orginazational-structure.html)

Vikram Pandit, Citi's chief executive officer, recently announced a comprehensive reorganization of Citi's structure to achieve greater client focus and connectivity, global product excellence, and clear accountability. The new organizational structure is designed to let Citi focus its resources toward growth in emerging and developed markets and improve efficiencies throughout the company.

Specifically, Citi has established a regional structure to bring decision making closer to clients. The new structure gives the leaders of the geographic regions authority to make decisions on the ground. The geographic regions are each led by a single chief executive officer who reports to Mr. Pandit.

In addition, Citi reorganized its consumer group into two global businesses: Consumer Banking and Global Cards. This brings Citi's number of global businesses to four: Institutional Clients Group and Global Wealth Management are already organized as global businesses. The four global businesses will allow Citi to deliver on product excellence in close partnership with the regions. The product leaders also will report to Mr. Pandit.

"Our new organizational model marks a further important step along the path we are pursuing to make Citi a simpler, leaner and more efficient organization that works collaboratively across the businesses and throughout the world to benefit clients and shareholders," said Mr. Pandit. "With this new structure, we reinforce our focus on clients by moving the decision-making process as close to clients as possible and assigning some of our strongest talent to lead the regional areas and global product groups."

As part of the reorganization, in order to drive efficiency and reduce costs, Citi will further centralize global functions, including finance, IT, legal, human resources, and branding. By centralizing these global functions, particularly IT, Citi will reduce unnecessary complexity, leverage its global scale, and accelerate innovation. Risk is already centralized.

The business reorganization reflects priorities outlined by Mr. Pandit, who has been conducting intensive business reviews, since being named CEO, to drive greater cross-business collaboration; eliminate bureaucracy and create a nimbler, more client-focused organization; ensure strong risk management and capital resources; and drive cost and operational efficiencies to generate additional shareholder value.

6.43: Points to Remember

Developing a global mind-set requires companies to accomplish the following:

1. Integrate the global aspects of strategy into their overall corporate strategy and change thinking patterns from a single domestic focus to a broad global focus.
2. Manage uncertainty while constantly adapting to change and accepting it as part of a process.
3. Get the right people in place with the skills necessary to focus on international expansion.
4. Combine the various cultures and values of the corporate work force into a unique global organizational culture.
5. Invest in people so they can help the company to succeed globally.
6. Embrace diversity and differences.
7. Learn how to cooperate with partners worldwide by successfully managing global supply chains, teams, and alliances,

On the subject of creating a global organization, the following factors are important:

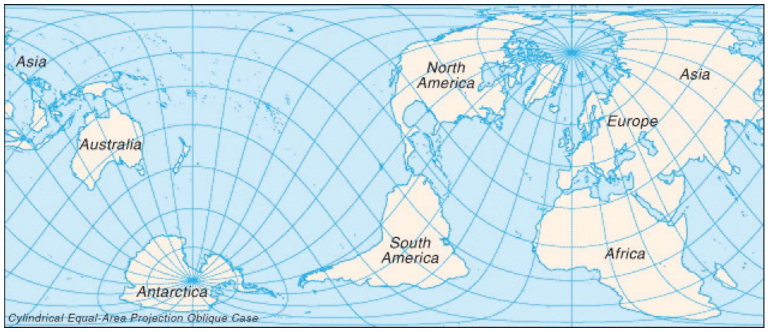
1. Globalization is driving a wholesale reinvention of organizational structure and management. The need for global scale and process efficiency is challenging corporate leaders to replace old paradigms of centralized control and decentralized autonomy with new models.
2. Achieving the potential of global operations requires a mix of “soft” and “hard” approaches. Optimizing global processes requires cultural change management, proactive team- and relationship-building, and also more traditional budgetary and accountability mechanisms and metrics.
3. Long-term vision, planning, and goal alignment can greatly increase chances of success. Corporations should start with a clear vision of their global objectives and values, and consciously develop shared language and identity, with participation from all global regions, not just headquarters.
4. Identifying and replicating successes quickly and continuously is crucial to global competitiveness. Today’s complex global markets require multifaceted, not monolithic, approaches and capabilities. Global collaboration with face-to-face feedback loops, and a focus on identifying local successes and building them into the global process portfolio, can maximize the value of a corporation’s global assets.

SECTION OVERVIEW

6.44: Winning through Effective, Global Talent Management

6.45: Chapter Introduction

Winning through Effective, Global Talent Management



WHAT'S IN IT FOR ME?

1. What is the scope and changing role of global, strategic human resources management (SHRM) in international business?
2. How can you visualize the battlefield in the global war for talent?
3. How can you engage in effective selection and placement strategies?
4. What are the roles of pay structure and pay for performance in effective talent management?
5. How can you use the Workforce Scorecard to gauge and proactively manage human capital, including your own?

You've probably heard the saying "people make the place." Moreover, firms with operations across borders have this added advantage: access to the best and brightest people from around the world, because talent isn't constrained by national borders. Indeed, one of the key forces in *flattening* the world is new technologies; other trends too are empowering people from every corner of the earth. At the same time, companies large and small are able to find and leverage human capital from the farthest reaches of the planet. This ability to arbitrage and attract human capital worldwide is a key driver in the the *war for talent*, which is a term signifying the strategic importance of attracting top employees to work for your company. In today's fast-changing environment, companies need employees who understand the organization's strategy and are empowered to execute it. To achieve this, organizations need to follow a strategic human resources management (SHRM) approach. SHRM ensures that people are a key factor in a firm's competitive advantage. Organizations need human resources to be a partner in identifying, recruiting, and hiring the types of employees who will be most qualified to help the company achieve its goals. SHRM requires attracting the right employees to the company, identifying metrics to help employees stay on target to meet the company's goals, and rewarding them appropriately for their efforts so that they stay engaged and motivated. Having all these components in place results in a high-performance work system, improves organizational performance, and unleashes employee talent.

Opening Case: Employee Recruitment, Selection, and Development Strategies at Enterprise Holdings

You may know this company through one of its businesses, Enterprise Rent-A-Car, and its "We'll pick you up" jingle. The Enterprise car-rental business is part of a much larger family business—Enterprise Holdings. Through its regional subsidiaries, Enterprise Holdings operates more than 1 million cars and trucks, the largest fleet of passenger vehicles in the world today."Enterprise Holdings Announces Fiscal 2010 Highlights," *MarketWire*, September 30, 2010, accessed November 24, 2010, http://www.marketwire.com/press-release/Enterprise-Holdings-Announces-Fiscal-2010-Highlights-1328012.htm. It's one of the largest and most comprehensive providers in the car-rental industry, serving approximately 7,600 neighborhood and airport locations in the United States, Canada, Mexico, the Caribbean, Latin America, the United Kingdom, Ireland, Germany, and Asia. In addition, Enterprise Holdings is part of a global strategic alliance with Europcar, creating the world's largest car-rental network. In this case study, you'll see how Enterprise—with more than 68,000 employees and $12 billion revenue—ensures it has the right people with the right skills in the right locations worldwide.

Core Values from the Start

Enterprise was founded in 1957 by Jack Taylor, who returned from World War II to start a car-leasing company in St. Louis. He launched with a total of seven cars and one employee, but he had a vision to grow and a strong motto: "Take care of your customers and your employees first, and the profits will follow."“Heritage,” Enterprise Holdings, accessed January 28, 2011, www.enterpriseholdings.com/about-us. This vision of exceptional customer service means that Enterprise has to identify, attract, and hire employees who would be good at delivering on its customer service mission. To accomplish this, Enterprise looks for potential new hires who have the following set of skills and competencies that support the company's objectives:

1. Customer service focus
2. Sales and listening skills
3. Positive work ethic (a drive to achieve results)
4. Leadership aptitude
5. Communication skills
6. Flexibility

The company has identified the competencies and behaviors that such skills provide and has clearly articulated the benefits that these skills provide to Enterprise. For instance, flexibility is defined as dealing well with challenges, demonstrating resilience, and being able to prioritize. Enterprise believes that it—the company—is better able to cope with changing circumstances when an employee exhibits flexibility.

Enterprise describes the competencies it seeks on its website so that job seekers can determine for themselves whether they will measure up and fit in with the Enterprise culture.

Attracting and Recruiting Employees

Enterprise has a team of 200 recruiters whose job is to identify potential new candidates at over one hundred college campuses each year."Recruitment and Selection at Enterprise Rent-A-Car," *The Times 100*, 2009, accessed May 10, 2011, www.thetimes100.co.uk/downloads/enterprise/enterprise_14_full.pdf. Given its growth and international expansion, Enterprise hires 8,000 college graduates a year to fill its future management needs.Seth Cline, "The Companies Hiring the Most New College Grads," *Forbes*, June 21, 2010, accessed January 27, 2011, http://www.forbes.com/2010/06/21/companies-hiring-college-graduates-leadership-careers-jobs.html? boxes=leadershipchannellatest. The recruiting function at Enterprise is decentralized: each recruiter is responsible for recruiting within his or her local market. The rationale for this structure is this: local hires reflect the local community for each branch office. "We try to mirror our communities," says Pam Webster, assistant vice president for recruiting at Enterprise.Fay Hansen, "Enterprise's Recruiting Model Transforms Interns into Managers," *Workforce Management Online*, May 2009, accessed January 30, 2011, http://www.workforce.com/section/recruiting-staffing/feature/enterprises-recruiting-model-transforms-interns-into/index.html.

Enterprise also uses an internship program as a way to identify potential future employees. The program is open to college juniors and seniors; interested interns then spend a summer working at Enterprise after graduating. Recruiters stay in touch with interns during the school year through e-mails and lunches. Some even send a care package to interns during final exam time.

In the United Kingdom, Enterprise began using Campus Brand Managers on university campuses to find potential interns and job applicants. These Campus Brand Managers are interns or students who already work for Enterprise and who act as liaisons for potential applicants."Recruitment and Selection at Enterprise Rent-A-Car," *The Times 100*, 2009, accessed May 10, 2011, www.thetimes100.co.uk/downloads/enterprise/enterprise_14_full.pdf.

Enterprise also has an employee-referral program through which current employees get a financial reward if they recommend a new employee to Enterprise and that candidate is hired into a full-time position. The referral program has been the company's primary source of minority and female hires, and approximately 40 percent of new hires join Enterprise that way.Fay Hansen, "Enterprise's Recruiting Model Transforms Interns into Managers," *Workforce Management Online*, May 2009, accessed January 30, 2011, http://www.workforce.com/section/recruiting-staffing/feature/enterprises-recruiting-model-transforms-interns-into/index.html.

Finally, Enterprise recruits online; about 50 percent of Enterprise's UK and Ireland workforce is recruited via the web.

Developing Employees

To develop new recruits who would like to enter the ranks of management, Enterprise offers its Graduate Management Trainee program, which is a program that teaches management skills such as leadership and big-picture thinking; finance and business management skills such as cost control and attention to profits; sales and marketing skills to generate more sales; fleet-control skills such as handling repairs and getting the right number and type of cars; and of course customer service skills. In as little as eight to twelve months, trainees can become assistant managers. Once they become assistant managers, they start to earn performance pay in addition to their salaries.David Lagess, "A 'Stealth Company' No Longer," *U.S. News & World Report*, October 17, 2008, accessed January 27, 2011, money.usnews.com/money/business-economy/small-business/articles/2008/10/17/a-stealth-company-no-longer?PageNr=2. The performance pay is based on branch profits, which means employees can directly benefit from the improvements they make to branch operations.

Enterprise's training program supports the company's promote-from-within philosophy. "We have always hired college grads into our management training program, and from there we promote entirely from within," says Marie Artim, assistant vice president of recruiting. "It's where I started, it's where our CEO started, and it's where almost all our senior leadership started."Seth Cline, "The Companies Hiring the Most New College Grads," *Forbes*, June 21, 2010, accessed January 27, 2011, http://www.forbes.com/2010/06/21/companies-hiring-college-graduates-leadership-careers-jobs.html?boxes=leadershipchannellatest. Enterprise Holdings' president and chief operating officer (COO), Pamela Nicholson, started as a management trainee in 1981, working behind the rental counter, as did current chairman and CEO Andy Taylor.Anne Fisher, "Get a Great Job after Graduation," *Fortune*, May 28, 2009, accessed January 27, 2011, http://money.cnn.com/2009/05/28/news/economy/new.grad.jobs.fortune/index.htm?postversion=2009052904. Nicholson moved steadily through the ranks of the company and in 1999 was promoted to senior vice president of the company's North American operations, then to COO in 2003, and to president in 2008."An Interview with Pamela M. Nicholson, President and Chief Operating Officer, Enterprise Holdings," *Leaders* 34, no. 1 (January–March 2011), accessed January 27, 2011, http://www.leadersmag.com/issues/2011.1_Jan/Missouri/LEADERS-Pamela-Nicholson-Enterprise-Holdings.html.

Global Entrepreneurship

In addition to customer service, entrepreneurship is another key corporate value at Enterprise. The tradition began with founder Jack Taylor and continued through innovations introduced by Enterprise's branch managers. For example, in 1974 a rental manager in Orlando decided to offer his customers a new service: a free ride to the Enterprise rental office. Other branches emulated this free pick-up service, which demonstrated that employees with a great idea can see it implemented across the company.

