INTERNATIONAL ENTRY AND COUNTRY ANALYSIS

A Lecture Programme delivered at the Technical University of Košice

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Andrew Harrison's Brief Biography

Andrew Harrison was a Principal Lecturer and Subject Group Leader in economics at Teesside University until August 2010 and has been a visiting lecturer at the Technical University of Košice since April 1993. He has also been a visiting lecturer in Germany, Ukraine and Singapore. Since leaving the full-time staff of Teesside University, he has continued to work as an occasional lecturer and as an external examiner at two other UK universities. He holds qualifications from London, Salford and Leeds Universities and Trinity College of Music, London. In April 2008, he was awarded the degree of Doctor Honoris Causa by the Technical University of Košice. He is married to Heather and has two grown-up children, David and Rachel. In his spare time he is a keen amateur pianist and organist.

Brief Course Description

International business activity is one of the key features of the contemporary global economy. The decision to venture abroad involves the evaluation of alternative entry modes, bearing in mind the degree of risk and the suitability of the business environment in a potential host country or region. Political, economic, cultural and other factors are all of vital importance. This short course aims to explore these issues in the light of current research and with reference to recent developments in the global economy. The course will be delivered through a combination of lectures, discussion groups, plenary discussion and case study analysis.

LECTURE PROGRAMME:
INTERNATIONAL ENTRY AND COUNTRY ANALYSIS

1. Motives for Going International

Businesses venture abroad for a variety of reasons and there is a large international business literature on this subject. In this section, we focus on the main factors that are likely to influence business decision makers in practice. These factors help to provide a broad overview of the topic. In section 3, we consider the main theoretical explanations, which offer a more comprehensive rationale for the decision to go international. First, we distinguish between the main overarching factors and the firm-specific factors that affect the decision to venture abroad (see figure 1). Fundamentally, this decision is motivated by an organization's mission and objectives: its overall aims and purpose and the detailed objectives it sets in order to achieve its aims. These are its primary motives for going international. The achievement of its aims and objectives, however, is significantly affected by the general international environment and by conditions within specific countries. For this reason, it is important to consider how the business environment affects a company's internationalization decision. A number of specific factors, including access to markets and resources and the need to reduce costs, will also influence this decision.

Figure 1: Factors Affecting the Decision to Go International

Overarching Factors

Primary Motives

- profit-making opportunities
- business growth
- international reputation
- competitive advantage

The Changing International Environment

- international peace and stability
- world economic growth and emerging regions
- reduction in trade barriers
- technological developments and skills

Country-Specific Factors

- political and economic stability
- culture and institutions
- a country’s stock of ‘created assets’
- supportive government policies
- absence of ‘nuisance costs’

Firm-Specific Factors

Access to Markets

- large and emerging markets
- access to a regional trading area
- first-mover advantages
- need to follow the competition

Access to Resources

- resources are core business
- large quantities of resources are needed
- specialized resources are immobile

Cost Reduction

- access to low-cost materials, energy, or labour
- financial incentives
- avoidance of trade barriers

Source: adapted from Harrison, A. L., Dalkiran, E. and Elsey, E. (2000), International Business, Oxford University Press, fig. 12.1, p. 256

1.1 Overarching Factors Affecting the Decision to Go International

- **Primary Motives** – For most private-sector businesses, profitability is of crucial importance. The opportunity to make profit by selling its products in a foreign market may therefore be attractive, especially if expansion in the home market is difficult because of slow market growth, market saturation, or regulatory obstacles. In some cases, significant business growth may only be possible through international expansion. International exposure also enables a company to achieve an international reputation, which may be important if it is to be regarded as an industry leader.

  Profitability also depends on competitiveness, so international expansion may be a way of reducing costs in a competitive international market. Access to international markets allows increased scale of production, leading to lower unit costs. Economies of scale are particularly important for a company like Nestlé whose home market in Switzerland is relatively small. Scale economies apply not only at the level of the production plant, but more especially at the level of the organization as a whole. Access to international production allows international procurement of components and supplies, international relocation of production operations or outsourcing of business functions that can be undertaken at lower cost abroad (known as 'offshoring'); these include not only call-centre operations, for example, but also many labour-intensive data-input tasks which are increasingly being outsourced to companies employing low-cost but highly skilled IT workers in countries like India (see section 4.5 below).

- **The Changing International Environment** – In broad terms, the main nations involved in international business activity have experienced an unprecedented period of peace and stable international relations since 1945. From time to time conflict in particular countries has disrupted trade flows, notably in commodities like oil during periods of turbulence in the Middle East, but the United States, Western Europe, and Japan, which have until recently been the major trading nations, have enjoyed generally cordial relations with each other. This has helped enormously to increase the volume of world trade and investment, clearly having a positive influence on internationalization decisions.

  The historic opening up of China and Eastern Europe since 1978 and 1989 respectively has also increased the opportunities for international trade and investment. The increase in international business activity has contributed to significant growth in the world economy over the post-war period. This growth has also been sustained by a general reduction in trade barriers between countries, thanks to the work of GATT and the WTO (see section 4.1) and the gradual liberalization of national trade and investment policies. The increased rate of growth in international business activity would not of course have been possible without significant developments in production and information technology and commensurate improvements in the quality of human capital.

- **Country-specific factors** – Whilst the general international environment influences overall internationalization decisions, the decision to do business in a particular country is primarily affected by conditions in the country concerned. A wide range of factors may be important, as indicated for example in the World Economic Forum global competitiveness report. Among the most important factors are political and economic stability, culture and institutions, and a country's stock of 'created assets'. The increase in economic activity, including foreign direct investment, that has occurred in Northern Ireland (and to some extent in the Republic of Ireland) after the signing of the Good Friday Agreement in 1998 clearly indicates the importance of political stability. The implications of differences in a country's culture and institutions are considered at length in chapter 6. Created assets, or what Michael Porter calls ‘advanced factors’, are assets which a country has developed through investment over a number of years. They include tangible assets such as the transport or communication infrastructure and intangible assets such as education and skills, technology and the capacity for innovation, intellectual property, and business networks.

When comparing alternative locations, either between or within countries, government policies such as tax rates or financial incentives may influence the decision to invest; for example, the Republic of Ireland’s 12½ per cent corporate tax rate (formerly 10 per cent) has undoubtedly influenced inward investment decisions in Ireland in recent years. In more difficult national environments, such as some of the former Soviet republics after the collapse of the Soviet Union in 1991, ‘nuisance costs’ have had the opposite effect by deterring foreign investors; these include bureaucratic obstacles, corruption, and mafia-style activities.

1.2 Firm-Specific Factors Affecting the Decision to Go International

- **Access to markets** – The lure of new markets either in large developed economies or in emerging economies with growth potential is often irresistible to businesses with international ambitions. Companies like Microsoft, Coca Cola, or Toyota could not have achieved global leadership positions in their respective industries without selling their products in most of the world’s markets. The opening up of China has attracted firms seeking low-cost production, but this advantage will in the longer term be dwarfed by the country’s market potential as the wealth of China’s massive population rises. The establishment of production facilities within a regional economic grouping also allows access to the region’s entire market. Thus, for example, Nissan’s UK investment allows the company to export around eighty per cent of its production to other EU countries. Similar explanations can be found for foreign investment in Latin America in recent years (see Practical Insight 1).

  In some cases, early entry into an emerging economy brings first-mover advantages and the possibility of market dominance before rivals have the chance to establish themselves. Tesco has achieved this position in some of the former communist countries of Central and Eastern Europe. Paradoxically, however, Pepsico’s early advantage in the same region before the end of communism was swiftly displaced by Coca Cola’s aggressive expansion into the region after 1989. Sometimes, it is simply necessary to follow the competition so as not to be left behind.

- **Access to resources** – Historically, a country’s deposits of coal, iron ore, copper, precious metals, or other natural resources were the main attraction for foreign investors. Indeed, this is still true today in the oil and mining industries, or where large quantities of natural resources are consumed in the production process – though Australian or Colombian coal, for example, can now be economically transported half way around the world. Perhaps a more generally important reason why a foreign investor may be attracted by resources is where a specialized resource such as highly skilled labour is relatively immobile. On the whole, resources have become less important as a motive for internationalization in the modern world, as highly transferable knowledge and technology have acquired greater importance than natural resources in many industries.

- **Cost Reduction** – It is not uncommon for a business to offshore some of its operations, obtain components and other supplies, or relocate a production facility to another country in order to reduce costs. For example, a number of British banks and insurance companies have outsourced their call centres to India and the British company, Dyson, has relocated its production plant to Malaysia, whilst keeping its research and design facility in the UK. Some companies have in fact been criticized for exploiting low-cost labour in developing countries where working conditions would be regarded as unacceptable in their home country. It should be remembered, however, that cheap labour is not necessarily attractive to capital-intensive businesses where relatively small amounts of highly specialized labour are needed – unless, of course, highly skilled labour is available at low wages, as has been the case in recent years with computer programmers in Russia or India, for example.

