International Business: Opportunities and Challenges in a Flattening World, v3

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CHAPTER 2

International Trade and Foreign Direct Investment

LEARNING OBJECTIVES

- Understand international trade.
- Compare and contrast different trade theories.
- Determine which international trade theory is most relevant today and how it continues to evolve.
- Know the different political systems.
- Identify the different legal systems.
- Understand government-business trade relations and how political and legal factors impact international business.

LEARNING OBJECTIVES

- 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.

WHAT IS INTERNATIONAL TRADE?

- Trade is the concept of exchanging goods and services between two people or entities.
- International trade is the concept of exchanging goods and services between people or entities in two different countries.

CLASSICAL COUNTRY-BASED THEORIES VERSUS MODERN FIRM-BASED 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: A classical, country-based international trade theory that states that a country's wealth is determined by its holdings of gold and silver.
  - The objective of each country was to have a trade surplus and to avoid a trade deficit.
    - Trade surplus: When the value of exports is greater than the value of imports.
    - Trade deficit: When the value of imports is greater than the value of export.
- Protectionism: The practice of imposing restrictions on imports and protecting domestic industry.

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CLASSICAL, OR COUNTRY-BASED, TRADE THEORIES

- Absolute advantage: The ability of a country to produce a good more efficiently than another nation.
- Comparative advantage: The situation in which a country cannot produce a product more efficiently than another country; however, it does produce that product better and more efficiently than it does another good.

CLASSICAL, OR COUNTRY-BASED, TRADE THEORIES

- Factor Proportions Theory/The Heckscher-Ohlin Theory: The classical, country-based international theory states that countries would gain comparative advantage if they produced and exported goods that required resources or factors that they had in great supply and therefore were cheaper production factors.
  - In contrast, countries would import goods that required resources that were in short supply in their country but were in higher demand.

CLASSICAL, OR COUNTRY-BASED, TRADE THEORIES

- Leontief Paradox: A paradox identified by Russian economist Wassily W. Leontief that states, in the real world, the reverse of the factor proportions theory exists in some countries.
  - For example, even though a country may be abundant in capital, it may still import more capital-intensive goods.

MODERN, OR FIRM-BASED, TRADE THEORIES

- Country similarity theory: A modern, firm-based international trade theory that explains intra-industry trade by stating that countries with the most similarities in factors such as incomes, consumer habits, market preferences, stage of technology, communications, degree of industrialization, and others will be more likely to engage in trade between countries and intra-industry trade will be common.
- Product life cycle theory: A modern, firm-based international trade theory that states that a product life cycle has three distinct stages: (1) new product, (2) maturing product, and (3) standardized product.

MODERN, OR FIRM-BASED, TRADE THEORIES

- Global strategic rivalry theory
  - Focused on MNCs and their efforts to gain a competitive advantage against other global firms in their industry
- Barriers to entry: The obstacles a new firm may face when trying to enter into an industry or new market.

MODERN, OR FIRM-BASED, TRADE THEORIES

- 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
  - The control of resources or favorable access to raw materials

MODERN, OR FIRM-BASED, TRADE THEORIES

- Porter's theory: A modern, firm-based international trade theory that states that a nation's or firm's competitiveness in an industry depends on the capacity of the industry and firm to innovate and upgrade. It identifies four key determinants of national competitiveness:
  - Local market resources and capabilities
  - Local market demand conditions
  - Local suppliers and complementary industries
  - Local firm characteristics

FOUR DETERMINANTS OF PORTER'S THEORY

WHAT ARE THE DIFFERENT POLITICAL SYSTEMS?

- Political system: The system of politics and government in a country; it governs a complete set of rules, regulations, institutions, and attitudes.
  - Anarchism: A political ideology that contends that individuals should control political activities and public government is both unnecessary and unwanted.
  - Democracy: A form of government that derives its power from the people.
  - Pluralism: A political ideology that asserts that both public and private groups are important in a well-functioning political system.
  - Totalitarianism: A political ideology that contends that every aspect of an individual’s life should be controlled and dictated by a strong, central government.