Other entrepreneurial ideas include WeCar, which is Enterprise's new car-sharing program for corporations and campuses.David Lagess, "A 'Stealth Company' No Longer," *U.S. News & World Report*, October 17, 2008, accessed January 27, 2011, money.usnews.com/money/business-economy/small-business/articles/2008/10/17/a-stealth-company-no-longer?PageNr=2. For example, Google is using the WeCar program and lets its employees choose among Priuses and Ford Escape Hybrids that Enterprise provides.Elizabeth Olson, "Car Sharing Reinvents the Company Wheels," *New York Times*, May 6, 2009, accessed January 27, 2011, www.nytimes.com/2009/05/07/business/businessspecial/07CAR.html?_r=1&ref=businessspecial.

Expanding internationally is likewise done through entrepreneurial employees. Enterprise opened its first German office in Ottobrunn in 1997. Enterprise's German pioneer, Jack Cope, said, "It's a lot of fun taking something from nothing and making it big, and I'm on my way to making that happen. A few years ago, Enterprise was unknown here in Germany. Today, thanks to the efforts of our motivated German workforce, the Enterprise mission, philosophy and culture are catching on.""For Management Trainees, Ours Really Is a World of Opportunity," *About Enterprise*, Enterprise Rent-A-Car, accessed January 27, 2011, www.enterprisealive.com/about-enterprise/global-locations.

The company entices international entrepreneurs through messages like the following one on its website:

Just imagine the possibilities that come with joining a huge, internationally successful company with a personal, entrepreneurial approach which allows individuals to stand out. Our secret lies in the fact that we're divided up into thousands of smaller, local businesses. So when you take one of our graduate trainee jobs, you'll be learning how to run the business yourself. And how many organizations with a $12 billion turnover can say that?"With a Company as Successful as Ours, It's Easy to Start Getting Ahead of Yourself," *About Enterprise*, Enterprise Rent-A-Car, accessed January 27, 2011, www.enterprisealive.com/about-enterprise/our-industry.

Opening Case Exercises

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. How does Enterprise use SHRM to support its customer service objectives?
2. What strategies does Enterprise use to attract new employees?
3. Do you think entrepreneurial employees would be motivated to work at Enterprise? Why or why not?

6.46: The Changing Role of Strategic Human Resources

Management in International Business

Learning Objectives

1. Understand how human resources management is becoming a strategic partner.
2. Recognize the importance of an organization's human capital.
3. Learn the key elements of SHRM.

HR as a Strategic Partner

The role of human resources management (HRM) is changing in business, particularly in international business. Previously considered a support function, HRM is now becoming a strategic partner in helping a global company achieve its goals. The strategic approach to HRM—**strategic human resources management (SHRM)**—means going beyond administrative tasks such as payroll processing. Instead, as shown in the opening case on Enterprise, managers need to think more broadly and deeply about how employees will contribute to the company's success.

SHRM is not just a function of the human resources (HR) department—all managers and executives need to be involved because the role of people is so vital to a company's competitive advantage.Brian E. Becker and Mark A. Huselid, "Strategic Human Resources Management: Where Do We Go from Here?," *Journal of Management* 32, no. 6 (2006): 898–925. In addition, organizations that value their employees are more profitable than those that don't.Mark A. Huselid, "The Impact of Human Resource Management Practices on Turnover, Productivity, and Corporate Financial Performance," *Academy of Management Journal* 38, no. 3 (1995): 635–72; Jeffrey Pfeffer, *The Human Equation: Building Profits by Putting People First* (Boston: Harvard Business School Press, 1998); Jeffrey Pfeffer and John F. Veiga, "Putting People First for Organizational Success," *Academy of Management Executive* 13, no. 2 (1999): 37–48; Theresa M. Welbourne and Alice O. Andrews, "Predicting Performance of Initial Public Offering Firms: Should HRM be in the Equation?," *Academy of Management Journal* 39, no. 4 (1996): 910–11. Research shows that successful organizations have several things in common: providing employment security, engaging in selective hiring, using self-managed teams, being decentralized, paying well, training employees, reducing status differences, and sharing information.Jeffrey Pfeffer and John F. Veiga, "Putting People First for Organizational Success," *Academy of Management Executive* 13, no. 2 (1999): 37–48. When organizations enable, develop, and motivate human capital, they improve accounting profits as well as shareholder value in the process.Brian E. Becker, Mark A. Huselid, and David Ulrich, "Six Key Principles for Measuring Human Capital Performance in Your Organization" (working paper, School of Management and Labor Relations, Department of Human Resources Management, Rutgers, State University of New Jersey, 2002). The most successful organizations manage HR as a strategic asset and measure HR performance in terms of its strategic impact. When each piece is in the right place, it creates a **high-performance work system (HPWS)**—a set of management practices that attempt to create an environment within an organization in which the employee has greater involvement and responsibility.

The following are some questions that HRM should be prepared to answer in this new world:David Ulrich, *Delivering Results* (Boston: Harvard Business School Press, 1998).

- **Competence.** To what extent does our company have the required knowledge, skills, and abilities to implement its strategy?
- **Consequence.** To what extent does our company have the right measures, rewards, and incentives in place to align people's efforts with the company strategy?
- **Governance.** To what extent does our company have the right structures, communications systems, and policies to create a high-performing organization?
- **Learning and Leadership.** To what extent can our company respond to uncertainty and learn and adapt to change quickly?

Crucial Role of SHRM in Global Firms

Developing an effective international workforce is much more difficult for a competitor to emulate than buying technology or securing capital.Dennis R. Briscoe, Randall S. Schuler, and Lisbeth Claus, *International Human Resource Management*, 3rd ed. (New York: Routledge, 2009). Besides, how well companies manage their HR around the world can mean the difference between success and failure. In a nutshell, firms that effectively manage their international HR typically outperform competitors in terms of identifying new international business opportunities, adapting to changing conditions worldwide, sharing innovation knowledge throughout the firm, effectively coordinating subsidiary operations, conducting successful cross-border acquisitions, and maintaining a high-performing, committed overseas workforce.Mary Yoko Brannen and Mark F. Peterson, “Merging without Alienating: Interventions Promoting Cross-cultural Organizational Integration and Their Limitations,” *Journal of International Business Studies* 40 (2009): 468–89; Yaping Gong, “Toward a Dynamic Process Model of Staffing Composition and Subsidiary Outcomes in Multinational Enterprises,” *Journal of Management* 29, no. 2 (2003): 259–80; Dana Minbaeva, Torben Pedersen, Ingmar Björkman, Carl F. Fey, and Hyeon Jeong Park, “MNC Knowledge Transfer, Subsidiary Absorptive Capacity, and HRM,” *Journal of International Business Studies* 34, no. 6 (2003): 586–99; Gary Oddou, Joyce S. Osland, and Roger N. Blakeney, “Repatriating Knowledge: Variables Influencing the ‘Transfer’ Process,” *Journal of International Business Studies* 40, no. 2 (2009): 181–99.

Did You Know?

Robert Half International (RHI), a professional consulting firm, has staffing operations in more than 400 locations worldwide.“About Us,” Robert Half International, accessed January 28, 2011, http://www.rhi.com/AboutUs. During the recession of 2009, RHI began hiring older, more experienced workers to add to its roster of temporary workers. Typically, temporary workers are low-level employees, but during the recession, many workers with fifteen or twenty years of experience lost their jobs or retired from full-time jobs. RHI hired older highly skilled workers, such as accounting and finance experts, to work on temporary projects—helping a company restructure or emerge from bankruptcy, for instance. The situation is a win-win: companies get access to experts they may not otherwise be able to afford, while retired workers earn extra money or income after a layoff. Zurich-based Adecco, a competitor to RHI, likewise hired older workers. “More companies are looking for flexible, highly skilled temporary employees because it’s much easier to end an assignment than terminate employment,” said Doug Arms, chief talent officer at Ajilon Professional Staffing, a unit of Adecco.Aili McConnon, “Temp Giant Robert Half Welcomes Boomers,” *BusinessWeek*, May 21, 2009, accessed January 28, 2011, http://www.businessweek.com/magazine/content/09_22/b4133054601320.htm.

In many multinationals, an important challenge is balancing the need to coordinate units scattered around the world with the need for individual units to have the control necessary to deal effectively with local issues.Randall S. Schuler, Pawan S. Budhwar, and Gary W. Florkowski, “International Human Resource Management,” in *Handbook for International Management Research*, ed. Betty-Jane Punnett and Oded Shenkar (Ann Arbor: University of Michigan Press, 2004), 356–414. Achieving this balance becomes more difficult as the level of diversity that firms are exposed to increases. For example, consider a situation where the parent firm’s national culture differs dramatically from the cultures in its overseas subsidiaries. In this case, it may be harder for the parent firm to share information, technology, and innovations between the home office and foreign outposts. It may also be more difficult to promote needed organizational changes and manage any conflicts that arise between employees in different countries.

Fortunately, international human resources management (IHRM) strategies can overcome such problems. For instance, IHRM professionals can help ensure that top executives understand the different cultures within the company workforce and around the world. They can also offer advice on how to coordinate functions across boundaries and develop outstanding cross-cultural skills in employees (e.g., through various training programs and career paths that involve significant overseas exposure).Dennis R. Briscoe, Randall S. Schuler, and Lisbeth Claus, *International Human Resource Management*, 3rd ed. (New York: Routledge, 2009); Carl F. Fey and Ingmar Björkman, “The Effect of Human Resource Management Practices on MNC Subsidiary Performance in Russia,” *Journal of International Business Studies* 32, no. 1 (2001): 59–75; Patrick M. Wright, Gary C. McMahan, and Abagail McWilliams, “Human Resources and Sustained Competitive Advantage: A Resource-Based Perspective,” *International Journal of Human Resource Management* 5, no. 2 (1994): 301–26.

Of course, these are general suggestions and a range of HR practices might be used to implement them. Companies should develop an international HR philosophy that describes corporate values about HR—this in turn, will shape the broad outline of what constitutes acceptable IHRM practices for employees all over the world. From there, individual units can fine-tune and select specific practices that best fit their local conditions. But this is easier said than done, especially for firms operating in dozens of countries. Multinationals typically find it extremely difficult, for example, to design a compensation system that is sensitive to cultural differences yet still meets general guidelines of being seen as fair by employees everywhere. Indeed, culture may impact local HRM practices in a variety of ways—from how benefit packages are constructed to the hiring, termination, and promotion practices used, just to name a few.Dennis R. Briscoe, Randall S. Schuler, and Lisbeth Claus, *International Human Resource Management*, 3rd ed. (New York: Routledge, 2009).

Nevertheless, selecting the right IHRM strategy can pay off, particularly in difficult foreign markets. Consider multinationals wanting to quickly enter countries with transitional economies—those that are moving from being state-dominated to being market-based (e.g., China and Russia). Choosing to enter those markets by buying local firms, building new plants, or establishing joint ventures may create significant HR challenges that will undercut performance if not handled well. Consequently, global firms need to adopt an appropriate IHRM strategy to meet transition economy challenges.

The Importance of Human Capital

Employees provide an organization's **human capital**. Your human capital is the set of skills that you have acquired on the job—through training and experience—which increase your value in the marketplace. The Society of Human Resource Management's *Research Quarterly* defined an organization's human capital as "the collective sum of the attributes, life experience, knowledge, inventiveness, energy, and enthusiasm that its people choose to invest in their work."Leslie A. Weatherly, "Human Capital—the Elusive Asset; Measuring and Managing Human Capital: A Strategic Imperative for HR," *2003 SHRM Research Quarterly*, March 2003, accessed November 2, 2010, www.ispi.org/pdf/suggestedReading/6_Weatherly_HumanCapital.pdf.