Practical Insight 1: FDI in Brazil

By the end of the 1990s, many of the world's leading motor manufacturers had assembly plants in Brazil. Some, like Volkswagen and General Motors, had come to Brazil much earlier, attracted by the size and opportunities of the Brazilian market and the difficulties in exporting to a country with punitive import tariffs. The 1990s saw a new wave of investment by companies such as Renault and Hyundai, attracted by Brazil's growing economy and membership of Mercosur, South America's largest regional economic grouping formed in 1991. Clearly, Brazil also offers a low-cost location for foreign investors from the developed countries.

Question: How important as a motive for foreign investment in Brazil are costs of production likely to have been relative to market access?

2. Multinational Enterprises and the Internationalization Process

2.1 Multinational Enterprises (MNEs)

Many of the firms involved in international business are multinational, that is, they have operations in more than one country. Firms which export but do not have a physical presence in another country would not generally be classed as multinational, but where they have facilities such as a factory, warehouse, or retail store abroad, whether owned directly or not, the term multinational is likely to be used. Multinational businesses are variously known as multinational corporations (MNCs), multinational enterprises (MNEs), or transnational corporations (TNCs). The term MNC is probably the most widely used, though the United Nations refers to them as TNCs, focusing on the trans-national nature of their activities rather than their multi-national locations.[6] Some leading international business scholars prefer the term MNE as it encompasses all kinds of multinational operation, including subsidiaries which are run as separate companies and licensing and franchising agreements where the foreign operation is not owned by the parent company and is not therefore strictly part of the corporation as a legal entity.

The definition of a multinational enterprise also varies, both in terms of the minimum number of foreign operations and the degree of management control required. Richard Caves provides a basic definition of an MNE as 'an enterprise that controls and manages production establishments – plants – located in at least two countries'. This is clearly a minimal definition, but it at least provides a basis for the study of multinationality. For example, UNCTAD ranks the world's largest TNCs by the ratio of their foreign assets, sales, and employment to total assets, sales, and employment in its 'transnationality index', indicating the extent to which a TNC's operations are outside its home country.

2.2 The Evolution of MNEs

Some writers have focused attention on the different types of multinational enterprise and what they tell us about the way in which MNEs develop over a period of time. One of the earliest attempts to do this was the work of Howard Perlmutter, who distinguished between ethnocentric, polycentric, and geocentric approaches to internationalization. An MNE with an ethnocentric approach would pursue strategies that view the world from the home country's perspective and would be likely to market products abroad that are produced in and developed for the home market without cultural adaptation. An MNE with a polycentric approach would be organized into separate divisions in different countries or regions, each using local resources and production, and marketing adapted to its own cultural environment. A geocentric approach would imply that the MNE has a global strategy for its worldwide operations, with international resourcing and production, and products designed for the global market, often with local adaptations. In effect, this typology represents the evolutionary progress of MNEs as they develop their international activities.

A more extensive typology is provided by Bartlett and Ghoshal, including multinational, global, international, and transnational companies. A multinational company operates with a number of decentralized divisions, each operating in its own area and retaining knowledge largely within its own business unit. A global company is centralized, has global strategies, and retains knowledge at the centre. An international company centralizes its core functions and decentralizes others, adapts its strategies to take account of local differences, and diffuses knowledge to its foreign divisions. The transnational company has a unified global approach, together with local variations, but it organizes its operations so as to achieve overall global competitiveness and flexibility. While the multinational company is responsive to change at the local level, the global company is more efficient at the global level, the international company is able to influence and disseminate knowledge to its local divisions, and the transnational company achieves global flexibility and competitiveness. Bartlett and Ghoshal clearly see the transnational company as the most appropriate type of MNE in an increasingly globalizing world. Perlmutter's and Bartlett and Ghoshal's typologies are compared in figure 2.

Figure 2: Typologies of Multinational Enterprise

Perlmutter's Typology		
Ethnocentric Approach	**Polycentric Approach**	**Geocentric Approach**
Home country orientation	Host country orientation	Global orientation
No cultural adaptation	Local cultural adaptation	Global strategy, local adaptation

Bartlett and Ghoshal's Typology			
Multinational Company	**Global Company**	**International Company**	**Transnational Company**
Decentralized	Centralized	Centralized core	Global approach
Local operations	Global strategies	Local adaptation	Local variation
Local knowledge	Knowledge at centre	Diffused knowledge	Global competitiveness

2.3 MNEs and Globalization

MNEs play an important role in the process of globalization. Not only do they carry out much of the trade, investment, and other international business activity, but their operations also involve the international movement of people and the spread and adaptation of cultures. They are influenced by the international environment and also influence that environment (an issue that is developed in section 6 below). During the early phase of modern globalization, international business activity was dominated by MNEs from the Triad nations, but MNEs from Russia, China, India, South Korea, Brazil, and other emerging countries are now becoming increasingly active around the world. This changing scenario is helping to make international business activity more global whilst, at the same time, altering the relative economic importance of MNEs and the countries they represent. HSBC provides an example of an MNE with roots in different parts of the world (see Practical Insight 2).

Practical Insight 2: HSBC

HSBC ranked the fifth largest bank in the world with revenue of $146.5 billion in 2008. The company started its life in Hong Kong in 1865 as the Hong Kong and Shanghai Banking Corporation. Today, HSBC has operations in all the main regions of the world, a position it has reached largely through whole or partial equity investments in other banks. The group's corporate headquarters were moved to London in January 1993, after the takeover of the UK's Midland Bank the previous year. Key functions including strategic management, human resource management, legal affairs, and financial planning and control are now centralized in London, but other operations are decentralized. The HSBC Group has also adopted common technology throughout its banking operations and a uniform international brand and logo. The global and local aspects of its mission are encapsulated in the strap line: 'The world's local bank'.

Question: What do these characteristics suggest about the type of multinational enterprise HSBC has become?

3 Assessing the International Environment

3.1 Country Analysis and International Entry

Before doing business in a foreign country, it is good idea to undertake an analysis of the environment in the country concerned. Country analysis may take many forms and a wide range of organizations provide general and sometimes specialized information on countries. These include government departments, international institutions such as the UN, OECD, and World Economic Forum, banks and leading newspapers which produce country profiles and surveys, and a variety of consultants and online services which offer analysis of what is often termed 'country risk'. Of course, detailed market research is required before launching a product in a foreign market, but the better the understanding of a country's political, economic, and cultural environment, the greater the probability of the product succeeding and the less risk to a company's profitability and reputation. The degree of risk may also affect the choice of entry strategy in a particular country; for example, joint-ventures, licensing, and franchising are more likely to be used than full ownership in high-risk environments. This issue is discussed more fully in section 5 below. Here, we focus on the main types of country analysis, including both risk factors and the general environment.

3.2 Types of Country Analysis

- **Background Information** – In order to appreciate the context within which a country's political, economic, and social institutions have emerged, some understanding of its history, geography, culture, and demography is necessary. For example, when comparing Russia with the Czech Republic, there are clearly differences in the size and ethnic composition of their populations, their geographical size and climatic location, and their political, economic, and military importance. There are also significant historical differences, even in recent times. Both countries have experienced communism, but over a much longer period in Russia (1917-91) than in Czechoslovakia (1948-1989), in the former as the dominant power and the latter as a reluctant satellite state. Before communism, Russia had a largely agricultural economy whereas Czechoslovakia was a developed industrialized country. Perhaps most important of all, however, Russia had never experienced democracy until 1991 – changing from one form of totalitarian rule under the Tsars to another under Lenin, Stalin, and the one-party communist state – whereas Czechoslovakia had been a democracy since its inception as an independent state in 1918**.** These very different historical paths during the twentieth century help to explain why the Czech Republic more readily accepted democracy and the market economy after the end of communism whereas, after brief experimentation with a more open society under Boris Yeltsin, the Russians sought refuge in strong central leadership under President Putin when times became difficult.

- **The General Political and Economic Situation** – It is difficult to understand the business environment in a country without studying the current political system and institutions, major government economic policies, and a variety of data and other information on the country's economy. The latter may include statistics on gross domestic product (GDP), the GDP annual growth rate, GDP per capita, inflation, unemployment, consumer expenditure, and the volume of external trade, as well as information on particular industries, the competitive environment, and the financial system. This information is constantly changing, so it is important to keep it up to date and to study long-run trends to give an idea how an economy is progressing over a period of time.

- **Cultural Assessment** – This would require an investigation into cultural elements such as language, religion, and social structure and attitudes (see chapter 6 for an extensive discussion of culture). Language presents particular difficulties when venturing into a foreign country, despite the prevalence of the English language. Not only can partial knowledge of a language lead to misunderstandings and unwittingly cause offence, but in-depth understanding of a culture is difficult to achieve without a good level of linguistic ability. Failure to appreciate differences in religious beliefs and practices or differences in social status, relationships, and attitudes may also create cultural pitfalls when attempting to do business in an unfamiliar environment. Cultural differences between countries are sometimes described as 'cultural distance', a factor which increases the risk of operating abroad and may either deter international entry or reduce the likelihood of success.

- **General Product Data and Other Development Indicators -** A variety of data can be used to give an indication of the standard of living in a country. This may include product data such as the number of passenger vehicles, television sets, telephones, or internet connections per 1,000 inhabitants or human development indicators such as life expectancy, the prevalence of particular diseases, or the literacy rate of the population.

