**Chapter 2**
**International Trade and Foreign Direct Investment**

## Introduction

Global business is more than just having business interests in each country. There's a convergence and sometimes a conflict of interests of the different stakeholders, from businesses to governments to local citizens. An essential part of international business is to understand the history of international trade and what motivates countries to encourage or discourage trade within their borders. 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.

**Opening Case: China in Africa**

**Exercises**

1. Describe China's strategy in Africa.

   Answer: Student answers will vary. China's successful development strategy combines state intervention with economic incentives to attract foreign investments. Since the early 2000s—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. Its investments are leading to major development work in the region. Chinese firms are able to provide low-cost options thanks in large part to their government's project support. And they are building much needed roads, schools, and hospitals that will be repaid in mineral resources. All of this is part of the overall trade between the globe's most populous country, China, and its poorest continent, Africa, which soared to a record total of $200 billion by 2013. That included a 44 percent spurt in Chinese direct investment 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?
   Answer: Student answers will vary. Some will say yes, because they believe that business should care about local government ethics and human rights policies. Some of the local government ethics of Sudan will be very different from that of China or other global economies. However, these ethics should be followed when the business is operating in Sudan. Some students may say no believing that business goals are more important. However, for these students, they should consider that unethical governments rarely provide consistent operating business environments, which is essential to long term business success.

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)?
   Answer: Student answers will vary. It would be ideal to enter into discussions with the core company management on how to implement ethical business in the company. The company's core management then should engage the local government in a discussion on the potential benefits of investments that the company is making.

**1. What Is International Trade Theory?**

- Understand international trade.
- Compare and contrast different trade theories.
- Determine which international trade theory is most relevant today and how it continues to evolve.

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**Section Outline**

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- Trade is the concept of this exchange between people or entities.
- International trade is the concept of exchange between people or entities in different countries.
- The Silk Road was the land and water trade route that covered more than four thousand miles and connected the Mediterranean with Asia.
- The main historical trade theories are called classical and are from the perspective of a country.
- Theories which are referred to as modern are firm-, or company-, based.
- **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.
- A **trade surplus** is a situation where the value of exports are greater than the value of imports.
- A **trade deficit** is a situation where the value of imports is greater than the value of exports.
- **Protectionism** was a strategy developed by the new nation states in the 1500s and is still used today.
    - Nations promoted exports by imposing restrictions on imports.
- **Absolute advantage** is a theory offered by famous economist Adam Smith in 1776.
    - The theory focused on the ability of a country to produce a good more efficiently than another nation.
    - He stated that trade should flow naturally according to market forces.
    - 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.
- David Ricardo, an English economist, introduced the theory of **comparative advantage** in 1817.
    - It 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.
- In the early 1900s, two Swedish economists, Eli Heckscher and Bertil Ohlin, proposed the **factor proportions theory**.
    - 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.
- In the early 1950s, Russian-born American economist Wassily W. Leontief proposed his theory that came to be known as **Leontief Paradox**—the reverse of what was expected by the factor proportions theory.
- **Intraindustry trade** refers to trade between two countries of goods produced in the same industry.
    - Japan exports Toyota vehicles to Germany and imports Mercedes-Benz

automobiles from Germany.

- Steffan Linder developed the **country similarity theory** in 1961.
  - It proposed that consumers in countries that are in the same or similar stage of development would have similar preferences.
- Raymond Vernon, a Harvard Business School professor, developed the **product life cycle theory** in the 1960s.
  - It stated that a product life cycle has three distinct stages: (1) new product, (2) maturing product, and (3) standardized product.
- The **barriers to entry** refer to the obstacles a new firm may face when trying to enter into an industry or new market.
- 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.
  - Some nations are more competitive than others because of local market resources and capabilities, local market demand conditions, local suppliers and complementary industries and local firm characteristics.
- Porter identified four determinants that he linked together. The four determinants are:
  - Local market resources and capabilities (factor conditions)
  - Local market demand conditions
  - Local suppliers and complementary industries
  - Local firm characteristics

**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**

1. What is international trade?
   Answer: 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.

2. Summarize the classical, country-based international trade theories. What are the differences between these theories, and how did the theories evolve?
   Answer: A classical, country-based international trade theory, states that a country's wealth is determined by its holdings of gold and silver.
   a. In 1776, Adam Smith developed a new trade theory called absolute advantage.

   b. To answer overcome the drawbacks of the absolute advantage theory, David Ricardo, an English economist, introduced the theory of comparative advantage in 1817.
   c. The theories of Smith and Ricardo didn't help countries determine which products would give a country an advantage.
   d. In the early 1900s, two Swedish economists, Eli Heckscher and Bertil Ohlin, offered the factor proportions theory,
   e. In the early 1950s, Russian-born American economist Wassily W. Leontief studied the US economy closely and his analysis later came to be known as Leontief Paradox.

3. What are the modern, firm-based international trade theories?
   Answer: Modern, firm-based theories emerged after World War II and were developed in large part by business school professors, not economists. These theories are listed below:
   a. Country similarity theory
   b. Product life cycle theory
   c. Global strategic rivalry theory
   d. Porter's national competitive advantage theory

4. Describe how a business may use the trade theories to develop its business strategies. Use Porter's four determinants in your explanation.
   Answer: Firms will encounter global competition in their industries and in order to prosper, they must develop competitive advantages. Porter's theory stated that a nation's competitiveness in an industry depends on the capacity of the industry to innovate and upgrade.
   a. Local market resources and capabilities (factor conditions)
   b. Local market demand conditions
   c. Local suppliers and complementary industries
   d. Local firm characteristics

**2. Political and Legal Factors That Impact International Trade**

- Know the different political systems.
- Identify the different legal systems.
- Understand government-business trade relations and how political and legal factors impact international business.