Focus on Outcomes

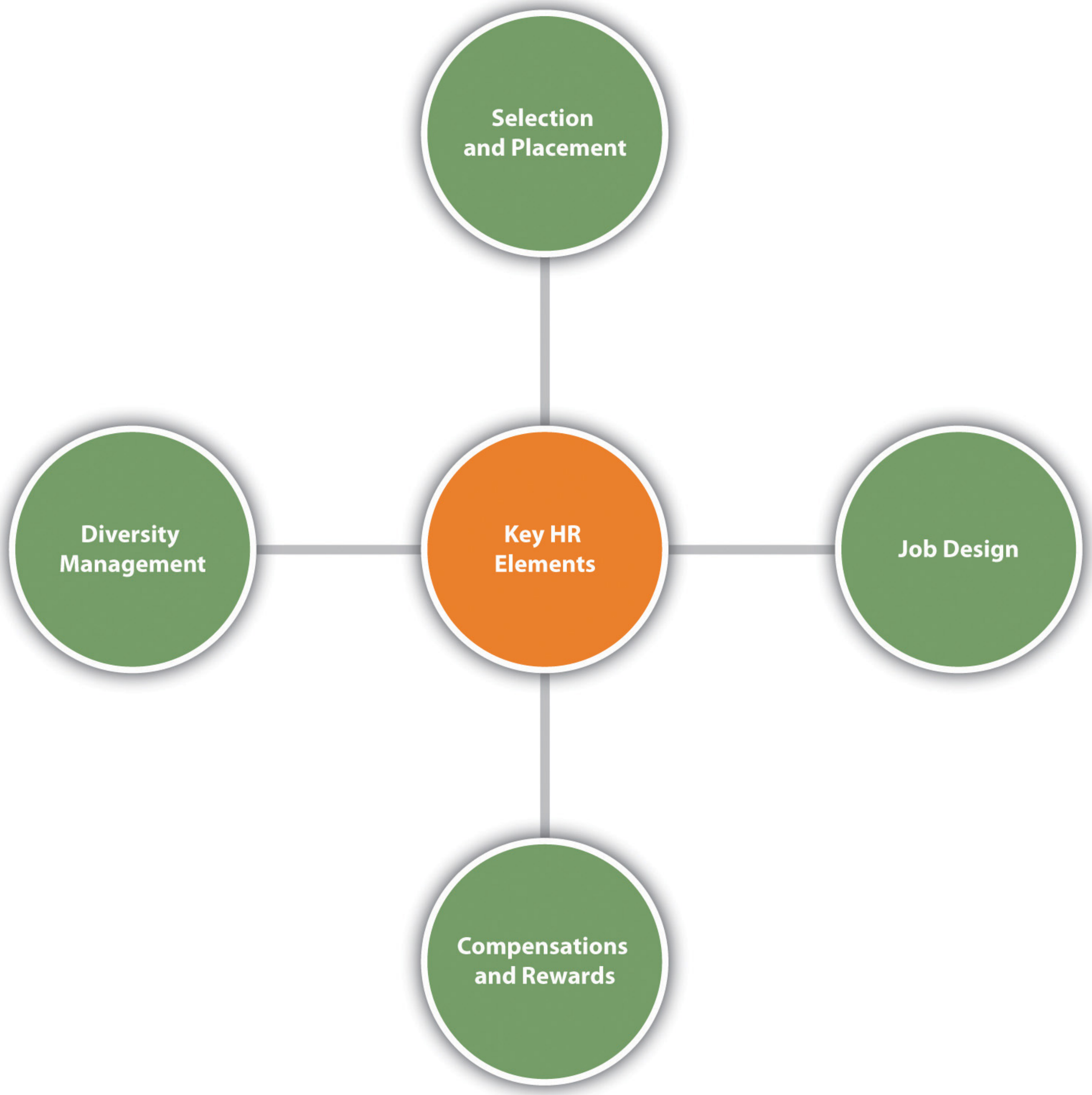
Unfortunately, many HR managers are more effective in the technical or operational aspects of HR than they are in the strategic, even though the strategic facet has a much larger effect on the company's success.Mark A. Huselid, Susan E. Jackson, and Randall S. Schuler, "Technical and Strategic Human Resource Management Effectiveness as Determinants of Firm Performance," *Academy of Management Journal* 40, no. 1 (1997): 171–88. In the past, HR professionals focused on compliance to rules, such as those set by the federal government, and tracked simple metrics—for instance, the number of employees hired or the number of hours of training delivered. The new principles of management, however, require a focus on outcomes and results, not just numbers and compliance. Just as lawyers count how many cases they've won—not just how many words they used—so too must HR professionals track how employees are using the skills they've learned to attain goals, not just how many hours they've spent in training.David Ulrich, *Delivering Results* (Boston: Harvard Business School Press, 1998).

John Murabito, executive vice president and head of Human Resources and Services at CIGNA, says that HR executives need to understand the company's goals and strategy and then provide employees with the skills needed. Too often, HRM executives get wrapped up in their own initiatives without understanding how their role contributes to the business. That's dangerous, because when it comes to the HR department, "anything that is administrative or transactional is going to get outsourced," Murabito says.Jessica Marquez, "On the Front Line: A Quintet of 2006's Highest-Paid HR Leaders Discuss How They Are Confronting Myriad Talent Management Challenges as Well as Obstacles to Being Viewed by Their Organizations as Strategic Business Partners," *Workforce Management* 86, no. 5 (1997): 22. Indeed, the number of HRM outsourcing contracts over $25 million has been increasing, with nearly 3,000 active company contracts recently under way."TPI Counts 2700+ Outsourcing Contracts," SharedXpertise Forums, December 2007, accessed January 30, 2009, www.sharedxpertise.com/content/4301/tpi-counts-2700-outsourcing-contracts. For example, Bank of America outsourced its HRM administration to NorthgateArinso. NorthgateArinso now provides timekeeping, payroll processing, and payroll services for 10,000 Bank of America employees outside the United States."Annual Report 2006," Arinso International, accessed March 10, 2011, bib.kuleuven.be/ebib/data/jaarverslagen/Arinso_2006eng.pdf. To avoid being outsourced, HRM needs to stay relevant and accept accountability for its business results. In short, the people strategy needs to fully align with the company's business strategy, keeping the focus on outcomes.

Key Elements of HRM

Beyond the basic need for compliance with HRM rules and regulations, the four key elements of HR are summarized in Figure 12.1. In high-performing companies such as Enterprise Holdings, each element of the HRM system is designed to reflect best practices and to maximize employee performance. The different parts of the HRM system are strongly aligned with company goals.

Figure 12.1 Key HRM Elements



Selection and Placement

It's good for firms to acquaint prospective new hires with the nature of the jobs they'll be expected to fulfill early in the hiring process. This includes explaining the technical competencies needed (e.g., collecting statistical data) and defining behavioral competencies. Behavioral competencies may have a customer focus, such as the ability to show empathy and support of customers' feelings and points of view, or a work-management focus, such as the ability to complete tasks efficiently or to know when to seek guidance.

In addition, an SHRM best practice is to make the organization's culture clear by discussing the values that underpin the organization. For example, firms can describe the "heroes" of the organization—those employees who embody the values of the organization. For example, a service company's heroes may be the people who go the extra mile to get customers to smile. In a software company, the heroes may be the people who toil through the night to develop new code. By sharing such stories of company heroes with potential hires, the firm helps reinforce the values and behaviors that make the company unique. This, in turn, will help the job candidates determine whether they'll fit well into that organization's culture.

Job Design

Job design refers to the process of combining tasks to form a whole job. The goal is to design jobs that involve doing a whole piece of work and that are challenging but ultimately doable for the employee. Job design also takes into account issues of health and safety of the worker. When planning jobs or assigning people to jobs, HR managers also consider training (ensuring that employees to have the knowledge and skills to perform all parts of their job) and giving them the authority and accountability to do so.Edward E. Lawler III, *The Ultimate Advantage* (San Francisco: Jossey-Bass, 1992).

One company that does training right is Motorola. As a global company, Motorola operates in many countries, including China. Operating in China presents particular challenges in terms of finding and hiring skilled employees. In a recent survey conducted by the American Chamber of Commerce in Shanghai, 37 percent of US-owned enterprises operating in China said that recruiting skilled employees was their biggest operational problem.Kevin Lane and Florian Pollner, "How to Address China's Growing Talent Shortage," *McKinsey Quarterly*, no. 3 (2008), accessed March 10, 2011, www.mckinseyquarterly.com/How_to_address_Chinas_growing_talent_shortage_2156. Indeed, polled companies cited HRM as a problem more often than they cited regulatory concerns, bureaucracy, or infringement on intellectual property rights. This is because Chinese universities don't turn out candidates with the skills that multinational companies need. As a result, Motorola has created its own training and development programs to bridge the gap. For example, Motorola's China Accelerated Management Program is designed for local managers. Motorola's Management Foundation program helps train managers in areas such as communication and problem solving. Finally, Motorola offers a high-tech MBA program in partnership with Arizona State University and Tsinghua University, so that top employees can earn an MBA in-house.Kevin Lane and Florian Pollner, "How to Address China's Growing Talent Shortage," *McKinsey Quarterly*, no. 3 (2008), accessed March 10, 2011, www.mckinseyquarterly.com/How_to_address_Chinas_growing_talent_shortage_2156. Such programs are tailor-made to the minimally skilled—but highly motivated—Chinese employees.

Figure 12.2 W. P. Carey and Motorola China High Technology MBA Program Graduation Ceremony

Source: W. P. Carey School of Business MBA China Programs.

Compensation and Rewards

The SHRM function also includes evaluating and paying people on the basis of their performance—not simply for showing up to the job. Firms must offer rewards for skill development and organizational performance, emphasizing teamwork, collaboration, and responsibility for performance. Good compensation systems include incentives, gainsharing, profit sharing, and skill-based pay that rewards employees who learn new skills and put those skills to work for the organization. Employees who are trained in problem solving and a broad range of skills are more likely to grow on the job and feel more satisfaction. Their training enables them to make more valuable contributions to the company, which, in turn, gains them higher rewards and greater commitment to the company.William F. Barnes, "The Challenge of Implementing and Sustaining High Performance Work Systems in the United States: An Evolutionary Analysis of I/N Tek and Kote" (PhD diss., University of Notre Dame, 2001). Likewise, the company benefits from employees' increased flexibility, productivity, and commitment.

When employees have access to information and the authority to act on that information, they're more involved in their jobs, more likely to make the right decision, and more inclined to take the necessary actions to further the organization's goals. Similarly, rewards need to be linked to performance so that employees are naturally inclined to pursue outcomes that will earn rewards and further the organization's success at the same time.Mason Carpenter, Talya Bauer, and Berrin Erdogan, *Principles of Management* (Nyack, NY: Unnamed Publisher, 2009), accessed January 5, 2011, www.gone.2012books.lardbucket.org/printed-book/127834.

Diversity Management

Another key to successful SHRM in today's business environment is embracing diversity. In past decades, "diversity" meant avoiding discrimination against women and minorities in hiring. Today, diversity goes far beyond this limited definition; diversity management involves actively appreciating and using the differing perspectives and ideas that individuals bring to the workplace. Diversity is an invaluable contributor to innovation and problem-solving success. As James Surowiecki shows in *The Wisdom of Crowds*, the more diverse the group in terms of expertise, gender, age, and background, the more ability the group has to avoid the problems of groupthink.James Surowiecki, *The Wisdom of Crowds* (New York: Anchor Books, 2005). Diversity helps company teams to come up with more creative and effective solutions. Teams whose members have complementary skills are often more successful because members can see one another's blind spots. Diverse people will probably make different kinds of errors, which also means that they'll be more likely to catch and correct each other's mistakes.

KEY TAKEAWAYS

- HRM is becoming increasingly important in organizations because today's knowledge economy requires employees to contribute ideas and be engaged in executing the company's strategy.
- HRM is becoming a strategic partner by identifying the skills that employees need and then providing employees with the training and structures needed to develop and deploy those competencies.
- All the elements of HRM—selection, placement, job design, and compensation—need to be aligned with the company's strategy so that the right employees are hired for the right jobs and rewarded properly for their contributions to furthering the company's goals.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What are the advantages of the new SHRM approach?
2. Name three elements of HRM.
3. What must HRM do to be a true strategic partner of the company?
4. What benefits does a diverse workforce provide the company?
5. If you were an HR manager, what steps would you take to minimize the outsourcing of jobs in your department?

6.47: The Global War for Talent

Learning Objectives

1. Define talent management.
2. Discover how to attract the right workers to your organization.
3. Understand the benefits of good talent management.

What Talent Management Means

You have likely heard the phrase "the **war for talent**," which reflects competition among organizations to attract and retain the most able employees. For years, agencies that track demographic trends have been warning that the US workforce will shrink in the second and third decades of the twenty-first century as the baby boom generation (those born between 1945 and 1961) reaches retirement age. According to one source, there will be 11.5 million more jobs than workers in the United States by 2010."Extreme Talent Shortage Makes Competition Fierce for Key Jobs and Highlights Needs for Leadership Development," *Business Wire*, November 26, 2007, 27. Even though many boomers say they want (or have) to continue working past the traditional age of retirement, those who do retire or who leave decades-long careers to pursue "something I've always wanted to do" will force employers to scramble to replace well-trained, experienced workers. As workers compete for the most desirable jobs, employers will have to compete even more fiercely to find the right talent.

Peter Cappelli of the Wharton School defines **talent management** as anticipating the need for human capital and setting a plan to meet it. Talent management goes hand in hand with **succession planning**, which refers to the process of recruiting and developing employees to ensure that the key roles in the company are filled.Peter Cappelli, "Talent Management for the Twenty-First Century," *Harvard Business Review* 86, no. 3 (March 2008): 74–81. Most companies, unfortunately, don't plan ahead for the talent they need, which means that they face shortages of critical skills at some times and surpluses at other times. Other companies use outdated methods of succession planning that don't accurately forecast the skills they'll need in the future.

Interestingly, however, techniques that were developed to achieve productivity breakthroughs in manufacturing can be applied to talent management. For example, it's expensive to develop all talent internally; training people takes a long time and requires accurate predictions about which skills will be needed. Such predictions are increasingly difficult to make in our uncertain world. Therefore, rather than developing everyone internally, companies can hire from the outside when they need to tap specific skills. In manufacturing, this principle is known as "make or buy." In human resources management (HRM), the solution is to make *and* buy—that is, to train some people and to hire others from the external marketplace. In this case, "making" an employee means hiring a person who doesn't yet have all the needed skills to fulfill the role but who can be trained to develop them. The key to a successful "make" decision is to distinguish between the high-potential employees who don't yet have the skills but who can learn them, from the mediocre employees who merely lack the skills. The "buy" decision means hiring an employee who has all the necessary skills and experience to fulfill the role from day one. The buy decision is useful when it's too difficult to predict exactly which skills will be needed in the future.Patricia M. Buhler, "Managing in the New Millennium; Succession Planning: Not Just for the C Suite," *Supervision* 69, no. 3 (2008): 19–23.