These indicators provide a picture of the level of economic and social development in a country.

- **Risk Factors** – The potential risks involved in entering a foreign country vary greatly with the country concerned. Political risks may include wars, civil unrest, terrorism, and changes in government policy or the law. Economic risks range from exchange rate exposure to the risk of non-payment or financial instability. A particular problem in some of the emerging and developing countries, though not exclusively in these countries, is the problem of corruption. These are just a few of the potential risks that may face a business venturing abroad. Cultural mistakes, human error, and natural disasters are among a long line of other possible risks (see Practical Insight 3). Some of these risks may of course arise in any country but the nature of the business or physical environment may increase their probability of occurrence.

Practical Insight 3: *Guanxi*

The Chinese concept of *guanxi* is used to describe the personal relationships and networks that are thought to be necessary when doing business in China. These relationships often require the exchange of favours, sometimes involving public officials, and they need to be actively maintained in the long term if they are to bring significant benefits. There is considerable debate, however, about the ethics of doing business in this way, the costs of maintaining active relationships, and the relative benefits of *guanxi* as opposed to having good products and a good marketing strategy.

Question: Relationships are important, in different ways, when doing business in most countries, but are they as important as is sometimes claimed?

3.3 Country Analysis in a Changing International Context

The changing international environment continually presents new opportunities and challenges for multinational enterprises. On the one hand, there has been a huge increase in world economic activity, fuelled initially by MNEs and economic liberalization in the Triad countries, then by a new economic dynamism in South-East Asia, China, Central and Eastern Europe, and Latin America. At the same time, there has been periodic financial turbulence, notably in Latin America (Mexico 1994-5, Argentina 2001-2), East Asia (1997-8), spreading to Russia and Brazil (1998) and international financial markets (2008-9), not to mention the internationalization of terrorism since 11th September 2001 ('9/11') and the subsequent increase in tension between the West and the Islamic world. These contrasting developments are compounded in a multiplicity of ways at the national level, creating enormous complexity for MNEs. Despite this, whilst some of the above events have brought a temporary slowdown in international business activity, the trend generally remains upwards. Rather than abandoning their international operations, MNEs tend to adapt their choice of country and entry strategy to the changing conditions. What is clear, however, is that the need to understand the international environment has become more important than ever.

4 Modes of International Entry

4.1 Direct and Indirect Exporting and Importing

International trade, involving exporting and importing, is the oldest form of international business activity and is still of huge importance today. For many businesses, it represents the most straightforward way to benefit from international markets and resources, though it carries significant risks, especially if a firm is dependent on a small number of international customers or suppliers or on markets or supplies in high-risk countries. MNEs frequently trade either with businesses within their own group (intra-company trade) or with external customers and suppliers. Direct exporting and importing involve direct contact between the exporter or importer and the foreign customer or supplier. Large established MNEs often trade in this way. For smaller or less experienced businesses, indirect exporting and importing is often used; this involves the services of an agent or other intermediary, providing specialist knowledge and a safer and more convenient way for a business to engage in international trade, though there is inevitably some loss of control unless the agent is entirely trusted. In practice, exporting and importing are often combined with other modes of international entry, as MNEs may engage in foreign direct investment or a foreign joint-venture to provide an export base for trade with neighbouring countries.

4.2 Foreign Direct Investment

The IMF Balance of Payments Manual defines foreign direct investment (FDI) as 'the objective of a resident entity in one economy obtaining a lasting interest in an enterprise resident in another economy'. FDI normally involves some degree of equity ownership on the part of the foreign investor and the IMF and UN regard a 10 per cent equity stake as the minimum requirement, though there is no universally agreed ownership requirement. More important is that FDI requires some degree of management control; this distinguishes direct investment from portfolio investment – the latter involving the purchase of shares or other financial assets but not control. Using the above definition, FDI may include the establishment of a wholly owned subsidiary (often called a 'greenfield investment'), a joint-venture with a foreign partner (involving joint-ownership), and a foreign acquisition or take-over. Examples include Kia Motors' greenfield investment in Slovakia from 2004-06, Volkswagen's initial joint-venture with Skoda in 1991 (see section 4.4 below for more detail), and Tatar Steel's takeover of Corus in 2007. Each of these examples involves management control on the part of the foreign investor. FDI has become a favoured strategy in many parts of the world since the 1980s and some of the reasons for its popularity will become clear when we consider the theories of internationalization in section 5 below.

4.3 Licensing and Franchising

Licensing and franchising are contractual arrangements whereby a licenser or franchiser allows a licensee or franchisee to use its intellectual property in return for a fee or royalty and, in some cases, an initial payment. The two parties are independent businesses but have engaged in a contract for a specified period of time. In international business, the licenser or franchiser is using this type of arrangement as a quick and relatively low-risk international expansion strategy, using the country-specific knowledge of the licensee or franchisee to establish and run its business in an unfamiliar environment. This is probably the reason why IKEA uses franchising in countries where it has no existing stores. The main risk, however, is to the reputation of the licenser or franchiser. Licensing is common in manufacturing and processing industries where the licensee is allowed to use a patent, trade mark, technical know-how, and other intellectual property under the terms of the licence. Many of Coca Cola’s bottling operations, for example, are licensed to independent companies in its foreign markets. Franchising is more common in service industries such as retailing, tourism, catering, and hospitality. It usually involves the use of a particular method of doing business, including not only a brand name but also corporate advertising, training, and other support services. Perhaps the best-known franchise is McDonald’s, but other examples include the Body Shop, Benetton, and Holiday Inns.

4.4 Joint-ventures, Strategic Alliances, and Other Collaborative Strategies

MNEs have increasingly become involved in collaborative strategies with foreign partners in recent years. As well as licensing and franchising arrangements which are discussed above, these may include joint-ventures, strategic alliances, agency agreements, subcontracting, and project management contracts, among others. Joint-ventures and strategic alliances have become particularly important international entry strategies and are now considered separately.

- **Joint-venture** – An agreement between two or more companies involving joint equity ownership and control is described as a joint-venture or join-venture agreement. Because a degree of control is involved, it may also be classed as a form of FDI. This type of arrangement has been used as an international entry strategy where full ownership is considered too risky or is not allowed in the host country, or where for some other reason the parties want to retain their separate legal identity. Joint-ventures between Western and local partners were very common in Russia during the transition years in the 1990s, especially in the oil, gas, and motor industries, were used as a way of attracting foreign expertise to develop Taiwan’s technology industries in the 1980s and 1990s, and were a common form of entry into China in the 1990s before full foreign ownership was allowed. Volkswagen’s initial investment in Skoda in 1991 involved a joint-venture with the Czech government, with VW owning a 31 per cent stake in Skoda, though this later rose to 70 per cent in 1995 and became full ownership in 2000. The alliance between Renault and Nissan, formed in 1999, is also technically a joint-venture, with mutual equity holdings, though Renault has management control of Nissan and, since 2005, the two companies have had a joint chief executive.

- **Strategic Alliance** – A non-equity cooperation agreement between two or more independent firms is generally known as a strategic alliance. The purpose of such an alliance is to gain a mutual competitive advantage through cooperation in production, research and development, marketing, or purchasing, for example. Sometimes, alliance partners may own equity stakes in each other, effectively making them joint-ventures, though alliances are usually more fluid arrangements than joint-ventures. Strategic alliances are often found in the motor industry, involving joint development of new models and common production platforms, and among commercial airlines, where code sharing agreements, shared facilities at airports, and joint purchasing arrangements provide marketing benefits and cost savings. Alliances of this type are often crucial in creating competitive advantages, allowing the partners to develop new products, access new markets, and reduce costs. They also raise competition issues, as they encourage cooperation rather than competition. This can be a problem when alliance loyalties are involved (see Practical Insight 4). However, in some cases competition between firms is replaced by competition between alliances.

Practical Insight 4: Rolls Royce

In 1998, Volkswagen bought Rolls-Royce Motors from Vickers after outbidding its German rival, BMW. Rolls-Royce had previously had an alliance with BMW to enable it to develop more efficient and environmentally friendly engines and allowing BMW to move further into the luxury car market. VW's purchase of Rolls-Royce ended this alliance, but BMW was able to use its close links with Rolls-Royce Aerospace, a separate company from Rolls-Royce Motors but the owner of the Rolls-Royce brand, to gain exclusive use of the brand. This left VW with the Rolls-Royce factory in Crewe, but only the Bentley brand and, since 2003, BMW has produced Rolls-Royce cars at its Goodwood production plant in south-east England. This case illustrates BMW's mixed fortunes with strategic alliances.

Questions: What lessons can be learned from BMW's experience?