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**Section Outline**

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- A **political system** is basically the system of politics and government in a country.
- **Anarchism** contends that individuals should control political activities and public government is both unnecessary and unwanted.
- **Totalitarianism** contends that every aspect of an individual's life should be controlled and dictated by a strong central government.
- **Pluralism** asserts that both public and private groups are important in a well-functioning political system.
- **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.
- **Capitalism** is an economic system in which the means of production are owned and controlled privately.

- A **planned economy** is one in which the government or state directs and controls the economy, including the means and decision making for production.
- **Civil law** is based upon a detailed set of laws that constitute a code and focuses on how the law is applied to the facts.
- **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.
    - **Sharia** is Islamic law governs a number of Islamic nations
    - The Jewish Halakha and the Christian Canon system are religious laws as well, neither of which is practiced at the national level in a country.
- Governments have several key policy areas that can be used to create rules and regulations to control and manage trade.
- Tariffs are taxes imposed on imports.
    - **Specific tariffs** are levied as a fixed charge.
    - **Ad valorem tariffs** which are calculated as a percentage of the value.
- A subsidy is a form of government payment to a producer.
    - Types of subsidies include tax breaks or low-interest loans
- Import quotas (tariffs on imports) and voluntary export restraints (VER) are two strategies to limit the amount of imports into a country.
- Governments may limit the convertibility of one currency (usually its own) into others, usually in an effort to limit imports which is known as currency control.
    - Many countries continue to require that a certain percentage of a product or an item be manufactured or "assembled" locally.
- Dumping occurs when a company sells product below market price often in order to win market share and weaken a competitor.
- In export financing, governemnts provide financing to domestic companies to promote exports.
- Free-trade zones are areas enjoy reduced tariffs, taxes, customs, procedures, or restrictions in an effort to promote trade with other countries.
- Administrative policies are the bureaucratic policies and procedures that governments may use to deter imports.

**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**

1. Identify the main political ideologies.
   Answer: The main political ideologies are listed below:
   a. Anarchism contends that individuals should control political activities and public government is both unnecessary and unwanted.
   b. Totalitarianism contends that every aspect of an individual's life should be controlled and dictated by a strong central government.
   c. Pluralism asserts that both public and private groups are important in a well-functioning political system.
   d. Democracy is the most common form of government around the world today.

2. What is capitalism? What is a planned economy? Compare and contrast the two forms of economic ideology discussed in this section.
   Answer: 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. Democratic governments have supported capitalism and authoritarian regimes have tended to utilize a state-controlled approach to managing the economy.

3. What are three policy areas in which governments can create rules and regulations in order to control, manage, and intervene in trade?
   Answer: Student answers will vary. 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:
   a. Defense
   b. Telecommunications
   c. Infrastructure

## 3. Foreign Direct Investment

- Understand the types of international investments.
- Identify the factors that influence foreign direct investment (FDI).
- Explain why and how governments encourage FDI in their countries.

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**Section Outline**

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- **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.

- **Foreign direct investment (FDI)** refers to an investment in or the acquisition of foreign assets with the intent to control and manage them.
- **Inward FDI** refers to investments coming into the country.
- **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.
- Some factors that influence a company's decision to invest are:
    - Cost
    - Logistics
    - Market
    - Natural resources
    - Technical know-how
    - Customer and competitors
    - Policy ease
    - Culture
    - Expatriation of funds
    - Exit
- **Horizontal FDI** occurs when a company is trying to open up a new market.
    - A retailer 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.
- **Greenfield FDIs** occur when multinational corporations enter into developing countries to build new factories or stores.
    - Facilities are built from scratch—usually in an area where no previous facilities existed.
- In a **brownfield FDI** a company or government entity purchases or leases existing production facilities to launch a new production activity.
- Many governments encourage FDI in their countries as a way to create jobs, expand local technical knowledge, and increase their overall economic standards by providing:
    - Financial incentives
    - Infrastructure
    - Administrative processes and regulatory environment
    - Invest in education
    - Political, economic, and legal stability
- Sometimes governments seek to limit or control foreign direct investment to protect local industries and key resources by:
    - Ownership restrictions
    - Tax rates and sanctions

**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**

1. What are three factors that impact a company’s decision to invest in a country?
   Answer: Student answer will vary. Many considerations influence its decisions such as:
    a. Cost—is it cheaper to produce in the local market or elsewhere?
    b. Market—has the company identified a significant local market?
    c. Logistics—is it cheaper to produce locally is transportation costs are cheaper?

2. What is the difference between vertical and horizontal FDI? Give one example of an industry for each type.
   Answer: Student answers will vary. Horizontal FDI occurs when a company is trying to open up a new market.
    a. Example: A retailer builds a store in a new country to sell to the local market.
    b. Vertical FDI is when a company invests internationally to provide input into its core operations—usually in its home country.
    c. Example: Auto, oil, and infrastructure

3. How can governments encourage or discourage FDI?
   Answer: Foreign direct investment (FDI) refers to investment or acquisition. Many governments encourage FDI in their countries as a way to create jobs, expand local technical knowledge, and increase their overall economic standards by providing:
    a. Financial incentives
    b. Infrastructure
    c. Administrative processes and regulatory environment
    d. Invest in education
    e. Political, economic, and legal stability
   
   Sometimes governments seek to limit or control foreign direct investment to protect local industries and key resources by:
    a. Ownership restrictions
    b. Tax rates and sanctions