Ethics in Action

One month after launching in Kenya, start-up txteagle became one of the country's largest employers with a workforce of 10,000 Kenyans.Kate Greene, "Crowd-Sourcing the World," *MIT Tech Review*, January 21, 2009, accessed January 23, 2011, www.technologyreview.com/business/21983. Nathan Eagle founded txteagle in 2008. Txteagle deconstructs work into microtasks that can be performed on any simple mobile phone through texting. For example, one task is to type in local road signs (the data will be used to create a satellite navigation system).Robert Bain, "The Power of Text in the Developing World," *Research*, January 20, 2011, accessed May 17, 2011, http://www.research-live.com/features/the-power-of-text-in-the-developing-world/4004395.article. Txteagle is similar to Amazon's Mechanical Turk (mTurk), which also asks workers to complete microtasks such as clicking on photos that contain a particular object. The difference is that workers for txteagle only need a simple mobile phone—no computer or Internet access is necessary. Txteagle distributes the microtasks to thousands of workers (currently primarily in Africa) who complete them and get paid via the mobile phone either in airtime minutes or in cash through the M-Pesa service.Andrea Meyer, "Workforce Innovation: How Txteagle Distributes Microtasks Worldwide," *Working Knowledge* (blog), January 23, 2011, accessed January 23, 2011, http://workingknowledge.com/blog/?p=1444; Jessica Vaughn, "Q&A: Nathan Eagle, Founder of txteagle," *JWT Intelligence*, March 3, 2010, accessed January 23, 2011, www.jwtintelligence.com/2010/03/qa-nathan-eagle-founder-of-txteagle. “Txteagle is a commercial corporation that enables people to earn small amounts of money on their mobile phones by completing simple tasks for our corporate clients,” says Eagle.Jessica Vaughn, “Q&A: Nathan Eagle, Founder of txteagle,” *JWT Intelligence*, March 3, 2010, accessed January 23, 2011, www.jwtintelligence.com/2010/03/qa-nathan-eagle-founder-of-txteagle.

Txteagle now has partnerships with 220 mobile operators in more than eighty countries.“Mobile Work,” *Economist*, October 28, 2010, accessed January 23, 2011, http://www.economist.com/node/17366137. This expands txteagle ’s reach to 2.1 billion cell phone users in sub-Saharan Africa, Brazil, and India, who can all participate as workers.Txteagle website, accessed January 23, 2011, txteagle.com. Currently, the firm earns revenues in forty-nine countries. Companies like txteagle and mTurk give citizens in poor countries an opportunity to get work. But some Westerners criticize mTurk because employers can reject a person’s work without explanation. The pay scale is also very low—about twenty-four cents an hour, which makes some critics call mTurk a “digital sweatshop.”Bryan Walsh, “Pennies for Your Thoughts,” *Time*, January 31, 2011, accessed January 31, 2011,www.time.com/time/magazine/article/0,9171,2043450,00.html. For workers in developing nations, however, where wages are low and unemployment rates are high, such wages may be better than the alternative of no work.

Another principle from manufacturing that works well in talent management is to run smaller batch sizes.Mason Carpenter, Talya Bauer, and Berrin Erdogan, *Principles of Management* (Nyack, NY: Unnamed Publisher, 2009), accessed January 5, 2011, www.gone.2012books.lardbucket.org/printed-book/127834. That is, rather than sending employees to three-year-long training programs, send them to shorter programs more frequently. With this approach, managers don’t have to make the training decision so far in advance. They can wait to decide exactly which skills employees will learn closer to the time the skill is needed, thereby ensuring that employees are trained on the skills they’ll actually use.

Attracting the Right Workers to the Organization

Winning the war for talent means more than simply attracting workers to your company. It means attracting the *right* workers—the ones who will be enthusiastic about their work. Enthusiasm for the job requires more than having a good attitude about receiving good pay and benefits—it means that an employee’s goals and aspirations also match those of the company. Therefore, it’s important to identify employees’ preferences and mutually assess how well they align with the company’s strategy. To do this, the organization must first be clear about the type of employee it wants. Companies already do this with customers—marketing executives identify specific segments of the universe of buyers to target for selling products. Red Bull, for example, targets college-age consumers, whereas Slim Fast goes for adults of all ages who are overweight. Both companies are selling beverages but to completely different consumer segments. Similarly, companies need to develop a profile of the type of workers they want to attract. Do you want entrepreneurial types who seek autonomy and continual learning, or do you want team players who enjoy collaboration, stability, and structure? Neither employee type is inherently “better,” but an employee who craves autonomy may feel constrained within the very same environment in which a team player would thrive.

As stated earlier, it’s important to “mutually assess” how well employees’ preferences align with the company’s strategy. Half of “mutual” refers to the company, but the other half refers to the job candidate. Potential employees need to know whether they’ll fit into the company well. One way to help prospective hires make this determination is to describe to them the “signature experience” that sets your company apart. As Tamara Erickson and Lynda Gratton define it, your company’s signature experience is the distinctive practice that shows what it’s really like to work at your company.Tamara J. Erickson and Lynda Gratton, “What It Means to Work Here,” *Harvard Business Review* 85, no. 3 (2007): 23–29.

Here are the signature experiences of two companies—Whole Foods Market and Goldman Sachs. At Whole Foods, team-based hiring is a signature experience—employees in each department vote on whether a new employee will be retained after a four-week trial period. This demonstrates to potential hires that Whole Foods is all about collaboration. In contrast, Goldman Sachs’s signature experience is multiple one-on-one interviews. The story often told to prospective hires is of the MBA student who went through sixty interviews before being hired. This story signals to new hires that they need to be comfortable meeting endless numbers of new people and building networks across the company. Those who enjoy meeting and being interviewed by so many diverse people are exactly the ones who will fit into Goldman’s culture.

The added benefit of hiring workers who match your organizational culture and are engaged in their work is that they will be less likely to leave your company just to get a higher salary.

Keeping Star Employees

The war for talent stems from the approaching shortage of workers. As mentioned earlier in this chapter, the millions of baby boomers reaching retirement age are leaving a gap in the US workforce. What's more, workers are job-hopping more frequently than in the past. According to the US Bureau of Labor Statistics, the average job tenure has dropped from fifteen years in 1980 to four years in 2007. As a manager, therefore, you need to give your employees reasons to stay with your company. One way to do this is to spend time talking with employees about their career goals. Listen to their likes and dislikes so that you can help them fully utilize the skills they like using or develop the new ones they wish to acquire.Beverly Kaye, *Love 'Em or Lose 'Em* (San Francisco: Barrett-Koehler, 2008).

Don't be afraid to "grow" your employees. Some managers want to keep their employees in their department. They fear that helping employees grow on the job will mean that employees will outgrow their jobs and leave.Anne Field and Ken Gordon, "Do Your Stars See a Reason to Stay?," *Harvard Management Update* 13, no. 6 (2008), hbr.org/product/do-your-stars-see-a-reason-to-stay/an/U0806A-PDF-ENG. However, keeping your employees down is a sure way to lose them. What's more, if you help your employees advance, it'll be easier for you to move up, because your employees will be better able to take on the role you leave behind.

In some cases, your employees may not be sure what career path they want. As a manager, you can help them identify their goals by asking questions such as the following:

- What assignments have you found most engaging?
- Which of your accomplishments in the last six months made you proudest?
- What makes for a great day at work?Timothy Butler, *Getting Unstuck* (Boston: Harvard Business School Press, 2007).

What Employees Want

Employees want to grow and develop, stretching their capabilities. They want projects that engage their heads as well as their hearts, and they want to connect with the people and things that will help them achieve their professional goals.Deloitte Research, *It's 2008: Do You Know Where Your Talent Is? Why Acquisition and Retention Strategies Don't Work* (Geneva, Switzerland: Deloitte Research Report, 2007), accessed May 10, 2011, www.deloitte.com/assets/Dcom-Venezuela/Local%20Assets/Documents/VE_Consulting_HC_connect_talentmgmt_Feb07.pdf. Here are two ways to provide this to your employees: First, connect people with mentors and help them build their networks. Research suggests that successful managers dedicate 70 percent more time to networking activities and 10 percent more time to communication than their less successful counterparts.Fred Luthans, Richard M. Yodgetts, and Stuart A. Rosenkrantz, *Real Managers* (Cambridge, MA: Ballinger, 1988). What makes networks special? Through networks, people energize one another as well as learn, create, and find new opportunities for growth. Second, help connect people with a sense of purpose. Focusing on the need for purpose is especially important for younger workers, who rank meaningful work and challenging experiences at the top of their job-search lists.Peter Sheahan, *Generation Y: Thriving (and Surviving) with Generation Y at Work* (Victoria, Australia: Hardie Grant Books, 2006).

Benefits of Good Talent Management

Global consulting firm McKinsey & Company conducted a study to identify a possible link between a company's financial performance and its success in managing talent. The survey results, reported in May 2008, show that there was indeed a relationship between a firm's financial performance and its global talent-management practices. Three talent-management practices, in particular, correlated highly with exceptional financial performance:

- Creating globally consistent talent-evaluation processes
- Achieving cultural diversity in a global setting
- Developing and managing global leaders"McKinsey Global-Talent-Management Survey of Over 450 Executives," December 2007, as cited in Matthew Guthridge and Asmus B. Komm, "Why Multinationals Struggle to Manage Talent," *McKinsey Quarterly*, May 2008, 19–25, accessed January 30, 2009, www.mckinseyquarterly.com/article_print.aspx?L2=18&L3=31&ar=2140.

The McKinsey survey found that companies achieving scores in the top third of any of these areas had a 70 percent chance of achieving financial performance in the top third of all companies.Matthew Guthridge and Asmus B. Komm, "Why Multinationals Struggle to Manage Talent," *McKinsey Quarterly*, May 2008, 19–25.

Let’s take a closer look at what each of these three best practices entail. First, having consistent talent evaluation means that employees around the world are evaluated on the same standards. This is important because it means that if an employee from one country transfers to another, his or her manager can be assured that the employee has been held to the same level of skills and standards. Second, having cultural diversity means having employees who learn something about the culture of different countries, not just acquire language skills. This helps bring about open-mindedness across cultures. Finally, developing global leaders means rotating employees through different cultures, giving them international experience. Companies that do this best also have policies of giving managers incentives to share their employees with other units.

KEY TAKEAWAYS

- The coming shortage of workers makes it imperative for managers to find, hire, retain, and develop their employees.
- Managers first need to define the skills that the company will need for the future. Then they can “make or buy”—that is, train or hire—employees with the needed skills.
- Retaining these employees requires engaging them on the job. Good talent-management practices translate into improved financial performance for the company as a whole.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. How might a manager go about identifying the skills that the company will need in the future?
2. Describe the “make or buy” option and how it can be applied to human resources management.
3. How would you go about attracting and recruiting talented workers to your organization? Suggest ideas you would use to retain stars and keep them happy in their jobs.
4. What skills might an organization like a bank need from its employees?

6.48: Effective Selection and Placement Strategies

Learning Objectives

1. Identify why a good job description benefits both the employer and the applicant.
2. Learn how company culture can be used in selecting new employees.
3. Know the advantages and disadvantages of personnel testing.
4. Recognize some of the considerations in international staffing and placement.

Job-Description Best Practices

Selecting the right employees and placing them in the right positions within the company is a key human resources management (HRM) function and is vital to a company's success. Companies should devote as much care and attention to this "soft" issue as they do to financial planning, because errors will have a financial impact and adverse effects on a company's strategy.

Let's use a hypothetical example of Walt, a manager in a midsize company who considers himself fortunate that the organizational chart allows him to have a full-time administrative assistant (AA) who reports to him. In the two years Walt has been in his job, however, five people have held this AA job. The most recent AA, who resigned after four weeks, told Walt that she hadn't known what the job would involve. "I don't do numbers; I'm not an accountant," she said. "If you want someone to add up figures and do calculations all day, you should say so in the job description. Besides, I didn't realize how long and stressful my commute would be —the traffic between here and my house is murder!"

Taken aback, Walt contacted the company's HRM department to clarify the job description for the AA position. What he learned was that the description made available to applicants was, indeed, inadequate in a number of ways, which resulted in frequent turnover that was draining Walt's company of resources that could be used for much more constructive purposes.

An accurate and complete job description is a powerful strategic human resources management (SHRM) tool that costs little to produce and can save a bundle in reduced turnover. While the realistic description may discourage some applicants (e.g., those who lack an affinity for calculations might not bother to apply for Walt's AA position), those who follow through with the application process are much more likely to be satisfied with the job once hired. In addition to summarizing what the worker will actually be doing all day, here are some other suggestions for writing an effective job description:Mason Carpenter, Talya Bauer, and Berrin Erdogan, *Principles of Management* (Nyack, NY: Unnamed Publisher, 2009), accessed January 5, 2011, www.gone.2012books.lardbucket.org/printed-book/127834.