4.5 Internationalization of Production: Outsourcing and Offshoring

Outsourcing, involving the contracting out of production operations or services to external suppliers, has been used for many years as a way of obtaining specialized expertise or reducing costs. In recent years, global competition has increased the pressure to reduce costs, leading to a vast increase in international outsourcing, and this activity has been made possible by massive improvements in information and communication technology. When business operations are transferred to another country, either through outsourcing or by setting up a wholly or partially owned subsidiary, this is often referred to as 'offshoring'. The international relocation or offshoring of production operations is not new in the manufacturing sector, but the term offshoring is now particularly being applied to the transfer of service functions to other countries. Technology has enabled a wide range of marketing and 'back-office' functions to be undertaken in low-cost countries; these include call centres dealing with customer enquiries or direct marketing activities, and IT services such as payroll processing, financial analysis, or software development.

Increasingly, higher added-value operations as well as more basic activities are being performed by well educated workers in India, Russia, Poland, China, the Philippines, South Africa, and other low-cost countries with English language skills and/or strong technical capabilities. Ireland, with its low corporate tax rates and technology graduates, is also attracting offshore operations. Much of this offshore activity is being undertaken by companies in the United States and UK, taking advantage of the widespread use of the English language as well as their more cost-conscious Anglo-Saxon business model with its liberal employment laws and flexible labour markets. It is estimated that the US accounts for around 70 per cent of global IT and business process offshoring and that US companies can achieve cost savings of between 45 and 70 per cent.

Offshoring raises a number of political, social, and ethical as well economic issues. When business operations are offshored unemployment is created in the home country, but the lower costs enable the offshoring company to reduce its prices and improve its profitability. Consumers benefit from the reduced prices and spend their surplus income on other goods and services. For the host country the gains from offshoring are significant, though the benefits may be short-term if the next wind of change takes the business elsewhere. Whether there is a net benefit for the home country depends on its ability to redeploy the redundant workers and on how one evaluates the social consequences for the workers concerned and their families. Politically, the negative impact of concentrated job losses tends to weigh more heavily on the minds of electors and politicians than the thinly spread benefits to consumers and producers. Even when an economy like the US is successful in creating new jobs, pockets of unemployment often remain in the districts and states most affected by offshoring. The shedding of existing workers in order to save money may also be seen as 'social dumping', a morally questionable practice from a stakeholder perspective.

Despite the above issues, offshoring has become increasingly common in recent years, spreading from traditional manufacturing to banking, insurance, retailing, publishing, logistics, and a number of other sectors (see Practical Insight 5). This reflects the cost savings and productivity gains that can be made from offshoring, particularly in relation to relatively standardized, though not necessarily low-skilled, business processes. Perhaps more than any other international business activity, offshoring is a response to globalization, reflecting the competitive pressures of operating in an inter-connected global environment and also the reality that the developing countries are increasingly able to offer highly sophisticated but low-cost services in a world where the barriers between rich and poor countries are being flattened. Essentially, offshoring represents a reallocation of the world's resources, driven by technology and competition. Resource reallocation on this scale causes uncertainty and fear, but it means that resources are being used more efficiently. The present distribution of resources and business activity will of course inevitably change over time as some of the developing countries replace their low cost advantages with higher value-adding activities.

Practical Insight 5: UPS

United Parcel Service Inc., better known as UPS, began its parcel delivery service in the USA in 1907, but now operates a global logistics and supply chain management service. Not only does the company manage the shipping of packages for customers in most countries of the world, it also carries out computer and printer repairs for customers of Toshiba and Hewlett Packard, manages orders for branded products like Nike, and goes into companies to help sort out their supply-chain problems – a process that has been dubbed 'insourcing'. In effect, UPS provides specialized services that its customers find more difficult or costly to provide themselves.

Questions: Is the principle behind these activities any different from any other kind of outsourcing or offshoring? Does it have the same ethical implications?

5 Theories of Internationalization

5.1 Conventional Theories of Trade and Investment

The theory of comparative advantage, developed by David Ricardo in the early nineteenth century, still provides a fundamental explanation for international trade and investment. The basic idea is that if each country specializes in producing goods in whose production it has a comparative advantage (can use its resources more productively than in the production of other goods), then trades with other countries with different comparative advantages, the world as a whole will be better off as the total output of goods produced from a given set of resources will have increased. Although this theory principally applies to countries rather than firms, it is firms that are actually engaged in production and trade, taking advantage of the comparative advantages of the countries in which they are based. It may also be argued that multinational enterprises will be attracted by a country's comparative advantages when investing abroad, so the theory can be used as a basic explanation for FDI as well as international trade. The Heckscher-Ohlin theorem, also known as factor endowment theory, adds a refinement to the theory of comparative advantage by arguing that specialization will occur in industries where inputs are available at relatively low cost because of their abundant supply. Conventional ideas about the sources of comparative advantage have tended to concentrate on the role of natural resources, proximity to which has become less important in modern industries. However, if the theory is adapted to take account of resources such as technology or human capital, it may still provide a plausible explanation for broad patterns of international location, if not necessarily for the motives of individual MNEs.

5.2 Internationalization in Imperfect Markets

The theory of comparative advantage was constructed with a world of perfect competition in mind. While this does not necessarily invalidate its general predictions, it leaves room for a number of possible alternative explanations of the behaviour of MNEs in practice. In a world of imperfect competition, with differentiated products, barriers to entry into international markets, and firms with varying degrees of market power, MNEs are likely to exploit their differentiated products, find ways of overcoming market entry barriers, and take advantage of their strategic position. For example, in the consumer goods and motor industries, MNEs in developed countries are able to achieve economies of scale by selling their differentiated products to consumers in other developed countries where similar but differentiated products are produced – a practice known as intra-industry trade. Intra-industry trade theory uses ideas from industrial organization theory, especially the analysis of oligopoly where markets are dominated by a few large firms, to help explain the behaviour of MNEs in international markets. Even smaller firms may be able to obtain external economies of scale by locating within an industry cluster, using the agglomeration economies of the cluster as a springboard to export their specialized goods or services.

International market entry barriers may include trade barriers such as tariffs, quotas, or local content requirements, exchange rate volatility or lack of currency convertibility, host country industrial policies that favour domestic firms, the existence of dominant competitors in the domestic market, or natural barriers such as geographical distance, transport accessibility, or language. MNEs can overcome some of these difficulties by locating their operations within the host country. This may also provide an export base for them to access a larger market in a regional trading area such as the EU or NAFTA. In effect, MNEs use their international entry strategy as a way of exploiting their differentiated products, internal or external economies of scale, market position, and/or reputation to achieve their overall goals of international expansion and profitability.

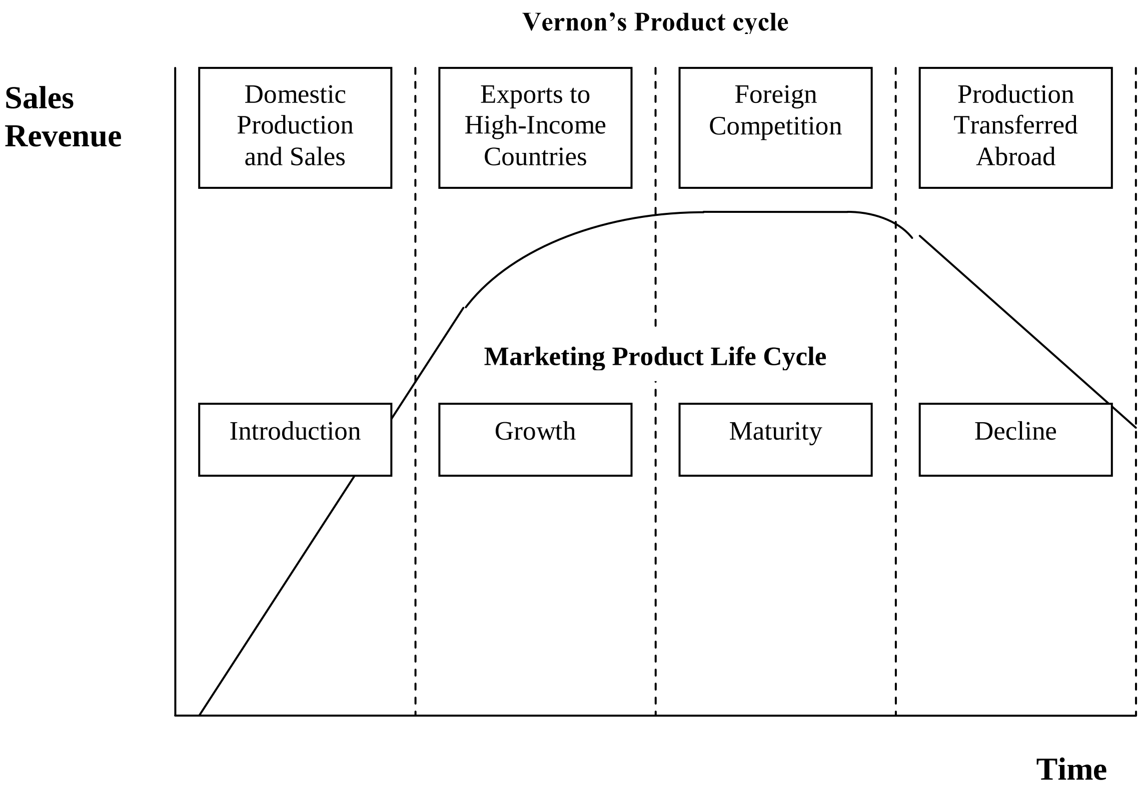
A significant contribution to internationalization theory in imperfect markets was made by Buckley and Casson, who proposed a long-run theory of the development of MNEs. Given that firms are operating in uncertain and sometimes poorly functioning markets, they will try to internalize the production of goods which incorporate substantial research and development or require specialized marketing techniques by retaining ownership through FDI as they venture abroad. According to Buckley and Casson, a firm’s knowledge and innovation ability are its crucial firm-specific assets during the internationalization process and these assets can be protected and exploited through FDI. As well as making use of resource-based and transaction cost ideas which are discussed in sections 5.5 and 5.6 below, this theory represents a significant departure from conventional theory by turning the focus of internationalization from countries to industries and firms.