WHAT ARE THE DIFFERENT POLITICAL SYSTEMS?

- A company asks several questions regarding a prospective country's government to assess possible risks:
  - How stable is the government?
  - Is it a democracy or a dictatorship?
  - If a new party comes into power, will the rules of business change dramatically?
  - Is power concentrated in the hands of a few, or is it clearly outlined in a constitution or similar national legal document?
  - How involved is the government in the private sector?
  - Is there a well-established legal environment both to enforce policies and rules as well as to challenge them?
  - How transparent is the government's political, legal, and economic decision-making process?

WHAT ARE THE DIFFERENT POLITICAL SYSTEMS?

- Capitalism: An economic system in which the means of production are owned and controlled privately.
- Planned economy: An economic system in which the government or state directs and controls the economy, including the means and decision making for production.

WHAT ARE THE DIFFERENT LEGAL SYSTEMS?

- Civil law: A legal system based upon a detailed set of laws that constitute a code and on how the law is applied to the facts.
- Common law: A legal system based on traditions and precedence.
- In these two systems, judges interpret the law and judicial rulings can set precedent.
- Religious law: Known as theocratic law; this legal system is based on religious guidelines.
    - Sharīʿah: Islamic religious law that addresses all aspect of daily life; in terms of business and finance, the law prohibits charging interest on money and other common investment activities, including hedging and short selling.

WHY DO GOVERNMENTS INTERVENE IN TRADE?

For a combination of political, economic, social, and cultural reasons

HOW DO GOVERNMENTS INTERVENE IN TRADE?

- Tariffs
  - Specific tariffs: Taxes or tariffs that are levied as a fixed charge, regardless of the value of the product or service.
  - Ad valorem tariffs: Tariffs that are calculated as a percentage of the value of the product or service.
- Subsidies
- Import quotas and VER
- Currency controls
- Local content requirements

HOW DO GOVERNMENTS INTERVENE IN TRADE?

- Antidumping rules
- Export financing
- Free trade zone
- Administrative policies

UNDERSTAND THE TYPES OF INTERNATIONAL INVESTMENTS

- Portfolio investment: 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): The acquisition of foreign assets with the intent to control and manage them.
  - A country's FDI can be both inward and outward
- Inward FDI: An investment into a country by a company from another country.
- Outward FDI: An investment made by a domestic company into companies in other countries.

FACTORS THAT INFLUENCE A COMPANY’S DECISION TO INVEST

- Cost
- Logistics
- Market
- Natural resources
- Know-how
- Customers and competitors
- Policy
- Ease
- Culture
- Impact
- Expatriation of funds
- Exit

FACTORS THAT INFLUENCE A COMPANY'S DECISION TO INVEST

- Forms of FDI
  - Horizontal FDI: When a company is trying to open up a new market that is similar to its domestic markets
  - Vertical FDI: When a company invests internationally to provide input into its core operations usually in its home country
- Kinds of FDI
  - Greenfield FDI: An FDI strategy in which a company builds new facilities from scratch
  - Brownfield FDI: An FDI strategy in which a company or government entity purchases or leases existing production facilities to launch a new production activity

WHY AND HOW GOVERNMENTS ENCOURAGE FDI

- To create jobs
- Expand local technical knowledge
- Increase their overall economic standards

HOW GOVERNMENTS DISCOURAGE OR RESTRICT FDI

- Ownership restrictions
  - Host governments can specify ownership restrictions if they want to keep the control of local markets or industries in their citizens' hands.
- Tax rates and sanctions
  - A company's home government imposes these restrictions in an effort to persuade companies to invest in the domestic market rather than a foreign one.

HOW GOVERNMENTS ENCOURAGE FDI

Financial Incentives

Infrastructure

Administrative Process & Regulatory Environment

Invest in education

Political, Economic, & Legal Stability