- List the job requirements in bullet form, so that job seekers can scan the posting quickly.
- Use common industry terms, which speak to knowledgeable job seekers.
- Avoid organization-specific terms and acronyms, which would confuse job seekers.
- Use meaningful job titles (not the internal job codes of the organization).
- Use key words taken from the list of common search terms (to maximize the chance that a job posting appears on a job seeker's search).
- Include information about the organization, such as a short summary and links to more detailed information.
- Highlight special intangibles and unusual benefits of the job and workplace (e.g., flextime or travel).
- Specify the job's location (and nearest large city) and provide links to local community pages (to entice job seekers with quality-of-life information).

Tailoring Recruitment to Match Company Culture

Managers who hire well don't just hire for skills or academic background; they ask about the potential employee's philosophy on life or how the candidate likes to spend free time. These questions help the manager assess whether the cultural fit is right. A company in which all work is done in teams needs team players, not just "A" students. Ask questions such as "Do you have a personal mission statement? If not, what would it be if you wrote one today?" to identify a potential hire's preferences. Jeffrey Pfeffer, *The Human Equation: Building Profits by Putting People First* (Boston: Harvard Business School Press, 1998).

At Google, for example, job candidates are asked questions such as "If you could change the world using Google's resources, what would you build?"Chuck Slater, "The Faces and Voices of Google," *Fast Company*, March 2008, 37–45. Google wants employees who will think and act on a grand scale—employees who will take on the challenges of their jobs, whatever their jobs may be. Take Josef DeSimone, Google's executive chef. DeSimone, who's worked everywhere from family-style restaurants to Michelin-caliber ones, was amazed to learn that Google had seventeen cafes for its employees. “Nobody changes the menu daily on this scale,” he says. “It’s unheard of.” When he was hired, DeSimone realized, “Wow, you hire a guy who’s an expert in food and let him run with it! You don’t get in his way or micromanage?”Chuck Slater, “Josef DeSimone—Executive Chef,” *Fast Company*, February 2008, 46–48. Google applies this approach to all positions; they let employees run with the challenge.

Traditionally, companies have built a competitive advantage by focusing on what they have—structural advantages such as economies of scale, a well-established brand, or dominance in certain market segments. Companies such as Southwest Airlines, by contrast, see its people as their advantage: “Our fares can be matched; our airplanes and routes can be copied. But we pride ourselves on our customer service,” said Sherry Phelps, director of corporate employment. That’s why Southwest looks for candidates who generate enthusiasm; they lean toward extroverted personalities. Southwest hires for attitude. Flight attendants have been known to sing the safety instructions, and pilots tell jokes over the public address system.

Southwest Airlines makes clear right from the start the kind of people it wants to hire. For example, one recruitment ad depicted Southwest cofounder Herb Kelleher dressed as Elvis and read “Work in a Place Where Elvis Has Been Spotted…The qualifications? It helps to be outgoing. Maybe even a bit off-center. And be prepared to stay awhile. After all, we have the lowest employee turnover rate in the industry.” People may scoff or question why Southwest indulges in such showy activities or wonder how an airline can treat its jobs so lightly. Phelps answers, “We do take our work seriously. It’s ourselves that we don’t.” People who don’t have a humane, can-do attitude are fired. Southwest has a probationary period during which it determines the compatibility of new hires with the culture. People may be excellent performers, but if they don’t match the culture, they’re let go. As Kelleher once said, “People will write me and complain, ‘Hey, I got terminated or put on probation for purely subjective reasons.’ And I’ll say, ‘Right! Those are the important reasons.’”Anne Bruce, “Southwest: Back to the FUNdamentals,” *HR Focus* 74, no. 3 (March 1997): 11; Kevin Freiberg and Jackie Freiberg, *Nuts! Southwest Airlines’ Crazy Recipe for Business and Personal Success* (Austin, TX: Bard, 2003); Roger Hallowell, “Southwest Airlines: A Case Study Linking Employee Needs Satisfaction and Organizational Capabilities to Competitive Advantage,” *Human Resource Management* 35, no. 4 (Winter 1996): 513–29; James L. Heskett and Roger Hallowell, “Southwest Airlines: 1993 (A),” Harvard Business School Case 694-023, 1993; “Southwest Airlines’ Herb Kelleher: Unorthodoxy at Work,” *Management Review*, January 1995, 2–9; Polly LaBarre, “Lighten Up! Blurring the Line Between Fun and Work Not Only Humanizes Organizations but Strengthens the Bottom Line,” *Industry Week* 245, no. 3 (February 5, 1996): 53–67; Kenneth Labich, “Is Herb Kelleher America’s Best CEO?,” *Fortune*, May 2, 1994, 44–45; Donald J. McNerney, “Employee Motivation: Creating a Motivated Workforce,” *HR Focus* 73, no. 8 (August 1996): 1; Richard Tomkins, “HR: The Seriously Funny Airline,” *Financial Times*, November 11, 1996, 14.

In many states, employees are covered under what is known as the **at-will employment doctrine**. The at-will employment doctrine defines an employment relationship in which either party can break the relationship with no liability, provided there was no express contract for a definite term governing the employment relationship and that the employer doesn’t belong to a collective bargaining unit (i.e., a union).Mark A. Rothstein, Andria S. Knapp, and Lance Liebman, *Cases and Materials on Employment Law* (New York: Foundation Press, 1987), 738. However, there are legal restrictions on how purely subjective the reasons for firing can be. For instance, if the organization has written hiring and firing procedures and doesn’t follow them in selective cases, then those cases might give rise to claims of wrongful termination. Similarly, in situations where termination is clearly systematic—for example, based on age, race, religion, and so on—wrongful termination can be claimed.

Organized Labor and International Business

Many labor markets around the world have organized labor and labor unions, just as the United States does. Historically, most labor relations departments were decentralized, operating on the individual subsidiary level. With the rise of globalization, however, labor unions are seeing new threats, such as multinational enterprises (MNEs) threatening to move production to another country if the local union is demanding too much.

Because the actions of labor unions can constrain a firm’s ability to pursue an effective global strategy, the firm’s SHRM function must develop policies and practices that maintain harmony and reduce potential conflict between labor and management. Similarly, MNEs evaluate the labor climate when considering entering a new international location. MNEs typically look for labor markets that do not have a history of strife. MNEs may also try to negotiate better terms with a local union in exchange for locating a new facility in the country. To counter this, organized labor has attempted to organize globally, but this has proven to be difficult due to legal and cultural differences among countries.James Heskett, “What’s the Future of Globally Organized Labor?,” *HBS Working Knowledge* (blog), October 3, 2005, accessed January 31, 2011, http://hbswk.hbs.edu/item/5029.html.

Tools and Methods: Interviewing and Testing

To make good selection and placement decisions, a company needs information about the job candidate. Testing and interviewing are two time-tested methods used to get that information.

A detailed interview begins by asking the candidate to describe his work history and then getting as much background on his most recent position (or the position most similar to the open position). Ask about the candidate's responsibilities and major accomplishments. Then, ask in-depth questions about specific job situations. Called **situational interviews**, these types of interviews can focus on past experience or future situations. For example, experienced-based questions draw on the employees past performance. One such question may be "What is a major initiative you developed and the steps you took to get it adopted? Describe a problem you had with someone and how you handled it." In contrast, future-oriented situation interview questions ask candidates to describe how they would handle a future hypothetical situation. An example of this kind of question is "Suppose you came up with a faster way to do a task, but your team was reluctant to make the change. What would you do in that situation?"

In addition to what is asked, it's also important that interviewers understand what they should *not* ask, largely because certain questions lead to answers that may be used to discriminate. There are five particularly sensitive areas. First, the only times you can ask about age are when it is a requirement of a job duty or you need to determine whether a work permit is required. Second, it is rarely appropriate or legal to ask questions regarding race, color, national origin, or gender. Third, although candidates may volunteer religious or sexual orientation information in an interview, you still need to be careful not to discriminate. Ask questions that are relevant to work experience or qualifications. Fourth, firms cannot discriminate for health or disabilities; you may not ask about smoking habits, health-related issues, or disabilities in an interview. Finally, you may not ask questions about marital status, children, personal life, pregnancy, or arrest record. These kinds of questions could be tempting to ask if you're interviewing for a position requiring travel; however, you can only explain the travel requirements and confirm that these requirements are acceptable.

In addition to interviews, many employers use testing to select and place job applicants. Any tests given to candidates must be job related and follow guidelines set forth by the US Equal Employment Opportunity Commission to be legal.Mason Carpenter, Talya Bauer, and Berrin Erdogan, *Principles of Management* (Nyack, NY: Unnamed Publisher, 2009), accessed January 5, 2011, www.gone.2012books.lardbucket.org/printed-book/127834. For the tests to be effective, they should be developed by reputable psychologists and administered by professionally qualified personnel who have had training in occupational testing in an industrial setting. The rationale behind testing is to give the employer more information before making the selection and placement decision—information vital to assessing how well a candidate is suited to a particular job. Most preemployment assessment tests measure thinking styles, behavioral traits, and occupational interests. The results are available almost immediately after a candidate completes the roughly hour-long questionnaire. Thinking-styles tests can tell the potential employer how fast someone can learn new things or how well she can verbally communicate. Behavioral-traits assessments measure energy level, assertiveness, sociability, manageability, and attitude. For example, a high sociability score would be a desirable trait for salespeople.Terri Mrosko, "The Personnel Puzzle: Preemployment Testing Can Help Your Bottom Line," *Inside Business* 8, no. 8 (August 2006): 60–73.

International Staffing and Placement

In our increasingly global economy, managers need to decide between using expatriates or hiring locals when staffing international locations. An **expatriate**, or expat, is a person who is living in a country other than his or her home (native) country. Most expatriates only stay temporarily in the foreign country, planning to return to their home country. Some expatriates, however, never return to their country of citizenship. On the surface, this seems a simple choice between the firm-specific expertise of the expatriate and the cultural knowledge of the local hire. In reality, companies often fail to consider the high probability and high cost of expatriates failing to adapt and perform in their international assignments.

There are four predictors of a manager's ability to succeed as an expatriate:

1. **Self-orientation.** The expatriate has attributes that strengthen his or her self-esteem, self-confidence, and mental well-being.Mark Mendenhall and Gary Oddou, "The Dimensions of Expatriate Acculturation," *Academy of Management Review* 10 (1985): 39–47.
2. **Others orientation.** The expatriate has attributes that enhance his or her ability to interact effectively with host-country nationals (e.g., sociability and openness).Paula M. Caligiuri, "Selecting Expatriates for Personality Characteristics: A Moderating Effect of Personality on the Relationship between Host National Contact and Cross-cultural Adjustment," *Management International Review* 40, no. 1 (2000): 65, accessed January 29, 2011, chrs.rutgers.edu/pub_documents/Paula_21.pdf.

3. **Perceptual ability.** The expatriate has the ability to understand why people of other countries behave the way they do.Mark Mendenhall and Gary Oddou, "The Dimensions of Expatriate Acculturation," *Academy of Management Review* 10 (1985): 39–47.
4. **Cultural toughness.** The expatriate has the ability to adjust to a particular posting given the culture of the assignment's country.J. Stewart Black, Mark Mendenhall, and Gary Oddou, "Toward a Comprehensive Model of International Adjustment: An Integration of Multiple Theoretical Perspectives," *Academy of Management Review* 16, no. 2 (1991): 291–317.

Individuals who are high on all four dimensions are generally better able to cope and thrive with an expat experience. Research also shows that a global mind-set (i.e., having cognitive complexity—the ability to differentiate, articulate, and integrate—and a cosmopolitan outlook) greatly increases the chances that a global manager will be successful in international assignments.Joana S. Story, "Testing the Impact of Global Mindset on Positive Organizational Outcomes: A Multi-Level Analysis" (PhD diss., University of Nebraska at Lincoln, April 2010), accessed January 29, 2011, http://digitalcommons.unl.edu/aglecdiss/4; Mansour Javidan, "Bringing the Global Mindset to Leadership," *Harvard Business Review* (blog), May 19, 2010, accessed January 29, 2011, http://blogs.hbr.org/imagining-the-future-of-leadership/2010/05/bringing-the-global-mindset-to.html. Ironically, however, studies show that most firms select expatriate managers on the basis of technical expertise and do not factor in a global mind-set.

Firms that use expatriates to staff international operations must be aware of and prepare for the possibility of expatriate failure, which means that the expatriate returns to the home country before completing the international assignment. Researchers estimate the expatriate failure rate to be 40 percent to 55 percent.J. Stewart Black, H. B. Gregersen, Mark Mendenhall, and L. K. Stroh, *Globalizing People through International Assignments* (Reading, MA: Addison-Wesley, 1999). For example, cultural issues can easily create misunderstandings between expatriate managers and employees, suppliers, customers, and local government officials. Given the high cost of expatriate failure, international-assignment decisions are often made too lightly in many companies. There are several factors that contribute to expatriate failure in US-headquartered multinational firms:

- The expatriate's spouse is unable to adapt to a foreign culture, or there are other family-related reasons.
- The expatriate is unable to adjust to the new culture or lacks personal or emotional maturity to function well in the new country.
- The expatriate is unable to handle the larger overseas responsibilities.