5.3 Vernon’s Product Cycle Hypothesis

Raymond Vernon’s product cycle hypothesis offers a possible explanation for the production cycle of a product. His work was based on empirical studies of US industries in the 1960s and its relevance relates mainly to product innovation in developed countries. The product cycle consists of four main stages: (1) a new product is developed for high-income domestic consumers with inelastic demand and production is based in the innovating country; (2) as the product becomes more successful and a dominant design is accepted, it is exported to other high-income countries to take advantage of economies of scale; (3) competitors in developed countries produce similar products as the technology becomes more widely available; (4) the product becomes more standardized and production is transferred to low-cost locations as price competition increases.

The international product cycle described above is often confused with the product life cycle used in marketing. Although in some ways similar, the marketing concept is derived from the analogy with a biological life cycle and is focused on the development of markets, whether domestic or international, whereas the international product cycle is focused primarily on production in an international context. However, the two concepts can be related to each other, as the product progresses from the new product stage to maturity and standardization in Vernon's model or through the introduction, growth, maturity, and decline stages in the marketing model. In could in fact be argued that the transfer of production to a low-cost country in the standardization phase of Vernon's model is a way of extending the product life cycle and delaying the decline phase in the marketing model. The production and market perspectives of the two models are compared in Figure 3.

Figure 3: Vernon's Product Cycle and the Marketing Product Life Cycle



5.4 Learning Models of Internationalization

Some of the literature on internationalization focuses on the way in which MNEs learn by experience, proceeding cautiously at first to countries that are perceived to be similar or involving less risk, then becoming more adventurous as their international experience grows. Whilst in some cases an MNE may begin by venturing into neighbouring countries that are geographically close, most researchers concentrate on the importance of *psychic distance* rather than physical distance. Psychic distance relates to a firm's perception of cultural and other business differences between its home country and other countries. Thus, for example, a British firm may be expected to venture initially into countries where English is widely spoken or understood, where the Anglo-Saxon culture predominates, or where historic ties have left a legacy of similar business practices; countries such as the USA, Ireland, India, Malaysia, or South Africa would satisfy one or more of these criteria.

The main focus of attention has been on the concept of *cultural distance*, a subset of psychic distance concerned with cultural differences between countries. One might expect MNEs to be more wary of entering culturally distant environments, especially during the early stages of internationalization, and to choose entry modes which involve less risk, such as joint-ventures or franchising rather than fully owned subsidiaries. However, recent research suggests that the relationship between cultural distance and international entry is more complex. In general terms, there appears to be no consistent pattern in this relationship, but when specific factors are isolated clearer links start to emerge. Firstly, political and economic uncertainties in a country seem to have a greater negative effect on entry decisions than differences in culture. Secondly, there is some evidence to suggest that MNEs devote fewer resources and prefer low-equity modes of entry in countries with high cultural distance, though this appears to vary with the origin of the investor. Thirdly, MNEs in high-technology industries appear to be more reluctant to invest in culturally distant countries than MNEs in other industries, perhaps because of the scale of the capital investment required and the higher risk involved. Fourthly, MNEs are more likely to ignore cultural distance in developed countries than in developing countries, probably because market conditions and institutions are more similar and knowledge and resources are more readily available. Finally, MNEs are becoming more at ease with cultural distance as previously isolated emerging economies provide opportunities for expansion, more familiar markets become saturated, and cultural awareness increases. These findings are consistent with the expected benefits of experience and learning, though they highlight some of the complexities of the internationalization process.

5.5 Resource-Based Theories of Internationalization

In a world of imperfect competition, firms gain competitive advantage in the international environment by exploiting their firm-specific assets and capabilities. The idea that an MNE's decision to locate abroad and choice of entry mode is determined by its ability to take advantage of its firm-specific assets is derived from the resource-based view of the firm. Firms acquire generic resources when they take on labour or purchase technology, but over time these resources become more specialized, giving a firm distinctive capabilities. Many of these firm-specific assets are intangible, including knowledge and skills, intellectual property, databases, customized computer programmes, and relationships with other organizations. It may indeed be that competitive advantage depends not so much on individual resources, but on a particular combination of resources available to a firm, such as a team of researchers who have worked together on the development of a new drug in the pharmaceutical industry. In particular, the resource-based view suggests that a firm is more likely to locate abroad rather than to export at a distance in order to retain control of its marketing strategy, form local relationships, and ensure that its products reach the customer in pristine condition, especially where complex technical products requiring pre- and after-sales service are involved. Similarly, full-ownership FDI may be preferred to other modes of entry, allowing the firm to retain full control of its firm-specific assets.

The growing use of the internet for international business transactions enables a business to exploit its firm-specific assets in an international environment. By breaking down some of the barriers that restrict entry into foreign markets, the internet allows entry into markets that might otherwise only be accessible after incurring the substantial investment costs. There may also be country-specific advantages that can be exploited when marketing culturally attractive products such as Celtic jewellery or African wood carvings to consumers hungry for new experiences. A recent study of internationalization by US-based internet firms suggests that country-specific websites may help to promote international expansion, though their success depends on factors such as a firm's reputation, the volume of website traffic, and the type of competitive or cooperative strategies employed. Even with the internet, resources alone are not sufficient to guarantee success; the right strategies are also required.

5.6 Transaction Cost Explanations of Internationalization

Whenever a firm undertakes a transaction with a customer or supplier, it incurs transaction costs in addition to the price paid for goods or services. These include the legal costs of drawing up a contract, the costs of going out to tender or searching for information on potential suppliers, or the cost of currency exchange or hedging, for example. In the 1930s Ronald Coase realized the significance of transaction costs for the very existence of firms, arguing that firms exist because they help to eliminate the costs of continually engaging in external contracting. Firms are often described in the literature as *hierarchies*, consisting of structures with different levels of decision making, to distinguish them from the more transitory arrangements involved in market contracting. In general, firms or hierarchies are regarded as preferable to market contracting where markets are characterized by imperfect information (*bounded rationality*), where incomplete or asymmetric information allows one party to exploit his or her advantage over the other (*opportunism*), or where dedicated assets and associated sunk costs are involved (*asset specificity*). In these cases, firms are able to minimize the risks of doing business and the associated transaction costs.

In the context of international business, FDI allows an MNE to internalize its operations and avoid the transaction costs that would be involved in exporting, especially where the MNE has full ownership and control of its foreign subsidiary. Clearly, different entry modes carry different start-up costs, but ongoing transaction costs are minimized where an MNE's international operations are closely integrated within the organization as a whole. The internet also allows even small online businesses to export directly to international customers without the need for an intermediary, thereby reducing the transaction costs involved in agency contracts. Transaction cost theory is probably the most widely accepted explanation for the decision to retain ownership and control when venturing abroad. Recent studies generally support this view, though they emphasize that the success of an international entry strategy is not only affected by the ability to reduce transaction costs, but also by the suitability of the institutional context (particularly in relation to legal restrictions) and the cultural context (affecting the investment risk) in the host country.

5.7 Dunning's Eclectic Paradigm

John Dunning, a leading international business scholar, has provided an eclectic view of the factors affecting the internationalization decision, with particular reference to FDI, by combining some of the above ideas into a single theory. Dunning's eclectic paradigm, or the OLI paradigm as it also known, focuses on the ownership (O), location (L), and internalization (I) advantages of FDI as opposed to exporting. These advantages may be summarized as follows:

- Ownership advantages: firm-specific assets such as knowledge and skills, technology, intellectual property, management or marketing competences, and internal and external relationships (mainly intangible)
- Location advantages: a good geographical location with respect to production costs, market access, psychic (including cultural) distance, and the general political and economic environment
- Internalization advantages: reduced transaction costs and the ability to protect management know-how and intellectual property

According to Dunning's eclectic theory, FDI decisions can be explained by considering all of the above factors, rather than focusing on one particular factor. It therefore draws on ideas from the resourced-based, transaction cost, and other approaches to internationalization and implies that decisions to go international are affected both by organizational and environmental factors. Practical Insight 6 illustrates something of the complexity of internationalization decisions and the difficulty in applying a single explanation.