The challenge is to overcome the natural tendency to hire a well-known, corporate insider over an unknown local at the international site. Here are some indications to consider in determining whether an expatriate or a local hire would be best.

Managers may want to choose an expatriate when the following factors are true:

- Company-specific technology or knowledge is important.
- Confidentiality in the staff position is an issue.
- There is a need for speed (i.e., assigning an expatriate is usually faster than hiring a local).
- Work rules regarding local workers are restrictive.
- The corporate strategy is focused on global integration.

Managers may want to staff the position with a local hire when the following factors are true:

- The need to interact with local customers, suppliers, employees, or officials is paramount.
- The corporate strategy is focused on multidomestic or market-oriented operations.
- Cost is an issue (i.e., expatriates often bring high relocation/travel costs).
- Immigration rules regarding foreign workers are restrictive.
- There are large cultural distances between the host country and candidate expatriates.Rebecca E. Weems, "Ethnocentric Staffing and International Assignments: A Transaction Cost Theory Approach" (presentation, Academy of Management Conference, San Diego, CA, August 9–12, 1998).

KEY TAKEAWAYS

- Effective selection and placement means finding and hiring the right employees for your organization and then putting them into the jobs for which they are best suited. Providing an accurate and complete job description is a key step in the selection process.
- An important determination is whether the candidate's personality is a good fit for the company's culture. Interviewing is a common selection method. Situational interviews ask candidates to describe how they handled specific situations in the past (experience-based situational interviews) and how they would handle hypothetical questions in the future (future-oriented situational interviews). Other selection tools include cognitive tests, personality inventories, and behavioral-traits assessments. Specific personalities may be best suited for positions that require sales, teamwork, or entrepreneurship, respectively.

- In our increasingly global economy, managers need to decide between using expatriates and hiring locals when staffing international locations.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What kind of information would you include in a job description?
2. Do you think it is important to hire employees who fit into the company culture? Why or why not?
3. List questions that you would ask in a future-oriented situational interview.
4. What requirements must personnel tests meet?
5. If you were hiring to fill a position overseas, how would you go about selecting the best candidate?

6.49: The Roles of Pay Structure and Pay for Performance

Learning Objectives

1. Explain the factors to be considered when setting pay levels.
2. Understand the value of pay for performance plans.
3. Discuss the challenges of individual versus team-based pay.

Compensation Design Issues for Global Firms

Pay can be thought of in terms of the "total reward" that includes an individual's base salary, variable pay, share ownership, and other benefits. A **bonus**, for example, is a form of variable pay. A bonus is a one-time cash payment, often awarded for exceptional performance. Providing employees with an annual statement of all the benefits they receive can help them understand the full value of what they are getting.Inez Anderson, "Human Resources: War or Revolution?," *Mondaq Business Briefing*, August 1, 2007.

There are five areas that global firms must manage when designing their compensation strategy. The first involves setting up a worldwide compensation system. What this means is that the firm is coordinating each country's compensation in such a way that the overall collection of countries operates as a system. Management, for instance, will have decided which features of the system to standardize and which ones to adapt to local customs, cultures, and practices. The second part of the strategy involves decisions about how to compensate third-country nationals. A **third-country national (TCN)** is an individual who is a citizen of neither the United States nor the host country and who is hired by the US government or a government-sanctioned contractor to perform work in the host country. TCNs most often perform work on government contracts in the role of a private military contractor. The term can also be applied to foreign workers employed in private industry in the Arab Gulf region (e.g., Kuwait, Qatar, and Saudi Arabia), in which it's common to outsource work to noncitizens.

The last three areas of compensation strategy relate to questions about international benefits and related taxes, pension plans, and stock-ownership plans. With expatriates, for instance, pay is but a small percentage of total compensation. A typical expatriate package will include the following:Carly Chynoweth, "King of the Expat Package," *Times* (London), March 14, 2010, accessed July 26, 2010, http://business.timesonline.co.uk/tol/business/career_and_jobs/senior_executive/article7060648.ece.

- A cost-of-living allowance to protect the employee's purchasing power (the goal is equalization, not a bonus)
- A mobility premium of 5 percent to 15 percent of gross salary
- A hardship allowance of up to 30 percent for employees moving to difficult areas
- Reasonable costs for moving furniture
- Schooling costs for children between four and eighteen years of age
- Family support to cover language and cultural training and help for the spouse to find work
- A one-off payment, usually of one month's salary, to cover miscellaneous expenses

Did You Know?

As firms enter emerging markets to take advantage of the tremendous growth opportunities there, they are finding that they need to develop in-country talent rather than just send expatriates. The knowledge that in-country managers have of the local culture and the sheer numbers of employees that will be needed to staff local operations drive managers to hire locally. Senior HR professionals need to ask themselves the following questions:

- How many of our current executives live in the countries where we do business?
- Is the number of native executives proportional to the revenue of those countries?
- How many of our senior executive team are from countries where we are experiencing growth?

It takes time to build talent in emerging markets, where the talent pool may be less experienced, so HR managers need to plan ahead.

Pay System Elements

As summarized in Table 12.1, pay can take the form of direct or indirect compensation. Nonmonetary pay can include any benefit an employee receives from an employer or job that doesn't involve tangible value. This includes career and social rewards—job security, flexible hours, opportunities for growth, praise and recognition, task enjoyment, and friendships. Direct pay is an employee's base wage. It can be an annual salary, hourly wage, or any performance-based pay that an employee receives, such as profit-sharing bonuses.

Table 12.1 Elements of a Pay System

Nonmonetary pay	Benefits that don't involve tangible value
Direct pay	Employee's base wage
Indirect pay	Everything from legally required programs to health insurance, retirement, housing, etc.
Basic pay	Cash wages paid to the employee. Because paying a wage is a standard practice, the competitive advantage can only come by paying a higher amount.
Incentive pay	A bonus paid when specified performance objectives are met. May inspire employees to set and achieve a higher performance level and is an excellent motivator to accomplish firm goals.
Stock options	A right to buy a piece of the business that may be given to an employee to reward excellent service. An employee who owns a share of the business is far more likely to go the extra mile for the operation.
Bonuses	Gifts given occasionally to reward exceptional performance or for special occasions. Bonuses can show that an employer appreciates its employees and ensures that good performance or special events are rewarded.

Source: Mason Carpenter, Talya Bauer, and Berrin Erdogan, *Principles of Management* (Nyack, NY: Unnamed Publisher, 2009), accessed January 5, 2011, www.gone.2012books.lardbucket.org/printed-book/127834.

Indirect compensation is far more varied, including everything from social security and health insurance to retirement programs, paid leave, child care, and housing. US law requires some indirect-compensation elements (e.g., social security, unemployment, and disability payments). Other indirect elements are up to the employer and can serve as excellent ways to provide benefits to both the employees and the employer. For example, a working parent may take a lower-paying job with flexible hours that will allow him to be home when the children get home from school. A recent graduate may be looking for stable work and an affordable place to live. Both of these individuals have different needs and, therefore, would appreciate different compensation elements.

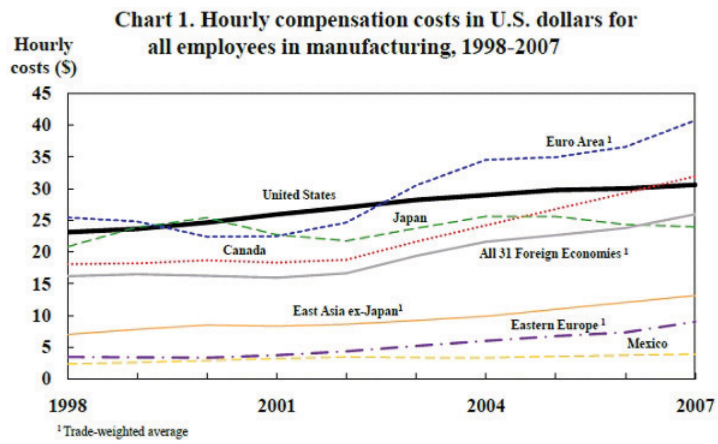
Setting Pay Levels

When setting pay levels for positions, managers should make sure that the pay level is fair relative to what other employees in the position are being paid. Part of the pay level is determined by similar pay levels at other companies. If your company pays substantially less than others, it's going to be the last choice of employment—unless it offers something overwhelmingly positive to offset the low pay, such as flexible hours or a fun, congenial work atmosphere. Besides these external factors, companies conduct a **job evaluation** to determine the internal value of the job—the more vital the job to the company's success, the higher the pay level. Jobs are often ranked alphabetically—"A" positions are those on which the company's value depends; "B" positions are somewhat less important in that they don't deliver as much upside to the company; and "C" positions are those of least importance—in some cases, these are outsourced.

The most vital jobs to one company's success may not be the same in other companies. For example, information technology companies may put top priority on their software developers and programmers, whereas retailers such as Nordstrom would consider the frontline employees who provide personalized service as the "A" positions. For an airline, pilots would be a "B" job because, although they need to be well trained, investing further in their training is unlikely to increase the airline's profits. "C" positions for a retailer might include back-office bill processing, while an information technology company might classify customer service as a "C" job.

When setting reward systems, it's important to pay for what the company actually hopes to achieve. Steve Kerr, a senior advisor and former chief learning officer at Goldman Sachs, talks about the common mistakes that companies make with their reward systems, such as saying they value teamwork but only rewarding individual effort. Similarly, companies say they want innovative thinking or risk taking, but they reward people who "make the numbers."Steven Kerr, "On the Folly of Rewarding for A, While Hoping for B," *Academy of Management Executive* 9, no. 1 (1995): 25–37. If companies truly want to achieve what they hope for, they need payment systems aligned with their goals. For example, if retention of star employees is important to your company, reward managers who retain top talent. At PepsiCo, for instance, a third of a manager's bonus is tied directly to how well the manager did at developing and retaining employees. Tying compensation to retention makes managers accountable.Anne Field and Ken Gordon, "Do Your Stars See a Reason to Stay?," *Harvard Management Update* 13, no. 6 (2008): 5–6.

As you can imagine, one of the reasons that firms seek workers in other countries is to take advantage of the low relative cost of labor. As shown in the following figure, the most recent US Bureau of Labor Statistics data show that the United States is among the costliest countries for manufacturing employees, exceeded only by Canada and countries in the Euro Area (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Slovakia, and Spain).



Source: US Bureau of Labor Statistics, "International Comparisons of Hourly Compensation Costs in Manufacturing, 2009," news release, March 8, 2011, accessed June 3, 2011, www.bls.gov/news.release/pdf/ichcc.pdf.

It's important to point out, however, that simply because a company locates an operation in a lower-pay market doesn't necessarily mean that the cost of the operation will be less. For instance, in a 2009 interview Emmanuel Hemmerle, a principal with executive search firm Heidrick & Struggles, noted,

There's a wrong assumption with regard to China. Headquarters in Japan, in Europe, in the US tend to believe that China, because it's low cost, should be cheaper in terms of executives' packages. Nothing is more wrong. In fact, if you want to woo top talent, you're going to have to pay the right amounts. Often you end up with packages for similar skill sets, similar responsibility, scope, size, everything…that is higher in China than what would be the case with similar counterparts in Europe and the US. And we spend a lot of time coaching companies, especially those that are headquartered overseas, that they need to invest in talent [in much the same way as they would] invest to create a new research center, to create new production facilities in China. They need to invest in the talent. If you want top talent, you're going to have to pay for it. We're starting to see some interesting trends. We can start seeing a number of top talents who meet the international best standards, who could compete with their peers in the US or in Europe—and I'm talking about in terms of performance, in terms of skill sets. And probably, we're going to start seeing more and more of that…I believe that it makes less and less sense to have Westerners, or [expatriates], let's say, who are compensated twice or three times as much as the local mainland Chinese, while performance is equivalent or sometimes even lower. That will create issues, very serious issues, in your organization. I'm always concerned and worried when a company tells me that they want to localize because they want to drive down costs. There's a host of reasons that are better reasons than just cost.Clay Chandler, "Winning the Talent War in China," *McKinsey Quarterly*, November 2009, accessed July 26, 2010, www.mckinseyquarterly.com/Organization/Talent/Winning_the_talent_war_in_China_2472.

As the Heidrick & Struggles example suggests, it's often a dilemma whether a multinational company should localize or globalize its compensation for the local managers. If they pay them on the basis of global standards, a higher cost will emerge. If not, it will be difficult to retain them. Pay inequity will often lead to a sense of unfairness. You can imagine a local manager asking herself, "Why should I get two or three times less pay even when I deliver a better performance than the expatriates?"

Pay for Performance

As its name implies, **pay for performance** ties pay directly to an individual's performance in meeting specific business goals or objectives. Managers (often together with the employees themselves) design performance targets to which the employees will be held accountable. The targets have accompanying metrics that enable employees and managers to track performance. The metrics can be financial indicators, or they can be indirect indicators such as customer satisfaction or speed of development. Pay-for-performance schemes often combine a fixed base salary with a variable pay component (e.g., bonuses or stock options) that varies with the individual's performance.

Innovative Employee-Recognition Programs

In addition to regular pay structures and systems, companies often create special programs that reward exceptional employee performance. For example, the financial software company Intuit instituted a program called Spotlight. The purpose of Spotlight is to "spotlight performance, innovation and service dedication."David Hoyt, "'Spotlight' Global Strategic Recognition Program," Stanford Graduate School of Business Case Study, accessed January 30, 2009, globoblog.globoforce.com/our-customers/case-studies/intuit.html?KeepThis=true. Unlike regular salaries or year-end bonuses, Spotlight awards can be given on the spot for specific behavior that meets the reward criteria, such as filing a patent, inventing a new product, or meeting a milestone for years of service. Rewards can be cash awards of $500 to $3,000 and can be made by managers without high-level approval. In addition to cash and noncash awards, two Intuit awards feature a trip with $500 in spending money.Eric Mosley, "Intuit Spotlights Strategic Importance of Global Employee Recognition," *Global Trends in Human Resource Management* (blog), August 15, 2008, accessed January 30, 2009, http://howtomanagehumanresources.blogspot.com/2008/08/intuit-spotlights-strategic-importance.html.

Pay Structures for Groups and Teams

So far, we have discussed pay in terms of individual compensation, but many employers also use compensation systems that reward all the organization's employees as a group or various groups and teams within the organization. Let's examine some of these less-traditional pay structures.

Gainsharing

Sometimes called profit sharing, **gainsharing** is a form of pay for performance. In gainsharing, the organization shares the financial gains with employees. Employees receive a portion of the profit achieved from their efforts. How much they receive is determined by their performance against the plan. Here's how gainsharing works: First, the organization must measure the historical (baseline) performance. Then, if employees help improve the organization's performance on those measures, they share in the financial rewards achieved. This sharing is typically determined by a formula.

The effectiveness of a gainsharing plan depends on employees seeing a relationship between what they do and how well the organization performs. The larger the organization, the harder it is for employees to see the effects of their work. Therefore, gainsharing plans are more effective in companies with fewer than 1,000 people.Edward E. Lawler III, *The Ultimate Advantage* (San Francisco: Jossey-Bass, 1992). Gainsharing success also requires the company to have good performance metrics in place so that employees can track their process. The gainsharing plan can only be successful if employees believe and see that if they perform better, they will be paid more. The pay should be given as soon as possible after the performance so that the tie between the two is established.

When designing systems to measure performance, realize that performance appraisals need to focus on quantifiable measures. Designing these measures with input from the employees helps make the measures clear and understandable to employees and increases their gainsharing buy-in.

Team-Based Pay

Many managers seek to build teams but face the question of how to motivate all the members to achieve the team's goals. As a result, team-based pay is becoming increasingly accepted. In 1992, only 3 percent of companies had team-based pay.Thomas Flannery, *People, Performance, and Pay* (New York: Free Press, 1996), 117. By 1999, 80 percent of companies had team-based pay.Charlotte Garvey, "Steer Teams with the Right Pay," *HR Magazine*, May 2002, accessed January 30, 2011, findarticles.com/p/articles/mi_m3495/is_5_47/ai_86053654/?tag=untagged. With increasing acceptance and adoption comes different choices and options of how to structure team-based pay. One way is to first identify the type of team you have—parallel, work, project, or partnership—and then choose the pay option that's most appropriate.

Parallel teams are teams that exist alongside (parallel to) an individual's daily team. For example, a person may be working in the accounting department but may also be asked to join a team on productivity. Parallel teams usually meet on a part-time rather than a full-time basis and are often interdepartmental and formed to deal with a specific issue. The reward for performance on this team would typically be a merit increase or a recognition award (cash or noncash) for performance on the team.

A *project team* is another temporary team, but it meets full-time for the life of the project. For example, a team may be formed to develop a new product and then disband when the new product is completed. The pay schemes appropriate for this team include profit sharing, recognition rewards, and stock options. Team members may be asked to evaluate each other's performance.

A *partnership team* is formed around a joint venture or strategic alliance. Profit sharing in the venture is the most common pay structure.

Finally, with the *work team*, all individuals work together daily to accomplish their jobs. Skill-based pay and gainsharing are the payment schemes of choice, with team members evaluating one another's performance.

Pay Systems that Reward Both Team and Individual Performance

There are two main theories of how to reward employees. Nancy Katz characterized the theories as two opposing camps. The first camp advocates rewarding individual performance, through plans such as commissions-sales schemes and merit-based pay. The claim is that this will increase employees' energy, drive, willingness to take risks, and task identification. The disadvantages of rewarding individual performance are that employees will cooperate less, that high performers may be resented by others in the corporation, and that low performers may try to undermine top performers.Nancy. R. Katz, "Promoting a Healthy Balance Between Individual Achievement and Team Success: The Impact of Hybrid Reward Systems" (presentation, "Do Rewards Make a Difference?," session, Academy of Management Conference, San Diego, CA, August 9–12, 1998).

The second camp believes that organizations should reward team performance, without regard for individual accomplishment. This reward system is thought to bring the advantages of increased helping and cooperation, sharing of information and resources, and mutual respect among employees. The disadvantages of team-based reward schemes are that they create a lack of drive, that low performers become free riders, and that high performers may withdraw or become "tough cops." **Free riders** are individuals who benefit from a the actions of others without contributing or paying their fair share of the costs. The term can apply to individuals who do not do their fair share of work on teams, and it can also apply to firms that benefit from a shared resource but do not pay or contribute to its creation or maintenance.

Katz sought to identify reward schemes that achieve the best of both worlds. These hybrid pay systems would reward individual and team performance and promote excellence at both levels. Katz suggested two possible hybrid reward systems. The first system features a base rate of pay for individual performance that increases when the group reaches a target level of performance. In this reward system, individuals have a clear pay-for-performance incentive, and their rate of pay increases when the group as a whole does well. In the second hybrid, the pay-for-performance rate also increases when a target is reached. Under this reward system, however, every team member must reach a target level of performance before the higher pay rate kicks in. In contrast with the first hybrid, this reward system clearly incentivizes the better performers to aid poorer performers. Only when the poorest performer reaches the target does the higher pay rate kick in.

KEY TAKEAWAYS

- Compensation plans reward employees for contributing to company goals. Pay levels should reflect the value of each type of job to the company's overall success. For some companies, technical jobs are the most vital, whereas for others frontline customer-service positions determine the success of the company against its competitors.
- Companies should identify the types of teams they have—parallel, work, project, or partnership—and then choose the pay options that are most appropriate.
- Pay-for-performance plans tie an individual's pay directly to their ability to meet performance targets. These plans can reward individual performance or team performance—or a combination of the two.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What factors would you consider when setting a pay level for a particular job?
2. What might be the "A" level positions in a bank?
3. If you were running a business, would you implement a pay-for-performance scheme? Why or why not?

4. Describe the difference between a base salary, a bonus, and a gainsharing plan.
5. Discuss the advantages and disadvantages of rewarding individual versus team performance.

6.50: Tying It All Together—Using the HRM Balanced Scorecard to Gauge and Manage Human Capital, Including Your Own

Learning Objectives

1. Describe the Balanced Scorecard method and how it can be applied to HRM.
2. Discuss what is meant by "human capital."
3. Understand why metrics are important to improving company performance.
4. Consider how your human capital might be mapped on an HRM Balanced Scorecard.

Applying the Balanced Scorecard Method to HRM

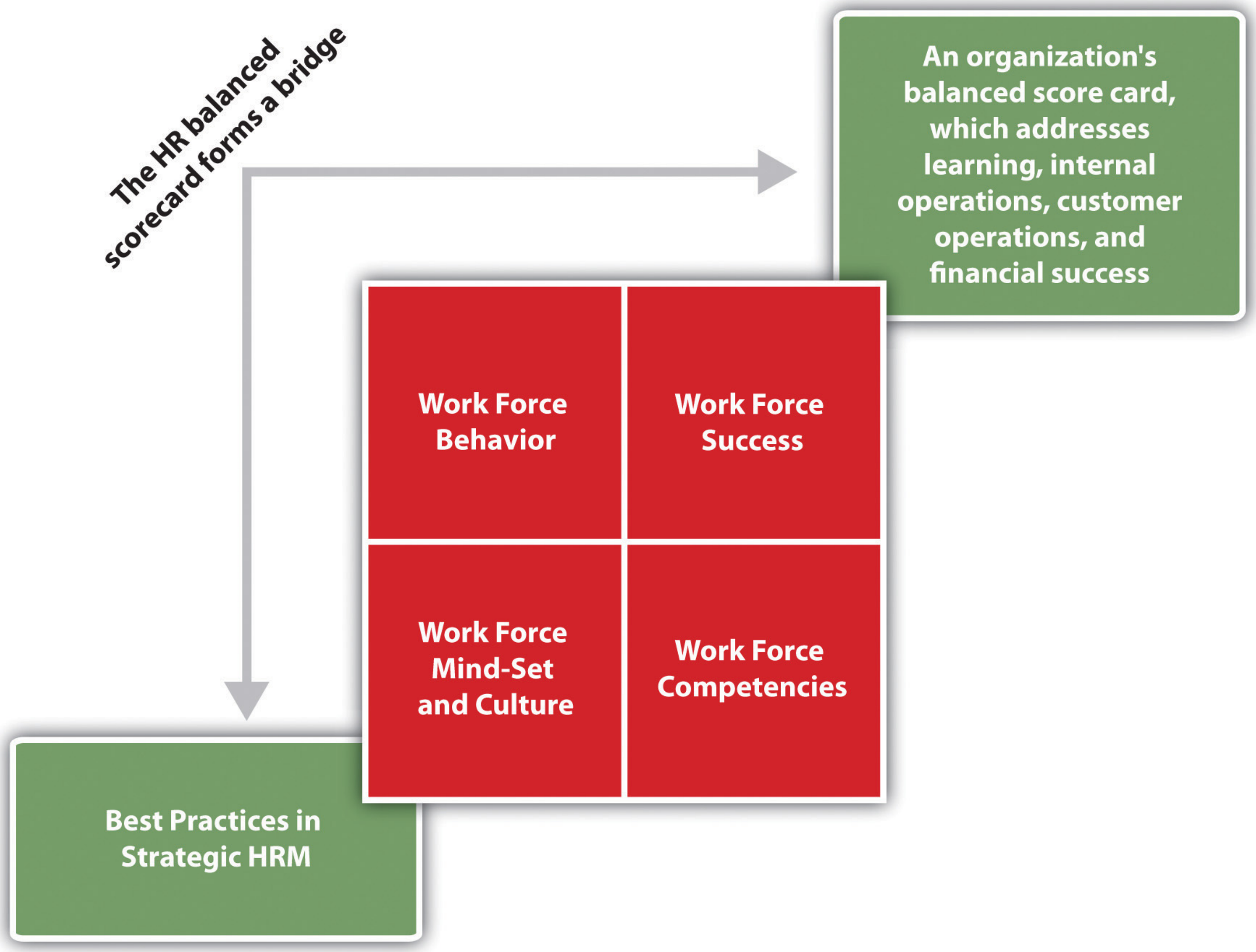
You may already be familiar with the Balanced Scorecard, a tool that helps managers measure what matters to a company. Developed by Robert Kaplan and David Norton, the **Balanced Scorecard** helps managers define the performance categories that relate to the company's strategy. The managers then translate those categories into metrics and track performance on those metrics. Besides traditional financial and quality measures, companies use employee-performance measures to track their employees' knowledge, skills, and contributions to the company.Robert S. Kaplan and David P. Norton, *The Balanced Scorecard* (Boston: Harvard Business School Press, 1996).

The employee-performance aspects of the Balanced Scorecard analyze employee capabilities, satisfaction, retention, and productivity. Companies also track whether employees are motivated (e.g., by tracking the number of suggestions made and implemented by employees) and whether employee performance goals are aligned with company goals.

Applying the Balanced Scorecard Method to HRM

Because the Balanced Scorecard focuses on the strategy and metrics of the business, Mark Huselid and his colleagues took this concept a step further and developed the Workforce Scorecard to provide a framework specific to HRM. According to Huselid, the **Workforce Scorecard** identifies and measures the behaviors, skills, mind-sets, and results required for the workforce to contribute to the company's success. Specifically, as summarized in the following figure, the Workforce Scorecard has four key sequential elements:Mark A. Huselid, Brian E. Becker, and Richard W. Beatty, *The Workforce Scorecard: Managing Human Capital to Execute Strategy* (Boston: Harvard Business School Press, 2005).

1. **Workforce mind-set and culture.** Does the workforce understand the strategy and embrace it? Does the workforce have the culture needed to support strategy execution?
2. **Workforce competencies.** Does the workforce, especially in the strategically important or "A" positions, have the skills it needs to execute the strategy? (Remember that "A" positions are those job categories most vital to the company's success.)
3. **Leadership and workforce behaviors.** Are the leadership team and workforce consistently behaving in ways that will lead to the attainment of the company's key strategic objectives?
4. **Workforce success.** Has the workforce achieved the key strategic objectives for the business? (If the organization can answer yes to the first three elements, then the answer should be yes here as well.)Mark A. Huselid, Brian E. Becker, and Richard W. Beatty, "'A Players' or 'A Positions'? The Strategic Logic of Workforce Management," *Harvard Business Review* 83, no. 12 (December 2005), chrs.rutgers.edu/pub_documents/Huselid-Beatty-Becker%20HBR%20Paper.pdf.