Practical Insight 6: A Tale of Two Hoffmanns

August Hoffmann began producing pianos in Sweden in 1838, but the company closed in 1988 and production was transferred to the Dongbei Piano Company in China (now owned by Gibson Guitar Corporation of the USA). Low-cost production allows this long-established brand to be marketed in North America and Europe at modest prices. Having a German-sounding name is an asset in the piano business, alongside famous names like Bechstein, Bluthner, Bösendorfer, and Steinway (actually American). There was also a German piano manufacturer called W. Hoffmann, a more up-market brand than August Hoffmann, now owned by Bechstein but produced under licence by Petrov Pianos in the Czech Republic. These stories are not untypical of many other examples of international production and marketing.

Question: Which of the theories of internationalization could be applied to these examples?

5.8 Internal Organizational Perspectives

Some research suggests that firm size and organizational behaviour are important factors in internationalization decisions. For example, there is evidence to suggest that large retailers are more likely to enter a foreign market through acquisition, whereas smaller retailers tend to use lower-risk strategies such as franchising. A key aspect of organizational behaviour that is likely to influence a firm's approach to internationalization is organizational culture. The internal culture of an organization can be classified in a number of different ways. One approach is to distinguish between a *hierarchical culture*, based on rules and procedures, a *clan culture*, based on loyalty and tradition, a *market culture*, orientated towards competition and achievement, and an *adhocracy culture*, which is entrepreneurial and innovative. Whilst the latter two cultures are likely to produce high-risk modes of entry involving full ownership and control, the former two are more likely to lead to low-risk entry modes.

5.9 The Economic Geography of Internationalization

Geographical location has always been recognized as an important factor in the decision to venture abroad. However, whilst in conventional theory location was the main focus, the dominant internationalization theories then turned their attention towards the role of the firm and its ability to exploit its resources or minimize transaction costs by internalizing the management of its foreign operations. Admittedly, location factors still played an integral role, as in Dunning's eclectic paradigm, but they no longer occupied a central position in the theory. The pendulum now seems to be swinging back towards location-specific explanations of internationalization behaviour - not exclusively so, but they are increasingly being integrated into established theory. The role of political and economic institutions and psychic distance is discussed in various sections above, but attention is also turning towards ideas from economic geography.

Two particular areas of interest are clusters and networks. Clusters are explored more extensively as an explanation for sub-national regional development in chapter 3, but essentially they provide an opportunity for firms in a particular industry to feed off each other by supplying specialized services, cooperating in research and development, attracting a pool of skilled labour, and creating a market for each other's products within close geographical proximity. In an international context, the agglomeration economies created by clusters create opportunities for exporting and are likely to attract foreign investors to a particular location. In this way, spatial patterns of economic development act as one of the determinants of internationalization decisions (see Practical Insight 7). Networks may also affect location decisions, especially telecommunication networks. MNEs dominate international telecommunications traffic and often lease telecommunication networks to support their international operations. The location of regional telecommunication hubs in countries like the UK or USA may then influence the strategic internationalization decisions of these MNEs.

Practical Insight 7: The Tees Valley Process Industries Cluster

An example of the agglomeration economies created by clusters can be found in the Tees Valley process industries cluster in north-east England. Although formerly a major chemical complex dominated by ICI, the cluster now attracts firms of various sizes in a wider range of process industries. These companies complement and interact with each other in a number of related fields, including the chemical, pharmaceutical, and biotechnology industries, and a variety of supporting services. Among these firms there have been a number of inward investors, including BASF (Germany), ConocoPhillips, Dow Chemical, DuPont, and Huntsman (USA), Petroplus (Switzerland), Sembcorp (Singapore), and Vopak (Netherlands).

Question: What features of this type of cluster are likely to be attractive to inward investors?

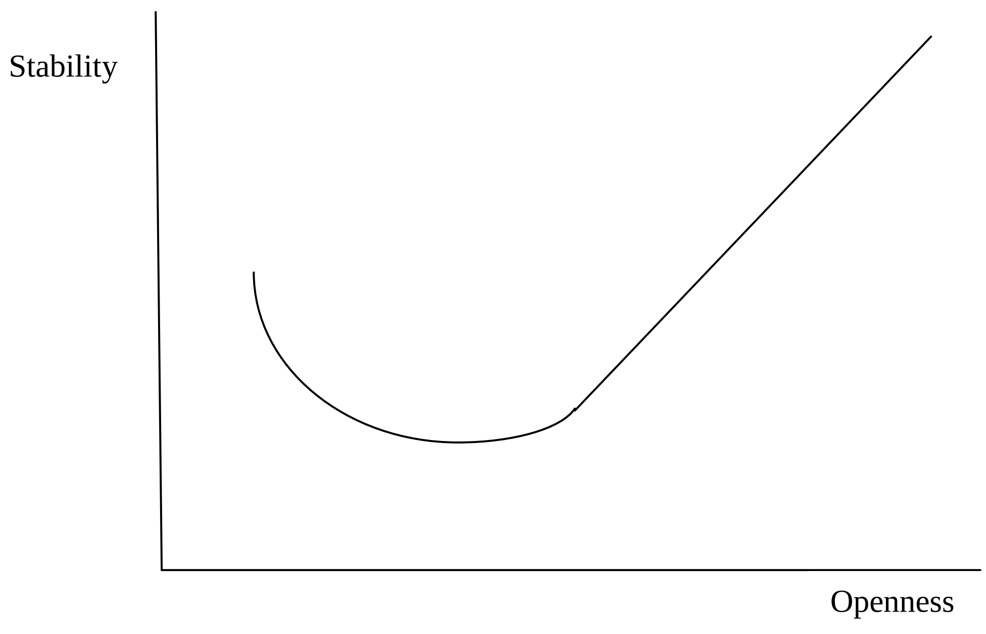
6. Country Risk Analysis

Whilst globalization poses a number of potential risks in the international business environment, many risks are specific to individual countries. Country risk is therefore an important consideration for any organization doing business internationally and, for this reason, it has been the subject of extensive analysis in recent years. The range of factors covered by country risk studies includes risks such as political and economic instability, government regulation and monitoring, infrastructure weaknesses, labour market difficulties, cultural pitfalls, currency instability or exchange restrictions, and nuisance factors like corruption or mafia-style activities. The range of organizations involved in these studies is equally broad, including political and business risk consultancies, debt-rating agencies, research institutions, and organizations such as the World Economic Forum (WEF). Indeed, the analysis of international competitiveness at the country level, for which the WEF and the International Institute of Management Development (IMD) are well known, provides a number of risk indicators that are useful when venturing into specific countries (see section 6.3 below).

6.1 Political Risk Factors

A particular focus of attention has been the issue of political risk, a term which encompasses not only political instability but also the impact of government regulation and policy decisions as well as issues such as corruption. A useful framework which encapsulates the concept of political risk is Ian Bremmer's idea of the 'J Curve'. In this context, the J Curve represents the relationship between stability and openness in a country (see figure 4). Countries which are higher on the graph are more politically stable and those to the right of the graph are more open. Political stability would include factors such as a political system based on the rule of law, a government which maintains order and a well functioning economy, and a safe and secure domestic environment. These conditions may of course apply to a country with an authoritarian political system as well as to a liberal democratic country. Openness relates to individual freedoms and democracy within a country, the freedom to trade, invest, or travel abroad, and the extent to which a country participates in recognized international institutions.

Figure 4: The J Curve



Source: Bremmer, I. (2007), The J Curve: A New Way to Understand Why Nations Rise and Fall, Simon & Schuster

Thus, a stable democracy such as the United States lies towards the top right-hand end of the J Curve. A more authoritarian but stable country such as China lies at the left-hand end of the J Curve. The greatest political risk arises when a country is at the bottom of the curve, where there is a significant level of instability. The situation in Zimbabwe, especially since 2000, provides an extreme example of political instability, where the rule of law has effectively broken down and the economy is in crisis. This puts Zimbabwe at the very bottom of the J curve. The case of Myanmar (Burma) is slightly different. Clearly, there is little if any openness for Myanmar's citizens. However, the tight grip with which Myanmar's military leaders rule the country creates a degree of stability, but this veneer of stability obscures more deep rooted unrest and economic failure which suggests that the country is only slightly to the left of the lowest point on the J curve.

The curve also illustrates the path that a country is likely to take as it moves from being a closed, stable country such as the former Soviet Union to being a more open but, in the short term, less stable society like present-day Russia. Most of the former communist countries of Central and Eastern Europe have progressed from left to right along the J curve since 1989, passing through the lowest point towards greater stability and openness. For some countries, the journey to stable democracy has been relatively smooth (i.e. the curve is higher on the graph), for others it has been more turbulent (i.e. the curve is lower).

A more difficult case is provided by Venezuela, whose populist socialist leader, Hugo Chávez, has been extending the power of the state through nationalization of the energy and mining sectors, but who has also adopted a modernizing agenda and social reforms. Venezuela is therefore relatively politically stable and has some degree of openness, though there are question marks over both these criteria. The country's leader has also made no secret of his dislike of US values and the neoliberal economic policies which the United States represents. The risk to foreign investors of expropriation of assets is also a concern, especially for US and European multinational companies. This suggests that Venezuela lies a little way up the left-hand side of the J curve – though Bremmer suggests that labour unrest or falling state revenues resulting from lower oil prices may increase instability over the next few years.

Practical Insight 8: A Brief Profile of Mexico

Mexico is a country of contrasts. After turbulent economic and political fortunes in the 1980s and 1990s, Mexico's economy had been progressing quite well until the world financial crisis and recession of 2008-9. The country was also the world's fifteenth largest merchandise exporter with 2 per cent of world trade in 2007. After a period of excessive dependence on oil revenues, state-owned industry, and international loans, Mexico has created a more open free-market economy and modernized some of its manufacturing industry. It is also a member of NAFTA, the largest free trade area in the world, and has been able to attract inward investment from the United States and to a lesser extent elsewhere, particularly in the automotive, chemical, and food processing industries.

Despite these successes, Mexico has large inequalities between rich and poor, some sectors of industry are still relatively underdeveloped, and drug trafficking and its associated violence are deeply rooted in some parts of Mexican society. The country was also at the centre of the 'swine flu' outbreak in early 2009, which caused considerable disruption to its economy as well as to the everyday lives of its citizens. Mexico offers a low-cost location with close access to the US market, but also stands at the dividing line between development and underdevelopment, both in an economic sense and in its location between the United States and Central America.

Question: How would you assess the risks of doing business in Mexico as compared to the United States?

The implications of this type of analysis for business organizations are complex. On the one hand, political stability creates an orderly business environment and openness allows greater freedom to do business, but stability without openness tends to increase the rigidity of the regulatory environment and increase the risk that a business will be unable to operate effectively. Even in a stable and open country, which in principle offers the most conducive business environment, there is no guarantee that particular restrictions will not limit what would otherwise be normal business activity. This may include restrictions on foreign ownership, most commonly found in closed countries but which also apply to the ownership of US airlines, for example. Assessing the risks of doing business in an unfamiliar country is therefore complicated by a number of different factors. A further example of these difficulties can be found in Practical Insight 8.

6.2 The Importance of International Competitiveness

The concept of international competitiveness has been applied to firms, countries, regions, and even to cities or city regions in recent years. Fundamentally, international competitiveness is about the ability of a firm to compete in international markets. Why then should we apply the concept to a region or country? After all, firms compete in business, not regions or countries. Regions or countries may 'compete' with each other to attract inward investment, using promotional strategies or financial incentives, but whilst these activities may support regional development, competition to offer the biggest incentives may be counterproductive if it influences short-term decisions without offering long-term advantages to investors.

Practical Insight 9: Should Cities or Regions Compete?

It is common for cities and regions to offer financial incentives such as grants, tax concessions, or low-rent accommodation to incoming businesses. Whilst perhaps understandable as a way of attracting investment, income, and employment to the region, competition to be the cheapest location is in some ways a 'race to the bottom'. This is especially true if one considers that cities and regions are located in an increasingly open and integrated global environment. Most cities in the developed world have little hope of being the cheapest location for companies operating in global industries. What they can offer, however, is a high-quality urban environment. The 'race to the top' to provide the most attractive environment is also more likely to improve the general economic welfare of the local community and of the country as a whole, as well as to reduce the risks for incoming investors. This type of territorial competition requires public authorities, development agencies, and community organisations to work together with private businesses to create the infrastructure, facilities, and networks that are needed to establish high-quality tangible and intangible assets in a city or region.

Question: Given that industrial specialization often occurs at the local or regional level, is city or regional competitiveness more important than national competitiveness?

Countries may also consider an increasing share of world exports to be an indicator of success, but herein lies the problem with this use of the term 'competitiveness'. As Paul Krugman has forcefully pointed out, the idea of a country competing for export market share implies that its exports are to be encouraged at the expense of imports (i.e. another country's exports). This contradicts the lessons from international trade theory that all trade (both exports and imports) is generally beneficial for individual countries and the world as a whole.

If national competitiveness is measured by export shares, therefore, the concept is potentially harmful if it leads to import protection as a means of restricting imports from 'competitor' countries'.

The concept of the international competitiveness of countries may be misleading in the context of international trade, but it has been increasingly applied to the quality of a country's business environment. In this context, it is about the ability of a country or region to provide an environment which enables firms to be internationally competitive – not only indigenous firms but also inward investors. Competition between countries to offer a high-quality environment for business seems entirely legitimate and healthy, and may even encourage countries with less attractive business environments to improve their performance. The concept of regional competitiveness has also attracted the attention of policy makers and development agencies, not only as a focus for improvements in the regional environment but also as a way of enhancing the reputation of a region (see Practical Insight 9).

6.3 The International Competitiveness of Countries

- **The Economic Approach**

Comparisons of international competitiveness at the national level have often focused on quantifiable macroeconomic indicators. These relate most closely to the cost or price competitiveness of firms engaged in exporting or importing. One of the most important indicators at the national level is a country's exchange rate. An increase in the exchange rate between the euro and US dollar, for example, will make euro-area exports to the USA more expensive and euro-area imports from the USA cheaper. Given the volatility of freely floating exchange rates between the world's major currencies, export and import prices may vary considerably over relatively short periods of time. It is often thought that a depreciating exchange rate is helpful to an economy, as it makes the country's exports more price-competitive. However, this benefit may be short-term if there are underlying productivity, product quality, or inflation problems in the country concerned, none of which will be resolved by exchange rate depreciation.

Market exchange rates, which determine the rate at which one currency can be exchanged for another at a particular time, are sometimes described as *nominal or bilateral exchange rates*. The rate of exchange between the British pound and the euro is an example of a nominal exchange rate. Between January 2008 and January 2009 the rate fell from a monthly average of £1 = €1.34 to £1 = €1.09 (or from €1 = £0.75 to €1 = £0.92 if expressed in terms of the euro). The nominal exchange rate can be quite volatile from day to day or even during the course of a day if economic or political conditions are changing. Such changes have a major effect on the price of exports and the value of investments between countries. A high exchange rate in the home country makes exports less competitive but imports cheaper and it reduces the cost of investing abroad. A low exchange rate has the opposite effect and also brings imported inflation into the country. Nominal exchange rate movements therefore create a significant business risk, which is sometimes described as exchange exposure.

A broader view of how a country's exchange rate is changing with respect to its main trading partners can be obtained by using an *effective or trade-weighted exchange rate*; this rate is calculated using an index to compare one currency's value in relation to a 'basket' of other currencies, weighted by the volume of trade between the countries concerned, over a period of time. Relative inflation rates in exporting and importing countries also affect price competitiveness, so *real exchange rates* are sometimes used in place of nominal rates; the real exchange rate combines the nominal exchange rate with the relative inflation rate between two countries and is therefore a more useful measure of international competitiveness than the simple nominal rate. The real exchange rate between the British pound and the US dollar can be calculated as follows:

$$RER_{£} = (£ \text{ price of UK goods})/(\$ \text{ price of US goods}) \times (\$/£)$$

Thus, for example, if the UK inflation rate rises while the US inflation rate and the nominal exchange rate ($/£) remain unchanged, the pound's real exchange rate ($RER_{£}$) will rise and US citizens will pay more for UK goods. UK inflation will therefore have caused a loss of competitiveness for UK exporters. It is also possible to measure a country's international competitiveness in relation to a group of major trading partners rather than one country alone using a *real effective exchange rate*, which combines the real exchange rate with the effective exchange rate.

The official rate of inflation, measuring changes in retail or consumer prices, is not the only factor affecting price competitiveness within a country. Sometimes, indices of producer prices (especially prices of manufactured goods) are used in preference to consumer prices as not all goods and services included in consumer price indices are exported. Export prices are also affected by costs of production. Cost competitiveness can be measured by comparing unit production costs in different countries. Unit production costs are the cost of labour, materials, energy, and other inputs per unit of output. They therefore take account of productivity (labour hours and other inputs per unit of output) as well as costs of production. Thus, for example, Germany, with its high labour costs, can to some extent mitigate its lack of cost competitiveness by having superior productivity.

- **Determinants of National Competitive Advantage (Porter's Diamond)**

The search for a wider range of competitiveness indicators owes much to the work of Michael Porter. Porter and his team carried out extensive research covering ten countries, identifying four main determinants of national competitive advantage. These determinants are sometimes illustrated diagrammatically as four points of a diamond and are commonly known as 'Porter's Diamond'. Porter also recognizes the role of 'chance' and government policies, but he argues that governments should influence the main determinants rather than try to determine competitiveness directly. The four main determinants are as follows:

(a) Factor endowments – Porter distinguishes between 'basic factors', such as natural resources, climate, and the size of the labour force, and 'advanced factors', such as a high-quality infrastructure, advanced technology, and highly developed human capital; advanced factors were found to be particularly important for competitive advantage.

(b) Demand conditions – the quantity and quality of goods demanded by consumers and the expectations of consumers were found to be important in encouraging the development of innovative products and in creating growth in the home market which allowed firms to achieve economies of scale.

(c) Related and supporting industries – the close proximity of internationally competitive suppliers and firms producing complementary products or services in the home market was found to be important in establishing a strong basis for the competitiveness of firms.

(d) Firm strategy, structure, and rivalry – organizational and industrial structure, including intense rivalry between firms and the need for effective competitive strategies, were also found to be influential in promoting innovation and other competitive advantages.