The Workforce Balanced Scorecard bridges HRM best practices and the firm's comprehensive Balanced Scorecard.

Human Capital

Implementing the Workforce Scorecard requires a change in perspective, from seeing people as a cost to seeing people as the company's most important asset to be managed—human capital. As discussed in Section 12.1, human capital is the collective sum of the attributes, life experiences, knowledge, inventiveness, energy, and enthusiasm that a company's employees choose to invest in their work. Such an asset is difficult to measure because it's intangible, and factors like "inventiveness" are subjective and open to interpretation. The challenge for managers, then, is to develop measurement systems that are more rigorous and provide a frame of reference. The metrics can range from activity-based (transactional) metrics to strategic ones. Transactional metrics are the easiest to measure and include counting the number of new people hired, fired, transferred, and promoted. The measures associated with these include the cost of each new hire, the length of time and cost associated with transferring an employee, and so forth. Typical ratios associated with transactional metrics include the training cost factor (i.e., the total training cost divided by the number of employees trained) and training cost percentage (i.e., the total training cost divided by the operating expense).Leslie A. Weatherly, "The Value of People: The Challenges and Opportunities of Human Capital Measurement and Reporting," *SHRM Research Quarterly* 3 (2003): 14–25, accessed February 6, 2011, http://www.shrm.org/Research/Articles/Articles/Documents/0303measurement.pdf. But these transactional measures don't get at the strategic issues—namely, whether the right employees are being trained and whether they're remembering and using what they learned. Measuring training effectiveness requires not only devising metrics but also changing the nature of the training.

Ethics in Action

How to Initiate an Ethics Program

The Balanced Scorecard doesn't explicitly have a facet on global ethics, but that doesn't mean you can't add one. Fostering business-ethics awareness in today's multicultural workplace and global marketplace is only the beginning. The following initiatives can be implemented to your corporate ethics program:

- Uncover or discover what the burning ethical issues are in your organization worldwide. This may involve conducting a broad survey to a cross section of all employees, covering all areas and departments of the organization worldwide.
- Make ethics explicit by developing a clear code of conduct that is based on values and that deals directly and cross-culturally with issues. Once articulated, the challenge is to communicate and inculcate this explicit code throughout the organization.
- Provide opportunities to learn about ethical dilemmas and how to resolve them. Practice doing so in nonthreatening, experiential ways, such as through simulation training or case studies. This might involve creating an ethics program built around the organization's explicit code of conduct.
- Network with others in your industry and with ethics personnel from other organizations and industries. This is an effective way to learn the best practices in the field and to benchmark your organization.
- Review the "ethical state of health" on a continual basis by repeatedly revisiting your research, communication and training programs, code of conduct, and so forth. Times change, and strategies shift. Thus there is always a need to revisit the subject. Don't expect the core values to change. However, one word in a definition may need to be edited or replaced, or a new value may emerge that is critical to the future character and success of your business.

The BMO Bank of Montreal has taken this step. "What we're trying to do at the Bank of Montreal is to build learning into what it is that people are doing," said Jim Rush of the Bank of Montreal's Institute for Learning. "The difficulty with training as we once conceived it is that you're taken off your job, you're taken out of context, you're taken away from those things that you're currently working on, and you go through some kind of training. And then you've got to come back and begin to apply that. Well, you walk back to that environment and it hasn't changed. It's not supportive or conducive to you behaving in a different kind of way, so you revert back to the way you were, very naturally." To overcome this, the bank conducts training such that teams bring in specific tasks on which they're working, so that they learn by doing. This removes the gap between learning in one context and applying it in another. The bank then looks at performance indices directly related to the bottom line. "If we take an entire business unit through a program designed to help them learn how to increase the market share of a particular product, we can look at market share and see if it improved after the training," Rush said.Jim Rush, interview by Andrea Meyer, *Fast Company*, July 1995.

Motorola has adopted a similar approach, using action learning in its Senior Executive Program. Action learning teams are assigned a specific project by Motorola's CEO and are responsible for implementing the solutions they design. This approach not only educates the team members but also lets them implement the ideas, so they're in a position to influence the organization. In this way, the training seamlessly supports Motorola's goals.

As you can see in these examples, organizations need employees to apply their knowledge to activities that add value to the company. In planning and applying human capital measures, managers should use both retrospective (lagging) and prospective (leading) indicators. Lagging indicators are those that tell the company what it has accomplished (e.g., the Bank of Montreal's documenting the effect that training had on a business unit's performance). Leading indicators are forecasts that help an organization see where it is headed. Leading indicators include employee learning and growth indices.Leslie A. Weatherly, "The Value of People: The Challenges and Opportunities of Human Capital Measurement and Reporting," *SHRM Research Quarterly* 3 (2003): 14–25, accessed February 6, 2011, http://www.shrm.org/Research/Articles/Articles/Documents/0303measurement.pdf.

Ethics in Action

As Mark Vickers of the Human Resource Institute points out, global corporations often have to operate in nations where bribery, sexual harassment, racial discrimination, and a variety of other issues are not uniformly viewed as illegal or even unethical.Mark R. Vickers, "Business Ethics and the HR Role: Past, Present, and Future," *Human Resource Planning* 28, no. 1 (2005), accessed January 28, 2011, http://www.entrepreneur.com/tradejournals/article/131500182_1.html. As a result, companies must grapple with maintaining an enterprise-wide standard of ethics in countries where these practices are not the norm and may even be counter to local traditions. For many companies, China may be the test bed for dealing with these issues. A recent study reported that in China "there is a need to harness the (largely neglected) ethical dimension to transform business practice along international standards… At a minimum, fraud and corruption must be suppressed in an atmosphere where contract and property rights are clearly defined and honored."Philip. C. Wright, Szeto Wing-Fu, and S. K. Lee, "Ethical Perceptions in China: The Reality of Business Ethics in an

International Context," *Management Decision* 41, no. 2 (2003): 182. As countries work together to develop multinational trade and labor agreements, a common set of ethical norms will develop over time, but the process will not happen overnight. In the meantime, companies will need to think internally about how to handle ethical issues in a way that makes sense at home and abroad.Philip C. Wright, Szeto Wing-Fu, and S. K. Lee, "Ethical Perceptions in China: The Reality of Business Ethics in an International Context," *Management Decision* 41, no. 2 (2003): 180–89.

The Payoff

Given the complexity of trying to measure intangibles with metrics and a scorecard, some managers may be inclined to ask, "Why bother doing all this?" Research by John Lingle and William Schiemann provides a clear answer. Companies that make a concerted effort to measure intangibles such as employee performance, innovation, and change in addition to measuring financial benchmarks perform better. Lingle and Schiemann examined how executives measured six strategic performance areas: (1) financial performance, (2) operating efficiency, (3) customer satisfaction, (4) employee performance, (5) innovation and change, and (6) community/environment issues. To evaluate how carefully the measures were tracked, the researchers asked the executives, "How highly do you value the information in each strategic performance area?" and "Would you bet your job on the quality of the information on each of these areas?" The researchers found that the companies that paid the closest attention to the metrics and had the most credible information were the ones that had been identified as industry leaders over the previous three years (e.g., 74 percent of measurement-managed companies but only 44 percent of others) and reported financial performance in the top third of their industry (e.g., 83 percent compared with 52 percent).Leslie A. Weatherly "The Value of People: The Challenges and Opportunities of Human Capital Measurement and Reporting," *HR Magazine*, January 30, 2011, findarticles.com/p/articles/mi_m3495/is_9_48/ai_108315188.

The Workforce Scorecard is vital because most organizations have much better control and accountability over their raw materials than they do over their workforce. For example, a retailer can quickly identify the source of a bad product, but the same retailer can't identify a poor manager whose negative attitude is poisoning morale and strategic execution.Brian E. Becker and Mark A. Huselid, "Strategic Human Resources Management: Where Do We Go from Here?," *Journal of Management* 32, no. 6 (2006): 898–925.

KEY TAKEAWAYS

- The Balanced Scorecard, when applied to HRM, helps managers align all HRM activities with the company's strategic goals. Assigning metrics to the HRM activities lets managers track progress on goals and ensure that they're working toward strategic objectives. It adds rigor and lets managers quickly identify gaps.
- Companies that measure intangibles such as employee performance, innovation, and change perform better financially than companies that don't use such metrics.
- Rather than investing equally in training for all jobs, a company should invest disproportionately more in developing the people in the key strategic ("A") jobs on which the company's success is most dependent.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Define the Balanced Scorecard method.
2. List the elements of a Workforce Scorecard.
3. Discuss how human capital can be managed like a strategic asset.
4. Why is it important to align HRM metrics with company strategy?
5. What kind of metrics would be most useful for HRM to track?

6.51: Tips in Your Walkabout Toolkit

Applying the Balanced Scorecard Method to Your Human Capital

Let's translate the Workforce Scorecard to your own Balanced Scorecard of human capital. As a reminder, the idea behind the HRM scorecard is that if developmental attention is given to each area, then the organization will be more likely to be successful. In this case, however, you use the scorecard to better understand why you may or may not be effective in your current work setting. When you create the Worforce Scorecard for your company, it should comprise four sets of answers and activities.Mason Carpenter, Talya Bauer, and Berrin Erdogan, *Principles of Management* (Nyack, NY: Unnamed Publisher, 2009), accessed January 5, 2011, www.gone.2012books.lardbucket.org/printed-book/127834.

1. **What are your mind-set and values?** Do you understand the organization's strategy and embrace it, and do you know what to do in order to implement the strategy? If you answered no to either of these questions, then you should consider investing some time in learning about your firm's strategy. For the second half of this question, you may need additional coursework or mentoring to understand what it takes to move the firm's strategy forward.
2. **What are your work-related competencies?** Do you have the skills and abilities to get your job done? If you have aspirations to key positions in the organization, do you have the skills and abilities for those higher roles?
3. **What are the leadership and workforce behaviors?** If you aren't currently in a leadership position, do you know how consistently your leaders are behaving in regard to the achievement of strategic objectives? If you are one of the leaders, are you behaving strategically?
4. **How are you contributing to the organization's success?** Can you tie your mind-set, values, competencies, and behaviors to the organization's performance and success?

This simple scorecard assessment will help you understand why your human capital is helping the organization or needs additional development itself. With such an assessment in hand, you can act to help the firm succeed and identify priority areas for personal growth, learning, and development.

6.52: End-of-Chapter Questions and Exercises

These exercises are designed to ensure that the knowledge you gain from this book about international business meets the learning standards set out by the international Association to Advance Collegiate Schools of Business (AACSB International).Association to Advance Collegiate Schools of Business website, accessed January 26, 2010, http://www.aacsb.edu. AACSB is the premier accrediting agency of collegiate business schools and accounting programs worldwide. It expects that you will gain knowledge in the areas of communication, ethical reasoning, analytical skills, use of information technology, multiculturalism and diversity, and reflective thinking.

EXPERIENTIAL EXERCISES

(AACSB: Communication, Use of Information Technology, Analytical Skills)

1. One of the reasons that firms seek to employ people in other countries is the relative cost of labor. Visit the US Bureau of Labor Statistics website and scan the available comparison data for international compensation (www.bls.gov/fls/flshcaeindnaics.htm). Which countries have the lowest wages? Which have the highest? Why wouldn't companies always locate their operations where labor costs are the lowest?
2. You are an SHRM consultant called in by an American firm that wants to staff its new international operations with expatriates. They have asked you to compile a checklist of the key concerns the company should address and steps it should go through before embarking on this endeavor. Engage Michigan State University's globalEDGE site (http://globaledge.msu.edu/) and similar resources to prepare your report.
3. Drawing on information in this chapter and in resources such as globalEDGE, design a preparation plan that might improve the chances for success in foreign assignments. Does your plan include selection criteria as well? Why or why not? If so, what might these selection criteria be?
4. Pick a foreign country where you'd like to sign up for a job assignment. How well do you know the business practices in that country? To see how well you understand the ways of doing business in other countries, go to Kwintessential—Language and Cultural Specialists' web page at www.kwintessential.co.uk/cultural-services/aims-and-objectives.html. Click on Tools and Resources. From here, you can choose several online quizzes to test your knowledge of business etiquette in a number of countries.

Ethical Dilemmas

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. Your company is just beginning to branch out of the United States, and your CEO suggests that it might be good for the company to put its ethical standards related to SHRM into writing for the entire company. Regarding selection and placement, job design, compensation and rewards, and diversity management, what standards would you propose? How would you go about determining if these standards fit every country in which your company wishes to do business?
2. Your company's home country believes in gender equality. What happens when locals from another country follow that country's customs by treating a female expatriate employee as a second-class citizen? What obligations does your company have to her? How should she respond?
3. Your company appears to be taking unfair advantage of the working conditions in an overseas subsidiary in which you work. At the same time, however, your company is providing much-sought-after employment in this developing region. Your conscience is bothered. What should you do? What rights and obligations does your company have in such a situation?

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