Whilst Porter's diamond provides a basic framework for the analysis of national competitiveness, a number of more specific factors can be identified and Porter's work in this area is now being developed through the World Economic Forum.

- **International Competitiveness Rankings**

The growing interest in the international competitiveness of countries has led to a number of international initiatives aimed at analysing the differences between countries. These studies of international competitiveness now include both quantitative and qualitative factors, and attempt to provide a more encompassing view of the business environment, including the productivity and growth potential of an economy. The two most important organizations involved in this process are the International Institute of Management Development (known as IMD), which is an international business school based in Lausanne, and the World Economic Forum (WEF), an organization coordinating international gatherings of politicians, business leaders, and a wide range of professionals and community leaders, also based in Switzerland. IMD has been publishing its World Competitiveness Yearbook since 1989, but the most extensive analysis of international competitiveness can now be found in the WEF's annual Global Competitiveness Report. The Report includes the Global Competitiveness Index, which in 2008-9 ranked 134 countries according to twelve competitiveness criteria (known as 'pillars'), organized under three general headings:

(a) Basic Requirements: institutions; infrastructure; macroeconomic stability; health and primary education

(b) Efficiency Enhancers: higher education and training; goods market efficiency; labour market efficiency; financial market sophistication; technological readiness; market size

(c) Innovation and Sophistication Factors: business sophistication; innovation

The above factors have been developed and refined in recent years. Some of them are measured using quantitative data, while the more qualitative indicators are derived from the WEF Executive Opinion Survey, which in the 2008-9 Report canvassed the opinions of over twelve thousand business executives around the world. At the time of writing, the WEF is in the process of introducing a new Global Competitiveness Index, incorporating many of the above factors but based on a more rigorous conceptual framework. The new index is being developed by a team led by Michael Porter and it will incorporate ideas from Porter's diamond at the microeconomic level, together with broader political, economic, social, and legal factors at the macroeconomic level. The underlying objective of the new Global Competitiveness Index is to identify the determinants of a country's productivity level in the belief that productivity is the main basis for sustainable economic growth and prosperity. Although this approach provides a broad view of the conditions under which businesses are likely to be successful, it is ultimately about national economic performance rather than simply the business environment. Perhaps inevitably, other factors could also be incorporated into indices of this type, especially bearing in mind the increasing emphasis now being placed on the role of social capital in national and regional economic development. Practical Insight 10 considers the concept of international competitiveness in relation to the Chinese economy.

Practical Insight 11.6: China's International Competitiveness

In the 2008-9 World Economic Forum Global Competitiveness Index, China ranked 30th out of 131 countries. Whilst this position is above most of the world's developing countries, it may nevertheless seem surprising to a western manufacturer accustomed to being undercut by low-priced Chinese exports. Clearly, in terms of price competitiveness, Chinese goods are among the most competitive in the world. Foreign investors can also take advantage of China's low-cost business environment. However, as China's economic development progresses, the demand for resources will inevitably raise the costs of production and China's long-term international competitiveness will depend on the quality of its institutions, infrastructure, and other advanced factors rather than on low prices. China received its lowest competitiveness scores for technological readiness, financial market sophistication, and innovation in the 2008-9 ranking, all advanced factors that will become more important as the country's economy develops.

Question: Do you think the WEF competitiveness rankings are less useful as a guide to the current business environment in a country than they are as an indicator of a country's future economic potential?

Case study: Wal-Mart's International Expansion

Wal-Mart was the largest company in the world ranked by sales revenue in 2008 and by far the largest retailer. Its sales revenue of $379 billion was over three times the size of its closest rival in the retail sector, Carrefour of France. Wal-Mart opened its first store in Rogers, Arkansas in 1962 and by the end of the 1970s had 276 stores in the USA. By the mid-1980s the number of stores had increased to 882 and in 1990 Wal-Mart became the US retail market leader, but the company did not venture abroad until 1991. Its first international store was opened in Mexico. This was followed by expansion into Puerto Rico, Canada, Hong Kong, Argentina, and Brazil, mainly through acquisition or greenfield investment. Wal-Mart then entered China through a joint-venture in 1996, Germany through the acquisition of Wertkauf and South Korea through a joint-venture in 1998, followed by the acquisition of Interspar in Germany and Asda in the UK in 1999. Wal-Mart also has operations in some of the Central American countries and, in 2007, formed a joint-venture with Bharti Enterprises in India and increased its equity stake in Seiyu of Japan to 95 per cent, having acquired majority ownership of the company the previous year.

Wal-Mart has pioneered its own distinctive business methods. Many of its outlets are large discount stores offering a wide range of goods at low prices. It adopts a paternalistic management style towards its employees, describing them as 'associates', and prefers minimal involvement with trade unions. The company has extensive international sourcing arrangements in order to keep costs to a minimum. Its cost-control measures, large volume of sales, and streamlined business practices have helped to create a highly profitable business. However, like other multinational enterprises, Wal-Mart has had to adapt its strategies to the cultural, institutional, and competitive environment it faces in different countries. Sometimes this has meant using a joint-venture agreement rather than full FDI, especially when first entering an unfamiliar environment. At other times, the company has built new stores on a greenfield site or has acquired an existing established retailer.

The European retail sector is dominated by a number of strong national competitors and Germany is no exception. Wal-Mart entered the German market through its acquisition of Wertkauf and Interspar, allowing immediate access to the country's mature retail sector. In addition to the established market leader, Metro, the German market includes successful discounters such as Aldi and Lidl. Germany also has a distinctive institutional environment with a highly regulated labour market and strong trade unions. In one instance, Wal-Mart met opposition when trying to introduce a new ethics code for its staff, as the code was seen as overly restrictive by its German employees. Wal-Mart's paternalistic management style also sat uneasily with Germany's system of *Mitbestimmung* – involving the participation of trade unions in company decision making. Whilst Wal-Mart was able to use its vast resources and global scale to source low-cost supplies from China and other parts of the world, these strengths offered little advantage when it came to supplying German beer, Bratwurst and the many specialized European brands that German consumers demand. This experience led Wal-Mart to sell its German operations to Metro in 2006.

Wal-Mart's UK acquisition, Asda, sat more easily with the company's business model. Although the British retail market is also well established with a dominant player, Tesco, and other strong competitors, the institutional environment is closer to that of the United States and Asda had been modelling its business practices on those of Wal-Mart even before the take-over in 1999. Wal-Mart's position in the UK market, as number two to Tesco, is clearly different from its leadership role in the US market, but Wal-Mart has nevertheless consolidated its position as a leading discounter in the UK market.

These experiences illustrate the significant differences between the cultural and institutional environments in different countries and the way in which Wal-Mart has responded to these differences. In particular, the case study provides an insight into the pattern of internationalization of one of the world's most successful companies and the extent to which its choice of country and mode of entry has been influenced by the company's organizational structure and strategy.

Case Study Questions

1. Why do think Wal-Mart did not venture abroad until 1991, despite its success in the USA?
2. How would you explain Wal-Mart's choice of countries during the early stages of its international expansion in the 1990s?
3. On what grounds do you think Wal-Mart chooses between acquisitions, greenfield investments, and joint-ventures when entering a foreign market?
4. Select two of the theories of internationalization and critically evaluate the extent to which they could be used to explain Wal-Mart's international expansion strategy.
5. To what extent is it possible or desirable for a company like Wal-Mart to use the same business model wherever it invests abroad?
6. Why do you think the German retail market proved to be a difficult environment for Wal-Mart?
7. In what ways, if any, might Wal-Mart have been able to adapt its practices in order to develop its business in Germany?
8. Despite the cultural and institutional similarities between the USA and UK, what differences is Wal-Mart likely to have experienced in the UK environment?

Topics for Discussion and Research

1. Carry out a brief country analysis of Slovakia as a potential location for market entry by a foreign company. Recommend an appropriate mode of entry for a company in an industry of your choice.

2. Choose another European country (i.e. excluding Slovakia) as a potential location for market entry by a foreign company. Carry out a brief country analysis and recommend an appropriate mode of entry for a company in an industry of your choice.

3. Choose a specific non-European country as a potential location for market entry by a foreign company. Carry out a brief country analysis and recommend an appropriate mode of entry for a company in an industry of your choice.

4. In what ways have the opportunities and risks of international business entry changed in (a) one of the countries affected by the 'Arab Spring' and (b) one of the countries directly affected by the sovereign debt crisis in the eurozone?

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Suggestions for Further Reading

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Preparation for the Examination on Friday 9th December

There will be a written examination based on this lecture programme. It will last **ONE HOUR** only and the examination will include three questions based on the following three topics:

1. Applying theories of internationalization to Wal-Mart’s international expansion strategy.
2. Brief country analysis of a specific non-European country and choice of entry mode for a company seeking to enter your chosen country.
3. The effect of **either** (a) the ‘Arab Spring’ **or** (b) the eurozone sovereign debt crisis on the opportunities and risks of international business entry; examples may used from any relevant country.

You will be required to answer **TWO** questions only. Further information will be given during the lecture programme.